Innovation that counts
Can smart governance help big companies innovate like start-ups?
Governance opinion article page 6

Is your business model fit for the future?
How does your business model add value? And will it in 2020?
Corporate reporting opinion page 10 & 11

HSBC & Unilever: action on IR Framework
What are the risks of not being involved in integrated reporting?
Interview page 12 & 13

Reporting labs: more than talking shops?
Labs are starting to deliver practical improvements; time for more regulators to join the experiment?
Financial reporting opinion page 16
Opinion

Innovation that counts
Spending big on research and development doesn’t guarantee growth – but with better governance, big companies can innovate like start-ups says Jean-Christophe Saunière

Bouncing back: two Japanese companies’ road to resilience
Japanese companies haven’t had the easiest ride, but new governance strategies are helping corporations to bounce back, say David Jansen and William Macmillan

Keeping the lights on
Steve Holliday, CEO of National Grid Group, discusses the challenges faced by a global electric utility company, in an era of growing pressure to move towards alternative energy sources

How does your business model add value? And will it in 2020?
Clear information and reporting on your business model is the first step in making it fit for the future, argue Mark O’Sullivan and Carlo Gagliardi. It’s a matter of survival

What does big business think about the Integrated Reporting Framework?
In these interviews Russell Picot, chief accounting officer at HSBC and Charles Nichols, group controller at Unilever share their vision for integrated reporting and the impact it’s already had on their organisations

Tell the whole tax story
Tax and transparency is under more scrutiny than ever, Janet Kerr explains why failing to communicate tax strategy clearly is an increasing risk to public trust

Conceptual framework debate – is it critical to engage?
Respond now to the imminent discussion paper and influence vital elements of financial reporting for the long term – and then it’ll be safe to ignore it for the next 20 years, says Peter Holgate

Financial reporting labs: a practical approach to better disclosures
Financial reporting labs are delivering on their promise to be more than talking shops. With practical improvements already showing through in company reports, it’s time for regulators to join the experiment, says Alison Thomas

Cash and debt – cash is still king
Financing is changing so businesses need to be crystal clear if they want to raise capital at the right price. Jennifer Sisson runs through reporting measures that make a difference

Government reporting: does it give the full picture?
By introducing accrual accounting, governments demonstrate their desire to achieve greater transparency and accountability, says Jan Sturesson

Mandatory firm rotation: not the answer
Independence, objectivity and scepticism are at the heart of the audit profession, but there’s no doubt that there is a perception of over-familiarity between the auditor and management that needs to be addressed, says Richard Sexton

News

Governance

24 EC: Long-term financing of the European economy
Green paper consultation on the challenges of funding Europe’s large-scale, long-term investment needs.

25 Switzerland: Blow to executive compensation
Draft law takes aim at remuneration packages – with public backing sending a strong message to boards

25 Call to halt ‘hard and fast’ rules
Massive sovereign wealth fund publishes a discussion note on corporate governance in favour of more principles-based guidance

26 Pakistan: Governance code changes the board
New corporate governance code adopted – significant changes signal high hopes

26 GCC: Gulf region must fall in line, says summit
A summit of the Gulf Co-operation Council regulators urges the region to pay closer attention to international best practice in governance and regulation

27 OECD calls time on revenue erosion
Report diagnoses the situation around base erosion and profit shifting, and proposes an action plan to tackle the problem

27 EC: Action plan on company law and corporate governance
Plan for non-financial companies addresses transparency, shareholder engagement and company law

27 EU: Women in the boardroom – quotas?
EU gives green light for a draft law on boardroom gender quotas; opposition is limited

Corporate reporting

28 US: Conflict minerals rule has a global impact
SEC issues a rule requiring disclosure of the origin of conflict minerals – significant challenges lie ahead

29 Country-by-country tax reporting: what’s going on?
Round-up of legislative developments in the tax transparency debate

30 GRI and IIRC cement a productive partnership
Memorandum of Understanding issued to formalise relationship. Position paper promotes robust ethical culture and provides guidance on integrated governance risk management

30 GRI launches G4: it’s all about relevance
Fourth generation sustainability reporting guidelines place materiality at their core

30 Road-testing the IR framework
PwC Netherlands piloted IR and found challenges alongside positive impacts

31 IIRC launches draft framework
Integrated reporting gathers speed with a new international framework. Deadline for comment is 15 July 2013
UK: BIS proposals on pay and performance pass test
Enhanced reporting on remuneration has broad support among investors, says a Financial Reporting Lab study

Investor concern on non-GAAP reporting
German investors voice concerns over non-GAAP ‘window dressing’. They want more clarity and consistency

UK: New legislation to require ‘strategic report’
Proposed changes to narrative reporting introduce a strategic report and mandatory GHG reporting

Stock exchanges press for better reporting
INCR paper recommends global listing standard for sustainability disclosures

Europe: Call for business transparency
Proposed amendments to EC directives aim to include more relevant non-financial information and related risks in annual reports would amend EC directives

Financial reporting

More support needed for international standards
ICAEW report concludes IASB needs more support to achieve a single global accounting language and regulators need to play their part

New going concern guidance ‘over complex’
FRC has issued consultation document on implementing the Sharman Report. Respondents concerned that recommendations on going concern and liquidity may prove impractical to apply

Support for improvements to income tax accounting
Respondents to FEE/EFRAG discussion paper on IAS 12 say it needs improving rather than rewriting

Financial instruments standard edges towards completion
The IASB/FASB joint project on financial instrument accounting will not achieve convergence, but the IASB is close to issuing a standard

Nepal to pilot IFRS Centre of Excellence
Nepal has been selected as the pilot for the first IFRS Centre of Excellence for a developing country, backed by the government

Australia: Will ‘Standard Business Reporting’ become mandatory?
Business awaits the decision of the government’s consultation on SBR, which seeks increased efficiency and a ‘common language’

Ireland: Mandatory iXBRL for tax reporting
Tiered introduction of mandatory iXBRL aims to bring Ireland in line with global best practice

Special adviser keeps an eye on IFRS
EC creates “special adviser” role to reinforce EU contribution to IFRS and oversee standard setting and governance

New advisory forum gets off the ground
Launch of Accounting Standards Advisory Forum to advise the IASB on its composition. Africa, Americas, Asia-Pacific and Europe are all represented

Report explores currency risk conundrum
Report explores how global companies communicate currency risk – it finds currency volatility is largely a communication problem

IASB survey finds disclosure overload and the will to fix it
Standard setters, auditors, preparers, regulators and investors need to collaborate to improve disclosure – 80% agree improvements needed.

Investors eager to improve ROCE reporting
Research in the investment community pinpoints what improvements are needed to reporting on return on capital employed

IASB: Agenda consultation highlights priorities
IASB maps out future priorities for the board following public consultation and review of over 240 comment letters

Canada: Investment professionals have their say on reporting
Survey shows investor satisfaction with transition from Canadian GAAP to IFRS but highlights improvements on their ‘wish list’

Assurance

Internal audit must act, survey finds
Survey reveals internal audit’s role in risk management faces marginalisation unless it improves the way it operates

Auditors’ report of the future starts to take shape
Changes to auditor reporting are a given, but the nature and extent is up for debate. UK finalises updated standard

UK: Audit market investigation reaches critical phase
Competition Commission investigation holds hearings on provisional findings and remedies. Final report expected in September 2013

Audit reform remains a key focus
PwC’s position on the audit reform agenda

What some territories are doing about rotation
Developments on mandatory firm rotation in the Netherlands, The Philippines, India and Russia

EC: Committees reject key elements of EU audit reform
Influential parliamentary committees water down commission’s proposals on audit reform

IAASB: Proposed framework emphasises wider involvement
Consultation paper supports broad involvement of stakeholders – to achieve audit quality – not only auditors

COSO: Internal controls aid assurance
Updated framework to clarify requirements of internal control, with increased focus on management’s role
Can we be the ‘right kind’ of transparent?

It’s safe to assume that transparency is an issue that’s just not going to go away. No company can afford to ignore it. It has always been important, but its ‘business-critical’ status has just been upgraded to ‘urgent’, in the light of global events ranging from the sovereign debt crisis to the horse-meat scandal.

But it’s not just about providing ever more content; it’s about being the right kind of transparent. And that’s a real challenge. How, for example, do you provide the right kind of information to the markets when mega trends such as digital opportunities, demographics and consumer behaviour are forcing change to the very core of our business models and how we create value? (page 10).

Clearly this prompts the need for new information – but showering the market with more and more risks misinterpretation, competitive disadvantage or even the kind of slip up that gets picked over on 24-hour news, and amplified by social media.

Is the market-led approach working?

We expect integrated reporting will be an important part of the transparency toolkit. For some organisations, it already is. And the business model is at the centre of the draft Integrated Reporting Framework published for comment recently by the International Integrated Reporting Council. The aim is to help businesses show clearly how they create value in the short, medium and long term (pages 12, 30, 31).

This collaborative and market-led approach to addressing real market issues – and the fact that so many companies, investors, regulators, standard setters and others are involved – is really encouraging. ‘Reporting labs’ often sponsored by market regulators, are designed to test ideas and assess where regulation might help or hinder – I agree with the view that it’s time for more this (page 16).

Irrespective of laudable market innovation there are plenty of mandatory requirements forcing the pace on transparency too. The EC has proposed action both on company law and corporate governance (page 27) and is set to increase the amount of non-financial information in annual reports (page 33). And there’s a host of legislative developments on tax – not least country-by-country tax reporting (page 14 and 29).

Influence successful outcomes

Regulation can only ever be part of the answer and cannot substitute for authentic market-led innovation so it’s important that all stakeholders are active so that changes bring a real benefit and achieve what they set out to do.

Relevant, reliable and timely information is crucial for business survival – regulatory and compliance driven change driving more and more information or just broadcasting high volumes of data simply won’t do. As HSBC’s chief accounting officer says (page 12), it’s a case of less is more.

The most effective solutions are emerging when different stakeholders get together to debate and innovate – so let’s all get involved.

Richard Sexton
Deputy global assurance leader, PwC

---

Contributors:
Felicity Hawksley, Matthew Kelly, Bridget Allerton, Catherine Bromilow, Roz Crawford, Tom Dane, Graham Gilmour, Jon Iversen, David Jansen, Robert van der Laan, Alan McGill, Dominique Menard, John Patterson, Suzanne Snowden, Nilofer Subhan and Anouk Wentink

Contact us:
PwC has a strong and effective network of people worldwide who can advise on the developments and the implications of regulations. If you would like to discuss any of the issues raised in this publication, please contact your local office, the people named in specific articles or the editors.

To subscribe to World Watch magazine (usually published twice a year) or to contribute articles, please email sarah.grey@uk.pwc.com

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

In the following articles prominent experts discuss their views on governance, reporting and assurance issues

**Governance strategy**
New strategies are helping Japanese companies bounce back
*See page 8*

**Mandatory firm rotation**
It’s not the right way to tackle the perception of cosiness between auditors and management
*See page 21*
Spending big on research and development doesn’t guarantee innovation or growth, but governance that supports collaborative innovation can help big companies innovate like start-ups, says Jean-Christophe Saunière

Even in times of crisis, innovation remains a top priority. In PwC’s annual CEO survey, 25% of business leaders identified developing new products and services as the main opportunity for business growth in the next 12 months. A further 17% expect growth to come from new alliances or businesses and 8% from new operations in foreign markets. This means that half of the 1,330 business leaders surveyed are relying on some form of innovation to develop their company.

The problem is, internal resources are no longer adequate to create this innovation. Research and development (R&D) budgets are strained in times of crisis, and at any rate, observation suggests that pouring money into R&D isn’t the answer – boosting funding isn’t directly correlated with boosting either ideas or profit.

So how do you increase innovation without spending on R&D? The answer lies in decompartmentalisation – or collaborative behaviour. Don’t assign innovation to a special group, draw on all the functions within the company and customers, suppliers and others externally. The traditional hierarchy in organisations is evolving towards a network-based structure that calls for more intelligent, flatter distribution of roles and responsibilities. These changes completely remodel work habits and interpersonal relationships.

Flattening the hierarchy and encouraging collaboration doesn’t mean setting your strategy adrift, or destabilising the company by taking huge risks and challenging structures beyond their capacity – but it’s essential that governance plays a conducive and controlling role for innovation to be both successful and safe.

Governance for innovation

Companies can’t just decide to innovate – they have to create the right climate and structures to bring about development. At times of economic difficulty, innovation does not come naturally, so preparing the organisation for collaboration is key. Some of the most important corporate governance strategies to support innovation are:

1. **Align strategy.** Ensure that the innovation strategy is in line with the global development strategy – particularly if the global strategy involves external partners. Sharing core business strategy as part of innovation may be too risky in terms of both control and intellectual property (IP). Awareness of IP concerns should be developed in parallel with the application of open innovation strategies.
Governance Opinion

Jean-Christophe Saunière
Partner at PwC

2. **Senior sponsorship.** Guarantee that innovation is ‘sponsored’ at the highest levels of the organisation. It shouldn’t be the purpose of a specific function, but should occur across all departments, led by an innovation ‘champion’.

3. **Clear process.** Put in place a well-defined process for innovation. The journey from idea to fruition should be subject to a structured process. This means that mistakes – which true innovation goes hand-in-hand with – are limited to preliminary development phases.

4. **Link to performance and reward.** Define individual and collective performance indicators to promote the type of behaviour that fosters innovation. Make the benefits of collaborating specific and openly value risk-taking.

**Prepare to innovate**

So how do you innovate like a start-up organisation? You can create the right conditions in large organisations by:

- Encouraging controlled risk-taking
- Supporting outside ideas
- Providing tools to enable collaboration
- Aligning individual appraisal criteria with innovation targets

Many companies regard innovation as a way of developing their market and setting themselves apart from the competition. Collaborative innovation is an important and growing trend – a response to increased budget constraints and ‘time to market’ pressures in a global economy.

Companies can no longer rely on their own resources to stay ahead of their competitors. Habits and relationships within companies have to transform to foster collaborative innovation. You may not be able to just ‘decide’ that innovation will happen – but you can prepare for it and increase the chances of new ideas creating tangible value.

