

# World Watch

Governance, Reporting and Assurance

Issue 2 2011

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# Breaking the mould

When the history books are written, will 2011 be remembered for systems change? At so many levels the world is in a state of flux; numerous political systems are going through radical challenge, as are economic systems in many nation states. The fall-out of the credit crunch still reverberates around the world reshaping the banking system and bringing the reporting and auditing systems into the spotlight.

There is a multi-layered agenda for change, but critically all with the common theme of 'systems change'. At the heart of all these challenges is a common recognition that systems change is not easy but is essential if society is to evolve and be re-invigorated.

One of the most significant barriers to change is the existing system itself, as a research study featured in this issue of *World Watch* highlights (page 21). In most systems, the institutional structures created for good purpose in the past become impediments to change, as do the behaviours and norms displayed by all the key participants in the system. Some are conflicted against change for good reason – why would you necessarily support an agenda that threatens your position and livelihood?

On reflection, it is not surprising that systems become outdated and stressed. Dependent on historic structures, rules and regulations, they are always going to lag behind the speed of innovation and change in society. Technological innovation and the advance of social networking have only made this problem more acute.

What everyone faced with systems change hankers after are mechanisms that facilitate some form of transition from the

old to the new. So as the debate about the relevance and future direction of reporting and audit strengthens, perhaps now is the time to reflect on what these mechanisms could be. Ill-informed regulation is unlikely to be the answer; what's needed is new ideas and innovation tested in the market place.

So what is the answer? What is it that those responsible for the system can do to nudge it into a better space and avoid 'revolution'? For those worrying about the reporting and audit agenda, the answer may lie with an idea being developed by the Financial Reporting Council in the UK. It's a 'reporting lab' – a place where market-oriented innovation can take place under the watchful eye of the regulator, a safe haven where companies, investors and auditors can come together to address the shortcomings of reporting, challenge established thinking, find practical solutions and act to reshape the reporting model and make it relevant for the 21st century.

Breaking the mould of an established system is never easy. While those responsible for reporting and audit might feel challenged, it's worth a thought for those faced with the unenviable task of constitutional change. Let's hope when we look back on 2011 it's seen as a watershed of change for all the right reasons.

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# Better merger and acquisition disclosures, please

Investors tell us that they need companies to explain their transactions more clearly. **Alison Thomas** shares insight from the investment community



Alison Thomas

Given the economic significance of mergers and acquisitions, it is not surprising that the investment community tells us about their intense interest in the disclosures relating to them. But we continually hear concerns about the quality of disclosures for these transactions. This article examines some of the areas commonly cited by investment professionals as offering opportunities to improve the effectiveness of disclosure in this critical area of reporting.

When talking to investors about reporting, two themes come through time and again: first, the desire to understand if management are spending capital wisely; second, the need to have the base of data to forecast with confidence. These themes dominate our discussions with investors when talking about both M&A and disposals disclosures.

### **What did the acquirer pay?**

Financial reporting standards do require management to report on the cash cost of an acquisition, but important detail about total cost can get lost. For example, investors want to know the enterprise value of an acquisition – that is, the transaction's effective net value. And investors typically cannot see the debts acquired or detailed information on pension liabilities assumed unless the scheme is material to the acquirer.

Some of this information might be provided elsewhere in the annual report or in analyst presentations – but the investors we spoke to were concerned because such information is unaudited. As investors need to assess and then

forecast the underlying performance of a business, they are also increasingly concerned about the income statement effects that might arise from implementing the revised business combinations standard – for example, remeasurement of contingent consideration and consideration linked to future service of the selling-shareholders.

### **Are the intangibles really goodwill?**

Having to capitalise acquired intangible assets separately from goodwill and then amortise these can be a source of frustration for investors. Some of the acquired assets will have a finite life (such as a patent), so an investor is happy for there to be an associated amortisation charge. However, investors may consider other intangibles to be goodwill, notwithstanding management's classification as separate assets with limited lives. In such cases, investors may wish to reverse amortisation charges.

In order to decide whether an amortisation charge makes 'economic sense' or not, investors would like to see greater detail about the nature of the identified intangible assets.

### **How has the acquired business performed since the transaction?**

Investors tell us that they want to know more about the strategy underpinning an entity's acquisition. They would like to know the rationale behind any acquisition and whether or not it was a success as measured against this strategy.

Investors quickly lose visibility of previous acquisitions. This is because, unless an acquisition is a reportable segment in its own right, it is absorbed into the acquirer's business, with no detailed information provided. If management thinks it important enough to monitor the acquisition separately, that information is also important to investors, even if separate disclosure is not required by the standards.

It would be helpful for acquirers to give the exact date of acquisition (or disposal) rather than a vague indication. Modelling future cash flows is challenging without the exact dates. Investors also appreciate clear disclosure of the non-cash deferred consideration.

### **What did a disposal raise?**

It is not just the disclosures associated with acquisitions that have drawn the attention of investment professionals. The reporting of disposals is also a source of frustration.

As with acquisitions, investors want to know the enterprise value realised on disposals, in addition to cash received. Similarly, they want to be able to assess management's stewardship of the assets they have been entrusted with, and to have sufficient historical data to be able to forecast the future.

**Stewardship:** Investors wish to hold management to account for its running of the entire business. Financial reporting standards distinguish between continuing and discontinued operations; management's narrative often concentrates only on the continuing operations. Management could better meet user needs by presenting clear narrative and financial information about the combined results, including the disposed business.

**Forecasting the future:** Current accounting standards require management to present quarterly comparative data only as each subsequent quarter is reported. This is not deemed sufficiently timely by investment professionals, who wish to update their forecasts for the residual entity immediately. They have told us that they would like to see, at the date of disposal, historic quarterly/interim data that would allow them to do this.

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# A critical system at risk

Corporate reporting is at a ‘tipping point’, **David Phillips** argues. It is time to take action and make sure that our reporting system does not fail

Much has been written in recent decades about the shortcomings of the corporate reporting model. Since the industrial revolution, this model has been predominantly focused on the output of business activity, measured in financial terms. Despite the world being transformed in so many ways over the past century and the limitations of this focus on financial measurement being recognised, it appears that the system has been constrained by its historic roots and become incapable of meaningful evolution.

As each economic crisis passes and as each new social challenge emerges, the system’s inability to evolve and change becomes a growing risk to society.

Without a reporting system capable of properly measuring all the resources being used by business, reported performance based on profitability will present a flawed view – business decisions will be sub-optimal, capital will be misallocated and society will have little ability to respond logically and responsibly to the demands of a world with nine billion people.

### **The case for change**

The case for a new reporting model will be made imminently when the International Integrated Reporting Committee (IIRC) publishes its long-awaited discussion paper on integrated reporting. This discussion paper will be open to consultation, and later in the year the IIRC will be engaging governments on the need for reform to the current reporting model. This occurs at a time when global agreement on almost any issue is difficult to achieve. But as with banking reform, the reporting model is central to the operations of the economic system on which society is totally dependent for its future wealth and well-being.

While the IIRC will make the case for change, the reality is that no new model will emerge overnight, change will take time and rushing to a new end game will

be counter-productive. What is needed is a structured and properly sponsored global programme to critically analyse the case for change. It could take two years to properly assess the case and make recommendations, but the implications of this agenda are of such significance to long-term system stability that it can only have one sponsor – the G-20.

The work of the IIRC and its call for change has recently been supported and informed by a ground-breaking research study undertaken by Tomorrow’s Company, PwC and CIMA. Uniquely, the study – *Tomorrow’s corporate reporting* – has looked at the whole reporting system (people, organisations, rules and processes) rather than the reporting model (specific requirement). It has tried to throw light on the issues that can assist in a change agenda. For those considering the IIRC’s proposals, the study provides some important insights on how structure, behaviours and incentives are critical ingredients for any plan to effect system change. The report highlights the rigidity of the current system and the entrenched position taken by its key players. A picture emerges of a system that shows all the hallmarks of its original architects and a behavioural response from all its stakeholders – companies, investors, auditors and standard setters – that, while sufficient for the 19th century, have now become barriers to change.

### **A roadmap for change**

Looking to the future, the research sets out a road map for change. It is this that sits comfortably alongside the progressive agenda encapsulated in the concept of integrated reporting and the ambitions of the IIRC. Central to this road map are a series of critical questions that need to be seriously addressed by those who oversee the reporting agenda, particularly its health, relevance and ability to explain business performance in a world that is constrained not just by financial capital, but also by our physical, human, natural and social capital.

### **Questions to answer**

For the architects of our market-based system, here are perhaps the four most important questions that need considered answers.

#### **1. What is the objective of corporate reporting, and is global convergence a worthwhile goal?**

It is clear that the original objectives of corporate reporting differ around the world and are in a constant state of flux. Creating a path to the future requires these questions to be answered in the knowledge that it’s easier to get global agreement on issues at the outset of change rather than after a period of rapid domestic innovation.

#### **2. Who has oversight of the system?**

The way reporting has evolved, it is rare for any single organisation to have oversight of the whole reporting system in a particular territory. For some, this fragmentation creates a weakness in the system and is one reason why the development of a more holistic reporting model, such as integrated reporting, has not occurred.

#### **3. Is the current reporting system itself a barrier to change?**

The more one analyses the construct of today’s reporting system and the established role and behaviours of the key players, the more one recognises why there has been little innovation and change.

#### **4. What are the implications for the structure and governance of established institutions that are central to the design and operations of the reporting system?**

If integrated reporting is the future, then what are the implications for organisations such as the International Accounting Standards Board (IASB), the Global Reporting Initiative (GRI) and the Carbon Disclosure Standards Board (CDSB)?

The answer to these questions and others raised in the road map are important and cannot be taken lightly. As a minimum, we need a programme of structured discussion and dialogue, ideally commissioned by the G-20, to consider the need for and implications of introducing a new reporting model. Realistically, the world has no more than five years to bottom out these important issues if reporting is to play its central role in the operations of the world economy and help facilitate the shift in performance measurement that is vital in our resource-constrained world.

Encouragingly, the time may be right for this agenda. The evidence from around the world suggests that there is a growing realisation that reporting needs to change. For the most part, the focus is on selected elements of the reporting model, such as fair value and insights into the judgements and assumptions that underpin reported financial performance. But the prominence of other aspects of integrated reporting is rising too – for example, there is more focus on the business model and risk disclosures, resource usage and emissions, governance and remuneration, as those responsible for the system look for solutions to the last crisis.

This provides a real opportunity – a chance to bring all these elements of the reporting jigsaw together, to recognise the value that emerges from a more integrated model and the dangers that lurk in perpetuating a model that is ‘siloes’ in its architecture and its operation. While we focus on the separate elements in isolation, the synergistic value of an integrated model is lost.

And finally, we need to think through how change can occur so that our reporting system can evolve. How can we move from ‘grid lock’ to a system that can flow and move forward freely? Are there actions that can be taken to unlock processes of innovation even within the regulatory mode? Perhaps there are some clues in the thinking currently doing the rounds in the UK. Here, two particular developments are worthy of note.

### **Time to innovate**

The Financial Reporting Council is one of the first regulators to publicly recognise that reporting has become too voluminous and cluttered by information that is not assisting user understanding. It has come up with a radical idea of introducing ‘reporting labs’ as a mechanism to promote ‘stakeholder-led’ innovation in a safe environment. This innovation model that is close to the market will encourage companies and investors to come up with practical ideas to deal with known shortcomings in reporting.

The FRC’s work is also supported by another branch of the UK government (The Department of Business Innovation and Skills) who are considering what actions can be taken to enable companies and their boards to create a shorter, more strategically-focused, report. This shift in thinking could provoke the positive behavioural response – where ‘less is seen as more’, where boards are more inclined to influence content, and where compliance information, while provided, is not allowed to clutter and undermine the critical elements of information that companies need to communicate.

For all the reasons set out above, it appears that we may be at a ‘tipping point’ in the future of corporate reporting. For those with overall leadership responsibility, for the economic system and its longer-term stability, now is the time to act. To kick off, a process to analyse the ability of the system to adapt to the economic and social needs of this century must be started, and should culminate in recommendations being made to the G-20. If we leave this agenda on the back burner for too long, financial reporting will survive, but the whole system may fail.

**David Phillips is the senior corporate reporting partner at PwC.**

***“Without a reporting system capable of properly measuring all the resources being used by business, reported performance based on profitability will present a flawed view – business decisions will be sub-optimal, capital will be misallocated and society will have little ability to respond logically and responsibly to the demands of a world with nine billion people”***

***“If we leave this agenda on the back burner for too long, financial reporting will survive, but the whole system may fail”***

# Are you confident about your response to a crisis?

A poor response to a crisis can wipe huge sums off stock valuations, argue **Martin Caddick** and **Paul Robertson**. But a focused response that impresses stakeholders can have the opposite effect

High-impact risk is now firmly on the boardroom agenda, driven there by the realisation of the damage certain events can do to corporate and management reputations. High-profile environmental disasters, weather-related public transport interruptions, natural disasters, machinery failures and sensitive data leaks – to name a few examples – grab media headlines.

The way that an organisation responds to such events is critical – more so now than ever. The public has expectations of how an organisation should respond, based on media coverage of past events. Business customers too have preconceived ideas about how their supplier or business partners should react in a crisis situation. A poor performance, which includes inadequate communication with key stakeholders, can wipe huge sums off corporate stock valuations. On the other hand, a focused, swift response that impresses stakeholders with management’s capability can actually increase corporate value – beyond the level it would have reached had no crisis occurred. Employee loyalty can also be strengthened and retention rates dramatically improved by demonstrating a high degree of employer care in a crisis situation.

Board members appreciate the need for their organisations to develop resilience – the capability to respond in appropriate ways in the event that disaster strikes. However, they are also increasingly seeking to gain confidence in that capability, rather than simply assuming it exists and will prove adequate. This trend complements the growing stakeholder interest – among governments, regulators, standard setters, business partners and the public – in the sustainability of business. There is mounting appreciation of the need to sustain profitability for the long term, in ways that support the communities in which businesses operate, and with minimal environmental impact. Effective crisis management is one small, but critical, requirement for such sustainable business activity.

## **Building capability**

Effective crisis management depends on the board and the crisis management team (CMT) having the capability they need to respond effectively. Leading organisations are increasingly looking for ways to develop that capability, and turning to real-time exercises as the most effective mechanism. Such exercises represent a step up from the more traditional half-day or one-day

simulation exercises involving specific functions, operations or geographies. Simulations are invaluable in developing team capability; however, they don’t provide the truly challenging, comprehensive and insightful learning experience of a real-time exercise.

Real-time exercises are effective learning experiences because they run concurrently with participants’ normal working life. Whereas an isolated, half-day simulation is conducted in an environment where participants are freed from normal distractions, the real-time exercise creates additional demands alongside ongoing daily responsibilities, just as a real crisis would.

