

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**INTERNATIONAL
ACCOUNTING and
REPORTING ISSUES**

2006 Review



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and
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Foreword

Through the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), UNCTAD has provided an intellectual home and an open forum for considering issues of corporate transparency — such as financial reporting, corporate governance and corporate responsibility — that have important implications for the economic development of member States. The twenty-third annual session of ISAR was held in Geneva from 10 to 12 October 2006. This session addressed issues central to current challenges in corporate transparency, including the practical implementation of International Financial Reporting Standards (IFRS), the use of corporate responsibility reporting in annual reports, and the promotion of good practices in corporate governance disclosure.

The globalization of the investment community is putting new demands on comparable financial reporting. While the year 2005 saw an unprecedented number of enterprises and countries around the world adopt IFRS as their basis for financial reporting, 2006 witnessed the ongoing practical implementation of these new standards. This presents a number of challenges, including the need to be sensitive to the circumstances of small and medium-sized enterprises (SMEs), while fostering a consistent implementation of the standards.

Meanwhile, the same social and economic forces that are shaping global trade and development are also driving changes in the type of information various stakeholders want from companies. Enterprises have begun to recognize the value that environmental, social and governance reporting has in building investor confidence and stakeholder support. Over the longer run, experts agree that the current practice of financial reporting will need to be complemented by more non-financial information, including both corporate responsibility reporting and corporate governance disclosure.

Building an appropriate institutional framework and implementing robust corporate reporting requirements are essential to the broader process of economic development. These issues are at the centre of ISAR's work. It is my hope that policymakers, regulators, members of boards of directors, corporate executives, academics and other readers interested in advancing corporate transparency issues will find this publication to be a timely and useful resource.

Supachai Panitchpakdi



Secretary-General of UNCTAD
Geneva, December 2006

Executive summary

This volume of the 2006 Review of International Accounting and Reporting Issues contains the proceedings of the twenty-third session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR). The two main agenda items the session dealt with were review of practical implementation issues of International Financial Reporting Standards (IFRS), and comparability and relevance of existing indicators on corporate responsibility.

Chapter I contains a summary of the main findings of five country case studies on the practical implementation issues of IFRS. The individual country case studies are contained in chapters II through VI. These chapters discuss practical implementation of IFRS, focusing on institutional, enforcement and capacity-building aspects. Chapter VII contains draft guidance on corporate responsibility indicators in annual reports. It presents a methodology for compiling and reporting selected indicators in annual reports aimed at establishing a consistent approach to measuring the selected indicators.

In 2006, the UNCTAD secretariat conducted two surveys: review of the reporting status of corporate responsibility indicators and review of the implementation status corporate governance disclosures. The indicators of corporate responsibility the survey analysed are based on the guidance proposed in chapter VII of this volume. The corporate governance disclosures surveyed are based on the *Guidance on Good Practices in Corporate Governance Disclosure*, published by ISAR in 2006. These two surveys are contained in chapters VIII and IX respectively.

On 9 October 2006, the UNCTAD secretariat organized a technical workshop on fair value measurement requirements in IFRS. Four panels of widely recognized experts on fair value discussed conceptual as well as practical implementation challenges of fair value. The final chapter contains articles contributed by panellists who participated at this workshop.

Introduction

The twenty-third session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) at UNCTAD drew a record number of participants — 270 experts from 80 countries. The session dealt with two main agenda items: review of practical implementation issues of International Financial Reporting Standards (IFRS) and comparability and relevance of existing indicators on corporate responsibility. Under “other business”, the session addressed corporate governance disclosure issues. ISAR also reviewed progress on follow-up work conducted on topics that it addressed at previous sessions.

Deliberations on the first main agenda item were facilitated by country case studies of Brazil, Germany, India, Jamaica and Kenya; an issues note that summarized the main findings of the case studies; and three panel discussions. The first panel discussion dealt with progress on the implementation of IFRS since 2005, adequacy of existing standards and interpretations, progress on convergence to IFRS, and concrete benefits of implementation of IFRS. This was followed by a panel discussion of the country cases studies, which focused on institutional, enforcement and technical capacity-building aspects of IFRS. The final segment of the first agenda item was dedicated to a discussion of the accounting and financial reporting needs of SMEs. In concluding its deliberations on the first main agenda item, the session reiterated the importance of principles-based, high-quality financial reporting standards for the coherence and efficient functioning of the financial infrastructure, and for mobilization of resources needed for economic development. The Group of Experts recommended that UNCTAD conduct further studies on issues and challenges of practical implementation of IFRS, with a view to developing guidance on best practices of addressing these challenges. The session underscored the importance of SMEs for the economic development of member States, and requested UNCTAD to reconvene a Consultative Group on accounting by SMEs to provide input into deliberations on the issue that the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are conducting. The session also requested UNCTAD to update its guidance on accounting for Level 3 enterprises.

During its consideration of the second main agenda item, ISAR deliberated on a draft guidance document on corporate responsibility reporting in annual reports. It also discussed findings of a 2006 survey of the reporting status of corporate responsibility reporting. A panel of experts discussed the draft guidance document that outlined a methodology for compiling and reporting on selected indicators of corporate responsibility reporting. The methodology was aimed at establishing a consistent approach to measuring and reporting selected corporate responsibility indicators in annual reports. The session concluded its deliberations on the second main agenda item by requesting UNCTAD to further refine the guidance on selected corporate responsibility indicators, with a view to providing a voluntary technical aid tool for enterprises. The session also recognized the usefulness of the survey on corporate responsibility reporting for refining the guidance proposed and requested UNCTAD to continue conducting such surveys.

One of the main items that the session considered under the “other business” segment of its agenda was corporate governance disclosures. The session reviewed recent developments in corporate governance disclosures and a panel discussed the 2006 survey of the implementation status of corporate governance disclosures. The survey’s findings indicated that while enterprises were providing sufficient information on the financial aspects of their performance, disclosure was lacking in areas such as auditing issues. The discussions highlighted the importance of good

corporate governance practices of state-owned enterprises, the importance of timely disclosure, the role of country examples in implementing corporate governance rules at stock exchanges and the impact that different legal systems have on different corporate governance codes. The session reiterated the importance of good corporate governance practices for promoting investment, economic stability and growth.

On 9 October 2006, one day before the twenty-third ISAR session, the UNCTAD secretariat organized a technical workshop that was dedicated to the discussion of fair value measurement requirements in IFRS. The topic has become the subject of extensive debate in international forums. The workshop featured four panels of prominent experts on the subject. The panels addressed: overview of fair value measurement requirements in IFRS; fair value measurement methods; recognition and measurement issues pertaining to fair values of financial instruments; and agricultural activities and practical fair value measurement issues. More than 130 participants attended the workshop and benefited from the technical discussions. The workshop highlighted practical implantation issues of IFRS in relation to fair value measurements.

UNCTAD expresses its gratitude to Mr. Rudolf A. Müller (Switzerland), Senior Counsellor, State Secretariat for Economic Affairs (SECO), Chairperson of the twenty-third session of ISAR; and Ms. Silvia Marques B. Silva (Brazil), Senior Advisor at the Financial Systems Regulation of the Central Bank of Brazil, Vice-Chairperson-cum Rapporteur, for their effective and efficient leadership which led to the successful conclusion of the session. UNCTAD gratefully acknowledges the excellent contribution of Mr. Alexandre Tombini, Deputy Governor for Financial System Regulation and Organization, Central Bank of Brazil, who delivered a keynote address at the opening of the twenty-third session of ISAR. UNCTAD also acknowledges with appreciation the contributions of Nancy Kamp-Roelands and Jackie Cook as resource persons in the areas of corporate responsibility reporting and corporate governance disclosure respectively.

UNCTAD appreciates the contributions of the following panellists who spoke on the practical implementation of IFRS. Members of the first panel were: Ian Ball, IFAC; Nelson Carvalho, IASB Standards Advisory Council; Remo Croci, European Commission; Robert Garnett, IASB; and John Hegarty, World Bank. The following panel members also assisted UNCTAD in preparing case studies in their respective countries: Kati Beiersdorf, German Accounting Standards Board; Dennis Brown, Institute of Chartered Accountants of Jamaica; Caroline Kigen, Institute of Chartered Accountants of Kenya; Paulo R. Lustosa, University of Brazilia, Brazil; and Shri Sunil H. Talati, Institute of Chartered Accountants of India. The following panellists addressed the accounting needs of SMEs: Federico Diomeda, President, European Federation of Accountants and Auditors for Small and Medium-Sized Enterprises; Ndungu Gathinji, Chief Executive, Eastern Central and Southern African Federation of Accountants; Richard Martin, Head, Financial Reporting, The Association of Chartered and Certified Accountants; Paul Pacter, Director Standards for SMEs, IASB; Syed Asad Ali Shah, Senior Partner, Deloitte Touche, Tohmatsu, Pakistan; and Paul Thompson, Technical Manager, International Federation of Accountants, Small and Medium Practices Permanent Committee.

UNCTAD acknowledges with appreciation the contributions of the following panel members to the deliberations on corporate responsibility reporting: Justine Bentham, KPMG, United Kingdom; Stephen Hine, EIRIS, United Kingdom; Georg Kell, United Nations Global Compact; Alan Knight, AccountAbility, United Kingdom; Parveen Mahmud, PKS Foundation, Bangladesh; Ambreen Waheed, Responsible Business Initiative, Pakistan.

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Last but not least, UNCTAD expresses its appreciation for the dedication and contributions of staff members at the secretariat to the success of the twenty-third session of ISAR and the technical workshop on the practical implementation of IFRS. These are: Tatiana Krylova, Head, Investment and Enterprise Competitiveness Branch; Yoseph Asmelash, Head, Accounting Unit; Martha Cuadros Büchner, Anthony Miller, Kairat Satkyn, Olena Vasylychenko and Bo Zhao. UNCTAD appreciates the contributions of Carole Combe and Marie-Emilie Guélé for the 2006 annual review of the implementation status of corporate governance disclosure.

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Chapter I

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Summary of discussions

In opening the discussions on this agenda item, a member of the UNCTAD secretariat provided participants with background information on UNCTAD's mandate in relation to the topic under consideration, and drew participants' attention to the issues note "Review of Practical Implementation Issues of International Financial Reporting Standards" (TD/B/COM.2/ISAR/33) and addenda TD/B/COM.2/ISAR/33/Add.1 through 5 that contained country case studies of Brazil, Germany, India, Jamaica and Kenya. She also said that three panels would be discussing the agenda item.

The first panel focused on broad IFRS implementation issues and presented perspectives of international organizations and regional regulators. During their presentations, panellists addressed progress in the implementation of IFRS since 2005, adequacy of existing standards and interpretations, progress on convergence to IFRS and concrete benefits of implementation of IFRS. A panellist who presented the perspectives of the accountancy profession said that large transnational enterprises based in developed countries encountered less challenges in implementing IFRS in comparison to smaller enterprises. He cited better transparency in financial reporting as one of the benefits of IFRS. The panellist also highlighted the importance of better transparency and financial reporting among Governments, given their highly significant participation in capital markets. He emphasized the need for better accounting and reporting by governmental agencies and State-owned enterprises.

The next panellist shared his organization's experience in assessing observance of international codes and standards in the areas of accounting and auditing. He emphasized the importance of high-quality accounting and auditing standards for economic stability and for private sector growth, job creation, poverty reduction and economic growth. The panellist noted that accounting standards form part of a financial reporting infrastructure. Efficient functioning of the infrastructure required strengthening all its components, including accounting standards, statutory framework, monitoring and enforcement, education and training, accounting profession ethics, and auditing standards. He discussed various impediments to the successful implementation of IFRS and highlighted the importance of coordination among regulatory regimes in a country for the success of the implementation process.

The next two panellists spoke on developments at the International Accounting Standards Committee Foundation, the IASB and its Standards Advisory Council (SAC). It was noted that the "quiet period", or the time interval during which no new IFRS or major amendments issued by the IASB would be required for implementation, was extended to 2009. This extension was expected to provide preparers enough time to overcome initial implementation challenges. The two panellists informed participants of various ways and means through which preparers, users and other stakeholders could communicate their views to the IASB and the SAC.

The last panellist discussed progress in the implementation of IFRS in the European Union (EU). He noted the importance of accounting standards in the Financial Services Action Plan of the European Union and said that the EU's policies in this area were firmly set with international cooperation in mind. He said that securities regulators played an important role in

the consistent implementation of IFRS and cited the positive contribution of the Committee of European Securities Regulators (CESR). The panellist discussed a recently established informal round table on the consistent application of IFRS in the EU. This round table, which consisted of all relevant stakeholders, was established to discuss problematic accounting issues relating to the actual implementation of IFRS in the EU member States and communicate those issues considered to be of common concern in the EU to the European Financial Reporting Advisory Group (EFRAG).

The panellists reiterated the importance of principles-based, high-quality financial reporting standards for the coherence and efficient functioning of financial infrastructure, and for mobilization of resources needed for economic development. The panellists also noted that various preparers were claiming that their financial statements were in compliance with IFRS as adapted in their respective jurisdictions. They observed that such claims of compliance created confusion, since it was not possible for users to determine how significant the difference was between IFRS as adapted in a specific jurisdiction and IFRS as issued by the IASB. The panellists expressed concerns that if such a trend were to continue, then the benefits that would be derived from using a single set of accounting standards across jurisdictions would not be realized.

During the debate, participants raised several questions pertaining to convergence in the area of accounting education and professional qualification of accountants, the suitability of full IFRS for SMEs, and on how the IASB decided on which of its standards to revise. The panellists responded that in the area of convergence in accounting education and professional qualification, the Model Curriculum ISAR adopted in 1999 and revised in 2003 was intended to facilitate the process of convergence. It was also noted that matters of mutual recognition were to be addressed bilaterally between member bodies of the IFAC and further progress was still needed in the negotiations at the World Trade Organization (WTO) with respect to trade in accountancy services. The representative of the IASB said that stakeholders could communicate to the International Financial Reporting Standards Interpretation Committee (IFRIC) certain issues that did not require major revisions on IFRS, and noted that IFRIC could respond as appropriate by providing interpretations.

The second panel discussed country case studies of Brazil, Germany, India, Jamaica and Kenya. The panellist who presented Brazil's case study provided an overview of that country's economic situation and historical background of financial reporting standards. He identified a recent decision of the Central Bank of Brazil that required all financial institutions under its supervision to implement IFRS by 2010 and the establishment of a Committee on Accounting Procedures (CPC) as important developments leading towards convergence with IFRS. The panellist said that Brazil's code-law system required significant deliberations and the passing of law by the legislative system was required before reforms could be made on the current financial reporting system. He identified the need for better coordination of efforts of different regulatory authorities in Brazil, education and training, and wider availability of materials on IFRS in Portuguese, as areas on which further work was needed. Another panellist elaborated further on the CPC's objectives and organizational arrangements.

In presenting Germany's case study, a panellist discussed historical developments that led to the introduction of International Accounting Standards in the country earlier than in many countries in Europe, and outlined the positive role of legislative authorities in the country in the implementation of IFRS. She further elaborated on the coexistence of IFRS and German Generally Accepted Accounting Principles (GAAP) following the wider implementation of the former. She highlighted some predominant technical issues such as classification of equities and liabilities that arose in the implementation of IFRS.

The next panellist presented India's case study. He highlighted the standard-setting role of the Institute of Chartered Accountants of India (ICAI) and the legal support provided to the Institute in this role. He said that accounting standards in India were being formulated on the basis of IFRS, and elaborated on various technical issues that arose in the implementation phase. In concluding his presentation, the panellist stressed that the implementation of certain requirements in IFRS should be a gradual process; he also said that guidance was needed in various cases for effective implementation, as was the need for capacity-building prior to convergence with IFRS.

This was followed by a presentation on Jamaica's case study. The panellist provided background information highlighting factors that prompted the country to adopt IFRS in 2002. He discussed the role of the Institute of Chartered Accountants of Jamaica in the country's transition to IFRS. He recognized the limited availability of people with required knowledge of IFRS as one of the challenges the country faced in the early stage of the implementation process. He underscored careful planning, extensive public education, allocation of sufficient resources, a legal and regulatory support system, and institutional support with strong management systems as critical success factors in the implementation of IFRS. In response to questions raised by participants, he provided further elaboration on human capacity-building efforts that the Institute of Chartered Accountants of Jamaica undertook. He also provided clarification on the definition of an SME in the Jamaican business environment.

The final presentation was on Kenya's case study. The speaker provided a review of IFRS implementation in Kenya, following the country's decision to adopt International Accounting Standards in 1999. She elaborated on various mechanisms the Institute of Certified Public Accountants of Kenya (ICAPK) used to overcome challenges it encountered in the implementation of IFRS. These included establishing an IFRS help desk at the ICAPK and providing members with the bound volumes of IFRS at a specially negotiated price that the Eastern Central and Southern African Federation of Accountants (ECSAFA) had arranged with the International Accounting Standards Committee (IASC) Foundation. In response to questions raised by participants regarding the usefulness of establishing an IFRS help desk, the panellist said that the help desk was utilized more widely and frequently at the beginning of the adoption of IFRS by the country. In recent years, the help desk was often being used by small audit firms.

The chairperson opened the floor for general discussion on the main findings of the case studies. One participant observed that, given the significant involvement of Governments in capital markets, it was important to promote good accounting and financial reporting practices in that sector. He also stressed the importance of the auditing profession in the implementation of IFRS and suggested that the UNCTAD secretariat could conduct studies in this area for future consideration by the Group of Experts. This participant also noted that some of the countries covered in the case studies did not clearly indicate a time frame by which they intended to fully comply with IFRS, and further observed that adapting IFRS indefinitely would not lead to realizing the full benefits of a single common benchmark for financial reporting. Another participant questioned whether the World Bank's Reports on Observance of Standards and Codes (ROSC) assessments should be based on IFRS. The World Bank representative responded that while in ROSC reviews national accounting and financial reporting standards are assessed for comparability with IFRS, his organization did not suggest that IFRS should be applied by all entities in a given jurisdiction. The chairman stressed that one of the main findings of the case studies was the need for a clear definition of the scope of application of IFRS.

