


World Watch*

Governance	3
Broader reporting	9
For the Audit Committee	13

Version for non-executives – Issue 1 2009



Crisis response
Revamping financial supervision

Governance review
Walker reins in financial institutions

Revenue recognition
Significant changes ahead

IFRS
Direction of travel

*connectedthinking

PRICEWATERHOUSECOOPERS 

Danger of divergence

World leaders will shortly be gathering in Pittsburgh, US, for the third summit of the G20 in less than twelve months. The agenda and subsequent communiqués are likely to talk of the need for global regulatory solutions to the banking crisis, the need for global accounting standards, a concerted commitment from governments to reflate their economies and the avoidance of protectionist tendencies.

In times of economic distress, however, the need to protect one's own comes to the fore. So if there is momentum around these issues at the moment, it is largely domestic in nature. Take for example the various initiatives to improve financial supervision. The regulatory responses are now starting to emerge and each comes with its own domestic colouring. As someone put it recently, the number-one priority of every politician and regulator is the introduction of stability to the national banking system and the shoring up of the public finances, the economy and employment.

These are natural instincts. But there is a danger that until these priorities are dealt with, there will be a drift away from the global agenda. That would be a shame, as the benefits of convergence towards global standards are no less than they were before the financial crisis. For multinational companies and the markets, this may mean a period of uncertainty, and potentially increased costs of doing business.

These divergent tendencies are also present in the other big challenge facing the world – namely climate change. While Copenhagen may deliver some form of global agreement, the devil may be in the domestic regulatory details that follow.

The global economy will not benefit if each country reaches for domestic solutions, each with their own 'bells and whistles'. We are already seeing different sets of guidance on carbon measurement emerging, all intended to be helpful, but each likely to create uncertainty and confusion and an unnecessary administrative burden on business at a time of economic challenge.

David Phillips, senior corporate reporting partner
PricewaterhouseCoopers

Richard Keys, global chief accountant
PricewaterhouseCoopers

Contents

Governance

- 3 Proposals to revamp financial supervision
- 4 De Larosière report recommendations
- 5 Obama's five key regulatory reform proposals
- 5 Consider reporting with governance
- 6 Walker reins in financial institutions
- 7 Recommendations on remuneration
- 7 The Combined Code – is it working?
- 8 G20 action on global crisis

Broader Reporting

- 9 Global position needed on carbon reporting
- 10 Business is ready for action on climate change
- 10 Commitment to sustainability pays off
- 11 Model for carbon emissions reporting
- 11 League tables for emissions reduction planned
- 12 Sustainability reports on the rise

For the Audit Committee

- 13 Downturn triggers reporting and audit challenges
- 14 Simplified IFRS
- 14 Fair value in one place
- 15 IASB addresses classification and measurement
- 15 Downturn impact on assumptions for pensions
- 16 Going concern guidance for directors
- 16 XBRL becomes mandatory
- 17 Leases – a preview
- 17 EC moves to adopt ISAs
- 18 Dynamic provisioning – suitable response to the crisis?
- 18 UK adopts ISAs
- 18 Clarity has worldwide support
- 19 What does your reporting say about you?
- 20 Financial statement presentation proposals – impact on cash flow?
- 21 Revenue recognition – changes ahead
- 22 Opinion varies on IFRS in the US
- 24 IFRS under review

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EUROPE

Proposals to revamp financial supervision

On 27 May the European Commission adopted a *Communication on Financial Supervision in Europe*, which proposes the creation of a European Systemic Risk Council (ESRC) to ensure better macro-prudential supervision and a European System of Financial Supervisors (ESFS) for micro-prudential supervision. This is part of a whole package of measures being taken forward by the Commission as a result of the de Larosière report.

European Systemic Risk Council

The ESRC would warn the Ecofin Council or the European Supervisory Authorities of threats to financial stability, whether these are general in nature or specific to one particular member state. Its recommendations would not be binding, but recipients of the recommendations would be required to follow them or give reasons for not doing so.

European System of Financial Supervisors

ESFS would be set up for the supervision of individual financial institutions, consisting of a network of national financial supervisors. The existing financial services committees (the so-called 'level three committees') would be transformed into three

European Authorities: a European Banking Authority; a European Insurance and Occupational Pensions Authority; and a European Securities Authority. Day-to-day supervision of financial institutions would remain the responsibility of the competent national authorities.

The three authorities will ensure harmonised rules through the adoption of binding technical standards and the drafting of interpretation guidelines. In the event of disagreement between national regulators, they will mediate during a conciliation phase after which they will be empowered, as a last resort, to take a final decision binding on all interested parties. They would play a coordinating role in the event of a financial crisis and would provide the ESRC with confidential information on the markets and the

cross-border groups under their supervision on a regular basis.

Next steps

The changes are expected to become formal legislative proposals in the last quarter of 2009, with a view to having them adopted in the first reading by the newly elected European Parliament. As the final legislation will have the form of regulations rather than directives, it will, if adopted, enter into force in early 2010.

Five types of regulation

In its communication, the commission mentioned five types of regulatory and legislative initiatives that it will bring forward this year. Some of those steps have already been achieved, (see panel overleaf).



De Larosière report recommendations

In March the European Commission adopted a communication following the wide-ranging recommendations made by a group of financial experts chaired by Jacques de Larosière (a former managing director of the IMF and former governor of the Banque de France) on how to improve supervision of financial institutions and markets in the EU. The report by the de Larosière High-Level Group was commissioned by the EU Presidency in late 2008, in the light of the financial crisis.



Key recommendations in the de Larosière report included:

- Developing common rules for investment funds across all 27 EU countries
- Reviewing remuneration structures
- The creation of a new pan-EU body under the auspices of the European Central Bank to identify systemic risks at European level and issue warnings to EU supervisors
- Further reflection on the financial and regulatory accounting issues arising from the economic crisis.

‘We support a better global working environment for the financial services sector with improved co-operation and exchange of information,’ said David Devlin, PwC regulatory partner. ‘The proposals set out in the de Larosière report for Europe are an important step towards improving the global environment.’

The proposals in the de Larosière report and the Commission’s own communication (see opposite) were largely consistent with the themes that European leaders wanted to see highlighted at the G20 summit in April (see page 9). The de Larosière report in particular is very broad in its scope, and its recommendations cover both the European infrastructure for financial supervision and the global landscape for market regulation.

Practical issues remain

Even though many market participants share the desire for a sound evolution of the regulatory framework in Europe, there are a number of practical issues that will need to be addressed to implement the proposals.

Mr Devlin concluded: ‘We believe the commission should adopt a careful approach to developing the proposals – analysing the reasons for current differences in regulatory approaches and consulting widely on any proposed EU measures, so as to avoid any unintended consequences.’

For more information visit http://ec.europa.eu/internal_market/finances

EU regulatory and legislative initiatives – supervision of financial institutions and markets

1. A European financial supervision package by the end of May 2009 (See article on previous page)

2. ‘Safety first’ proposals to fill gaps in EU or national regulation

- A comprehensive legislative instrument establishing regulatory and supervisory standards for alternative investment funds – comprising hedge funds, private equity and other fund managers (issued April 2009)
- A white paper on tools for early intervention to prevent a crisis in future (June 2009)
- A report on derivatives and other complex structured products (June 2009) and, based on that, appropriate initiatives to increase transparency and ensure financial stability
- Legislative proposals to increase the quality and quantity of prudential capital for trading book activities and tackle complex securitisation (June 2009), and to address liquidity risk and excessive leverage (Autumn 2009)

3. Ensure confidence in savings, access to credit and consumers’ rights relating to financial products

- A communication on retail investment products to strengthen the effectiveness of marketing safeguards (issued April 2009)
- Further measures to reinforce bank depositor, investor and insurance policyholder protection (Autumn 2009)
- Measures on responsible lending and borrowing (Autumn 2009)

4. Improve risk management in financial firms and align pay incentives with sustainable performance

- Strengthen the Commission’s 2004 recommendation on remuneration of directors (issued April 2009)
- Bring forward a new recommendation on remuneration in the financial services sector (issued April 2009), followed by legislative proposals to include remuneration schemes within the scope of prudential oversight (Autumn 2009)

5. More effective sanctions against market wrongdoing

- A review of the Market Abuse Directive is planned for Autumn 2009
- Proposals on how sanctions could be strengthened and better enforced

Obama's five key regulatory reform proposals

The Obama administration has proposed sweeping financial regulatory reforms designed to ensure stability in the financial markets. The proposals, presented in a white paper – *Financial regulatory reform, a new foundation: Rebuilding financial supervision and regulation* – seek to meet five key objectives: robust supervision of firms and markets; protection of consumers and investors; tools to manage financial crisis; and better international standards and cooperation.

The white paper describes the reasons for each objective and sets out a number of legislative and regulatory actions intended to achieve them. Democratic leaders in Congress have said they intend to pass legislation before the end of 2009. Robust debate is likely, as the proposals are considered highly controversial. Many companies are expected to feel the regulatory and financial impacts.

The proposals are also considered noteworthy for what they don't include. Proposals for a single federal bank regulator, a single capital markets regulator and a federal insurance regulator are all absent.

What is the Obama administration proposing?

1. Promote robust supervision and regulation of financial firms

Proposed actions to include:

- Create a new Financial Services Oversight Council. Financial regulators would identify emerging systemic risks and improve interagency cooperation.
- Give the Federal Reserve new authority to supervise any firm that poses a threat to financial stability, regardless of whether the institution is or owns a bank.
- Mandate stronger capital and other prudential standards for all financial firms and even higher standards for large, interconnected firms.
- Register hedge funds advisers and other private pools of capital with the SEC.