The real-time exercise can also involve large numbers of people from different departments, such as HR, IT, the supply chain and finance, and potentially several subsidiaries and locations. This enables a far more complex crisis scenario to be developed, one that combines multiple strands requiring responses from numerous parts of the business. This creates a more realistic situation for decision makers – a series of challenging events that occur over several days or weeks and that gradually build to a conclusion. Board members

**“A focused, swift response that impresses stakeholders with management’s capability can actually increase corporate value – beyond the level it would have reached had no crisis occurred”**

**“Real-time exercises are effective learning experiences because they run concurrently with participants’ normal working life”**



*“The challenge for any organisation is to understand the points at which they should remain issues for functional and operational teams to handle, when they should be brought to the attention of senior management, and when a formal crisis management response should be initiated.”*

and management have the opportunity to behave as they would in a real crisis – being able to request information, delegate tasks and take strategic decisions over a period of time in response to an escalating crisis scenario.

Another important characteristic of real-time exercises is that information on the crisis can be fed into the organisation in realistic ways – using the channels of communication that would occur in a real-life crisis. Emails received by participants appear to have come from appropriate people using the right tone and terminology; dummy news websites reflect unfurling events in a highly realistic manner. Staged media enquiries, interviews or conferences, and phone calls with government officials can be arranged, providing added and realistic pressure on participants. Responses can also be monitored to inform the later review process and learning experience.

The real-time exercise culminates in a final simulation event, which provides the necessary set up for final decision-making. This is followed by a closing review to wrap up the

experience, enabling the organisation to analyse its crisis response and see how its capability has been developed or validated. Areas for future development and action can be identified, perhaps addressing issues around resilience of the supply chain or other key third parties.

### ***Building confidence***

The completion of real-time exercises builds capability in the organisation. And as capability develops, so boards become more confident that key personnel understand the actions required of them if a real crisis occurs. But this confidence must also be underpinned by sound preparation and planning.

Effective crisis management is an ongoing process – a cycle of activity that revolves through planning, response and subsequent review. One essential element of the planning process concerns the identification of triggers – the events that could and should trigger the initiation of formal crisis management procedures.

*Continued overleaf* >

Some triggers will be obvious, such as fire, floods or terrorist events. More challenging are the triggers that arise incrementally. For example, the supply chain may have normal fluctuations such as occasional late deliveries or quality concerns. But at what point does an increase in quality failures or supply stoppages move outside normal tolerance levels and into a crisis situation? Similar scenarios can arise in all areas of business operations: in finance (foreign exchange losses or cash flow shortages), personnel (staff sickness or resignations), manufacturing (machinery breakdowns) or IT (server failures or lost email access).

The challenge for any organisation is to understand the business implications of all such events – in particular, the points at which they should remain issues for functional and operational teams to handle, when they should be brought to the attention of senior management, and when a formal crisis management response should be initiated. Once a formal response is launched, senior management can consider the strategic impact of the crisis situation, taking strategic decisions to safeguard the business going forward, while operations teams handle the immediate problems being presented.

Crisis management planning also covers the identification of response teams. The CMT itself will generally consist of senior board members: the chief operations officer or the CEO and directors of key business functions (for example finance, HR, IT, communications) as well as business unit leaders. This group will typically need the support of another team drawn from across the business and consisting of senior individuals, such as the director of security, deputies of HR and finance. This group will respond to the CMT's information requests and implement its strategic decisions. Additional subordinate teams may also be required, depending on the nature of the crisis.

Communication channels – when to escalate information, how and to whom – also need to be established. These should encompass how to pass information both up and down the management chain. The overarching aim behind all such crisis management planning is to save time when a crisis occurs. By identifying key personnel and establishing communications and response frameworks beforehand, the crisis response can get underway more quickly and effectively.

### **Organisational maturity**

The ultimate goal is to mature an organisation through the various stages of crisis management capability. This begins with the achievement of core compliance – creating a robust crisis management framework and plan – through to the development of comprehensive capability, and ultimately the building of confidence – so that boards have sound reasons to believe that their organisation has the right teams, systems and processes in place to deal with any crisis effectively.

Achieving this greater maturity depends on the development of a programme of work, which enhances crisis management capability over a sustained period of time. As increasing numbers of leading organisations now realise, it also depends on the completion of comprehensive real-time exercises. These build capability in the most effective way, which in turn generate board-level confidence.

The ultimate proof of the benefits of such sustained activity and rehearsal comes, of course, when a real-life crisis does actually occur and the company must respond. Only then can the true value of planning, real-time exercises and review be fully appreciated.

**Dr Paul Robertson is the crisis management leader in the UK and Martin Caddick is the business continuity leader in the UK. They are both members of the Governance Risk and Compliance team at PwC.**

### **Five questions every board should ask**

1. How capable is the business of handling a crisis effectively?
2. How does the board gain confidence in the organisation's response?
3. How does our crisis management strategy tie in to our organisation's risk appetite?
4. What are the triggers that would initiate a crisis management response in this organisation?
5. Who is responsible for developing and sustaining crisis management capability?

### **Five tips for ensuring successful crisis management**

1. Identify triggers: events or situations that should result in the organisation initiating its crisis management response.
2. Define, train and support your crisis management team.
3. Ensure that escalation channels of communication are understood and that they work.
4. Create subordinate working teams (such as a support team) that can work concurrently on different issues – conducting an investigation, assessing ongoing operations etc.
5. Practise, practise, practise: the extent and complexity of exercises and rehearsals should reflect your organisation's risk appetite and the degree of confidence required in its crisis management capability.

# IASB changes regime

As Sir David Tweedie prepares to step down from the International Accounting Standards Board, **Hitoshi Kiuchi** looks back on the highs and lows of his decade at the helm

The phrase ‘regime change’ is generally used in the context of countries seeing the need to replace a local despot, usually someone who has been in place for around 30 years. Yet in the more peaceful environment of international standard setting, we see on 30 June 2011 the end of the Tweedie regime – the end of Sir David Tweedie’s 10 years as chairman of the International Accounting Standards Board (IASB) – and the start of the Hoogervorst/Macintosh regime.

David Tweedie has been at the helm of the IASB since its inception, when the IASB took over from the International Accounting Standards Committee (IASC), which had a part-time committee and smaller staff. The IASB has had a full-time board and has been a serious player with comparable resources to the US Financial Accounting Standards Board (FASB). Indeed the joint agenda of the IASB and the FASB has been a dominant part of the IASB’s work in this last decade.

In many respects, the IASB has had a very successful decade. It has grown in importance as more and more countries have adopted IFRS, with more at various stages of adopting IFRS, including Canada, Japan and India. The IASB has developed new standards on various subjects, some in isolation but most in conjunction with the FASB. These include share-based payments; business combinations; financial instrument disclosures; and segment reporting.

The story has been less rosy in other respects. For example, the standards on financial instruments (IASs 32 and 39), inherited from the IASC in 2001, have been largely retained, with only a small part replaced, by the first element of IFRS 9; and that only in 2010. Financial instrument accounting has been one of the areas where the IASB and the FASB have sought to work together. Yet this has been an unsatisfactory process, with the boards not increasing the chance of a common outcome by addressing the project in different ways, coming up with different proposals and consulting

on it in different timescales. Not surprisingly, as the end of the Tweedie regime approaches, the two boards are some way apart.

Working together towards convergence is never easy, but more success has, it appears, attended the work on revenue recognition and lease accounting. Yet even here, where the objective was joint new standards by June 2011, the two boards have had to announce (14 April 2011) that a few more months are needed to make sure that the standards are of the right quality and that constituents’ concerns have been properly addressed. (See news article, page 30).

So in practice, rather than inherit a clean position where a number of major projects are finished, Messrs Hoogervorst and Macintosh will have to spend the first few months finishing off the final stages of these late-running projects. Their hope, no doubt, will be that the July 2011 board changes will not derail the projects at their final stage.

## **Which way for the new regime?**

The new regime will want to consider their strategy. Indeed, a consultation on the work programme and the priorities from 2011 onwards has already been announced. Where should they start? What should be the priority areas?

There is something to be said for a pause for reflection, to catch breath, to allow implementation of the current batch of new standards. Perhaps, as was argued in 2001, there would be merit in stopping work on all standards-level projects, to concentrate on finalising the updated conceptual

framework. This, after all, is said to be the foundation on which all standards are built. If we believe that, then we should believe that it is something to write before the standards are written. Writing it after the standards downgrades its importance.

Other options for the future work programme include: post-implementation reviews of existing standards; standards on new subjects such as emissions trading; standards on specific industries such as extractive; and the wider reporting agenda (integrated reporting), including management commentary and reporting of risk, strategy and corporate social responsibility.

## **The US question**

Underlying all these decisions about agenda priorities is the question of whether the US SEC will approve the use of IFRS by US domestic companies. An announcement is expected later in 2011. The US is likely soon to be the only major economy that does not permit or require IFRS. Yet it is far from clear that the SEC will vote in favour. Even if they do, there are likely to be SEC interpretations of IFRS – which would presumably not apply elsewhere. A possible outcome is ‘yes, subject to...’ followed by a list of conditions that might be difficult or take a long time to achieve. So it is possible that US GAAP will still be in use in 10 years’ time.

The board of the IASB, under its new leadership, has many major questions to face.

**Hitoshi Kiuchi is IFRS and Japan GAAP technical leader at PwC in Japan.**

*“There is something to be said for a pause for reflection, to catch breath, to allow implementation”*

# Effecting change in a fast-moving environment

The need for high-quality accounting standards is paramount, but is the current standard setting process effective? **Peter Holgate** weighs up the options



Peter Holgate

Much has been written on change management. Often it seems to be a matter of changing hearts and minds, of involving people through discussion and consultation. A government or other benevolent rule-maker has an idea, seeks views, moulds opinion, persuades an initially-sceptical populace that the new idea is what it really wanted all along, and implements the change to warm applause.

There is a more jaundiced version, along the following lines. The authority in question has an idea that it wishes to impose. It has decided in its wisdom that the change in question is necessary, either to improve a process or to resolve a problem. It has to go through the process of consultation, which it views as a necessary evil, so that it can be seen to have been democratic and given constituents the opportunity to submit views. It then proceeds, irrespective of the submissions received, with what it had already decided was necessary.

Sometimes change has to be introduced in a more brutal manner; in wartime, for example, governments make decisions and implement them the same afternoon ('emergency rule').

Sometimes, on the other hand, the need to consult can be an excuse for taking a long time. This can be very helpful if the official in question does not really want to pursue the change in question. "It is necessary to have a full and wide-ranging investigation of all possible viewpoints and to identify the potential effects rather than act hastily..." By the time that has happened, there has been a change of government, or a change in the membership of the relevant body.

In fields such as climate change, where there are many opinions about the urgency but also about the nature and even the existence of the problem, there are some who argue that the situation is so extreme that there isn't time to consult, merely time to act. In practice the response of governments is to make incremental changes, for example to taxation, to encourage, or 'nudge', behaviour in a particular direction.

How do changes to financial reporting fit into this? The need to reform accounting in the height of the recent financial crisis was impressed upon the International Accounting Standards Board (IASB) and the US Financial Accounting Standards board (FASB) by the G-20, who gave the boards ambitious targets and quite short deadlines. This seems to be not far from a wartime basis, although the boards seem to have taken longer than the G-20 envisaged to meet the deadlines and yet still to be in business.

In more normal times, the development and reform of accounting standards seems, on a slightly generous reading, to fit into the category of gradual rule change by consultation and consensus. But those who work in standard setting are not there entirely to run a popularity contest. Indeed it would be a poor IASB member whose stance was: "let's see what people think, because I'm far from sure what we should do here". So in practice, there is often a tension between the desire to push accounting in a

particular direction (say, a strong focus on assets and liabilities) and the desire, or need, to consult in a genuine way.

A current example brings these issues into focus. The European Financial Reporting Advisory Group (EFRAG) issued a 51-page paper in January 2011 – *Considering the effects of accounting standards*. The basic proposition is that the IASB should carry out "effects studies" throughout the standard-setting process.

There is some ambiguity as to whether the objective of these 'studies' is to improve standards or increase the accountability of the standard setter. The proposals have the potential to be highly bureaucratic and could slow down the standard-setting process considerably. Of course, a standard setter would want to be aware of the likely effects (costs, benefits, micro- and macro-economic effects) of a proposed standard; indeed the IASB's framework envisages that it should take into account costs and benefits.

But what should be done if a macro-economic effect is identified? Say, for example, a new standard on pensions or leasing might result in the industry changing or contracting as a result of the costs of the activity being better understood. Most accountants would say that it is not a reason to abandon the idea if it would improve accounting and transparency at a reasonable cost relative to the benefits. Indeed it is positively a good thing to understand the costs and risks associated with, for example, defined benefit pension plans.

A politician might think otherwise.

**Peter Holgate is senior technical partner at PwC in the UK.**

**The EFRAG paper is out for comment until 31 August 2011.**

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

# Internal audit can shine

The boardroom focus is now on growth and the future. But is internal audit responding to the changing risk environment? **John Feely** explains why internal auditors should keep pace

After several years of extreme financial uncertainty, there's a surprising level of confidence among chief executive officers. Those who anticipate how business is changing and creatively search for value in new markets with new customers and partners, expect to find great opportunities.

As CEOs step onto a larger stage, their internal auditors should be taking a similar approach by preparing for a best supporting actor role. And as companies focus outward, internal auditors would be wise to expand their reach to encompass a more diverse set of risks and engage stakeholders on the need for support in non-traditional areas.

Internal audit leaders can help their audit committees and management understand the dynamic and complex risk environment and make it easier to adapt to a rapidly changing world. Those who succeed in this endeavour will add tremendous value; those who do not seize this opportunity risk losing relevance within their organisation.

## Internal audit response

PwC's 2011 *State of the internal audit profession study* examines how internal audit is responding to this changing risk environment. The need to grow businesses in emerging markets, staying competitive by adopting innovative technologies and responding to a rapidly changing regulatory environment underpin the critical risks facing today's businesses.

We interviewed chief audit executives (CAEs) to learn how they are responding to today's business challenges. They confirmed that leading internal audit functions have strategic growth initiatives, emerging technologies and increasing regulation near the top of their risk and audit agendas (see below) and are preparing to play a significant role in a changed world. However, the survey data also shows a lack of confidence in internal audit's ability to effectively address these topics.

## Scripting internal audit

As internal audit organisations strive to transition from financial controls

oversight to advising on a wide range of strategic, business and compliance risks, it is important that management assesses and recognises internal audit's skills and capabilities in these areas. CAEs consistently told us that the skills necessary for success are: effective communication; an ability to build strong relationships with company leadership and the audit committee chair; and the capacity to engage internal and external partners. If the internal audit department isn't involved in significant initiatives, why not? Is it because the team lacks the required knowledge or skills to contribute? Or, it is because the internal audit function hasn't earned a place at the table?

