

# World Watch

Governance, Reporting and Assurance

Issue 1 2011

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## Towards integrated reporting, assurance and governance

Across the business world the issue of trust appears to be high on the agenda. It's an issue at the heart of a company's reputation and its ability to develop and maintain the right business relationships. In this complex area the role of transparency is paramount - finding ways to communicate that build confidence and trust in how a company acts, operates and performs. We've seen this issue on the minds of investors in past editions of *World Watch*, and in this edition we see the agenda is moving into the sphere of regulators, standard setters, and governments across the world.

It has become clearer during the financial crisis that the right flow of information, focused on the substance of business activity, can not only enhance market efficiency but also assist the critical checks and balances in the system to mitigate the chance of systemic failure.

One hot topic under discussion is whether 'integrated reporting' can help meet the needs of the investment community and society as we front up to the new challenges of the 21st Century. This is a term nobody used 12 months ago, but is increasingly on the lips of accountants, regulators and some progressive companies. In part, this is due to the formation of the International Integrated Reporting Committee (see page 32) and its ambition to engage the G-20 in the need for reporting

reform. But it is also the fact it has captured the imagination of so many groups, such as the Harvard Business School.

These developments indicate that the debate about how to achieve relevant, accessible and understandable reporting is now underway at an international level. By coincidence, it has arrived at a time when there is intense focus on the audit at regional and national levels (see pages 15 and 39). Perhaps the two agendas provide an opportunity to reassess whether both reporting and audit should be re-calibrated to recognise the critical roles governance, business models and risk will play in ensuring the sustainability and success of business in a world challenged by economic imbalances, climate change, resource usage and significant demographic shifts.

The future will require an environment that encourages thought, not just compliance, and provides incentives for the right behaviours.

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PwC has a strong and effective network of people worldwide who can advise on the developments and the implications of regulations. 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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# Trust: the overlooked asset

A business's long-term survival and success depends on its ability to build and sustain trust, claims **Richard Sexton**

In an era of increasing connectivity and intensifying public scrutiny, trust is the lifeblood of any organisation – a critical asset in ensuring a business's long-term survival and success.

Paradoxically, this essential asset doesn't appear on the balance sheet. As a result, trust is widely overlooked at a time when it is actually more pivotal than ever. Recent events have demonstrated that organisations need to examine how they can bring building and sustaining trust back into the core of their corporate and business culture.

**'Without trust, words become the hollow sound of a wooden gong'**

**John Harold, poet**

### Trust matters

Trust builds confidence, faith and a sense of belief in an individual or an organisation. It brings us a sense of safety and security, and makes a range of things possible for which there are no guarantees.

We see the impact of trust on businesses all the time. A writer in the Financial Times recently referred to a hugely successful television advertising campaign by John Lewis, the UK retail stores group, and explained the success of the campaign with the words: 'But John Lewis has the priceless asset of public trust'. In other words, trust is intangible – but its effects are anything but. People will pay a premium for proven products and services.

Recent experience has underlined time and again just how fragile trust can be, and how serious the consequences can be when it evaporates. Witness – among others – the events surrounding Lehmans, Toyota and BP. Despite these examples, trust often does not appear to be clearly understood, or its importance fully factored into the business model.

### The moment of truth

Trust is particularly valuable when a crisis hits. But it will depend on the response – if it is not considered appropriate, doubt and suspicion can creep in overnight. The airline that loses a passenger's bags but manages to restore them swiftly and with grace, charm and courtesy, will gain the benefit of enhanced trust as that passenger tells and retells the story of how a potential disaster was transformed into a positive experience.

Such events underline the dual role of trust, as both a defence against the future and an asset bringing long-term competitive advantage.

### A culture of total trust

Our experience suggests that trust – as the 'overlooked' asset – is widely understood, but only on a personal level. It is not always transferred automatically into the culture of a business.

Publicly identifying trust as a key strategic goal will be a challenge for many organisations, partly because it is difficult to measure. But we believe that companies should be brave, and build trust into their strategic agenda and report on it.

'Tone from the top' is a vital ingredient in making trust part of the corporate DNA. The right example from senior management will help to create the right architecture to support the creation of trust – the right information flows, the right culture, the right values, the right behaviours, and so on.

### Giving business a future

Unless trust is nurtured actively as a fully functioning and hugely productive asset, we believe that business faces a bleak future.

We would go so far as to suggest that trust is the essential asset that will define the businesses of the future, and shape the different and changing environments in which they can thrive. Without trust at its heart, PwC's view is that the business world will run into insurmountable problems that will make the recent financial turmoil resemble a minor blip.

It is that clear-cut – and that important.

### Dilemmas on trust

The crucial challenge for any organisation is to translate the concept of building and sustaining trust from theory into practice, and take whatever steps are necessary to embed it into its organisational DNA. Each organisation will face its own specific set of dilemmas:

- Total transparency versus selective transparency
- Trust only matters in a crisis versus trust matters all the time
- Principles versus rules
- Tone from the top versus tone from within
- Financial performance versus stakeholder performance

**Richard Sexton is an executive board member at PwC in the UK and the assurance leader for the PwC central cluster of territories.**

**This article is based on a PwC point of view – see [www.pwc.co.uk/trust](http://www.pwc.co.uk/trust)**

# Tone from the top – transforming words into action

Most companies articulate ethical values and principles though many struggle to make them ‘live’. **Joel Osborne** explains why leadership needs to put words into action

Setting the right tone from the top is an increasingly important leadership skill that can make or break relationships with shareholders, employees, customers and business partners. You only have to look at recent high profile cases to see the impact that leadership actions can have on a company’s reputation, as well as its share price.

PwC recently conducted research into the ‘tone from the top’, surveying the membership of its Fraud academy. This survey found a resounding agreement between respondents that tone from the top is vital in developing and maintaining the ethical integrity of the business. Without it, the ability to mitigate the risk of something going wrong was viewed as significantly impaired.

The survey found that a wide range of approaches are being used to establish the foundations for ethical tone. These include establishing a set of core values and principles; regular communications of ethical values by leadership; and even turning away business where it is not aligned with the ethical values of the company. This is, in itself, encouraging news and positive affirmation that organisations are responding to the emerging and increasing risks if companies fail to conduct their business on an ethical basis across the globe.

## Worrying messages

But the survey also uncovered some worrying messages. There were references to short-term actions such as improved leadership communications, but little evidence of steps being taken to build on this to achieve behavioural change. For example, only one third of companies regularly assess their values and principles for relevance and applicability and only one third attempt to measure or evaluate ethical risks. Just

## What is important when transforming words into action?

Survey respondents were asked to identify key elements of what makes effective Tone from the Top. For example, 80% of respondents state that consistent and frequent communication are important drivers, but only 63% state that this is done well by management - a clear disconnect between delivery and intention.



17% provide all employees with annual refresher training on the code of conduct (or equivalent).

Less than half of the respondents reported that senior leadership always act as role models in setting the right tone from the top and more than 40% said that, on occasions where tone from the top had been undermined, it was due to leadership actions not matching the ethical message being delivered.

The overriding message is that, while leaders are articulating the ethical values and principles they want others to work by, these are not regularly measured or evaluated and are often undermined by their own behaviours.

## Leadership behaviour

People are more likely to ‘do the right thing’ consistently and reliably if they are in a wider culture that celebrates and rewards this. While such a culture needs to exist at all levels of an organisation, the tone that creates and sustains it can only be set from the top, by committed leaders who exhibit the behaviour and values they expect of their people. There is a commercial imperative too – customers are more likely to buy from businesses that they trust to act responsibly.

Regulators and enforcement agencies are increasingly focused on non-financial factors – such as leadership’s behaviours

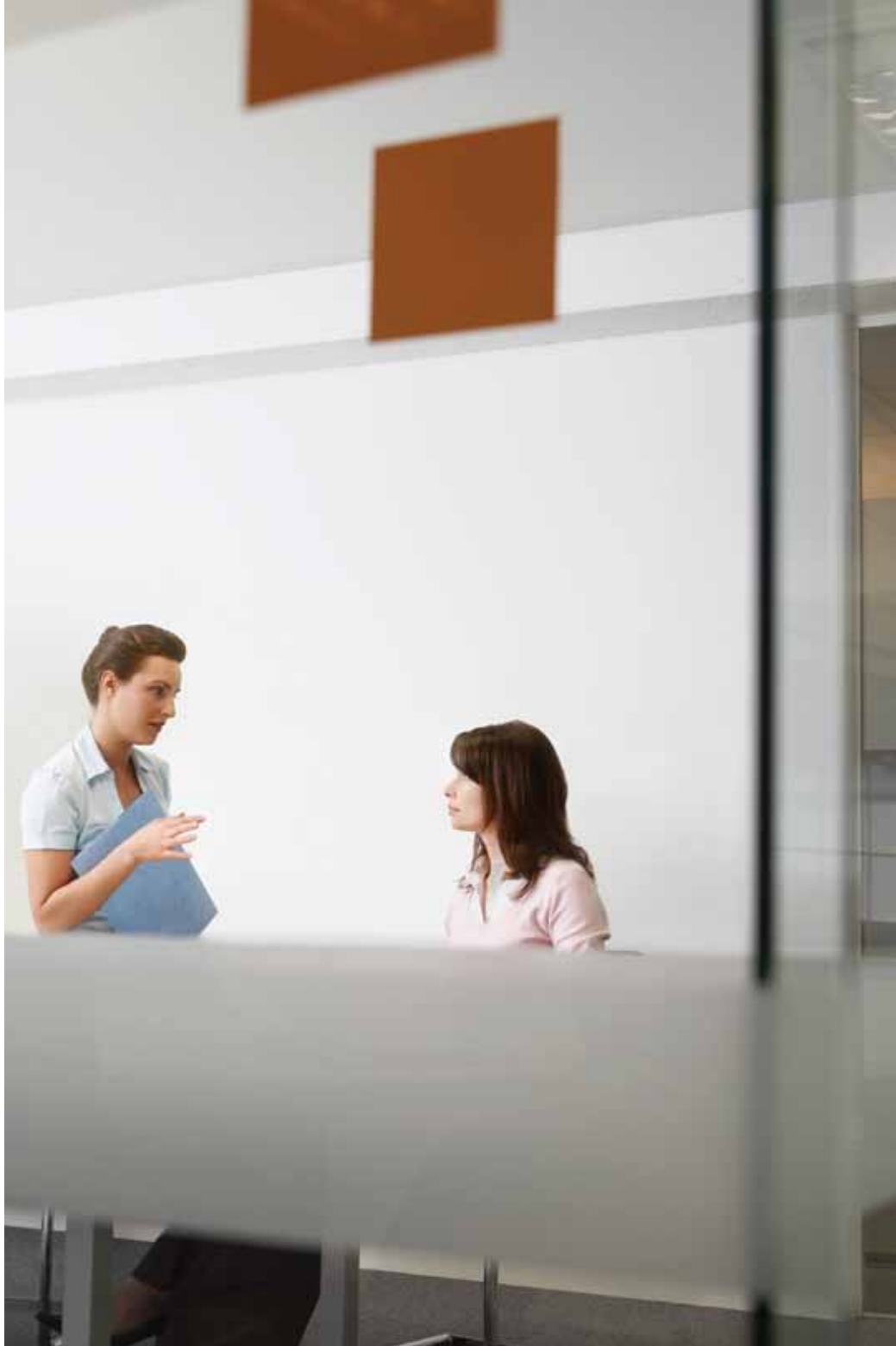
and the corporate culture – to indicate whether a business is more or less likely to remain a sustainable enterprise. An example is the UK Bribery Act under which companies will need to ensure they can demonstrate ‘adequate procedures’ to protect themselves from the corporate offence of failure to prevent bribery. Though the government is yet to clarify what adequate procedures comprise, setting the right tone from the top undoubtedly features as an element of what constitutes ‘adequate procedures’.

A further motivating factor is that organisations can gain competitive advantage through increasing the transparency of their decision-making and actions from the top down; strengthening the organisation’s value and goodwill with investors and customers by demonstrating integrity and trust.

### ***Sustain the right tone***

Our experience of helping clients define and develop their approach to building an ethical culture has demonstrated that the following principles are key to establish and sustain the right tone from the top:

- Understand what ‘tone from the top’ means to the board – what does success look like?
- Consistent and visible executive sponsorship for ethics and compliance – this is essential if change is to occur.
- Understand what the prevailing culture is, before attempting to make any wide-sweeping changes – this will inform your ‘messages’ and ensure they fit the organisation.
- Leaders must consistently ‘do as they say’, not ‘do as they want to do’, in a way that is aligned and enforces the values and ethical standards of the business.
- Good behaviours must be rewarded and recognised; poor behaviours must be acted upon and necessary action taken in open and transparent ways.



- Embed systems and processes to ensure ‘tone from the top’ becomes business as usual – this will help shape the organisational culture and measure the effectiveness of leadership actions and behaviours over time.

The board needs to consider these issues before they establish the specific tone for their organisation. If board members are not acting as role models and consistently practicing what they preach, why should the rest of the organisation heed their ethical messages?

**Joel Osborne is in the Forensic Services team and Risk Resilience team at PwC in the UK. He is also co-author of *Tone from the top*. See also page 41, ‘Assurance on ethical conduct’.**

[http://fraudacademy.pwc.co.uk/publications/tone\\_from\\_the\\_top\\_july\\_10.html](http://fraudacademy.pwc.co.uk/publications/tone_from_the_top_july_10.html)

# 'Integrated reporting' is an outcome, not a goal

King III has put South Africa at the head of the field in governance and reporting. **Alison Ramsden** looks at how companies are responding, the strategic journey they must take and the likely direction of travel.

South Africa has again found itself on the world map – not because of politics or football. It is seen by many as one of the world's leaders when it comes to governance principles. The latest King Code of Governance Principles and the King Report on Governance for South Africa (King III) set the bar high for governance practices. Many countries around the world are using this as one of the benchmarks for setting their own requirements for how companies should ensure good quality governance.

Integrated reporting is one of the underlying principles of King III. In addition to financial information, stakeholders are now expecting information that will provide them with a thorough understanding of a company's impact and its competency in handling the governance, economic, social and environmental aspects of business.

King III applies to all entities in South Africa and became a must for companies listed on the Johannesburg Securities Exchange (JSE) for financial years commencing on or after 1 March 2010. As they begin to implement the requirements, companies are already beginning to realise that the choices they make now need to be strategic, whether they choose to comply with King III or explain why they have not done so.

In some industries, such as mining and finance, companies are already experimenting with the concept of 'one report'. However this is not a one-off event – it is a process that needs to involve people in many different areas at board level, as well as in operational, technical and corporate communication roles. Many companies are opting for a roadmap approach, which spells out their particular evolutionary route for integrated reporting and assurance.

The Global Reporting Initiative's framework has been useful to some companies to guide them on sustainability reporting. However, the new King III requirements take things to a much more strategic level. A company's governance and strategy needs to be clearly linked to its material risks, opportunities and key performance indicators, and ultimately to the long-term viability of its business. But for most this is a tremendously challenging thing to achieve in the short term.