2. Establish comprehensive supervision of financial markets

Strengthen financial markets to withstand both system-wide stress and

the failure of one or more large institutions. Proposed actions:

- Better regulation of securitised markets, including new requirements for market transparency, and stronger regulation of credit rating agencies
- Require issuers and originators to retain a financial interest in securitised loans
- Federal Reserve to oversee payment, clearing and settlement systems
- Create comprehensive regulation of all over-the-counter derivatives (see also PwC publication *Should All Customized Derivatives Be Standardized?*).

3. Protect consumers and investors from financial abuse

To rebuild trust in the markets, new protections would be provided for consumer financial services. More transparent, less complex financial products are also envisaged with fairer access to financial products. Proposed actions include: creating a new Consumer Financial Protection Agency and strengthened regulations to improve transparency and fairness.

4. Provide the government with the tools to manage financial crises

Proposals here include: a new regime to resolve non-bank financial institutions whose failure could have serious systemic effects; and revising the Federal Reserve's emergency lending authority to improve accountability.

5. Raise international regulatory standards and improve international cooperation

The US proposes to continue work with the G20 to establish more consistent regulatory standards across jurisdictions, including to: strengthen the capital framework; improve oversight of global financial markets; coordinate supervision of international active firms; and enhance crisis management tools.

For extensive analysis see PwC's white paper – *The Obama Administration's 'New Foundation for Rebuilding Financial Supervision and Regulation'* on www.pwc.com

Consider reporting with governance

The Report Leadership Group's comments on the Walker Committee review of corporate governance in the UK banking industry highlights the importance of looking at the issues of governance and reporting in parallel.

It points out that the quality and scope of information is a critical determinant of how well a company is managed by its executive team and whether non-executive directors are in a position to exercise effective governance. Reporting also affects a company's ability to communicate effectively to its shareholders and shareholders' ability to exercise effective oversight.

Is good governance working?

The group argues that one sign of whether governance is working is a company's overall commitment to transparency and its ability to present a joined-up picture of the activities that are critical to its corporate success. It concludes that very few companies today achieve this joined-up picture.

The letter called on the Walker Committee to focus on a company's ability to:

- Explain its strategy and provide evidence that it is grounded in a real understanding of the markets in which it operates and the factors that will have an impact on it across the economic cycle
- Explain the dynamic of the business model and the key risks and relationships to which it is exposed
- Articulate its risk appetite and how this is reinforced by the tone from the top, the cultures and behaviours of the organisation and the structure of remuneration and incentive schemes.

'With so much scrutiny of governance at the moment, it may be a good time for companies to reassess whether they have good enough governance in place,' said PwC corporate reporting partner David Phillips.

www.reportleadership.com

Walker reins in financial institutions

An independent review of the corporate governance of banks and other financial institutions in the UK has led to 39 recommendations to improve the way they operate, particularly in the areas of risk management, remuneration, board behaviour and regulation.

Sir David Walker, a former executive director of the Bank of England, was engaged by the UK government to make recommendations on:

- The effectiveness of risk management at board level
- The balance of skills, experience and independence required on the boards
- The effectiveness of board practices
- The role of institutional shareholders
- International best practice.

The Walker Review was made public in July 2009 as a consultative document.

The report recognises that financial institutions' excessive, risk-taking culture played its part in the global financial crisis, and a lack of governance contributed to this. To counter this and avoid a future repetition, it says that weaknesses in risk management, board quality and practice, control of remuneration, and the exercise of ownership rights all need to be addressed both in the UK and internationally.

Sir David said: 'The recommendations on remuneration are as tough or tougher than anything to be found elsewhere in the world, an important and urgent

challenge is to promote adoption of similar approaches internationally.'

The findings of the Review can be summarised under five main themes.

1. Corporate governance

The Financial Reporting Council's Combined Code on Corporate Governance remains fit for purpose. However, the code's 'comply or explain' principles could be strengthened if combined with robust capital and liquidity requirements and a tougher stance on the part of the Financial Services Agency.

2. Board behaviour

The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risks and strategic issues. This will require close attention to board composition to ensure the right mix of capability and experience. It will also require a materially increased time commitment from non-executive directors and the chairman.

3. Risk management

Board-level engagement in the high-level risk process should be materially increased. A dedicated non-executive director focused on risk issues is needed as well as an executive risk committee process and full independence in the group risk management function.

4. Investor engagement

Fund managers and other major shareholders should engage more productively with their investee

companies to support long-term performance improvement – and boards should be more receptive to this. Fund managers should be expected to conform to principles of stewardship on a 'comply or explain' basis to provide comfort to prospective clients.

5. Remuneration policies

Substantial enhancement is needed in board level oversight of remuneration policies. Board remuneration committees' responsibility should be extended beyond board members to cover the remuneration framework for the whole entity. In addition, not less than half of expected variable remuneration for executive board members and other senior executives should be on a long-term incentive basis, with vesting, subject to performance conditions, deferred for up to five years.

'These proposals are designed to improve the professionalism and diligence of bank boards, increasing the importance of challenge in the board environment,' concluded Sir David. 'If this means that boards operate in a somewhat less collegial way than in the past, that will be a small price to pay for better governance.'

Next steps

The consultation document is open for public comment until 1 October, with conclusions expected in November 2009. The independent review will make recommendations to the UK government, which will then make a decision on which of the recommendations to adopt.

www.hm-treasury.gov.uk/walker_review_information

The Walker Review proposals in brief

- Board level risk committees chaired by a non-executive
- Risk committees to have power to scrutinise and if necessary block big transactions
- More power for remuneration committees to scrutinise firm-wide pay
- Remuneration committees to oversee pay of high-paid executives not on the board
- Significant deferred element in bonus schemes for all high-paid executives
- Increased public disclosure of remuneration for high-paid executives
- Chairman of remuneration committees to face re-election if report gets less than 75% approval
- Non-executives to spend up to 50% more time on the job
- Non-executives to face tougher scrutiny under FSA authorisation process
- Chairman of board to face annual re-election
- Financial Reporting Council to sponsor institutional shareholder code
- FSA to monitor conformity and disclosure by fund managers
- Institutional shareholders to agree Memorandum of Understanding on collective action

EC

Recommendations on remuneration

The European Commission (EC) has issued two recommendations covering remuneration policies in the financial services sector and the regime for the remuneration of directors of listed companies. As a result, companies operating within the EU are likely to be required to strengthen their governance processes and reporting of remuneration.

The move follows a statement of principles for sound compensation practices issued

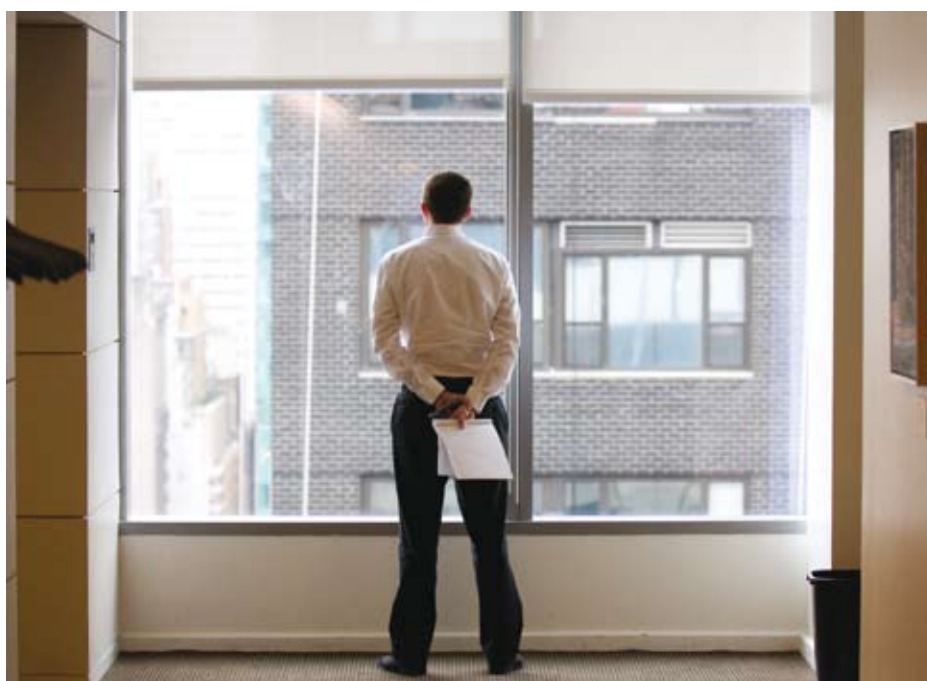
by the Financial Stability Forum in early April (and endorsed by the G20 leaders at their summit in London). This was wholly consistent with the UK Financial Services Authority's (FSA's) draft Code of Practice on remuneration, issued in March 2009.

Member states must take measures to promote the application of the EC recommendations by 31 December 2009. In many territories some of the provisions are already included in local regulation

and/or may already be reflected in companies' remuneration structures. But some change is expected for most companies.

Examples of recommended practices that may not be in common use already include:

- Directors' contracts should provide for claw-back of bonuses where performance is subsequently proved to be misstated
- Directors should retain a fixed number of shares until their retirement from the board (eg, twice total annual remuneration)
- Information should be shared on: the policy for retention of shares following the vesting of awards and the composition of peer groups used to determine remuneration policy
- The remuneration committee should ensure that remuneration of individual executive directors is proportionate to that of other executive directors and members of staff
- The implementation of the remuneration policy (for financial sector companies) should be subject to central and independent internal review by control functions for compliance on at least an annual basis.



UK

The Combined Code – is it working?

The Financial Reporting Council (FRC) in the UK has announced a review of the Combined Code for corporate governance. A progress report was issued on 28 July, incorporating the recommendations of the Walker review, with an exposure draft of proposed changes due before the end of the year.