Our survey did indicate that internal auditors' interactions with company leaders are broadening. While the highest level of interaction remains with traditional finance and accounting leaders, the survey also found a considerable level of contact with companies' operations leaders such as the chief operating officer and chief information officer (see table). These relationships are critical to internal auditors' ability to identify and respond to a broader range of risks and continue

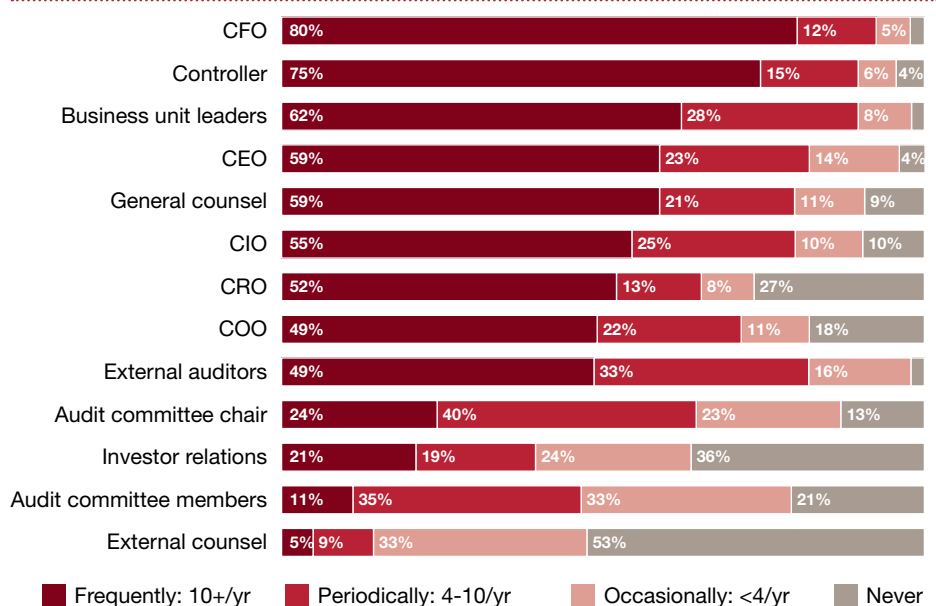
the migration from financial risks to more operational and strategic risks.

Leading CAEs consider the audit committee as key to their relationships, interacting with them frequently outside of scheduled meetings. Establishing a good working relationship with the audit committee cannot be over-emphasised. Because internal audit is well-positioned to see across the entire enterprise, it has the perspective and the objectivity to help the audit committee understand significant challenges and risks.

Some in the profession see a potential conflict between active relationship building and maintaining auditor objectivity and independence. Our belief is that meaningful and sustainable relationships are built on trust. For internal auditors, that trust is built through transparent and candid dialogue with stakeholders, and sharing a point of view that is not only fact based but also reflects an understanding of the business, its strategies, and its risks.

**John Feely is the global leader of internal audit services at PwC.**

## CAEs contact with people outside audit committee meetings



Source: PwC

US

# Turning up the heat on executive compensation

The provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) will have a significant impact on the way public companies determine their executive compensation arrangements. Although some of the requirements are effective now, clarification on many of the implementation issues is still awaited.

A topic that has received extensive focus in the 'Wall Street versus Main Street' debate has been the relationship between executive compensation and the company's financial performance, and the vast discrepancies between CEO pay levels and those of rank-and-file employees.

### **CEO pay ratio**

Dodd-Frank directs the SEC to adopt rules requiring companies to disclose the relationship between executive compensation actually paid and the company's financial performance, as well as internal pay equity or the so-called 'CEO pay ratio', to compare the total annual compensation of the CEO to the median total annual compensation of all employees. There are significant questions and challenges associated with these disclosures, particularly for large multinational corporations. At issue are both the census of 'all employees' and the definition of total annual compensation. The SEC has tentatively scheduled proposed rulemaking for the second half of 2011.

The implementation of the CEO pay ratio disclosure is likely to be difficult and complex, particularly for large multinational corporations. Total annual compensation, as defined in the act, would include all components of employee income, including stock compensation, deferred compensation arrangements, pension and other post-retirement benefits alongside salary and other elements. Few companies maintain information on these various components for all employees on an



annual basis. To overcome this, many companies will need to set up new administrative systems and controls. In recognition of these likely implementation difficulties, the SEC has asked for comments in advance of issuing proposed rules.

### **Independent compensation committees**

Dodd-Frank's provisions will require companies to ensure independence of compensation committee members as well as their advisers. The Act requires the SEC to direct national securities exchanges to prohibit listing of any company that does not have an independent compensation committee.

In determining independence, securities exchanges are instructed to consider relevant factors including any consulting, advisory or other compensatory fees paid to the director by the company, and whether the director is otherwise affiliated to the company.

The independence of compensation consultants, legal counsel and other advisers to the company will also be assessed. This will be based on factors such as whether the adviser provides other services to the company, fees received as a percentage of the adviser's total revenue, policies the adviser has implemented to prevent conflicts of interest, any business or personal relationships between the adviser and members of the company, and whether the adviser holds stocks in the company.

Disclosure on compensation committee independence is required in proxy statements for annual shareholder meetings occurring on or after 21 July 2011.

Dodd-Frank requires the SEC to perform a study of the use of compensation consultants, and the effects of their use, with a report to Congress by 21 July 2012.

**For more information on the requirements of the Dodd-Frank Act, see *World Watch*, Issue 1 2010, page 20 or visit [www.pwcregulatory.com](http://www.pwcregulatory.com)**

# What makes investors trust management?

A survey of investors and analysts reveals that although trust in management is now lower than before the credit crisis, the majority still trust CEOs and CFOs.

The global analyst and investor survey was conducted in late 2010 by PwC and the Rotterdam School of Management, Erasmus University. As part of the research, 1,400 sell-side and buy-side analysts and portfolio managers worldwide were asked for their opinion on the level of trust they place in the CEO/CFO, what traits make them trustworthy, and the usefulness and reliability of capital market communications.

## Impact of behaviour

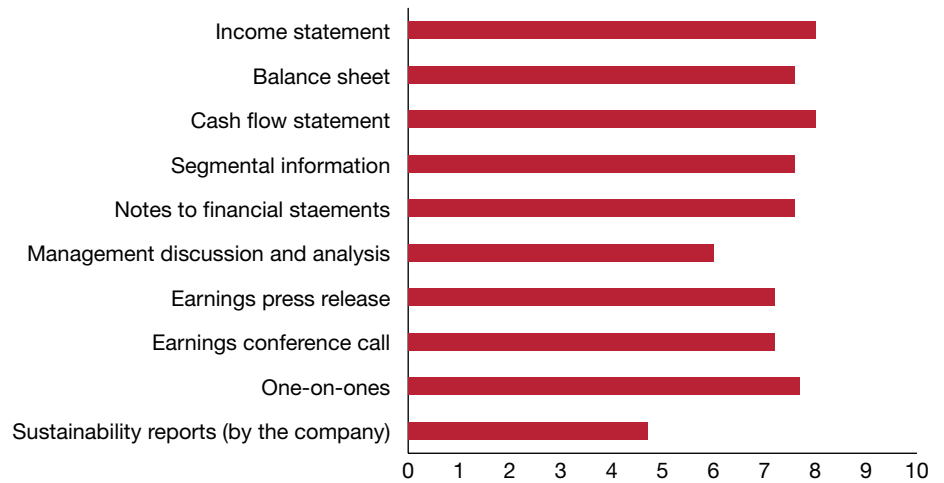
The research looked at how the CEO's and CFO's behaviour can win or lose investor trust. It identified frequently changing accounting policies as the way most trust is lost, with providing inaccurate information a close second. Investors and analysts are concerned that companies opportunistically change accounting policies – a worrying concern given the large number of new accounting standards that the International Accounting Standards Board and the US Financial Accounting Standards Board are proposing to introduce. Companies that are unable to appropriately explain what they are changing may struggle with negative perceptions and the loss of investor trust.

Not surprisingly, investors lose trust with CEOs who behave offensively. This includes those who complain about shareholders, refuse to answer questions and belittle analysts or investors. However, trust can be gained through empathetic behaviour, such as asking investors for their views.

Investors said reporting good performance prompted the biggest gain in trust, with other good news gaining equal trust as material good news. However, material bad news results in a much larger loss of trust than bad news with no material impact. This implies a limit to the trust that can be gained from good performance.

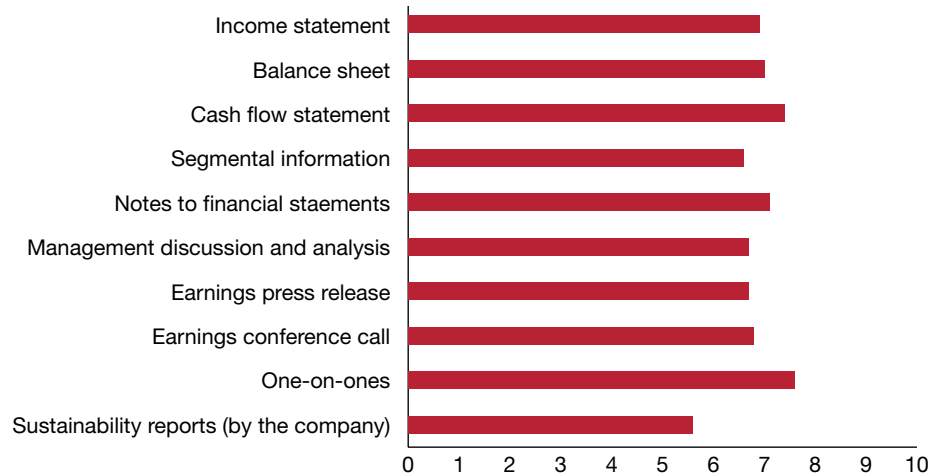
The findings confirm that consistently increasing earnings result in more trust than earnings that develop less predictably; and trust is reduced by having more volatile earnings than

## Usefulness of capital market communications



Source: PwC & RSM

## Reliability of capital market communications



Source: PwC & RSM

peers. This reinforces what CEOs and CFOs say they see in practice.

## Usefulness of information

Investors and analysts were asked to rate the usefulness of the capital market communications available to them.

While most components of the financial statements score between seven and eight (on a score of one to ten), the management discussion and analysis (MD&A) scores significantly lower (see chart above). In theory, the MD&A would appear well suited to reporting information such as progress against strategic objectives, which fall outside the framework of the primary financial statements and notes. However, investors say they get more useful information from one-on-one meetings with management.

## Reliability of communications

Although investors rate face-to-face meetings above all other capital market communications, the tangible communication they value most is the cash flow statement (see table above). And when investors have high trust in the auditor, they rate the reliability of all publicly disclosed information higher. The fact that a trustworthy auditor has thoroughly examined the business seems to enhance the perceived reliability of all public disclosures by the company, whether audited or not.

Find out more about the RSM Global analyst and investor survey at [www.rsm.nl/home/news/detail?p\\_item\\_id=6417982](http://www.rsm.nl/home/news/detail?p_item_id=6417982)

# The importance of speaking up

Legislation around the world is upping the stakes for organisations in terms of their provision of whistleblowing arrangements. However, in many entities, more support from senior management would be 'advantageous'.

A PwC paper, *Striking a balance: Whistleblowing arrangements as part of a speak up strategy*, highlights the importance of an open 'speak up' culture, where individuals feel able to raise any business or ethical concerns they may have. Its content draws on an online survey among members of the PwC Fraud Academy and a roundtable discussion with clients, as well as PwC experience in general.

The findings show that more can be done to establish open cultures. Although 80% of survey respondents

said senior management was very or quite supportive of promoting an open speak up culture, 42% also thought that more support from senior management would be advantageous.

As the paper notes, organisations must be guided by jurisdictional requirements when developing whistleblowing arrangements. They should not underestimate the impact of the Bribery Act in the UK and the Dodd-Frank Act in the US, for example. European data protection and other laws also bring constraints, as well as raising the bar in terms of regulators' and other stakeholders' expectations.

Against this background, the paper encourages organisations to establish arrangements that reflect their individual make-up and approach to

fostering an open culture. There is no 'one size fits all' solution. It does, however, set out five milestones as a framework to help organisations develop an effective, tailored whistleblowing programme.

### The five milestones

1. Gain top-level commitment
2. Develop a whistleblowing policy
3. Design whistleblowing reporting mechanisms
4. Embed a whistleblowing programme
5. Monitor, evaluate and report on the whistleblowing arrangements

[www.fraudacademy.pwc.co.uk](http://www.fraudacademy.pwc.co.uk)

## COSO

# Board risk reporting has room for improvement

A study of the risk oversight processes applied by boards of directors found inconsistency in the frequency and type of risk reports that the board is asked to review. Although evidence suggests that the boards of public companies fare best, in some organisations directors receive risk reports less than once a year.

The survey was commissioned by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). It asked over 200 directors to assess the current and desired future state of risk oversight applied by the boards on which they served. The findings suggest that while many believe their boards are performing their risk oversight responsibilities diligently and achieving a high level of effectiveness, a strong majority indicate a lack of formality in executing mature and robust risk oversight processes.

The survey, *Board risk oversight – A progress report: Where boards of directors currently stand in executing their risk oversight responsibilities*, identified nine

types of risk reports that the board might receive on a periodic basis to inform its risk oversight. Respondents were asked to identify how frequently each is received in their organisation.

The top three reports that boards received at least once a year are:

- High-level summary of the top risks for the enterprise as a whole and its operating units (71%)
- Periodic overview of management's methodologies used to assess, prioritise and measure risk (65%)
- Summary of emerging risks that warrant board attention (59%)

According to the majority of respondents, reports that the board does not receive at least annually include: scenario analyses evaluating the effect of changes in key external variables that have an impact on the organisation; a summary of exceptions to management's established policies or limits for key risks; and a summary of significant gaps



in capabilities for managing key risks and the status of initiatives to address those gaps.

In general, public companies provide more regular reporting to the board on risk-related matters. However, the report finds there is scope for all companies to make their risk reporting more effective through an improved risk-reporting process and increased regularity of reporting.

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

# Taking a closer look at EU governance framework

The European Commission has issued a green paper to assess the effectiveness of the corporate governance framework for companies across Europe and to explore how to improve the current mechanisms in place across member states.

The paper, *The EU corporate governance framework*, was issued on 5 April 2011 as part of a longer-term review into companies' corporate governance framework. An earlier green paper, published in 2010, is directed specifically at financial institutions (see *World Watch*, Issue 1 2011, page 19).

This consultation focuses on how all listed companies, not just financial institutions, operate. The paper asks 25 questions covering three broad areas: boards, shareholders and the 'comply or explain' principle. Areas such as greater diversity in boards, shareholder

engagement and the quality of corporate governance statements are being explored.

## **The board of directors**

The paper looks at the effective functioning and composition of the board, including creating a richer mix through gender diversity, a variety of professional backgrounds and skills as well as nationalities. The availability and time commitment of directors are also under scrutiny, along with issues around risk management and directors' remuneration.