At the opening of the third panel discussion under this agenda item, the UNCTAD secretariat presented background information on the objectives and process of UNCTAD-ISAR's work in developing Accounting and Financial Reporting Guidelines for Small and Medium-Sized Enterprises (SMEGA) for Level 2 and 3 SMEs, which started in July 2000 and culminated in the publication of these two documents in 2003. The first panellist discussed the IASB's project on accounting standards for SMEs. He elaborated on the approach that the IASB had taken towards developing an IFRS for SMEs, including definition of SMEs, recognition and measurement simplifications, fallback to full IFRS and progress of the project in the due process of the IASB. He said that a preliminary version of an Exposure Draft of the SME standard was available on the IASB's website, and a final Exposure Draft was expected by the end of 2006. The Exposure Draft would be available in French and Spanish as well as English. In responding to questions raised by participants, the panellist clarified that countries that wished to translate the Exposure Draft of the SME standard were welcome to do so. He also said that it was for each jurisdiction to decide which entities were to be required to apply the IASB SME standard and also that it was not the intention of the IASB to issue another standard for micro-entities.

The next panellist discussed his country's experience in implementing IFRS and the approach taken there to address the needs of SMEs. He noted that, previously, "approved" IFRSs were required for all entities in his country, including SMEs. More recently, the country adopted a three-tier approach to financial reporting, similar to the approach ISAR took in developing SMEGAs. He described the applicable thresholds in his country of categorizing entities into the three levels.

Another panellist who represented a regional federation of SME accountants and auditors highlighted the importance of SMEs in his region and shared his hands-on experience in dealing with SME financial reporting needs. He said that user needs should be emphasized in the process of addressing the accounting needs of SMEs. He noted that SME-related issues raised during previous panel discussions at the twenty-third session of ISAR in the context of developing countries were also valid in the setting of developed economies. The speaker also observed that certain audit related issues might deserve special attention in the case of SMEs or small and medium practices (SMPs).

The next panellist shared the views of his organization's committee on SMPs. He presented his committee's assessment of the preliminary version of the Exposure Draft of the IASB SME standard. He stated that his committee was satisfied with the high priority afforded to the IASB SME project, the extent of consultations and stakeholder engagement, and the length of time that was going to be provided to respond to the exposure draft and the decision of the IASB to conduct field testing. Additional areas of satisfaction included broad definition of non-public accountability, stand-alone nature of the proposed standard and emphasis on historical cost as basis for measurement. The speaker noted several areas of concern, including inadequacy of the analysis the IASB conducted on specific needs of users of SME financial statements; enforceability of the SME standard, given that many SMEs were exempt from audit; and the extent of fair value measurement requirements that still remained in the preliminary Exposure Draft. He also discussed the financial reporting needs of micro-entities and expressed his organization's interest in cooperating with UNCTAD-ISAR in this area.

The next speaker said that there was widespread acceptance of the need for considering the special needs of SMEs with respect to accounting and financial reporting. He gave examples of countries that developed guidance for SMEs, including some that looked into UNCTAD-ISAR's SMEGAs, in developing their own guidance. He urged participants to respond when the IASB's SME Exposure Draft was published at the end of the year. In responding to the Exposure

Draft, the panellist reminded participants to consider that user needs of financial information might be different, and to take into account cost-benefit considerations and preparers' concerns. He also said they should consider the appropriateness of simplifications of recognition and measurement requirements, and also assess whether there was a need for a third tier of financial reporting guidance for SMEs.

The last speaker in the third panel discussed the experience of his region in dealing with the accounting and financial reporting needs of SMEs. He noted that the accountancy profession in his region was closely following up developments at the IASB with respect to the project on accounting for SMEs. The accountancy profession in his region felt that there was still a need to provide guidance to a third level of SMEs that the IASB SME standard was not likely to cater to. Such guidance was accordingly developed. Unlike the SMEGA Level 3 developed by ISAR, the guidance issued by the accountancy profession in the speaker's region required a cash-flow statement. He expressed concern that the preliminary version of the Exposure Draft of the SME standard issued by the IASB was too complex for SMEs in his region to apply.

In the course of the deliberations that followed the panel presentations, participants raised several issues. It was stressed that, in addressing the issue of IFRS reporting, a country should first decide which companies should be required to prepare general-purpose financial statements and whether SMEs should be subject to such requirements. Many speakers argued that use of full IFRS for SMEs was not cost-effective. The question was raised of whether users' needs as they relate to SMEs should be further explored. In particular, some participants were of the view that the needs of SMEs' employees as users of financial statements were not adequately recognized by preparers. The broad understanding was that the definition of stakeholders of an entity and the type of financial information to be provided was beyond the scope of the discussion of an SME standard. This was a matter for regulators in respective jurisdictions to decide. With respect to simplification of language of the IASB SME standard, participants were informed that efforts aimed at simplifying the language were underway.

I. Introduction

For over three decades, the United Nations provided an important forum where policymakers, regulators, standard-setters, professional accountancy organizations, academia, and other stakeholders deliberated with a view to increasing the comparability and reliability of corporate reports. The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) at UNCTAD has served as a focal point within the United Nations system for deliberations on corporate transparency matters.

The year 2005 marked a watershed in the history of financial reporting. An unprecedented number of enterprises and countries around the world adopted International Financial Reporting Standards (IFRS) as their basis for financial reporting. In the light of the widespread transition to IFRS, the twenty-second session of ISAR reviewed practical implementation issues of IFRS. The UNCTAD secretariat prepared an issues note on the Review of practical implementation issues of International Financial Reporting Standards (TD/B/COM.2/ISAR/28) to facilitate ISAR's consideration of the topic.

In concluding its deliberations, ISAR reiterated the importance of a common-set of principles-based and high-quality financial reporting standards in support of the coherence and consistency of the international financial system for mobilizing and efficient allocation of financial resources and for facilitating investment needed for the economic development of member States. Sound and internationally comparable corporate financial reporting that meets

the requirements of financial markets improves investor confidence, facilitates risk assessment in making investment decisions, and helps to reduce the cost of capital.

ISAR also recognized that in order to reap the full benefits of harmonized global reporting standards and their consistent application in countries with different economic and business environments, a number of practical implementation challenges need to be addressed to assist developing countries and countries with economies in transition in meeting internationally recognized standards, particularly in the area of institutional and technical capacity-building.

In concluding its twenty-second session, ISAR agreed to conduct further reviews of the practical implementation challenges of IFRS, as well as ways to meet these challenges, including by preparing country case studies. One of the objectives of such reviews would be to develop guidance on good practices in IFRS implantation that could assist policymakers, regulators and others in considering feasible implementation strategies to meet international standards in enterprise financial reporting and enhance their input into the process of international convergence.

In accordance with the request of the twenty-second session of ISAR, the UNCTAD secretariat conducted country case studies in Brazil, Germany, India, Kenya and Jamaica. The objective of the case studies is to draw important lessons learned in the practical implementation of IFRS and share these with member States that are either implementing IFRS or that intend to do so in the future. The main findings of the case studies are summarized in this chapter. It is important to note that although countries were selected to ensure coverage of diverse regions, economic systems and approaches in IFRS implementation, the case studies that have been prepared do not represent the whole range of issues in this area. The objective of the case studies is to provide an overview of status of IFRS implementation and main challenges faced in this respect rather than an in-depth and detailed analysis of these issues which could be a subject of further research and discussion.

The individual country case studies can be found in the following documents: Brazil – TD/B/COM.2/ISAR/33/Add.1, Germany – TD/B/COM.2/ISAR/33/Add.2, India – TD/B/COM.2/ISAR/33/Add.3, Jamaica – TD/B/COM.2/ISAR/33/Add.4, and Kenya – TD/B/COM.2/ISAR/33/Add.5.

II. Recent trends towards convergence with IFRS

Since the twenty-second session of ISAR, several developments have occurred supporting the trend towards convergence with IFRS. In assessing the widespread transition to IFRS in 2005, Sir David Tweedie, the Chairman of the International Accounting Standards Board, stated that the implementation of IFRS had gone "surprisingly well". However, the Chairman also noted that those tasked with the implementation of IFRS found the process to be more demanding than expected.¹ He also indicated that close to 100 countries now require, permit, or have adopted a formal policy of convergence with standards developed by the IASB.²

At the end of February 2006, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the United States published a Memorandum of Understanding (MoU) reaffirming their shared objectives of developing high quality, common accounting standards for use in the world's capital markets.³ The IASB and the

¹ KPMG (2006). *International Financial Reporting Standards: Views on a financial reporting revolution*, April , pp. 35-38.

² Statement of Sir David Tweedie, Chairman, IASB before the Committee on Banking, Housing and Urban Affairs of the United States of America Senate, Washington D.C: 14 June 2006.

³ Further information on the Memorandum of Understanding can be found at; <http://www.iasb.org>.

FASB stated that the MoU was a further elaboration of the objectives and principles first described in the Norwalk Agreement that they signed in October 2002.

In accordance with the MoU the FASB and the IASB signed in February 2006, the two organizations will reach a conclusion on whether major differences in focused areas should be eliminated through one or more short-term standard-setting projects, and if so, their goal will be to complete or substantially complete work in those areas by 2008. The two organizations will examine several topics for short-term convergence – some of them jointly, and others just one Board alone. Topics that both Boards will examine jointly are impairment and income tax. The FASB will examine fair value option, investment properties, research and development, and subsequent events. The IASB will examine borrowing costs, government grants, joint ventures and segment reporting.

In March 2006, the European Federation of Accountants (FEE) called for mutual recognition between IFRS and the United States Generally Accepted Accounting Principles (US-GAAP).⁴ FEE took the view that an acceptable minimum level of convergence between the two standards had been reached and urged for the elimination of reconciliation statements or other forms of disclosure for foreign issuers that prepare their financial statements in accordance with IFRS and that are listed in the United States of America, or United States issuers listed in the European Union that prepare their financial statements in accordance with US-GAAP.

In May 2006, the Financial Times reported that some partners based in the United Kingdom at the accounting firm of PricewaterhouseCoopers (PwC) were of the view that convergence of IFRS and US-GAAP would "result in a set of United States-style standards likely to be too complex and prescriptive". These PwC partners also considered that the IASB should focus on improving its standards.⁵ Following this, the then Chairman of the Trustees of the International Accounting Standards Committee Foundation was obliged to publish a response in the Financial Times justifying why efforts towards convergence should continue.⁶

The Accounting Standards Board of Japan (ASBJ) and the IASB held their third meeting in March 2006 and reviewed progress towards convergence of Japanese Generally Accepted Accounting Principles (GAAP) with IFRS. The meeting noted that significant progress had been made in six areas, namely: valuation method of inventories; segment reporting; related-party disclosures; uniformity of accounting policies on overseas subsidiaries; investment property; and cost of issuing new shares. The ASBJ and the IASB agreed to add three new items to the convergence programme. These are asset retirement obligations, construction contracts and disclosure of financial instruments at fair value.⁷

In February 2006, the Ministry of Finance of China released 39 Chinese Accounting Standards for Business Enterprises. The new system of accounting standards in China is a step towards substantial convergence with IFRS. All listed companies in China will be required to prepare their financial statements in accordance with the new accounting standards starting from 1 January 2007.⁸

In January 2006, the Canadian Accounting Standards Board approved a five-year strategic plan with respect to the future direction of Canadian Generally Accepted Accounting Principles (GAAP). In accordance with the plan, Canadian GAAP applicable for listed companies will

⁴ Fédération des Experts Comptables Européens (FEE) (2006). Financial Reporting: Convergence, Equivalence and Mutual Recognition, FEE position paper, March.

⁵ Financial Times, London, 3 May 2006.

⁶ Tommaso Pada-Schioppa, "Work on converging accounting standards must go on", Financial Times, London, 19 May 2006.

⁷ Further information can be found at the website of the Accounting Standards Board of Japan at: <http://www.asb.org.jp>.

⁸ Ministry of Finance of China, Release Ceremony for Chinese Accounting Standards System and Auditing Standards System held in Beijing, Press Release 15 February 2006.

converge with IFRS over a transitional period of five years. At the end of the transition period, Canadian GAAP will cease to exist as a separate, distinct basis of financial reporting for listed companies.⁹ The Canadian Accounting Standards Board initiated its deliberations on this matter by issuing a draft strategic plan for comment in March 2005.

In March 2006, the Central Bank of Brazil announced that it will require all Brazilian financial institutions under its supervision, including leasing companies, savings and loans etc., to prepare their consolidated financial statements in accordance with IFRS, as issued by the IASB, beginning with financial statements for the year ending 31 December 2010.¹⁰ The Central Bank has established working groups that will conduct a comprehensive analysis of the efforts required to achieve convergence with IFRS by 2010.

Among countries working towards convergence with IFRS, there is also a noticeable trend towards convergence with International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). For example, in February 2006, when the Ministry of Finance of China issued the new Chinese Accounting Standards for Business Enterprises, it also issued 48 Auditing Standards for Certified Public Accountants. In December 2005, the Chinese Auditing Standards Board and the IAASB held a meeting to discuss convergence of China's auditing standards to ISAs.

In November 2005, the Auditing and Assurance Board of Canada issued an invitation to comment on its proposal that calls for the convergence of Canadian auditing and assurance standards with ISAs. The proposed convergence programme would commence in 2006 and would be completed by 2011. In its communiqué issued in March 2006, the Central Bank of Brazil also announced its commitment to require by 2010 that external auditors that provide auditing services to financial institutions under its supervision to conduct their work in accordance with International Standards on Auditing.

With the wider implementation of IFRS around the world, it became clearer that the financial reporting needs of SMEs are different from those of large companies. There has been growing demand on the IASB to develop an accounting standard for SMEs. Over the past two years, the IASB has been working towards developing such a standard. It established a Working Group, published a discussion paper and a questionnaire on possible modifications of the measurement and recognition principles in IFRS, and held public roundtables on possible accounting measurement and recognition simplifications. In August 2006, the IASB posted on its website a draft of an Exposure Draft of an IFRS for SMEs¹¹ that was prepared by IASB. A final Exposure Draft for public comment is expected before the end of 2006.

III. Main practical implementation issues of IFRS

As discussed above, the country case studies cover Brazil, Germany, India, Jamaica and Kenya. These countries have taken a variety of approaches towards implementing IFRS. In the case of Brazil, the implementation of IFRS will come into effect in 2010 and will affect financial institutions under the supervision of the Central Bank of Brazil. German companies started preparing financial statements based on International Accounting Standards beginning in the early 1990s. The approach in India has been to adapt IFRSs to the economic realities of the country. Jamaica started implementing IFRS in 2002, while Kenya began the implementation process in 1998.

⁹ The Canadian Institute of Chartered Accountants (CICA), Communiqué 10 January 2006.

¹⁰ Central Bank of Brazil, Communiqué 14,259, Brasilia, 10 March 2006.

¹¹ This document can be accessed at: http://www.iasb.org/uploaded_files/documents/16_33_DraftEDSMEs.pdf.

The factors that initially contributed towards the introduction of IFRS in the countries covered in the case studies vary. In Brazil, the Central Bank's intention is to bring financial reporting practices of financial institutions in line with international best practice with a view to facilitate the comparability of financial reports and foster investor confidence. In Germany, a number of large companies began to prepare their financial statements in accordance with International Accounting Standards, not because they were required by national regulators, but in order to be able to access financial markets outside Germany. In 1998, German lawmakers gave listed companies the option to prepare their consolidated financial statements in accordance with International Accounting Standards. The implementation of IFRS for the preparation of consolidated financial statements of listed companies in Germany became mandatory following the decision of the European Union to implement the IAS Regulation of 2002. The case study of Germany illustrates a European Union-wide approach to implementing IFRS. Therefore, the implementation challenges extend beyond domestic factors.

The case study of Kenya shows a desire to raise national financial reporting requirements to international best practices in the aftermath of significant collapses in the country's financial services sector that occurred in the 1980s and 1990s. The case study of Kenya also indicates another factor that was taken into consideration in deciding to adopt International Accounting Standards in place of national ones. By adopting IAS, the standard-setting body intended to reallocate resources away from setting national accounting standards to strengthening other activities aimed at more effective implementation of accounting and auditing standards.

In India, the case study shows again a desire to harmonize domestic financial reporting requirements with international standards. However, in the case of India, yet another approach is taken, i.e. a programme of converging Indian accounting standards with International Accounting Standards by adapting the latter to the economic reality of the country. The case study of Jamaica also cites an intention to harmonize corporate reporting practices across countries in the Caribbean in accordance with international requirements and with the position taken by the International Organization of Securities Commissions (IOSCO) on its endorsement of International Accounting Standards.

The scope of application of IFRS in the countries included in the case studies varies from one country to another. As discussed earlier, the application of IFRS in Brazil will be required for financial institutions. Listed companies are required to follow national standards that are gradually being converged with IFRS. In the case of Germany, listed companies are required to apply IFRS for preparing their consolidated financial statements. Non-listed companies are also allowed to use IFRS for the preparation of their group financial statements. However, both listed and non-listed companies are prohibited from using IFRS for preparing their individual (separate) financial statements. In Jamaica and Kenya, all listed and non-listed companies are required to prepare their financial statements – both consolidated and non-consolidated – in accordance with IFRS.