Sir Christopher Hogg, chairman of the FRC, has been meeting chairmen of FTSE 350 companies to gather evidence and to seek first-hand views of how well the code and the 'comply or explain' mechanism is perceived to be working. Anecdotal

evidence suggests that the code is working, but could potentially benefit from some adjustments in areas such as: executive remuneration; time commitment; expertise and independence of non-executive directors; shareholder engagement; and the board's responsibility for risk assessment and risk management.

'There will be considerable pressure to make revisions to the code, but the justification for any change should be based on substantive evidence generated by independent research,' said PricewaterhouseCoopers governance

director Margaret Cassidy. 'Clearly, the whole system isn't broken, so the FRC might want to look at sectors or businesses that have survived, or even thrived in the current climate, and consider what has worked well.'

The next steps for the FRC will be to establish whether there are weaknesses in the framework provided by the Combined Code, or whether the issues that led to the economic crisis were a result of poor implementation of the framework.

www.frc.org.uk

G20 action on global crisis

Graham Gilmour analyses the outcomes of the G20 summit in April and the implications for regulatory scrutiny and standard setting



Graham Gilmour

The UK hosted the summit of the Group of Twenty (G20) leading developed and developing nations in London earlier this year. The event was a follow-up to the G20's Washington summit last November, which was called to analyse and respond to the global financial crisis.

At the April summit, the leaders issued a number of new communications – each of which has an impact on accounting and financial reporting.

The main communiqué called on the accounting standard setters 'to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards.'

The leaders also agreed a *Declaration on strengthening the financial system* that covered a number of areas including:

- Setting up an expanded and enhanced Financial Stability Board (formerly the Financial Stability Forum) with a broadened mandate to promote financial stability
- Strengthening international frameworks for prudential regulation and cross-border regulatory cooperation
- Including all systemically important financial institutions, markets and instruments within the scope of appropriate regulation and oversight
- Endorsing international principles on pay and compensation in significant financial institutions
- Taking action on tax havens and non-cooperative jurisdictions
- Introducing more effective oversight of credit rating agencies

G20 declaration – impact on accounting

We have agreed that the accounting standard setters should improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons, while reaffirming the framework of fair value accounting.

We also welcome the FSF recommendations on pro-cyclicality that address accounting issues. We have agreed that accounting standard setters should take action by the end of 2009 to:

- Reduce the complexity of accounting standards for financial instruments
- Strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information

- Agreeing that accounting standard setters should improve standards in a number of respects (see box below).

Taken as a package, the recommendations demonstrate the reality in the current economic environment of continued regulatory and political scrutiny of accounting standards and standard setting. The IASB reacted to the outcome of the April summit by issuing a paper showing how it proposed to respond to each of the recommendations, recognising that many actions were already in progress. Having to devote time and resources to addressing the accounting matters arising from the financial crisis will continue to have a significant impact on the board's work programme and priorities.

Scrutiny and pressure will remain intense

Political pressure on accounting standard setting is likely to continue to be at its most intense in Europe. The EU finance ministers issued a statement very shortly after the G20 summit, welcoming and reinforcing its conclusions, but also flagging up concerns about the need to maintain a 'level playing field' between IFRS and US GAAP.

A further important outcome from the G20 process is the growing importance of the strengthened Financial Stability Board. The FSB will be undertaking joint strategic reviews of the policy development work of the various international standard setting bodies, including the IASB. There is a keenness in political circles to ensure that organisations such as the Basel Committee on Banking Supervision, IOSCO and the IASB work together more closely, under the umbrella of the FSB, in the interests of maintaining the stability of the financial system.

The next G20 summit will take place in Pittsburgh, US in September. It is likely that attendees will pick up on many of these themes again.

Graham Gilmour is a director in PwC's Regulatory and Public Policy team.

- Improve accounting standards for provisioning, off-balance sheet exposures and valuation uncertainty
- Achieve clarity and consistency in the application of valuation standards internationally, working with supervisors
- Make significant progress towards a single set of high-quality global accounting standards
- Improve involvement of stakeholders within the framework of the independent accounting standard-setting process, including prudential regulators and emerging markets, through the IASB's constitutional review.

www.g20.org

STANDARDS FOR CARBON

Global position needed on carbon reporting

A clear need for a global position on what and how to report on carbon is emerging as many different agencies plan to launch guidance. This year, for example, new carbon reporting guidelines have been published by the Climate Disclosure Standards Board (CDSB), the Confederation of British Industry (CBI), and the UK government (Defra).

In the US, the Environmental Protection Agency has launched its own version of what mandatory carbon reporting will look like for Scope 1 emissions for US corporations. The direction of travel can be clearly seen – it covers not just what to report on carbon, but also how to report decision-useful information.

At the recent World Business Summit on Climate Change, the CDSB launched their exposure draft on a global reporting framework around climate change disclosures. This report, as well as the CBI one, is centred on the factors that a company needs to consider when measuring and managing the impact of carbon on its business. The CDBS framework is the first to demonstrate how reporting on emissions connects financial and non-financial data to see the value and impact of carbon emissions on a business.

PricewaterhouseCoopers has launched the first example carbon report that combines all the elements of these standards to illustrate for companies what they will need to do (see Typico article, page 11).

‘There is a clear need for a global position on what and how to report in this area,’ said Malcolm Preston, PwC global sustainability leader. ‘This is



essential to aid comparability for investors and help companies deal with carbon reduction targets and the emerging transparency requirements around carbon and climate change issues. This area of reporting will

increasingly become part of the mainstream model, and all stakeholders need to consider how it can be developed in a way that enhances user understanding, rather than being seen as an additional regulatory requirement.’

Business is ready for action on climate change

At the recent World Business Summit on Climate Change – the last major business gathering before the UN meeting to agree a new deal on climate change in Copenhagen in December – over 550 business leaders, plus experts, gathered to develop ideas and recommendations for policy makers to support an ambitious global deal.

The overriding message from the meeting is that the economic downturn should not temper the ambitions of governments to achieve a robust climate treaty. The summit recognised that, while action to tackle emissions growth will result in short-term costs, these will be outweighed by the long-term benefit of avoiding dangerous climate change.

Turning risk into opportunity

The summit focused on nine issues, ranging from technology collaboration to adaptation, which are critical in the transition to a low-carbon economy and form key parts of the UN negotiations. Four consistent messages from participants underpinned the recommendations from the meeting:

- Investors need robust, clear and long-term regulatory signals – whether trading programmes, performance

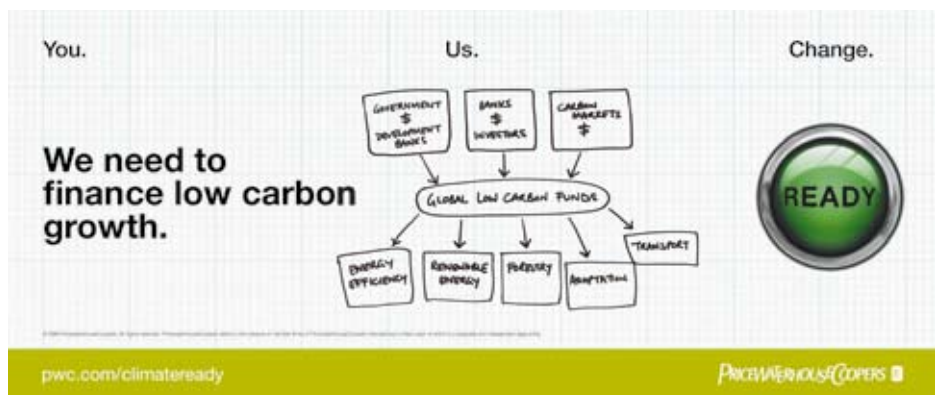
standards or taxes – that provide greater predictability when making long-term capital allocation decisions, such as investment in infrastructure

- New collaborative financing mechanisms – such as green infrastructure funds, public-private partnerships, or ‘climate bonds’ – are needed to support low-carbon technologies that are currently not commercially viable, and to scale up the deployment of those technologies that are commercially viable
- Governments should be ‘technology neutral’ and enable all cost-effective greenhouse gas emissions reductions. The governments should focus on and incentivise energy efficiency improvements and limit deforestation,

as these can deliver significant, cost-effective carbon emissions reductions, as well as provide a range of other benefits

- Better disclosure is essential to drive change among investors and consumers. This includes: disclosure of corporate strategy and capital investment decisions; greater use of carbon labelling and energy-efficiency performance; robust monitoring, reporting and verification protocols; and transparency about the costs and benefits of new government policies.

More details of the recommendations from the summit can be found in the summary of the discussions produced by PwC and the Copenhagen Climate Council, see www.pwc.co.uk/publications



SURVEY

Commitment to sustainability pays off

Companies with a commitment to sustainability tend to outperform their peers during the financial crisis, according to the recent study undertaken by A.T. Kearney.

In 16 out of 18 industries, companies with a commitment to sustainability were the clear leaders in the financial markets, outperforming industry averages by 15% over the six months from May through November 2008. This superior performance averages out to \$650m in protected market capitalisation per company.

The report – *Green Winners: The Performance of Sustainability-focused Companies in the Financial Crisis* – looked at 99 companies identified as having a strong commitment to

sustainability (on the Sustainability Index and Goldman Sachs Sustain Focus List) and compared their performance with industry averages.

‘Our study indicates that the market rewards specific companies,’ said Daniel Mahler, author of the study. ‘We find common characteristics among the leading companies that show that sustainability goes far beyond the narrow definition of being environmentally friendly.’

These characteristics include:

- A focus on long-term strategy, not just short-term gains
- Strong corporate governance
- Sound risk-management practices



- A history of investment in green innovations.

Reducing packaging and fuel consumption are expected to become increasingly common in the current cash-strapped economy, but the report concludes that investing in sustainability for the long term may be the best way to protect a company’s value.

Model for carbon emissions reporting

A carbon emissions reporting model that provides an illustrative example for business on climate change and greenhouse gas emissions reporting has been developed by PricewaterhouseCoopers.