## **Shareholders**

Looking particularly at shareholders' involvement in corporate governance issues, the paper seeks to learn how to encourage more investors to take an active interest in sustainable returns and longer-term performance, as well as how to enhance the protection of minority shareholders. It also considers whether

there is a need for shareholder identification – a mechanism to allow issuers to see who their shareholders are – and for an improved framework for shareholder cooperation.

## **'Comply or explain'**

The commission is also looking for ways to improve monitoring and enforcement of the existing national corporate governance codes to provide investors and the public with meaningful information. Companies that fail to comply with national corporate governance recommendations have to explain why they deviate from them. Too often, this doesn't happen. The green paper asks whether there should be more detailed rules on these explanations and whether national monitoring bodies should have more say on companies' corporate governance statements.

There are two broad opening questions considering whether EU corporate governance measures should take into account the size of listed companies and whether unlisted companies should be brought into scope, perhaps with the introduction of new voluntary codes.

The commission is due to issue a feedback statement summarising the results of the consultation in the autumn. On this basis a decision will be made on whether legislative proposals are necessary. An impact assessment will also be carried out.

The deadline for responses is 22 July 2011.

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



## UK CODE

# 2011 AGMs: set for re-election of directors

One of the main topics of the UK Corporate Governance Code was the new 'comply or explain' provision requiring all directors of FTSE 350 companies to be subject to annual election.

Institutional investors Hermes, Railpen and the Universities Superannuation

Scheme publicly stated in a letter to 700 companies that they are against this annual re-election provision and will back companies that do not comply. In the letter, the investors warned that the annual election of directors could lead to a 'short-term culture' and undermine collective decision-making.

Despite these initial misgivings and the code referring to a 'transitional period', over three-quarters of the FTSE 350 companies that have so far posted their 2011 AGM notices are proposing annual re-election of the full board.

## Boards under pressure to appoint women

The European Commission is taking a stand in getting member states to increase the number of women in the boardroom, warning that regulation will be forthcoming if companies fail to take action to redress the balance voluntarily.

According to commission figures published in March 2011, only 12% of board members at Europe's largest companies are women, and in 97% of cases a man is chairing the board. What concerns the commission is that the percentage of female business leaders has remained largely unchanged over the past 10 years.

There is also disparity in the proportion of women on boards on a country-by-country basis. For example, women hold just under 40% of the board positions in the largest companies in Norway, where there is a legal requirement for balanced

representation. However, in Malta, Luxembourg, Cyprus and Italy, less than 5% of the board are women.

In the case of Germany, government pressure is being put on companies to narrow the gender gap, with a warning that they have two years to act. Failure to do so will lead to adoption of a legal requirement to reduce the under-representation of women in management positions.

Figures from the German Institute for Economic Research show that in 2010 only 2.2% of executive board members at 30 major companies on the Frankfurt Stock Exchange (30 DAX) were women. One government minister is calling for a 30% minimum legal requirement. The largest listed companies have responded to the challenge by saying they will set voluntary quotas for women in top management by the

end of 2011, hoping this will stave off the threat of regulation.

The European Commission is pressing companies to voluntarily increase the percentage of women on corporate boards to 30% by 2015 and 40% by 2020.

*"I call on publicly listed companies from all over Europe to sign the 'Women on the Board Pledge for Europe' and to develop their own credible way to get more women into top jobs," stated EU commissioner Viviane Reding. "A year from now... the commission will assess whether credible self-regulatory initiatives were developed to enhance women's participation in decision-making. If this has happened by March 2012, I will congratulate the European business world. If not, you can count on my regulatory creativity."*

## FINANCIAL REPORTING COUNCIL

### Risk responsibilities: what is good practice?



The UK Financial Reporting Council (FRC) has deferred its planned review of the Turnbull guidance (on internal control). It first wants to explore how companies are responding to the new principle in the revised UK Corporate Governance Code that boards are responsible for determining the nature

and extent of the significant risks they are willing to take in achieving their strategic objectives.

The FRC has been holding a series of meetings with board chairs, audit and risk committee chairs, executives, investors and advisers to share views

and experience. Questions on the agenda include:

- What are the respective roles of the board, board committees and management, and how do they interact? Where does oversight end and operational management begin?
- How are boards determining their appetite for risk?
- What are the risks that the board needs to 'own'?
- What information and advice do the board and audit committee need to carry out their responsibilities?
- How do boards get confidence that the risk management and internal control system function effectively at operational level?
- How do boards report effectively on these issues to shareholders?

The meetings will inform how the FRC can most usefully help boards and committees, including through an update of the Turnbull guidance, if there is a need for this.

## Strengthening governance to attract investment

The Securities and Exchange Commission of Pakistan (SECP) has pushed back the introduction of a revised Code of Corporate Governance to allow more time for consultation with stakeholders.

The proposed code will replace the 2002 Code of Corporate Governance, applicable to all listed companies. Revisions were published in October 2010 with a view to bringing the proposals into effect from 31 March 2011. However, the SECP announced in January 2011 that implementation would be delayed until 1 July, to allow more time for input from interested parties. This will include consultations with the chambers of commerce and a roundtable with large companies in the corporate sector.

The SECP initiated a review of the code to take into account lessons learned from practical implementation and to bring corporate governance requirements in

line with international best practice, as well as helping Pakistan to build strong and transparent capital markets.

The commission's view is that good corporate governance is essential to safeguard the interests of all stakeholders, especially minority stakeholders. "Good corporate governance practices serve as an incentive for attracting foreign investment and enhance companies' access to capital," explained Muhammad Ali, the SECP chairman.

The proposed amendments focus on the board's roles and responsibilities. These include: the representation of independent and executive directors; the roles of chairman and CEO; the number of total directorships in listed companies held by an individual; self-evaluation of the boards; director's education and training; and remuneration and additional committees of the board.

### Proposed amendments to the code

The main proposals include:

- Separation of the roles of chairman and non-executive directors
- Chairman to be elected from the non-executive directors of the company
- One third of the board to be independent directors (or three, whichever is higher)
- No individual to hold more than five listed company directorships
- Introduction of board evaluation reviews to improve accountability
- Mandatory for directors to hold accredited education credentials
- Audit committees to have a majority of independent directors and an independent chairman

## TURKEY

# A blueprint for the future

A new Commercial Code has been approved to strengthen corporate governance, public trust and transparency. With an overhaul of the corporate structure, it brings significant change for business.

The new Turkish Commercial Code (TCC) was approved by parliament in January 2011, and comes into effect from 1 July 2012. With a focus on good corporate governance, the code is built around the four pillars of: transparency, fairness, accountability and responsibility.

Parallel to the pillar of transparency and the need for restructuring Turkish companies to be internationally competitive, the new code places importance on the need to speak the language of the international markets. The financial statements of all companies, public or not, will need to be prepared in accordance with Turkish Accounting Standards (TAS), which are a local translation of International Financial Reporting Standards (IFRS).

The New TCC makes it mandatory for all capital stock companies to have an independent audit, with audit firms allowed to audit the financial statements of all companies, regardless of size. Audits will follow Turkish Standards on Auditing (TDS), which are consistent with International Standards on Auditing. Another change is the introduction of the transaction auditor, who will audit various business deals such as incorporation, merger, and capital market listings.

"The requirement for an independent audit is an important development," said Adnan Akan, PwC partner in Turkey. "This increased accountability will give stakeholders greater confidence in the financial statements of Turkish companies."

### Stakeholder communications

One of the ways the code aims to ensure transparency is by requiring companies to have a website with an area dedicated to stakeholder communications. This must make available all legal announcements, financial statements,

annual reports and the auditors' reports. The website will also be used to provide access to general assembly and board meeting papers and for electronic voting.

### Single shareholder

The TCC introduces the concept of the single shareholder or partner. This change abolishes the requirement for incorporation by a minimum of five shareholders for joint stock companies, or two partners for limited liability companies. The single shareholder or single member partner is allowed to exercise all the authorisations granted to the general assembly, with full responsibility for decision making. In addition, companies may have a board of directors consisting of one person.

"The new TCC is expected to attract more foreign investment to Turkey," concluded Mr Akan. "The improved transparency the code introduces will provide more protection to the minority shareholder, even if they intend to acquire a non-controlling interest."

# The internet just got scary



Cyber security issues top CEOs' list of 'risks to watch', ahead of weapons of mass destruction and resource scarcity, according to the *Global Risks 2011 Report*, published by the World Economic Forum. Company boards and CEOs are clearly recognising that they need to be 'cyber savvy' if they are to survive and thrive in today's internet world.

"2010 was the year the internet got scary – get used to it!" That's how technology writer Arik Hesseldahl describes the start of a new era in which

information security issues are becoming regular headline material. While the internet presents enormous opportunities, the threats are getting more sophisticated and serious – take the recent WikiLeaks scandal and the impact it has had on both governments and businesses.

Addressing the 2011 Munich Security Conference, William Hague, UK Foreign Secretary, said: "The internet, with its incredible connective power, has created opportunity on a vast and growing scale...But there is a darker side to cyberspace that arises from our dependence on it."

"CEOs and boards need to balance the risks and rewards if they are to reap the benefits it offers," said William Beer, a director in the Security practice at PwC. "Getting the IT right is not enough. People, process and technology all require equal attention." He added that CEOs today, across every type of organisation, need to adapt and be able to respond with agility and clarity to the issues threatening both their operations and their reputations.

## What can boards and CEOs do?

PwC argues that good governance around this issue can make all the difference to protecting companies. Their tips for CEOs and boards include:

- Understand your responsibilities as distinct from other senior executives and plan ahead to protect the share price and reputation
- Recognise that threats are as likely to come from within the organisation as outside it
- Seek competitive advantage from innovation in areas such as social media, cloud computing and mobility
- Know enough to ask the right questions of chief information security officers (CISO) and be able to respond confidently to challenges from non-executive directors, investors and the media
- Set the right 'tone from the top', developing a culture that minimises behavioural risk
- Recognise that this is much more than an IT issue for the CISO to fix

## CYBER SECURITY

# How to assess green fraud risks

The €45 million cyber fraud that shut down all European Union emissions trading registries clearly demonstrated the seriousness of cyber crime, and confirms a growing trend by organised criminals looking for 'soft targets', such as companies that do not prioritise security as much as banks.

A recent PwC report – *How to assess your green fraud risks* – explores fraud risks in the sustainability market and the steps you should take to mitigate or eliminate them. It includes an overview of the carbon markets, divided into: emissions trading schemes; project-based carbon credits; and the voluntary carbon market.

The paper also considers the dangers for companies when reporting on their own green credentials – for example: 'cherry

picking' to report only sustainability successes will quickly destroy trust in a company; and so will changing the measurement basis to prevent comparability of year-to-year data; or manipulating the way data is processed or changing key assumptions to show improving sustainability performance.

The report highlights potential new areas of green fraud risk, such as:

- Fraudulent activity by computer hackers is expected to increase.
- New carbon markets are expected to attract fraudsters, especially where there are inexperienced players and unproven or inadequate systems and infrastructure to support the market.
- Bribery and corruption will be a particular risk where very substantial funds are being committed to support climate action in the developing world.

- Development aid to prevent deforestation (REDD+) is also likely to attract fraud.

"Tackling green fraud is more about good governance than anything else," said Jonathan Grant from PwC's sustainability and climate change practice. "Technology and globalisation are making the world a smaller place for fraudsters."

"We are seeing a surge in frauds with a green element," added Jonathan Holmes of PwC forensic services in the UK. "Often this is down to a lack of a mature information security policies and controls."

[www.pwc.co.uk/eng/publications/how-to-assess-your-green-fraud-risks.html](http://www.pwc.co.uk/eng/publications/how-to-assess-your-green-fraud-risks.html)

TOMORROW'S CORPORATE REPORTING

# Reporting system at risk, study finds

A new report by Tomorrow's Company, PwC and the Chartered Institute of Management Accountants looks at the underlying issues with today's corporate reporting system. One stakeholder quoted in the report defines reports as: "too big, too cumbersome and incomprehensible". But another points out: "[Complex reporting] is a reflection of the inherent difficulties in understanding [complex] businesses, not a failure of the reporting system." See Opinion article on page 10.

*Tomorrow's Corporate Reporting: A critical system at risk* highlights that very few, if any, stakeholders in the current reporting system see it as a 'system' at all – rather they see particular pieces of the jigsaw. The elephant on the cover illustrates this point, depicting people touching different parts of the elephant – but failing to see the whole 'beast'.

The research also considers the culture and behaviours of those involved in the system and aims to help stakeholders understand each other's perspectives. It gives a framework for how they might play a role in innovating and evolving the reporting system to ensure it remains relevant and meets the needs of the market and our society going forward. 'Fit for purpose reporting', according to one point of view in the report, means: "...to give a complete picture of the health and prospects of a company..."

This study does not look at the content of an ideal report and has, intentionally, not reached a conclusion on the way ahead, but has asked some critical questions, including about the objective of corporate reporting, global convergence and whether the current structure of the system is itself a barrier on change.



### **Key challenges of today's reporting system**

The research calls for the key challenges to be understood and addressed to create a reporting system that is responsive to the changing business environment and adequately accounts for long-term value creation.

- Stakeholders tend to see a 'jigsaw in pieces' rather than a whole system.
- The system is often treated as purely an information system for processing data – the report defines the system as: "all the individuals, organisations, institutions, rules and processes through which companies communicate their performance and activities."
- There are many different and conflicting views about the purpose of reporting.
- There are a number of parallel reporting systems – eg, for internal management reporting, regulated financial reporting and voluntary sustainability reporting – which are frequently not aligned.
- There is a focus on quantity, not quality as numerous requirements have been bolted on to the model.
- Complexity is a barrier and yet there is little incentive for change because that might bring new liabilities.
- The tradition has been to report historical, rather than forward-looking, information.

# Reporting insight

A series of investor views from PwC provides companies with insight gleaned from ongoing dialogue with the investment community. It highlights the reporting areas of most interest to analysts and investors, with the aim of helping preparers improve their communication to the capital markets.

The topics covered in *Investor view* include net debt reconciliation, non-GAAP measures, IFRS transition, accounting policies, narrative reporting, cash flow disclosure, and merger and acquisition disclosures.

Email [info@corporatereporting.com](mailto:info@corporatereporting.com) for copies.

## MAURITIUS

### Effective reporting recognised

The judges at the 13th Corporate Reporting Awards organised by PwC in Mauritius said that for most companies the quality of reporting has hit a plateau in the last few years, and called for a 'quantum leap' in quality.

Several companies were recognised for their effective reporting, including:

- Robert Le Maire – listed companies and governance disclosures awards
- SBM Group – online reporting
- Shell Mauritius – new award for risk management disclosures

Professor Mervyn King spoke at the event and highlighted the importance of an integrated reporting approach to communicate board and management's decisions to stakeholders and explain both the negative and positive aspects of business performance.

The judges made their assessment against three key criteria: content, clarity and correlation.