It has become clear that the big issues to address are less about reporting and more about ensuring effective management of company strategy, systems, values, culture and information, so that reporting does not raise questions about management proficiency. Leaders in reporting in

South Africa have been quick to recognise that this requires long-term processes for monitoring and analysis and stakeholder engagement, setting targets and accepting that there will be trade-offs between different elements. They see that an 'integrated report' is an outcome of a more fundamental business process, and not a goal in itself.

Advocates of comprehensive forward-looking reporting have been buoyed-up by several initiatives in the global community to harmonise guidelines for integrated reporting – for example, the International Integrated Reporting Committee (IIRC) (see page 32). South Africa has its own local chapter, which is feeding ideas to the parent body. It is supported by influential organisations, including: The Association of Savings and Investment, Business Unity South Africa, the Institute of Directors, JSE Ltd and the South African Institute of Chartered Accountants.

These developments and the corporate sector's slow realisation that a demonstrably strategic approach to governance, risk and reporting adds value to their business is a sign of real and positive change. I expect that this will lead to better, more 'integrated' reporting on company performance and more meaningful assurance on this information.

**Alison Ramsden is head of governance and sustainability at PwC in South Africa**

*It has become clear that the big issues to address are less about reporting and more about ensuring effective management*

*A demonstrably strategic approach to governance, risk and reporting adds value to their business*

# Making time for high-quality standards

The pace of standard setting has caused concern. **Dianna Taylor** considers the boards' response and asks if it is enough to allow robust preparer and user input to new standards



Dianna Taylor

The International Accounting Standards Board (IASB) has been working vigorously with the US Financial Accounting Standards Board (FASB) to develop standards that will converge IFRS and US GAAP in many areas. The boards were originally targeting completion of a number of projects by June 2011, an ambitious timeline given the task at hand.

In late June this year, however, the IASB provided details of a modified strategy that slows the development of several of these standards. The modification follows concerns expressed from various constituents about the fast pace of the standard-setting.

The modified strategy prioritises the projects on both boards' convergence agenda. Projects considered a priority are still targeted for completion before June 2011, while others are delayed past this date. Priority projects include financial instruments, revenue recognition, leases, the presentation of other comprehensive income and fair value measurement. The IASB also made a priority of consolidations, insurance contracts and improved disclosures about derecognised assets. In addition, the board is committed to increasing its stakeholder outreach to gain input on proposals.

A few months after the modified strategy was announced, the FASB made

known the early retirement of its chairman Bob Herz, as well as the increase in the number of FASB members from five to seven, see news page 30. This could slow progress of convergence in the near term as new members get up to speed.

While the boards have taken a step forward by prioritising key projects and delaying completion of a few, the programme remains challenging. The timeline should allow enough time for the boards' normal thoughtful, rigorous processes. These processes include performing field studies and research, taking the time to thoughtfully analyse issues and write clear standards, as well as obtaining input from preparers and users of the financial statements.

However, the pace of change is still intense. The IASB issued four exposure drafts related to convergence projects in the second quarter alone and another three in the third quarter. These exposure drafts include proposed new standards relating to defined benefit plans, fair value option for financial liabilities, presentation of other comprehensive income, revenue recognition, fair value measurement, insurance contracts and leases. Preparers, many of whom are

simultaneously dealing with regulatory change and the effect of the economic downturn, need time to understand the implications of the proposed changes and respond to the proposals. With the current volume of exposure drafts issued, short timeframe, this is a difficult task even for the largest entities.

### Robust input essential

Without robust preparer and user input, the boards may not achieve their objective of issuing operational, high-quality standards. Standards developed and issued too quickly may require subsequent corrections, which undermines confidence in the standard-setting process and is costly for both preparers and investors.

Issuing high-quality standards is paramount, and the thoughtful, rigorous process necessary to do so takes time. The boards need an aggressive timeline with specific dates to drive discipline in their process but this must continue to allow for the input necessary to produce the high quality accounting standards desired by the boards.

**Dianna Taylor is from the PwC strategic thought-leadership team in the US.**

### Expected timings for final standards

#### Q1 and Q2 2011

Revenue recognition

Leases

Insurance contracts

Post-employment benefits

Consolidations

Joint ventures

Presentation of items of other comprehensive income

Financial instruments:

- Hedge accounting
- Fair value measurement guidance

#### Q3 2011 and beyond

Financial Statement Presentation – replacement of IAS 1 and IAS 7

Presentation – discontinued operations

Financial instruments with characteristics of equity

# Turning complaints into progress

The core quality of IFRS is high, but **John Hitchins** argues that complaints from preparers and users should inspire further debate about how future standards could be improved

International Financial Reporting Standards (IFRS) have been coming in for considerable flack. Both preparers and users have expressed discontent, with complexity being a frequent lament. Taking a closer look at these complaints and their triggers could increase our understanding of what makes for a good financial reporting standard, and help to maintain the high quality of IFRS going forward.

Some reporting standards deserve criticism because they are unnecessarily complex. Deferred tax reporting is a prime example. The standard itself is difficult to understand, its ambitions appear unrealistic to preparers, and users struggle to understand the disclosures that result.

Some standards, however, are criticised for complexity that may be unavoidable – such as those addressing financial instruments. The ways business use financial instruments are varied and complex, so the associated reporting standards are likely to have complexities too. Any standard involving valuations, in fact, is likely to have complex elements. That said, there are ways to help users understand the information they are given. For example, tables of derivatives and fair values can be meaningless without an explanation of how they are used in different segments of the business.

### **Too much, too fast**

Complaints about complexity may to some extent reflect recent accounting history. Preparers and users of financial statements have struggled to cope with the high volume of change in IFRS. This was initially driven by the goal of convergence, but exacerbated by the global financial crisis and calls for enhanced transparency over financial instruments. The added pressure for both preparers and users to meet and comprehend the new information requirements has been intense.

Other factors too lie behind complaints over standards. Preparers often dislike requirements to report information they do not use to run the business. This makes sense, because if management doesn't have the information, by definition they don't consider it useful. However, there are occasions when companies are willing to disclose such content because they believe the capital markets find it useful.

Investor criticism of reporting standards may sometimes stem from conflicting impulses. On the one hand, it is often said that the mass of detail included in financial statements makes it hard to see the wood for the trees. On the other hand, it is a rare investor who would sign up for the wholesale chopping out of disclosures. Most want a full set of data for consecutive years, even if they don't currently need it. Company management teams sense that non-disclosure of information considered immaterial in a particular year will not necessarily be welcomed by investors or regulators. It is no surprise, therefore, that financial reports become ever longer and simultaneously harder to digest.

### **Making segments a priority**

Detail is clearly required by investors – but it needs to be the right detail. Based on what investors tell us, detail about segments is a top priority – in terms of the three primary statements and key performance indicators. Investors need this in order to understand individual business models and to reach informed conclusions over past performance and future sustainability. Consolidated information is often meaningless in this regard. Take a banking group with both wholesale and retail businesses that use different definitions of non-performing and impaired loans. There is no value in attempting to aggregate that information in a consolidated note.

Sometimes criticisms of reporting standards arise because those standards are poor quality and fail to give investors what they want. Lessee accounting has huge room for improvement but changes are always controversial, as reactions to the IASB's exposure draft have shown. Many investors argue that the current pension standard results in boilerplate disclosures that they do not value, while omitting other information that would be valuable.

### **The way ahead**

Even so, the quality of most standards and of standard-setting is high – arguably higher than it has ever been. So where do we go from here to ensure that IFRS retains its core high quality, that problematic standards are improved and that complaints from preparers and users reduce?

Ensuring that changes made really are for the better is not always easy. However, there are a number of benchmarks that any current and future reporting standard should be measured against. An obvious starting point is the IASB's *Conceptual framework for financial reporting*. This is currently being updated. The first phase of work on the objective and qualitative characteristics of financial reporting was completed in September.

Separately, the Global Public Policy Committee, representing the six largest accounting firms, has identified key characteristics essential to the success of principles-based accounting. These are closely aligned to proposed criteria developed by PwC for assessing the quality of standards. For example, there is general agreement about the importance of clarity – standards should be clearly written and understandable, and not contain excessive detail.

### ***Focus on the user***

But standards must also focus on the user perspective – any standard should result in companies providing financial information that is relevant and helpful to investors and other users. The financial reporting model must be driven by stakeholder needs. Changes to standards and the development of new ones must be evidence based. In this context, PwC supports the IASB's attempt to be as inclusive as possible about getting feedback from all parties. Its move towards post-implementation reviews is also welcome.

Applying this stakeholder focus in practice means that all those involved in financial reporting should strive towards disclosures that are relevant to individual business segments, rather than dominated by consolidated data. Some information could perhaps be presented only in segment form, with reconciliations back to the consolidated balance sheet. Perhaps we also need a new emphasis on the 'comply or explain' philosophy for areas of disclosure that are currently voluntary, but which investors value – such as reconciliations of net debt.

Finally, any changes to a standard should meet a 'cost/benefit' test. This means both that the costs to the company should not exceed the likely benefit to users, and that the standard should not present an obstacle to timely financial reporting. For example, if preparers are to be asked to use a new valuation method, the reason for the additional effort must be clear.

These are areas deserving of sensible debate. Complaining about complexity is easy; finding solutions is the hard part. Improvement should be possible if we focus on the key characteristics required of high quality reporting standards.

**John Hitchins is the global chief accountant at PwC.**



***Strive towards disclosures that are relevant to individual business segments***

***Any changes to a standard should meet a 'cost/benefit' test***

# Investors speak out on fair value

The debate over accounting for financial instruments continues, but has enough attention been paid to the views of the professional investor? **Alison Thomas** unravels their responses to a recent survey



Alison Thomas

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have accounting for financial instruments on their 'convergence agenda', yet their current proposals are far from aligned. The IASB favours an approach that is broadly similar to today's mixed-measurement model: that is, a combination of fair value and amortised cost on the balance sheet. The classification between the two is driven by the underlying business purpose for holding the instrument and by the instrument's structural characteristics. The FASB, however, proposes that all financial instruments are reported at fair value, including bank loans and deposits.

The boards' fundamentally different approaches to the accounting for financial instruments have attracted heated discussion, both in the press and through direct comments to the boards. Yet, to date, relatively little has been heard from the professional investor – a user group that relies on financial statement information as the basis for their investment decisions.

### Views captured

A recent PwC survey – *What investment professionals say about financial instrument reporting* – sought to understand the importance investors place on financial instruments, how they prefer to see them measured, and how they use financial instrument information in their analyses.

The survey findings were gained by interviewing 62 banking and insurance investors from different countries. By

engaging each investor individually in an hour-long meeting, we were able to get down to basics on how they use financial statement information and what changes they would make to improve that information. Admittedly, the survey results may not be representative of the view of all investment professionals, but they do provide some consistent findings from a cross section of the community.

### Preferred model

A majority of the survey respondents favour a mixed-measurement model, with fair value reporting for shorter-lived instruments and amortised cost reporting for longer-lived instruments. This view is held consistently across all the regions and industry sectors included in the survey sample.

Those who favour the mixed-measurement model do so because they believe that the information better reflects an entity's underlying business and economic reasons for holding an instrument. They also stress the importance of keeping net income free from fair value movements in instruments that are held for long-term cash flow rather than for short-term trading gains.

When asked for a preference between an impairment model based on expected losses or one based on incurred losses, there is widespread support for the former. This preference is accompanied by a desire to define how an expected loss model is applied. Respondents express concern that if loosely defined, an expected loss model could lead to an excessively subjective approach to reserves in order to facilitate earnings management.

### Relevant, but not key

Investors consider fair value information for financial instruments to be relevant and valuable (according to the majority of survey respondents) but it is not necessarily the key consideration in their analysis of an entity. It is used in a variety of ways, but usually as investors form their views on an entity's liquidity or capital adequacy or in an enterprise value calculation. It is seldom used as an indicator of future cash flow generation.

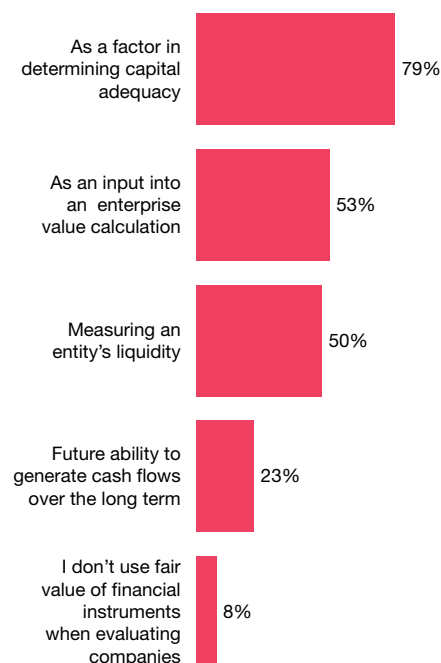
### Disclosures

Respondents voice a consistent desire for improved disclosure of fair-value information. Specific improvements cited include detailed, but not excessive, information about portfolio composition and risk factors, valuation methods and assumptions, and sensitivity analyses for movements in key assumptions.

### Future uncertain

The comment period for the FASB's proposed changes to the accounting for financial instruments closed in late September. We will watch with interest to see whether the result of this process is a single, converged standard, or whether this is a step too far in the quest for unified reporting standards.

### How investors use fair value information



The survey can be found at: [www.pwc.com/gx/en/ifrs-reporting/IP\\_Financial\\_instrument\\_reporting.jhtml](http://www.pwc.com/gx/en/ifrs-reporting/IP_Financial_instrument_reporting.jhtml).

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

# Investment community wants 'narrative with numbers'

At the 2010 *Meet the Experts* conference investment professionals from the Corporate Reporting Users' Forum told the audience what they are looking for in corporate reports

### **Focusing on the long term**

Many in the investment community are struggling to make sense of current macro-economic conditions. Will there be inflation or deflation; a double-dip recession or a surge in growth, stimulated both by quantitative easing and the resurgence of emerging markets?

In the face of such uncertainty, long-term investors return to fundamentals. History shows that, over time, earnings are rewarded. So the CRUF emphasised the importance of earnings to their analysis and the need for companies to go beyond the boilerplate in their communication of performance.

### **Telling the story of performance**

The CRUF panel highlighted the need for management to present a coherent view of performance – “a narrative with numbers”. In particular, they called on management to:

- Ensure that the front and back halves of the annual report present a joined-up picture of performance.
- Provide the information investors need to assess the performance of the underlying business. Reporting should be structured around the company's business model, and not simply follow the letter of compliance with financial reporting standards.
- Report the key non-GAAP items that management use to run the business.

- Where possible, reconcile these broader reporting items back to GAAP.
- Provide a more logical structure to disclosures. Help the reader to navigate swiftly between related areas of the annual report (for example, risk disclosures) through cross-references or by bundling information together in one place.

### **Ongoing challenges with financial statements**

Pensions accounting remains unsatisfactory, the investors told delegates – assets can be used to flatter the income statement; some entities are hedging risks with derivatives; and disclosure is often insufficient for investor needs.

The CRUF panel asked management to report service charges as an operating expense and present other charges as finance items. They also asked for better disclosures on longevity, hedging and planned cash contributions.