This follows the UK government's launch of the world's first legally-binding carbon budget, aimed at achieving an 80% reduction of carbon emissions by 2050. It is also a response to the Climate Disclosure Standards Board, the new regulatory reporting guidelines in the UK being launched by Defra, and the CBI.

The model is based on a fictitious technology company, Typico plc, which produces consumer durables and IT products with operations in Asia, UK and the US. It illustrates how to report the strategy, targets, performance and benchmarking of a company's work to reduce its impact on, and adapt to, climate change.

To date the format and composition of information published by business on their sustainability strategy has varied widely. While the extent of disclosure will vary according to the nature and size of the company, the Typico example sets out what PwC believes to be good practice for larger companies that will potentially face mandatory reporting of greenhouse gas emissions by 2012.

'This model is the first to demonstrate how reporting on emissions connects financial and non-financial data to see the value and impact of carbon emissions on a business and its strategy,' said Alan McGill, PwC sustainability and climate change reporting partner. 'Information presented in this context will more accurately reflect the real risks – and opportunities – that climate change presents.'

'I expect that forward-looking analysis and statements of the risks and opportunities affecting a business will become an established part of the reporting cycle. This model will support companies' preparations for that by helping them identify the right questions to ask, the right data to measure and report on, resulting in them taking the right actions for their business.'

The Typico plc model forms part of PwC's contributions to the work of the international Climate Disclosure Standards Board, and the CBI Carbon Reporting Group.

UK CARBON REDUCTION COMMITMENT

League tables for emissions reduction planned

From April 2010, thousands of organisations in the UK will have to take part in a mandatory cap and trade scheme for carbon dioxide emissions know as the Carbon Reduction Commitment (CRC), if proposals go ahead as planned.

Those covered by the regulation will have to report emissions each year and will be ranked according to their success in reducing them. The results will be published in a league table and there will be an incentive to reduce emissions by distributing some of the revenue from the worst performers to the best. The scheme is expected to be revenue-neutral to government.

The CRC will not include emissions covered by other regulations such as the EU Emissions Trading Scheme (EU ETS). Eligible emissions are those arising in the UK



from the use of gas, electricity and other fuels for non-transport uses. The first sale of allowances will be in April 2011.

The scheme is different from other carbon trading schemes in that it falls on the organisation, rather than a particular facility. The implications of this approach are very different from the EU ETS. For example:

- Holding companies will need to consolidate emissions from across UK operations
- Investment funds that constitute owners of a business under the 2008 Companies Act will be treated as the parent company. They will need to consolidate data from companies in their portfolios.

Sustainability reports on the rise



The number of companies worldwide publishing sustainability reports rose 8% between 2007 and 2008, according to the global online directory corporateregister.com. However, this is a lower rate of growth than in previous years. Europe stands out as the clear regional leader, with 11,570 reports published since 1992; some way behind are North America (3,486 reports) and Asia (2,910).

There has been a significant shift in the type of reports that companies issue. Throughout the 1990s companies were issuing predominantly environmental reports. However, in the last nine years the trend has moved towards sustainability and corporate social responsibility reports, perhaps due to greater global emphasis on this and greater awareness of the potential impact companies can have on various stakeholder groups.

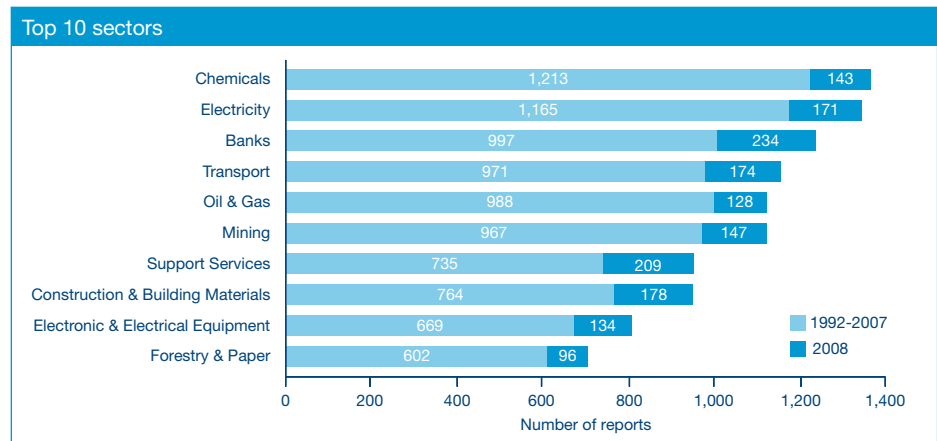
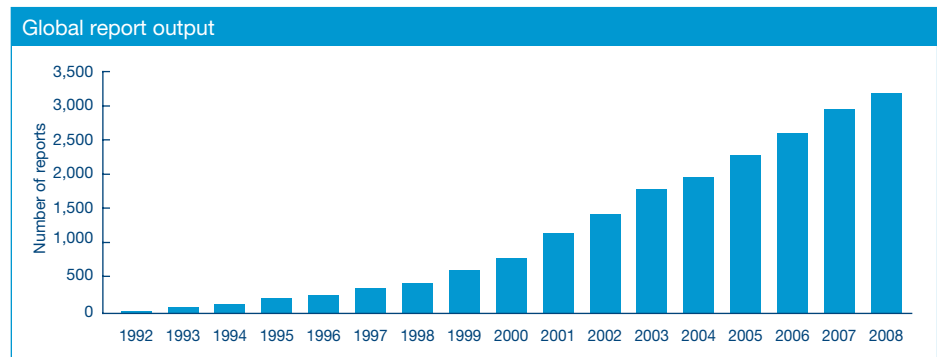
A new trend that has emerged in the last three years is the small, but growing, number of companies that are integrating their sustainability reporting with their main annual report. 'We expect this to be the way forward for many more companies in the next few years,' said PwC sustainability partner Alan McGill. 'With sustainability considerations now integral to business planning and operations, it makes good sense for companies to include them in their main report and show how they are material to the business.'

Sector breakdown

Companies operating within the chemical sector lead the way in sustainability reporting. These are followed by those in the energy and banking sectors. However, looking at just 2008, the banking sector led the way, followed by support services, construction and building material industries.

The leading country by the number of reports published is the UK, with companies issuing a total of 2,909 reports, including 384 published in 2008. The US is in second place, closely followed by Japan.

The corporateregister.com findings are valid as of April 2009.



For the Audit Committee

GOING CONCERN

Downturn triggers reporting and audit challenges

The challenges faced by directors, audit committees and auditors in relation to year-end financial reporting in a downturn are continuing as interim reporting cycles approach. Those challenges include evaluating the effect of the credit crisis and economic downturn on the entity's financial position and performance, as well as on the entity's ability to continue as a going concern.

A problem shared...

Over 70 partners and senior executives from 24 international networks of accounting firms met at a Forum of Firms symposium in London in April to discuss going concern and related audit considerations. The event gave attendees the opportunity to collectively share experiences on some of the practical auditing considerations being faced by auditors across various industries. Participants debated current practices on hot topics, such as: companies' access to funding; implications of going concern on financial statements and audit reports; valuation and impairment; materiality; and internal control implications.

To help guide auditors, the International Auditing and Assurance Standards Board (IAASB) has already released two Audit Practice Alerts: *Audit considerations in respect of going concern in the current economic environment* (January 2009) and *Challenges in auditing fair value accounting estimates in the current market environment* (October 2008). The latter highlighted the challenges in auditing the measurement and disclosure of fair values when market information to value financial instruments is hard to obtain.

Tackling interim financial information

For many companies, issues such as going concern, impairments, valuation, misstatement risk and foreign currency volatility have continued to be significant well beyond signing of the year-end accounts.



The International Standard on Review Engagements (ISRE 2410) outlines responsibilities when conducting a review of interim financial information. It directs the auditor to include an emphasis of matter paragraph to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.

This may be necessary, for example, if the auditor had modified the previous audit or review report and the material uncertainty still exists. Equally, the material uncertainty may come to the

auditor's attention as a result of the auditor's enquiries or other review procedures.

IAS 1, *Presentation of Financial Statements*, clarifies that the guidance on going concern applies equally to interim financial reporting. Thus when management and auditors assess whether the going concern assumption remains appropriate in the interim financial information, they will need to take into account all available information about the future that is at least, but not limited to, 12 months from the end of the interim reporting period.

Simplified IFRS

The IFRS for small and medium-sized entities standard is now available. The standard is intended to be easier to apply, accessible to the majority of private entities and, with the IFRS 'branding', will be internationally recognised and accepted.

The exposure draft issued in 2007 attracted a large number of comments from potential users. The board spent a year deliberating the many technical topics before coming up with a final standard that is less complex than the original exposure draft. The resulting standard demonstrates that the IASB has recognised the different needs of intended users. That is:

- The different character of a private entity compared to a listed entity with public securities market responsibilities
- Cost-benefit considerations relating to the accounting expertise available to private entities.

'There is now a greater differential between the final SME standard and full IFRS,' according to Hugo van den Ende, PwC partner and member of the IASB Working Group on IFRS for Small and Medium-sized Entities. 'For example, the new standard permits amortisation of goodwill whereas full IFRS requires the impairment approach. Simplification in the standard was very much desired, as private entities can now often avoid sophisticated and expensive impairment calculations,' he continued. 'Other key simplifications can be found in the sections on financial instruments and

defined benefit obligations. These and other decisions will further lower the barrier for private entities to apply IFRS for SMEs.'

The IASB has publicly stated that there will be no amendments to the new standard within the first two years of implementation. After that period, an assessment of implementation issues encountered by a broad range of entities will be undertaken.

Future changes to full IFRS will not necessarily mean changes to simplified IFRS. It has been decided, for example, that borrowing costs should be recognised as an expense whereas full IFRS requires the capitalisation of borrowing costs. Similarly, under the SME standard entities are allowed to apply the relatively simple indirect method for the cash-flow statement, whereas it is expected that in the near future the direct method will be the only acceptable alternative in full IFRS.