In India, there is a three-tier system of classification of entities (Level I, II and III). Those in the first-tier are required to apply IFRS, as adapted for the country. The remaining two tiers are composed of small- and medium-sized enterprises (SMEs). The reporting system allows certain simplifications and exceptions with respect to Level II and III entities.¹²

There are long established laws and regulations governing corporate reporting, including parliamentary legislation on, among others, commercial codes and company acts. There are also a number of sector-specific regulations and institutions covering areas such as banking and insurance. For example, in Brazil and Germany regulation on corporate financial reporting is

¹² This approach is similar to the one ISAR recommended in (UNCTAD 2004) Guidance on accounting and financial reporting for small- and medium-sized enterprises (UNCTAD/ITE/TEB/2003/5 and UNCTAD/ITE/TEB/2003/6).

strongly linked to the legislative system. As a result, the introduction of new reporting systems or amendments to existing ones requires significant consultation and processing through the legislative system. In the case studies of India, Jamaica and Kenya, the professional accountancy bodies, i.e., the Institutes of Chartered Accountants in India and Jamaica and the Institute of Certified Public Accountants in Kenya play a central role in the setting of accounting standards or the implementation of IFRS and ISAs. The legislative systems in these countries delegated the task of standard-setting in the areas of accounting and auditing to these private institutions.

New German institutions have been established in recent years with significant responsibilities in the areas of corporate financial reporting is noted. These are the German Accounting Standards Committee (and its standard-setting arm – the German Accounting Standards Board), the German Financial Reporting Enforcement Panel and the Federal Financial Supervisory Authority. The latter two were established following the passing of the Accounting Enforcement Act of 2004. In Brazil, the proposed amendments on the current Corporate Law call for the establishment of a single entity responsible for preparing and issuing accounting standards. These provide examples of the types of new institutional developments that are needed for the proper implementation and enforcement of IFRS.

The country case studies illustrate a number of practical challenges faced by these countries in implementing IFRS. These issues can be grouped into three main areas: institutional, enforcement and technical.

Institutional issues

When IFRS are introduced in a given jurisdiction, they form part of the pre-existing laws and regulations in the country pertaining to the governance of business entities. The case study of Jamaica shows a large number of regulatory institutions that have a bearing on the implementation of financial reporting standards. Often, laws and regulations overlap or become inconsistent with each other, especially when the roles and responsibilities of different institutions are not clearly defined and coordination mechanisms are not in place. Lack of coherence in the regulatory system becomes cause for serious misunderstandings and inefficiency in the implementation of IFRS.

As the case studies reflect, most of the laws and regulations pertaining to corporate reporting were enacted several decades before the introduction of IFRS. For example, the Companies Act of India was passed into law in 1956. These laws remain in place without amendments to recognize the introduction of IFRS in the respective countries. As a result, the IFRS lack the necessary legal backing. For example, some company laws require specific formats for financial statements. These requirements often contradict the ones in IAS 1 Presentation of Financial Statements. For example IAS 1 specifically requires a cash flow statement. Such a situation impedes the smooth implementation of IFRS.

In recognition of that fact some countries have started to introduce necessary changes. For example, in Jamaica the Companies Act was passed in 2004 superseding the Companies Act of 1965. This new act does not specifically require compliance with IFRS; it states that companies should prepare their financial statements in accordance with the Generally Accepted Accounting Principles promulgated by the Institute of Chartered Accountants of Jamaica. In Brazil, a Bill has been proposed to revise the Corporate Law which was passed by Congress in 1976.

The case study of India illustrates some approaches of how the accounting standards issued by a professional body could be given the necessary authoritative clarity and backing by various regulators. The Reserve Bank, the Securities and Exchange Board, and the Insurance

Regulatory and Development Authority specifically require compliance with the accounting standards issued by the Institute of Chartered Accountants of India (ICAI). The same case study also illustrates the interactions between standard-setters, preparers and the courts when differences of opinion arise between standard-setters and preparers. For example, when the ICAI issued an accounting standard on leasing, based on the equivalent IAS, the Association of Leasing Companies approached the courts to seek relief from the standard, arguing that it was onerous on the leasing companies.

IFRS are intended to be used for the preparation of general-purpose financial statements. However, as the case studies show, IFRS-based financial statements could be also required to be prepared for statutory purposes as well. However, while extending the use of IFRS for such purposes might appear to be cost-efficient, it may create misunderstanding between reporting entities and regulators, particularly in situations where the regulator for a given sector has specific financial reporting requirements that differ from IFRS. Some of the regulatory bodies that put in place statutory financial reporting requirements on specific sectors include banking and insurance oversight authorities. For example, in the case study of Kenya, we noted the lack of coordination between the Insurance Commissioner, who is responsible for the enforcement of the Insurance Act and the Institute of Certified Public Accountants of Kenya (ICPAK), which has the responsibility to ensure that its members comply properly with implementing IFRS. Differences emerged due to differing requirements in IFRS 4 on Insurance Contracts and specific schedules required by the Insurance Commissioner. The Insurance Commissioner and ICPAK reached an agreement covering situations when the IFRS-based schedules differed from those required by the Insurance Commissioner, a reconciliation certified by the auditor of the entity would be provided.

There are also further examples of inconsistencies between prudential regulation and IFRS-based measurement requirements. For instance, IFRS 4 Insurance Contracts requires that the percentage to be applied for calculating claims reserves on insurance contracts should be based on the past experience of the reporting entity in question. However, the prudential regulation on insurance would usually prescribe a pre-determined percentage to be applied sector-wide, regardless of the prior experience of the entity in question. A similar situation arises with respect to provisioning for losses in the banking sector. Central banks often set a prescribed percentage amount that does not take into account the loss experience of the reporting entity as IFRS requirements would do.

Enforcement issues

One of the critical elements in the implementation of IFRS is the rigorous enforcement of standards. The responsibility of enforcing IFRS rests with a number of parties. Institutions such as securities exchange commissions, banking and insurance supervisory authorities, stock exchanges and capital market authorities play important roles in enforcing financial reporting requirements such as IFRS.

As discussed earlier, the case study of Germany shows examples of additional institutions established in the country with a view to ensuring proper enforcement of IFRS. The German Accountancy Enforcement Act of 2004 established a two-tier enforcement mechanism. The first-tier is the German Financial Reporting Enforcement Panel composed of fifteen professional and industry associations. The second-tier in the mechanism is the Federal Financial Supervisory Authority. The Financial Reporting Enforcement Panel examines both consolidated and non-consolidated financial statements of entities listed in Germany. If the Panel discovers violations that cannot be resolved with the entity examined, it refers the case to the Federal Financial Supervisory Authority. Listed entities in Germany make financial contributions to cover the costs of the Financial Reporting Enforcement Panel. An interesting aspect of such an institutional

arrangement is that it makes use of the extensive technical expertise that resides with private sector bodies, while still retaining the enforcement responsibility with the government entity, in this case the Federal Financial Supervisory Authority.

The case study of India also shows how the professional accountancy body, i.e. ICAI, plays a positive role in strengthening the financial reporting practices of entities in India. The Institute established the Financial Reporting Review Board (FRRB). The Board selects and reviews financial statements of various entities to ensure that, among other things, the entities comply with accounting standards. In situations where the FRRB identifies lack of compliance with accounting standards and other applicable standards and codes, it advises the ICAI and/or refers the case to the appropriate authorities for action.

One of the common aspects of the countries covered in the case studies is that all require that an audit of IFRS financial statements be conducted in accordance with International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Board of IFAC. The Brazilian convergence programme also envisages the implementation of IFRS and ISA by 2010. The Basel-based Financial Stability Forum has recognized ISAs as one of the twelve core standards (including IFRS) which are needed to ensure financial stability of countries around the world. Thus, coupling the implementation of IFRS with ISA both helps to raise the quality of financial reporting and auditing to international best practice. ISA provide an important tool in enforcing the proper implementation of IFRS.

Professional accountancy bodies also play a role in the enforcement of IFRS as they discharge their responsibilities with respect to ensuring adherence to their membership by-laws. The case studies of India and Kenya provide examples of peer review programmes that the respective professional accountancy bodies in these countries introduced to ensure proper implementation of financial reporting and auditing standards.

Technical issues

The case studies illustrate a number of technical challenges in the practical implementation of IFRS. The concurrent implementation of IFRS and ISA further compounds the difficulties. One of the principal difficulties encountered in the practical implementation process is the shortage of accountants and auditors who are technically competent to implement the IFRS and ISA. Usually, the time between when a decision is made to implement the standards and the actual implementation date is not sufficiently long to train a sufficient number of professionals who could competently apply international standards. For example, the case study of Kenya shows that the decision to implement IAS and ISA effective in 1999 was actually made in 1998. The case study on Kenya further shows that there is still a shortage of actually professional accountants in general, and those who are adequately trained on IFRS and ISA in particular.

A related technical problem is the limited availability of training materials and experts on IFRS at an affordable cost. The case study of Kenya shows the challenges ICPAK faces in this respect. The difficulty is further complicated in countries where training materials on IFRS that are currently available in English are not readily usable due to language barriers. The case study of Brazil highlights this issue.

Another technical challenge occurring after completing the initial implementation process is the difficulty in coping with the rapid frequency and volume of changes made by the IASB to existing IFRS, as well as keeping pace with new standards. A particular example highlighted in the case studies of India and Kenya is IASB's decision to amend 13 standards at the same time as part of its improvements project. As a result, more than 20 standards were affected because of the

consequential amendments that were made. Repeated amendments on IFRS strain available technical capacity, which in many cases could have been already insufficient.

Fair value measurement requirements in IFRS pose yet another significant technical implementation challenge. In particular, the case studies of India and Kenya indicate that where trading volume is low and capital markets are not sufficiently liquid, obtaining reliable fair value for IFRS measurement purposes becomes difficult. Preparers face difficulty in obtaining reliable measures and data for, among others: discount rates in a volatile financial environment, cash-flow trends, crop yields, loan yields, loan default rates and sector-wide benchmarks for determining fair value for some items. The technical difficulties discussed above pose challenges to auditors as well – since they need to assess the reliability of fair value measurements contained in the financial statements.

There are also regulatory complications that arise when fair value requirements in accordance with IFRS are applied in certain circumstances. For example, when life insurance contracts are unbundled in accordance with IFRS 4, gains on the investment (deposit) component of the life insurance contract are recognized on a fair value basis. However, insurance regulators might decide not to accept such gains as a part of profits available for distribution to shareholders.

The case study of Germany shows that the basis for classification of financial instruments either as equity or debt in accordance with IAS 32 differs from the requirements in German GAAP and law. When classified in accordance with IAS 32, certain instruments that would normally be classified as equity under German GAAP would be categorized as liability. This is mainly due to the right granted under German law to certain shareholders such as private partnerships to put back their shares to the entity. The result is a significant shift of equity to liabilities in a balance sheet prepared under IFRS. The legal form of a partnership is common in Germany and such partnerships are often subsidiaries of listed companies that are required to apply IFRS. As the case study indicates, the reduction in equity discourages many German entities from adopting the option of preparing their financial statements in accordance with IFRS.

The case studies reveal the difficulties encountered in implementing IAS 17 Leases, particularly among entities such as banks and insurance companies that would be required to re-classify certain leaseholds as operating leases to comply with the standard. The impact of this re-classification on banks and insurance companies was a reduction of capital with serious implications on capital adequacy requirements. The case study on Kenya gives examples of situations where financial institutions had to dispose of non-core assets such as leasehold land and buildings that were held as investments. As discussed earlier, the Association of Leasing Companies in India challenged in Indian courts the Indian standard on leasing which is based on IAS 17.

Implementing the requirements of IAS 12 Income Taxes on recognition of deferred tax liability for taxable temporary differences seems to be another area where preparers are experiencing difficulties in complying with the requirements. The case study in India indicates that Indian Accounting Standard 22 – the IAS 12 equivalent – that is supposed to introduce the concept of deferred taxes in India for the first time is being challenged by preparers in the courts.

IAS 16 Property, Plant and Equipment takes the components approach to depreciating assets. Thus, each part of a tangible fixed asset is to be separately depreciated. This approach might be new to various preparers whose previous basis of financial reporting did not require a components approach. A technical issue that might need further guidance in this area is the extent to which preparers need to go on breaking a fixed asset into its various components for depreciation purposes.

The complexity of certain IFRS and the need for estimating certain elements of the financial statements require expertise beyond those issues that would normally fall within the

domain of professional accountants and auditors in developing countries. For example, IAS 19 Employee Benefits requires actuarial valuation to measure the obligations of a reporting entity. This valuation requires input from professional actuaries on a regular basis. The availability of qualified actuaries is critical in this context. Furthermore, there might be a need for coordination between the professional bodies of accountants and actuaries with a view to reaching agreements on how estimations are to be conducted and the nature of details to be provided by the actuary. The case study of India provides an example where the Institute of Chartered Accountants of India and the Actuarial Society of India worked together to ensure that the actuaries report contained the details required in IAS 19.

IV. Lessons learned

In general, a review of the case studies shows that there is growing appreciation of the usefulness of IFRS by countries in different regions of the world irrespective of the size of their economies or financial reporting traditions. However, there are serious institutional, enforcement and technical challenges that countries need to overcome in order to benefit fully from the introduction of IFRS in their jurisdictions.

There are clear indications in the case studies that the implementation of IFRS requires considerable preparation both at the country and entity levels. One of the critical considerations is the need for ensuring coherence in the regulatory framework and for providing clarity on the authority that IFRS will have in relation to other existing national laws. Undertaking the necessary tasks to ensure coherence and clarity will require considerable resources and time. The case studies show that the implementation process of IFRS needs to be a gradual process in order to allow time for the necessary preparations to be made.

The transition plan to IFRS and its implications for preparers, users, educators and other stakeholders has to be effectively communicated. As can be seen in the case study of Jamaica, the country's transition action plan to IFRS needs to have a logistical framework of targeted activities to be completed within a specified period of time. The communication programme could include elements such as road shows to present the objectives of the transition to IFRS, sensitizing regulatory bodies on the potential impact of the conversion, identifying regulatory synergies to be derived, and communicating to preparers and users the potential temporary impact of the transition on business performance and financial position.

As the case study of Germany illustrates, entities need an average preparation period ranging from 12 to 18 months. Entities in countries where there is a need to translate IFRS from English into another language might need a considerably longer period of time to be ready to transition to IFRS. The cost of staff training, updating information technology systems and arranging for obtaining external advice in preparation for the implementation of IFRS could be significant and needs adequate consideration.

The transition plan needs to clearly define the scope of application of IFRS with respect to the size and type of entities and also on whether IFRS will apply for the preparation of consolidated as well as separate financial statements. The case studies show that SMEs encounter serious difficulties when they are required to apply IFRS to prepare their general-purpose financial statements. Therefore, prior to the transition to IFRS, a reporting regime for SMEs needs to be in place. It should also be clearly communicated to preparers and users. As the case study of India indicates, a three tier approach could be used: a first tier to apply IFRS, a second tier to apply IFRS-based standards adapted for that particular tier, and a third tier consisting of micro-entities applying a highly simplified system that is close to cash-based accounting.

Certain national financial reporting systems are traditionally integrated to serve general-purpose as well as some special-purpose reporting needs such as taxation and dividend distribution – as the case studies of Brazil and Germany illustrate. While the IFRS financial reporting model is designed to serve a range of accounting models, it might not be easily adapted to meet special-purpose requirements in line with what the traditional emphasis of the financial reporting system in a country was – for example creditor protection and capital maintenance in the case of Germany. As can be observed in the case study of Germany, both listed and non-listed companies are prohibited from using IFRS for preparing their separate (individual) financial reports.

The case of certain countries that transition to IFRS might need a special consideration of their economies experience of hyperinflationary situations. As indicated in the IASB Framework for the Preparation and Presentation of Financial Statements,¹³ through consultations with the IASB, such countries might be able to specify a financial reporting model that is suitable for their specific circumstances. Thus, in addition to the general implementation that transition to IFRS implies, countries with hyperinflationary currencies need to make additional considerations.

The role of professional accountancy organization in implementing IFRS has been highlighted in the case studies. Successful implementation of IFRS needs extensive and ongoing support from professional accountancy associations. Therefore, an IFRS implementation programme needs to adequately assess the state of readiness of relevant professional accountancy organizations so that the necessary resources are available to ensure competent and continuous support from such organizations. In this respect, it is also important to recognize the importance of standards that are being issued by the International Accounting Education Standards Board (IAESB) of IFAC which address various aspects of pre- and post-accountancy qualification programmes and also continuing professional development (CPD) requirements.¹⁴ The model accountancy curriculum adopted by ISAR in 1999 and updated and revised in 2003, is another resource that could be useful in aligning national qualification requirements with international standards and guidelines.¹⁵

Integrating IFRS and ISA modules into university accountancy education curricula and coordinating university accountancy education programmes with professional qualification and regulation could contribute positively to the smooth implementation of IFRS in an economy. Lack of coordination in this area could lead to inefficient management of financial and human resources, especially in situations where university programmes are supported by local or national governments as part of national human resources development programmes.

As presented in the case studies, professional accountancy bodies contribute to the effective implementation of IFRS and ISAs through requirements that hold their members responsible for observing due care in implementing these standards. As part of the implementation strategy of IFRS, professional accountancy bodies could establish task forces or response teams that would reply to queries from members on IFRS and ISA implementation issues. Such a structure could be in place at the earlier implementation phase and could also be reconstituted at latter stages in response to the issuance of new standards or amendments that require extensive elaboration for preparers and auditors to apply.

Peer review programmes among auditors are a useful oversight mechanism and also provide information on difficulties that are encountered in the financial reporting and/or audit process. Implementation difficulties that frequently arise in the findings of peer reviews provide useful feedback on where further education programmes need to focus. In those cases where challenges are sector specific more focused training programmes and additional resources such as

¹³ This issue is addressed in paragraph 110 of the IASB Framework for the Preparation of Financial Statements.

¹⁴ Further information on the IAESB is available at: <http://www.ifac.org/Education/>.