Investors would like management to run the cash flow statement from an operating line (for example, EBIT) through to the movement in net debt. Some 'direct' lines are also helpful – most notably, cash receipts from customers.

Mandatory disclosures about acquisitions are unsatisfactory, according to the CRUF panel. Investors want to know:

- What do entities spend, including all financial assets and liabilities?
- How has the acquired business performed since the transaction took place?
- How much of the subsequent group amortisation cost is meaningful?
- How much was raised from divestments?

The underlying business reality for lessees is almost never visible from the numbers, the investors argued. The split between operating and finance leases can seem arbitrary, in their view and cash flow and 'real' debt levels are often distorted by captive leasing businesses.

### **The direction of travel**

The CRUF participants at *Meet the Experts* supported the basic thrust of a number of the projects on the IASB's agenda (such as leasing and financial instruments). However, they expressed concern that their ability to provide informed feedback to the IASB and FASB was constrained by the lack of 'real world' examples.

They invited the audience to contribute to the debate on key accounting topics by re-casting their numbers (even if just prior-year numbers) using the proposed standards and by providing a sense of the cost of implementation. Additional information is always welcome, they said, but not when it comes at a prohibitive cost.

To access the CRUF's *Meet the Experts* presentation, please visit [www.cruf.com](http://www.cruf.com)

**Cash flow reporting is like doing a jigsaw with half the pieces missing and without the box**

**Re-cast your numbers using the proposed standards to give us a sense of the cost benefit**

# Time to move the audit forward

To build trust in business and the capital markets the audit must be relevant. **Ian Powell** outlines key reforms to make it fit for purpose

Those of us leading the audit profession have got to be prepared to change. The financial crisis was a case of systemic market failure; but one of the key lessons it highlighted was that auditing has to move forward, if it is to be relevant and valued.

As participants in the market, and as a matter of public interest, the audit profession should examine its role and responsibilities, and how they should be changed. I welcome the increasing public debate about the value and relevance of audit and the calls for auditor reporting to be more informative.

I intend for PwC to be at the forefront of making the changes that are needed. While there is no single right answer to what those changes need to be, there is a broad spectrum of possible reforms that could have a positive impact.

### **Time for action**

There are some actions that we could start taking now. Some will take longer to emerge and find acceptance and will need to be based on a broad consensus with business, regulators, and other public interest parties.

I see that there are actions we can take in five main areas:

- Audit quality and consistency
- Transparency around the audit
- Auditor reporting on narrative information
- Review standards in light of key issues from financial crisis
- Longer-term, more fundamental reform

First, we as auditors will continue to raise the standard of all the work that we do to strive for an even higher, consistent standard of excellence. If just one of our audits is found wanting, for whatever reason, then that is one too many.

### **Audit transparency**

The second area for action is to improve transparency around the scope, processes and decision-making involved in an audit. As a profession, we have not done a good job of explaining what an audit is. And if we don't improve this, we can hardly complain that auditing is not well understood.

It will take time to consider how the auditor's report could be adapted to meet market challenges. But, the most immediate way to consider giving more



Ian Powell

information is through the audit committee's governance report, where there is greater discretion over the content.

We have wide-ranging discussions with our clients, in particular with audit committees, about the risks of misstatement and the areas of judgement in the financial statements. Much of that debate stays private between us and the committee. It may well be that by making more of those discussions public, through the vehicle of the audit committee's report to shareholders, we can collectively improve understanding of the audit and its value for companies and the functioning of the capital markets.

This idea is being discussed with the audit committee chairs of some of our clients to see if we can work with companies on a voluntary basis to improve the disclosure of such matters over the next reporting cycle. To succeed, clearly this will need to be a collaborative effort.

### **Action on 'the front half'?**

Another area of action is to look at how we can make our reporting more useful on the narrative information that goes with the financial statements and that

is not covered by the audit report. Currently we report by exception on what we call 'the front half' of the annual report. In our discussions with investors it is clear many already, and wrongly, believe that all quantified information in the annual report is subject to audit.

The fourth area that we need to examine is whether changing the standards for reporting and auditing can give clearer, better assured information in the areas that received particular focus in the financial crisis. For example, can we improve the information on the business model and its inherent risks, or the uncertainties and judgements that underlie a set of financial statements? Can we be clearer about the assumptions and sensitivities that underpin the going concern assessment? These issues are already high on regulatory agendas.

### **More fundamental reform?**

The fifth and final area for action is to consider longer-term, more fundamental reform. Technical complexity and volume have grown in recent years, often at the expense of clarity and understanding. I believe some auditing and corporate reporting standards will need to change and I want business and

the audit profession to be at the forefront of this process. I am keen for this reform to find ways to improve the connectivity between the information reported on governance, remuneration, risk and sustainability.

I hope that the agenda that I have outlined to bring greater transparency to the audit process and to improve the relevance of the reporting model, will play a part as we collectively do our utmost to build the public trust business needs to cement its critical position in society.

I recognise that this is a challenging agenda, and changing systems demands the involvement of a wide group of interested parties to build the necessary consensus. This will take time, but we must start now.

**Ian Powell is the chairman and senior partner of PwC in the UK. This article is based on part of his speech at PwC's Building Public Trust Awards to recognise trust and transparency in corporate reporting.**

***In my view, the assurance offered by audit is essential to capital markets and the orderly conduct of business***

***As auditors we need to be prepared to continue to develop the audit model so that it is as fit for purpose in the 21st century as it was in the 19th***

# Generating value through transparency

Many companies have embarked upon a journey to restore, sustain or enhance trust in their businesses. As they strive to increase transparency, **Steve del Vecchio** finds that many are taking a fresh look at what external verification has to offer



Steve del Vecchio

Recession, unprecedented instances of financial fraud and widespread product recalls by some of the most trusted global brands have all dented investor and consumer confidence. As a result, calls for increased transparency are reverberating across global markets.

Stakeholders are demanding greater visibility of areas that present the greatest concern and risk such as: supply chain integrity, regulatory compliance and environmental and social responsibility. But often these are the very areas where business leaders lack visibility themselves. In response, companies are conducting internal reviews of business practices – and increasingly taking the next steps towards seeking external assurance on those practices.

## Key risk areas

Supply chains are an important area of focus. Companies are operating in an increasingly global and virtual world, making them more vulnerable to disruptions that can cascade quickly through businesses and damage reputations. A PwC analysis of 600 companies experiencing supply chain disruptions – *From vulnerable to valuable* – found that their average shareholder

value dropped and their stock prices experienced greater volatility than their peers for years after the event. Not surprisingly, organisations are increasingly looking for reassurance that their suppliers comply with regulations such as health and safety standards and have appropriate controls for their business.

Information technology is another area where the ability to demonstrate an understanding of risk and validated controls can bring considerable benefits. An impartial assessment of IT operations can help business leaders identify specific vulnerabilities and develop a more integrated approach to maintaining information security. For companies that generate large amounts of revenue through credit and debit cards, for example, being able to demonstrate certified compliance with data security standards provides reassurance to both customers and payment card providers.

## Transparency brings value

Increased transparency over key risks can do more than boost public trust. There are bottom line benefits too. Research has shown that expanded voluntary disclosure of company-specific information reduces market- and industry-driven stock price fluctuations, as well as the frequency of stock price crashes. See *Financial Management*, “Does voluntary disclosure improve stock price informativeness?”.

In industries where increased regulation seems imminent, some companies see particular value in being at the forefront of providing the most credible information possible and potentially influencing how new reporting

requirements are defined. For example, in the financial services industry – particularly in currently unregulated but fast-growing institutions such as alternative asset managers or hedge funds – institutional investors have begun seeking greater transparency around internal controls. In response, one major alternative asset manager produced for investors a detailed, independent assessment of its trade flow processes and controls. Although investors remain most interested in market performance, substantive information about financial controls can help deepen credibility.

## The certification goal

While transparency is valuable in itself, it delivers most benefit when the information is considered credible. One academic study at the University of Utah, for example, found that companies providing verifiable detail in their non-financial disclosures (information that could be validated by external parties) experienced more persistent, positive changes in financial performance than companies that did not.

One area where voluntarily gaining independent validation can be useful is environmental reporting. As environmental performance becomes an increasingly important factor in consumer, investor and employee engagement, stakeholders are demanding greater and more consistent insight into it. However, reports provided by companies often vary hugely. Organisations providing increased disclosures are therefore finding value in the kind of independent validation that enhances their credibility. According to a 2009 study of 100 corporate sustainability reports,

*Research has shown that expanded voluntary disclosure of company-specific information reduces market- and industry-driven stock price fluctuations, as well as the frequency of stock price crashes*

44% provided third-party verification (see *CSR Trends 3* by PwC and Craib Design & Communications).

Taking voluntary action early can have maximum impact because when it comes to third-party certification – there may be a first-mover advantage. A study by Mary Benner and Francisco Veloso of 87 automotive suppliers over 10 years showed that, as the majority of firms within an industry certified best practices, the late adopters no longer gained financial benefits.

***Benefiting from the journey***

While pursuing third-party assurance – on financial issues, IT, the supply chain and sustainability – can be a vital part of the trust equation, it's not all or nothing. For many companies, increased disclosures or independent evaluations may be longer-term goals, but there are benefits to be gleaned along the way. The process of preparing can create incremental value as management gains greater insight into the practices that drive cost efficiencies, facilitate innovations and, ultimately, establish a competitive advantage in the marketplace.

Knowing that an external evaluation will be conducted can give impetus to internal programmes designed to document and /or strengthen controls. In industries or business areas where regulation is imminent but uncertain, the process of preparing for greater scrutiny – getting your house in order – can be particularly fruitful. But for all industries, making moderate investments to begin the journey towards greater transparency and certified reporting can bring long-term cost savings, enhanced credibility with stakeholders and competitive advantage.

**Steve del Vecchio is the PwC Assurance Systems and Process Services leader in the US.**



# Looking beyond the cloud

Companies are looking to cloud computing to improve business efficiency and reduce the financial burden of maintaining a complex IT infrastructure. **Cara Beston** advises keeping an independent eye on its use



*Cloud computing provides easy, scalable access to cutting-edge computing resources and IT services over the internet as they are needed*

IT transformation for greater business agility is a must for many companies to stay competitive, but for most this isn't just an IT initiative. It also means a shift in the way companies do business.

More and more companies are embracing 'cloud computing' to help achieve this agility. It provides easy, scalable access to cutting-edge computing resources and IT services over the internet as they are needed. And it removes the burden of maintaining all the infrastructure yourself. But it also means that companies will rely less on IT servers that are under their control and more on hosted services, which involves a different level of risk.

### Ask questions

Security and data protection rank high on the risk agenda when considering cloud computing. Management will need to scrutinise every aspect of their cloud provider's service level agreements (SLAs). Providers will need to be questioned about how they will keep your data safe, deal with

customer demand, maintain their data architecture and comply with regulatory requirements. They will also need to explain how and what companies are charged for. Every business will have different demands and each cloud provider should be flexible in negotiating each SLA.

### Third-party assessment

No matter how much assurance the cloud provider gives you it may not be enough. Doing the right level of due diligence up front may help you sleep at night.

A third-party evaluation should look at the cloud provider's processes, controls, people and technology to address your security, privacy, availability, and data integrity and retention concerns – some of which might be unique to cloud computing. Done properly, this kind of independent assessment can provide a critical foundation of trust between the customer and provider.

To date, there is no standardised assurance report that covers all the inherent risks and many cloud providers are unable to offer the level of assurance companies need. Increasingly, providers are adopting the US *Statement on Auditing Standard No 70 (SAS 70)* (see page 42) or the *International Standard on Assurance Engagements 3402*. SAS 70, for example, applies to a cloud provider only when that provider is hosting applications or systems that are used to process transactions relevant to the user's financial reporting. It does not extend to operational, compliance, or performance data.

### Continue to monitor

Cloud computing continues to evolve, and as more companies place their trust in the internet to benefit from competitive advantage, so the risk of security and data breaches rises. For this reason it is imperative that companies continually assess their relationship with their service provider and how market practices are evolving. For example, is the provider sharing

information on security risks – known and potential?

A coordinated risk-assessment plan is a good starting point, enabling companies to review the security, governance, finance, compliance and tax implications of their IT systems. It is a pragmatic foundation for a successful relationship with any cloud provider. For example 'cloud' hosting of data for redundancy and business continuity could create a taxable presence in another country. The burden is often on the CFO to anticipate the implications of using cloud services and avoid surprises that could affect the balance sheet in unexpected ways.

### Essential questions for management to ask

- What transformations could your business undergo with the help of cloud solutions?
- How will you encourage greater collaboration among your business network of internal and external partners?
- How do you analyse and benchmark current IT costs, and how will you benchmark internal IT effectiveness against external cloud providers?
- What access will you require from cloud services providers to audit, assess, and maintain control over workflow processes?
- What are the implications of moving to external 'cloud' providers from the regulatory, compliance, accounting and tax perspectives?
- What decisions must be made now to make sure you can be agile in the mix of public and private cloud resources that you deploy?

**Cara Beston is a PwC partner in the Systems and Process Assurance group in the US.**

### EUROPEAN COMMISSION

# Reforming corporate governance to reduce risk

The European Commission is considering responses to a green paper on corporate governance in financial institutions and a report on remunerations. Reforms implemented as a result of the findings could kick start further regulatory changes for Europe's listed companies.



*Corporate governance in financial institutions and remuneration policies*, was issued in June 2010 in response to the commission's promise to examine and report on corporate governance practices in financial institutions before, during and after the financial crisis. The results of the consultation are expected any time now.

The commission has made it known that issues related to the corporate governance of listed companies more generally also deserve to be addressed and has started a review. A separate green paper is due out soon.

Improving corporate governance is fundamental to the commission's work on crisis prevention and a key part of its regulatory reform package to create a safer financial framework. Aligned to this will be the work of the recently approved European Supervisory Authorities in monitoring risk (see page 22).

The green paper considers how to:

- Improve the functioning and the composition of boards to enhance supervision of senior management

- Establish a risk culture at all levels, to ensure the business's long-term interests are taken into account
- Enhance the involvement of shareholders, financial supervisors and external auditors in corporate governance
- Change remuneration policies to discourage excessive risk taking

### **Remuneration**

With regard to remuneration policy, the paper considers what legislative

proposals might be necessary over and above those proposed in the 2005 and 2009 recommendations for directors of listed companies (including directors of listed financial institutions). In particular, the paper asked:

- Does the favourable tax treatment of stock options and other similar remuneration existing in certain member states encourage risk-taking?
- Should the role of shareholders, employees and their representatives be strengthened in establishing remuneration policy?
- Should severance packages (golden parachutes) be regulated at community level, prohibited, and/or awarded only to remunerate effective performance of directors?

The primary focus of the green paper is on banks and life insurance companies although the commission considers that the solutions explored are relevant to all regulated financial institutions.