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

# Direction for world's first 'integrated reporters'



South Africa's Integrated Reporting Committee (IRC) issued a report in January this year to give direction to the 400 companies listed on the Johannesburg Stock Exchange (JSE) that are obliged to produce the world's first mandatory 'integrated reports' for their current financial years. The guidance views the integrated report as the organisation's primary report.

The guidance defines for the first time what the content of an integrated report should be. It is part of a growing international trend to encourage organisations to report on their total performance and not just their financial performance. The IRC in South Africa has strong links with the International Integrated Reporting Committee (see page 23).

The old form of annual reports focus primarily on financial information and the short-term horizon, and this is now being seen as no longer adequate to meet the needs of investors and other stakeholders today. This is the reason that the King Committee recommended – in the *King Report on Governance for South Africa 2009* (King III) – that organisations issue integrated reports, connecting material financial and non-financial information. Stakeholders could then make an informed assessment of the long-term sustainability of a business and how the material issues for the business have been incorporated into its strategic direction.

*“The path to integrated reporting is an ever evolving one,” said PwC partner in South Africa Zubair Wadee. “There will be reporters who simply combine reports and those who strive towards integrated reporting. However, we believe that early integrated reporters will see benefits such as improved stakeholder confidence – this will win over many sceptics and result in further improvements to the quality of reporting.”*

In February 2010, the JSE, through its Listings Requirements, made it compulsory for all listed companies to comply with King III, including the requirement for a company to produce an integrated report for its financial year starting on or after 1 March 2010, or to explain why it was not doing so. Integrated reporting is an evolution of corporate reporting and is gathering pace internationally as a way to deal with the narrow focus of the existing corporate reporting model on mainly financial information.

“I believe this will lead to a fundamental shift in the way companies and directors act and organise themselves,” said Mervyn King, chairman of the IRC and the King Committee in South Africa. “As companies integrate and connect the financial, economic, social and environmental aspects into their businesses, they are likely to become more innovative and competitive and recognise new business opportunities.”

# Global support for integrated reporting

The International Integrated Reporting Committee (IIRC) continues to gather global support – this time from the Chinese government during their recent meeting in Beijing in January.

This was attended by the Chinese Ministry of Finance and VIPs from large companies, the Japanese Stock Exchange, IOSCO and the Global Compact. The committee made

a significant agreement to focus on a framework of ‘integrated reporting’ primarily for the capital markets, rather than wider stakeholders.

A significant discussion paper is expected from the IIRC in July, see opinion article on page 6.

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

## Viva reporting on sustainability!

Sustainability reporting in Spain has been given a parliamentary boost. From 2012, state-owned companies in Spain will be required to produce sustainability reports in accordance with the Sustainable Economy Law, which was passed by the Spanish parliament in February. The law emphasises gender equality and the integration of people with disabilities. Businesses with over 1,000 employees will also be required to notify the Spanish Social Responsibility Council (CERSE) of their annual reports.

## WBCSD

# Beware risks if you don't value ecosystem dependencies and impacts



**Businesses that fail to incorporate ecosystem values into their decision making are putting themselves at risk, according to the World Business Council for Sustainable Development (WBCSD). These risks are real, but if managed properly, can be transformed into new opportunities.**

A new framework to help management understand the benefits and value of ecosystems as they strive to achieve more sustainable business practices was launched by the WBCSD in April 2011. It enables companies to consider the actual benefits and value of the ecosystem services they depend on and have an impact on, providing new information and insights that can be used in business planning and financial analysis.

The ecosystem valuation guide allows companies to set out in detail the full value of their ‘inputs’ to the ecosystem and their impact on it, including benefits linked to assets and costs associated with ecosystem loss. This links ecosystem service opportunities and risks more closely to a business’s core operations, supply chain and financial bottom line.

The *Guide to Corporate Ecosystem Valuation (CEV)* was developed by the WBCSD, working closely with PwC, World Resources Institute (WRI), Environmental Resources Management (ERM) and the International Union for Conservation of Nature (IUCN). The system was road-tested by member companies (see box below) before launch to provide key examples of the

opportunities and risks associated with ecosystems – such as fresh water, food, fibre and natural hazard protection.

“Business and ecosystems are inextricably linked. Simply put, companies that don’t know their ecosystem impact put their businesses at a greater risk and miss out on potential opportunities,” said James Griffiths, managing director, ecosystems, water and sustainable forest products industry for the WBCSD. “Valuing these impacts and dependencies helps companies make better decisions,” he added. “In addition, CEV allows business to become a bigger part of the solution for biodiversity loss and ecosystem degradation rather than just part of the problem.”

### The company road testers

AkzoNobel	Lafarge
EDP	Mondi
Eni	Rio Tinto
Eskom	Syngenta
GHD	Veolia Water
Hitachi	Weyerhaeuser
Holcim	US BCSD

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

# Fight the clutter!



A new drive has begun to cut clutter from annual reports to help users find the information they need, and to avoid wasted time for preparers.

The most recent impetus comes from the UK Financial Reporting Council (FRC) and the Accounting Standards Board's report, *Cutting clutter: Combating clutter in annual reports*, published in April.

The report defines clutter as “immaterial disclosures that inhibit the ability to identify and understand relevant information”, and “explanatory information that remains unchanged from year to year”. As the report explains: “Clutter makes it more difficult for users to assess a company's progress by obscuring relevant information. Due to the time and effort involved in preparing such disclosures, clutter is also a big issue for preparers.”

The task of cutting clutter does not fall only to preparers, the report notes – “regulators and standard setters also bear a degree of responsibility”. So do “those providing guidance to preparers, such as auditors and institutes”. All these parties need to change their behaviours.

“Understanding the behavioural influences leading to clutter is key,” the report asserts. In particular, “lack of agreement over what materiality means from a disclosure perspective results in each reviewer erring on the side of caution” – leading to immaterial disclosures and cluttered reports.

To encourage change, the report includes two short behavioural aids for

use by teams preparing and reviewing annual reports. These highlight key questions to consider at the planning phase and during subsequent review.

The report then makes three ‘calls to action’ that the FRC believes are necessary to remove existing barriers to the reduction of clutter:

- Encourage continuing debate about what materiality means from a disclosure perspective
- Investigate the possibility and potential benefits of separating explanatory information within or outside the printed annual report
- Engage with other stakeholders about their information requests

The FRC and the ASB have also developed three disclosure aids – covering governance, accounting policies and share-based payments – to demonstrate what these key areas of the annual report could look like without the clutter.

Ten other areas commonly causing clutter are also listed, including corporate social responsibility reporting, financial instruments, principal risks and remuneration reports. Examples of disclosures in these areas where clutter has been minimised are welcomed. The ASB will hold a meeting in the autumn to share views and showcase developing good practice.

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

[www.corporatereporting.com](http://www.corporatereporting.com) for examples of good practice reporting

## Sustainable business in practice

Business leaders and advisers seeking to develop sustainable business strategies can now find practical help in a handbook.

Launched at the International Federation of Accountants' 2010 World Congress in Kuala Lumpur, *Sustainable business development – The future, next exit*, focuses primarily on the ‘how’ rather than the ‘why’ of sustainable development – although it makes clear the urgent need for change to address the world's current over-consumption of non-renewable resources.

Author Lars-Olle Larsson, a partner with PwC in Sweden and a specialist within the sustainable business field, brings together multiple sources of guidance on the development and management of sustainable business activity. These include business model frameworks (such as IFAC's 2009 sustainability framework), carbon and sustainability accounting and reporting initiatives (such as the Carbon Disclosure Project and the Global Reporting Initiative) and sustainability assurance developments. Mr Larsson also emphasises the importance of creating trust in a business through brand building, communication and ‘practicing what you preach’.

The handbook is intended for use by corporate management, boards of directors and their advisers, as well as investors, asset managers, analysts and the accountancy profession, in discussions about what must be done to achieve sustainable business development.

As Larsson writes: “It should be obvious to everyone that we have come to ‘the end of the road’ and that an adjustment of former business models is necessary. Product and service development must be steered towards renewability to create a carbon free society. We are in a time of change and must find alternative solutions to the problems we face.”

For further information contact Lars-Olle Larsson at PwC in Sweden or email [info@corporatereporting.com](mailto:info@corporatereporting.com)

# Focus more on performance than disclosure



This year's annual exercise for the Carbon Disclosure Project (CDP) is now underway, and large companies around the world have been asked to respond to the annual request for information from the investors who sign up to and support CDP. Now in its 11th year, CDP is not only concerned with improving company disclosures around how climate change

and carbon affects their business. Critically, it now also considers how this information is being used to drive performance across the organisation as evidenced by the development of the Carbon Performance Leadership Index (CPLI).

The standard of disclosure over the past seven years has increased dramatically,

and the number of organisations taking part in CDP has risen steadily over the years. The increase also reflects greater activity by companies to mitigate climate change. It is this effort that CDP and its investors are now exploring further. Performance scores serve to present a fuller picture to investors and policy makers of corporate commitment to mitigate the effects of climate change.

"The change in emphasis from disclosure to performance is an interesting one," said PwC sustainability partner Alan McGill. "It shows that investors want information that gives them insight into how companies are preparing to transition and compete in a low carbon economy. Given the targets that governments are setting for carbon, management teams may want to consider how they can influence regulatory plans to ensure that they deal effectively with issues such as measurement of carbon footprints so that information is comparable, both locally and internationally."

## CARBON TAXES

# Global dash for carbon disclosures and taxation?

Governments and regulators around the world are thinking about what information they need from companies on their carbon emissions and how to incentivise business to lower their emissions through tax and other mechanisms. In the UK, for example, the Carbon Reduction Commitment Energy Efficiency Scheme (CRC scheme) provides a strong and clear financial incentive for companies covered by the scheme to invest in energy efficiency.

Recent changes have been announced to put back the first allowance sales for emissions to 2012, rather than 2011, and to base them on past energy consumption rather than on forecasts.

At the same time, the government has decided to change its original plan to keep the CRC 'revenue neutral' and redistribute funds raised to business, giving more to low emitters. Instead, revenues from allowance sales (expected to total £1 billion a year by 2014-15), will be kept by the government.

This change will increase the cost for business, particularly the larger carbon emitters, who now have a strong financial incentive to be more energy efficient to minimise the tax and offset rising energy prices. The scheme will also have a potential impact on reputation as the UK government plans to publish performance league tables and fine those companies that miss deadlines.

Alan McGill, PwC sustainability partner, said: "It makes sense for companies around the world to look at ways they can improve energy efficiency as prices continue to rise. Management teams also need to be alert to local developments as there could be a 'dash for carbon tax' as governments look for opportunities to raise taxes to help tackle large deficits and raise tax revenue in the future. Countries will want to ensure that they get their fair share of this potential tax revenue."

More information can be found at [www.decc.gov.uk](http://www.decc.gov.uk)

# Momentum for integrated guidelines and reporting picks up

**Momentum towards more globally consistent guidelines on sustainability reporting has been boosted by a partnership between the Global Reporting Initiative and the Organisation for Economic Cooperation and Development.**

The two bodies have signed a Memorandum of Understanding, aiming to establish a three-year programme to encourage companies to use both the OECD Guidelines for Multinational Enterprises and the GRI Sustainability Reporting Framework. The move reflects growing interest in the achievement of consistent and comparable non-GAAP reporting.

The OECD guidelines and the GRI framework promote the same standards and principles for responsible business conduct, addressing social, economic and environmental matters. The GRI framework provides guidance on how to measure sustainability performance, while the OECD guidelines offer a benchmark to assess such performance.



## G4 guidelines

The GRI has also started work on a new version of its guidelines – the GRI G4 Reporting Guidelines – to be ready by the end of 2012.

G4 is intended to be an important component and building block for companies preparing an integrated

report based on the framework currently in development by the International Integrated Reporting Committee (IIRC). The aim is that these will be robust enough to support higher levels of assurance and help companies to produce reports on their overall performance that are trusted by the markets and stakeholders.

## FINANCIAL REPORTING REVIEW PANEL

# NGOs take action on reporting quality

Large, complex groups have many risks to manage, but how they do this and, critically, how they communicate what they are doing, is coming under increasing scrutiny by outside interested parties. NGOs and other stakeholders have recognised how they can use existing regulation in some cases to improve the quality and consistency of company reporting.

A recent complaint by an NGO to the Financial Reporting Review Panel (FRRP), the UK regulator, is an interesting example. It raised issues about how an international mining company was responding to the reporting requirements of the Companies Act 2006. The act provides that the business review included in the directors' report must contain a fair

review of the company's business and that the review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year and the position of the company's business at the end of the year.

As a result of the investigation the company has included further information about environmental matters, social and community issues and related reputation risk to allow a more balanced analysis of its business.

## FRRP means business

The regulator has also had a much sharper focus this year on the requirement for companies to give a "description of the principal risks and uncertainties". It has already challenged

a number of listed companies' disclosures, saying that some descriptions are too generic and asking how long lists can all be 'principal' risks.

On 1 February 2011, the FRRP issued a statement in which it argued that the Act's requirements, in their interpretation, should result in companies stating:

- What their principal risks and uncertainties are
- How they affect the company
- How the company manages each of the principal risks and uncertainties

This last point – management of risks – had not been widely understood to be a requirement.

## Reducing emissions

New regulation requires companies classified as large greenhouse gas emitters to prepare and submit verified greenhouse gas emissions data every year. The legislation is set to warm up companies ahead of the stricter reporting requirements of the Green Growth Act, which comes into effect in 2015.

Despite the uncertainty surrounding a global climate agreement, South Korea has pledged to reduce its greenhouse gas by 30% against 'business as usual' in 2020.

To execute its rather ambitious goal, the Korean government passed the Green Growth Act in April 2010, which allows it to introduce carbon obligations, such as a cap and trade system, at a national level. The government originally set the starting date for the mandatory cap and trade scheme at 2013. However, the business community's concerns about the impact on Korean companies' competitiveness have led to a delay in implementation until 2015.

The government has introduced a Target Management System as an interim step toward reducing greenhouse gas emissions. The system will be operational for five years from 2011 as a mechanism for 'cap without trade' to underpin Korea's national climate change mitigation strategy.

A key aspect of the Target Management System is mandatory monitoring, reporting and verification. This requires companies to report data on their energy consumption, greenhouse gases and their carbon reduction plan. Under the regulation, 486 large emitters are obliged to submit annual, verified GHG emission data starting this year.

"Companies may find themselves struggling to prepare carbon data that satisfies the stringent external review ahead of the first reporting period," commented On Cyan Change, assurance partner at Samil PwC. "However, this new regulation is an opportunity for Korean companies to build trust in emissions reporting and enhance their sustainable brand in an age of low carbon."

## Guiding directors through the sustainability agenda



In a move to attract new investors and listings to the stock market, Bursa Malaysia has launched a business sustainability programme for directors. The programme sets out to promote sustainable practices in an organisation and provides directors with the guidance they need to oversee the implementation of an effective sustainability strategy.