Collaborative innovation is no longer optional

We expect the number of companies spending over a quarter of their R&D funds on collaborative innovation to grow dramatically

<table>
<thead>
<tr>
<th>Today</th>
<th>In 5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>37%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Source: PwC/INPI 2012

**Q: Of all these potential opportunities for business growth, which one is the main opportunity in the next 12 months**

- **Organic growth in existing domestic market** 32%
- **Organic growth in existing foreign market** 17%
- **New product or service development** 25%
- **New M&A/joint ventures/strategic alliances** 17%
- **New operation(s) in foreign markets** 8%

Source: PwC 16th Annual Global CEO Survey

Base: All respondents (1,330)

Over 60% expect the number of companies spending over a quarter of their R&D funds on collaborative innovation to grow dramatically in the next 5 years.

60% in 5 years

37% today

Source: PwC/INPI 2012

**World Watch Issue 2 2013**
Japanese companies bounce back

Japanese corporations’ resilience has been tested to the limit in recent years. After the Bank of Japan’s (BoJ) inaction over interest rates following over-investment in the 1980s, a period of stagnation followed. The last 20 years have seen slow or non-existent economic growth become the norm – until the BoJ’s recent spring foray into quantitative easing, which has helped restore growth. Many Japanese companies have been grappling with changing workforces, mutating key industries and gradual structural disruption.

The economy wasn’t – and isn’t – the only pressure. Severe catastrophes over the past few years have threatened the very survival of many companies. Here we look at two such groups – Hitachi and Lawson (a convenience store group) to see how each has developed the necessary resilience to cope with both dramatic events and long-term changes.

**Breaking with the past**

The sacrifices both companies made, and the risks they took would once have been unthinkable in corporate Japan. At Hitachi, the once-iconic TV business was shed, as part of a shift away from consumer goods. Lawson was willing to break with the entrenched interests of large shareholders and form new alliances – encouraging face-to-face management practices and uprooting long-established interests.

**Open to new ideas**

At Hitachi, a restructuring of the board to include seven external members – three of whom were not Japanese – out of a total of 13 provided the anchor for a pivot towards a more international focus. At Lawson, they embraced full meritocracy, which supported long-term innovation and lessened the likelihood of knowledge stagnating. Both company leaders had to weigh the benefits of these changes against the risk of compromising Japanese cultural norms, where loyalty to companies is long-heralded.

**Broadening horizons**

At Hitachi, managers were instructed to benchmark against international competition as the company reoriented itself towards providing infrastructure solutions globally. Lawson tapped into the market opportunities provided by the demographic shift in Japan towards older people with growing concerns about the environment – it developed new product ranges that reflected these trends. Both organisations illustrated risk resilience by turning competition or tricky demographics to their advantage.

**Strengthening flexibility**

At Lawson in particular, management spotted the need to decentralise decision-making and provide incentives to create stronger local autonomy. The trade-off was to let go of some control at headquarters, but the upside was a more flexible and nimble organisation, which triggered more innovation and stronger motivation.

There was nothing easy in what Hitachi and Lawson leadership teams attempted. Both took strategic risks that none of their predecessors were willing to attempt.

---

**Source:** Nikkei and Thomson Reuters, November 2012
Steve Holliday, CEO of National Grid Group, discusses the challenges faced by a global electric utility company, in an era of growing pressure to move towards alternative energy sources.

Q. How adaptable would your organisation be if a shock hit in the centre of your activity? And at the board level, do you plan for such shocks?
We have a very particular role in the UK because we sit at the heart of the electricity and gas market. So we model an enormous number of scenarios to try and think about potential shocks.

Of course, a number of these scenarios get close to Armageddon, but none of them would cover something like Fukushima, where you decide to shut down all of the nuclear plants. You can’t handle that in the UK. So you think about these scenarios, across different timescales. How can we be sure that we’ve got reliable energy supplies and how do we make sure our investments are robust against a range of scenarios? That’s exactly the way we think about our business.

Q. How would you assess your organisation’s ability to adapt to change and disruptive events generally, compared to the past?
It’s been a huge challenge to get an industry – that by definition is thinking 20 or 30 years ahead, is associated with slow thinking and has historically liked to have a plan – to change into an industry that thinks much more flexibly, much more about scenarios and how to adapt to warning signs of change in those scenarios.

So there is a speed of thought process, a speed of decision-making that is different today than in the past. Are we where we need to be yet? No, and stakeholders would not yet describe us as agile. We’ve got a long way to go.

Q. How much is the influence of stakeholders, and the level of engagement with them, growing in your business?
The regulator and government have always been major stakeholders, but today there is a very new set – right down to you and me. The public is a large stakeholder because they can take part in discussions on social media.

They can influence our decisions and we actually want them to do that. Part of our challenge has been to make sure that we are genuinely consulting – to build a process that goes out and listens.

The most interesting part of that journey has been that as we’ve listened, surprise surprise, we’ve actually learnt something. So we’ve not ended up getting to the answer we thought of when we started.

Q. How have you increased your impact on your new stakeholders and their communities? What benefits has that impact had for your organisation?
One of the challenges I’ve been focused on for the last few years is how we bring the benefits of scale to customers and yet be seen really as being local. National Grid is made up of many companies that have come together through acquisition to be the organisation it is today. What that led to though, was a real view from many customers about the loss of their local company at a time when everyone wants to get much more involved in decision-making on a local basis.

So achieving this balance, bringing the benefits of international scale and yet going back almost 40 years to considering how to connect to your “local communities is difficult for an industry like ours”. 

Steve Holliday
CEO of National Grid Group
Interview for PwC’s global CEO Survey
How does your business model add value? And will it in 2020?

Clear information and reporting on your business model is the first step to making it fit for the future, argue Mark O’Sullivan and Carlo Gagliardi. It’s a matter of survival

Are traditional business models dead?

Only six of the Fortune 100 companies active in 1940 are active today. But now it’s not about surviving the next 70 years – it’s really, urgently, about the next ten. Massive changes to technology and particularly digital’s unrelenting grip on most aspects of business is accelerating the success of those that get it right – and the decline of those that don’t.

Very few of the business models thriving in 2005 will be around in 2020 in the same form. We can already see a variety of new business models bubbling up in industries from banking to media. But we’ve also seen many companies collapse in the last few years and, more often than not, failure to adapt the business model is a key factor.

There are two trends that will require completely new business models within the current decade:

- People brought up with computers in the home – ‘digital natives’ – will become the dominant type of customer, and

- After years of digital technology changing the way products and services are transacted, we will see it increasingly change the way value is created

We were all ‘traditional consumers’ in 2000, but this year the ‘transitionals’ who have learned to use digital technology will overtake. And by 2020, digital natives will become the main consumers, which will have a dramatic impact on business models.

Digital changes the way value is created

The next decade will demand a much more sophisticated understanding of how value is created in our business ecosystems and the key to making the most of these opportunities is relevant data. Successful companies are studying interactions, spheres of influence and roles, and collecting data that provides the knowledge to evolve their business models. They understand:

- How customers – by consuming products and services – create and consume value for themselves

- How providers capture a portion of that value by enabling customers to create and consume value for themselves

“The dynamics and alchemy of value creation are changing fundamentally, and this creates both threats and opportunities for growth.

But there’s a big cultural challenge: for the last 20 years most companies have improved performance by focusing on their operating models; now they need to change their business models.”
Leading companies will be those who equip themselves with business models that:

• Articulate how ‘value-adding activities’ transform inputs into outputs, and

• Articulate how orchestrating and understanding the interactions between all stakeholders (ie, your suppliers, suppliers’ suppliers, distributors, customers, customers’ customers, etc) can create value

**Take a long, hard look at your business model**

These emerging trends create a host of opportunities – and threats. And to navigate these, companies will need to take a long, hard look at their business model.

But has your organisation explicitly defined and documented its business model? Start-up businesses are usually adept at explaining their business model succinctly – but many larger organisations are out of the habit. It’s almost as if a new language is needed to help us all answer the tough questions about our business models and take action to evolve or transform them.

So if you do find yourself looking down the barrel of your business model, what kind of questions should you be asking?

• What business are you actually in? Are you selling computers, or an experience?

• Can the current model survive the mega trends in technology, digital trading, demographics, climate change, etc? Where will value come from in future?

• Go beyond products and services – what customer outcomes are you trying to enable?

• Are you driven by your customer? Are you allowing them to create part of the value?

• Where will your critical insights come from? How will you get hold of them and use them effectively?

• Does your customer trust you enough to use information about them for their benefit? If not, why not?

**Are you building trust?**

Sustaining and building trust in the business model will depend on communicating effectively with investors and others about how value is created now and going forward.

If you ask any investor about their assessment of a company, they’re likely to tell you that one of the first things they try to do is form a view on a company’s business model – they just haven’t used a single point of reference before, because the information hasn’t been there.

Articulating your strategy and business model is going to be more important than ever in the next 10 years. But how do you take all the elements into account and communicate them clearly? And can you show that the model is sustainable? How will investors react?

The problem is, no-one is very clear about how to define ‘business model’, or what you should say to your stakeholders about it. As one finance director commented when grappling with business model reporting: “we know what we do…it’s just very hard to articulate it on paper”.

Current reporting is not meeting investors’ or other stakeholders’ need to understand the business model and its current and future viability. They’d like to understand your value proposition, profit formula and the key resources required to deliver the proposition. They would then like to know how this business model interacts with your risk profile, strategic priorities and KPIs.

**Where to start with explaining your business model**

Integrated reporting could really help (see page 31) – the business model is at the centre of their draft framework.

To identify the right external disclosures, there needs to be real clarity internally about what your business model is and how it links to both operational and financial drivers of the business.

It can help to start with some simple questions that stakeholders might ask:

• What do you do and where?

• What resources and relationships do you rely on?

• Who do you interact with and how does that create value?

• How do you make money from that value?

• What differentiates your business from others?

• How will you sustain that value creation and ensure that your business model is versatile?

• How can you share the relevant information about your business model in the context of a changing environment?

• What do your providers of capital perceive your investment case to be? Is this consistent with your view?

However you approach working out what your business model is, and how it works, it’s clear that reporting effectively on it today is the first step towards making it fit for the future.

---

**Mark O’Sullivan**

Corporate reporting director at PwC

---

**Carlo Gagliardi**

Strategy partner at PwC
What does big business think about the Integrated Reporting Framework?

**HSBC: IR promises a major breakthrough in reporting quality**

Russell Picot, chief accounting officer at HSBC, tells Jessica Fries why they’re one of the first to join the IIRC’s pilot programme to test integrated reporting. He explains the risks of not being involved and the benefits they’ve experienced so far.

You’ve been on board from the start of the integrated reporting (IR) journey – so why are you involved, and why is HSBC a pilot company?

We believe in expressing our corporate voice on issues that we think matter to society quite broadly. We also believe in a voluntary approach in this area, and that’s why we’re heavily involved in the pilot programme with the International Integrated Reporting Council (IIRC). We’re trying to develop good ideas, bring corporate and institutional voices together and avoid the concern that some of these very innovative ideas might get hard-coded into legislation too early.

In February, we released about 700 pages of investor material to the market – it’s a big challenge for us to distil the important messages about our strategy. So we see integrated reporting as holding the promise to provide a major breakthrough in the quality of corporate reporting, globally.

**So what steps have you taken as a company to really shape the reporting?**

Our annual report is our main communication to the market – we don’t have a preliminary results announcement. So we’ve been experimenting with restructuring our risk document – bringing upfront what happened in the market during the year, how we responded to it, and how it’s reflected in our numbers. Then we put all our standing data and boilerplate information about our systems (which may not change) at the back of the document.

**Are there a few key messages from investors about what they want from integrated reporting?**

It really is a classic example where less will be more. No one wants to see another 50 or 100 pages of material. So the challenge is to distil it down.

If you look at the banking industry, investors said very clearly that they thought banks’ business models were quite opaque, and that in some parts of the market, they were uncertain about the viability of funding models. They said that they were exacting a heavy penalty in terms of our equity prices being marked down.

For investors, it’s all about clarity and transparency, which all good corporates should want to achieve anyway.

**And what are the key challenges?**

Because this is a voluntary programme, it requires voluntary support, and that’s one challenge – to harness the interests of all the stakeholders.

Also, this won’t be successful if we don’t get a strong investor voice. My message for investors is: “please get involved, please send us your views”.

Another issue that needs to be dealt with early comes from those CEOs or CFOs saying, “well, this just sounds like more work”. I don’t believe that’s the case – I think it’s a question of starting afresh, ensuring a broad engagement programme within the company and looking at your corporate communication model and then deciding what’s important.

If it’s just a programme by the finance function, for the finance function, the company’s not going to reap the sort of benefits that they should expect.

**So what are the key benefits of adopting an integrated reporting approach?**

The major benefit of IR is clarity of communication to the market. I think that over time, we will see that this could lead to a lessening of the financial reporting burden – creating a much more relevant model of corporate reporting.

It also provides a unifying, integrating force within a company. The CEO, the major business heads and the department heads are getting into a room and discussing how they create shareholder value and how they communicate that to the market – and that’s really powerful. It has both internal and external benefits.

---

**Russell Picot**

Chief accounting officer at HSBC

---

12  World Watch  Issue 2  2013
Unilever: Is your business model safe without IR?

Charles Nichols, group controller at Unilever, tells Jessica Fries why integrated reporting is critical for companies and investors to be able to take a longer-term view of their business model and properly assess its performance.

How does integrated reporting support your business model?

It’s really about the needs of our business. We live in a very volatile world where businesses such as Unilever face issues that need long-term solutions. I think it’s natural that we should be thinking in terms of how we talk about our long-term perspective internally and the way we tell our story externally.

Is IR already having an impact on internal decisions and external reporting?

Yes. One thing you’ll notice is that in our 2012 annual report, we talk about our business model more holistically. Internally, there’s a growing recognition that sustainability isn’t just about corporate social responsibility, but is actually a fundamental economic business issue. We’re not only thinking about what outcomes we’re looking to achieve in terms of financial performance, but also in terms of our impact on the environment and society.

Do you see any barriers to integrated reporting?

Potentially, yes. The first is fragmentation: we could get a proliferation of regulation with stakeholders pushing development in different directions, which would be a great shame.