[www.europa.eu](http://www.europa.eu)

### **Green paper suggestions to improve governance**

- Limit the number of directors' board memberships, eg, three
- Require more expertise on boards
- Enhance the role of supervisors in the review of corporate governance structures
- Mandate risk committees and strengthen the authority of the risk management function
- Strengthen the legal liability of directors via an expanded 'duty of care'
- Regulate or restrict stock options and golden parachutes
- Separate the functions of the chairman and chief executive officer
- A stricter duty for auditors to flag anything serious to boards and supervisors
- Institutional investors to publish voting and engagement policies and records, and adhere to stewardship codes

# Reshaping regulation for long-term gain



Recent regulation aimed at financial services companies will have a far-reaching impact on all US public companies. The Dodd-Frank Wall Street Reform and Consumer Protection Act is intended to overhaul the nation's financial system and will introduce numerous new regulatory requirements.

The Dodd-Frank Act was signed into law in July 2010. It seeks to address specific issues that contributed to the financial crisis and is heavily remedial in nature. It will take some time for the legislation in its entirety to be embedded into corporate reporting and to fully understand its long-term implications. However, the US administration will be urging other countries to follow its principles and standards.

The Act introduces reforms that will affect how public companies report to stakeholders, particularly in the areas of executive compensation and corporate governance. The key executive compensation and corporate governance reforms include:

**Say on pay** – Companies are required to give shareholders a non-binding vote at least every three years on executive compensation and golden parachutes. At least once every six years, shareholders will vote on whether they want the 'say on pay' vote to be annual, biannual or triennial.

**Proxy access** – The Act authorises the SEC to adopt a rule allowing shareholders to nominate directors in a company's proxy statement. The rule was adopted by the SEC in August 2010. However, in response to a petition challenging the legality of proxy access, the commission has delayed implementation of the rule for the 2011 season.

**Clawbacks** – Companies are required to implement and disclose a clawback policy. Under the policy, if the company is required to restate its financial statements, it must reclaim any excess incentive compensation paid to executives based on the erroneous financial information, for the three years prior to the year of restatement.

**Independence** – Compensation committee members face additional independence restrictions, similar to those required for audit committee members. Committees will also need to consider various independence factors for their advisors. The SEC will be defining those factors.

**Additional pay disclosures** – The company must disclose the relationship between executive compensation and the company's financial performance. In addition, the company must disclose the median compensation of all employees (excluding the CEO), the CEO's total compensation, and the ratio of the two.

**Hedging by employees** – The company must disclose whether any employees or directors are permitted to hedge against declines in any equity securities they received as part of compensation.

**Whistleblowers** – Whistleblowers are eligible for a portion of the fines the SEC charges a company, if they provide original information to the SEC that leads to a successful enforcement action. This may provide an incentive to whistleblowers to bypass internal reporting mechanisms and go directly to the SEC with allegations.

## Boards struggle to control CEO compensation

Company boards are still having trouble effectively controlling CEO compensation, according to a recent study undertaken by PwC's Centre for Board Governance.

The *Annual Corporate Directors Survey* conducted in the US found that directors overwhelmingly believe CEO pay policies could be reformed by such measures as setting minimum stock ownership guidelines, re-evaluating compensation benchmarks, and devising realistic peer-group comparisons – all concepts that fall outside the remit of the Dodd-Frank Act.

"The corporate governance provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act focused on policies such as say on pay and clawbacks," said Catherine Bromilow, partner in PwC's Centre for Board Governance. "Our survey uncovered other areas that may go further to address CEO pay. As compensation issues continue to be a concern, boards will be well-served by closely examining their compensation policies and how well their rewards link to company performance."

The survey also sought answers to questions on topics such as the new proxy disclosure requirements for 2010, effectiveness of the audit committee, confidence in the board's governance regimes, and 'red flag' incidents that might lead to increased board involvement.

The full survey can be found at <http://www.pwc.com/us/en/corporate-governance/publications/annual-corporate-directors-survey.jhtml>



## Modernising internal control framework

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) has initiated a project to update its widely-used internal control framework in time for its 20th anniversary – and make it more relevant for an increasingly complex business environment.

The original COSO *Internal control – integrated framework* was published in 1992 from a set of core principles covering operations, compliance and financial reporting objectives. More recently, the framework has been expanded to incorporate internal control over financial reporting in compliance with the US Sarbanes-Oxley Act of 2002 (SOX) and other similar national regulatory requirements.

Enhancements to the framework will not alter the core principles or underlying framework but should enable more effective application of internal controls over operations, compliance and financial reporting. Certain concepts and discussions are expected to be refined to reflect the evolution of the business environment and changed expectations in the market place. It is also the intent of the COSO Board to keep the framework as succinct as possible.

COSO has engaged PwC to support the framework's modernisation programme and is forming an advisory council to provide input as the project progresses.

“The updated framework is intended to help organisations more effectively design and manage internal control,” explained Miles Everson, project team leader and a PwC partner in the US. “It will also help to explain the interconnections with the *Enterprise risk management – integrated framework*, the 2006 *Internal control over financial reporting – guidance for smaller public companies*, and the 2009 *Guidance on monitoring internal control systems*.”

[www.coso.org](http://www.coso.org)

## Addressing governance in developing countries



A study of corporate governance disclosure requirements in 22 developing countries finds listed companies are required to provide significantly less information than their counterparts in developed countries. The results identified a number of common disclosure requirements and regulatory areas where standards could be raised to meet the expectations of capital providers, based on good international practice.

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) commissioned the study to assess the state of corporate governance reporting in countries with relatively small equity markets (frontier markets).

The corporate governance disclosure requirements of relevant laws and stock exchange listing rules were compared against the ISAR benchmark of good practices identified in the *Guidance on good practices in corporate governance disclosure* issued by UNCTAD. The study assessed disclosure in five key areas:

- Financial transparency
- Ownership structure and exercise of control rights
- Board and management structure and process

- Auditing
- Corporate responsibility and compliance

There was even less disclosure of some areas than in 2009. For example, only one country (Nigeria) requires disclosure of the board's responsibilities for financial communications; and only Croatia requires disclosure of the board's confidence in their external auditors' independence and integrity. Disclosing the impact of environmental and social responsibility policies on sustainable development is not mandatory in any of the frontier markets.

The findings identified that the majority of the emerging markets studied do not have mandatory disclosure rules for most of the items in the ISAR benchmark of good practices. This contrasts with earlier UNCTAD studies of larger emerging markets where most of the benchmark items were subject to mandatory disclosure rules.

The best performing 'frontier' markets in the study, which require half or more of the ISAR benchmark items, were Slovenia, Nigeria, Croatia and Lithuania.

[www.unctad.org/isar](http://www.unctad.org/isar)

## Investors oppose annual re-election of directors

**A new governance code containing a 'comply or explain' requirement for directors of FTSE 350 listed companies to be subject to annual election has met with resistance from some of the UK's major institutional investors.**

As reported in the *Financial Times*, institutional investors Hermes, Railpen and the Universities Superannuation Scheme have publicly stated in a letter to 700 companies that they are against this annual re-election provision and they will back companies that do not comply. In the letter, the investors warn that the annual election of directors could lead to a 'short-term culture' and undermine collective decision making.

The FRC said it had consulted widely ahead of announcing the change and had received the support of major institutional shareholders. The change was made with the objective of encouraging more engagement between companies and investors.

Before the new code, directors stood for re-election every three years. There is a feeling among some institutional investors that annual election of the entire board will result in a loss of long-term focus on the success of the company.

The UK Corporate Governance Code was published by the Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting confidence in corporate reporting and governance. The code has replaced the Combined Code, although there is some debate about when the new provision applies. When applying the code for the first time, companies will have to disclose in the annual report whether they have complied throughout the financial year.

[www.frc.org.uk](http://www.frc.org.uk)

## Watchdogs have bite

**The European Parliament has given the go-ahead for three new European Supervisory Authorities (ESAs) to oversee the activities of banks, securities markets and insurance companies with effect from 2011.**

The establishment of the ESAs was proposed by the European Commission in September 2010 as one part of legislative reforms to tackle perceived weaknesses in the way Europe's financial markets are policed. (See *World Watch*, Issue 1 2010, page 5).

The new ESAs are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). From 1 January 2011, they will

collectively watch over the activities of national financial supervisors while helping the European Systemic Risk Board (ESRB) to monitor the build up of risk in the financial system overall.

Under new powers the ESAs can intervene as mediator in the event of disagreement between national supervisors and have the authority to settle disputes. They will also be able to ban risky financial products and activities.

"This legislative package is one of the cornerstones in rebuilding economic growth in the EU," commented Jerzy Buzek, president of the European Parliament. "The new and strengthened financial supervisory authorities will help to ensure that we avoid deep financial crisis in the future."

### UK STEWARDSHIP

## Code for investors

The UK Financial Reporting Council (FRC) has introduced a Stewardship Code setting out good practice for institutional investors when engaging with listed companies. The code promotes better dialogue between shareholders and company boards, and more transparency about the way investors oversee the companies they own.

The code is based on the Institutional Shareholders' Committee's Code with only limited amendments. It includes principles on:

- The monitoring of investee companies
- The escalation of activities taken to protect or enhance shareholder value
- Collective engagement
- Voting policy
- Managing conflicts of interests
- Public reporting and reporting to clients

Introducing the new code, FRC chairman Baroness Hogg said:

"We hope this new code will be a catalyst for better engagement between shareholders and companies and create a stronger link between governance and the investment process."

"Disclosures made by institutions under the code should assist companies to understand the approach and expectations of their major shareholders. They should also assist those issuing mandates to fund managers."

The FRC is encouraging all institutional investors to report on their website the extent to which they follow the code on a 'comply or explain' basis. To endorse this, the FRC is publishing on its own website a list of investors that have signed up to follow the code.

The UK Financial Services Authority (FSA) has introduced a requirement that all UK-authorized asset managers will need to produce a statement of commitment to the code from 6 December 2010. Those that fail to do so will need to explain why the code is not appropriate to their business model.

## THAILAND

## Driving governance from the bottom up

A recent analysis of corporate governance standards across the Asian region credits Thailand as the country that has made the most progress by using good governance reporting to educate investors.

*Corporate Governance Watch 2010* surveys the corporate governance (CG) activities of 580 Asia-listed companies in eleven countries, with scores awarded against five categories: CG rules and practices, enforcement, political and regulatory environment, IGAAP (accounting and auditing), and CG culture. Thailand's score rose by 8%, with a rise in rank from 8th to 4th.

The Thai Institute of Directors Association, in cooperation with the

Stock Exchange of Thailand (SET) and the Securities and Exchange Commission (SEC), created a rating system from information disclosed, awarding 'stars' to companies for their reporting.

"Thailand's score has risen in part due to the improvement in reporting by companies on the Market for Alternative Investments (mai) which is a stock market for small and medium sized enterprises with high potential growth," said Chanitr Charnchainarong, President of mai and group head of the Issuer & Listing Division of the Stock Exchange of Thailand (SET). "Peer pressure from this group has kick-started good governance practices in larger listed companies on the SET."

"The star-rated system has helped investors to see who is reporting well and improved the information they use to identify how well companies are performing," he added. "More importantly, management are now focused on practicing good corporate governance, recognising that educated investors help raise the share price."

Mai members that achieve a 4-star rating or above, are able to share best practice with their peers, while those achieving three or less do not have their rating announced. This practice has led under-performers to raise their game and generated competition between mai and SET companies for investor attention.

[www.acga-asia.org](http://www.acga-asia.org)  
[www.thai-iod.com](http://www.thai-iod.com)

## AUSTRALIA

## Diversity and remuneration key to changes



**The Australian Securities Exchange (ASX) has issued new corporate governance recommendations to improve governance around issues such as diversity, remuneration and trading policies.**

Listed companies will be required to comply, or explain why they have not complied in their annual report. The ASX Corporate Governance Council believes adoption of a 'comply or explain' culture allows boards to develop policies and objectives fit for their individual circumstances, while providing a mechanism for increased market transparency and accountability.

The changes to the Corporate Governance Principles and Recommendations are effective from 1 January 2011. They follow consideration of public responses to the exposure draft issued by the ASX council in April 2010.

### Key amendments

**Diversity** – Companies must disclose how they have achieved against the gender objectives set by the board and disclose the proportion of women employed on the board, in senior management roles, and elsewhere in the organisation. ASX has noted that listed companies with a reporting date of 30 June 2010 should be able to establish a gender diversity policy and report

against the new recommendations for the year starting 1 July 2010.

**Remuneration** – ASX-listed companies should set up a remuneration committee to review and provide recommendations to the board on remuneration by gender. The committee should be made up of mainly independent directors, chaired by an independent director, and have no less than three members.

**Trading policies** – Changes to the principles and recommendations will reflect the introduction of ASX listing rules requiring entities to adopt and disclose a company trading policy from 1 January 2011.

**Briefings** – Companies should arrange for advance notification of significant announcements (eg, on results) and make these more widely accessible (eg, through the use of webcasts). Companies should also keep a summary record for internal use of the issues raised at group or one-on-one briefings with investors and analysts.

[www.asx.com.au](http://www.asx.com.au)

# Raising the governance bar

Findings from a report on the governance of listed companies show improved corporate governance and executive remuneration practices. Despite the improvements, new recommendations have been published to raise the bar still further.

The report was published by the Autorité des Marchés Financiers (AMF) in July 2010. It is based on responses from a sample of 60 companies whose shares are listed on Euronext Paris. It found that companies have improved their governance practices and transparency in areas such as:

- Reporting on compliance with a corporate governance code – widespread application of the ‘comply or explain’ principle. However, 60% of respondents set aside some (but not all) of the code’s provisions, with 80% explaining why.
- More independent directors on boards and committees – 88% of audit committees and 79% of compensation committees are led by an independent director. All respondents have independent directors although some fail to identify who they are.



- Proportional representation in the boardroom – rise in the proportion of women directors on the boards of 40 sample companies, from 11.4% in 2009 to 15% in 2010. The AMF would like to see a broader-based approach in this area.
- Better information about the work and evaluation of boards – over two thirds of respondents carried out a formal evaluation in 2009 and more than 60% provided a detailed description.
- Increased disclosure of the CEO’s role and responsibilities – all sample companies provided information about restrictions on the CEO’s powers.
- Action to prevent conflicts of interest – more companies are introducing (or plan to introduce) a lead director or board vice-chairman responsible for governance. The AMF recommends more detailed information about the lead director’s role, particularly when the role of CEO and chairman are combined.

AMF urges further improvement too – it calls for companies to better define the role of the non-executive chairman, particularly the nature of the tasks and how they are taken into account for compensation purposes. It also recommends better explanation of the criteria used to appoint independent directors, boards and committees.

[www.amf-france.org](http://www.amf-france.org)

## CEBS

# Internal governance guidance for European banks

The Committee of European Banking Supervisors (CEBS) has published a draft consultation paper updating and consolidating guidelines on internal governance.

The *Guidebook on internal governance* contains principles directly aimed at sound implementation of internal governance. New principles have been included on the transparency of the corporate structure (know-your-

structure principle); the role, tasks and responsibilities of the supervisory function; IT systems, and business continuity management.