'We now know that the standard for SMEs is manageable,' said Allan Watson, global PwC private company leader. 'We think the new standard has clear benefits for investors, lenders and those seeking to raise finance through the transparency afforded by a consistently applied, global set of financial reporting standards,' he added. 'The advantages to mid-tier companies around the world applying IFRS include increased comparability, more convenient cross-border acquisitions, improved relationships with overseas customers and improved negotiations with finance providers.'



The IASB is advising jurisdictions not to rush to make the standard mandatory in 2009. It recommends allowing time for companies and auditors to familiarise themselves with the contents and to plan their transition process.

Mr Van den Ende predicts that the standard will be adopted in the near future by a number of territories and companies, but adds a word of caution for those keen to adopt: 'It is very important to consider the consequences for your company. The starting point for a UK-based private company, where the current GAAP is quite close to IFRS, will probably be very different from the starting point for Eastern European companies with reporting standards that are further away from full IFRS.'

For further information see pwc.com, including *IFRS for SMEs: Pocket guide 2009*.

IASB

Fair value in one place

An exposure draft has been issued to try to create a standard that is a single source of guidance for fair value measurement. The ED does not propose any extension of fair value, and has a definition that is very close to the one currently in IFRS.

Guidance on measuring fair value of some assets, liabilities and equity instruments has been added to IFRSs piecemeal over many years. It is also

dispersed across many standards and is not always consistent. Hence the ED's objectives are:

- To establish a single source of guidance for all fair value measurements
- To clarify the definition of fair value
- To enhance disclosures about fair value.

Proposed disclosures are extensive, particularly for non-financial assets and

liabilities that are not already covered by IFRS 7. This includes a fair value 'hierarchy' of inputs into valuations, with disclosures about movements between different levels of that hierarchy. The ED also proposes disclosures about assets that have a 'highest and best use' that is different from their current use. The response period ends on 28 September 2009.

IASB addresses classification and measurement



The International Accounting Standards Board (IASB) has published an exposure draft (ED) that proposes a fundamentally new model for the classification and measurement of financial instruments. This ED is the first phase in a longer process to replace IAS 39, the standard that establishes the accounting treatment for financial instruments, in its entirety.

There is a short comment period, ending 14 September 2009, so that the IASB can meet its commitment to respond to G20 recommendations and publish a standard before the year end. The European Commission has recently called for a final standard by November so that changes can be adopted into European law before the year end.

In this phase, the IASB is proposing that financial instruments will be classified into

two measurement categories: fair value or amortised cost. Financial instruments will be available for classification into the amortised cost category if they: contain only basic loan features; are managed on a contractual yield basis. All other financial instruments will be measured at fair value.

‘We support the continuing efforts to simplify IAS 39,’ said PwC partner Pauline Wallace. ‘Simplification of accounting standards should not be an objective in its own right, but moves to reduce unnecessary complexity for preparers and users are welcome, provided that they result in the presentation of information that is useful as a basis for economic decision-making. The recent financial crisis has highlighted problems for both users and preparers in understanding the existing reporting requirements for financial instruments and the data provided.’

The fundamental changes proposed in the ED are likely to have far-reaching implications for companies with significant portfolios of financial instruments, particularly for those in the financial services sector. Proposals are likely to result in reclassifications between measurement categories in both directions – from amortised cost to fair value and from fair value to amortised cost.

The extent of any net impact on the income statement will depend largely on the complexity of the financial instruments that each entity holds and the way in which they are managed.

The proposed changes may be voluntarily adopted by entities in their December 2009 reports; however, they are not expected to be mandatory until January 2012. *ED/2009/7 Financial Instruments: Classification and Measurement* is available on the ‘Open for comment’ section of www.iasb.org.

The US Financial Accounting Standards Board is also reviewing financial instruments but is expected to issue one ED next year, rather than three. US thinking currently differs from international proposals in that it will propose that more financial instruments are recognised at fair value on the balance sheet. An ED is expected from FASB at the end of 2009.

PENSIONS

Downturn impact on assumptions for pensions

The need to reduce pension costs and risks in the current economic environment has resulted in more employers either altering the design of defined benefit schemes or closing them to future accrual. In addition, employers are increasingly looking at removing pension risk through buy-in or buy-out arrangements, offering members inducements to transfer or give up benefits, and hedging investments and longevity.

Assumptions mean more risk disclosures

The significant range in actuarial assumptions adopted for pension

accounting purposes calls for greater disclosure of pension risks in employers’ financial statements.

Recent press coverage and market analysis about companies carrying significant pensions burdens has highlighted the huge range of assumptions being adopted, and that some companies are adopting optimistic assumptions to reduce the pensions deficit on their balance sheets. In addition, liabilities presented in financial statements (eg, under IAS 19) are currently much lower than those being agreed with pension scheme trustees for scheme funding purposes. The IASB is

proposing possible amendments to pension disclosures to better explain the nature and extent of risks arising from defined benefit plans.

Choosing more optimistic assumptions can significantly reduce the level of pension liabilities disclosed. A 1% increase in the assumption for annual inflation, for example, results in a 20% increase in pension liabilities.

Given the significance of pension deficits to many companies, it is likely that disclosures in annual reports will receive increased scrutiny by regulators going forward.

Going concern guidance for directors

The Financial Reporting Council in the UK has issued an exposure draft to update its 1994 version of guidance for directors on going concern.

The guidance brings together in one place all the different requirements that exist, and provides practical advice on the procedures to be undertaken by directors in making an assessment about the going concern status of companies. It includes some useful additions to previous guidance on half-yearly and interim financial statements. It can be a useful reference for directors of listed and unlisted companies internationally as well as in the UK.

Four high-level principles are set out in the guidance, with supporting analysis and commentary. The principles cover:

making an assessment; the review process; the review period; and disclosures. In terms of making an assessment, the directors will generally reach one of three conclusions:

- No material uncertainties leading to significant doubt about going concern have been identified
- Material uncertainties leading to significant doubt exist, or
- The going concern basis for preparing the financial statements is not appropriate.

The review period is not entirely straightforward, with differences between UK and IFRS standards. However, the draft guidance proposes that for both annual and interim financial statements, the directors should disclose if the period



considered is less than 12 months from the date of approval of the accounts. In relation to disclosures, directors are encouraged to bear in mind the need for clarity and transparency on the material uncertainties that have led to significant doubt, with a reminder that auditors are under an obligation to report if an appropriate level of clarity has not been achieved.

www.frc.org.uk

US & UK

XBRL becomes mandatory

The US Securities and Exchange Commission has mandated XBRL for all public companies' and mutual funds' reporting. The US joins the growing band of countries that have already mandated XBRL for some companies, including Spain, Belgium, Japan, China, South Korea and Singapore. The new SEC rules will apply to overseas companies with US listings.

The 500 largest public companies will be the first to provide interactive data reports, starting with their first quarterly reports from 15 June 2009. The remaining US GAAP filers will be required to come on board over a two-year, phased schedule. IFRS reporters will start their XBRL reporting from 15 June 2011, and by the end of that year all US public companies will have filed interactive data financial statements.

Mutual funds will be required to include XBRL tagging in 2011 to provide investors with information on objectives and strategies, risks, performance and costs. All registrants must concurrently also post the XBRL information as 'exhibits' on their public website, if they have one.

Investors will benefit

'Interactive data will help provide investors with the information they need, rather than just a warehouse of forms on which they can try to find it,' said former SEC chairman Christopher Cox. 'Interactive data will enable new analysis tools to put key information at every investor's fingertips within seconds, exactly as the investor wishes to see it.'

Companies will have to tag their data for websites as well as SEC reporting. Investors will need to familiarise themselves with the enhanced features of their tagging tools that make the most of interactive data for faster access, more accurate and complete searches, enhanced analysis, and better comparison of business performance across reporting periods and industries.

Standardisation improves reporting

Companies that take the 'bolt-on' approach to compliance with this reporting regulation will add some time and cost but may miss key benefits. 'XBRL can be used to standardise and streamline currently pervasive manual internal processes and controls,' said PwC partner Mike Willis. 'US

registrants should make the most of this compliance transition to lower costs and improve process efficiencies. Regulators should consider collaborating on the use of relevant taxonomies (say IFRS) to converge compliance requirements. This will smooth the path for future convergence efforts and provide cost savings for both producers and consumers.'

UK: XBRL by the back door

Companies House has not yet mandated the use of XBRL for financial reporting in the UK (small and Medium-Sized Enterprises have the option to do so) – but the tax authorities have. HM Revenue and Customs proposes that corporate tax returns for periods ending after 31 March 2010, filed after 31 March 2011, will need to use XBRL.

This requirement covers the CT600 return, the tax computation and the statutory accounts. A separate tagging exercise is likely to have to be carried out for the statutory accounts and many companies have said they are concerned about the costs of making the change.

Leases – a preview

Proposals on lease accounting are expected to affect nearly all large companies. Under the proposed standard, all leases will be treated in a similar way to finance leases today. Operating lease accounting will be eliminated entirely.

The IASB is currently considering responses to its leasing discussion paper and is expected to issue an exposure draft in 2010. A final standard is unlikely to be issued until 2011.

The discussion paper focuses primarily on lessee accounting. The boards argue that lessor accounting is more appropriately addressed in the revenue recognition project. For lessees, the high-level direction of the leasing project is clear – the boards have tentatively settled on a right-of-use model. This model would require the lessee to recognise an asset representing its right to use the leased asset, and a corresponding liability for its obligation to pay rent. Under the right-of-use model, operating lease accounting under IAS 17

would be eliminated, and lessees would account for all leases in a similar way to that used for finance leases today.