I think fear is another barrier. Inherently, companies are more comfortable with backward-looking financial information rather than forward-looking non-financial information. I think there are understandable concerns about exactly how much transparency is appropriate before you start providing more information to the competition than you would normally wish to share.

How have you attempted to overcome some of the barriers?

We’ve taken a fairly phased approach. We launched our Unilever Sustainable Living Plan a few years ago and developed a number of metrics to measure our performance on it. So far, we’ve been trying to improve the robustness and the maturity of those metrics, ready to offer them up for independent assurance.

We shouldn’t lose sight of the fact that we spent 150 years developing our financial KPIs and here we are, in 18 months trying to do the same on the non-financial front.

Do you see a role for assurance?

I think there is a role for independent assurance. It provides credibility to external stakeholders – there is some degree of scepticism out there – so independent verification of the progress that’s being reported is important.

It also raises the bar in terms of the rigour and discipline of our own internal processes. If you know that the KPI you’re responsible for is going to be subject to external assurance, that’s a pretty high motivation to do a good job.

It’s also about future-proofing. I see it as inevitable over time that non-financial information will become an ever more important part of our corporate narrative – so we might as well get our ducks in a row now. And we need the kind of rigour that assurance provides.

So far, the IIRC has adopted a market-led approach. Do you think that without a ‘regulatory stick’, integrated reporting will become the norm for how companies communicate to the market and stakeholders?

I think that this is a unique opportunity to shape something that’s probably going to happen anyway and really start to shape this thing for the future. If companies don’t get their act together, then sooner or later the regulators are going to do it for us.

But are investors really asking those broad non-financial questions?

If they’re not, then they should be. There are enough highly-publicised examples of market failures where companies have destroyed inordinate amounts of value because investors, and in some cases, the boards, haven’t really understood the business model and been able to ask the right questions at the right time.

A passive approach risks losing control of this agenda, so I would encourage companies and investors to respond.

So what’s your vision for the future of integrated reporting?

It would be nice to think that in the not too distant future we will have one single approach to corporate reporting across the world. It might be wishful thinking, but standardised non-financial KPIs, comparable between different companies and across the world, would be nice to have.

One of the most important components for ‘nirvana’, as it were, is a shift away from the short term and the backward view of life, towards something that is more forward looking and longer term.

Charles Nichols
Group controller at Unilever
Tell the whole tax story

Tax and transparency are under more scrutiny than ever. Janet Kerr explains why failing to communicate tax strategy clearly is an increasing risk to public trust.

Explaining your ‘total tax contribution’ can help explain to stakeholders the impact on the business of all the taxes paid not just corporation tax (which forms, on average, only 8% of the government’s total receipts).

Total Tax Contribution (TTC) splits taxes into taxes borne and taxes collected – or those that are a cost to the business and those that are not. It can help give a clearer picture of taxes paid even when corporate income tax payments are low perhaps due to poor results, the use of prior year losses, capital investment or the application of tax incentives for investment or research.

Some civil society organisations want this information from all companies, so that they can draw conclusions on whether the ‘right’ amount of tax is being paid. In the absence of data on this, they have taken a simplistic approach to what they think should be the total contribution. Typically they assume an average profit margin, apply that to territorial sales to find a profit, and then apply the local statutory rate. If the amount of tax actually paid is lower, then the questioning may start.

Drawing the right conclusions?

We have also seen financial analysts looking at effective tax rates when considering investments. If the actual effective tax rate is lower than the estimated rate, then the investor may ask questions to see if the low tax rate is the result of an aggressive tax policy to minimise payments.

Businesses need to work backwards from their market communications. Put simply, if someone were to question the impact of tax on your company’s strategic decisions, what conclusions could they draw from the corporate reporting and publicly available information? And would they be right?

For many companies, it’s time to realise that the questions aren’t going to stop soon.

Janet Kerr
Total Tax Contribution specialist at PwC

Janet Kerr
Conceptual framework debate – is it critical to engage?

Respond now to the imminent discussion paper and influence vital elements of financial reporting for the long term – and then it’ll be safe to ignore it for the next 20 years, says Peter Holgate

It is a conundrum that the conceptual framework for financial reporting is, at the same time, both the most important single thing in financial reporting that can be studied and developed, and also virtually irrelevant to the everyday lives of most accountants. How should one react in such an odd situation?

Frameworks are not a new idea. The US standard setter was the first to develop a conceptual framework in the 1970s; the International Accounting Standards Board (IASB) has had a conceptual framework since 1989; and a small number of other territories have developed their own too.

The IASB partially updated theirs in 2010, perhaps recognising that 20 years or so was the useful economic life of a conceptual framework. The sections updated in 2010 were: Objectives of general purpose financial reporting; and Qualitative characteristics of useful financial information. Completing the rest of the update is high on the IASB’s list of priorities – it got considerable support from people who responded to the 2011 agenda consultation.

The remaining sections of the framework update are likely to address:

- Elements of financial statements – eg, definitions of assets, liabilities, income, expense
- Measurement – eg, cost, fair value etc
- Reporting entity – eg, how do we define a group
- Presentation and disclosure – eg, how do we distinguish different elements of comprehensive income; and how do we make disclosure useful but finite

A discussion paper dealing with these aspects is expected in July.

So how should we react to this?

Is it important at all? Or is it best left to the IASB? My view is that it is well worth taking an interest in the current phase of the IASB’s work on the framework – in order to be able to ignore it for the next 20 years.

It is important that the IASB gets it right; and the chances of that occurring are greater if a wide range of people comment. The 2010 phase illustrates this. What could be more basic than the objectives of financial reporting? Yet a serious debate raged about whether the objective was to provide information that would (a) enable users to predict future cash flows (ie, a future-oriented, investment-focused approach) or (b) enable shareholders to monitor what the directors had done (ie, a backwards-oriented, stewardship approach).

Stewardship was a casualty of this debate, though not a fatal casualty. Stewardship still has many supporters, who are currently urging the IASB to re-open the question in their current work, even though it is in a section that has been completed.

Conceptual debate: far reaching impact

The stewardship debate illustrates that a conceptual point can be highly important and emotional. It can also be practical in the sense that the result of the theoretical debate could well affect requirements in specific standards.

This is particularly so in the forthcoming chapters on measurement, presentation and disclosure. A bold conceptual decision on measurement, for example, could affect what we carry at cost and what at fair value.

A conceptual decision on presentation could affect how we report earnings and comprehensive income; it might even yield an answer to the question of how we distinguish what goes in earnings from what goes in other comprehensive income – something that has eluded all who have considered it to date.

A conceptual decision on disclosure could help us determine what is ‘good disclosure’ and how to distinguish it from the temptation of ‘more disclosure’.

For all these reasons and more, then, it is important for constituents – but especially preparers and users of financial information – to take part in the debate on the conceptual framework. It might sound dry and irrelevant but the opposite is the case. Give it a read.

Peter Holgate
Senior technical partner at PwC
Financial reporting labs are delivering on their promise to be more than talking shops. With practical improvements already showing through in company reports, it’s time for more regulators to join the experiment, says Alison Thomas.

Tasked with rebuilding trust in the capital markets following the financial crisis, and with key elements of the corporate reporting model clearly not working, what’s a responsible regulator to do? Well, regulate is the traditional and natural first reaction – and often with good reason as a great deal of reporting needs to be mandatory.

But is more regulation always the best approach to fixing a reporting regime that preparers say is too complex and onerous and leaves investors and analysts struggling to uncover a company’s true performance and risk profile?

The reporting labs are an innovative alternative to top-down regulation. Various labs have been set up by the UK’s Financial Reporting Council (FRC) and Japan’s Ministry of Economy, Trade and Industry (METI), along with the Enhanced Disclosures Task Force (EDTF) at the Financial Stability Board (FSB). By providing investors and companies with a safe environment to explore new reporting solutions, the regulators have cleared the way for market forces to devise improvements that better suit their needs. (See panel).

**How labs work**

Companies, analysts and investors collaborate with practical outputs in mind. They set the agenda, focusing on the areas of disclosure and presentation that they think most need fixing. Companies join in to find out how they can improve their reporting by getting a better understanding of user needs. Investors and analysts look to highlight examples of good reporting and tackle areas that can be made easier to understand or less frustrating for users.

The goal is not to come up with new reporting requirements, but to show how new approaches and practices can have an immediate impact on the relevance, practicality and usefulness of financial reports. Accounting and legal professionals add their perspectives, helping to find ways forward.

**Why labs work**

For a company, the collaborative lab approach can significantly bring down the cost and remove the guesswork from innovation in its reporting. While companies talk to investors every day, they rarely focus on the nuts and bolts of reporting.
The lab environment gives management a really granular insight into where they can make their reporting more valuable. And by testing a new approach, getting feedback and adjusting, they can introduce positive changes cost-effectively and quickly, without having to wait for the next reporting cycle.

Investors have welcomed the labs’ voluntary disclosure approach as a fast track to real improvements in company reports. The labs are promoting good practice and highlighting examples of good practice rather than generating white papers and exposure drafts. Key topics on the investors’ agenda are being addressed far sooner than they would be under formal standard-setting procedures, and are therefore having an impact in the markets.

The regulators deserve a great deal of credit for stepping back, setting aside their ‘thou shalt’ mandates, and creating the space for dialogue between the market players actually involved in the allocation of scarce resources.

Preparers often complain of a ‘laundry list’ approach to disclosures and question who really uses the information they are being asked to present, and why. In the lab environment, both the ‘who?’ and the ‘why?’ are embedded in every conversation.

In the FRC’s reporting lab, for example, analysts and companies have been looking at fundamental information that can help users understand the cash companies will need to repay debts and what this says about current and future cash flows. The output is practical and relevant and is a far cry from any high-level, conceptual exercise.

**Preliminary results**

It’s a win-win approach that is already producing results. Reports from the labs have been widely praised by the corporate and investment communities. The first round of financial reports that could include recommendations and examples devised in the labs are coming on stream now, and the signs are that companies are already adopting new practices.

**More please**

Regulators have shown both their influence and imagination in setting up reporting labs. The concept has tapped a rich vein of creativity and innovation among participants with a genuine interest in finding solutions to common problems of communication and presentation. With successful precedents in place covering two major jurisdictions and a core global industry, it is now time for other regulators to follow suit.

Alison Thomas
PwC director and former investor
Cash and debt – cash is still king

In the tough current climate, how can companies report on cash and debt, and win the competition for capital? Jennifer Sisson explains

The ongoing economic downturn and continued strain on the availability of financing is a challenge for business. It means both management teams and investors are much more focused on cash and companies’ ability to fund working capital requirements, refinance and secure new debt.

Statistics show that there is a significant shift towards bond financing and away from corporate loans. So if companies want to raise capital at the right price, it’s crucial that they consider the needs of the fixed income investor as well as the equity investor.

How well are you telling your story?

Now is the perfect time to take a step back and assess your cash and debt reporting. Is it telling the right story to the market? Have you made sure that the information debt and equity investors need is clearly available in your accounts? Our survey of FTSE 350 reporting in 2012 – Trust through transparency – shows that there’s plenty of room for improvement on cash and debt reporting.

A clear future funding strategy is vital

In the current climate, a failure to show clearly underlying cash and debt positions could be the difference between lenders ‘playing ball’ and ‘playing hardball’. If companies want to be bankrolled in this financial environment, crystal clear disclosure is essential.

As bond issues increase dramatically, fixed income investors tell us a similar story; they need to know the game plan for future financing.

There are a couple of basic questions investors want to know the answer to:

- What is your current funding situation?
- What is your strategy to access the capital you need to meet your operational and growth objectives?

But how do you answer these questions clearly? The first step is to include more insight than simply current cash and debt – define funding more broadly. Give details of the all important sources of finance, such as working capital (now and in the future) and payments in advance.

What’s reporting like today?

89% of companies had debt, of those companies ...

53% have a ‘net debt rec’

43% mention covenants, although only 15% in a detailed way

32% have annualised debt maturity information

Source: PwC survey of FTSE 350 reporting
It’s also important to be consistent. Investors tell us that it can reflect badly on management if there isn’t a cohesive message across the annual report. For example, is the funding strategy discussed in the financial review consistent with that portrayed in the notes to the financial statements? It might indicate a lack of joined-up thinking and controls, or, in the worst case, an intention to deliberately mislead the market.

The most innovative reporters are tackling the problem of information on complex issues – such as liquidity risk – being scattered around the report by experimenting with ordering their notes, including ‘plain English’ introductions and moving elements of the financial review alongside the relevant notes to present each area more clearly.

**How to win the competition for capital**

Investment professionals tell us that companies can secure the right funding at the right price with three simple, voluntary disclosures: cash, net debt reconciliations (‘net debt rec’) and debt.

To take each in turn: cash flow is critical for investors. It’s a vital input to their valuations and allows them to understand management’s ability to service the entity’s working capital requirements and debt position – and any risk associated with it. Investors would like to see disclosure of capital expenditure split into ‘maintenance’ and ‘growth’ spend. Yet only 15% of the FTSE 350 companies with debt discuss their spending plans to support their future priorities.

A ‘net debt rec’ is an easy way to assess whether an entity that seems to have had a significant increase in cash has, for example, achieved this only by taking on a corresponding increase in debt. Investors tell us that a net debt rec sets an organisation apart. In the FTSE 350, just under half (47%) of the companies with debt provide a net debt rec.

Investors also tell us that they need a comprehensive maturity table for all material components of debt, including the contractual maturity of each type of debt and when management expects it to be repaid (if different). Rather than reporting broad bands, investors are looking for year-on-year detail of debt repayments falling due. Only 32% of the FTSE 350 currently share this information.

Change won’t happen in a vacuum though, and companies clearly need advice on what information to include, where. They need not worry – there are market forces at work to help improve disclosures. Reporting labs, along with accounting and legal professionals (see page 16) are testing new approaches and practices to gauge their immediate impact on the relevance, practicality and usefulness of financial reports. It’s a development that investors and the corporate community alike have welcomed, and there are signs that companies are already adopting the new, recommended practices.

**Disclosures that can help investors understand your cash and debt**

You can use this checklist to benchmark your organisation against the best practices we see in reporting of cash and debt.