A survey on the implementation by supervisory authorities and institutions of CEBS’ internal governance guidelines, conducted in 2009, showed weaknesses in oversight of the supervisory function, risk management and internal control frameworks. The updated guidebook

addresses those weaknesses and complements earlier principles: *High level principles on risk management* (February 2010), and *High level principles on remuneration* (April 2009).

The consultation is open until 14 January 2011. All interested parties, including supervised institutions and other market participants are invited to comment.

[www.c-eps.org](http://www.c-eps.org)

IFRS

# Proposals put leases on the balance sheet

The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) have published a joint exposure draft, *Leases*. The primary objective is to ensure assets and liabilities arising from lease contracts are recognised on the balance sheet. The ED will significantly change the way entities account for leases.

Some entities will be affected more than others, depending on the number and type of leases in existence at the transition date.

The proposals were issued in August 2010 and will apply to all entities. However, certain types of lease are excluded. The ED includes leases of property, plant and equipment, but does not include leases of intangible assets. It also excludes leases to explore for or use natural resources (such as oil), leases of biological assets and leases of investment property measured at fair value.

### Key provisions

The proposed model will eliminate off-balance-sheet accounting by lessees. All assets currently leased under operating leases will be brought onto the balance sheet, removing the distinction between finance and operating leases. The new asset (representing the right to use the leased item for the lease term) and liability (representing the obligation to pay rentals) will be recognised and carried at amortised cost, based on the present value of payments to be made over the term of the lease.

The proposed model will require lease renewal and contingent rents to be continually reassessed, and the related estimates to be updated as facts and circumstances change.



Income statement 'geography' and timing of recognition will change for assets leased under operating leases. Straight-line rental expense will be replaced by depreciation. The ED also covers lessor accounting.

### Disclosures and transition

More extensive disclosures will be required, focused on qualitative and quantitative information, and on the significant judgements and assumptions made in measuring and recognising lease assets and obligations.

Pre-existing leases are not expected to be grandfathered. The new approach is expected to be applied for all outstanding

leases at the date of the earliest period presented, using a simplified retrospective approach.

### Action plan

The implications of the proposals are wide-ranging and companies will need to consider carefully what this means for their business in both the short and long term. The IASB will review the comment letters (after the 15 December deadline) before issuing a final standard. The effective date is likely to be 2012 or later, since no effective date has been proposed in the exposure draft.

# Insurance contracts set for a shake up

**The International Accounting Standards Board (IASB) has issued an exposure draft that will fundamentally change the accounting for insurance contracts. It addresses recognition, measurement, presentation and disclosure for insurance contracts and will apply to all entities that issue insurance contracts, not just insurers.**

The proposals are the output of joint efforts between the IASB and the US Financial Accounting Standards Board (FASB). If adopted, they will replace IFRS 4, *Insurance contracts*, which currently permits a variety of practices in accounting for insurance contracts.

The exposure draft mainly retains the IFRS 4 scope and definition of an insurance contract but with some changes – for example, financial guarantees are now included and fixed-fee service contracts excluded. The proposals require an insurer to measure its insurance contracts using a current measurement model (that is, one where current estimates of cash flow are re-measured each reporting period).

All entities that issue contracts that meet the definition of insurance contracts, including financial guarantee contracts, will be affected by the proposals.

This is likely to result in increased volatility in the income statement and significant changes in the presentation of the income statement. The proposals will also create additional demands on data and modelling systems.

Given the profound impact of the proposed changes, management should begin to assess the implications of the new model on their existing contracts and current business practices.

A final standard is expected in mid-2011.

[www.iasb.org](http://www.iasb.org)

## CESR

# Report finds better reporting in Europe



**A report published by the Committee of European Securities Regulators (CESR) shows that European enforcers of International Financial Reporting Standards (IFRS) have identified an overall improvement in the standard of financial reporting.**

CESR published its first annual activity report on monitoring enforcement of IFRS in Europe in September 2010. The report is based on the activities of

the European Enforcement Co-ordination Sessions (EECS), reporting to the Corporate Reporting Standing Committee of CESR.

The report finds an increase in regulators' enforcement activities. However, it also found greater consistency in the remedial action taken by enforcers and that many took additional pre-emptive steps to improve the quality of financial reporting.

The findings highlight where enforcers found recurring problems, which provides listed companies in the EU with a useful indication of where reporting could be improved. These areas include financial instrument reporting, impairment of non-financial assets and business combinations.

“The report provides a clear message for listed companies, operating under challenging market conditions, that they must focus their efforts further to ensure the highest possible quality in financial reporting in order to maintain investors' confidence,” commented Fernando Restoy, chair of the Corporate Reporting Standing Committee. “This report will provide them with a valuable indication of areas on which, enforcers across Europe, will be particularly vigilant and seeking improvements.”

**The report can be found at [www.cesr.eu](http://www.cesr.eu)**

# Revenue recognition model to change

The exposure draft for a single new revenue recognition model was published by the International Accounting Standards Board (IASB) in June 2010. It proposes significant conceptual changes that will affect most companies and is expected to fundamentally alter the way some entities recognise revenue.

The exposure draft, *Revenue from contracts with customers*, was issued by the IASB and US Financial Accounting Standards Board (FASB) as part of a joint project to develop a common revenue standard.

The proposals would require a contract-based approach that focuses on the assets and liabilities created when an entity enters into and performs under a contract. Entities that have followed industry-specific guidance in the past may be more significantly affected than others. For example, the new model could cause pervasive change in the construction, pharmaceutical, aerospace and defence, and technology sectors.

Arrangements excluded from the proposals include: lease, insurance and financial instrument contracts, and guarantees (other than product warranties).

## Performance obligation

The proposed model requires revenue to be recognised when an entity satisfies a performance obligation to its customer. A performance obligation could be an online retailer promising to deliver an MP3 player; or a promise to build and deliver an aircraft carrier.

Identifying performance obligations in a contract will require significant judgement. It may be particularly challenging for service arrangements and long-term contracts, such as a contract to build a ship. Another challenge is to determine when performance obligations should be combined and when they should be



separated, which is necessary to determine the amount and timing of revenue recognition.

Revenue would be measured based on the transaction price, which is the amount the customer promises to pay in exchange for goods or services. This may be difficult to determine where consideration is non-cash or could vary in the future.

Greater use of estimates is expected under the new proposals and the transaction price will include variable or contingent consideration when such amounts can be reasonably estimated, which is a fundamental change from most current practice. The transaction price will need to be measured using a probability-weighted estimate of the consideration expected to be received. For example, movies are licensed for a base fee plus a percentage of box office receipts. Revenue would be recognised when the box office receipts can be estimated.

The proposed model requires an on-going assessment of costs expected to satisfy outstanding performance obligations. A loss is recorded immediately if the direct costs exceed the allocated transaction price related to a performance obligation.

## Disclosures

The proposed model would require more extensive disclosures than currently required under IFRS. These disclosures focus on qualitative and quantitative information, and the significant judgements and assumptions made in measuring and recognising revenue.

## Next steps

The comment period for *Revenue from contracts with customers* closed in October 2010 and the IASB is now be deliberating how the final standard will look. No specific effective date has been proposed, but it is unlikely to be before 2014.

## Trustees look to the future

The trustees of the IFRS Foundation are seeking stakeholder views on their strategy for the next decade. Specifically, they are looking at the foundation's mission, governance, standard-setting process and financing.

The extent of the foundation's success is partly what makes the review so necessary. For example, it has established IFRS in over 100 countries and there is ongoing interest from countries in Asia-Oceania, Africa and Americas, such as the US, Japan, China and India. The foundation is widely recognised as an independent standard setter with the ability to create a set of high-quality global standards.

However, a number of challenges remain:

- **Convergence and adoption** – A number of key countries still need to

make a decision on whether to adopt IFRS. Convergence alone will not produce a single set of global standards.

- **Quality and implementation of the standards** – As IFRS adoption crosses the globe, there is a risk of inconsistency in implementation and adoption.
- **Governance and accountability** – Global adoption has resulted in increased interest in the institution's accountability and governance.

Comments are requested by 24 February 2011. The deadline has been extended from 31 December 2011 in response to stakeholder requests for more time.

See <http://go/ifrs.org/strategyreview>

### Questions to answer

All parties are encouraged to feedback their views by 24 February 2011:

1. **Mission:** How should the organisation best define the public interest to which it is committed?
2. **Governance:** How should the organisation best balance independence with accountability?
3. **Process:** how should the organisation best ensure that its standards are high quality, meet the requirements of a well-functioning capital market and are implemented consistently across the world?
4. **Financing:** how should the organisation best ensure forms of financing that permit it to operate effectively and efficiently?

## IASB CHAIRMAN

# One out, two in



Sir David Tweedie

The announcement in December 2009 that Sir David Tweedie was to retire as chairman of the International Accounting Standards Board (IASB) at the end of his second term in office led to a guessing game as to who would replace him in June 2011.

In the event, the Trustees of the IFRS Foundation (the oversight body of the IASB) have elected two new appointees to the board. Hans Hoogervorst joins as

chairman, supported by Ian Mackintosh as vice-chairman.

Hans Hoogervorst is not an accountant but is a senior politician and regulator from The Netherlands. A former finance minister, he is currently chairman of the Dutch securities and market regulator, as well as chairman of the technical committee of the International Organisation of Securities Commissions (IOSCO).

He is also co-chairman of the Financial Crisis Advisory Group, an independent body of senior leaders formed to advise accounting standard setters on their response to the global financial crisis.

Commenting on his appointment, Mr Hoogervorst said, "I have investor protection in my DNA. I strongly believe that a global set of accounting standards, set for investors by an independent standard-setter, is an essential component for the world's financial markets. These will remain my priorities."

Ian Mackintosh is a former chief accountant of the Australian Securities and Investment Commission, with more than 30 years experience of national and international accounting standard-setting. He joins the IASB from the UK Accounting Standards Board where he was the chairman. He is also chairman of the group of national accounting standard setters, a body comprising over 20 national and regional accounting standard-setting organisations.

"The combination of these two appointments is, I think, a good response to the dilemma the appointments committee faced, which is: how do you find someone to replace Sir David Tweedie's skills as someone who deals with the technical agenda and also deals with the global politics that surround the IASB?" said John Hitchins, PwC global chief accountant. "It is indeed difficult to find both of those talents in one person and to appoint two people with that skill set in combination seems to me a very good solution."

## Fraudulent reporting doesn't pay



Proof that fraudulent financial reporting by US public companies has significant negative consequences for investors and executives can be found in a study of financial statement fraud allegations investigated by the US Securities and Exchange Commission (SEC) over a ten year period.

The study, *Fraudulent financial reporting*, was undertaken by the Committee of Sponsoring Organisations of the Treadway Committee (COSO). It looked at nearly 350 alleged accounting fraud cases and provides helpful insights into new and ongoing issues that need to be addressed.

“All parties involved in the financial reporting process need to continue to focus on ways to prevent, deter, and detect fraudulent financial reporting,” commented COSO chairman David Landsittel. “COSO plans to sponsor additional research on fraudulent financial reporting, as well as the development of further internal control-related guidance to assist those involved in the financial reporting process.”

The COSO study found:

- Initial news in the press of an alleged fraud resulted in an average 16.7% abnormal stock price decline in the two days surrounding the announcement.
- Companies engaged in fraud often experienced bankruptcy, delisting from a stock exchange, or material asset sales.

The full findings of the study can be found at [www.coso.org](http://www.coso.org)

## SEC publishes progress report on IFRS work plan

The US Securities and Exchange Commission (SEC) has published its first progress report on its effort to evaluate the suitability of International Financial Reporting Standards (IFRS) for use by US companies (domestic issuers). A final decision is expected in 2011, but the SEC has not said when.

The report sets out the SEC's observations to date in the six key areas covered by the work plan (see *World Watch* Issue 2 2010, page 20). However, the commission still needs to look in detail at whether IFRS is sufficiently comprehensive, how it compares across jurisdictions when applied in practice, and how easily it can be audited and enforced in the US.

### SEC observations

Findings in the six areas can be summarised as follows:

- 1. Sufficient development and application of IFRS for the US domestic reporting system**  
The SEC noted that the majority of jurisdictions that have mandated the use of IFRS have done so by incorporating the standards into their national accounting norms rather than adopting IFRS as issued by the International Accounting Standards Board (IASB). It also observed that where a private standard-setting body was previously used, the majority have been retained, albeit with a diversity of roles. These roles include acting as an endorser to IFRS, facilitating dialogue between the IASB and the jurisdiction, and issuing standards for entities not required to apply IFRS.
- 2. Independent standard setting for the benefit of investors**  
The IASB and the IFRS Foundation do not meet certain minimum structural and funding independence requirements embedded in US law and regulations. The SEC will continue to explore how it might help to fund the IASB.

- 3. Investor understanding and education regarding IFRS**

The SEC is researching how well US investors understand IFRS, how they educate themselves on changes in accounting standards, and how long that takes. Initial feedback shows that investors have begun to develop their understanding of IFRS.

- 4. Regulatory environment**

There are concerns about how IFRS might be incorporated into regulatory regimes. Some regulators have commented that incorporating IFRS directly into US GAAP would resolve a number of significant issues. However, some industry regulators remain concerned about: the costs of modifying processes and systems; whether there is sufficient ability to influence the IFRS standard-setting process; and the lack of industry-specific guidance.

- 5. Impact on issuers**

The SEC is continuing to assess the logistics and the level of effort required to make the change to IFRS. To date, it has focused on the effect IFRS would have on contractual arrangements and compliance with corporate governance standards.

- 6. Human capital readiness**

The SEC plans to seek the views of academics and others to understand how long it will take to educate people ahead of transition. Meetings are also planned with accounting firms, foreign regulators and others to understand the potential impact on audit quality, cost and competitiveness.

[www.sec.gov](http://www.sec.gov)



## Disclosure framework under scrutiny

A pan-European group of advisors has been appointed by the European Financial Reporting Advisory Group (EFRAG) in response to concerns from some quarters that the financial disclosure requirements under IFRS fail to provide a clear picture of a company's health. The group will support the work of EFRAG in developing a disclosure framework.

The advisory panel brings together representatives from the large accountancy firms, industry and academia. They are joined by observers from the Committee of European Securities Regulators (CESR) and the International Auditing and Assurance Standards Board (IAASB).

The group will advise EFRAG in developing a disclosure framework that will improve the presentation and relevance of information in financial reports. The first stage will be to release a discussion paper in 2011 to stimulate debate about the content and form of disclosures in the financial statements.

A similar group has been established by the US Financial Accounting Standards Board to work with the Securities Exchange Commission to develop a framework that includes disclosures outside the notes to the financial statements. EFRAG and the FASB have been encouraged to share views as their projects progress.

[www.efrag.org](http://www.efrag.org)

## Headcount boosted



The Financial Accounting Standards Board (FASB), the US standard setter, is increasing its board membership from five to seven – marking a return to its original size. The board operated with seven members from its inception in 1973 until 2008, when a reduction to five members was made. The expanded board is expected to be in place by early 2011, once the process to recruit and evaluate candidates has been completed.

Jack Brennan, chairman of the Financial Accounting Foundation, which oversees the FASB, said: "Returning the board to the seven-member structure will enhance the FASB's investment in the convergence agenda with the International Accounting Standards Board, while addressing the unprecedented challenges facing the American capital markets."