Reporting of corporate social responsibility (CSR) activities in the annual report has been a requirement for all Malaysian listed companies since 2006. The comprehensive programme aims to raise awareness of the reporting requirements through its sustainability guide for directors, a knowledge portal, and a series of thought leadership sessions for more than 600 directors of public-listed companies.

*Powering business sustainability: A guide for directors* draws heavily on the experience and good practice guidelines from global organisations, including PwC, the Association of Chartered Certified Accountants (ACCA), Sustainable Asset Management (SAM) and the Financial Times Stock Exchange (FTSE). It is intended to support the board in discharging its sustainability role, where it needs to provide strategic guidance and management oversight. This includes reviewing and approving the company's sustainability strategy and ensuring transparent sustainability reporting.

The key sustainability concepts addressed in the guide include:

- 1. Why is sustainability relevant?** When viewed strategically sustainability can act as a catalyst for innovation and help identify new business opportunities, reduce risks and improve cost efficiencies
- 2. Enabling effective sustainability in the organisation:** The importance of a sustainability strategy that is aligned to stakeholder expectations, corporate strategy and values
- 3. Prioritising sustainability focus areas:** The common sustainability issues faced by companies in different industry groups
- 4. Engaging stakeholders:** The stakeholder management process and the benefits of proactive engagement
- 5. Measuring and reporting:** Good practice reporting emphasises the impact of sustainability initiatives and is transparent, credible and reflects a balanced picture of the company's activities and performance

The sustainability knowledge portal has been developed to provide up-to-date information, with interactive tools to encourage information sharing. It is intended to become a global source for sustainability information.

[www.bursamalaysia.com/sustainability/](http://www.bursamalaysia.com/sustainability/)

# FRC proposals on reporting and audit



The Financial Reporting Council (FRC) in the UK has called for higher-quality narrative reporting, particularly around strategy and risk management. It also wants to see more widespread recognition of the importance of audit committees, and greater transparency about how they discharge their responsibilities.

Its views were set out in the recent report – *Effective company stewardship: Enhancing corporate reporting and audit* – which looked at how the UK’s corporate reporting and audit models might be improved to deliver greater value to investors. This is an outcome of the FRC’s project to examine the lessons learned from the financial crisis.

Key recommendations in the report include:

- Company annual reports, viewed as a whole, should provide a fair and balanced report on the directors’ stewardship of the business.

- Directors should describe in more detail the steps they take to ensure: the reliability of the information on which the management of the company, and their stewardship, is based; transparency around business activities and any associated risks.
- Fuller reports by audit committees setting out the way they have discharged their responsibilities for the integrity of the annual report and other aspects of their remit (such as their oversight of the external audit process).
- An expanded audit report that includes a separate new section on the completeness and reasonableness of the audit committee report and identifies any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.
- Companies should take advantage of technological developments to increase the accessibility of the annual report and its components.
- Greater investor involvement is needed in the auditor appointment process.
- Development of the FRC’s powers needed to enable it to support and oversee the effective implementation of its proposals.
- Establishment by the FRC of a market participants group to advise it on market developments and international initiatives on corporate reporting and the role of assurance, and to promote best practice.

## Reporting lab

The FRC has also proposed to set up a ‘reporting lab’ as a forum where “new financial reporting models and concepts could be explored, tested and trailed (without liability) to enable greater innovation in the market”. It is intended to be a safe environment where companies and investors can come together to develop pragmatic solutions to today’s reporting needs.

The lab’s priorities are expected to be determined in large part by the companies and investors involved, but areas that might be considered include: risk reporting; rethinking the content and structure of governance and remuneration reports; better integration of financial and non-financial information; the better use of websites; and so on.

*“The recommendations around more expansive reporting by the audit committee are to be welcomed,” said PwC director Alison Thomas. “This is something that PwC has already been calling for. Making more public the discussions between the audit committee and the external auditors, through the vehicle of the committee’s report to shareholders will help collectively to improve understanding of the value of corporate reporting and audit. We also welcome the proposals for a market participants group and for a reporting lab.”*

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

## UN GLOBAL COMPACT

# Differentiate yourself, companies urged

**A new framework has been launched to help stakeholders make more thorough assessments of companies’ sustainability performance and disclosures – and to encourage companies to pursue a process of continuous improvement.**

The UN Global Compact Differentiation Programme, launched in February

following four months of testing, aims to help businesses improve their sustainability performance and reporting. The programme will classify participants in one of two categories – the GC Active or GC Advanced Level – based on their disclosures of progress made in implementing the ten Global Compact principles. Companies will also be assessed on their levels of direct

communication with stakeholders about their policies and processes for managing sustainability risks and opportunities.

The launch of the differentiation programme marks an important step in the collaboration between the UNGC and the Global Reporting Initiative, announced in May 2010. The Differentiation Programme encourages use of the GRI’s reporting framework.

## Reporting breakthrough with first environmental P&L



PUMA and PRR HOMES's new environmental profit and loss (E P&L) account makes them the first global business to put a true value on the natural resources used and the environmental impacts caused by providing products to its customers. This is expected to provide a more detailed understanding of the implications of decisions, enabling better informed actions to deliver commercial benefits and safeguard the natural assets that the business depends on.

PUMA worked with PwC and Trucost to develop a methodology to first quantify the tonnes of Greenhouse Gas Emissions (GHG) emissions and cubic meters of water consumed in their business and supply chain operations, and then apply values to account for the associated economic impacts.

The company plans to extend this P&L over the next couple of years to add social and economic impacts, such as fair wages, job creation and tax contributions to the environmental impacts.

Alan McGill, PwC sustainability and climate change partner, said: "Currently, the value of the resources used and any costs associated with environmental impacts are not fully included in the prices paid for products and this assessment represents an unprecedented

move by PUMA to address this and better report the more holistic performance of their business." Businesses that understand their impacts and dependencies on nature, he added, and understand the risks and opportunities these present, are expected to build more resilience into their business models and gain competitive advantage.

*"This type of report is a glimpse of the future of corporate reporting, enabling management to take more informed decisions about the resources used in production and giving consumers a far better picture of what goes into manufacturing and delivering a product."*

Ian Powell, PwC UK chairman

### CORPORATE SUSTAINABILITY

## Investors call for stock exchange action

Institutional investors with US\$1.6 trillion in assets under management have called on the world's largest stock exchanges to address what they perceive as inadequate corporate sustainability reporting.

The call comes in a letter from 24 major institutional investors to 30 exchanges, and is part of a broader initiative launched by Aviva Investors and facilitated by the UN-backed Principles for Responsible Investment, which encourages investors to incorporate sustainability matters into their decision making.

Drawing on Bloomberg data, the letter ranks individual listing authorities based on the current level of environmental, social and governance (ESG) disclosure by listed companies. Exchanges where a large number of companies disclose ESG data include Euronext Paris, Tokyo Stock Exchange, Helsinki, Euronext Amsterdam, Euronext Lisbon and Borsa Italiana. However, exchanges with the least number of companies disclosing such data include the Australian Stock Exchange, NASDAQ GS, Korea Exchange, Santiago Stock Exchange and Philippine Stock Exchange.

"Many global companies understand that long-term shareholder value is enhanced by both embedding sustainability into their long-term strategy and by disclosing fully their progress," commented Georg Kell, executive director of the UN Global Compact, a key supporter of the initiative. "Only when investors have business-relevant information at their fingertips will they be able to assess one company relative to its peers and allocate capital accordingly. Stock exchanges now have a significant role to play in taking obvious and important next steps to create truly sustainable capital markets."

One suggestion, particularly advocated by Aviva Investors, is that stock exchanges introduce a listing requirement for companies to consider how responsible and sustainable their business model is. Companies could also be required to put a forward-looking sustainability strategy to the vote at their AGM. This would encourage the right kinds of discussion about sustainability within listed company boardrooms, and then between companies and their shareholders.

### EUROPEAN COMMISSION

## Report assesses sustainability reporting

Readers of sustainability reports think that many "lack materiality, are incomplete and are sometimes selective in their content", according to a recent study commissioned by the European Commission. Coverage of human rights issues is highlighted as an area in need of particular improvement.

The report – *The state of play in sustainability reporting in the European Union* – looks at how companies are reporting on environmental, social and governance issues and the challenges they face. It also considers the extent to which companies' reporting and readers' needs match, and the public policy instruments available to stimulate sustainability reporting.

Key points made by the report, include: sustainability reports are growing in number, but still costly for many SMEs; companies are increasingly using the internet and web-based applications to disclose their sustainability information; and governments have a role to play in stimulating sustainability reporting.

IASB/FASB

# Convergence shifts back

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have announced that they are extending the target date for completion of their joint priority projects to the end of 2011.

The announcement came in April 2011, only two months before the previously agreed target for completion of their priority projects. These include revenue, leases, financial instruments and insurance contracts. The boards have received significant feedback on each of these, and many stakeholders expressed concern over the boards' ability to deliver high-quality standards by June 2011.

In a podcast delivered in April, IASB chairman Sir David Tweedie and FASB chairman Leslie Seidman emphasised the importance of producing high-quality standards. They also acknowledged the critical role of evaluating and incorporating stakeholder feedback.

### Progress report

The boards followed this announcement with a report updating their progress on the convergence agenda. Noteworthy actions since November 2010 include progress on a number of projects that the boards are due to complete soon. Joint standards on various aspects of group accounts (consolidations, joint arrangements and disclosures) and on fair value measurement were issued in May 2011. In addition, the IASB will issue new standards and other comprehensive income and post-employment benefits.

The boards continue to prioritise their efforts on the revenue, leasing and financial instrument projects. Plus, the boards will continue to give priority to their joint project on insurance. The boards are on the same track for revenue and leasing, although their timing may differ for financial instruments and insurance. See the detail below.

### Next steps

**Revenue and leasing** – the boards will consider whether to re-expose the proposals once they finalise their redeliberations. If re-exposure is not considered necessary, the draft standards will be made available on the boards' websites for review and for consultation with parties most affected by the proposals. The draft standards will also be subject to a 'fatal flaw' review process. The boards will consider the feedback received from these steps and either finalise the standards or consider whether additional work or re-exposure is necessary.

**Financial instruments** – the FASB plans to finalise its deliberations on classification and measurement in the third quarter of this year and consider whether re-exposure is necessary. The IASB has already finalised its classification and measurement phase set out in IFRS 9. However, it plans to expose the modified FASB approach to seek views from constituents.

The IASB will continue to deliberate its hedging proposals over the next few months. The FASB will meanwhile participate in the discussions and determine whether to move forward with the new IASB approach to hedge accounting. The FASB timing on hedge accounting is not yet clear.

The boards are working side by side on impairment. They plan to decide on a basic impairment approach in the next couple of months and then consider whether re-exposure is necessary. They also expect to finalise the joint



proposals on balance sheet offsetting in the third quarter.

**Insurance** – the boards are deliberating the insurance project jointly, but the IASB is a step closer to issuing a final standard. The boards aim to complete their deliberations on the major issues in June 2011, but further discussions are likely to carry on into the second half of 2011. The IASB is planning to release a final standard by the end of 2011. The FASB, on the other hand, plans to issue an exposure draft by the end of 2011, with a view to finalising the standard in 2012.

# US expected to adopt IFRS

**Most finance executives in a recent survey expect the US to adopt International Financial Reporting Standards (IFRS) – the key question is: when?**

A PwC survey of 1,400 finance executives and professionals, typically in businesses operating internationally and 85% headquartered in the US, has found that the vast majority (80%) expect IFRS to be adopted in the US at some point. Overall, 39% believe IFRS will be adopted in the US in either 2015 or 2016, while another 41% expect adoption after 2016. Only 12% do not believe it will be adopted at some point.

What will actually happen remains uncertain: the US Securities and Exchange Commission is expected to make a decision about the way forward for IFRS in the US late in 2011.

The survey – *2011 US GAAP convergence & IFRS survey: How companies are preparing for convergence between US GAAP and IFRS* – also sounded out opinions on which of the Financial Accounting Standards Board and International Accounting Standards Board's prioritised convergence projects could have most impact. Leasing came top of the list, with 43% of respondents expecting this project to have a very high impact on their organisation. Revenue recognition ranked second, with 31% expecting its impact to be very high, and financial instruments came third: just over one in five respondents (21%) expect its likely impact to be very high. Given that only 19% of respondents came from the financial services sector, the result shows how widespread the impact of the financial instruments project is expected to be, having repercussions across many industries.

## Cost concerns

Asked how the convergence projects would affect the quality of standards, roughly two-thirds of respondents (67%) thought quality would improve. However, just under two-thirds (60%) thought the cost-benefit insufficient to merit a change. In essence, 37% of all respondents thought convergence would improve quality – but the cost wasn't worth it.

There are also some concerns about the pace of recent standard-setting activity. Some 43% of survey participants said the pace was too fast – although another 15% thought it was too slow. Just under a third (28%) said the pace was just right.

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## CANADA

# IFRS brings opportunity to influence standard setting

The move to International Financial Reporting Standards (IFRS) has been a driver for Canadian companies to get involved in the standard setting process at an international level. This has been driven, in part, by the lack of industry-specific guidance.

IFRS came into effect for Canada's publicly accountable enterprises (PAEs) from 1 January 2011. The international standards are now required for companies with publicly listed debt or equity securities as well as companies with a fiduciary responsibility to third parties. Private companies can choose to adopt IFRS, or use Accounting Standards for Private Enterprises (ASPE), a set of Canadian-specific standards, for their financial reporting.

The lack of industry-specific guidance in areas where Canadian GAAP is explicit, or areas where IFRS is still evolving, has

created challenges for companies applying IFRS for the first time. In response to this, Canadian corporations and industry groups have been lobbying the International Accounting Standards Board (IASB) in areas such as rate-regulated activities, accounting for investment companies and insurance accounting. They have also been actively involved in ongoing IASB projects including leases, revenue recognition, financial instruments and first-time adoption of IFRS.

## A change for the better?

Adoption of IFRS should enable better comparability of financial statements for Canadian companies competing internationally. Some have questioned whether alignment with the US timeline for adoption to IFRS would have been a smarter move, given that the US is Canada's largest trading partner.

However, the move to IFRS has brought some relief for dual-listed companies, which will now be able to file IFRS financial statements with the US Securities and Exchange Commission without providing a US GAAP reconciliation.

*“Existing Canadian GAAP is closer to IFRS than the national GAAPs in Europe that investors had to contend with when Europe moved to IFRS in 2005,” said Diane Kazarian, IFRS partner at PwC in Canada. “Since 2005, international investors have become familiar with the IFRS framework. Even so, effective and timely communication by companies reporting under IFRS for the first time continues to be an important way of managing the expectations of investors and other users of the financial information as Canada approaches the first quarter of IFRS reporting.”*

# Reporting progress toward IFRS

As the date for adoption of International Financial Reporting Standards (IFRS) approaches, the Mexican National Banking and Securities Commission (CNBV) is taking steps to ensure companies are prepared for conversion and that their stakeholders are being kept informed of progress.