- A reconciliation of movements in net debt
- Debt maturity information on an annualised basis
- Detailed discussion of debt covenants
- Average debt balance in the year
- A cash flow statement that starts form an operating line
- Disclosure of key ratings triggers
- Broad discussion of funding needs and future funding strategy
- Clear breakdown of maintenance vs. growth capital expenditure
- A measure of cash flow on a segmental basis

Jennifer Sisson
Investor engagement team at PwC
Realising the benefits

While accrual accounting is the basic foundation for a modern finance function, to really deliver value within government the finance team will need to move beyond its ‘score keeper’ role and the year-end, historical financial statements. It must play a proactive role to provide key information that informs strategic and operational decisions. Only then will it earn its place at the decision-making table and be recognised as an important business partner within the government as a whole.

Sound and transparent public accounting does not in itself guarantee good public financial management. But it is a necessary step towards that goal. Better accounting leads to improved reporting, which provides the information necessary for better decisions. And this in turn should lead to better use of public resources.

If we want to create a positive legacy for the next generation, a pre-requisite is that we use clear, consistent and relevant information to plan ahead.

The majority of governments still use cash-based accounting practices, which fail to capture information on public sector assets and liabilities, and present a very short-term view of public finances.

The global financial meltdown and the subsequent sovereign debt crisis have brought government public finance management practices under scrutiny from the accountancy profession, the international donor community, the capital markets and the general public. This additional pressure to control spending and improve public finances can lead to the use of accounting devices, such as hidden borrowing and deferred spending, by politicians and governments. Tactics like these can give an illusion of improved fiscal measures in the short-term by reducing current deficits, but they do so by increasing future deficits and debt levels.

The demand has never been stronger for governments to adopt sound and transparent accounting rules as part of their wider public finance management. It’s vital for governments and their stakeholders to understand the full economic impact of today’s decisions that affect financial performance, financial position, and cash flows. We need to know what all the liabilities are in the government balance sheet, including long-term debts and pension obligations.

Will we create or consume a legacy for the next generation? We can only answer that question if we have sound and transparent government accounting and reporting that doesn’t hide the real picture.

A growing trend

This demand for clearer information has prompted a trend towards accrual accounting frameworks, such as International Public Sector Accounting Standards (IPSAS), especially in non-OECD countries in Africa, Asia and Latin America. In these countries, the transition to accrual-based accounting frameworks is often included as part of wider public finance reforms and combined with investments in better financial information systems.

In Europe, the European Commission has completed its assessment of IPSAS’ suitability for EU countries. The EC’s report concludes that, even if IPSAS cannot be implemented in the EU as it stands, they are a good reference for the potential development of European Public Sector Accounting Standards.

Transitioning to an internationally-recognised, accruals-based accounting framework is a challenge. It demands a clear vision and strong political commitment to strengthen public institutions, develop high quality standards and practices, enhance skills, and build capacity. Converting to accrual accounting standards based on IPSAS usually involves a transformation project that extends well beyond the finance function and takes several years.

By introducing accrual accounting, governments demonstrate their desire to achieve greater transparency and accountability, says Jan Sturesson

Government reporting: does it show the full picture?

Jan Sturesson
PwC global leader, Government and Public Sector

Watch the results of the PwC Global survey on accounting and financial reporting by central governments
www.pwc.com/ipsassurvey

Find out more about IPSAS and public sector accounting developments see IPSAS in a nutshell, from principles to practice
www.pwc.be/ipsas-book

With Jean-Louis Rouvet, Patrice Schumesch and Jean-Philippe Duval
Mandatory firm rotation: not the answer

There's a perception of over-familiarity between the auditor and management that needs to be addressed, but enforced rotation is not the way to do that, argues Richard Sexton.

What's going on?
When the European Commission proposed a package of legislative reforms aimed at reinforcing audit independence in November 2011, it set in motion a renewed debate on mandatory firm rotation, or MFR, worldwide.

In the UK, the Competition Commission investigated the dominance of the statutory audit market by four firms, and suggested MFR amongst its possible remedies in its 'provisional findings'. In the US, the Public Company Accounting Oversight Board (PCAOB) has asked for input on questions of auditor independence including the possibility of MFR. And the Netherlands has enacted MFR – it will start in 2016.

You could be excused for thinking that mandatory firm rotation is a new idea – but it's not. Some countries have previously adopted it – and some of those, such as South Korea and Singapore, have already abandoned it as unworkable. So for Europe as a whole to mandate MFR could put the EU at a competitive disadvantage. Our view on this is also supported by many investors and a large part of the European business community.

Why is it important?
Independence, objectivity and scepticism are at the heart of the audit profession, but there's no doubt that there is a perception of over-familiarity between the auditor and management that needs to be addressed. But enforced rotation is not the way to do that – it is an inappropriate and disproportionate response.

Simply, mandatory audit firm rotation will put audit quality at significant, unnecessary risk. There are more effective, less disruptive and less costly ways to reinforce independence.
So why not MFR?

MFR reduces the quality of an audit, through loss of significant cumulative knowledge of the company’s business. This increases the risk of audit failure. It’s essential that an auditor’s familiarity with the business is not equated with over-familiarity with management.

It also reduces an audit committee’s ability to fulfil its responsibilities. If the incumbent firm meets the needs of the audit client best, and the audit committee cannot choose this firm, the committee’s ability to fully discharge its oversight responsibilities is reduced. This in turn disenfranchises shareholders.

Some promote MFR as a way to increase competition in the audit market. But MFR actually reduces competition and restricts free market forces. Not only can the incumbent firm not bid to audit the client, but the Review of the EC impact assessment by Copenhagen Economics concluded that MFR may actually weaken competition, as companies gravitate towards a large firm upon rotation.

In certain complex industries, such as oil and gas, and particularly global finance, MFR could have additional adverse consequences on competition.

Importantly, there are alternatives to MFR. The package of proposals from the European Parliament’s influential Legal Affairs Committee (JURI) contains some suggestions we agree with – including an annual audit quality review, carried out by the audit committee. But there are other ways of strengthening the audit market too, namely:

- Strengthen the role of the independent national regulators of the profession.
- Improve coordination and communication between regulators, auditors and audit committees.
- Make external audit inspection requirements more consistent to allow for greater comparability of inspection results.
- Closer involvement of the national audit regulators and supervisors in the appointment of the auditor under certain exceptional circumstances.

Further improvements might include more transparency about the audit and auditors:

- By the auditor to the audit committee about the conduct of the audit
- By the audit committee to the public about their oversight of the audit, including how they evaluate the performance of the auditor and the appointment/reappointment process
- By the audit firm to the public about its quality processes and additional commentary on companies.

These alternative solutions enhance oversight of the auditor, further promoting audit quality, while also reinforcing the role and responsibilities of the audit committee, as well as enabling better communication with regulators and shareholders.

It makes sense to explore new ways to enhance auditor independence and the broader objective of audit quality. On that point, everyone can agree.

But MFR isn’t the right way to do it, and it might have the opposite effect. MFR wouldn’t meet the stated aims of the legislators and regulators, nor would it answer the concerns of stakeholders. It would not be in the public interest.

There are other ways of reinforcing independence and corporate governance, while at the same time maintaining choice and enhancing audit quality.

“There are other ways of reinforcing independence and corporate governance, while at the same time maintaining choice and enhancing audit quality.”
News

Keep abreast of worldwide news on governance, reporting and assurance, and see how it might affect your business

Curbing executive pay
A 68% majority of the Swiss parliament have passed a law to curb pay
See page 25

Action on tax
Tax transparency requirements are developing fast in the EU, the US and elsewhere
See page 29

Auditor’s report to change
It’s not a matter of ‘if’ but ‘how much’ it will change – proposals and consultations abound
See page 43
Long-term financing of the European economy

The European Commission has launched a Green Paper consultation on how to foster the supply of long-term financing and how to improve and diversify the system of financial intermediation for long-term investment in Europe. The closing date for responses to the consultation is 25 June 2013.

The paper focuses on how to enhance the productive capacity of the economy – how to ensure funds are channelled into, for instance: energy, transport and communication infrastructures; industrial and service facilities; climate change and eco-innovation technologies; education; and research and development. It also addresses the specific challenges for small and medium-sized companies (SMEs) to access bank and non-bank finance, as they are seen as a major source of potential long-term growth.

Internal Market and Services Commissioner Michel Barnier said: “Europe’s economy is facing massive challenges, including large-scale, long-term investment needs. These are essential as a basis for innovation and competitiveness, supporting a return to sustainable growth and jobs in Europe. These needs require long-term financing. Ensuring our economy and our financial sector – including banks and institutional investors such as insurers and pension funds – are capable of funding long-term investments is an important but complex task. We need to identify what barriers exist to long-term financing and what more can be done to overcome them.”

The Green Paper gives respondents the chance to challenge the EC’s analysis of the problem and potential remedies in a number of areas, including:

• Balancing prudential regulation and liquidity requirements for banks and institutional investors with encouraging long-term investment
• Getting intermediaries in the capital markets to facilitate the flow of funds to long-term investment
• Developing savings and investment vehicles to allow short-term funds to be transformed into long-term finance
• Corporation and income tax reforms, including rebalancing the treatment of debt and equity investments

The role of financial and non-financial information in allowing a long-term view is raised in the paper, as is the need to align incentives for asset managers, investors and companies and improve engagement between them.

Responses to the consultation will determine the way forward. Follow-up could take several forms, both legislative and non-legislative. The fact that the Barroso Commission is coming to an end in 2014 could, however, affect the timing of any actions.

“Investors need financial stability and confidence in the markets before they can take a long-term view, but they will do so if they think it is in their best interests,” said Kevin Desmond, director in PwC’s Capital Markets Group. “Appropriate regulation and supervision can contribute to this and we are encouraged that the commission recognises the need for a balance between prudential regulation and measures that discourage, or even prevent, appropriate risk-taking.”

“Fundamentally, however, we need a rebuilding of trust between business and investors – including the various links in the investment chain. This cannot be achieved simply through legislation or technical means alone.”

Kevin Desmond, Capital markets director at PwC
SWITZERLAND

Blow to executive compensation

In Switzerland, a draft law proposing measures to curb executives’ pay and make a number of changes to other compensations has passed with a majority of 68%. The public approval of the package, known as the ‘minder initiative’, is – according to its namesake Swiss senator Thomas Minder – a “strong signal” from the people to boards, the federal council and the parliament.

Swiss public discontent with the bonus culture has been growing since 2008, when a flagship bank received a government bailout following losses that many attribute to large rewards for bankers who made risky bets.

If passed, the law would limit the mandate of board members to one year. It would also ban certain kinds of compensation on joining or leaving a company and would outlaw bonuses paid for taking over or selling off a part of the business. It is intended to apply to Swiss companies listed on Swiss or foreign stock exchanges.

If the law passes, all board compensation packages will need shareholder approval, and failure to comply might result in a jail sentence or a very large fine.

Critics of the initiative have warned that it could result in big business re-homing. Mr Minder hopes that the law will prove inspirational, and encourage investment by leading on transparency and shareholder priority.

The new rules are due to take full effect in March 2014, with a ‘transitional ordinance’ in the interim.

“This is a surprising move,” said PwC executive compensation specialist Roz Crawford. “The Swiss environment has traditionally been benign. The proposals are not dissimilar to a number of other remuneration initiatives across Europe – particularly in the area of shareholder votes on remuneration. But the ban on termination payments and sign-on bonuses are tougher than in other regimes.”

It remains to be seen whether similarly tough, public opinion-led clampdowns on remuneration arise in other countries around the world.

Call to stop ‘hard and fast’ rules

When one of the world’s largest sovereign wealth funds speaks out about how it thinks the market could improve, investors, legislators and journalists tend to take heed. In February, Norges Bank Investment Management (NBIM) published a discussion note detailing its expectations of corporate governance.

The fund, an investor across 8,000 companies worldwide, took the position that from an investor’s perspective, further formalising best practice guidance into hard and fast rules is not a helpful approach.

“Market practice should conform to high-level universal principles, rather than to detailed, prescriptive rules,” said Gavin Grant, the head of Active Ownership at NBIM. He added that deviation from best practice – “if well thought out and persuasively justified” should be “expected and welcomed”.

In its somewhat controversial rejection of continuing codification of principles, the note lays out some convincing arguments. Its most persuasive position is on prioritising protections for minority shareholders and their role in monitoring management for sustained success.

NBIM is clear about equal treatment of shareholders – it urges the board to act in the interests of all shareholders, and to make decisions that treat all shareholders equitably.

Businesses face a variety of challenges that justify a number of governance approaches, says NBIM – but detailed legislation and guidance is no substitute for business judgement – so long as that judgement is exercised with shareholder equality in mind.
PAKISTAN

Governance code changes the board

The Securities and Exchange Commission of Pakistan (SECP) has finalised the new Corporate Governance Code (CGC) for the country. The code is now in effect and penalties for non-compliance are active.

There are significant changes to the original 2002 code, with major alterations to the rules surrounding: composition of the board of directors; corporate and financial reporting; and the mandatory qualifications and experience of some key personnel.

- The position of CEO and chairman must now be separate.
- Independent directors on boards are now mandatory, rather than simply encouraged.
- The test for independence is more rigorous

The changes broadly reflect three aims: greater diversity, mandatory representation of minority shareholders and directors’ independence.

The new Code brings Pakistan’s corporate governance framework more in line with international standards and current global developments.

“The Code of Corporate Governance 2012 signals the SECP’s aim to raise the bar for standards of corporate governance in Pakistan. The changes are intended to lead to better disclosure and transparency for investors.”

Nilofer Subhan, Ethics and compliance specialist at PwC Pakistan

IFAC

Principles-based approach aims for global consistency

The International Federation of Accountants (IFAC) has released a policy position paper promoting a “robust ethical culture” and providing guidance on “effective governance, risk management and internal control”.

The paper emphasises the increased level of public interest in good practice following the financial and sovereign debt crises and explicitly links good governance with “sustained organisational success”. Accountants, the paper suggests, have the skills to “play critical leadership and support roles” in many aspects of management.

IFAC takes into account the variety of legislation, jurisdiction and workplace and advocates a principles-based approach that aims at global consistency, saying: “it is clear that what works in one environment may not work – or might work differently – in another”.