### Board changes

Robert Herz has retired from his chairmanship of the FASB, after more than eight years in the leading role. Mr Herz described his years as chairman as "among the most professionally challenging and personally satisfying of my career". His retirement came as a surprise – his term of office was due to extend until 30 June 2012. Mr Herz was a strong supporter of the 'fair value' model for the reporting of financial assets – an issue of ongoing debate.

Leslie Seidman, a FASB member since July 2003, became acting chairman on 1 October 2010. Prior to joining the board, Ms Seidman managed her own consulting firm and previously served as vice president of accounting policy at JP Morgan.

Mr Herz's membership place on the board has now been filled by Russell Golden, previously technical director of the FASB.

## Advisory committees expand numbers

The Trustees of the IFRS Foundation have expanded the membership of two XBRL advisory committees - the XBRL Advisory Council (XAC) and the XBRL Quality Review Team (XQRT) - to provide a broader range of international views.

The XAC and XQRT now have greater representation from auditors and preparers, financial institutions, accounting bodies, standard-setters, regulators and software vendors. Their role is to provide strategic advice to the IFRS Foundation on the global adoption and implementation of the IFRS taxonomy as its use spreads.

The new committee members will join reappointed members in office from 1 January 2011 for a three-year period. Both chairmen have both been reappointed.

"I am honoured to have been reappointed chairman of the XAC", said Bruno Tesnière, chairman of XAC and partner at PwC France. "The calibre of the



applications received and of the newly-appointed members is testimony to the growing interest and significance of XBRL reporting around the world, which goes hand in hand with financial reporting, and in particular IFRS."

The XQRT is chaired by Roland Hommes, a data architecture consultant to the Dutch Standard Business Reporting Programme.

[www.iasb.org/xbrl](http://www.iasb.org/xbrl)

## Joint voice for IFRS dialogue



India and Japan have signed a Memorandum of Understanding (MoU) to jointly address critical issues around International Financial Reporting Standards (IFRS). The aim is to tackle any concerns they have on application or convergence and to strengthen their say on hot topics at the International Accounting Standards Boards (IASB).

The MoU was signed during the first meeting of the newly created India-Japan Joint Working Group in July 2010. The group has representation from the regions' governments, stock exchanges, regulators, accounting standards boards, accountancy bodies and others.

The MoU will focus on facilitating exchange of views and cooperation on legal, regulatory and other issues. It will also strive for consensus and seek to provide leadership on emerging issues by engaging with global, regional, intra-regional organisations and its member bodies.

The next meeting takes place in 2011.

[www.ica.org](http://www.ica.org) and [www.asb.or.jp](http://www.asb.or.jp)

## Three steps to IFRS

The Nigerian Federal Government has announced a staged approach to adoption of IFRS, starting in 2012.

The September announcement follows recommendations from the Stakeholders' Committee on the Roadmap for the Adoption of IFRS in Nigeria. This was set up a year ago to consider the best route to strengthen the credibility and reliability of financial reporting in Nigeria.

IFRS adoption is being approached in three stages:

- **Phase 1** – Publicly listed entities and significant public interest entities will prepare their financial statements using applicable IFRS by 1 January 2012.
- **Phase 2** – Other public interest entities are expected to mandatorily adopt IFRS, for statutory purposes, by 1 January 2013.

- **Phase 3** – Small and medium-sized entities (SMEs) will mandatorily adopt IFRS for SMEs from 1 January 2014.

Entities that do not meet the criteria to report under IFRS for SMEs will report using Small and Medium-sized Entities Guidelines on Accounting (SMEGA) level 3, issued by the United National Conference on Trade and Development (UNCTAD).

Responsibility for implementing the roadmap will fall to the Nigeria Accounting Standards Board (NASB). The board is expected to fully converge local accounting standards with IFRS, and has been tasked with ensuring a smooth transition. In addition, NASB has responsibility for creating awareness on the potential impact of conversion to IFRS, identifying regulatory synergies and providing education and training.

## Long road to IFRS

Following six years of deliberation the requirement for listed companies to prepare consolidated financial statements according to International Financial Reporting Standards (IFRS) has passed into Russian federal law. According to the law, only consolidated IFRS financial statements should be prepared. Standalone financial statements will continue to be prepared in accordance with Russian Accounting Standards (RAS).

Disagreement over which companies should produce consolidated financial statements in accordance with IFRS was believed to be the main reason for the legislation's slow passage through the State Duma.

"IFRS adoption will improve transparency and comparability of Russian companies," said Adrian Dadd, ACS leader in PwC in Russia. "This will improve investor confidence and should open up the market."

The new law will apply to companies listed or quoted on a stock exchange and/or other trading platforms on the securities market. Many of these companies already produce IFRS accounts.

The date that the law comes into effect for companies listed on the Russian stock exchange will be triggered when the Russian translation of IFRS is officially adopted. Companies will need to prepare IFRS consolidated financial statements from the year following the official adoption.

Slava Sokolov, partner in the Russian Statutory Accounting group said: "Broader adoption of IFRS will eventually impact on business processes, accounting systems and possibly the tax system. There will also be a huge need to train accounting professionals on the different requirements."

INTERNATIONAL INTEGRATED REPORTING COMMITTEE

# *IIRC aims for new model 'fit for the 21st century'*

The formal launch of the International Integrated Reporting Committee (IIRC) in August is evidence that many prominent stakeholders believe much more thought and effort is needed globally to ensure reporting of company performance develops in a way that is market relevant, cohesive and accessible (see also, *World Watch*, Issue 2 2010, page 37).



David Phillips, corporate reporting partner at PwC said: "This is an important step on the journey to create a new corporate reporting model fit for the 21st century."

The first meeting of the IIRC steering committee in London, agreed to a radical programme to develop the integrated reporting framework. It also committed to engage the G-20 in 2011 on the changes that need to be put in train to integrate mainstream financial reporting with other significant information, such as on governance, remuneration and environmental and social issues.

Stakeholders involved in the project include regulators, stock exchanges, accounting firms and businesses, such as Nestlé, Aviva, EDF, HSBC and Tata, and influential not-for-profit groups such as

the Global Reporting Initiative and the Accounting for Sustainability Initiative.

It is significant that the initiative is also backed by the International Accounting Standards Board and the US Financial Accounting Standards Board. "The case for globally consistent financial reporting standards is well understood and accepted," said IASB chairman Sir David Tweedie. "It is appropriate to apply the same global approach to other aspects of corporate reporting. This initiative represents an important step on that journey."

The intention is to provide consistent standards to help with the development of more comprehensive and comprehensible information about an organisation's total performance (prospective as well as retrospective) to meet the needs of investors.

Currently, the quality and relevance of reporting on non-financial information varies widely, largely because there is no single set of globally accepted standards for measuring and reporting this information.

Professor Mervyn King, GRI chairman said: "Integrated reporting...equips companies to strategically manage their operations, brand and reputation to stakeholders and be better prepared to manage any risk that may compromise the long-term sustainability of the business."

Ian Ball, CEO of the International Federation of Accountants added: "The goal of the IIRC is not to increase the reporting burden on companies and other entities. Rather, it is to help them and all their stakeholders make better resource allocation decisions..."

# International call for integrated reporting

**Business leaders from around the world have called for drastic changes in the format of financial reporting. Their recommendations result from the final phase of the International Federation of Accountants' project on the financial reporting supply chain.**

In detailed interviews, 25 business leaders from around the world – representing companies, regulators, investors, accountancy firms and other interested parties – gave their views on what should be done to improve corporate governance, business reporting and auditing in the aftermath of the financial crisis.

The interviewees called for major changes to financial reporting, arguing that current reports are becoming less relevant due to their complexity and narrow focus. They suggested a new form of integrated, connected and holistic business reporting focused on the social, environmental and economic fundamentals of an organisation. However, they highlighted that this will require all stakeholders to deal in a coordinated way with potential barriers to change, such as litigation risks and stifling, box-ticking regulation.

Consensus also emerged on the need for organisations to learn lessons from the financial crisis, evaluating what went wrong and taking measures to prevent it happening again. In doing so, directors must realise that stakeholders' primary interest is the performance of an organisation.

The business leaders also emphasised the increasing significance of organisations for a wide stakeholder group – their clients, employees, suppliers, governments, regulators, financial markets and societies as a whole – as well as their owners. Organisations must therefore adopt a wider stakeholder view and take into account social, environmental and economic factors when determining their performance objectives. They should also strive for better integration of governance and sustainability issues into their strategy, operations and stakeholder communications.

IFAC is publishing the interview transcripts grouped into five themes (see box), supported by summary articles drawing together key findings and recommendations.

Building on the interviewees' recommendations, and on any feedback received from other interested parties through completion of online surveys, IFAC is developing an action plan and principles-based international good practice guidance, *Evaluating and Improving Business Reporting in Organisations*.

## The five key themes

1. Good governance and sustainability fundamental for improved business reporting
2. Business reporting beyond the crisis: How to make sure that we don't tumble into another black hole
3. Business reporting through the lens of the investor
4. A global language for business reporting
5. Towards a broader view of business reporting

[www.ifac.org](http://www.ifac.org)

## CORPORATE PERFORMANCE MANAGEMENT

# Moving beyond finance

**Companies are looking to performance management to optimise their cost-to-value ratios and evaluate performance on a real-time basis, according to PwC partner Gary Apanaschik. He reports that as companies start to emerge from the after-shocks of the financial crisis, corporate performance management disciplines are moving rapidly beyond the finance department and into operations arenas.**

Top-performing companies are applying corporate performance management to activities such as:

- Pinpointing the new customer segments that will show the strongest growth
- Gauging the success of new product development

- Guiding the organisation's approach to mergers and acquisitions
- Influencing how employees are evaluated – and compensated
- Identifying and tracking supply chain costs
- Quantifying the risks of outsourcing non-core functions

Mr Apanaschik reports a growing trend for information systems that support these activities to provide one integrated information set. "This gives executives a continual flow of coherent, actionable information to guide their operational and financial decisions – they can see how each cost relates to a specific activity and to a related benefit. Companies are using corporate performance management to help them address the

fundamental questions of: How are we doing? What should we be doing?"

## Questions business leaders are asking to help meet the reporting needs of their investors

- What information do we really need to meet our strategic and operational goals?
- To what extent do our current performance management systems and processes benefit managers outside of finance?
- How do our performance management systems guide our growth?
- What will it take to align our corporate performance management systems and processes with our future business needs?

# Climate change climbs boardroom agenda

Despite the lack of a global climate change agreement, many of the world's largest companies believe carbon management is becoming a real strategic business priority and competitive driver. This is illustrated by that fact that more Global 500, S&P 500 and FTSE 350 companies have responded to the Carbon Disclosure Project (CDP) this year. There is a pronounced increase this year from the BRIC countries (Brazil, Russia, India and China).

The quality of reporting on climate change has increased dramatically as well as participation. The results highlight ways in which organisations are capitalising on commercial opportunities, especially around emissions reductions.

CDP provides institutional investors with analysis of how the world's largest companies are responding to climate change. PwC has been appointed its global advisor and report writer.

Nine out of 10 companies in the Global 500 identified significant commercial opportunity arising from climate change and 65% implemented emissions reduction targets. But, despite significant increase in boardroom engagement, only 19% are showing significant emissions reductions. Actions are being taken to improve emissions reductions, however.

For the first time this year, respondents were asked to highlight their commitments to developing carbon strategies, emissions reduction plans, governance and stakeholder

communication. Leaders in this area have been given a performance score and ranking in a Carbon Performance Leadership Index.

The index highlights the disparity between incorporating climate change strategy across the business and actually seeing concrete cuts in emissions.

Alan McGill, PwC sustainability partner said: "As companies evaluate sustainability trends – such as competition for natural resources, economic globalisation and climate change – the likely outcome is a fundamental shift in business strategy. Leaders in this area recognise the need to design corporate-level objectives to pursue growth while simultaneously reducing emissions."

[www.pwc.com/cdp](http://www.pwc.com/cdp)

## GREENHOUSE GAS PROTOCOL

# Road testing GHG standards complete

More than 60 companies have completed the road testing of new global standards designed to help measure the greenhouse gas (GHG) emissions of their products and supply chains.

As reported in the previous edition of *World Watch* (Issue 2 2010, p31), the two new GHG Protocol standards were developed by the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD). They provide methods to account for emissions associated with individual products across their life-cycles and for company emissions across their value chain.

The 62 companies from multiple sectors and 17 countries started road testing the standards in January. In June, they submitted written feedback on their usability along with final GHG inventory reports. A summary of the feedback is posted on the GHG Protocol website.

"The road testing experience illustrates how developing rules around measurement, reporting and verification involves complex technical and policy



decisions that need real-world feedback to ensure the right balance between rigour and ease of use," said Jennifer Morgan, director of WRI's Climate and Energy Programme.

The companies that road tested the *Product life cycle accounting and reporting standard* reported they had little difficulty completing an inventory to conform with the requirements and found the guidance provided in the draft helpful.

The companies that road tested the *Scope 3 accounting and reporting standard* found it achievable to

complete a Scope 3 inventory and many companies believe it practical to complete one on an annual basis.

The road testers shared similar views on the business value of using the standards. Most road testers agreed that the standards help in:

- Identifying GHG reduction opportunities and prioritising reduction efforts
- Engaging suppliers and enabling supply chain GHG management
- Understanding risks and opportunities associated with emissions in the supply chain
- Creating competitive advantage and product differentiation
- Improving credibility and transparency in GHG reporting

The final text of the standards is expected to be finalised shortly and published by March 2011.

[www.ghgprotocol.org](http://www.ghgprotocol.org)

# Companies suffer from ‘compliance fatigue’ in their corporate reporting

Analysis of how the UK’s top 350 companies communicate with their stakeholders shows that many still fall short of what’s expected of them and risk undermining trust in their management teams and the business, according to PwC research.

The report – *Insight or Fatigue?* – identifies four major challenges to good reporting:

- Compliance fatigue
- Difficulties in assessing the value delivered by the annual report
- Compartmentalised reporting processes
- Weaknesses in the links between strategy, remuneration and key performance indicators

To meet these challenges, PwC has identified a number of actions that preparers of accounts and others, in particular government, should consider if the quality of corporate reporting is to be substantially improved over the levels indicated in the report.

“From talking to preparers of corporate reports, we sense that some are suffering from compliance fatigue

due to successive waves of ad hoc legislation, regulation and governance requirements,” said David Phillips, head of corporate reporting at PwC. “As a result they may be tempted to cherry pick the content they provide – reporting Key Performance Indicators (KPIs), for example, but not necessarily clearly aligning them with the company’s stated strategic priorities or executive remuneration. The challenge is to determine how we can streamline reporting and balance market relevance with regulatory compliance.”

Legislators and regulators should coordinate their activities, added Mr Phillips, to reduce the burden created for companies by constantly changing and overlapping requirements. They should also incentivise the right behaviours to encourage the kind of high quality reporting that leading companies already demonstrate.