Issues that remain are the practical problems associated with large numbers of small value and short duration leases, which can be material when aggregated.

Similarly, the boards have set out their preliminary views on some of the common features in lease arrangements, such as options to extend the lease, contingent rental payments, and options to purchase, but such matters remain contentious even among board members.

Potential implications

The proposals would have the greatest impact on lessees with significant amounts of ‘large-ticket’ items, such as real estate, manufacturing equipment, power plants, aircraft, railcars and ships. However, they would also affect virtually every company, including those that lease computer or telecommunications equipment, copiers and office furniture.

The proposed model would require lessees to re-measure their lease obligation at each balance sheet date, based on updated estimates. This would require incremental effort compared to the current model, where lease accounting is set at inception and revisited only if there is a modification or extension of the lease.

The right-of-use model would also impact on financial statement presentation and financial metrics, including many that tie directly to debt covenants or compensation arrangements.

‘Management teams may need to re-examine their “lease versus buy” decisions as the economics of leases change as a result of the proposals,’ said PwC director John Williamson. ‘Management will also need to consider the implications of these potential changes as they negotiate long-term leases, even before the effective date of the new standard. It is unlikely that accounting for existing leases will be grandfathered.’

EUROPEAN UNION

EC moves to adopt ISAs

Adoption of the ‘clarity’ International Standards of Auditing (ISAs) is on the cards for statutory audits of European companies. The first step is a public consultation by the European Commission (EC).

‘The use of international standards, accepted worldwide, for statutory audits in the EU is an opportunity to enhance the quality and credibility of the financial statements of EU companies, to the benefit of investors and citizens,’ said EC Commissioner Charlie McCreevy.

The consultation paper states that the ‘governance of the IAASB has matured to a stage where it may be justifiable to adopt ISAs in the European Union’. It cites, for example, that the EC has been included in the process and there is evidence that the standard setter has been responsive to comment letters. The current governance structure is also subject to regular effectiveness reviews by the Monitoring Group.



EC endorsement of the standards is also dependent on sufficient international acceptance of ISAs. The paper acknowledges, however, that there is a lot of evidence supporting international acceptance of the ISAs – to date more than 100 jurisdictions’ audits are based either directly or indirectly on ISAs.

The evidence set out in the paper certainly makes a strong case for going ahead with adoption. It covers, for example, ISA recognition by public authorities, regulators and investors and highlights that: ‘Reliance on auditor’s reports could be enhanced if the investors know that a single set of

auditing standards are being used in the European Union (and at a global level).’

Scope of adoption

The paper asks interested parties to state their views on the scope of ISA adoption for Europe, for example: should ISAs be made mandatory for all statutory audits? What should the adoption timetable be and is it acceptable for the EC to amend the standards?

It is clear that if responses to the consultation are generally positive, ISAs could be applicable within a relatively short timeframe in the EU.

Dynamic provisioning – suitable response to the crisis?

Dynamic provisioning has been in the news extensively of late. It is seen as part of the proposed response to the financial crisis, or at least a method of accounting for banks that will ‘help’ by reducing the reported swings in capital and results between good times and bad. Yet it is not a well-defined term. It is generally taken to mean one of two things:

- Affecting reported profit by charging the income statement and building up a reserve (or is it more like a provision?) in good times, and doing the reverse in a downturn. The idea is to build up the bank’s capital so that it can better withstand a downturn. It also has the effect of dampening the swing of profits and losses. It can be viewed as a method of reporting losses on a ‘expected loss’ approach as opposed to IAS 39’s ‘incurred loss’ approach
- Not affecting reported profits but merely making a reserve transfer between retained income and a special reserve. The idea is to regard this special reserve as part of the bank’s capital and not distributable.

Although this concept can easily be trivialised by conjuring images of ‘squirrels and nuts’, it is a serious issue. It involves the interaction of (a) regulatory reporting and banking supervision and (b) true and fair reporting.

‘In my view, the second approach is sounder in the context of general purpose reporting,’ said PwC technical partner Peter Holgate. ‘It secures financial reporting as being the true and fair reporting of economic events, and does not confuse the picture by trying to accommodate financial regulation as well.’

‘But to arrive at “true and fair” reporting, it is important that the IASB considers carefully whether the “expected loss” approach to impairment of assets should be used rather than the “incurred loss” approach.’

UK adopts ISAs

The UK Auditing Practices Board (APB) has decided to introduce the Clarity ISAs – recently finalised by the International Auditing and Assurance Standards Board – into UK auditing standards. The new standards will be effective for years ending on or after 15 December 2010. This follows the APB’s consultation last year, which received strong positive endorsement for the planned introduction of ISAs.

Attention now is focused on the APB’s proposed additions to the IAASB’s standards, often referred to as the ‘UK & Ireland pluses’. There are two different types of pluses, those that insert existing law and regulation relevant to

the audit into a relevant place within the standards and those that are intended to raise the level of audit quality over and above the IAASB’s standards. The former are relatively uncontroversial.

The APB has issued a consultation paper proposing a significant reduction in the number of quality-driven UK & Ireland pluses from the current forty-four, down to five. This reduction is prompted by the introduction of most of the additions into the clarity ISA texts. Nevertheless, even the few remaining quality-driven pluses are controversial, as it is not clear that the case has been made for the UK to depart from the international standards on any of them.

IAASB

Clarity has worldwide support



The International Auditing and Assurance Standards Board (IAASB) has completed its Clarity project, meaning that auditors the world over now have access to 36 newly updated and clarified International Standards on Auditing (ISAs) and a clarified International Standard on Quality Control.

The Clarity project was launched in 2005 to improve the clarity and consistency of IAASB standards. Redrafting of the standards using one consistent format and language (for example using the present tense to describe actions by the auditor) has made them easier to understand and should remove any possible ambiguity on what is required, and what the guidance is globally.

Completion of the project has been welcomed by the Forum of Firms, an

association of international networks of accounting firms that perform audits of financial statements. ‘This is one of the most significant projects in the history of the IAASB,’ commented David Maxwell, chairman of the Forum of Firms. ‘Completion of this project will result in many improvements to the ISAs and significantly advance global convergence of auditing standards.’

The Forum’s members are being encouraged to plan now for the timely implementation of the revised ISAs to help promote consistent and high-quality standards of financial reporting and auditing practices worldwide.

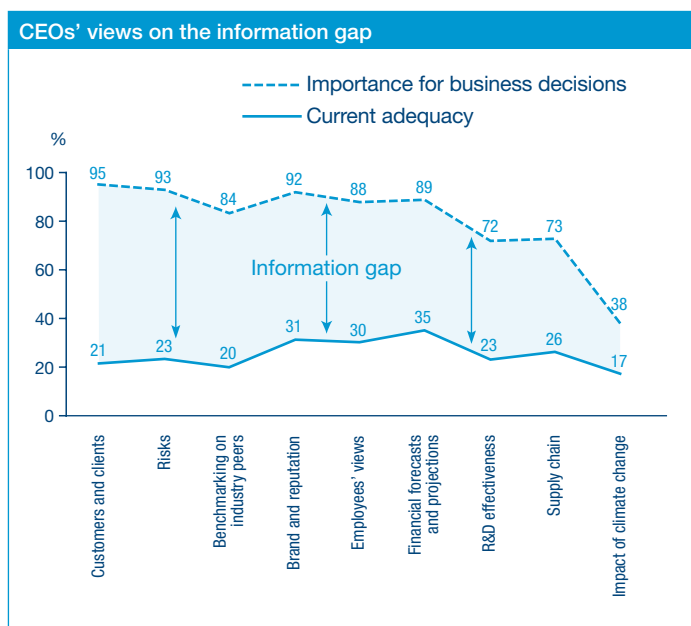
‘We have been encouraging Forum members to consider implementation matters as and when the standards were promulgated so they have sufficient time to update audit methodologies and training programmes in advance of the effective date,’ advised Nick Fraser, chairman of the International Federation of Accountants’ Transnational Auditors Committee, the executive arm of the Forum of Firms. ‘However, there is no doubt that timely adoption of the ISAs by national regulators will also provide significant impetus in promoting the convergence process, and we look forward to seeing rapid progress in this respect.’

What does your reporting say about you?

The information available for effective strategic decision-making and external reporting is a barometer of the quality of management and governance, argues **David Phillips**

The financial crisis left CEOs and their teams in all industries around the world questioning the scope and quality of the information they have available for strategic decision-making. Earlier this year, we published findings from a global survey of over 1,000 CEOs that hints at the extent of the challenge companies face as they set about enhancing this information.

Management's decision-making is only as good as the information at its disposal. The chart below graphically illustrates the breadth of information that CEOs hold to be critical as they assess what needs to be in place for the long-term success of the business. The chart also highlights the degree to which management information systems struggle to produce reliable non-financial data. CEOs believe that agility, customer service, talent and management/ reputation are the most important factors in long-term competitive advantage, so the information they identify as most critical to the business (below) is no surprise. Yet it is precisely these areas where information is considered inadequate and the biggest gaps exist.



Far-reaching implications

It is clear from over a decade of research with investors and corporates, as well as intelligence gathering from non-executive directors, that a knock-on effect from the inadequacies of internal information highlighted above, is that reporting to the board and external stakeholders is not meeting expectations either. This has far-reaching implications:

- Management is expected to plan using hindsight, instead of being given insight
- Effective governance and oversight is undermined because boards are restricted to a diet of voluminous, often out-of-date financial information

- Companies are struggling to rebuild market trust because the quality of engagement with shareholders and other stakeholders is disjointed and unstructured and the appropriate information set is not available.

Inaction is not an option

When change is the only constant, it is perhaps not surprising that CEOs say the information they have to support their decision-making falls far short of the mark. Re-evaluating corporate strategy in the light of evolving influences is tough enough. Adapting internal information systems to monitor and manage that new strategy is all too often, in practice, a step too far.