Successful organisations, says IFAC, “adhere to governance principles... periodically evaluate results... and adapt their governance” to changing opportunities and threats.

The paper is a useful addition to IFAC’s guidance, which focuses on enhancing good practice across both public and private sector business to help develop strong international economies.

www.ifac.org

GULF REGULATION

Gulf region must fall in line, says summit

The Gulf region must recognise and implement international best practice in governance and regulation if it wants to expand its financial centres and improve their influence, according to key speakers at the summit of the Gulf Cooperation Council regulators.

The summit, held in Qatar, convened to discuss the quality of regulation in the region, as well as emerging regulatory trends and the impact of legislation.

There was significant debate over whether exporting extraterritorial rules – for example, the US-based Volcker Rule, restricting proprietary trading – would be appropriate. Some CEOs present, including former Securities and Exchange Commissioner, Paul Atkins, think that the tough US approach would not be helpful in the GCC. Privately, one official said that exported, stringent approaches had as much to do with politics as banking.

The summit accepted that regulatory issues are becoming more globalised and that larger institutions must pay close attention to international best practice if they want to be “taken seriously”. The general push for a single approach to financial regulation was held to be a positive move.
OECD calls time on revenue erosion

The erosion of tax bases and the shifting of profits is a very current, very critical concern among many of the G20 nations, as well as some individual governments. The Organisation for Economic Co-operation and Development (OECD) has released a report comprehensively diagnosing the situation around base erosion and profit shifting (BEPS) and proposing the need for an action plan to tackle some key pressure points.

The report suggests that the loss of tax revenue by profit-shifting to lower-tax jurisdictions is an unsustainable symptom of the changing global business environment – particularly the development of the digital economy. The report acknowledges that there is no silver bullet for addressing BEPS, but positions the OECD as ideally placed to advance a collaborative solution.

The report solicits input for an action plan that the OECD hopes to have fully developed by June 2013. Particular areas of focus include:

- Instruments to end/neutralise the effects of hybrid mismatch arrangements
- Improvements to and clarifications of current transfer pricing rules
- Updated solutions to ‘jurisdiction to tax’ issues, in particular, for digital goods and services
- More effective anti-avoidance measures
- Rules on the treatment of intra-group financial transactions
- Solutions to counter harmful tax regimes more effectively

Richard Collier, tax partner at PwC says: “The response of the OECD is more likely to be built around modifications to existing rules to bring in further anti-avoidance measures and possibly specific rules for ‘special situations’ such as internet businesses. But it remains unclear whether digital business will, as initially indicated, be dealt with by specific rules as a special case or whether any changes intended to apply to e-commerce will apply across the board”.

EUROPEAN COMMISSION

Action plan to modernise company law and corporate governance

After two years of consultation and analysis, the European Commission’s action plan on company law and corporate governance for non-financial companies has been released. The plan aims to balance the need for additional shareholder rights with the need for shareholders to “fully assume their responsibilities”.

Eventually, the EC plans to merge all major company law directives into one single, accessible instrument.

Key transparency measures include:

- Increasing transparency on board diversity and risk management policies
- Improving corporate governance reporting
- Increasing the transparency of institutional investors on voting and engagement

Proposals to encourage long-term shareholder engagement include:

- Enhanced transparency on remuneration policies
- Increased shareholder oversight on dealings between the company and its directors
- More advice to shareholders on voting, conflicts of interest and similar matters
- Where possible, encouraging employee share ownership

“The modernisation aims to keep companies effectively governed and competitive over the longer term.”

Graham Gilmour, PwC director

Initiatives in company law include:

- Making cross-border activities easier to carry out eg, by making a number of cross-border rules clearer
- An information campaign on the European Company Statute
- More transparency about group structures

EU LAW

Women in the boardroom – quotas?

Two years after EU Justice Commissioner Viviane Reding’s Women on the board pledge for Europe, 21 out of 27 national assemblies of the EU have given the go-ahead to draft a law on female quotas in the boardroom. The six dissenters are the Czech Republic, Denmark, the Netherlands, Poland, Sweden and the UK.

Reasons for no-votes vary, but only Sweden and the UK voiced concerns about the substantive detail of the proposals. Sweden said that the plans impose restrictions on dismissal of board members. The UK takes issue with the notion of a quota at all, parliamentary under-secretary of state for women and equalities, Jo Swinson, arguing that “the majority of women are not in favour of quotas” for fear of tokenism. The UK ranked 18th out of a sample of 27 OECD countries for PwC’s Women in Work survey.

The EU will press ahead with crafting the legislation – 21 out of 27 member states is a healthy majority. Data from past surveys suggests that member state electorates are overwhelmingly in favour of legislation promoting gender balance on company boards.
Conflict minerals rule has a global impact

In August 2012, the US Securities and Exchange Commission (SEC) issued a rule requiring US-registered companies (issuers) to assess and disclose the origin of conflict minerals – including tantalum, tin, tungsten and gold – in their products.

If those minerals originated, or may have originated, in the Democratic Republic of Congo or certain surrounding countries, issuers must also perform due diligence to determine whether their purchase of conflict minerals may have benefited armed groups. They must also have that due diligence process audited by a third party.

The SEC was mandated by the Dodd-Frank Act to issue the rule in response to concerns that the exploitation and trade of conflict minerals is funding armed groups responsible for extreme violence in that region. The rule is effective for this calendar year.

Who is affected?
The SEC estimates almost 6,000 issuers will fall within the scope of the rule. And that more than 275,000 global suppliers who sell to those issuers will also be affected, as US companies look to them to gather the necessary information to help them comply. The rule is applicable to all issuers that file periodic reports with the SEC, whether they are domiciled in the US or abroad.

“Issuers have to dig down through their supply chains to find the data they need to comply,” said PwC partner, Barbara Kipp. “Many suppliers – especially those outside the US – may not realise that they’ll be on the hook for providing that information.”

The estimated financial impact of the rule is substantial. Initial compliance costs could range between US$3 billion and $4 billion, while the ongoing costs are estimated to reach US$200 to $600 million annually. Non-public suppliers both within and outside the US are expected to spend a hefty US$1.2 billion to comply with information requests.

Reaction to the rule
Some leading companies are already planning to be conflict free in an effort to meet goals for sustainable and responsible sourcing. Others have voiced doubts over whether it will achieve the intended goal of reducing violence in the DRC region and see the compliance exercise as costly and time consuming.

Several significant business groups have filed a joint lawsuit to try to stop or amend the rule. But no decision is likely this year, so many issuers are starting compliance efforts as the rule is already effective. Not complying with the rule may result in being ineligible to raise new capital under SEC regulations and risks pressure to take action from human rights activists, consumer groups and others.

“Many issuers are just beginning their compliance efforts, so their suppliers may not realise that they will be affected by the rule. Considering the depth and breadth of many companies’ supply chains, and the absence of tracing mechanisms in most, the rule poses significant challenges for many companies.”

Barbara Kipp, PwC partner
Country-by-country tax reporting: what’s going on?

The media and public interest in tax and tax transparency continues to grow. Tax will also be a central theme of the G8 and G20 meetings in 2013. On 23 May 2013, EU commissioner Michel Barnier announced an intention to extend country-by-country reporting of tax payments to all large EU companies and groups. At the time of writing however there are no further details on this proposal and it is not clear where this would fit into EU legislation.

Various pieces of country-by-country tax reporting legislation are developing fast – outlined below is a summary of where things stand in May 2013.

These rules and regulations broadly require companies to disclose data on the amount of tax they pay in each country where they operate. There are differences in the industries and countries affected and in the data to be published.

**EU Capital Requirements Directive IV (CRD IV)**

Provisions on country-by-country tax reporting were introduced into CRD IV in early 2013. The provisions will require all banks, other credit institutions, and certain investment firms in the EU to publish detailed financial data on a country-by-country basis.

If the directive is adopted by the end of June 2013 as planned, all affected institutions will have to publish information on activities, turnover, employees, profits, taxes and subsidies from 1 January 2015.

**EU Directives on Accounting and Transparency**

These directives are to be amended to require country-by-country reporting of tax and other payments to governments for the extractive and logging industries. The most recent draft of the amendments (12 April 2013) clarifies some of the open questions around de minimis levels, the requirement to report on a project-by-project basis and the precise numbers to be reported.

The proposed amendments are due to be voted on by the EU Parliament in June 2013 and are expected to apply from 1 January 2016 at the latest.

**Dodd-Frank Wall Street Reform and Consumer Protection Act**

The country-by-country tax reporting provisions in the Act were adopted by the US SEC in August 2012. They require SEC-listed extractive companies to disclose, on a country-by-country basis, payments made to governments.

In October 2012 the American Petroleum Institute launched a legal challenge against the inclusion of country-by-country provisions in the Act. On 26 April 2013 the US Court of Appeals for the District of Columbia unexpectedly decided that the case should not be heard in that Court, but in the District Court. This change has created uncertainty around the timing of any final court decision. Unless the court rules otherwise, companies affected by the Act are due to start reporting from 1 October 2013.

**Extractive Industries Transparency Initiative (EITI)**

The EITI was one of the first country-by-country initiatives. It is adopted by countries on a voluntary basis and applies only to the extractive industries. Once adopted by a country, it applies to all extractive companies in that country subject to any exemption or de minimis provisions adopted.

The overall EITI framework is undergoing a process of review, consultation and amendment. The final consultation draft of the revised standard was issued in April 2013 and adopted at the EITI conference in Sydney in May 2013. The changes are substantial and aim to make the reports more user friendly and relevant, align some areas with the SEC and EU transparency rules and seek to provide more information in a number of areas.

[www.pwc.com/gx/en/taxpublications/tax-transparency-reporting.jhtml](www.pwc.com/gx/en/taxpublications/tax-transparency-reporting.jhtml)
GRI launches G4: it’s all about relevance

Materiality has been placed at the centre of the new sustainability reporting guidelines issued by the Global Reporting Initiative. The fourth generation of the framework, termed simply ‘G4’, aims to improve the common language of corporate reporting, focusing heavily on the issues that are material to the organisation and important for stakeholders.

CEOs worldwide have identified the need to build public trust as a crucial part of improving operational effectiveness and engaging with customers following the financial crisis. Sustainability reporting, says the GRI, plays a key role in this, with non-financial reporting being singled out as a particularly effective means of communicating long-term commitment to sustainability.

The new model of disclosure focuses on ‘accordance’, and unlike its predecessor, it does not reward reporting of large quantities of indicators. G4 also requires companies to indicate and explain omissions of standard or material disclosures.

Further notable changes include amended guidance on supply chain and procurement practice, as well as enhanced disclosures on:
- Management approach
- Anti-corruption
- Greenhouse gas emissions
- Governance
- Remuneration

Overall, the GRI has strengthened technical definitions and handled most ambiguities, bringing processes more in line with the international standard.

There is a sense that G4, although concise, relevant and aligned to the mainstream, could go further and draw out the link between sustainability and integrated reporting.

“G4 is a big step forward,” said Robert van der Laan, PwC partner in the Netherlands. “We should not forget that long-term investors are the most important change agent. What they need is a common language. Neither G4 nor the complementary integrated reporting framework ensures this, so there is still a lot of work to be done. I hope that investors get more closely involved in that follow-up process.”

Road-testing the IR framework

The Dutch arm of PwC has thoroughly road-tested the draft Integrated Reporting Framework (IR), recently launched for consultation by the International Integrated Reporting Council (IIRC). The firm, part of the IR pilot scheme, reports positive results from using the framework – the quality of its reporting outputs and its internal processes have both improved.

“Integrated reporting is a real challenge, but it forces us to think about true value for society”, said Robert van der Laan, PwC integrated reporting partner. At first we thought that was an easy question – but it’s not. Defining how we create value proved to be one of the most difficult aspects of IR. We succeeded, after a lot of discussion, and now we’re working on a more mature model, based on our latest insights and best practices.

“But why should we burden ourselves voluntarily with integrated reporting, which is a lot more trouble? It’s because we are convinced that just more numbers is not what society needs. It also increases dialogue with our own people and our clients and improves integrated thinking in our organisation. As a result of integrated reporting, we have more insight into the value drivers and risks of our organisation.

“Integrated reporting is a journey – we learn and grow by doing it. And we expect that in a couple of years, integrated reporting will feel straightforward, just like financial reporting does now.”
IIRC launches a draft framework for comment

The International Integrated Reporting Council (IIRC), a global coalition of investors, companies, regulators and the accounting profession, has released its blueprint to encourage a more cohesive approach to reporting. The deadline for comments is 15 July 2013.

The framework focuses on how organisations create value in the short, medium and long term. It is intended to be flexible enough for organisations to talk about their way of creating value in their own language – rather than making a high volume of disclosures in boilerplate language.

The framework also aims to improve accountability and company stewardship, and to support strategic thinking and decision-making. The integrated reporting initiative is built around the notion that good reporting and good business strategy are mutually reliant. Integrated reporting is therefore a response to the widely-held belief across business that business models need to evolve and become resilient to survive. The IIRC hopes that IR will underpin a higher level of investor trust and confidence.

The initiative has been tested in a pilot programme involving 85 companies and 50 investors. A survey of pilot organisations suggests that IR does indeed deliver benefits for the organisation and its stakeholders. Results showed:

- 95% believe IR provides a clearer view of the business model
- 93% found it broke down internal silos
- 95% felt it increased board focus on the choice of KPIs
- 93% said it leads to better quality data collection
- 88% think IR leads to improved business decision making

“It is increasingly clear that if companies provide a more cohesive view of their business it can improve their access to capital and resources,” said Richard Sexton, PwC’s global assurance leader-elect. “Companies with the best information to inform their decisions are also far more likely to develop the right strategies and business models to succeed.”

Dennis Nally, chairman of PwC International, added: “Integrated reporting can make a critical contribution towards financial stability. Companies that make their performance and prospects visible in a credible and well-structured way will avoid the risk that investors undervalue their organisation.”

“In an environment where the public, investors, regulators, politicians and commentators continue to challenge companies for failing to communicate effectively, there is a trust issue at stake here. A less than coherent or partial view of a company’s performance or prospects can undermine confidence in the business.”