The report calls on companies to think about the value of their narrative reporting to investors, working harder to deliver a coherent message and report information that helps users understand

how performance relates to stated strategic aims. It also highlights the need for management and boards to challenge whether their internal management information is of sufficient depth, breadth and quality to enable them to exercise effective oversight and communicate externally.

“The quality of reporting is the tell-tale sign of how well a company is managed and run,” continued Mr Phillips. “Companies that go the extra mile to get it right ensure that what they report externally is directly based on the data they use to manage the business. This requires financial data to be joined up with information on operations, governance and remuneration as well as environmental and social data, in a coherent and integrated way.”

The focus of integrated reporting, Mr Phillips concluded, should be on what’s strategically important and material to business success. He believes that this focus should help companies remove clutter and explain the critical inter-relationships between different data sets.

[www.corporatereporting.com](http://www.corporatereporting.com)

## What’s clear and what’s not in reporting

| Business area reported | What’s clear in reporting        | What’s not clear                    |
|------------------------|----------------------------------|-------------------------------------|
| Market context         | 74% talk about the future        | 13% explain what it means           |
| Strategy               | 90% include strategic priorities | 12% base reporting on strategy      |
| Risks                  | 75% say how they deal with risks | 35% explain each risk fully         |
| Performance            | 88% explicitly identify KPIs     | 25% clearly match KPIs to strategy  |
| Sustainability         | 61% give sustainability KPIs     | 15% link sustainability to strategy |

## Building Public Trust

### Excellence in reporting award winners

FTSE 100: Man Group  
Highly commended: National Grid, Xstrata

FTSE 250: Great Portland Estates  
Highly commended: Amlin, Logica

## Sustainability reporting award winners

FTSE 100: Xstrata plc  
Highly commended: British American Tobacco, Centrica

FTSE 250: The Berkeley Group Holdings plc  
Highly commended: Balfour Beatty, Ladbrokes

# Pressure on business to manage biodiversity risk

The pressure on business to regard biodiversity as an extension of their asset base is growing. Increasingly, ecosystem protection will be factored into investment appraisal and capital allocation decision making for all businesses. Reporting on biodiversity-related risk is therefore expected to increase significantly.

No sector or business in the economy will escape unaffected by changes to the availability of environmental resources for business and consumers, according to analysis by PricewaterhouseCoopers as part of a study by the UN Environment Programme (UNEP) examining the economics of biodiversity and ecosystem loss for business.

The study – *The Economics of ecosystems and biodiversity (TEEB)* – indicates that scrutiny of big business and its impact on the world’s natural capital is likely to intensify as better evaluations and assessments come to the fore. Already, TEEB estimates the global economic impact annually of biodiversity loss at between \$2-4.5 trillion, and this is felt in product pricing, availability of products and financing, and supply chain disruptions for consumers, business and government.

Despite this, the PwC research found that less than one in five companies see biodiversity as an important business issue. Only two out of the world’s largest 100 companies currently manage it as a strategic risk.

Over 50% of CEOs in Latin America and 45% in Africa see declines in biodiversity as a challenge to business growth. In contrast, less than 20% cent of their counterparts in western Europe share such concerns. The findings indicate that corporate chiefs who fail to make sustainable management of biodiversity part of their business plans may find themselves increasingly out of step with the market place.

Unpriced, and largely unaccounted for in business life, the flow and use of natural resources is embedded in the



global economy today. Water used in food and drink production, timber for packaging, furniture and paper, productive land for fruit and vegetables, and fibres for clothes, are just some of the biodiversity and ecosystem ‘services’ whose economic value and protection is examined in the study. New accounting and reporting tools will be needed to value these resources.

Malcolm Preston, sustainability and climate change leader at PwC said: “When estimates in the study put the economic impact of biodiversity loss at between \$2-4.5 trillion annually, you realise that this is not just about environmentalists and scientists, but economically rational conservation that protects the long-term prospects for business.

“That means putting more value on the resources that supply and sustain business, including companies and projects the financial services sector is investing in.”

The *TEEB for business* report, was part of the TEEB synthesis report launched at the Convention on Biological Diversity in Nagoya, Japan.

## 5 steps any concerned company can take:

1. Educate senior management on ecosystem services and biodiversity loss and the role they can play in reducing this
2. Understand your ecosystems and biodiversity ‘footprint’ (including supply chain risks)
3. Manage the local impact of your operations in areas with high biodiversity values, working in partnership with the conservation community
4. Strive for a net positive impact on ecosystems and invest in projects overseas where your support can make a real difference
5. Engage your customers to help them understand the efforts you are making

[www.teebweb.org](http://www.teebweb.org)

# Direction for business clearer

A major international conference on biological diversity in Nagoya in October agreed a new strategic plan to address biodiversity loss – many of the targets are directly relevant to business. The 10-year strategic plan is intended to guide national and international efforts and includes a requirement for national plans to be operational by 2012 and to at least halve the rate of loss of natural habitats by 2020.

A long-awaited and wide-ranging deal on Access and Benefit Sharing (ABS) was also agreed that will guide contracts to be developed at a national level by which companies can obtain or maintain access to genetic resources. The ABS Agreement will be particularly relevant for companies with products derived from genetic resources, such as pharmaceuticals. Access to these resources is now likely

to come at a price and will require prior planning and negotiation.

Following the conference, many countries will be developing national accounts of their ‘natural capital’ for the very first time. These accounts will attempt to capture the health of ecosystems, and in due course their economic value as well. As these national accounting systems develop, companies in these countries may face regulatory requirements to account for and report their own impacts on biodiversity and ecosystems.

Agreements also included an expansion of protected areas to 17% of the world’s land and 10% of its oceans. As a result of this and other measures, companies in primary industries are likely to experience increased challenges obtaining resources that rely on

access to land and seas. Downstream operators may be expected to demonstrate that raw materials in their supply chain are not being sourced from protected areas, or that, where they are, this is being done on a legal and sustainable basis.

Financial services will also be affected as new markets will be needed to leverage private-sector finance, potentially on a similar basis to the development of global carbon markets.

“The message for business from the strategic plan is clear: destructive extraction, harvesting, and production techniques have less than 10 years to drastically alter, or become extinct,” said PwC biodiversity specialist Chris Knight.

[www.pwc.uk/forestry\\_ecosystems](http://www.pwc.uk/forestry_ecosystems)

## EUROPEAN COMMISSION

# Proposals on remuneration

The European Commission (EC) has determined that financial sector companies should assess their capital adequacy requirements against risks that include risks arising from remuneration policies. Accordingly, the Banking Consolidation Directive – known as the Capital Requirements Directive (CRD3) – has been amended to include requirements on the supervisory review of remuneration policies in regulated banks, building societies and investment firms.

The main remuneration provisions of CRD3 apply to senior management, risk takers, control functions and employees receiving total remuneration similar to senior management. The requirements are seen by many to be indicative of the direction of travel for other listed companies, as well as the financial sector.

The scope of CRD3 is much wider than the original remuneration code and covers around 2,500 companies.

Member states are expected to implement the requirements in a way that is appropriate to the size and complexity of individual companies.

The remuneration principles in CRD3 are effective for payments or awards made on or after 1 January 2011 and include:

- Performance-related remuneration should be assessed over a multi-year framework
- Performance measures should be adjusted for risk and take into account cost of capital and liquidity requirements
- At least 50% of variable remuneration should be delivered in shares
- Guaranteed bonuses must be limited to one year and only for new hires
- Incentives in banks that have received government support should be a limited percentage of net revenues



Remuneration disclosures have also been updated in CRD3. Information on the remuneration committee and its activities must be disclosed, for example, and details of the link between pay and performance made clear. The scope of incentive schemes must also be reported, along with quantitative information on remuneration by business area.

## Final reporting framework for climate change launched

The Climate Disclosure Standards Board (CDSB) has issued a final global framework for company disclosure of climate-change related information in their main annual reports. The initial draft was launched at the World Business Summit on Climate Change in Copenhagen.

The aim is to elicit information of value to investors and lenders in gauging how climate change affects company

strategy, performance and prospects. The framework is voluntary and aligned as far as possible with existing standards and principles from bodies such as the IASB, government and regulators. The ultimate aim is to achieve harmonisation of existing standards, not duplication.

The CDSB was formed at the 2007 annual meeting of the World Economic Forum in response to increasing demands for standardised reporting

guidelines on the inclusion of climate change information in mainstream reports.

The CDSB is also conducting a study on how investment professionals are dealing with climate reporting issues to identify how the framework can be used to develop a set of benchmark indicators relevant to institutional investors.

[www.cdsb-global.org](http://www.cdsb-global.org)

## EMISSIONS TRADING SCHEME

### Diverse accounting for carbon

The inconsistent and diverse accounting practices for emission allowances across Europe means that company performance in this area is not comparable, according to a new survey by the Association of Chartered Certified Accountants (ACCA) in partnership with the International Emissions Trading Association.

The study of the largest greenhouse gas emitters in the European Emissions Trading Scheme (ETS) corroborates the findings of previous research in 2007 by

PwC and highlights the seriousness of this issue both for companies and those who use carbon-related disclosures. The issues are expected to intensify with the next phase of the ETS (2013-2020), which will see a shift towards auctioning of emissions allowances, rather than giving them out at no charge.

To date there are no firm rules about how to account for European emission allowances (worth Euro 63bn in 2008), and this uncertainty has allowed a range

of accounting models to flourish. The issue is on the agenda of the international and US accounting standards boards, but the project has been delayed and an exposure draft is not expected until late in 2011.

The ACCA has called on large emitters to work with each other and their auditors to try and harmonise accounting practices in the run up to draft guidance from the IASB.

[www.accaglobal.com/research](http://www.accaglobal.com/research)

## UK GOVERNMENT

### Focus on narrative reporting

The UK government Department for Business, Innovation and Skills (BIS) will shortly issue its conclusions following a consultation on narrative reporting and the directors' remuneration report. It is investigating ways of improving corporate accountability and transparency to enable more effective shareholder engagement.

One of the key aspects of the consultation considers how well the remuneration report explains the relationship between the performance measures for directors' remuneration and the company's strategic objectives.

A recent review of the top 150 UK listed companies' remuneration reports by PwC, looked at how well companies demonstrated a link between key performance indicators (KPIs) and business strategy. The review found that, while many companies state in the remuneration report that the KPIs for directors' annual bonuses are linked to corporate strategy, only around 20% clearly demonstrate that the performance measures for incentive purposes are consistent with the corporate objectives described in the chairman's statement.

"The alignment of incentives with strategy and KPIs is a growing area of focus for both investors and regulators in the UK and internationally," said PwC corporate reporting director Mark O'Sullivan. "It is unlikely that investors will accept a failure to disclose the outcome of performance targets on the grounds of 'commercial sensitivity'." He added that many remuneration committees will need to consider how best to demonstrate that the setting and assessment of these metrics is robust.

[www.bis.gov.uk](http://www.bis.gov.uk)

EUROPEAN COMMISSION

# Statutory audit ripe for debate

The European Commission has launched a ‘green paper’ to gain views on the role of the statutory audit and the wider role of those involved in the audit of European companies. The debate comes on the back of the continuing debate and reflection following the financial crisis and the fact that there was precious little in the way of warnings issued by any market participant

The green paper – *Audit policy: Lessons from the crisis* – poses a number of questions in relation to, among other things, the relevance of the audit, the role of audit firms, and how risk can be better managed.

The commission is keen to gain insight into a number of areas, including:

- The reliance stakeholders can place on audited financial statements. Is there an expectation gap between what investors expect and what the audit delivers?
- The auditor’s communication to stakeholders and regulators about what work has been done, and the findings of the audit. How can this be improved?
- The independence of auditors. Do conflicts of interest exist?
- The potential for systemic risk due to concentration in the audit market. How should risk be assessed and managed?



- The role played by supervisors. Is national supervision fully effective?
- Improving the internal market of audit. How can barriers to auditor mobility be removed?
- The needs of small businesses. Can the administrative burden be reduced?

“The issues covered in the green paper will affect a wide range of

stakeholders, including companies, audit committees and others that prepare and use financial statements, It is important that they engage in the consultation. A number of the proposals could jeopardise the currently good, but continuously improving, quality of the audits delivered to the largest, most complex national and international organisations.” commented Richard Sexton, PwC assurance leader in the UK.

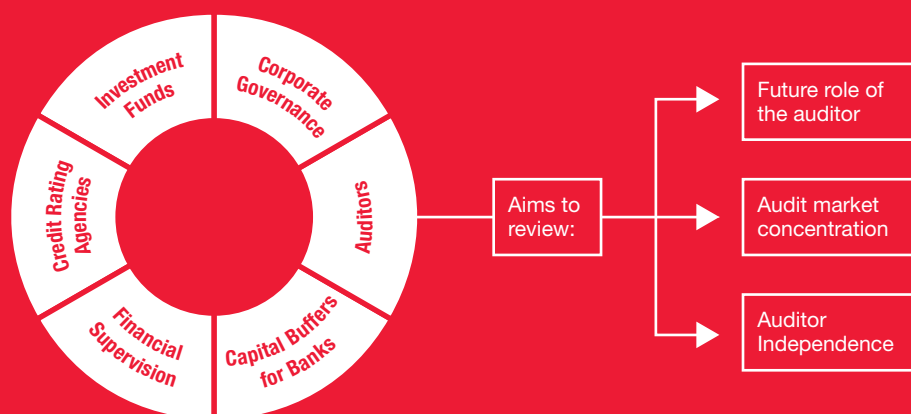
The commission is seeking comments from a broad stakeholder base such as investors, lenders, management, employees, government authorities, auditors, tax authorities, credit rating agencies, equity analysts, regulators, business and SMEs.

The consultation will be followed by a conference in Brussels on 10 February 2011. The commission will decide on the need for any new measures during 2011.

The green paper can be found at [http://ec.europa.eu/internal\\_market/auditing](http://ec.europa.eu/internal_market/auditing).

See Ian Powell opinion article on page 14.

## Key EC initiatives further to the financial crisis



# Using the work of internal auditors

The proposed revision to ISA 610 on using the work of internal auditors has attracted unprecedented interest from audit oversight bodies and regulators. The IAASB is currently considering the responses it has received.

The proposals, released by the IAASB in June 2010 address three key areas:

- How external auditors can use the knowledge and findings of internal auditors to better inform the external auditor's own risk assessment.
- Strengthening the framework for the judgements made by external auditors about when, where and how the external audit can use the work of the internal audit function in obtaining audit evidence.
- Addressing circumstances when internal audit personnel may provide direct assistance to external auditors.

The proposals attempt to find a balance between audit quality, effectiveness and efficiency, and provide a robust framework for the judgements involved. There is some controversy, as there are perceptions by some regulators that there have been instances of undue reliance by auditors on internal audit work.

Responses indicate wide ranging views on the factors that should be taken into account in deciding whether it is appropriate to use internal audit work, and how much work the external auditor needs to do to justify its use.

There are also strongly held, and differing views, on the appropriateness of internal audit staff providing direct assistance to the engagement team. Some respondents have trouble reconciling this with independence requirements.