Because of this, instead of building new information systems, management has typically adopted a series of ad hoc 'workarounds', which is a breeding-ground for risk. Inadequacies in day-to-day management information can expose organisations, leaving their boards to fly blind and inhibiting their ability to exercise effective oversight. And, because external reporting is incomplete, investors' reliance on other sources of information increases.

Expectations of business are changing, and current spotlight on governance, risk and remuneration driven by the economic downturn has only exacerbated the pressure on the reporting model, management information and companies for greater transparency. Inaction is no longer an option. These issues need to be properly investigated and understood so that urgent issues can be addressed and a clear vision established for how to meet the information needs of management, the board and external stakeholders.

Managing for the long-term

The right information

- How joined up is the information in your organisation?
- Has management assessed the scope of information that is available for decision-making?
- Who 'owns' that data within the organisation? Is it reliable? Is it subject to internal audit?
- If it is a critical input into investors' decision-making, should it be subject to independent review?
- Is the information investors need to forecast with confidence routinely reported to the capital markets?
- Does your reporting – internal and external – present a coherent picture of the business that is likely to build trust in the quality of management?

David Phillips is a senior corporate reporting partner at PricewaterhouseCoopers.

Financial statement presentation proposals – impact on cash flow?

The presentation project has generated heated debate within both the corporate and investment communities. **Tony Debell** offers insight into the proposals



Tony Debell

This is the first step towards the development of a new standard to address how information is presented in financial statements.

The discussion paper (prepared jointly by the International Accounting Standards Board and US Financial Accounting Standards Board), proposes a number of changes that will fundamentally alter the

way primary statements are prepared.

The most obvious change is a new format applied to the three primary statements – the statement of financial position (the balance sheet); the statement of comprehensive income; and the statement of cash flows. Each statement would be subdivided into ‘operating’, ‘investing’ and ‘financing’ sections. Management would decide how line items should be split between these categories based on how it uses each item in the business. However, once assigned to a particular category, that line item should appear in the same category across each of the primary statements.

One change – the mandatory use of a direct method cash flow statement – has prompted particularly intense discussion. The standard setters argue that the direct method (which resembles your personal bank statement) is the investment community’s preferred presentation of cash flows. Investors need to see ‘actual’ cash flows, they contend, rather than the numbers that, for most companies today, are derived indirectly from operating profit or net income.

This proposal raises a number of questions. First, does the investment community really want the direct method cash flow statement? Second, what is meant by ‘direct’? And finally, what is the cost/benefit of providing cash flow in this format?

What do investors want?

On the first point, there is little ambiguity about the position of the international investor body – the CFA Institute Centre for Financial Market Integrity. It has long argued that direct cash flows should be reported. However, there are other studies (including PwC research – *Corporate Reporting: Is it what investment professionals expect?*), which suggest that the views of investment practitioners are not so clear cut. PwC research found there are advantages and disadvantages to both the direct and indirect approaches, with some

investment practitioners indicating that a combination of the two methods would be ideal. Under this model some key direct lines (eg, cash receipts from customers) would be presented with some critical indirect items (eg, movement in working capital). In addition, many investors have been vocal about the desire to see a reconciliation between changes in net debt and movements in cash flow.

‘Direct’ cash flow needs defining

The second issue – what is meant by ‘direct’ – is creating perhaps even more controversy. How are terms such as ‘cash receipts from customers’ defined? And how should the cash flow numbers be determined?

Should cash receipts from customers be defined in the same way as revenue? This would mean excluding sales tax and cash received from a customer on behalf of another party (eg, the money received by travel agents on behalf of the airlines). What should be included and excluded from the definition of cash should be governed by the informational needs of investors – but this is a debate that has still to take place.

How management actually generates a direct cash flow statement is perhaps the biggest single point of contention within the preparer community. For a small company, it may be simple to literally add up the cash book to determine the cash receipts from customers (often referred to as a ‘direct direct cash flow statement’). But for a multinational concern this may be hard to replicate. An ‘indirect direct’ cash flow statement is thus used by many companies that prepare direct method cash flows where a cash receipts number is derived by adjusting revenue for changes in debtors and non cash items.

Is this sufficient for investor needs? What would be the costs to preparers of generating a ‘direct direct’ cash flow statement?

Does benefit outweigh cost?

All this leads to the third question: what are the costs/benefits of either approach? Is moving to the direct method as costly as some claim? And are the benefits to shareholders sufficiently high?

The boards’ proposals are currently presented as Preliminary Views. The next stage will be a review of comments before publication of an exposure draft.

Tony Debell is a partner in the Global Accounting Consulting Services group at PricewaterhouseCoopers.

Revenue recognition – changes ahead

Proposals to change the accounting for revenue recognition could have a significant effect on some industries. **Mark Lohmann** and **Katie Woods** explain why companies should look carefully at the impact on current business activities

The IASB and the FASB issued their long-awaited discussion paper on revenue recognition in December 2009. Every industry within the scope of the project may be impacted to some extent – some significantly. This is true for both IFRS and US GAAP reporters, particularly those that have followed industry-specific guidance.

In summary, one of the key changes is a shift to a single, contract-based, asset and liability approach to revenue recognition. In the proposed model, revenue is recognised based on increases in contract assets or decreases in contract liabilities. The boards believe a more consistent application can be attained by using a single model based on changes in contract assets and liabilities resulting from contracts with customers. This is contrasted with the multiple revenue recognition models in use today that are focused on an earnings process, where difficulties can arise in determining when revenue is recognised.

Another key change is the singular focus on transfer of control of an asset in determining when a contract liability is satisfied and revenue is recognised. Current revenue standards take other criteria into consideration, such as when risks and rewards are transferred to the customer or when collectability of economic benefit is reasonably assured. This change could have a considerable impact on the timing of revenue recognition if control of an asset transfers at a different time from risks and rewards.

Contracts – asset or liability?

The move to a model where revenue is based on the changes in contract assets and liabilities means that all contracts (the possible exceptions being those for financial instruments, insurance and leasing) would be analysed into contract assets (the right to receive payment from customers) and contract liabilities (an obligation to deliver a service or good to customers). Revenue would only be recognised when either the net contract liability is reduced or the net contract asset has increased, both as a result of the entity discharging its contract liabilities by performing.

For a simple transaction this may seem straightforward. However, with revenue only being recognised when control over an asset has passed to the customer, the question of what the asset is and how control is defined are key. Taking the construction industry as an example, if control over an asset passes gradually to the customer as work progresses during the construction period, then revenue will be recognised in line with the gradual shift of control. On the other hand, if control does not pass until the construction project is fully completed, revenue will not be recognised until then.

Performance obligations

The focus on recognising revenue when control of an asset is transferred requires that a contract may need to be segregated if assets are transferred at different times. The board refers to these individual obligations as performance obligations (the promise to transfer an asset – either a good or service). Performance obligations are identified so that revenue can be recognised as control of the promised asset for each of the obligations is passed from the seller to the buyer. Telecommunications companies, for example, which might currently bundle together phones with a service contract, may have to identify and recognise revenue for each element of the transaction when control of the assets underlying the promises to provide a phone and services are passed.

Similarly, transactions where products are sold with a standard warranty obligation will be treated as a performance obligation. The seller would have to allocate part of the contractually agreed revenue to the warranty and recognise that allocated revenue as the warranty coverage is provided. Even a simple contract may include many performance obligations. Identifying and separating those obligations may be challenging.

There is some debate over whether performance obligations should be remeasured. The discussion paper proposes that remeasurement should only occur when the obligation is onerous. This will limit how often remeasurement will occur. Certain board members have expressed concern that useful information will not be provided to investors in situations where outcomes are highly variable due to volatile prices or where significant changes in circumstances are likely, eg, some insurance contracts.

Accounting for costs

Another significant area of change relates to costs. Unlike some of the current revenue guidance, the board proposed that preparers should follow the guidance in other standards such as: IAS 2, *Inventories*, IAS 16, *Property, Plant and Equipment* and IAS 38, *Intangible Assets*, to determine how costs are accounted for. The suggestion is that costs associated with a contract will be expensed as incurred unless they meet the definition of an asset under one of these standards. Entities that have previously used the cost guidance in the revenue standards may find they are required to recognise costs earlier if they are not defined as assets in the existing standards.

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Opinion varies on IFRS in the US

The move to IFRS in the US may have moved to a slower timetable, but there is still overwhelming support for a single set of global accounting standards.

John Barry offers an insight into responses to the SEC's proposals, and his view on the direction of travel

IFRS is clearly having an impact on many US businesses already, with frequent changes to US GAAP as part of the ongoing convergence process, and widespread IFRS adoption by foreign subsidiaries of US companies. IFRS is also influencing the behaviours of investors, non-US customers, suppliers and others. It was therefore unfortunate that the SEC only received 240 comment letters on its proposed roadmap for IFRS adoption, despite the 60-day extension to allow respondents more time to analyse the issues.

Four main themes emerged from responses to the SEC proposed roadmap. There was overwhelming support for moving to a single set of global accounting standards, but varied opinion on the path to get there. Respondents consistently requested more time to prepare. The independence of the International Accounting Standards Board (IASB) emerged as a priority, and many also recognised that changing to IFRS will have a wider impact than just on financial reporting.

PricewaterhouseCoopers' letter to the SEC observed that while the premise behind full convergence with no mandatory change date sounds great, it cannot be achieved within any reasonable time frame. The convergence process has already proved to be too slow, costly and in many instances it has not fully eliminated the differences. This sentiment was echoed by Robert Herz, chairman of the US Financial Accounting Standards Board, at the Financial Crisis Advisory Group meeting in April. When asked about the timeline for full convergence between IFRS and US GAAP, he responded that it 'won't be reality for another 10 to 15 years'.