Richard Sexton, Global assurance leader elect at PwC
New legislation to require ‘strategic report’

Proposed changes to narrative reporting requirements in the UK are expected to have effect for financial years ending on or after 30 September 2013. The regulation falls short of the original UK government objective to re-energise narrative reporting. The aim now is to bring narrative reporting more in line with current good practice.

The proposed changes introduce a strategic report – quoted companies will be required to report on their strategy, business models, diversity and human rights issues.

One of the most significant changes in the latest draft legislation is to mandate that quoted companies detail their greenhouse gas emissions in their directors’ report.

A further significant change replaces the option for companies to send shareholders a summary financial statement with the option to send them a strategic report with supplementary material.
Exchanges press for better reporting worldwide

A number of stock exchanges already enforce specific sustainability disclosure standards, but reporting on environmental, social and governance issues could soon become a listing requirement worldwide.

A consultation paper by the Investor Network on Climate Risk (INCR), written partly at the behest of stock exchanges including NASDAQ QMX, sets out a recommended baseline for company listings, regardless of exchange size, location or familiarity with sustainability issues.

The paper – *Proposed sustainability disclosure listing standard for global stock exchanges* – is the result of a consultation with public interest groups, investors and companies. It recommends that listing requirements have three segments:

- A materiality assessment of environmental, social and governance issues (ESG)
- A link in the financial reports to a GRI Content Index
- Disclosure (or reasons for non-disclosure) on: climate change, diversity, employee relations, environmental impact, government relations, human rights, product impact and safety, and supply chain

The paper makes it clear that pure, risk-based financial reporting does not do enough to cover ESG issues. A global listing standard, it says, will improve consensus and clarity, as well as address the current imbalance between those exchanges that do require sustainability reporting, and those that don’t.

Other recommendations include:

- Independent assurance of ESG disclosure data
- Capitalisation and time thresholds for compliance
- Monitoring of overall levels of disclosure
- Ensuring consistency of disclosures between exchanges
- Developing centres of expertise to run educational programmes

——

AMENDMENTS TO DIRECTIVES

EC gives weight to call for business transparency

Larger companies may soon have to enhance the quality and scope of information in their annual report, following the European Commission’s (EC) adoption of proposals on non-financial and diversity information.

The proposals – amendments to existing European Council directives – would require large companies (all those with over 500 employees and a balance sheet total of €20m+ or a net turnover of €40m+) to disclose material information relating to: the environment, social and employee-related matters, respect of human rights, and anti-corruption and bribery matters. In each case, management would need to give a description of the company’s policy and its results, as well as the related risks and how they are managed.

Both the areas covered and the disclosures needed are broader than some of the parallel reporting developments in member states. But the EC has specifically stated that it intends to take a flexible and non-intrusive approach to allow companies to use existing national or international reporting frameworks and to explain where aspects of the requirements are not relevant for them.

The measures were drawn up following broad consultation by the EC with stakeholders, which revealed a consensus that current legislation is both unclear and ineffective. The consultation also concluded that inclusion of more relevant non-financial information in the annual report encourages better long-term decision making and leads to more sustained success.

“The emphasis on materiality will steer companies towards relevant communication and a strategic approach to sustainability. If done well, the provision of more non-financial information will answer investor and stakeholder demands and help to level the playing field.”

Jessica Fries, PwC integrated reporting leader and member of EC expert group on non-financial disclosure
More support needed for international standards

The hesitancy of the US to commit to International Financial Reporting Standards is only one of the obstacles to achieving a single accounting language globally, according to a recent report from the Institute of Chartered Accountants in England and Wales (ICAEW).

The report, *The future of IFRS*, admits that “not everything in the IFRS garden is rosy”, with several issues leading to this conclusion. The report goes on to suggest that “the IASB needs more active support, including through IOSCO (the International Organisation of Securities Commissions), and regulators around the world need to work together more closely to deliver consistent enforcement”.

This was the subject of a recent speech delivered by the chairman of the International Accounting Standards Board (IASB) Hans Hoogervorst at the Cass Business School in London. He noted that it is not the IASB’s job to manage the uniform application of the standards – that is for regulators and auditors. However, he did address how the IASB could contribute to the consistent application of IFRS, alluding to expanding the cooperation with securities regulators at international and regional levels, possibly through formal agreements.

The paper also highlights the potential issue that regulators need to make sure that they don’t “stifle the exercise of professional judgement or stray into the area of general interpretation”.

Two-thirds of the G20 countries either allow or require their listed companies to use IFRS (or national standards closely based on them). The ICAEW wants to see all G20 members allowing optional use of IFRS in their capital market, but acknowledges that the complexity of IFRS could be a barrier. It calls on the IASB to “strive to minimise unnecessary complexity in its standards and hold fast to the vision of principles-based standards that require a reasonable degree of judgement”.

**The IASB’s role**

Mr Hoogervorst outlines areas where he believes the IASB could contribute to the consistent application of IFRS.

- **Principle-based standards** – in agreement with the report, he highlighted the need for standards that can be applied, audited and enforced consistently world wide. Closer cooperation with international organisations such as the European Financial Reporting Advisory Group (EFRAG) and the new Accounting Standards Advisory Forum (ASAF) will be important eg, for road testing new standards (see page 38).

- **Post-implementation reviews** – he believes these are essential to help improve consistency, eg, the review of IFRS 8, *Segments*, currently underway.

- **IFRS Interpretations Committee (IC)** – Extending the scope and responsibilities of the IC, he says, should give it the tools it needs to react more quickly and effectively to reduce discrepancies in practice.

- **Education** – More educational materials, such as the recent ones on IFRS 13, *Fair value measurement*, will also help consistent application.

“It certainly appears that the key players are aligned on the way forward to achieving better global consistency,” commented PwC chief accountant, John Hitchins. “In the meantime, as Mr Hoogervorst said: ‘even an unevenly applied global standard provides much more global comparability than an equally unevenly applied multitude of diverging national standards’.”
EFRAG & FRC

Support for improvements to income tax accounting

The International Accounting Standard for income tax is complex to apply, but not fundamentally flawed. It needs improving rather than rewriting, say respondents to a discussion paper issued by the European Financial Reporting Advisory Group (EFRAG) and the UK Financial Reporting Council (FRC).

The discussion paper, Improving the financial reporting of income tax, was published in December 2011 (see World Watch, issue 1 2012) to stimulate debate among the user and preparer communities on whether IAS 12, Income taxes, needed to be improved or rewritten from scratch. EFRAG and the FRC have now released a feedback statement analysing the comment letters received and responding to the main issues raised.

Almost all respondents noted that IAS 12 has deficiencies, both on a conceptual level and an application level, which should be addressed. However, they would rather see the standard improved than accept some of the proposals put forward for a new approach based on different principles. In their view, some of these would entail high implementation costs that would not result in significant benefits to users.

Those respondents that did support a ‘back to the drawing board’ approach to IAS 12 were generally in favour of an accruals approach, commenting that income tax accounting should be based on a principle that requires tax assets and liabilities to be recognised according to the recognition criteria in the IASB’s Conceptual framework.

EFRAG and the FRC intend to share their findings with the International Accounting Standards Board (IASB). However, they do not intend to undertake further proactive work on this topic.

FRC & SHARMAN PROPOSALS

New going concern guidance “over-complex”

The Financial Reporting Council (FRC) in the UK has just closed its consultation on Implementing the recommendations of the Sharman Panel. Chaired by Lord Sharman, the panel undertook a wide-ranging inquiry on going concern and liquidity, and published its final report last year. The consultation paper issued by the FRC in January 2013 was aimed at putting the recommendations into practice.

Key elements of the Sharman proposals include:

- Integrating the going concern assessment by company boards with the directors’ planning and risk management processes
- Stress testing and enhanced disclosure of both liquidity and solvency

Two different concepts of going concern are proposed in the paper – the existing ‘financial reporting’ concept and a new ‘stewardship’ concept that requires directors to look ahead and achieve a “high level of confidence” about the entity’s solvency and liquidity for the foreseeable future. The paper also includes supplementary guidance on the special considerations for banks on going concern, specifically around liquidity support from central banks.

Commenting on the proposals, Graham Gilmour, a director in PwC’s UK public policy team said: “We continue to support the desire of the Sharman Panel and FRC to see enhanced narrative reporting. The proposed guidance is, however, over-complex and impractical for companies to operate. The consultation document introduces many new concepts and terminology that companies and auditors are not presently used to dealing with in their current assessments of going concern.”

The FRC intends to issue its final guidance by the end of June, but it remains to be seen if the FRC will stick to this timetable in the light of comments received.

Support for discussion paper proposals

Most supported

- Effective tax reconciliation
- Improved disclosure on deferred tax assets and tax losses
- Recognition and measurement of uncertain tax positions

Least supported

- Reconciliation of the tax paid with the current tax expense
- Discounting of deferred tax assets and liabilities
- Disclosure on uncertain tax positions
- Disclosure that involves forward-looking and ‘entity-sensitive’ information
We are now entering what many people hope will be the final phase of the IASB’s major project to reform accounting for financial instruments. But are the International Accounting Standards Board (IASB) and the US Financial Standards Board (FASB) any closer to convergence?

The joint project started in earnest in 2008, post-financial crisis. The IASB took the G20’s call for aspects of financial instruments accounting to be improved as an opportunity for wholesale reform of IAS 39, Financial instruments: Recognition and measurement, which was perceived to be a difficult and unwieldy standard. The project was also added to the IASB’s agenda for convergence with the FASB, adding an additional layer of complexity to what was already an ambitious project.

Full convergence, meaning identical standards, will not be the outcome. For example, derecognition requirements remain different, and the FASB has not even begun to deliberate the IASB’s hedging proposals. But how close are we to convergence in the two major areas – classification and measurement of assets, and impairment?

Classification and measurement

The IASB has started to discuss comments on an exposure draft of limited changes to the classification and measurement chapters of IFRS 9, its new financial instruments standard. The existing chapters of IFRS 9 propose that financial assets are classified at either amortised cost or at fair value based on their cash flows and the holding entity’s business model (a hold-to-collect business model and principal plus interest cash flows would lead to amortised cost measurement). One of the main changes proposed to the existing guidance is a new category for debt instruments held in a collect-and-sell business model: fair value through other comprehensive income.

Similar proposals are being exposed in the US. If passed by both the IASB and the FASB, US GAAP and IFRS will be very close in this area.

Impairment

Both boards also have proposals out on impairment. The good news is that both proposals are ‘expected’ rather than ‘incurred’ loss models, trying to address the ‘too little too late’ criticism of existing requirements. But there is one key difference. The FASB proposes full lifetime expected losses on ‘day 1’ whereas the IASB model is based on credit deterioration. At the beginning, a 12-month expected loss is provided, with full lifetime expected losses not being recognised until there is a significant increase in credit risk.

While both boards recognise the pressure from parties such as the G20 and the Financial Stability Board for a single solution, given the strength of feeling on both sides of the debate, it may be difficult to fully converge.

www.ifrs.org

Nepal to pilot IFRS Centre of Excellence

A new IFRS Centre of Excellence for a Developing Country (IFRS COEDC) is due to be set up in Nepal, with the backing of the Asian-Ocean Standard-Setters Group (AOSSG) and the full support of the Nepal government. This pilot programme will help the Nepal Accounting Standards Board (NASB) promote improvements in its financial reporting and attract investment to its economy.

Nepal currently follows accounting standards based on outdated International Financial Reporting Standards (IFRS), but is looking to update its norms to comply with the current IFRSs promoted by the International Accounting Standards Board (IASB).

Nepal was selected as the pilot for the first IFRS COEDC based on the findings of a survey conducted by the AOSSG in 2012. The development of further centres of excellence will depend on the progress achieved by this pilot.
Financial reporting news

Ireland

Mandatory iXBRL for tax reporting

The Irish Revenue Commissioners is following the HMRC in the UK and introducing a requirement for iXBRL-formatted financial statements to be filed along with the corporate tax returns. This will become mandatory from October 2013 starting with large companies; although the Revenue has been encouraging companies to voluntarily file in iXBRL since November 2012.

Revenue commissioner Niall Cody provided a key-note address at XBRL26, the Global XBRL Conference that was held in Dublin on 16th April, where he highlighted the importance of iXBRL for financial reporting to the Revenue.

“The Revenue has planned their implementation in line with best practice around the world,” said Richard Day, PwC partner in Ireland and chair of the XBRL26 conference. “They are introducing a voluntary programme of sufficient length and a mandatory programme that is tiered with the largest companies first.”

“Irish businesses will be able to leverage the experience gained from filing in iXBRL in the UK, either directly through their own subsidiaries or indirectly through their advisors.”

Richard Day, PwC partner

Australia

Will ‘Standard Business Reporting’ become mandatory?

The Australian government has been seeking views on whether Standard Business Reporting (SBR) should be made mandatory for the financial reports of companies listed on the Australian Securities and Investments Commission (ASIC).

Around 27,000 entities are required to lodge their financial reports with ASIC and although reporting using SBR-enabled software has been an option since 2010, very few have taken this route. The idea is to base reporting to government more closely on the information that businesses already use to run their business and to facilitate this with a ‘common language’ of reporting.

The government sees SBR as a way of enhancing the transparency of financial reports, supporting business efficiency and reducing the regulatory burden on business by allowing information to be ‘recorded once, reported to many’. SBR would also enable investors to compare company reports using financial analysis tools, rather than the lengthy process they follow today to compare paper copies and pdf files.

The government consultation sought views from preparers and users of financial reports alongside software developers – whose products would need to be enabled before companies could use their software to file their reports. Three options were put forward for comment: mandatory use of SBR, voluntary preparation of financial reports in iXBRL format using SBR or no change.

The comment period closed in March 2013. Australian business now awaits the outcome and the government’s decision.
ACCOUNTING STANDARDS ADVISORY FORUM

New forum to advise the IASB gets off the ground

A new group has been set up to advise the International Accounting Standards Board (IASB). The members of the group, the Accounting Standards Advisory Forum (ASAF), were chosen by the trustees of the International Financial Reporting Standards Foundation and will act as a single-forum technical advisory body.