# Differences on prospectuses

The proposed new assurance standard on pro forma information is designed to enhance public confidence in how such information is produced – which is important in regions, such as Europe, where prospectuses issued in one jurisdiction can be accepted in another.

Comments received on the exposure draft indicate differences of view on whether these engagements should provide assurance on the process of compiling the pro forma information, or on the final pro forma information itself, and whether the auditor's work effort would be fundamentally different under either approach.

[www.ifac.org/iaasb](http://www.ifac.org/iaasb)

# Get ready to comment on new proposals

**The IAASB has asked for comment on a number of exposure drafts, and is preparing to issue several others.**

## Financial instruments

The financial crisis brought into sharp focus the practical issues auditors face, particularly in the audit of fair value estimates and the valuation of assets in illiquid markets.

In a recent exposure draft, the IAASB is proposing a new practice statement that leverages lessons learned in practice in dealing with these issues. IAPS 1000, *Special considerations in auditing complex financial instruments*, does not establish new requirements for auditors, but is designed to provide practical auditing guidance that is educational as well as useful.

## When audits not needed

A priority for the IAASB in 2010 has been to create robust standards for

services that can be used by entities that are either not required or that do not need to be audited to meet business reporting needs. Two EDs are likely to be of particular interest to jurisdictions that are looking to reduce the regulatory burden on small and medium sized entities, including possibly eliminating the requirement for audited financial statements.

An ED for a revision to the international standard on compilation engagements (ISRS 4410) has been recently released. It deals with engagements when practitioners apply their expertise in accounting and financial reporting to assist management in preparing and presenting financial statements or other historical financial information.

Early in 2011, the IAASB expects to issue an ED for a revision to International standard on Review Engagements 2400 when the practitioner is not also the auditor of the entity. The proposals

clarify the work effort and reporting in these limited assurance engagements, and are designed to result in an engagement that, although providing less assurance than an audit, is still a meaningful service for users.

## Assurance goes green

Early in 2011, the IAASB also expects to release an ED on assurance engagements on greenhouse gas statements. With many jurisdictions introducing carbon emissions reduction targets and trading schemes, there is increasing demand for assurance services to enhance the credibility of entities' public reporting of their greenhouse gas inventories.

The proposed new assurance standard addresses both limited and reasonable assurance engagements, and will be followed later in the year with a proposed revision to ISAE 3000, the framework standard for assurance engagements.

# Assurance on ethical conduct

Businesses are putting their reputation at risk by failing to gain assurance that systems and processes are supporting their ethical conduct, according to a recent survey of 144 companies by PwC. Respondents were those with responsibility for managing fraud, corruption and integrity risk and they are members of the PwC Fraud Academy in the UK.

Despite acknowledgement that ethical decisions drive long term value, businesses are not being consistent or robust in how they gain assurance. The PwC survey – *Tone from the top* – found the majority of respondents (52%) use internal audit to provide ethical business assurance, yet only 8% use the services of an independent assurance provider. More worrying, 22% admitted to having no assurance processes in place (see table below).

This raises some fundamental questions that management and the board should be asking:

- Do we have comfort that the organisation is working and adhering to a consistent ethical standard?
- Do we know how effectively processes, procedures and controls to manage ethical risks are designed and operating?
- Do we have the right governance and behavioural framework in place to facilitate good judgement by staff?

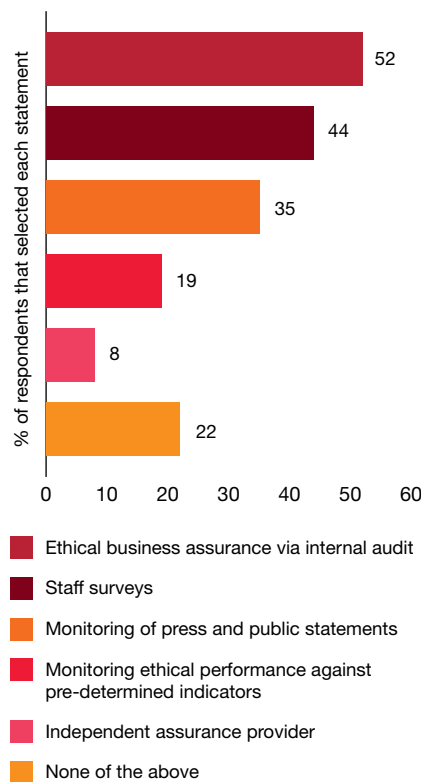
“There are a number of reasons why an organisation would want to seek assurance over the systems and processes supporting its anti-bribery and corruption programme,” said Tracey Groves, PwC forensic services director in the UK. “Assessment of its robustness and comprehensiveness will help to identify areas for improvement. Assurance can safeguard and enhance the organisation’s reputation as a business committed to high standards of integrity and transparency.”

The report outlines some of the reasons why companies are starting to seek

assurance in this area, including:

- Enhanced credibility with internal and external stakeholders
- Validation of the existence and design of the systems and processes supporting the compliance programme
- Provision of a basis for mitigation of sentencing in the event of a bribery incident
- Restored market confidence following the discovery of a bribery incident
- Meeting any future pre-qualification requirements
- Evidence of compliance with the requirements of voluntary and industry initiatives

## How do survey respondents gain assurance?



Base: 144 members of the PwC Fraud Academy

The report can be downloaded from <http://fraudacademy.pwc.co.uk>

# Fast-track to global acceptance



The Malaysian Audit Oversight Board (AOB) has been accepted as a member of the International Forum of Independent Audit Regulators (IFIAR), less than six months after being set up.

The AOB was established in Malaysia in April 2010, under the auspices of the Securities Commission (see *World Watch* Issue 2, 2010). In September the IFIAR welcomed the AOB into its fold as an auditor of public interest entities in Malaysia. Membership brings recognition that the AOB is a well-structured, independent audit regulator on a par with equivalent bodies in other jurisdictions. It represents another step forward in the AOB’s continuing efforts to enhance audit quality in Malaysia.

“The AOB plays a key role in Malaysia’s financial reporting ecosystem”, said Johan Raslan, executive chairman of PwC Malaysia. “Membership of IFIAR will enhance investor confidence by facilitating working arrangements with other member bodies. This will help reinforce international audit oversight co-operation and further increase investor protection.”

## Strategy survey builds picture for the future

The IAASB received over 100 responses on its strategy survey and is now developing a consultation draft of its proposed 2012-14 strategy. It is expected to be released for public comment in early 2011.

Responses were received from a broad range of stakeholders, including preparers, users of financial statements, audit oversight bodies and other regulators, national standard setters, professional accountancy bodies, investors and analysts.

Overall, there was broad agreement that the IAASB's three areas of strategic focus remain appropriate:

- Developing standards
- Monitoring and facilitating adoption of those standards
- Implementation activities designed to improve the consistency with which the IAASB's standards are applied in practice

However, a clear view was expressed across stakeholder groups about the need to shift the allocation of time/resources towards more focus on adoption and implementation.

Views were mixed about the balance of attention the IAASB should pay to ISAs, and to other assurance and related services standards. This reflects the strong demand in the small and medium-sized entity market for services, such as reviews. There was also strong support for projects to address assurance on sustainability reporting, corporate governance statements and internal control.

A key question is likely to be whether the final proposed strategy and workplan will be seen to be sufficiently in tune with the outcome of debates around the scope and relevance of audit.

[www.ifac.org/iaasb](http://www.ifac.org/iaasb)

## Farewell SAS 70



Organisations that provide services to their customers are often subject to independent assessments of the processes executed on behalf of their customers. From next year, the most widespread standard for performing these assessments – *Statement on Auditing Standards (SAS) No. 70* – will be superseded.

For reporting periods ending on or after 15 June 2011, assessments of processes will need to be conducted in accordance with a new US standard, *Statement on Standards for Attestation Engagements 16 (SSAE 16)*. Alternatively, service organisations that need an attestation standard to deliver consistent reporting worldwide can turn to the similar *International Standard on Assurance Engagements 3402 (ISAE 3402)*, issued by the IAASB in December 2009.

Whichever new standard is applied, engagements will have many similarities to those under SAS 70, for example:

- The scope of assessments will be focused on controls likely to be relevant to user entities' internal control over financial reporting
- Reports may include or exclude services provided by sub-service organisations
- The service organisation's description of controls under SAS 70 will generally provide a basis for the system description under SSAE 16 and ISAE 3402

- The service auditor's report will still be restricted to use by the service organisation's management, its customers/service users and customers' auditors

There are however some differences.

For example:

- Under the new US and the international standard, management's responsibilities are formalised by being required to provide a written assertion about the organisation's controls
- Subservice organisations are required to provide a similar assertion when included in the scope of the report
- The service auditor is required to disclose any reliance on the work of internal audit (or other independent management testing functions) within the report

Organisations implementing the new standards may need to prepare by evaluating current control monitoring processes undertaken by management to see if any enhancements are necessary to support management's written assertion.

"The change in assurance standards provides all organisations with a great opportunity to take stock of any reports they produce," said Neil Hewitt, PwC's UK head of third-party assurance. "I would recommend they grab this opportunity with both hands to make the most of the increased trust and transparency that the new standards offer for their commercial advantage."

Mr Hewitt adds that the number of organisations preparing such reports on their services is increasing as the demand for more transparency and trusted information grows.

The change may also be an opportunity to consider reporting on the provision of non-financial services for which there are other reporting standards. To date these non-financial reports have principally been prepared in the financial services and IT sectors, but are becoming more frequent in other sectors.

The focus is typically on areas such as adherence to codes of practice, service levels and security, under SAE 3000.

# Diverse views on how to improve the audit



The Technical Committee of the International Organisation of Securities Commissions (IOSCO) has completed a review of responses from investors, audit oversight authorities, industry and other relevant stakeholders on how auditor transparency and auditor communication could be improved. A diverse range of views emerged, both within and across stakeholder groups – albeit with a disappointing response from investors.

IOSCO issued three consultation papers in September 2009 (see *World Watch* Issue 1 2010, page 24). Given the wide-ranging views held by respondents the technical committee is undertaking further research on auditor communications and auditor transparency, although no further work is planned on auditor ownership.

## Auditor communication

The consultation paper looked at how the standard audit report has evolved in Europe, North America, Australia and Asia.

### Under discussion

- Whether the current audit report meets the needs of financial statement users, and the advantages/disadvantages of alternative formats

### Commonly held views

- Support for collaborating toward a global approach
- IOSCO, together with other parties considering this topic (eg, IAASB), should consider findings from international organisations

## Transparency of firms that audit public companies

The consultation paper explored whether reporting additional information about audit firms would enhance transparency.

### Under discussion

- The types of disclosures that might be considered in evaluating audit firm governance, audit quality indicators, audit firm financial data and other types of information and the usefulness, risks and benefits associated with enhanced disclosures

### Commonly held views

- Defining audit quality would be challenging or impossible.
- A definition of audit quality is not necessary to address the factors that contribute to it
- Consideration should first be given to the effectiveness of Article 40 of the recently enacted EU Statutory Audit directive

## Exploration of non-professional ownership structures for audit firms

The consultation paper addressed the impact of audit firm ownership restrictions on the availability of audit services.

### Under discussion

- Whether a change to the allowable forms of ownership would affect the availability and continuity of audit services
- The effect of ownership restrictions on audit quality

### Commonly held views

- A change to the ownership structures would not affect large listed companies

## Taking the temperature of implementation

When the Clarity ISAs were released in March 2009, the IAASB committed to monitoring their implementation and gathering information to help evaluate whether further changes may be needed.

The IAASB recently released a report on the results of phase one of this process – *Pre-implementation monitoring*. In this first phase, the IAASB sought input from countries and firms about their experiences of introducing the Clarity ISAs into their national standards or firm audit methodologies.

Key findings from 11 countries and eight larger auditing networks are that the new format, structure and drafting are viewed as helpful improvements. Many thought the added rigour of the new standards was appropriate and a helpful response to issues raised in the global financial crisis.

There were no ISAs that were seen to pose significant difficulties, although there is anxiety about how the new standards can be applied in a cost-effective way to audits of smaller entities. Some respondents also anticipated that there may be practical problems in applying ISA 600 on group audits, particularly to significant components by size that the group doesn't control.

National standard setters are making some modifications when adopting the clarity ISAs, often adding requirements to deal with particular national laws. But in some circumstances, ISA requirements have been modified, or existing national requirements retained. Most national standards retained their own name and few have taken the step of making an unambiguous statement about the conformance of their national standards with the ISAs, nor provided a detailed trail of the modifications.

The second phase will be a post-implementation review, which will be done when the clarified ISAs have been in use for two years.

## Diary dates

| Date                       | Key upcoming events                                   | Location/Contact   | Sponsors/Organisers                             |
|----------------------------|---|--|---|
| 2-5 January 2011           | 2011 Winter Global Conference on Business and Finance | Las Vegas, US<br><a href="http://www.theIBFR.com">www.theIBFR.com</a>  | The Institute for Business and Finance Research |
| 26-30 January 2011         | World Economic Forum Annual Meeting                   | Davos, Switzerland<br><a href="http://www.weforum.org">www.weforum.org</a>   | World Economic Forum                            |
| 9-10 February 2011         | Financial Reporting and Auditing – A time for change? | Brussels, Belgium<br><a href="https://webgate.ec.europa.eu/fmi/scic/AccountAudit11/start.php">https://webgate.ec.europa.eu/fmi/scic/AccountAudit11/start.php</a> | European Commission                             |
| 10-11 February 2011        | IFRS Foundation Trustees meeting                      | Tokyo, Japan<br><a href="http://www.iasb.org">www.iasb.org</a>   | International Accounting Standards Board        |
| 16 February 2011           | BASE 2011   | London, UK<br><a href="http://www.baseshow.co.uk">www.baseshow.co.uk</a>   | Business and a Sustainable Environment          |
| 16-17 February 2011        | 2nd International Accounting & Business Conference    | Johor, Malaysia<br><a href="http://iabcc2011.uitm.edu.my/">http://iabcc2011.uitm.edu.my/</a>   | University Teknologi MARA                       |
| 28 February - 1 March 2011 | ICGN 2011 Mid-Year Conference                         | Kuala Lumpur, Malaysia<br><a href="http://www.icgn.org/conferences">www.icgn.org/conferences</a>   | International Corporate Governance Network      |
| 9 March 2011               | Investing in a Sustainable Future                     | New York, US<br><a href="http://www.ftconferences.com/csr2011">www.ftconferences.com/csr2011</a>   | Financial Times / Social Investment Forum       |
| 17-18 March 2011           | Responsible Business Convention                       | London, UK<br><a href="http://www.csr360gpn.org/">http://www.csr360gpn.org/</a>  | Business in the Community (BITC)                |

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***'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.'***

Corporate reporting hot topics and the emerging issues that companies, investors and other interested parties

need to think about are discussed in the PwC blog. It was set up in recognition of the growing importance and rapid changes in this area.

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

responsibility for communicating and analysing corporate performance.

Recent postings have included: thoughts on collaborative working and integrated reporting, 'Insight or fatigue?' – a review of FTSE 350 reporting, and a progressive agenda to rebuild trust.

[pwc.com/worldwatch](http://pwc.com/worldwatch)