The CNBV announced its plans for adoption of IFRS as issued by the IASB in 2009. Since then, the publicly listed companies that will be required to change, and the accounting firms that will be auditing the IFRS financial statements, have been actively making plans. In addition, the CNBV has been proactive in its oversight of IFRS adoption by introducing measures that will identify problems at an early stage.

One such measure is the introduction of quarterly IFRS conversion reports. These must be prepared by public companies and presented along with the interim financial statements prepared under Mexican Financial Reporting Standards (MFRS). The reports contain reporting on three key elements:

- Identification of the conversion team
- IFRS training
- Conversion timeline

The objective of the conversion report is to ease adopting entities' communication to their stakeholders about their progress toward IFRS adoption, without the need for reporting detail on policies taken or adjustments made as a result of conversion. The conversion timeline identifies the timing of communications to stakeholders, an evaluation of the impact of IFRS adoption on the business and its financial statements, and timing for the implementation of the standards and the preparation of IFRS-compliant financial statements.

The CNBV has also formed a group to monitor the progress of IFRS adoption, made up of people from the Mexican Stock Exchange (BMV), the accounting standard setter (CINIF), public companies and the large accountancy firms. The group meets every two months to discuss progress and the issues that converging companies face.

## **IFRS adoption challenges**

**Hyperinflation:** The economy was considered inflationary until 2007 under MFRS, but only until 1997 under IFRS. The exemptions provided in IFRS 1, *First-time adoption of IFRS*, give inconsistent approaches to similar items in the balance sheet at transition date. In some instances it is acceptable or required to leave the effects of inflation (eg, in items such as property, plant and equipment and goodwill), but in other instances, eg, other intangibles and equity accounts, preparers are required to eliminate the effects of inflation.

**Investments in subsidiaries, joint ventures and associates:** MFRS requires accounting using the equity method in the separate financial statements, resulting in the same bottom line in the holding company's consolidated financial statements. This is not the case under IFRS – a point some entities find hard to understand.

**IFRS resource:** Companies are challenged by the shortage of IFRS-trained staff as they tackle conversion and implementation.



*“IFRS-compliant financial statements from a range of countries are being used to provide a benchmark for Mexican adopters,” said Michelle Orozco, a PwC partner and member of the monitoring group. “Where benchmarked companies have been inconsistent in their reporting this is presenting Mexican entities with an additional challenge as they strive to comply with the standards.”*

# IFRS proves a cultural challenge

**The majority of Brazilian entities have now published their first set of IFRS consolidated financial statements. For them, the move to IFRS has proved to be a cultural challenge as well as a change in accounting practice.**

The Brazilian accounting standards setter, the Comitê de Pronunciamentos Contábeis (CPC), has issued the IFRSs and interpretations applicable as of 31 December 2010 as Brazilian GAAP. These are applicable to all Brazilian companies – listed and unlisted, apart from Banks (see *World Watch*, issue 2, 2008).

The number of adjustments between former Brazilian GAAP and IFRS has been small for many entities. Despite this, several underestimated the amount of effort required to prepare a full set of IFRS financial statements, with the Brazilian securities regulator, the Comissão de Valores Mobiliários (CVM),

finding problems with at least 80% of the 2009 financial statements it reviewed. Related parties and financial instruments disclosures were the most common areas with problems.

Accounting for concessions has led to some debate, with one of the main areas of controversy being whether a contract is executory or not. Should an entity recognise an asset and liability at the start of the contract or just recognise payments made in the income statement over the period of the concession?

“Many in the electricity and toll-road sectors have been upset by the requirement to recognise financial liabilities on which interest accrues over the next 20 or 30 years,” said Tadeu Cendon, a partner at PwC Brazil. “When the Brazilian Central bank’s reference interest rate is 11.25% this really makes a difference. A frequent complaint is: ‘I’ll never be able to pay a dividend again’.”

The level of communication with investors has been less timely and less extensive than it might have been – certainly compared with communications made during the European move to IFRS. “This has been partly due to changes in the regulatory requirements,” added Mr Cendon. “At first, listed companies were required to file their quarterly financial information in accordance with IFRS, but the CVM later relented and allowed them to file based on old Brazilian GAAP. Companies will need to re-file their quarterlies under IFRS ahead of publishing their annual financial statements.”

Brazilian banks are exempt from applying IFRS until 31 December 2011. The Brazilian Central bank has permitted them to not present comparative information in their 2010 IFRS consolidated financial statements, and many will be taking advantage of this exemption. However, when the time comes, they will have their own challenges to face.

## INDIA

# Slowing the pace of convergence

The convergence of Indian GAAP with International Financial Reporting Standards (IFRS) was the talk of the town in the run-up to the proposed transition date of 1 April 2011. However, since March this year there has been an eerie silence from the various bodies that were working to write and endorse the new standards.

The silence has been accompanied by a general realisation that India has failed to meet its May 2008 commitment to the G-20 for convergence with IFRS by April 2011. While there has been no official word on any deferral, senior government officials have been quoted as confirming a delay in requiring companies to apply the new accounting standards.

No indication has been given of any revised timetable for convergence.

India’s failure to adhere to its proposed plan is seen by many as a victory for India Limited. The Federation of Indian Chambers of Commerce and Industry (FICCI) had earlier lobbied hard with

the Ministry of Corporate Affairs (MCA), which is supervising the convergence process. In an open letter, the FICCI advocated a deferral to provide preparers with more time to prepare for implementation of the new standards, saying the deadline was “highly unworkable” and “unfair”.

The deferral may come as the second blow in almost as many months to the International Accounting Standards Board’s plans to bring India into the growing list of countries already embracing IFRS-based standards. In January the Institute of Chartered Accountants of India (ICAI) published ‘near-final’ drafts of the converged Indian Accounting Standards, typically referred to as Ind AS. These standards were closely followed by ‘final’ standards published on the MCA’s website, although these have still not been notified or, therefore, become effective. Each suite of published standards introduced additional differences through exceptions, ‘carve-outs’ and ‘carve-ins’ relative to IFRS.

“A company that wishes to apply Ind AS in a manner broadly similar to IFRS could minimise GAAP differences by not taking advantage of the myriad of relaxations and exemptions in the revised Ind AS,” said Ian Farrar, accounting consulting services leader for PwC in India. “The financial statements of those companies that do avail themselves of these liberalised requirements could well bear little resemblance to those of an IFRS reporter, particularly if they operate in real estate, agriculture, or industries – such as the power sector – that regularly enter tolling arrangements.”

Given the modifications made to IFRS to arrive at the proposed Ind AS, many have questioned whether the cost of making a wholesale change in the reporting framework will translate into benefits for India Limited. “Perhaps postponing convergence may allow the rule-makers to pause for thought, enabling them to weigh up the costs and benefits of adopting a watered-down version of IFRS,” Mr Farrar concluded.

# Proposals to boost IASB governance

The governance of the IASB and the IFRS Foundation (the Trustee body that directly oversees the IASB) is currently being reviewed by the Monitoring Board of regulatory authorities. The Monitoring Board's review is focused on "the institutional aspects relating to governance, in particular the composition and respective responsibilities and roles of the Monitoring Board, Trustees and IASB".

The Monitoring Board issued a consultative report in early February 2011, with a two-month comment period. Key recommendations or proposals for comment included:

- Separating the roles of IASB chair and CEO, and clearer separation of Foundation and IASB staff
- Formal procedures and clearer criteria for nomination of trustees
- Expansion of Monitoring Board membership to eleven (from the present five) – to include four new permanent members from securities authorities in major emerging markets plus two rotating from other territories not represented
- Increased involvement of other public authorities (for example prudential regulators) – by extending observer status or creating an advisory body
- Consideration of an explicit provision to allow the Monitoring Board to place an item on the IASB agenda
- Enhancing the Monitoring Board's role in the nomination of the IASB chair
- Consultation with the Monitoring Board on the broad composition of IASB membership
- Establishing a permanent secretariat for the Monitoring Board
- Consideration of whether the current arrangements for standard setting take all relevant public policy objectives into account

The Monitoring Board's review of governance is being coordinated with the IFRS Foundation Trustees' separate,

concurrent review of the strategy of the organisation (which is more focused on the IASB's mission, due process and operations). In addition to its written consultation, the Monitoring Board also held public roundtables in March 2011 – in Brussels, Kuala Lumpur, Tokyo and Palo Alto, California.

PwC participated in the roundtables and submitted a letter responding to the proposals. John Hitchins, PwC global chief accountant, told *World Watch*: "We support the emphasis on the capital markets and agree with the Monitoring Board's view that the governance structure of the IFRS Foundation should be accountable

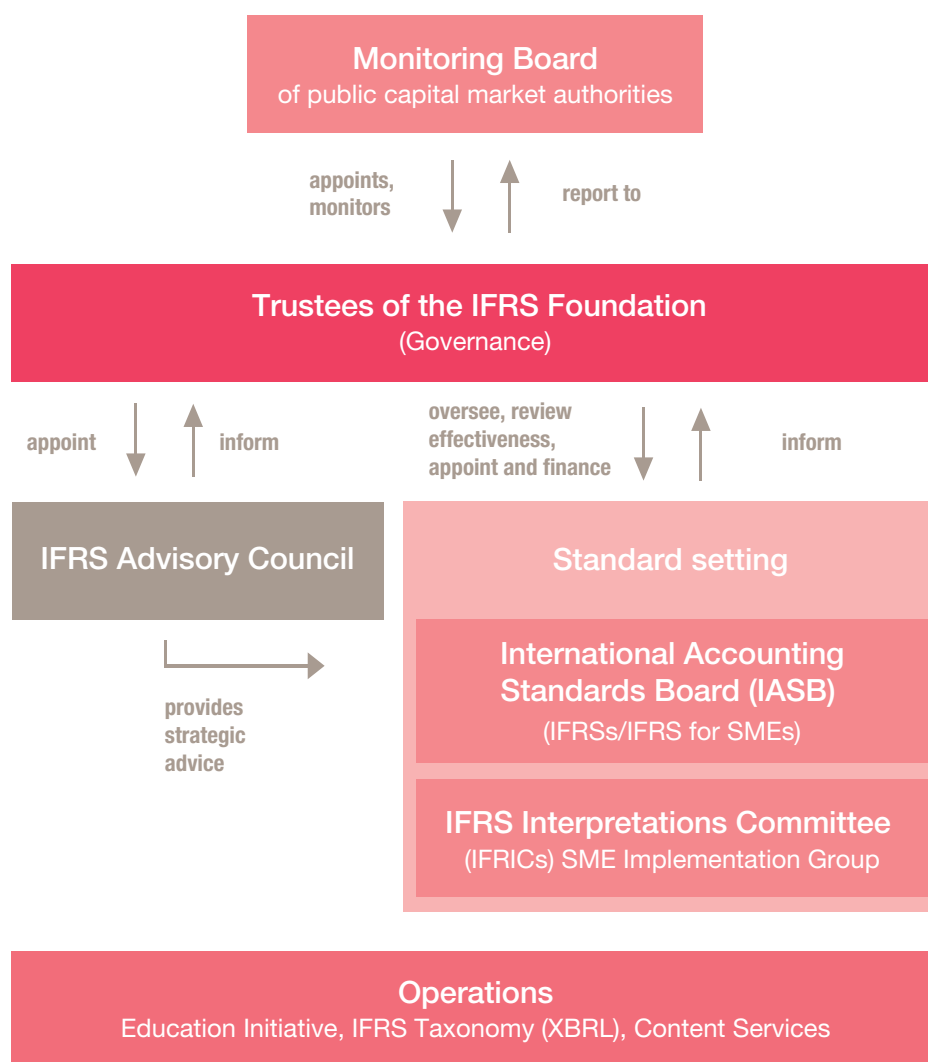
primarily to the needs of capital providers while also taking into account the needs of other users of financial statements."

Feedback from the consultation process will be used to assess support for the proposals and to enhance them. The Monitoring Board expects to publish, in coordination with the IFRS Foundation Trustees, an action plan for implementation of its proposals early in the third quarter of 2011.

The discussion paper is open for comment until 31 August 2011.

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

## Structure of the IASB



Source: IASB [www.ifrs.org](http://www.ifrs.org)

## New challenges: companies will have to raise their game

Changes in tax reporting are placing challenging demands on tax directors. The layout of tax reporting in financial statements itself may not be altering much, but the context is continuously evolving, and this has an impact on the disclosure of the tax numbers and the processes and people behind them, according to Thierry Morgant and Andrew Wiggins at PwC.

In particular, companies will need to be alert to the impact of new accounting standards, requirements from tax authorities, evolving business models, and the changing needs of different stakeholders. The IRS in the US, for example, has introduced new rules around the disclosure of uncertain tax positions (on the US income tax return) linked to the accounting basis under US GAAP or IFRS. Fundamental accounting changes are on the horizon, such as on revenue recognition and leasing, that could have a significant impact on cash taxes and profile where tax systems are aligned to accounts.

New business models using shared service centres create challenges too, particularly where local knowledge is required to access data, justify tax numbers as part of local tax authority audits and comply with local compliance requirements. Where companies are introducing organisation-wide accounting (ERP) systems, often these have not been appropriately configured for taxes, which can cause complications for tax reporting.

As tax becomes more of a boardroom issue, there are many more interested

parties who scrutinise the tax numbers, and who have a perspective on what the tax numbers should look like, what they mean, and how they should be communicated. At the same time, tax authorities are changing their approach to audits. Pressures on costs and headcount have driven them towards a more risk-based approach, which means that the onus is increasingly on companies to identify and quantify their tax risks.

### Tips for tax reporting

- Assume that tax authorities will require more identification and quantification of risks as they impact on individual territories. Prepare for greater transparency and disclosure around uncertain tax positions.
- Actively engage in strategic decision-making around new business models or accounting systems and ensure that decisions are taken in full knowledge of the tax challenges that can result.
- Consider the impact of tax authority investigations on a shared service centre model and make sure people with local tax knowledge are able to respond to queries.
- Get involved in lobbying activities with tax authorities and the accounting standards boards to make sure your perspective is heard.
- Ensure you are aware of forthcoming International Financial Reporting Standards (IFRS) changes and what they mean for taxes in your organisation.

### IFRS

## Guidance on preparing interims

To help companies preparing IFRS interim financial statements, PwC has published *Illustrative interim financial information 2011*. This updated illustrative set of condensed interim financial information reflects IFRS standards and IFRIC interpretations that are mandatory for annual reporting periods starting from 1 January 2011.

The guidance includes a disclosure checklist, an overview of IAS 34, *Interim financial reporting*, and an appendix with example disclosures for first-time adopters of IFRS 9, *Financial instruments*.

To obtain your copy, contact your local PwC office or download a pdf from [www.pwc.com/ifrs](http://www.pwc.com/ifrs)

## IFRS taxonomy draws an audience

The inaugural IFRS taxonomy convention took place in London in March, hosted by the IFRS Foundation and XBRL International. It provided a forum for various stakeholders with a common interest in the use of XBRL to exchange views on its preparation, application and use for the analysis of financial information. These included international government agencies, financial institutions and regulators, including the US Securities and Exchange Commission (SEC), the IASB and XBRL International.