The ASAF is made up of national standards setters and regional groupings of accounting bodies from around the world. Previously, the IASB had a series of bilateral Memoranda of Understanding with such bodies. But maintaining the network as it grew became increasingly complex. The ASAF replaces these bilateral arrangements.

Of 25 nominations for membership, 12 were chosen by the IFRS Foundation Trustees who took geographical balance into account. There is a mix of territories that have already adopted IFRS and some that are in the course of adopting or that aspire to do so.

The initial membership is:
- **Africa (1)** – the South African standard setter with the Pan-African Federation of Accountants
- **Americas (3)** – the Group of Latin American Standard Setters (represented by Brazil), Canada and the US
- **Asia-Pacific (4)** – Australia, China, Japan, and the Asia Oceania Standards Setters Group (represented by the Hong Kong Institute of Certified Public Accountants)
- **Europe (4)** – Germany, Spain, UK and the European Financial Reporting Advisory Group (EFRAG).

The ASAF does not replace the existing IFRS Advisory Council, which comprises a wider range of stakeholders and which will continue to offer strategic-level advice to both the IASB and the Trustees.

“The signs from the first meeting are positive,” said John Hitchins, PwC global chief accountant. “However, the ASAF should be viewed as a complement to the many other opportunities for engagement with national and regional bodies, including those not directly represented in the Forum.”

“We agree that it’s important for the IASB to receive high quality input from national standard setters and regional bodies on major technical matters related to its work programme and on national and regional issues.”

John Hitchins, PwC global chief accountant

---

EUROPE

Special adviser keeps an eye on IFRS

A new role of ‘special adviser’ has been created by the European Commission to reinforce the EU’s contribution to International Financial Reporting Standards (IFRS) and improve the way the institutions that develop those standards are governed.

EU Commissioner for Internal Market and Services, Michel Barnier, announced the appointment of Philippe Maystadt as special adviser in March 2013. Mr Maystadt will initially focus on a review of the governance of the European Financial Reporting Advisory Group (EFRAG) and the Accounting Regulatory Committee (ARC) – the EU bodies responsible for financial reporting and accounting.

The role of special adviser includes responsibility for advising the Commission as it endorses new IFRSs and recommending improvements to the current system.

“The EU has always been a strong advocate of high quality, global accounting standards,” said Mr Barnier. “Accounting policy choices have an impact on the public interest, and so our choices in this area need to be carefully thought through. To do this, the EU needs a strong framework for the development of high quality standards.”

Mr Maystadt will conduct interviews and public consultations before drafting a report setting out his recommendations on improvements to the current system and how to incorporate different views yet ensure that the EU speaks with one voice. The report will be submitted at the ECOFIN Council meeting in November 2013.

---

We agree that it’s important for the IASB to receive high quality input from national standard setters and regional bodies on major technical matters related to its work programme and on national and regional issues.”

John Hitchins, PwC global chief accountant
PWC & WHARTON BUSINESS SCHOOL

**Report explores currency risk conundrum**

Better reporting of a company’s exposure to currency risks could lead to increased investor confidence, shrewder capital allocation and improved management – so says a paper on presenting the effect of currency volatility on the bottom line.

The document – *How should global companies communicate currency risk?* – compiled collaboratively by PwC and Wharton Business School, seeks the opinions of experts in the space. Currency fluctuations in the financial markets are currently outside the historically 'stable' 2% margin of change, so the paper provides timely insight on currency reporting.

Currency volatility is, essentially, a communication problem, the report argues. The volatility itself might not have much effect on net profit and loss, or affect future cash flow, but over or under-reporting it can have a serious effect on investor relations and subsequent access to capital. The question is, therefore: how should a multinational company present data so that investors can extract the effects of currency from the overall performance?

The paper discusses both the non-GAAP measure of constant currency treatment (reporting pure profit and loss, excluding fluctuations) and hedging, which involves crunching a great deal of data. It explicitly recommends neither but does suggest that clear explanations in the management discussion and analysis section of a report, along with the core earnings, may lead to better insight and improved management of the risk. It also says that this can improve capital allocation and provide an edge over competitors, if done early.

**Survey finds disclosure overload and the will to fix it**

**Disclosure overload and poor communication of financial information** are a significant issue for those involved in our capital markets, according to a recent survey by the International Accounting Standards Board (IASB).

There was no agreement on the root causes of the problem, but it was agreed that standard setters, auditors, preparers, regulators and investors need to work together to find a solution to the problem.

Over 80% of respondents agreed that improvements could be made to the way financial information is disclosed. Half of those respondents think improvements are needed across all parts of the annual report, not only the financial statements.

Preparers responding to the survey think that disclosure requirements are too extensive and not enough is done to exclude immaterial information. Users, on the other hand, feel that preparers could do more to improve the communication of relevant information within the financial statements, rather than leaving them to sift through large amounts of data.

The survey attracted 225 responses from Africa, Asia, Europe and North America with around 50% of respondents identifying themselves as preparers and roughly 20% as users of financial statements.

Reflecting on the findings, IASB chairman Hans Hoogervorst said the feedback “indicated a need for standard-setters, auditors, preparers, regulators and investors to work together to deliver much needed improvements to all disclosures, not just those contained within the financial statements.”

When questioned on the underlying causes of the disclosure problem a range of views was expressed. Some feel there could be improvements in the way standards are set out. Others expressed the view that preparers, auditors and regulators see financial reporting as a compliance exercise rather than a means of communication.

A discussion forum held earlier this year reinforced the findings of the survey. However, it also highlighted a problem with the application of materiality in relation to disclosures. The IASB agreed to open dialogue on this with auditors and regulators as soon as possible.

■ **See also page 16, for the opinion article on disclosures.**
Investors eager to improve ROCE reporting

‘Return on capital employed’ (ROCE) is a crucial part of how investors quantify company performance, yet it is tricky for them to assess.

PwC’s research in the investment community has pinpointed some of the difficulties, and suggested some improvements to disclosures that could help investors and benefit companies too.

Historical cost
The research finds that ROCE can be challenging to calculate when assets are restated to reflect their fair value. For example, the returns generated from a real estate investment can be obscured if the asset is marked to the current market value. Investors would appreciate disclosure of the historical cost of capital expenditure, to give them a more relevant number to work with.

M&A
Acquiring another business can be the largest discretionary use of capital by management, so investors say it is a key focus for them. And yet we are told that all too often, the disclosures that accompany an acquisition fall short of investor needs. Even basic data, such as the total cost of the acquisition can be hard to find. Current accounting standards do not require management to provide information on the debt acquired, or liabilities assumed, like pensions.

Investors often struggle to calculate whether an acquisition has generated adequate returns over time. As assets may have been acquired for strategic purposes, the financial performance of the investment can be hard to isolate from broader corporate performance measures.

Consistency is key
“Consistency is key with disclosures,” reports PwC director Alison Thomas. “It’s crucial that companies are transparent about how they measure ROCE and if definitions change, prior years should be restated for comparison. To really differentiate reporting for investors: reconcile ROCE measures to GAAP and share your capital employed by segment.”

Agenda consultation highlights five priorities for the board

The International Accounting Standards Board (IASB) has concluded its far-reaching public consultation on its future agenda by releasing a feedback statement that maps out its future priorities and how it will address the key themes that emerged.

The feedback statement was issued in December 2012 and marks the first of three-yearly public consultations on the IASB’s future technical agenda. There is clear public interest in this – more than 240 comment letters were received from a broad range of respondents. The IASB also consulted widely with investors and business communities and held public discussions around the world.

Messages for the board
Five broad themes emerged from the responses to the public consultation:

• A decade of almost continuous changes in financial reporting should be followed by a period of relative calm, allowing time to adjust to the new standards issued or to be issued.
• Almost unanimous support for the IASB to prioritise work on the conceptual framework, which would provide a consistent and practical basis for standard setting. (see opinion article on page 15)
• Additional guidance is needed to help first-time adopters with the application of IFRS.
• Shift the focus away from large projects to the implementation and maintenance of current guidance from the IASB.
• Enhance the standard-setting process, with a greater emphasis on cost-benefit analysis and earlier recognition of problem areas.

A new chapter
The IASB has responded to the messages by starting the process of improvements. This includes using the Accounting Standards Advisory Forum to promote a more collaborative way of working with the world’s accounting standard setters (see page 38).

The IASB’s technical work programme will in future focus on three areas:

• Implementation and maintenance: The Interpretations Committee (IC) has been given a wider remit and there will be more transparency around its decisions.
• Conceptual framework: The project was restarted in May 2012 with an ambitious goal to publish a discussion paper by June 2013.
• IFRS projects: Nine research projects will be explored over the next three years, with a focus on defining the problem (ie, research papers or discussion papers) before moving towards a solution.

Research projects for the next three years

• Emissions trading schemes
• Business combinations under common control
• Discount rates
• Equity method of accounting
• Intangible assets; extractive activities; and research and development activities
• Financial instruments with the characteristics of equity
• Foreign currency translation
• Non-financial liabilities (amendments to IAS 37)
• Financial reporting in high inflationary economies
Investment professionals have their say on reporting

A recent survey finds that investors gain comfort from the information companies provide following their transition from Canadian GAAP to IFRS. But they still have a ‘wish list’ of reporting improvements they’d like, from management or standard setters.

The survey – Market value: Professional investors’ views about financial reporting in Canada – sought the views of over 30 investors on the transition to IFRS, their use of financial reports in decision making and their views on non-GAAP measures. It was conducted by the Canadian Institute of Chartered Accountants (now CPA Canada), PwC and Veritas Investment Research.

Communicating with clarity

Most investors said that debt retirement data, cash flow and balance sheet information are adequately communicated for their needs. But only half believe that the notes to the financial statements (as a whole) are adequate, and only a third agree or strongly agree that segment information and the income statement are sufficiently descriptive.

“One problem we have with segment information is the lack of consistency,” said one investor. “Everybody breaks out their segment information differently.”

Areas for improvement in financial reporting

Investors were asked for their ‘wish list’ – the three things they would most like management or standard setters to improve about corporate reporting. The most common responses were:

1. Consistency, disclosure of calculations and appropriateness of non-GAAP measures
2. Improved segment information and/or increased disaggregation of information to enhance users’ understanding of the underlying operations
3. Reduction in the volume of notes, but increased relevance and readability of items disclosed
4. Disclosure of pension solvency calculations
5. An enhanced MD&A, which provides a variance analysis between management’s planned actions and actual results and eliminates boiler-plate disclosures
6. Better disclosures of significant assumptions used in financial statement preparation to allow investors to re-perform calculations
7. Disclosure that distinguishes maintenance capital expenditures from growth capital expenditures
8. More meaningful risk disclosures
9. Increased disclosures concerning the constitution and calculation of debt covenants
10. Increased consistency of accounting policies between companies in similar industries

Non-GAAP measures

Over 50% of respondents think the use of non-GAAP measures has increased since the adoption of IFRS – 80% find these measures useful. But what they really want is comparability across reporting periods and between peers.

Areas for improvement

The survey found that several investors are uncomfortable with their current level of understanding of accounting standards, particularly given the increasing complexity in financial reporting. Although partly addressed through companies’ information sessions and disclosures of material new accounting standards, the report suggests that this knowledge gap may indicate a need for investors to update their professional development plans.

Investors identified various additional areas where reporting should be improved, including segments, pension solvency and debt covenants. See table for detailed findings.

World Watch Issue 2 2013
Internal audit must act, survey finds

Internal audit will become marginalised in the risk management infrastructure if it does not significantly improve the way it operates, according to a new study – 2013 State of the internal audit profession – by PwC.

The research sought senior executives’ views on internal audit’s capability to undertake successful risk management activities. It covers 18 industries, 60 countries and draws on 140 in-depth case study interviews.

Internal audit’s role in risk management is in the spotlight as most companies accept that volatility and complexity, along with political and regulatory change, are here to stay. And as a result, there is also growing recognition of the need for investment in internal audit to ensure its services can keep pace with today’s major challenges.

Misaligned, underperforming

The survey identified three main areas in which the internal audit function is not performing sufficiently well: stakeholder alignment, core capabilities (see table) and impact. Stakeholders disagreed, for example, on the value that internal audit contributes – 79% of board members see significant value, but only 44% of executive management do. Fewer managers also rate the performance of internal audit as ‘strong’ and overall there are notable percentage differences between stakeholders’ opinions. This suggests that internal audit has work to do on stakeholder alignment, which would increase demand for internal audit services and trigger a need to build capacity.

On internal audit capabilities, stakeholders agreed that internal audit has to ‘fix itself’ and identified three areas of weakness where it could make a start:

- Promoting quality improvement and innovation
- Using technology
- Sourcing the right talent

There was also stakeholder agreement that internal audit must build its capabilities to meet higher expectations, particularly in non-traditional areas such as new product introductions.

Breaking the cycle

The challenge is complex – breaking the cycle of misalignment to bring the chief audit executives’ (CAEs) goals in line with both the capabilities of internal and external audit, and the executives.

The gap for opportunity throughout the survey, however, is unmistakable. The final recommendations request input from all the actors in the internal audit process, to upgrade internal audit functions from assurance providers to trusted advisors. The recommendations encourage management to expect more, audit committees to ask more questions and CAEs to deliver more – more quality and more value, more proactively.

“Audit committees and management expect more from internal audit,” said Jason Pett, PwC partner and US internal audit leader. “This provides a huge opportunity for internal audit functions to be relevant contributors to protecting stakeholder value and the business from the most critical risks.”

---

Stakeholders are not aligned on how well internal audit is performing

How well is internal audit performing in each of the following areas?

- Promoting quality improvement and innovation
- Leveraging technology (such as automation, data and advanced analytics)
- Delivering cost-effective services
- Delivering services with a service-oriented team
- Engaging in and managing a relationship with stakeholders
- Obtaining, training and/or sourcing the right level of talent for audit needs
- Aligning scope and audit plan with stakeholder expectations
- Focusing on critical risks and issues

Percent of respondents who believe internal audit is performing well or very well

On average, 56% of board members rated internal audit’s performance as strong, compared with 37% of management.

Source: PwC: 2013 state of the internal audit profession.
The focus of the debate on the future of auditor reporting is now on the nature and extent of changes – and whether auditors’ reports will look similar in different parts of the world or if different reporting models will emerge.