Also, a longer-term, convergence-only approach risks derailing the goal of global standards. If the US is not clearly committed to IFRS, IFRS stakeholders are likely to become less willing to cooperate and may disengage from the convergence process. There are signs that they may already be doing this. Thus we think that the US should establish a mandatory date to change to IFRS as soon as reasonably possible, but continue with convergence in the interim.

Support for global standards

The fact that a large majority of respondents support the goal of moving to a single set of global accounting standards is consistent with other countries around the world, many of which have already moved to adopt IFRS. In our view, IFRS is the only viable choice for the US because of its growing global acceptance as a high-quality, comprehensive and sufficiently robust set of accounting standards that is continuing to improve. Internationally, US GAAP is seen as too complex and difficult to apply.



Which path to take?

Opinions varied on the best approach for the US to adopt IFRS – essentially three broad approaches were suggested: full convergence without setting a mandatory change date (43%), partial convergence coupled with a mandatory adoption date (24%), and establishing a mandatory adoption date immediately (28%). When considering the first year of adoption, 88% of respondents prefer to present just one year of comparative financial statements, to be consistent with companies around the world and limit compliance costs. However, all investor organisations called for two years of comparative data. Virtually everyone agreed that companies would only take advantage of early adoption of IFRS, if offered, if there was a clear commitment from the SEC that there was no risk of reverting back to US GAAP.

Independence concern

A number of letters to the SEC made reference to the importance of the IASB's independence, accountability and funding. Concerns were focused on perceptions of political pressures that have an impact on the independent standard-setting process. In our view, the IASB's independent funding and accountability should be the only prerequisites for mandating transition to IFRS by US companies. The IASB's trustees are working to establish independent funding through open-ended, country-specific commitments, and a Monitoring Board (with SEC representation) has recently been formed as a step to address this issue.

IFRS fit in US environment?

There were many letters that highlighted the need for the SEC to work with other federal and state agencies, such as the Internal Revenue Service, federal and state industry regulators, and the federal government itself, to ensure that those agencies will also accept IFRS. Otherwise, the move to IFRS could result in significant additional costs and perhaps perpetuate parallel financial reporting for companies in some industries.

We expect that the SEC will take note of the emphasis placed on this matter, particularly as there was no question on this topic in the roadmap proposals.

Many respondents mentioned some concern that increased use of judgement would subject companies to higher scrutiny and increased litigation risk. Our view is that much of the risk comes from reporting errors resulting from the complexity of US GAAP standards. Companies could be better positioned to defend themselves with principles-based standards, provided they have well-reasoned and contemporaneously documented conclusions on accounting matters.

Several letters pointed out actions the SEC should take, such as adopting the recommendations presented by the Advisory Committee on Improvements to Financial Reporting in August 2008.

The financial crisis

The financial crisis has highlighted certain concerns about IFRS that the SEC will consider in its final roadmap decisions. The global focus on fair value accounting, for example, has caused increased pressure on the IASB and the FASB to establish level playing fields and justify how fair-value accounting has improved financial reporting. It has also increased political pressure on the standard setters – further significant European political pressure on the IASB could cause the SEC to react by slowing down the change process in the US.

Notwithstanding the challenges created by the financial crisis, we continue to believe the US will transition to IFRS for the following reasons:

- The global transition to IFRS is too significant to ignore – transition continues, for example, with Brazil, Canada, and South Korea by 2011 and Mexico in 2012
- Approximately two-thirds of US investors have shareholdings in companies outside the US, most of which have adopted, or are planning to adopt, IFRS
- SEC inaction means that global comparability will decrease for US investors
- The current financial crisis has shown the interconnected nature of capital markets around the world, which demonstrates the imperative to achieve a common accounting language
- The January 2009 G20 meeting highlighted the dedication of the world's leaders to achieve a single set of high-quality accounting standards.

Although the exact US path to IFRS seems unclear at the moment, we remain confident that the ultimate adoption of IFRS in the US is inevitable. We believe the SEC will continue to approach change with a thoughtful, measured process and will ultimately propose a revised roadmap that is likely to contain a slightly slower timetable for change. We expect the SEC to provide more clarity around the road to IFRS later this year, or into next year.

In the short term, the Memorandum of Understanding between the IASB and the FASB to converge standards will change accounting in critical areas such as revenue recognition, consolidations, financial instruments and leasing. There is also a growing need for US finance executives to understand IFRS so that they can maintain control over financial statements prepared by their overseas subsidiaries, which are increasingly operating in IFRS environments. Companies need to take action now to deal with what is already happening and prepare for further changes ahead.

Getting ready for IFRS

Companies in the US, and other territories where timing of IFRS adoption is still uncertain, need to consider how to respond to the impact of IFRS today. Some steps to consider:

- **Focus on the challenge for your business.** The next several years will bring major changes to financial reporting. Whether changes arrive through convergence, a mandated move to IFRS, or continued IFRS adoption by subsidiaries and counterparties, the effect on businesses will be considerable.
- **Perform an assessment.** Consider the effects these alternative paths could have and identify business, accounting, tax, investor, control, systems and work-force related issues.
- **Be ready to adapt to ongoing change.** Use scenario planning to incorporate likely convergence and IFRS adoption expectations into your strategy and planning.
- **Monitor actual changes.** Follow actions of the regulators and standard setters. Consider how they will influence your overseas counterparties (eg, customers) and affect your reporting, long-term contractual commitments, tax structures, financing, systems and controls.
- **Maintain corporate oversight.** Influence transition timing, strategies, and policy decisions of overseas subsidiaries that are or may soon be IFRS users.
- **Identify what you can do now.** Be mindful of the specific aspects of convergence and IFRS transition that will take the longest, and consider smaller controlled one-off projects and 'easy wins' where desirable.

See www.pwc.com/usifrs

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IFRS under review

Standard under review	Can I still comment?	Overview of proposals
Financial crisis-related projects		
Derecognition	No. Comments on ED currently being considered by the IASB	Part of the IASB's response to the global financial crisis and conclusions of G20. Will result in amendments to IAS 39 and IFRS 7. Proposals seek to improve ways of assessing whether an entity should derecognise assets or not, and explain risks related to on and off balance sheet financial instruments.
Consolidation	No. Revised standard expected Q4 2009	Part of the IASB's response to the global financial crisis and conclusions of G20. The revised standard will provide a single IFRS on consolidation combining IAS 27 and SIC 12. The proposals revise the definition of controls, and expand disclosure requirements to give an overall view of companies' involvement with consolidated and unconsolidated entities.
Credit risk in liability measurement	Yes. Staff paper issued June 2009 for comment by 1 September 2009	The Invitation to Comment is accompanied by a staff paper that describes the most common arguments for and against including credit risk in measuring liabilities.
Fair value measurement guidance	Yes. ED issued and comment invited by 28 September 2009	Proposals to replace fair value measurement guidance contained in individual IFRSs with a single, unified definition of fair value, as well as further authoritative guidance on the application of fair value measurement in inactive markets. (See page 14)
Financial instruments: Replacement of IAS 39		
Phase 1: Classification and measurement of financial instruments	Yes. ED issued 14 July 2009 for comment by 14 September 2009	Financial instruments would be classified into two measurement categories: fair value or amortised cost. (See page 15)
Phase 2: Impairment methodology	Yes. Request for comments on the feasibility of an expected loss model by October 2009	One impairment method would be applied to all financial assets measured at amortised cost – a major simplification compared with today's requirements. The IASB is seeking information on the feasibility of an expected loss model.
Phase 3: Hedge accounting	Yes. ED due December 2009	Direction of this project will be decided by the outcome of phases 1 and 2.
New standards		
Revenue recognition	Yes. ED expected first half of 2010	See page 21
Leases	Yes. ED expected first half of 2010	IASB/FASB proposals for a possible new approach to lease accounting based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position (see page 17).
Income taxes	No. Comments on ED being considered by the IASB	The objective is to clarify and improve IAS 12 and to reduce the differences with US GAAP for income tax, by removing most of the exceptions.
Emissions trading schemes	Yes. ED due Q4 2009	IASB/FASB joint project to develop comprehensive guidance on accounting for emissions trading schemes. These are designed to achieve a reduction of greenhouse gases through the use of tradable emission permits.
Financial statement presentation	Yes.	Project being undertaken in 3 phases (see page 20). Phase 1: completed; Phase 2: DP comment period closed April 2009; Phase 3 ED expected first half of 2010.
Financial instruments with characteristics of equity	Yes. ED expected Q4 2009	This is a joint project with the FASB. The boards are working together to develop and publish an exposure draft.
Insurance contracts	Yes. ED expected Q4 2009	Phase 1 completed with the publication of IFRS 4, <i>Insurance Contracts</i> . In phase II, the current phase, the board intends to develop a standard that will replace IFRS 4 and provide a basis for consistent accounting for insurance contracts in the longer term.
Joint ventures	No. IFRS expected Q3 2009	Comments to an earlier exposure draft revealed differences in how respondents assessed the likely effect of the proposals and how the board assessed the implications. Clarification is being sought from respondents before proceeding to a final standard.
Management commentary	Yes. ED issued June 2009. Comment period closes 1 March 2010	The Board is proposing a non-binding framework that could be adapted to jurisdictions' legal and economic circumstances. The proposals will not result in an IFRS, but are intended to provide the basis for the development of good management commentary.
Post-employment benefits (including pensions)	Yes. ED expected Q3 2009	The IASB is undertaking a comprehensive review of IAS 19 with a view to completing the revision by 2011. The project is in two parts. A discussion paper on the first part concerning matters that the board believes can be addressed quickly was issued in 2008 and an ED is being prepared. The timing for Part 2 remains uncertain.
Rate-regulated activities	Yes. ED expected Q3 2009	The project objective is to develop a standard on rate-regulated activities that clarifies whether regulated entities could or should recognise an asset or a liability as a result of rate regulation.

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