¹⁵ UNCTAD, International Accounting and Reporting Issues - 2003 Review, pp. 200-257.

sample audit files could be prepared by the relevant professional association or responsible regulatory body.

The case study of Kenya describes an annual award programme whereby the Institute of Certified Public Accountants of Kenya selects and recognizes entities that ranked highest in preparing their financial statements in accordance with IFRS. Contestants submit their financial statements for review on a voluntary basis. Such an award programme encourages improved implementation of IFRS. At the same time, it provides the Institute with valuable information on the particular areas of IFRS that preparers frequently encounter difficulties in implementation, and which could be considered for directing future continuing professional education programmes and other training events.

Data compiled on the 2005 IFRS Awards by the ICPAK highlights the need for continued efforts to improve IFRS-based financial reporting. Despite Kenya's transition to IFRS which began over six years ago, there is clear lack of compliance with disclosure requirements in IFRS particularly in the banking sector. As the companies participating in the IFRS Awards programme are among the largest, and also subject to multiple regulatory regimes, such low compliance in financial reporting is reason for concern. The broader message is that implementation of IFRS is not a one-time process, but rather an ongoing effort that requires continued institutional support.

The shortage of expertise in the field of IFRS affects not only the private sector but also regulators and other governmental agencies. Therefore, in order to effectively discharge their oversight responsibilities, such agencies need to assess early enough in the implementation process their needs for expertise in IFRS and accordingly establish a human resources development programme. As IFRS change due to amendments to existing standards or new standards being issued, regulatory agencies need to have a plan in place to keep up with the changes. Part of the plan needs to include continuing education programmes for personnel in charge of reviewing IFRS-based statements for regulatory purposes. As discussed earlier, regulatory agencies could benefit from expertise that resides with the private sector, including with preparers and auditors, by creating a mechanism whereby regulators receive technical advice, but maintain the regulatory decisions with the governmental oversight body.

Professional accountancy bodies, preparers and users, including regulators, could provide the IASB with useful feedback not only after standards are finalized and ready for implementation, but early in the drafting process. The case studies show that while some professional bodies and national accounting standard setters are in a position to directly or indirectly (on a regional basis) interact with the IASB, others are not – mainly due to a lack of resources. One of the approaches suggested in the case studies is to develop a coordination mechanism at a regional level so that by pooling resources countries are able to influence the standard setting process starting from the early stages.

Unlike countries that implement IFRS, those that have chosen to adapt IFRS to their specific circumstances have more flexibility with respect to issuing additional interpretation and guidance on the IFRS equivalents which are deemed to apply to their economies. As shown in the case study of India, the ICAI issues various interpretations and guidance on the IFRS adapted to the economic environment of India. However, interpretation or guidance that diverges from the general thrust of IFRS might defeat the purpose of adapting IFRSs in the first place, particularly if the objective is to ultimately comply with IFRS as issued by the IASB. This is especially relevant when considering that the IASB does not allow any further guidance or interpretation other than the implementation guidance it issues or the interpretations issued by the International Financial Reporting Interpretations Committee.

The case studies indicate that substantial financial support is needed to achieve the goal of IFRS implementation. International and regional development banks can provide assistance in

overcoming the implementation challenges faced by developing countries in implementing IFRS. As the case study of Jamaica indicates, subsequent to the decision of the Institute of Chartered Accountants of Jamaica to implement IFRS, the World Bank conducted an assessment of the implementation of accounting and auditing standards as part of a programme to determine the gaps in standards and compliance. This was carried out as part of the World Bank's programme of the reports on the observance of standards and codes (ROSC) initiative. The Inter-American Development Bank provided the ICAJ financial support in the form of technical cooperation to disseminate information on IFRS, training and outreach, building enforcement and compliance capabilities, and establishing sustainable training programmes.

V. Conclusion

This note has summarized the main findings of the selected case studies on review of practical implementation issues of IFRS in Brazil, Germany, India, Jamaica and Kenya. These countries have taken a variety of approaches in implementing IFRS. While in most cases the main objective of implementing IFRS was to raise national financial reporting practices to the level of international benchmarks and ensure economic stability, other considerations also include promoting better integration of regional and international capital markets.

The case studies illustrated institutional, enforcement and technical implementation challenges that the countries face in implementing IFRS. Lack of coherence in the regulatory framework, insufficient legal backing of IFRS as reporting standards in a country, extending the use of IFRS beyond the scope of large companies and beyond general-purpose financial reporting may pose significant challenges in implementing and enforcing IFRS. Shortage of personnel with technical expertise in IFRS, unavailability of training materials at affordable prices and in national languages, technical complexity of IFRS and frequent and extensive amendments to existing standards form technical barriers in the process of implementing IFRS.

The Intergovernmental Working Group of Experts might wish to consider the following issues for further deliberations:

What are some good practices with respect to promoting coherence in the regulatory framework so that the implementation of IFRS is conducted smoothly and effectively?

While some countries have chosen to adopt IFRS as issued by the IASB, others have decided to adapt them to their specific economic environment. What could be the implications of such divergent approaches for the progress towards achieving one common financial reporting benchmark around the world?

There are concerns with respect to the practical implementation of fair value based measurements in IFRS. Would it be advisable for the IASB to examine current implementation challenges before issuing further standards that require fair value based measurements?

The IASB has active convergence programmes with accounting standard-setting bodies in some major economies of the world. How is the decision made to initiate a convergence programme? If more and more countries wished to initiate convergence programmes, would the IASB be in a position to accommodate convergence programmes with each country?

What are some good practices in making IFRS training materials available at affordable prices, particularly in developing countries and countries with economies in transition and in places where such materials are needed in languages other than English?

How could some of practical implementation issues be addressed through international technical cooperation programmes?

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Chapter II

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS: CASE STUDY OF BRAZIL

I. Introduction¹⁶

In 2004, the Brazilian economy experienced significant growth with the country's Gross Domestic Product (GDP) growing by 5.2 per cent – the highest growth rate since 1994.¹⁷ Brazil attracted close to \$18 billion in foreign direct investment (FDI). At the same time, outward investment from Brazil amounted to \$9.5 billion.¹⁸ As of June 2006, there were 31 Brazilian companies listed on the New York Stock Exchange. Integrating into global capital markets and facilitating the mobilization of capital and fostering investor confidence call for national corporate transparency requirements which are consistent with international best practices, including in the area of corporate financial reporting. These trends have underpinned efforts aimed at converging national accounting and reporting standards to International Financial Reporting Standards (IFRS) in Brazil. To this end, various reforms in the area of accounting are being undertaken in the country.

Brazil is currently undergoing a gradual process of converging its accounting standards with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards (Board). The main institutions that are leading the convergence process are the Brazilian Securities Commission (Comissão de Valores Mobiliários (CVM)), the Instituto dos Auditores Independentes do Brasil (IBRACON) and the Central Bank of Brazil.

A number of developments have recently advanced Brazil's progress towards IFRS. In March 2006, the Central Bank of Brazil announced that, as of 2010, all financial institutions under its supervision will be required to prepare their consolidated financial statements in accordance with IFRS. The Brazilian Securities and Exchange Commission has promoted efforts aimed at the gradual adoption of IFRS by companies listed in capital markets in Brazil. For example, the CVM has been working more closely with IBRACON with a view to accelerating convergence to IFRS. Companies listed on São Paulo Stock Exchange's (BOVESPA) New Market (launched in December 2000) are required to provide financial statements prepared in accordance with IFRS or to the United States Generally Accepted Accounting Principles (GAAP), in addition to those that are prepared under Brazilian accounting standards. A Committee of Accounting Pronouncements was recently set up in Brazil and has said that its objective will be to achieve full adoption of IFRS in the country.

However, despite the significant changes that have occurred in the Brazilian accounting system in recent years, there are still important remaining differences between Brazilian accounting standards and International Financial Reporting Standards. Some practical and

¹⁶ This chapter was prepared and edited by the UNCTAD secretariat based on significant inputs provided by Professors Paulo Roberto B. Lustosa, Jorge Katsumi Niyama, Ducineli Régis Botelho de Aquino (all at the University of Brasilia, Brazil).

¹⁷ Central Bank of Brazil, *Annual Report 2004*.

¹⁸ UNCTAD *World Investment Report 2005*, pp. 64-66.

operational factors such as the legal environment and economic, tax, cultural and educational issues, tend to place obstacles in the path of convergence of Brazilian accounting standards with IFRS. Economic and tax issues particularly affect the process of convergence of Brazilian accounting to IFRS, because in Brazil the accounting system is strongly tied to tax laws and regulations that establish rules for recognition, measurement and disclosure of business transactions.

This chapter provides a brief overview on the development of accounting systems in Brazil and its current status, discusses the salient features of regulatory frameworks and enforcement, outlines some of remaining major differences of accounting rules in Brazil with regard to IFRS, and summarizes main lessons learned through the recent process of reforming of accounting system towards IFRS.

II. Regulatory framework and enforcement

Brazil's accounting system was initially developed under the influence of European countries (mainly Italy) and was later affected by United States accounting practices. It is strongly influenced by the country's tax legislation, corporate laws and by rules established by government agencies. These agencies include a number of organizations such as Brazil's Central Bank (BACEN), the Brazilian Securities Commission (CVM), the Superintendence of Private Insurance (SUSEP), the National Telecommunications Agency (ANATEL) and the Secretariat for Complementary Pension Funds (SPC).

The development of the stock market and national financial system reforms in the 1970s underpinned the development of accounting in the country. In 1976, the Brazilian Securities Commission was created to supervise the stock market and to regulate the establishment of accounting standards for listed companies.

Reforms of the financial system included measures such as the requirements for listed companies to have their financial statements audited by independent auditors and to comply with the financial reporting standards issued by the Central Bank of Brazil under instruction n° 179/72. Another measure included the introduction of a Corporate Law (6.404/76), which included specifications on accounting principles that companies were required to apply. It also established recognition and measurement criteria and accounting procedures that were strongly influenced by the United States Generally Accepted Accounting Principles (GAAP). Prior to the 1970s, Brazilian accounting was strongly influenced by tax legislation.

With regard to the regulatory framework, Brazilian companies can be classified as: a) companies listed in the stock exchange (i.e. that are registered with the CVM); b) banks and financial institutions; c) transnational companies with subsidiaries in Brazil; and d) other non-listed companies including private limited partnerships.

Both listed and unlisted business entities are subject to the requirements of the Corporate Law. Listed companies are required to follow CVM-approved accounting standards. They also are required to have their financial statements audited by independent auditors. In general, unlisted companies usually apply accounting standards established by the CVM.

Banks and financial institutions are required to follow accounting standards set by the National Monetary Council and the Central Bank of Brazil. There are more than 2,450

institutions supervised by the Central Bank of Brazil;¹⁹ the top ten banks make up more than 65 per cent of the total assets of the national financial system. These entities follow a prescribed chart of accounts (known as the accounting plan for institutions of the national financial system). Banks and financial institutions are to follow recognition, measurement and disclosure criteria are consistent with IFRS.

Transnational corporations or subsidiaries of foreign companies in, among others, the automobile, chemical, pharmaceutical, paper and cardboard and foodstuffs industries are usually established as limited liability partnerships and are not required to provide financial statements. They are not subject to audits by independent auditors. In case audit reports are prepared, they are meant for use in managerial decision-making.

Other companies not included in the previous categories are not required to report and disclose their financial statements or be audited by independent auditors. They are required to provide some company information only to the Federal Tax Revenue Service in accordance with the tax law.

As mentioned previously, Brazilian accounting has been traditionally subject to legislation and regulation by governmental bodies. Progress with respect developing accounting principles and concepts has not been fast. It was only in 1972 that the Federal Accountancy Council (CFC), through resolution 321/72 and the Central Bank of Brazil, through instruction 179/72, included the wording “accounting principles” as part of the requirements for financial reporting by listed companies. However, there was no definition of these accounting principles.

In accordance with the requirements of the Institute of Independent Auditors of Brazil (IBRACON) the auditor’s report had to state whether the financial statements were in conformity with generally accepted accounting principles or not. However, IBRACON also did not provide details on such principles.

It was not until 1981 that the CFC issued a resolution which defined what was applicable in Brazil. However, this did not affect the basic accounting principles (as opposed to generally accepted accounting principles and auditors in practical terms), as the prevailing thinking was that it was more important to ensure that financial statements were in accordance with legislation or regulatory requirements, rather than with accounting principles.

Further steps took place in 1993, when the CFC published another resolution (replacing the one it published in 1981) defining seven basic accounting principles, namely: legal entity, going-concern, historical cost, prudence, accrual basis, objectivity and monetary adjustment. In 1996, the CFC established a working group composed of accounting experts, with the goal of developing accounting standards for Brazil. This working group was comprised of members of various Brazilian regulatory agencies, such as the CVM, BACEN, SUSEP, the Federal Revenue Service, the National Treasury Secretariat and the Brazilian Institute of Independent Auditors.

One of the main objectives of the working group was to propose ways to adapt Brazil’s accounting practices to standards issued by the International Accounting Standards Committee (the predecessor of the International Accounting Standards Board (IASB)). Accounting standards issued by the CFC do not have legal authority since the CFC is not recognized by Brazilian law as an accounting standard-setter for regulatory filing purposes. Only accounting standards issued by the CFC are approved by the CVM (Brazilian Securities Commission) become mandatory for listed companies. However, the CFC could sanction its members for not following its accounting standards in preparing financial general purpose financial statements.

¹⁹ More information is available at: <http://www.bcb.gov.br>.

Significant changes have also taken place in the area of audit regulation in Brazil. Auditing gained more importance in the 1970s after listed companies were required to have their financial statements audited by independent auditors. Prior to that, audited financial statements were required only for subsidiaries of transnational corporations, or as part of requirements for submitting loan applications from private or public financial institutions.

At present, in addition to listed companies, other public service companies regulated by the Federal Government, e.g. banks, insurance companies, telephone service providers and utility companies are required to have their financial statements audited by independent auditors. Currently, the Brazilian Securities Commission requires that new accountants who apply for accreditation as independent auditors must pass a technical examination. As of May 2006, 481 firms were officially recognized as independent auditors in Brazil.²⁰

The Brazilian Securities Commission and the Central Bank of Brazil require that independent auditors be rotated every five years. After rotation, independent auditors could be hired once again by the same client after a break of three years. This requirement is intended to avoid auditors losing their impartiality if they maintained a long-term relationship with a client.

In accordance with current regulation, audit firms in Brazil have the option of participating in peer-review programmes. Independent audit firms apply auditing standards which are very similar to the ones issued by the American Institute of Certified Public Accountants (AICPA) or the International Auditing and Assurance Board of IFAC. Furthermore, in accordance with emerging international good practice, independent audit firms in Brazil are prohibited from providing consulting services to their audit clients. However, they are allowed to provide advice on tax planning and other similar activities which, in Brazil, are considered to be compatible with the duties of an independent auditor.

Education and business culture are, in general, important factors affecting the pace of convergence of Brazilian accounting standards with IFRS. The quality of accounting education and the status of the accounting profession in a given country has had a significant impact on the quality of financial information that an accounting system is required and able to produce. Significant efforts have been undertaken in the country over recent years to improve the quality of accounting education.

The first accounting school in Brazil, the Alvares Penteado Foundation (Fundação Álvares Penteado – FECAP), was established in São Paulo in 1906. It was strongly influenced by the Italian school of accountancy that emphasized the double-entry bookkeeping system rather than reporting concepts. This style of accounting education prevailed until the mid-1970s before financial reforms took place and Corporate Law was introduced.

At present there are 885 university accounting programmes authorized by the Ministry of Education delivered throughout Brazil. Most of the institutions that deliver accounting education are located in the southern and south-eastern regions of the country. In 2005, about 150,000 accounting students were enrolled in these institutions. It is important to note that the University of São Paulo (USP) was the first educational institution in Brazil that was authorized to regularly accept students for graduate and doctoral degree programmes. As of 30 April 2006, USP had conferred a total of 147 PhD degrees in accounting.

However, accounting in Brazil is still not as well known and held in such wide regard as a profession as it is in some other countries with a long history of accounting. In general, the prevailing opinion is that accountants are responsible for bookkeeping and corporate tax.

²⁰ More information is available at: <http://www.cvm.gov.br>.

Accounting education at Master's and PhD programmes attracts less than 1 per cent of all undergraduate students in accounting. Research on international accounting in the form of dissertations, theses and publications in professional and academic journals is still not significant. As a result, expertise on international accounting matters is highly concentrated in a small number of experts and professional accountants. One of main obstacles is the fact that these standards are written in English and are not widely available in languages that most professional accountants in Brazil could easily understand.

In Brazil, there are two bodies that are designated to regulate and supervise the accounting profession. These are the Federal Accountancy Council (CFC) and the Institute of Independent Auditors of Brazil (IBRACON). The Federal Accountancy Council is a representative agency of the Brazilian accounting profession created by Decree 9295/46 to supervise professional accounting practice in Brazil.

Prior to 1999, all persons who held a bachelor degree in accounting and who graduated from an academic institution accredited by the Ministry of the Education were eligible to practice accounting by registering with the Regional Accountancy Council. After 1999, a new regulation that required candidates to pass a qualifying examination was introduced. The pass rate fluctuated between 50 per cent and 65 per cent of the total number of candidates enrolled.

According to the Federal Accountancy Council, 393,382 accountants are currently licensed to practice as independent auditors. Among these, 200,707 or 51 per cent are accounting technicians or secondary school graduates, 192,875 or 49 per cent hold bachelor degrees in accounting.

Furthermore, the CFC established requirements for continued professional development (CPD) for independent auditors. Accordingly, independent auditors were required to undertake 24 hours of CPD during 2003 and 32 CPD hours annually after that. Activities that qualify for CPD were specified in resolution 945/02 of the CFC. The CPD requirements are expected to apply to all accountants licensed by the Council.