The IFRS Foundation and XBRL International both have an interest in making the exchange of business and financial information more effective. In today's world, applying different standards to economic information can make comparison difficult and transparency almost impossible. Getting regulators to agree on an acceptable taxonomy is difficult. In April, the SEC issued a 'No action' letter, which states that foreign private issuers that prepare their financial statements in accordance with IFRS, are not required to submit interactive data files to the SEC or post them on their company websites – at least until the SEC specifies a taxonomy for them to use when preparing their interactive data files.

"XBRL is being taken up by regulators across the world as an opportunity for them to achieve better risk profiling, more efficient processing of information and improved standardisation of regulatory submissions," said Jon Rowden, PwC UK XBRL assurance leader. "Many of the attendees were regulators keen to explore the possibilities and take these back to assess the business case for introduction. It seems clear that XBRL has now achieved lift-off, thanks to the pioneering work of early-adopting regulators such as the SEC and the UK tax authority."

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## AUDIT REPORTING

# Is a global perspective possible?

Debate is heating up on audit reporting and whether the current standard form of auditor's report meets investors' needs. Consultations have either been released or are expected to be released within the next few months in the UK, US and globally.

Fuelled by the turbulent events of the global financial crisis, investors are demanding additional, and more pertinent, information about entities and the processes that support the quality of their financial statements. Part of the focus has been on the auditor's report, with investors and other stakeholders arguing that the current 'binary' audit opinion fails to provide any insights into an entity's financial reporting that they believe would add value.

The UK Financial Reporting Council's (FRC's) consultation – *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* – proposes a model of fuller reporting by audit committees with an expanded audit report that would comment on the completeness and reasonableness of the audit committee report. See also page 28. Other models already in practice today are the German long-form reports to supervisory boards and French audit reports that include auditors' 'justification' for their audit opinion (which, in effect, direct readers to the financial statement notes that deal with key risks and uncertainties in estimates made in the financial statements).

The US Public Company Audit Oversight Board (PCAOB) recently released the results of extensive consultation with investors, preparers and auditors (see page 38). The PCAOB expects to release a Concept Release on possible changes that could be made to the auditor's report at the end of June, and plans to hold roundtables later this year in anticipation of an exposure draft for a new auditor's report early in 2012.

The International Auditing and Assurance Standards Board (IAASB)



will release a consultation paper by June 2011 to bring a global perspective to the debate. The purpose of the international consultation is to determine whether there are common views among key users of audited financial statements and other interested parties about the usefulness of audit reporting today, and to explore possible options to enhance the quality, relevance and value of audit reporting. It will explore ways to narrow the perceived 'information gap' or improve the communicative value of the auditor's report.

Possible options to narrow the 'information gap' include:

- Improvements to the content and presentation of information in the current auditor's report
- Introducing more narrative in audit reports
- Expanding the scope of the audit to include a broader range of disclosures by companies

Expectations for a new approach to audit reporting are high. But with so much debate and differing legal, regulatory and corporate governance structures around the world, it may be difficult for the IAASB to find globally acceptable solutions.

# The audit market in the spotlight

The structure of the audit market, the role of the auditor, and their independence are among a number of topics being considered by the European Commission (EC) and the Office of Fair Trading, resulting from the report of the UK House of Lords Economic Affairs Committee.

## EC consults on the audit

In February the European Commission published its summary of the responses to its green paper – *Audit Policy: Lessons from the Crisis*. Approximately 700 responses were received by the commission (with 48% originating in Germany), providing 10,000 pages of comments. This is a record for an Internal Market Commission consultation.

The summary identifies that among the responses there was little support for a number of areas identified by the commission such as: third party appointment of auditors; mandatory audit firm rotation; an audit opinion to provide comfort on the financial health of companies; or for the immediate enforced breakup of the four largest accounting firms.

The responses to the green paper showed clear support for improved transparency in the audit, for redefining the role of the auditor and for improved EU-wide coordination of audit oversight. There is also concern from some groups around the need to reinforce professional scepticism, and around the potential issues for the market if there was a collapse of a Big Four Firm.

To support their investigation of this topic, the commission held a conference in February. The opening speech was given by the internal market commissioner Michel Barnier. He said that the commission has yet to reach conclusions on which areas it wishes to pursue, and implied that topics such as a total prohibition on auditors providing non-audit services and joint audit were under consideration.

The European Parliament report will be final in June and a legislative proposal is likely to be brought forward towards the end of 2011. However, we are still quite a long way away from the introduction of any new legislation.

## House of Lords action on audit

The House of Lords Economic Affairs Committee completed its hearings to gather evidence in mid January and published its report on 30 March. The committee had three main areas of focus: the relationship between the auditor and financial regulators; the role of the auditor in providing assurance on 'forward looking' statements made by companies; and audit market concentration. A number of groups provided evidence, either written and/or verbal, to the committee.

The committee claims that the audit market for large listed companies offers insufficient choice, and recommends that the Office of Fair Trading (OFT) conduct an investigation into the level of competition and choice in the audit market. The committee also claims that the firms auditing large banks could have done more to raise concerns in the run up to the financial crisis.

"There is much in the report that we welcome, including the recommendation that bank auditors and banking regulators and supervisors should have an enhanced dialogue," said PwC UK chairman Ian Powell. "We are already working with the Financial Services Authority (FSA) to implement this."

He took issue, however, with the recommendation that the OFT should consider these matters and some of the language in the report. "I am particularly disappointed that the committee recommends that the OFT should hold an investigation into the audit market. This is a fiercely competitive market at all levels – more than 55% of AIM audits are already provided by non- Big Four firms.

"I am surprised at the committee's claim that there was a 'dereliction of duty', given their stated view that we fulfilled our legal duties. Like other market participants, we accept there are lessons to be learned from the financial crisis and we have already implemented a number of measures to reinforce the relevance of the audit."

## OFT Enquiry

On the 17 May, the OFT announced that it had "provisionally decided that there are competition problems in the audit market" but was intending to "discuss with interested bodies whether, in practice, potential remedies exist that could allow the [Competition] Commission to resolve these problems".

The OFT has signalled that it will be holding a number of bilateral meetings and roundtables to consider these matters before the end of June. It appears that part of the OFT's deliberations will also consider the international dimension of the audit market.

In reaching its provisional view the OFT has decided that a market study is unnecessary in this case, which it something it would usually carry out.

The OFT will consult later this year on whether, or not, to refer the matter to the Competition Commission.

For some time, PwC has been looking for ways to improve audit transparency, for example by encouraging audit committees to enhance their reporting on their dialogue with auditors. Some companies are already responding to this, for example a large bank has published a comprehensive report setting out key issues that were considered by the committee on the financial statements and accounting policies. Another company has included additional information on key risks and accounting policies in their audit committee report.

PwC has also initiated a dialogue with investors to discover their views on what value they get from audits and how the areas on which auditors give assurance might usefully change in the future.

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[www.ec.europa.eu/internal\\_market/auditing/index\\_en.htm](http://www.ec.europa.eu/internal_market/auditing/index_en.htm)

[www.parliament.uk](http://www.parliament.uk)

*"Like other market participants, we accept there are lessons to be learned from the financial crisis"* Ian Powell, PwC UK chairman

# Call for more insight from auditors

US investors are calling for more information about the process of an audit as well as more detail about what auditors find out during their audits. The US Public Company Accounting Oversight Board's (PCAOB's) Investor Advisory Group surveyed leaders at major investment houses, including banks, private equity funds, pension funds, and hedge funds.

While almost three quarters of respondents skim audit reports quickly for any departures from the norm, a significant minority (45%) of respondents said that audit reports don't provide enough valuable information. As one CEO of a hedge fund said: "The statement feels very binary – either a qualified opinion or not. Not a lot of incremental information once a company gets an unqualified opinion."

In contrast, an audit committee member commented that the audit report was not intended to be read in isolation but together with other disclosures, the management discussion & analysis, management's statements on controls and the audit committee report.

## Survey results

Of the 73 respondents, 77% were keen to understand more about how auditors deal with audit risk, and 56% wanted to know how auditors deal with materiality levels and factors.

A large majority of investors also wanted to know more about what auditors find out during the audit:

- 79% want to know more about auditors' assessments of the estimates and judgements made by management and how auditors make these assessments.
- 67% support discussion of unusual transactions, restatements, and other changes.



- 65% of investors call for an assessment of the quality of accounting policies and practices.
- 65% want discussion of sensitivity analyses performed by the auditor in significant judgemental areas.

More than half of respondents were supportive of including or requiring a narrative summary of the information that the auditor communicates to the audit committee (56%); and 52% called for a separate auditor discussion and analysis (AD&A). However, respondents expressed opposing points of view.

"Any insight into the disconnect between the company's and the auditor's assumptions gives a better sense of management, and management's willingness to engage in aggressive accounting," said one mutual fund credit analyst. However, a mutual fund audit committee member had concerns: "The zeal for more specific information to be made public will, in my opinion,

constrain quality dialogue among auditors and audit committees."

In a series of recent public meetings, PCAOB staff presented the outcome of their consultation to understand the views of investors, preparers and auditors. PCAOB chairman James Doty said: "We heard from investors that they want more information in the auditor's report. Investor dissatisfaction with the current auditor's reporting model should concern other constituents as well, including preparers, auditors and regulators."

"The auditor's reporting model is a top standard-setting priority of the board," said Martin Baumann, chief auditor and director of professional standards at the PCAOB.

A concept release with meaningful proposals for change is expected to be released by late June 2011.

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

# What influences audit quality?



**In January, the International Auditing and Assurance Standards Board (IAASB) released a short thought piece on audit quality. *Audit quality: An IAASB perspective.* Audit quality is, of course, a matter of particular importance for IAASB. The International Standards on Auditing and International Standard on Quality Control play a pivotal role in contributing to audit quality by providing globally recognised and accepted benchmarks for performance of audits.**

But the paper makes the important observation that standards are only one of several components influencing audit quality. Other influences include: user perceptions; the skills and competencies of auditors; the actions of others in the reporting supply chain, and the legal, regulatory and business environments.

A key theme in the paper is the need for dialogue and collaboration among stakeholders with an interest in audit quality. Different stakeholders – investors, audit committees, regulators, preparers – are likely to have different views about what audit quality is and how it can be enhanced. The IAASB seeks to share and discuss the different perspectives in order to reach a common vision that will guide its activities.

The paper discusses the contribution of IAASB standards to audit quality, including:

- Promoting a ‘thinking’ audit and emphasising the importance of professional scepticism
- Increasing audit effort in areas that pose a higher risk of material misstatement (eg, estimates and fair values and related party transactions)
- Addressing the quality of audit evidence, and ensuring that there is an appropriate basis when using the work of others
- Emphasising the importance of open and constructive dialogue between auditors and audit committees and management.

The IAASB is now considering what more can be done to contribute to the debate on audit quality. One option being considered is a public consultation on the development of an international audit quality framework.

In the meantime, the IAASB intends to generate debate on the topic in its outreach activities. Views on the thought piece and other perspectives on audit quality are welcomed.

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

## Disclosures discussion paper released

As anticipated, the International Auditing and Assurance Standards Board (IAASB) released its discussion paper – *The evolving nature of financial reporting: Disclosures and its audit implications* – in January.

With greater use of fair values and other estimates in financial reporting, financial statement disclosures have taken on increasing importance. Financial reporting has evolved to try and meet users’ changing needs as business models become more complex and sources of risk and uncertainty change. It is now common to see disclosures that are more forward-looking or qualitative – this information is relevant to users, even if it may be more subjective and less reliable.

This development, however, raises important questions:

- What constitutes sufficient appropriate audit evidence for different types of disclosures?
- How do you apply materiality judgements to disclosures?
- How do you evaluate the significance of identified misstatements or omissions?
- Are all disclosures being proposed by accounting standard setters even ‘auditable’?

The discussion paper was developed by the IAASB in response to comments received from stakeholders during various outreach efforts that auditors were not seen to be performing sufficient work or exercising sufficient judgement around companies’ disclosures.

Such issues are not solely audit issues – they apply equally to preparers, regulators and accounting standard setters. Through this discussion paper, the IAASB seeks to better understand different points of view on a range of issues about financial statement disclosure practices, as well as the implications from an auditing perspective.

The IAASB will consider comments on the paper from June 2011.

## Diary dates

Date	Key upcoming events	Location/Contact	Sponsors/Organisers
17-19 May 2011	22nd XBRL International Conference	Brussels, Belgium <a href="http://www.xbrl.org">www.xbrl.org</a>	XBRL International
12-14 June 2011	3rd Strategic Corporate Governance and Responsibility Forum	Amman, Jordan <a href="http://www.cgrforum.com">www.cgrforum.com</a>	CGR Forum/Schema
30 June – 1 July	Global Ethics Forum	Geneva, Switzerland <a href="http://www.globalethics.net">www.globalethics.net</a>	Global Ethics
5-6 July 2011	IASB Foundation Conference, Europe	Zurich, Switzerland <a href="http://www.informaglobalevents.com">www.informaglobalevents.com</a>	Informa Group
13-14 July 2011	IASB Foundation Trustees meeting	New York, USA <a href="http://www.ifrs.org">www.ifrs.org</a>	International Accounting Standards Board
12-14 September 2011	ICGN Annual Conference	Paris, France <a href="http://www.icgn.org">www.icgn.org</a>	International Corporate Governance Network
12-14 September 2011	Forbes Global CEO Conference	Kuala Lumpur, Malaysia <a href="http://www.forbesconferences.com">www.forbesconferences.com</a>	Forbes Conferences
15-16 September 2011	World Standard Setters meeting	London, UK <a href="http://www.ifrs.org">www.ifrs.org</a>	International Accounting Standards Board
27-28 September 2011	CSR Asia Summit	Kuala Lumpur, Malaysia <a href="http://www.csr-asia.com/summit2011">www.csr-asia.com/summit2011</a>	CSR Asia
12-13 October 2011	IASB Foundation Trustees meeting	Paris, France <a href="http://www.ifrs.org">www.ifrs.org</a>	International Accounting Standards Board
7-8 November 2011	13th Meet the Experts Conference	London, UK <a href="http://www.meet-the-experts.com">www.meet-the-experts.com</a>	PwC/Informa Group
3-6 January 2012	Winter 2012 Global Conference on Business and Finance	Honolulu, Hawaii <a href="http://www.theibfr.com">www.theibfr.com</a>	The Institute for Business and Finance Research

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## PwC blogs

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### IFRS blog

[www.pwc.blogs.com/ifrs](http://www.pwc.blogs.com/ifrs)

PwC's global chief accountant, John Hitchins, discusses and debates the hot topics in International Financial Reporting Standards in his IFRS blog.



### Corporate reporting blog

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

Corporate reporting hot topics and the emerging issues that companies, investors and other interested parties need to think about are discussed in this blog written by David Phillips, PwC's corporate reporting partner.



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