“Of course, it is central to all the consultations going on around the world to determine what information will be meaningful and valuable to investors and to avoid simply adding more boilerplate,” said PwC partner Diana Hillier. “Investors have focused most on seeking the auditor’s perspective on risks around the significant accounting estimates and the more subjective areas of the audit. But it is too early to conclude exactly what the final content of the future auditor’s report will be.”

June exposure draft for the IAASB
The International Audit and Assurance Standards Board (IAASB) is on course to release its vision of an expanded audit reporting model in an exposure draft in June. It will feature increased transparency into those matters that were of most significance in the audit and a new section on going concern.

The key audit matters reported would be drawn from matters communicated to those charged with governance – it would be surprising if they weren’t. In deciding which of those matters to include, auditors would be asked to take into account such matters as:

- Areas of focus in the audit
- Areas in which the auditor encountered significant difficulty in performing the audit
- Circumstances that required a significant modification to the audit plan

“These and other proposals on auditor reporting will represent a huge change in practice,” said IAASB chairman Arnold Schilder. “But the IAASB sees them as critical to the continuing perceived value and relevance of the audit, and to enhancing audit quality.”

US PCAOB Q3 consultation
Over the US Public Company Accounting Oversight Board (PCAOB) also anticipates issuing a proposal for public comment this summer. While their new model is not yet known, recent speeches make clear that the nature and scope of the audit won’t change – rather it’s about making the results of that work more relevant.

“I hope it will...help focus the auditor’s mindset on the investor needs and perspective,” remarked PCAOB chairman James Doty in a recent speech. “The audit report should speak to the financial statement user.”

UK FRC focus on audit process
In the UK, at least some of the matters that the IAASB and PCAOB envisage will be in the auditor’s report will be in the audit committee’s report as a result of the UK Financial Reporting Council’s (FRC) 2012 Effective Company Stewardship recommendations.

The FRC has also just released an update to ISA700 (UK and Ireland), mandating: “a fuller description of the work the auditor has undertaken”. This follows its consultation on how far audit reports should provide insight into the audit itself. It is hoped that this new requirement (live for companies with audits commencing after 1 October 2012) will provide a ‘hook’ for investors to engage with the company about the audit, and give them far more insight.

The standard requires auditors to:

- provide an overview of the scope of the audit, showing how this addressed risk and materiality;
- and describe the risks that had the greatest effect on the audit strategy, resourcing and audit team focus.

Nick Land, UK FRC Audit and Assurance Council chairman said: “the improved report will be a better basis for engagement by investors with companies and we encourage auditors and companies to work together to develop succinct communication to do so”.

EU audit reform proposals
There remain many hurdles before the EU audit reform is completed, but the JURI Committee of the European Parliament (EP) recently voted on what they support. The outcomes of this vote are significant in that they represent the current position of the Parliament as it enters into detailed negotiations with the Council of Ministers and the European Commission (EC) on a ‘compromise text’, which will form the basis of any new legislation (see page 45).

On the auditor’s report, the EC’s original proposals were modified to align more closely with International Standards on Auditing (ISA) requirements and latest thinking of the IAASB, and include:

- Conclusions on going concern
- A description of the most important assessed risks of material misstatement, together with a summary of the auditor’s response to those risks and key observations from that audit work.
UK COMPETITION COMMISSION

Audit market investigation reaches critical phase

The UK Competition Commission’s (CC) investigation into the market for audit services is reaching a critical phase as it holds hearings on its Provisional Findings and Remedies Notice with various parties and moves toward publishing its final report, due in September 2013.

The importance of the investigation cannot be understated given its relevance to discussions around the world, and in Europe in particular, and the fact that the remedies will reflect an 18-month market investigation.

The CC did not identify evidence to support the most serious anti-competitive allegations, such as bundling audit and non-audit functions and tacit collusion between the Big 4. The CC has confirmed that competition is effective at the point of tender.

However, based on its provisional findings about features it saw in the audit market, the CC is exploring the following possible remedies:

- Mandatory tendering on a more frequent basis
- Mandatory audit rotation
- Increased frequency/remit of the Audit Quality Review team
- Prohibition of ‘Big-4 only’ clauses in loan documentation
- Strengthened accountability of the external auditor to the audit committee
- Enhanced shareholder-auditor engagement

In the Provisional Findings, the CC asserts that auditors “compete to satisfy management rather than shareholder demand” and that there are “significant, persistent and widespread concerns regarding the quality of audits”. The PwC UK firm has clearly said that it doesn’t believe this is the case.

PwC UK has some serious reservations about the process so far, but nevertheless believes that changes could and should be made to further underpin audit quality, improve transparency and reinforce competition.

The firm has proposed a far-reaching and ambitious package of changes, including many of those suggested by the CC. Taken together with the September 2012 changes to the UK Corporate Governance Code on audit tendering, PwC believes that they would respond proportionately to the evidence that the CC has gathered and drive competition and transparency without damaging quality or reducing the incentives for innovation.

In summary, PwC proposals for change are to:

- Strengthen the accountability of the auditor to the audit committee
- Enhance communication between shareholders, auditors, and audit committees
- Put a greater focus on examining and reporting audit quality
- Remove any artificial barriers impeding competition

PwC strongly opposes, however, mandatory firm rotation (see Opinion, page 21) and short-term mandatory tendering because these measures would disenfranchise shareholders.

Audit reform remains a key focus

As the news articles in this edition of World Watch show, audit reform remains very much centre stage in a number of territories across the network – with different governments and regulators consulting on a variety of measures to promote audit market competition, auditor independence and audit quality.

While PwC does not support all of the specific measures being mooted, as Richard Sexton, head of reputation and policy said regarding the UK Competition Commission findings: “We remain very supportive of measured changes that will promote competition and choice, enhance quality and increase transparency between auditors, audit committees and shareholders.”

Many of these consultations are at critical stages. The best outcomes depend on all interested parties participating constructively in the dialogue and debate.

www.pwc.co.uk/who-we-are/competition-commissions-audit-market-investigation.jhtml
Mandatory Firm Rotation (MFR) is the talk of audit reform right now. Where countries are drafting legislation or initiating inquiries, MFR is at the forefront of discussion. However, many companies argue that this will increase the regulatory burden and cost of the audit without improving its quality. (See also articles on page 44 and 21)

The Netherlands – MFR will take effect on 1 January 2016, but its inception will be reviewed in the latter half of 2015. The decision to rotate auditor is part of a legislative package that aims to regulate the audit profession more closely.

The Philippines – MFR is being abandoned as ‘not feasible’. Listed companies had expressed strong opposition to the measures and cited the lack of firms capable of providing the required level of audit services.

Russia – the Central Bank proposed MFR as part of a handful of measures including scope of service restrictions and more stringent rules surrounding bank audits. The Russian legislature has held a committee debate on possible changes to audit legislation, and parliamentarians were generally critical of the Ministry of Finance and its perceived lack of action in encouraging market opportunities for smaller audit firms. The audit council is currently considering information about the success, or otherwise, of MFR elsewhere in the world.

India – the draft Companies Bill, containing a provision for MFR, passed the lower house (Lok Sabha), but not the upper (Rajya Sabha). It was considered as part of the Budget sessions, which ended on 22 March 2013. If given assent, the Act would require rotation of individual auditors every five years, and every ten for audit firms, with a uniform ‘cooling off’ period of five years in both cases.

Key elements of EU audit reform rejected

The European Commission’s (EC) proposed audit reforms continue to work their way through the lengthy political process. Two influential parliamentary committees have recently weighed in. The outcomes of the votes are significant in that they represent the current position of the European Parliament as it enters into detailed negotiations with the Council of Ministers (the Council) and the EC to reach agreement on a ‘compromise text’ which will form the basis of any new legislation.

In their vote in March, European Parliament’s Economic and Monetary Committee (ECON) rejected mandatory firm rotation (MFR) – albeit by a narrow majority – but did support mandatory tendering on a seven-year basis and mandatory re-assessment of audit quality by the audit committee.

In April, the Legal Affairs Committee (JURI, the lead committee) voted to set the maximum duration of the combined audit engagement at 14 years, but to allow member states to extend this to a maximum of 25 years when certain conditions are met (including the possibility of joint audit). JURI rejected the recommendation for a seven-year mandatory tendering requirement and would require it only when a change of auditor is proposed to shareholders.

**Competitiveness Council meeting**

In the Council, the Presidency requested views from the member states on three key areas at the Competitiveness Council meeting on 29 May. Member states’ responses indicated:

- Overall support for the principle of MFR, but with a number of conditions (eg, on overall term).
- Support for the principle of a black list of prohibited non-audit services, but the majority reject the 70% cap. A wide range of views on what should be included but support for a principles based approach similar to the IFAC / IESBA Code.
- Major opposition to the ESMA proposals and support for the compromise of expanding the role and remit of the European Group of Auditors’ Oversight Bodies (EGA OB).

The responses to these questions will now be used to further develop Council negotiations with the European Parliament.

Both committees also rejected the separation of audit and non-audit services and creating ‘only-audit’ firms. As there has been major opposition to these proposals among EU countries, it is considered highly unlikely they will be resurrected. JURI also rejected most of the EC’s more prescriptive and restrictive proposals regarding the prohibition and provision of non-audit services, but recommended introducing a requirement for audit committees to have a policy governing which services need to be approved by the board and shareholders and communicated to competent authorities. ECON favoured a list of prohibited services broadly in line with the IESBA Code.

It is now unlikely that the final parliamentary report and vote will take place before the end of 2013.
A recent consultation paper of the International Auditing and Assurance Standards Board (IAASB) makes it clear that audit quality is best achieved in an environment where there is support from other participants in the financial reporting supply chain.

The IAASB’s consultation paper – *A framework for audit quality* – has three main objectives:

- Raise awareness of the key elements of audit quality
- Encourage key stakeholders to explore ways to improve audit quality
- Facilitate greater dialogue between key stakeholders on the topic

The IAASB recognises that the primary responsibility for audit quality rests with auditors. But it argues that input from a broad group of stakeholders is essential because there is such a variety of views about what ‘audit quality’ looks like in practice. The proposed framework explores not only how inputs at the levels of auditors, audit firms and professional bodies influence audit quality, and how outputs can influence perceptions of it, but also the impact of broader contextual factors and how interactions among auditors, management, audit committees, regulators and users can support audit quality.

Arnold Schilder, IAASB chairman, explains: “There are many factors that contribute to maximising the likelihood of quality audits being consistently performed. There is value in identifying and describing these, and thereby encouraging audit firms and other stakeholders to challenge themselves to think about whether there is more they can do to increase audit quality in their particular environments”.

Internal controls – especially those concerning financial reporting – have to evolve to stay relevant in rapidly changing business and operating environments. To help business respond to these changes, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) has updated its *Internal Control – Integrated Framework*.

Although the original framework is considered fundamentally sound, the May 2013 amendments (authored by PwC under the direction of COSO) aim to:

- Clarify the requirements of effective internal control
- Update the context for applying internal control to many changes in business and operating environments
- Broaden its application by expanding the operations and reporting objectives beyond financial reporting

One of the more significant updates to the framework concerns the five components of internal control – control environment, risk assessment, control activities, information and communication, and monitoring activities. Management is expected to obtain persuasive evidence to support its determination that each of the components and relevant principles is present and functioning and the five components are operating together in an integrated way.

On a broader scale, the framework is an opportunity to refresh systems of internal control and consider any new applications. For example, controls designed to evaluate whether to accept a new customer agreement may (or may not) consider overlapping operational and internal reporting objectives, in addition to supporting a system of control over financial reporting.

Global events, such as the horse meat scandal in the UK and Europe, have highlighted the critical importance of internal controls and appropriate assurance over them. In the case of the food industry, crucial controls and assurance were missing throughout the supply chain.

COSO has stated that the amended framework will come into effect from 15 December 2014. Until that time companies can continue to use the current framework. In the interim, organisations that must comply with regulatory requirements for reporting on the effectiveness of their internal controls should disclose which framework they are using.

Global events, such as the horse meat scandal in the UK and Europe, have highlighted the critical importance of internal controls and appropriate assurance over them.
# Diary dates

<table>
<thead>
<tr>
<th>Date</th>
<th>Key upcoming events</th>
<th>Location/contact</th>
<th>Sponsors/organisers</th>
</tr>
</thead>
<tbody>
<tr>
<td>11 July 2013</td>
<td>IFRS Foundation Trustees meeting</td>
<td>Johannesburg, South Africa</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>2-5 September 2013</td>
<td>Forbes Global CEO Conference</td>
<td>Bali, Indonesia</td>
<td>Forbes Conferences</td>
</tr>
<tr>
<td>15-19 September 2013</td>
<td>OICV/IOSCO Annual Conference</td>
<td>Luxembourg</td>
<td>IOSCO</td>
</tr>
<tr>
<td>17-18 September 2013</td>
<td>CSR Asia Summit</td>
<td>Bangkok, Thailand</td>
<td>CSR Asia</td>
</tr>
<tr>
<td>23-24 September 2013</td>
<td>World Standard Setters meeting</td>
<td>London, UK</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>17 October 2013</td>
<td>IFRS Foundation Trustees Meeting</td>
<td>Frankfurt, Germany</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>31 October 2013</td>
<td>FT Investment Management Summit</td>
<td>New York, USA</td>
<td>Financial Times</td>
</tr>
<tr>
<td>11 November 2013</td>
<td>Meet the Experts</td>
<td>London, UK</td>
<td>PwC/Informa Group</td>
</tr>
<tr>
<td>22-26 January 2014</td>
<td>World Economic Forum Annual Meeting</td>
<td>Davos, Switzerland</td>
<td>World Economic Forum</td>
</tr>
</tbody>
</table>

# Corporate reporting insights

Regular updates on effective corporate reporting

*Corporate reporting insights* is our monthly update on effective reporting. It includes quick links to topics of the moment, such as:

- The latest reporting opinions and debates
- New reporting research
- Examples of what effective reporting looks like
- What investors think
- Guidance on effective communication

To receive this monthly update, email: info@corporatereporting.com
World Watch – Would you like a free subscription?

Published twice a year to share insights and opinions on governance, reporting and assurance. Simply email us: info@corporatereporting.com