Comparison of Brazilian accounting standards with IFRS

According to research by the CVM,²¹ the convergence process of Brazilian standards with the IFRS is developing at a moderate pace.

Recently, CVM²² presented the main differences between Brazilian accounting standards and IFRS. The following deserve special mention: (i) the introduction and application of the fair value measurements, particularly by non-financial companies; (ii) accounting for financial instruments also in relation to fair value; (iii) accounting for and reporting on finance leases in financial statements; (iv) business combinations; (v) accounting for government grants; and (vi) segment reporting.

The following is a brief description of some of accounting requirements in Brazil, mainly of those that differ from IFRS.

²¹ Official Memorandum/CVM/SNC/SEP No. 01/2006.

²² *Ibid.*

Inventory

Inventory measurement criteria in Brazilian legislation are similar to those of the IASB. The first-in-first-out, weighted average, and lower of cost or net realizable value are accepted methods of valuation. Interest related to the acquisition of inventory is treated as an expense – in the same manner as required in IAS 2 Inventories.

Construction contracts

Long-term construction contracts, especially civil construction contracts, are subject to fiscal rules that affect the general-purpose financial statement of construction companies. Tax regulations require that revenue from construction contracts be recognized on a cash basis. It is important to remember that most companies active in the construction industry are limited liability companies that are not required to publish their financial statements. The few publicly-traded corporations are subject to CVM standards that require recognition of revenue based on the percentage-of-completion method.

Joint ventures and consolidation

In Brazil, legally established joint ventures are treated in the same way as other corporate interests and consolidated using either the cost or equity method. Consolidation is mandatory only for companies regulated by the Brazilian Securities Commission and by the Corporate Law.

Impairment

Brazilian standards require that recoverable value be based on the present value of future cash flows, regardless of the net selling price.

At present impairment testing is required only for listed companies, and only with respect to specific assets such as property, plant and equipment.

Property, plant and equipment – revaluation and subsequent costs

Revaluation

Brazilian standards require that property, plant and equipment should be valued using the cost model, i.e. the historical cost less any accumulated depreciation. The revaluation model is an allowed alternative. However, the revaluation model is not applied routinely. The general tendency in Brazil has been to apply revalue property, plant and equipment in limited circumstances, e.g. when mergers, incorporation and other corporate restructuring occur.

There are some discrepancies in accounting practices regarding procedures for tax deferral and downward revaluation, but they are not significant. It is important to remember that in previous years, revaluation of assets was inappropriately used in Brazil as a way of increasing assets and equity. Currently, recognizing inflationary effects on financial statements is prohibited under corporate reporting law and tax regulation.

Subsequent costs

There are some differences between Brazilian accounting standards and IFRS in accounting for subsequent costs incurred in relation to property, plant and equipment. According to the IFRS, these costs should be expensed when incurred, unless these expenses contribute towards increasing the future economic benefits of the related item of property, plant and equipment. In Brazil, subsequent costs that cannot be capitalized as items of property, plant and

equipment are recorded as deferred expenses and must be amortized over a period of 10 years in accordance with corporate law or within 5 years according to tax legislation.

Research and development costs

Accounting for research and development expenses constitutes one of main areas where there is discrepancy between Brazilian standards and IFRS. According to IFRS, costs incurred during the phase of researching new products should be recorded as expenses. Costs incurred during the development phase can be capitalized only when certain specific conditions stipulated by the IASB are met, namely: technical feasibility of completing the intangible asset so that it will be available for use or sale; viability of use or sale; probability of generating future economic benefits; availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and ability to measure reliably the expenditure attributable to the intangible asset during its development. In Brazil, research and development (R&D) costs must be capitalized and amortized over a period of 10 years. However, recent accounting practice in Brazil has leaned towards expensing all R&D costs, in accordance with tax legislation, on the grounds of uncertainty in obtaining future benefits from the products for which the costs were incurred.

Intangible assets (other than goodwill)

In accordance with IFRS – expenses incurred for software development for internal use are expensed when incurred. However, Brazilian standards allow entities to defer expensing of costs incurred for the development of new software systems.

Revenue recognition

General speaking, there are no significant differences between Brazilian and international standards on the recognition of revenue.

Financial instruments

With regard to accounting and reporting on financial instruments in Brazil, a distinction has to be made between financial and non-financial institutions as the former are subject to mandatory accounting procedures issued by the Central Bank of Brazil. The recognition and measurement requirements that banks and financial institutions need to adhere to are essentially similar to those stipulated in IFRS, including with respect to classification as mark-to-market and hedging. However, the extent of disclosure required in Brazil is lower relative to IFRS.

In contrast, Brazilian corporate legislation is totally silent on financial instruments. As a result listed companies apply CVM requirements. In general, these corporations treat certain financial instruments as off-balance-sheet items. The CVM only requires disclosure of estimated market value of financial instruments in the notes to the financial statements. Some of the alternative valuations that are allowed include the value that could be obtained by trading a similar financial instrument, or the adjusted present value based on current market interest rates for similar financial instruments. In this respect, the notes become more important than the financial statements.

Accounting policies, changes in accounting estimates and errors

IFRS require corrections of errors to be made by restating comparative prior period amounts; if the error occurred prior to the earliest period presented in the financial statements, this needs to be restated in the opening balance sheet. The common practice in Brazil is restating

the opening balance sheet. Although convergence in this area is not perfect, users are not disadvantaged as long as the procedures applied are clearly stated in the notes to the financial statements.

Leasing

Finance leases represent one of the difficult accounting problems in Brazil, particularly with respect to achieving convergence between Brazilian standards and IFRS. According to Brazilian tax regulations, all leases are accounted for using procedures similar to operating leases. Thus, lease transactions that are predominantly financial in nature are accounted for in a manner similar to operating leases. The lessee is not required to reflect the value of the leased asset and the corresponding liability in the balance sheet. It is worth noting that the Federal Accounting Council (CFC) has published accounting requirements for leases similar to IFRS, but as discussed earlier CFC standards, they are not mandatory.

With regard to leaseback operations, IFRS stipulates different approaches depending on the circumstances of the transaction. If it results in a finance lease, any profit should be deferred and amortized over the lease term. If it results in an operating lease, the profit or loss should be recognized immediately. In Brazil, profit obtained by the lessee on the sale of the leased asset must be recognized at the time of the transaction. Tax regulations prohibit deferral of such profit.

Government grants

Under Brazilian accounting standards, government investment grants are recognized in a capital reserve in equity when received and without any specific link to the assets or the project's lifespan. IFRS require that they should be recognized only when there is a reasonable certainty concerning compliance with conditions for receiving the grant.

Effects of changes in foreign exchange rates

In general, conversion and consolidation procedures in Brazil requiring the use of exchange rates are essentially the same as those required by IFRS. This reasonable degree of convergence with IFRS could possibly be explained by the influence of independent auditors in large accounting firms who work both in Brazil and abroad.

Business combinations

In Brazil, there is no legal obligation to assess the fair value of assets and liabilities when a business combination takes place. It is usually done for management purposes in order to determine the value of the asset which is being restructured. By contrast, this is mandatory in IFRS.

With respect to premiums and discounts in acquisitions of investments assessed by the equity method, amortization of goodwill deriving from expected future results cannot exceed 10 years (according to the CVM), while IFRS stipulates that goodwill should not be amortized but tested for impairment annually.

With respect to business combinations in Brazil, the legal form is more important than the essence of the transaction. IFRS principally require an assessment of the essence of the deal and consider practically all business combination transactions as acquisitions, unless it is impossible to identify the buyer. In comparing CVM's standards with the IASB goodwill requirements (on business combinations), the following specific procedures deserve mentioning:

(a) Goodwill is recorded according to its economic basis under the CVM standards, whereas under the IFRS it is recorded as goodwill resulting from a business acquisition;

(b) IFRS obliges the acquirer to recognize in profit and loss the acquirer's interest in the net fair value of the acquired asset that exceeds the cost of the combination. However, in accordance with CVM standards in force in Brazil, this is carried in account that reduces the equity of the investment that it refers to.

Investments in associates

In order to apply the equity method to investments in associated companies, Brazilian accounting standards require ownership of 20 per cent or more of the associated company's capital. IFRS stipulate that if an investor, directly or indirectly, holds 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence and the equity method must be used.

The CVM standard is similar to IASB's in stipulating that investments in subsidiaries do not necessarily have to be significant in order to apply the equity method; however, they differ in that the CVM standards stipulate that the equity method can be applied for all associated companies with a minimum of a 10 per cent investment in the company's capital, while the IASB determines that it can only be applied when there is a minimum of 20 per cent ownership of voting stock.

Finally, there are some technical differences in the calculation and determination of equity related to provisions, reporting dates, etc.

Employee benefits

Listed companies in Brazil recognize and measure employee benefits in accordance with a standard issued by IBRACON. The CVM subsequently made the IBRACON standard mandatory for listed companies. The objective of IFRS and Brazilian accounting standards on employee benefits is to establish the accounting and disclosure requirement for employee benefits, including short-term benefits, pensions, post-employment life insurance and medical benefits and other long-term employment benefits. The Brazilian standard deals with benefits that employees will be entitled after their time of service, whether paid directly to employees or indirectly through contributions to a social security entity.

Certain companies use cash-based accounting. Some do not have to use it at all as they do not have employee benefit programmes because in Brazil the Federal Government has an official retirement plan to which both employer and employee contribute.

Interest payments on shareholders' equity

In Brazil, interest payments related to remuneration on shareholders' equity are treated as an expense by tax legislation and as a reduction of the earned surplus account by corporate legislation. Under both types of legislation, this interest essentially represents dividend payments. IFRS require that dividend payments on shares that are wholly recognized as liabilities should be treated in the same way as interest payments on bonds.

Cash flow statement

Cash flow statements are optional in Brazil, but supplementary information is required in IFRS. The Statement of Source and Application of Funds (known in Portuguese under the acronym DOAR) is a requirement. Replacing the DOAR with a cash flow statement is one of the

goals of convergence to IFRS. This has been proposed as one of the amendments on Brazil's Corporation Law.

Earnings per share

In Brazil, earnings per share are calculated by dividing fiscal year net profit by the number of common and preferred stocks in circulation at the end of the period, while IFRS require calculation by dividing the period's net profit or loss attributable to common stockholders by the weighted average of the number of common stock outstanding during the period. Unlike in IFRS, in Brazil, calculation of diluted earnings per share is not required.

Segment reporting

Brazilian accounting standards do not require information or reports on business segments. The CVM has published a voluntary orientation report recommending that listed companies provide segment-level reporting.

Interim financial statements

In Brazil, only financial institutions – as required under the Central Bank of Brazil's legislation – are required to prepare and publish monthly and half-yearly balance sheets. Listed companies must prepare quarterly information to be made available to the stock exchange and investors.

Provisions, contingent liabilities and contingent assets

Brazilian and IFRS requirements are similar with respect to recognition of contingencies.

III. Lessons learned

The need to improve the efficiency of the development of accounting standards is recognized in Brazil. Various efforts are being undertaken towards improving the standard-setting process. These efforts are expected to result in: (1) harmonization of accounting standards for different business sectors; (2) greater alignment with international standards; and (3) faster turnaround time for implementing new standards.

One of the main lessons learned so far during the process of convergence of Brazilian accounting standards and IFRS was the need for better coordination of efforts among the various organizations involved in this process. As a number of agencies are involved in the regulatory processes affecting accounting, legislative approval of proposed accounting standards calls for extensive consultations and takes a considerable amount of time. As a result accounting standards are not keeping pace with changes in the business environment.

Therefore, in recent years, there has been increased interaction between the CVM and IBRACON with a view to harmonizing the standards issued by the two agencies. IBRACON has worked jointly with the CVM and its consultative body on accounting standards towards the goal of gradually reducing existing differences between Brazilian accounting standards and IFRS.

Another important development in Brazil is a Bill (no. 3741/2000) that is currently being considered by the Chamber of Deputies' Finances and Tax Commission in the Brazilian Congress. It proposes various measures to promote convergence between Brazilian standards and the IFRS that are expected to facilitate the process.

The main proposals of the Bill include: creating a single entity responsible for preparing and issuing accounting standards; CVM issued standards should be in conformity with IFRS; a clear separation of tax legislation from financial reporting requirements; making cash flow statements mandatory for listed companies; making the presentation of the Economic Value Added (EVA) obligatory; and requirements that large companies, corporations, private companies, and limited liability companies disclose their audited financial statements.

As discussed in previous sections, IFRS expertise in Brazil is currently highly concentrated in a small circle of professional accountants. Therefore, further concerted efforts are needed in the area of education and training on IFRS-related issues.

There is a strong need for greater international cooperation to ensure a wider dissemination of knowledge on IFRS, including in languages that are easily understood in Brazil. The IASB could facilitate access to IFRS by conducting a series of technical discussions in Brazil so that communication and expertise are enhanced.

IV. Conclusions

Brazil's legal culture has had strong repercussions on the country's system of accounting. Law no. 6404/76 has defined in detail the accounting standards that corporations must follow. The Corporate Law contains accounting standards that in other countries are developed by a whole series of rules and regulations. Therefore, to change an accounting standard prescribed by the law, one must pass another law, which causes the process of change in the Brazilian system of accounting to be slow and inflexible.

Despite this challenge, modern accounting in Brazil has evolved through legally constituted agencies that supervise and inspect the financial market. However, this development has been slowed down by lack of coordination between related regulatory bodies. In particular, between the CVM that supervises and inspects the capital market for non-financial institutions and the Central Bank of Brazil's Department of Banking Standards and Inspection that monitors financial institutions.

The new Corporate Law contained in Bill no. 3741/2000, and around which consultations have been conducted in the Brazilian Congress for over five years, proposes substantive changes in the formal structure of developing the country's accounting standards. The law is expected to abandon the current scope of prescriptive accounting rules and will instead take on an authorizing role. The process of developing standards will then be conducted by an independent agency that will be established by law. It will comprise professionals with specific expertise and will also include academics, trade associations, and businesses. It is hoped that this change will increase quality, speed and convergence with IFRS.

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Chapter III

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS: CASE STUDY OF GERMANY

I. Introduction²³

Germany has a long tradition of accounting regulation, which has always been within the responsibility of the legislator.²⁴ Many changes have taken place in recent years in the accounting environment as a result of European regulations and numerous national laws, as a result of changes in capital markets. Predominant triggers were the increasing importance of capital markets to provide financing and the internationalization of investors. Consequently, new demands on accounting, especially with regard to timely and decision-useful investor information, arose.

The question at stake is, however, how traditional German GAAP will adapt to, or coexist with, international accounting philosophies (systems), whose influence is constantly increasing. In addition to accounting regulation, new enforcement regulations were developed to enhance both investor protection and market efficiency. Financial scandals such as Enron, WorldCom or Parmalat have brought to the fore the need for revised enforcement regulations worldwide. Furthermore, a European requirement for all listed companies to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS)²⁵ demands an effective enforcement.

This study illustrates the process of implementing IFRS in Germany. It begins by explaining the structure of traditional German GAAP in order to point out the fundamental conflicts accompanying the implementation of IFRS (section II). Due to market forces German GAAP opened up and internationally accepted accounting standards were integrated in the German legal system. Exactly how the capacity was built and what institutional structures were needed to integrate and efficiently allow for the application of such a fundamentally different accounting system is described in section III. In section IV, specific transition issues and the predominant technical issue with regard to the IFRS are demonstrated. The study finishes summarizing the results and presenting an outlook on future developments.

²³ This chapter was prepared and edited by the UNCTAD secretariat with substantive inputs from Kati Beierdorf and Kristina Schwedler, Accounting Standards Committee of Germany (ASCG).

²⁴ The first uniform accounting law (General German Commercial Code, AGHGB), which was adopted as early as 1861, requires all entities – independent of legal form or size – to prepare financial statements.

²⁵ For the purpose of this chapter, IFRS also comprise International Accounting Standards (IAS) and related Interpretations (SIC and IFRIC interpretations).

II. The German financial reporting system and the need for internationally accepted accounting standards

The German accounting system

The main features of the German Commercial Code

German General Accepted Accounting Principles (German GAAP) are principle-based accounting standards. They consist of underlying principles (the so-called principles of proper bookkeeping, GoB) which are both codified and non-codified. The source for codified GoB and the majority of further accounting standards is the German Commercial Code (Handelsgesetzbuch, HGB). Legal requirements often lack detailed descriptions for specific accounting issues, e.g. guidance on leasing accounting. Therefore, additional literature and court decisions interpreting accounting issues are an essential part of the accounting system. Thereby the German GAAP evolved over time and adjusted gradually to the changes in the accounting environment.

Each accounting system needs to define its objectives and to develop accounting standards accordingly. For example, financial statements according to German GAAP are not only prepared to provide information for investors.²⁶ They also function as the basis to determine distributable profits which serve to protect creditors of the company. The creditor protection is the predominant objective in Germany. As a result, German GAAP focus on capital maintenance, because creditors are mainly interested in the capital remaining in the company to build up and strengthen the capacity to repay debt when due.

However, only the separate financial statements²⁷ (of individual legal entities) serve as the basis to determine distributable profits. Furthermore, separate financial statements serve as a basis for tax accounting. The initial idea of implementing the so-called conformity principle²⁸ was to simplify accounting. Companies were to prepare only one single balance sheet serving commercial and tax purposes. However, tax accounting did not only use commercial accounting regulations. Over time additional tax regulations were adopted. In order to continue to prepare one single balance sheet, some tax accounting standards are accepted under HGB. For instance, article 254 of the HGB states that additional depreciations are acceptable in order to carry items of fixed or current assets at the lower value that results from the application of accelerated tax depreciation. In addition, accounting options under HGB are carried out in accordance with the tax requirements. Therefore, the tax regulation influences financial statements under HGB. Contrary to the various objectives of separate financial statements (such as profit distribution, basis for tax accounting, and information for general users) consolidated financial statements are prepared solely for information purposes.

Since capital maintenance is generally sought by creditors, the German GAAP comprises of numerous principles which together form a prudent accounting system. An important feature of this accounting system is the imparity principle, which splits up into the realization principle and the anticipation of loss principle. The realization principle ensures that only realized gains are recognized as profits; the anticipation of losses principle requires accounting for unrealized losses. For instance, property (cost = €1 million), whose value increased over time (fair value = €

²⁶ While the current IASB Framework acknowledges many different users of financial statements, IFRS focus on the investors. It is assumed that other users' needs are satisfied by providing information according to the investors' needs.

²⁷ In this chapter, separate financial statements refer to the individual accounts of legal entities (non-consolidated).

²⁸ The conformity principle states that the separate financial statements are used for tax purposes, unless specific tax regulations require to depart from German GAAP.

2 million) is still measured at cost in the balance sheet. If the value decreases (fair value = € 0.5 million) the property is impaired and has to be written down in the balance sheet to the lower value, with the impairment loss recognized in profit and loss. As a result, increases and decreases in value are treated differently, as German GAAP follow a strict “lower of cost or market principle”. Further examples of the importance of prudence are non-recognition of internally generated intangible fixed assets (see article 248 (2) of the HGB) and no revenue recognition according to the percentage of completion method.²⁹ The same principles and accounting regulations apply to consolidated financial statements even though they only serve information purposes.

The German Commercial Code in the light of European accounting regulations

The objective of the EU has always been to harmonize legal requirements in its Member States in order to create a more efficient European market.³⁰ With regard to a more transparent and hence more efficient capital market the need for harmonized accounting regulations was acknowledged. The EU published the Fourth (on annual accounts) and Seventh (on consolidated accounts) Council Directives,³¹ a legal measure which each Member State is required to implement into national law. The directives did not succeed in fully harmonizing accounting requirements throughout the European Union due to numerous Member State options in the directives and different national interpretations. As a result, the directives did not meet the needs of companies that wished to raise capital on pan-European or international securities markets.³²

In 2000, the EU chose a different legal measure, i.e. a regulation as opposed to a Directive. It concluded that the vision of a single European financial market based on transparent and comparable financial statements called for unambiguous accounting standards. While the European Commission had expressed its preference for IFRS as the set of standards for listed European companies as early as 1995,³³ it was not before 2000 that the European Commission announced its intention to require the application of IFRS for consolidated financial statements from 2005 onwards. The regulation on the application of international accounting standards³⁴ was finally adopted in 2002. The IAS-Regulation directly entered into force in all Member States with regard to the mandatory application of IFRS for listed companies preparing consolidated accounts.³⁵ Member State options were solely granted with regard to the requirement or permission of IFRS for non-listed companies preparing consolidated accounts and/or for companies preparing annual statutory accounts. Without member state options or possible delayed implementation, a basis for uniform and comparable financial statements on the European capital market was established.

²⁹ Instead, the completed contract method is used.

³⁰ The first treaty creating a European Community was signed on 18 April 1951. The Treaty on the European Union was signed in Maastricht on 7 February 1992.

³¹ Fourth Council Directive of 25 July 1978 (78/660/EEC), OJ L 222, 14.8.1978, p. 11; Seventh Council Directive of 13 June 1983 (83/349/EEC), OJ L 193, 18.7.1983, p. 1. See p.2 of the Fourth Directive for details about reasons. The directives were implemented in Germany in 1985 through the Bilanzrichtliniengesetz (BiRiLiG). With the implementation of these directives otherwise fragmented German accounting laws were restructured to form a broad accounting regulation for all companies (Third Book of German Commercial Code).

³² This conclusion is also drawn by the EU. See for example European Commission, COM (2000) 359, 13.6.2000. More details on the options: *Roques* (1996) Service Statistics and the International Harmonization of Accounting Rules, p. 284 seq.

³³ See European Commission, COM (1995) 508, 14.11.1995 “Accounting Harmonization: A new strategy vis-à-vis international harmonization”.

³⁴ See Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002, OJ L 243 of 11.9.2002, p. 1 (IAS-Regulation).

³⁵ See Article 4 of the IAS-Regulation.

Enforcement of German GAAP

The German Commercial Code requires the annual financial statements and the management report of corporations to be audited by auditors.³⁶ Auditors are securing the proper application of the accounting standards. Furthermore, to ensure the conformity with the applicable accounting standards penalties (imprisonment of up to three years or a monetary fine) are imposed if accounting standards are violated.³⁷ In addition to the audit requirements within the German Commercial Code, the Law regulating the Profession of Certified Auditors³⁸, which addresses admission requirements as well as the rights and duties of a certified auditor, have to be complied with.

All legal requirements are reviewed and updated on a regular basis. For example, in 1998 civil penalty provisions were tightened (Article 334 of the HGB) and a mandatory auditor rotation system was introduced (Article 319a (1) Nr. 4 of the HGB); in 2001 peer reviews were introduced, which represent an external quality control by other auditors.

The Chamber of Public Accountants (Wirtschaftsprüferkammer, WPK) and the Institute of Public Accountants in Germany (Institut der Wirtschaftsprüfer in Deutschland e.V., IDW) are the authoritative institutions to ensure the efficiency of audits of financial reporting instruments. The WPK is a public body under public supervision in which public accountants/auditors and accounting firms are organized on a mandatory basis. The tasks of the WPK are codified and include quality control of the members or conduction of aptitude tests.³⁹

The IDW, on the other hand, is a private-sector association in which public auditors and auditing companies are organized on a voluntary basis. Technical issues of the profession are analysed and generally accepted auditing principles are predominantly developed by this institution. With auditing standards and auditing guidelines the IDW significantly contributes to standardized audits of financial reports with a high level of quality in Germany.

The need for internationally accepted standards: first movers

In the course of globalization of business activities large German companies had an increased demand for capital and were thriving to participate in large international capital markets, especially the New York Stock Exchange – the largest capital market in the world.

However, financial reports prepared according to German GAAP were not accepted. In the beginning, the problem of acceptance arose mainly due to the fact that German GAAP was not known outside of Germany. In due course, companies were to prepare additional financial statements in accordance with US-GAAP in order to be listed at the NYSE.

DaimlerChrysler AG (formerly listed as Daimler Benz AG) was the pioneer, preparing additional consolidated annual financial statements in form of reconciliation to US-GAAP. In 1996 many other companies such as Deutsche Telekom, Fresenius Medical Care AG, Pfeiffer

³⁶ In 1931 the obligation to audit annual financial statements was adopted in the German Commercial Code. See Article 316 HGB.

³⁷ See Article 331 HGB.

³⁸ Gesetz über eine Berufsordnung der Wirtschaftsprüfer (Wirtschaftsprüferordnung).

³⁹ For further information see <http://www.wpk.de/english/home/home.asp> and <http://www.idw.de>.

Vacuum Technology AG, followed DaimlerChrysler to the NYSE; Digitale Telekabel AG for instance got listed on the NASDAQ.⁴⁰

But companies were not solely driven by access to new sources of finances. Several other reasons drove them to seek a listing at the NYSE:

- listing as a marketing instrument (no other listing involves such publicity and makes the company known worldwide);
- improve company image and presentation to investors;
- align external financial reporting and internal management accounting to allow for a more efficient internal planning and control;⁴¹
- preparation for buy-outs abroad, if shares are to be used as acquisition currency.

In 1994 the first “dual consolidated financial statements” were prepared by companies in the pharmaceutical and chemical industry such as Schering AG. A dual financial report is prepared under HGB using all accounting choices that were available in IAS.⁴² At that time, IAS tended to be closer to German GAAP and compared to US-GAAP, IAS provided more accounting options. Therefore, to prepare the necessary dual group accounts, German GAAP group accounts were still required and as a result, it appeared to be less burdensome to follow International Accounting Standards than US-GAAP.

These first movers were followed by other companies, which were listed on the “Neuer Markt” (New Stock Exchange) in Germany that was established in 1997 to give smaller “growth companies” the opportunity to raise equity. One of the prerequisites to access this market segment was to prepare financial statements in accordance with internationally accepted accounting standards (IFRS or US-GAAP).

Just how much the international accounting systems differed from national GAAP became obvious when financial statements were prepared in accordance with national GAAP and the figures were compared with those prepared under IFRS or US-GAAP. Substantial discrepancies in the given information and specific accounting positions were revealed. DaimlerChrysler for example had an increase in equity of 8 billion DM (= €4.1 billion), the resulting profit decreased by 2.5 billion DM (= €1.3 billion). The main differences and effects will be presented in section III of this study.

Consequently, German GAAP was not particularly enjoying positive publicity. Looking at German GAAP from an international accounting perspective (of capital market investors) they are not popular, in part because of the following features of German GAAP:

- too creditor-oriented and thus too much emphasis on the prudence principle;
- artificial stabilization of profits by building-up and reducing hidden reserves, thereby making it difficult to identify a company crisis and then only possibly with a time-lag (until hidden reserves are used up);
- tax accounting affects commercial accounting and distorts the objectives of the commercial balance sheet;
- major recognition and measurement issues are not explicitly addressed within the German Commercial Code;

⁴⁰ Seventeen German companies are currently listed on the NYSE and two on the NASDAQ.

⁴¹ In Germany, the external financial reporting and internal management accounting are completely separated systems. Due to the focus of external financial reporting on creditor protection, it is not of much use for internal management purposes.

⁴² Any remaining differences were usually immaterial, thereby allowing the financial statements to be labelled as IFRS financial statements.

- too many accounting policy choices (e.g. in relation to goodwill or measurement of inventories);
- distortion of results of operations (e.g. provisions for certain expenses permitted).

III. Integration of IFRS into the German financial reporting system

Regulatory framework

The way towards IFRS

The German legislator (parliament) realized that both previous European efforts to harmonize accounting regulation and existing German GAAP did not live up to the expectations and demands of German capital market-oriented companies. Germany responded accordingly and opened up its accounting system to internationally-accepted accounting standards long before any European legal measure on the application of IFRS was decided upon. In 1998 the national legislator allowed listed⁴³ companies to prepare consolidated financial statements in accordance with internationally accepted accounting standards (IFRS or US-GAAP) instead of German GAAP.⁴⁴ As laid out above, consolidated financial statements – contrary to separate financial statements – are prepared solely for information purposes. Therefore this concession did not seem to interfere with other national accounting issues.⁴⁵

The legislator – expecting European developments – viewed this permission as an interim solution, which was effective only until 31 December 2004. Until then German requirements regarding consolidated accounts were to be brought in line with international requirements. To support the legislator with this ambitious task, a privately organized institution was established in 1998: the Accounting Standards Committee of Germany (ASCG) and its standard setting body, the German Accounting Standards Board (GASB). The ASCG is authorized by Article 342 of the HGB to:

- develop recommendations on the application of German accepted group accounting principles (German Accounting Standards, GASs);
- advise the Federal Ministry of Justice on accounting regulations;
- represent Germany in international standard-setting bodies.

For the first time, a private institution was assigned by the legislator to attend to accounting issues. There were several reservations, especially to independence and credibility of a privately organized accounting standard setting body and the legal effect of standards developed by this institution. However, a private accounting standards body allowed a greater flexibility in the development of accounting and financial reporting principles and a quick adaptation of such principles to meet the changing needs of preparers and users of financial

⁴³ This initially only included companies which were issuing equity. Later, all capital market-oriented companies were included (issuers of equity as well as issuers of debt).

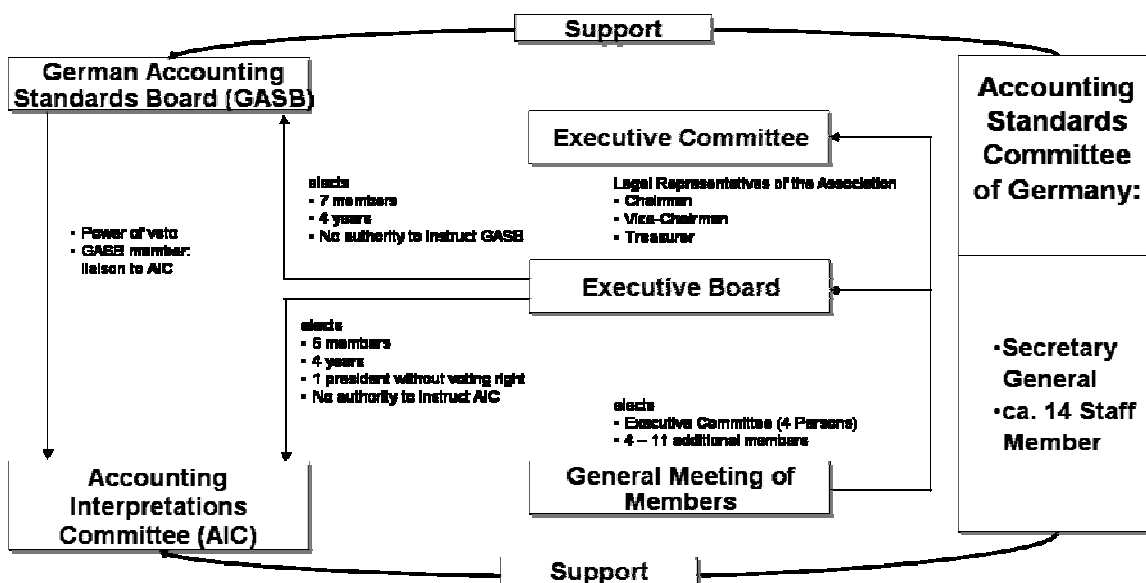
⁴⁴ The legislator temporarily (until 31 December 2004) adopted article 292a HGB through the KapAEG, BGBl. I 1998 of 20.4.1998, p. 707 seq.

⁴⁵ However, accounting experts predicted impacts on separate financial accounts since legal requirements concerning consolidated accounts refer to recognition and measurement requirements for separate accounts. See Article 298 (1) of the HGB.

statements. Furthermore the due process allowed the integration of all parties interested in accounting issues.

The ASCG is organized similar to the IASC Foundation. The GASB comprises independent accounting experts with different backgrounds, including academics, preparers (industrial and financial businesses), analysts and auditors. To round off the structure of the GASC the Accounting Interpretations Committee (AIC) was founded in 2004. The AIC picks up on national issues regarding the application of IFRS. It subsequently analyses whether this is a solely national or internationally relevant issue. Depending on its conclusion it will refer the issue to the respective international organization (IFRIC) or develop a specific national guideline for application of the IFRS in question. Figure 1 gives an overview of the structure of the ASCG.

Figure 1. Overview of the structure of the ASCG



The GASs have had a big impact on the preparation of financial reports under HGB up to present day. In particular, the standards fill gaps within legal requirements, e.g. on management report, risk report, cash flow statements, segment reporting or statement of changes in equity, have changed and harmonized the national financial reporting tremendously. However, there are still doubts as to the degree of legal authority of these standards. This is due partly to preparers and auditors questioning the legal authority of GASs and partly to lack of enforcement. In particular standards which limit accounting choices existing under HGB are rarely being applied (e.g. GAS 4 on Acquisition Accounting in Consolidated Financial Statements).

At the same time, the HGB has undergone some further developments. For example Article 297 of the HGB expanded requirements with regard to the elements of consolidated financial reporting by cash flow statements and statement of changes in equity.

Current Situation: Coexistence of IFRS and German GAAP

With the IAS-Regulation, the permission in HGB to prepare IFRS or US-GAAP consolidated accounts became obsolete and was replaced by the requirement for listed companies to prepare consolidated accounts in accordance with IFRS. As mentioned above, member states had the options to allow or require IFRS for other companies as well. Due to the objectives of separate financial statements (see section II) which IFRS accounts supposedly were not

adequately designed to fulfil, Germany has chosen a less rigorous approach on the implementation of the options:

Figure 2. German GAAP and IFRS

	Group Accounts	Individual Accounts
LISTED Companies	IFRS MANDATORY since 2005	IFRS: Prohibited ⇒ German GAAP Accounts Still Mandatory
	Obligation Effective from 2007 for Listed debt instruments and users of US GAAP	Large Companies may file IFRS financial statements with the Federal Gazette
NON-LISTED Companies	IFRS: Option	IFRS: Prohibited ⇒ German GAAP Accounts Still Mandatory

As shown in figure 2, German GAAP and IFRS (until 2007 also US-GAAP) currently co-exist when dealing with consolidated accounts.

Problems of further expansion of IFRS

IFRS are only required for a small number of about 1,500 German companies. Compared to the larger number of roughly 3 million non-listed companies, which prepare separate or consolidated financial statements, German GAAP appears to be the predominant GAAP at present and in the future. Due to the number of functions a separate financial statement has to fulfil (profit distribution, serving as a base for tax accounting and information) IFRS are not applicable for these statements at the moment. However, there are discussions about splitting up these contradictory functions by establishing a solely separate tax accounting law or implement other means of determining distributable profits (such as the solvency test).

While these discussions are still at a relatively early stage other measures to update German GAAP are being taken in the meantime. The explicit objective of the legislator is to further develop German GAAP towards an information oriented accounting system, harmonising the requirements in accordance with IFRS.⁴⁶

In addition, most companies do not yet see the benefits of converging to IFRS, which is perceived as a voluminous and complex set of accounting standards. There are major concerns – in particular in small and medium-sized enterprises (SMEs) – as to the applicability of these standards, which are intended to serve the purposes of capital market investors. The IASB has

⁴⁶ The legislator plans to publish a draft law, the Accounting Modernization Act. (Bilanzrechtsmodernisierungsgesetz, BilMoG), later in 2006.

considered the concerns and responded by setting up a project to develop an IFRS for SMEs.⁴⁷ In addition to national developments this could enhance and accelerate the expansion of IFRS, contributing to the harmonization of accounting regulations in Germany. So far, SMEs are not very supportive of a possible IFRS for SMEs due to the additional benefits that separate financial statements prepared in accordance with national GAAP provide in the form of multi-purpose financial statements.

Enforcement of IFRS

Enforcement through audit requirements - application of International Standards of Auditing (ISA)

In principle, the requirements of the German Commercial Code (presented in section II.2 of this chapter) have to be applied. However, with standardized accounting provisions the need for standardized audit requirements evolved. In contrast to internationally harmonized accounting standards, standardized auditing requirements were only recently discussed and developed. The relevant international organizations are the International Federation of Accountants (IFAC) and its International Auditing and Assurance Standards Board (IAASB), which are developing and issuing International Standards of Auditing (ISA). Both German organizations, WPK and IDW (see section II) are members of IFAC.

So far, the IDW has transformed ISA into national auditing standards. However, the recent EU Directive⁴⁸ on statutory audits of annual accounts and consolidated accounts stipulates that Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with ISA. The EU Commission – in accordance with the procedure specified by the European Council⁴⁹ – will have to adopt these international auditing standards. It is probable that the German Commercial Code will soon incorporate a reference to ISA. In compliance with the EU-Directive additional national auditing standards will apply if they cover subject-matters for which the Commission has not adopted an ISA.⁵⁰

Enforcement through supervisory bodies (FREP and BaFin)

The legal requirements on securities or stock exchange regulation of the European Member States are lacking consistency at the moment. In addition, the corporate governance structures of companies differ significantly throughout Europe. Due to these differences in legal requirements and companies' structures a pan-European enforcement institution does not seem feasible at the moment. Nevertheless, it is believed that harmonization of enforcement systems throughout Europe is an effective tool to create an efficient capital market and a level playing field within the Union. To this end, IAS regulation states that "a proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets. [...] The Commission intends to liaise with Member States, notably through the Committee of European Securities Regulators (CESR) to develop a common approach to enforcement."⁵¹

⁴⁷ See http://www.iasb.org/uploaded_files/documents/16_33_0601SMEProjectUpdate.pdf for a full project report.

⁴⁸ Directive of the European Parliament and of the Council of 17 May 2006 (2006/43/EC), OJ L 157, 9.6.2006, p. 87; here Article 26 No 1 of the Directive.

⁴⁹ So-called *Comitology Process*. See Council Decision of 28 June 1999 (1999/468/EC), OJ L 184, 17.7.1999, p. 23. The Comitology Process is also applied to adopt IFRS.

⁵⁰ For example guidance on auditing a management report.

⁵¹ See recital no. 16 of the IAS regulation.

The principles on the structure of national enforcement institutions as laid out in CESR's no 1 standard⁵² were implemented into German law in 2004 through the Accounting Enforcement Act.⁵³ The fundamental approach installed with this act is a two-tier enforcement system.

The first tier is the German Financial Reporting Enforcement Panel (FREP), a privately organized institution. In accordance with the article 342b of the HGB representatives of fifteen professional and industry associations,⁵⁴ under the lead of the German Federal Ministry of Justice, have founded FREP, which is to serve as the sponsoring organization for an independent body (panel) enforcing financial reporting requirements in listed entities. In a next step to build up the necessary resources 12 members of the panel were elected and appointed. The appointed members had to satisfy high job specifications with regard to expertise, experience, independence and integrity. The panel operates under the lead of a president and vice-president, who both are distinguished accounting experts in Germany. Legal requirements also provide funding provisions. Since all entities listed⁵⁵ at a national stock exchange are subject to examination by the enforcement panel, all of these entities need to contribute to financing the FREP.⁵⁶

The panel examines both consolidated financial statements and separate financial statements of entities listed in Germany. But the national legislator has recently published a draft law (Entwurf-Transparenzrichtlinienumsetzungsgesetz, TUG-E) to implement the requirements of the European Transparency Directive. Article 24 (4) h) of the Transparency Directive requires the Member States to enforce all reporting requirements within the Directive. Therefore the TUG-E proposes half-yearly financial statements to be subject to enforcement. This would significantly broaden the range of functions of the FREP.

The enforcement panel shall conduct its examination:

- if there are concrete indications of an infringement of financial reporting requirements, including IFRS; this may also include complaints brought forward by whistle-blowers (motivated audit);
- upon request by the Federal Financial Supervisory Authority (BaFin); or
- without any particular reason (regular sampling audit).

If non-conformity with accounting standards is detected, the panel is asked to seek a solution together with the entity under examination. If, however, infringements or even violations done on purpose are discovered, the panel is to advise the Federal Financial Supervisory Authority (BaFin) – the second tier of the enforcement structure – of the result of its examination. In accordance with Article 342b of the HGB the panel does not have any authority to impose sanctions; its remit is solely to discover infringements of financial reporting requirements by listed entities.

The FREP has to report to BaFin on the overall volume and the results of their examinations. Beyond these general reports the BaFin – as the second tier – is only called upon when further actions are needed. The BaFin has to take further action if the panel discovers infringements or in case of non-cooperation of the entity (no correction of the erroneous

⁵² So far, CESR has published two standards, the first of which establishes minimum requirements with regard to the organization, competencies and methods of enforcement by which harmonization on the institutional oversight systems in Europe may be achieved. Standard no. 2 attends to financial information coordination of enforcement activities.

⁵³ Accounting Enforcement Act (Bilanzkontrollgesetz, BilKoG).

⁵⁴ At present, 17 associations are registered FREP members.

⁵⁵ This includes both issuers of equity and issuers of debt.

⁵⁶ There is a spectrum for the amount to be contributed by the entities reaching from a minimum of €250 to a maximum of €15 000 per year, depending on the annual turnover of the entity.

accounting policy) under examination. Being a federal authority, the BaFin (and only the BaFin) is authorized to impose sanctions upon the entities. It is believed that combining private and public elements in a two-tier structure demonstrates that the best expertise can be brought together when dealing with ever more complex issues of financial reporting.

FREP's first report illustrates its work in 2005. The enforcement panel began its work on 1 July 2005. During the second half of 2005 a total of seven motivated audits and 43 regular sampling audits were conducted. All entities examined agreed to cooperate with the enforcement panel. Three of the motivated audits and four of the regular sampling audits were completed within 2005. In two cases, non-compliance with accounting requirements was discovered. One of those entities was instructed by the BaFin to announce the non-compliance. The other case is still pending, as the institutions are assessing whether the entity rightly claims a legitimate interest to refrain from the announcement. The WPK (see section I) was informed that possibly an ineligible auditor was elected. FREP intends to conduct 120 to 160 audits per year.

In general, enforcement aims at ensuring a consistent application of the IFRS. Inherent in every accounting system is the problem of possible lack of regulation: since no single set of accounting standards can address every existing or possible accounting issue, standards requiring further interpretation or regulatory gaps are issues not covered by a specific accounting standard are inevitable. Therefore, enforcement institutions often necessarily have to interpret the relevant accounting standards to evaluate whether the standards have been appropriately applied. Consequently, next to discovering infringements and taking the appropriate measures, enforcement institutions in fact also interpret existing accounting standards.

However, CESR advises national enforcement institution not to publish national interpretations or guidelines, but to forward the issue to the International Financial Reporting Interpretations Committee (IFRIC) or the IASB for clarification. This approach is strongly supported by the German enforcement institutions. Arising accounting issues are to be discussed at the recently established European Roundtable. The roundtable is coordinated by the Accounting Regulatory Committee (ARC) and aims at a consistent application of IFRS. If applicable, the accounting issues are referred to IFRIC.

To ensure a uniform application of accounting standards throughout Europe, CESR introduced a database, which will comprise enforcement decisions. These former decisions ought to be considered for future cases to allow for consistent enforcement over time.⁵⁷

IV. Issues regarding the transition to IFRS in Germany

Developments of transition to IFRS

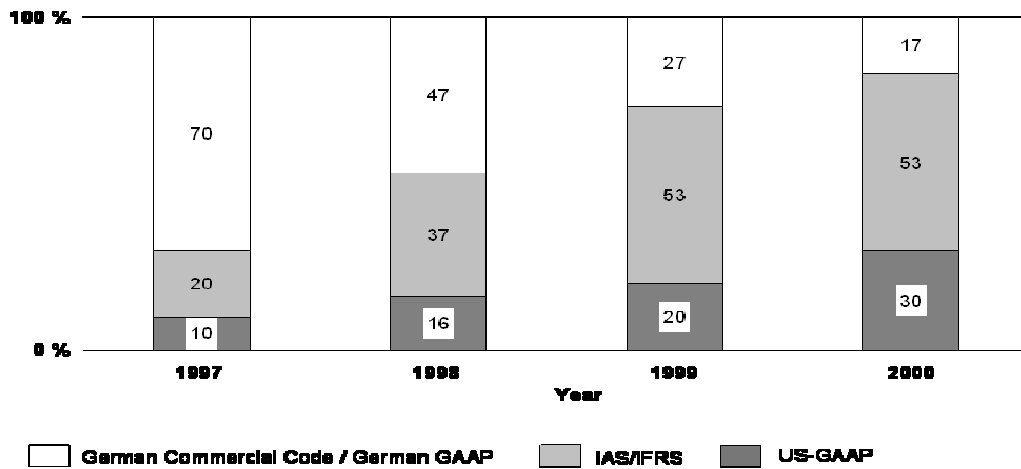
As mentioned in section II, international accounting standards became relevant in connection with listings of German companies at the NYSE (US-GAAP) and dual consolidated financial statements (HGB/IFRS). In 1997, already 20 per cent of the 30 companies listed at the German Primary Index (DAX-30)⁵⁸ published financial statements in accordance with IFRS; 10 per cent of the companies listed at this index published financial statement in accordance with US-GAAP. The following table gives an overview of the development until the year 2000, when the EU announced its intention to make IFRS mandatory for all listed companies preparing

⁵⁷ Moreover, it is planned to open up the database to other interested parties such as auditors, auditing companies, preparers or securities regulators outside of Europe.

⁵⁸ This index was developed in 1988 and encompasses Germany's 30 largest-volume and most actively traded stocks. The DAX-30 is the leading index of the German stock exchange.

consolidated financial statements. The numbers demonstrate that German companies had favoured IFRS even prior to the EU announcement.

Figure 3. Accounting systems applied by DAX-30 companies until 2000



For the decision on the international accounting system companies for instance took into consideration:

- European and national influence on IFRS standard setting process (no influence on US-GAAP, which in the end are a form of national GAAP);
- explicit options within IFRS;
- IFRS closer to German Commercial GAAP;
- IFRS more principle-oriented than rule-based US-GAAP; IFRS therefore less detailed.

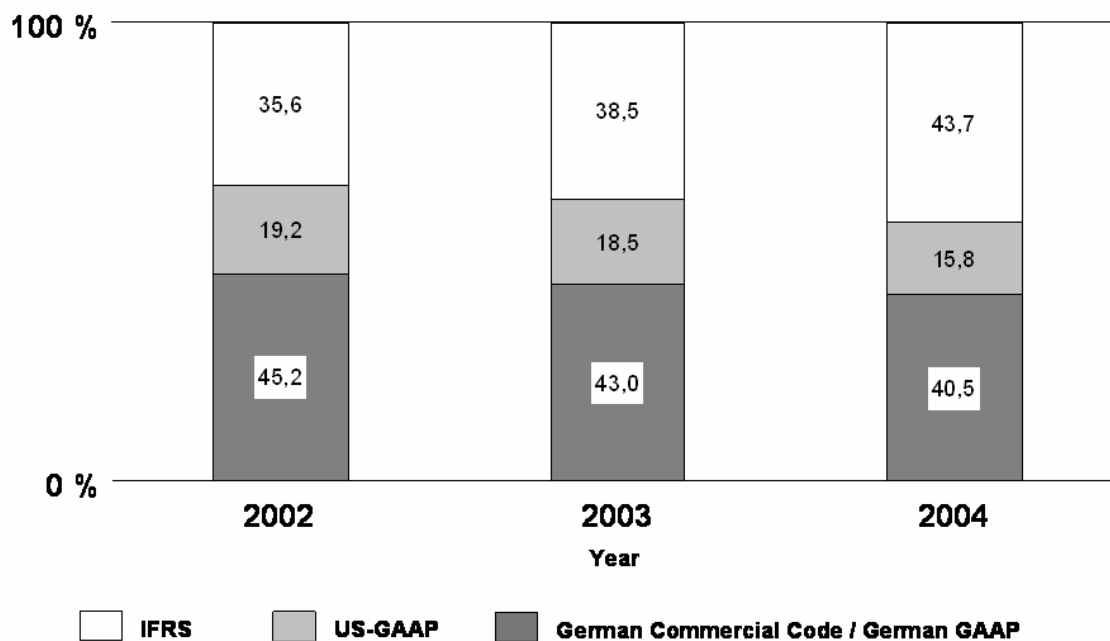
US-GAAP is mostly appropriate for companies seeking a listing on a United States stock exchange or if their business activities are focused on the United States market. IAS regulation state that companies applying US-GAAP will have to perform another transition: from US-GAAP to IFRS (effective for financial years starting 1 January 2007). Therefore, for those companies listed in the USA there is again a potential risk to have to prepare multiple financial statements and to reconcile from IFRS to US-GAAP, as IFRS are currently not accepted by the Security Exchange Commission (SEC). As a result, the convergence program of both the US-American FASB (Financial Accounting Standards Board) and the IASB⁵⁹ and the efforts to achieve mutual acceptance are extremely relevant for the German companies.

In 2002, the year of the IAS-Regulation, about 36 per cent of all group companies required to prepare IFRS consolidated financial statements by article 4 of that regulation, were applying IFRS already.⁶⁰ Compared to the total of 5 per cent (350 out of about 7000) of all European companies addressed by Article 4 of the IAS regulation German companies were ahead of most other European companies.⁶¹ After the adoption of the IAS regulation the application of accounting systems was spread as illustrated in figure 4:

⁵⁹ The so-called "roadmap" for developing common accounting standards by 2008 was published on 27.2.2006.

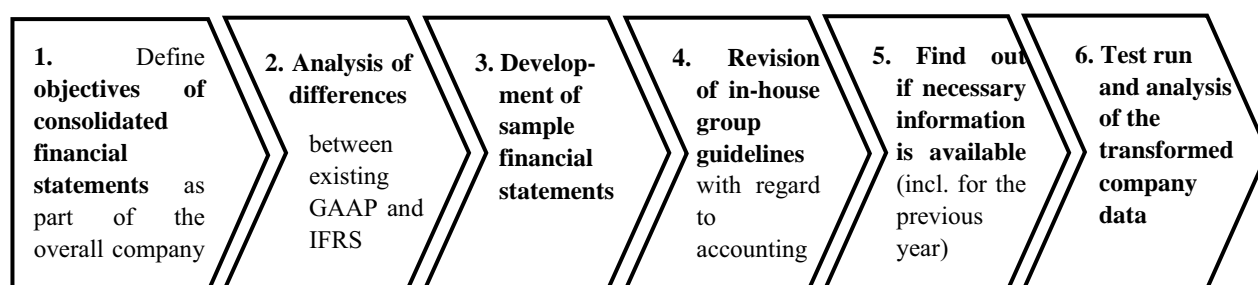
⁶⁰ 45 per cent of those companies were still applying German GAAP.

⁶¹ See research conducted by PwC (2004), *IAS/IFRS – capital market oriented companies in Germany*, p. 6-7.

Figure 4. Accounting systems applied by German subject to Article 4 of the IAS regulation

Procedure of transition to IFRS

The transition to IFRS is a complex procedure which does not affect only the accounting department of a company. It is to be carefully planned and implemented. Figure 5 illustrates a possible breakdown into six phases.

Figure 5. Possible phases of a transition process

In 2004, a survey⁶² of 88 companies listed at the prime standard of the Frankfurt Stock Exchange showed that on average companies needed 5.7 months to plan the conversion and 7.7 months to implement the new accounting standards.⁶³ In general, a total of 12 – 18 months should be allowed to complete the transition process. Next to the one-time costs of the conversion, there

⁶² Research conducted by Deloitte (2004). “Turning away from German GAAP – Accounting Transition Experiences, from German GAAP to IFRS or US-GAAP”, p. 9.

⁶³ These data show a high statistical spread; therefore, the average numbers are only approximate.

are recurring costs of applying the new accounting standards to be considered. While these touch some of the same sectors, following are illustrations of main sectors subject to increased costs occurring during the process of conversion:

- hiring and training of staff, coordination with external consultants;
- IT-reorganization, revision of in-house guidelines and costs of test-run.

The most significant share of the conversion costs are expenses for knowledgeable staff and adjustments of accounting-related information technology systems. Table 1 gives an overview of major conversion expenditures incurred in 88 companies of the German prime standard:⁶⁴

Table 1. Major cost components of transformation process

Cost component	Average expenditure (in thousands of Euro)
in-house staff	255,52
Information technology	247,62
external consultants	154,20
training	59,47
<u>Total Costs</u>	<u>716.81</u>

All companies agreed that it is crucial for a successful implementation project to provide sufficient financial resources and staff during the conversion process.

Implication of the transition on the statements of financial reporting

A general statement about the effect of the conversion of the accounting system to IFRS is not possible due to opposing effects on separate positions. However, any impact on the presented company profit represents a one-time only effect. The value of net assets or the financial position of a company will not constantly be higher or lower compared to national GAAP. Any impact of the accounting transition signifies only temporary changes. Substantial differences between German GAAP and IFRS consist for example in the following cases:

In table 2, the up and down arrows and the horizontal line are used to indicate decrease, increase and no change on the P&L and equity of an entity that would be the consequence of transitioning to IFRS. Where two directions are indicated, an increase or a decrease on P&L or equity could result, depending on the specific circumstances of the entity transitioning to IFRS.

⁶⁴ See Deloitte (2004), *op. cit.*, p. 12.

Table 2. Impact of IFRS on the presentation of profit & loss (P&L) and equity

	P & L	Equity
Capitalisation of Development Cost	↑	↑
Non-Amortisation of Goodwill	↑	↑
Change of Depreciation Methods	↑	↑
Reclassification of Leases	—	—
Fair Value Measurement of Securities and Derivatives	↑↓	↑↓
Changes in Measuring Inventory	↑	↑
Change in Recognition of Provisions	↑	↑
Increase in Pension Liabilities	↓	↓
Comprehensive Recognition of Deferred Taxes	↑↓	↑↓
Consolidation of SPEs	↑↓	—

Predominant technical issue: classification of equity and debt

The predominant issue concerning the application of IFRS by German companies is the differing classification of equity and liabilities. This has an extremely problematic impact on the balance sheet, namely significant reduction of equity. As a result, it appears to be the main obstacle on the way to an overall acceptance of IFRS in Germany. The distinction between equity and liabilities according to IAS 32 follows an approach based on the existence of an obligation of the entity. Therefore, any instruments that are repayable within the lifetime of the entity are classified as liabilities. But the term “obligation” encompasses both present and contingent obligations. Therefore, if an instrument is repayable at the option of the holder (the holder has a right to put the instrument back to the entity), this instrument will also be classified as a liability. Even if the put option is exercisable in a number of years or if the put option has a remote probability of being exercised, this would not change the liability classification.

On the contrary, under German GAAP other criteria are important for the classification. As German accounting aims at capital maintenance, risk capital remaining with the entity even for a short period of time will be classified as equity. To be classified as equity, the capital must be loss absorbing, and it must be subordinated to straight debt on liquidation. In contrast to IAS 32, the capital may be repayable or the instrument may be puttable by the holder. For example, every member in a private partnership has a legal right to quit the partnership and the law grants the member the right to put back his or her share. Consequently, due to this legal right German private partnerships may not present equity in their financial statements if prepared under IFRS. As the legal form of the partnership is quite common in Germany for all types of businesses, and also as subsidiaries of listed companies, this IFRS implementation issue is of high importance. In addition, co-operative societies are affected, as their members also have the legal right to put back their shares.

Some hybrid instruments which may be classified as equity under German GAAP would be classified as debt under IAS 32. At present, the IASB is discussing possibilities for granting exemptions for certain kinds of capital instruments which would undoubtedly be classified as debt under current the principle of IAS 32. The exposure draft deals with instruments puttable at fair value. Since they are puttable, there is a contingent obligation for the entity to repay the

instrument. But, there are additional criteria which cannot be fulfilled due to legal peculiarities of some partnerships, for example, such as those in Germany. Therefore, this exposure draft will arguably not solve the German companies' equity problem. This exposure draft is regarded as a short-term problem fix by the IASB. In addition, the IASB and the FASB are currently working on a joint project dealing with a completely new distinction between equity and debt. Preliminary views are not expected before 2007.

The ASCG is also working on the issue and tries to develop an alternative approach to IAS 32. The GASB set up a working group comprising of academics, practitioners and auditors. Furthermore, the ASCG is the project leader of the EFRAG working group on the same issue under the Proactive Accounting in Europe (PAAinE) initiative.

V. Conclusion and outlook

In recapitulating the developments of the past two decades, a tremendous change to the German accounting environment is evident. Due to globalization and internationalization of the business environment and increasing demand to access capital markets outside of Germany, alternatives to traditional German GAAP were needed. The initial European strategy towards harmonized accounting regulations through convergence of national requirements did not succeed fully in meeting the needs of companies that wished to raise capital on pan-European or international securities markets. Regardless of lack of legal requirements to do so, many capital market-oriented companies turned towards internationally accepted accounting standards driven by general economic conditions.

Significant differences between financial statements according to International Accounting Standards and financial statements according to German GAAP were revealed. While German GAAP was designed and perceived to be creditor oriented and therefore ruled by the prudence principle, DaimlerChrysler's profit had decreased under US-GAAP by €1.3 billion. A negative impact on the profit was obviously contrary to the strong emphasis on prudence, which suggested hidden reserves. This particular effect resulted from a lack of recognition and lower measurement of pension benefit plans.

However, it was hard to communicate any of the causes of differences in the annual accounts. From an international investor's perspective, German GAAP with its strong emphasis on a prudence principle was looked upon as incompatible with value oriented financial reporting.⁶⁵ German GAAP did not stand up to compete with other accounting systems for international acceptance. In the light of obvious shortcomings, the many merits of the systems remained unnoticed.

German capital market oriented companies were exposed to burdensome, cost intensive dual accounting, until the German legislator allowed consolidated financial statements to be prepared following internationally accepted accounting standards. This decision was confirmed by the European legislator with the IAS-Regulation of 2002.

At present, multiple accounting systems are coexisting, the inefficiency of which being obvious from an economical point of view. Therefore the challenge lies in:

⁶⁵ The provisions with regard to pension benefit plans, which admitted that all liabilities need not be recognized and measured at lower than market value, were seen by international investors as an important shortcoming of German GAAP.

- enhance acceptance of IFRS;
- further explore possibilities to open up separate financial statements to IFRS.

When converting to IFRS, companies have to: a) gain knowledge of a fundamentally different accounting system; b) apply more complex accounting standards with an increasing tendency to market valuation; and c) cope with constant changes of the accounting regulation. In 1998, German legislators decided to allow listed companies to prepare consolidated financial statements in accordance with internationally accepted standards (IFRS or US-GAAP). Thus, listed companies in Germany embarked on the implementation of IFRS many years ahead of other entities outside Germany. For example, most listed entities in the European Union began the process later – in response to the IAS regulation that became effective in 2005. As a result, German listed companies had relatively more time to adopt IFRS and to build up the necessary resources. The capacity building process in the form of establishing public and private accounting and enforcement institutions has helped to set the frame for German GAAP that is increasingly becoming internationalized.

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Chapter IV

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS: CASE STUDY OF INDIA

I. Introduction⁶⁶

India has in recent years experienced strong economic growth, rising foreign exchange reserves, falling inflation, global recognition of its technological competence, and the interest shown by many developed countries to invest in the engineers and scientists produced in the country including setting up of new Research and Development centres. Above all, as the largest democracy in the world, India has a reputation for providing leadership for one billion people in a country with different cultures, languages and religions. India's technological competence and value systems are highly respected. Foreign institutional investors find investing in India attractive. Indians are also investing in companies abroad and are opening new business ventures. The Government of India is also committed to economic development by ensuring a growth rate of 7 to 8 per cent annually, enhancing the welfare of farmers and workers and unleashing the creativity of the entrepreneurs, business persons, scientists, engineers and other productive forces of the society. Today, India is one of the fastest growing economies in the world with a compounded average growth rate of 5.7 per cent over the past two decades. The Government of India has plans to transform India into a developed nation by 2020.

In India, accounting standards are issued by the Institute of Chartered Accountants of India based on IFRSs. Departures from the IFRS are made keeping in view the prevailing legal position and customs and usages in the country. Accordingly, this case study of India is prepared to highlight the practical challenges involved in adapting International Financial Reporting Standards in India. This case study also throws light on the existing regulatory framework in the country and the enforcement of the standards in the country.

Accounting Standards-setting in India: A Historical Perspective

India's accounting profession was among the earliest to develop after the introduction of the Indian Companies Act in the mid-1800s, giving the accounting profession its start. Since then, considerable efforts have been made to align India's accounting and auditing standards and practices with internationally accepted standards. Indian accounting and auditing standards are developed on the basis of international standards; and the country has many accountants and auditors who are highly skilled and capable of providing international-standard services.

The Institute of Chartered Accountants of India (ICAI) set up the Accounting Standards Board (ASB) in 1977 to prepare accounting standards. In 1982, ICAI set up the Auditing and Assurance Standards Board (initially known as the Auditing Practice Committee) to prepare auditing standards. ICAI became one of the associate members of the International Accounting Standards Committee (IASC) in June 1973. The ICAI also became a member of the International

⁶⁶ This chapter was prepared and edited by the UNCTAD secretariat with substantive inputs from Avinash Chander, Institute of Chartered Accountants of India.

Federation of Accountants (IFAC) since its inception in October 1977. While formulating accounting standards in India, the ASB considers International Financial Reporting Standards (IFRS) and tries to integrate them, to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

The Accounting Standards Board has worked hard to introduce an overall qualitative improvement in the financial reporting in the country by formulating accounting standards to be followed in the preparation and presentation of financial statements. So far, the Board has issued 29 Accounting Standards. Besides this, it has also issued various accounting standards interpretations and announcements, so as to ensure uniform application of accounting standards and to provide guidance on the issues concerning the implementation of accounting standards which may be of general relevance. Appendix A contains a Comparative Statement of International Accounting Standards/International Financial Reporting Standards and Indian Accounting Standards.

As accounting standards in India are formulated on the basis of IFRS (issued by IASB), ICAI interacts with the IASB at various levels, namely:

- Sending comments on the various draft IFRSs issued by IASB;
- Active participation in the meetings of the global standard-setters with IASB;
- Active participation in the meetings of the regional standard-setters with IASB;
- Contribution in the discussions on various ongoing projects of the IASB, e.g. on the IASB management commentary project;
- ICAI is approaching IASB to take up projects to be carried on by India, e.g. IFRS for regulated enterprises.

II. Regulatory framework and enforcement of accounting standards

In the following paragraphs, the regulatory framework of financial reporting and enforcement of accounting standards will be discussed.

(A) Legal Recognition of Accounting Standards issued by ICAI under the Companies Act (1956)

The Companies Act (1956) provides the basic requirements relating to financial reporting of all companies incorporated in India. The Act requires the preparation, presentation, publication, and disclosure of financial statements, as well as an audit of all companies by a member-in-practice certified by the Institute of Chartered Accountants of India (ICAI). Under the Act, the Central Government has the power, by notification in the Official Gazette, to constitute the National Advisory Committee on Accounting Standards (NACAS), to advise the Central Government on the formulation and laying down of accounting standards for adoption by companies or class of companies. For this purpose, the Act requires that NACAS has to consider accounting standards issued by the ICAI when recommending accounting standards to the Government. While, as stated earlier, the ICAI bases its accounting standards on the corresponding IASs/IFRSs, NACAS also specifically considers the deviations – and reasons, if any – from the corresponding IAS/IFRS while reviewing ICAI accounting standards. In case the NACAS is not satisfied about any deviation, it requests ICAI to amend the standard to comply with IFRS. ICAI generally deviates from the corresponding IAS/IFRS because of the following factors:

- Legal and regulatory environment prevailing in the country;
- Alternatives permitted in IFRSs would lead to incomparable financial information;
- Economic environment within the country;
- Level of preparedness of industry.

NACAS has recommended that all 29 accounting standards issued by ICAI, with the exception of AS 8, Accounting for Research and Development, which has already been withdrawn pursuant to AS 26, Intangible Assets, becoming mandatory, to the Government, for notification under the Companies Act (1956). These include the revised AS 15, Employee Benefits, recently issued by ICAI in line with IAS 19, Employee Benefits. These are expected to be notified by the Government shortly. Until then, the Companies Act (1956) specifically provides that ICAI accounting standards need to be adhered to by companies.

(B) Legal recognition of accounting standards by other regulators

Reserve Bank of India

The Reserve Bank of India (RBI) was established to regulate the issue of banknotes and keeping reserves to secure monetary stability in India, as well as to generally operate the currency and credit system of the country to its advantage. **The Banking Regulation Act (1949)** empowers the RBI to regulate financial reporting of the financial sector, including banks and financial institutions. One of the Schedules to the Banking Regulation Act prescribes formats for general purpose financial statements (e.g. balance sheet, and profit and loss accounts) and other disclosure requirements. Banks are also required to comply with requirements of the Companies Act (1956), provided they are consistent with the Banking Regulation Act. The RBI has issued circulars requiring banks to comply with the accounting standards issued by ICAI.

Securities and Exchange Board of India

The Securities and Exchange Board of India (SEBI) Act protects investors and regulates the securities market. Listed companies in India are required to comply with the requirements prescribed by the SEBI in its Act of 1992 and the Securities Contracts (Regulation) Act of 1956, which provides for the regulation of securities transactions. To protect investor interests, SEBI has issued a listing agreement which specifies disclosures applicable to listed companies in addition to other applicable auditing and accounting requirements. In particular, it requires compliance with the accounting standards issued by ICAI.

The Insurance Regulatory and Development Authority (IRDA)

The Insurance Regulatory and Development Authority (IRDA) regulates the financial reporting practices of insurance companies under the Insurance Regulatory and Development Authority Act (1999). This Authority has been constituted to regulate, promote and ensure orderly growth of the insurance business and reinsurance business. Insurance companies and their auditors are required to comply with the requirements of the IRDA regulations of 2002 titled "Preparation of Financial Statements and Auditor's Report of the Insurance Companies", in preparing and presenting their financial statements and the format and content of the audit report. IRDA regulations require compliance with the accounting standards issued by ICAI.

The Institute of Chartered Accountants of India as a regulator

The ICAI requires its members to ensure compliance with all the accounting standards it issues while discharging their attest function. Further, the ICAI members are required to follow a detailed **Code of Ethics**, as prescribed under the Chartered Accountants Act, (1949). The ICAI Council is also entrusted with the disciplinary powers that are exercised through its Disciplinary Committee. Recently, extensive changes have been made in the Act through the Chartered Accountants (Amendment) Act, 2006, which has made the disciplinary mechanism of the ICAI more stringent.

The ICAI, with a view to further improving and strengthening financial reporting practices in India, has also constituted the **Financial Reporting Review Board (FRRB)**. The FRRB reviews general purpose financial statements of certain selected enterprises with a view to check compliance, inter alia, with the accounting standards. In cases, where non-compliance is observed, an appropriate action is taken by the ICAI and/or it is referred to an appropriate authority for the action. This step definitely helps in improving the quality of financial reporting in the country.

ICAI's introduced a **peer review of audit firms** by establishing an 11-member Peer Review Board in March 2002. The Peer Review Board provides guidance to enhance the quality of services provided by ICAI members. In the first phase, peer review focuses on the review of firms that audit major enterprises at least once in a three-year period. The peer review does not lead to any disciplinary or regulatory mechanism. Peer review certification is either given or not given based on the findings of the review. Peer reviewers are practitioners with at least 15 years of audit experience.

The Chartered Accountants (Amendment) Act (2006) created a Quality Review Board (QRB) in place of the Peer Review Board; this board can make recommendations to the ICAI Council on the formulation of standards regarding the quality of services provided by the members. Further, the proposed QRB would also review the quality of services provided by the members of the ICAI, including audit services, and guide the members of the ICAI on how to improve the quality of services and adherence to the various statutory and other regulatory requirements.

Challenges involved in adoption of IFRSs and implementation issues

(A) Convergence with IFRSs in India

A financial reporting system supported by strong governance, high quality standards and a sound regulatory framework is key to economic development. Indeed, high quality standards of financial reporting, auditing and ethics form the foundations of the trust that investors place in financial information and therefore play an integral role in contributing to a country's economic growth and financial stability. As the forces of globalization prompt more and more countries to open their doors to foreign investment and as businesses expand across borders, both the public and private sectors are increasingly recognizing the benefits of having a commonly understood financial reporting framework, supported by strong globally accepted standards. The benefits of a global financial reporting framework are numerous and include:

- Greater comparability of financial information for investors;
- Greater willingness on the part of investors to invest across borders;
- Lower cost of capital;

- More efficient allocation of resources; and
- Higher economic growth.

However, before these benefits can be fully realized, there must be greater convergence to a single set of globally accepted high quality standards. International convergence is a goal that is embraced in the mission of the International Federation of Accountants (IFAC) and shared by IFAC members, international standard-setters and many national standard-setters.

As a member body of IFAC, India has recognized in its preface to the Statements of Accounting Standards that “ICAI, being a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to actively promote the International Accounting Standards Board’s (IASB) pronouncements in the country with a view to facilitate global harmonization of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India”.

Accordingly, the accounting standards issued by ICAI are by and large in conformity with the IFRSs. Indeed, with respect to certain recently issued/revised Indian Accounting Standards, there are no differences between the Indian Accounting Standards and the IFRSs. For example, Accounting Standard (AS) 7, Construction Contracts, and AS 28, Impairment of Assets, are identical with the corresponding IFRSs. However, in exceptional cases, when a departure from IFRS is warranted in light of Indian conditions, the major areas of differences between the two are pointed out in the appendix to the accounting standard.

ICAI endeavours to bridge the gap between Indian accounting standards and International Financial Reporting Standards by issuing new accounting standards and ensuring that existing Indian accounting standards reflect any changes in international thinking on various accounting issues. In this regard, it should be noted that ICAI is making a conscious effort to bring the Indian accounting standards into line with International Financial Reporting Standards by revising existing accounting standards. ICAI has so far issued 29 Indian accounting standards corresponding to IFRSs.

In view of the above, Indian accounting standards (ASs) are largely in step with the IFRSs. This is also recognized by the following extracts of article in an Indian financial daily (Hindu Business Line) on 5 November 2005:

“Indian Companies can now get listed on London Stock Exchange (LSE) by reporting their financial results based on Indian Accounting Standards. Until now, these companies had to report their financial data in accordance with the International Financial Reporting Standards (IFRSs).”

This is an indication of the growing convergence of Indian accounting standards to IFRS.

(B) Challenges and issues involved in convergence with IFRSs in India

Legal and regulatory considerations

In some cases, the legal and regulatory accounting requirements in India differ from the IFRSs; in such cases, strict adherence to IFRSs in India would result in various legal problems. The following examples illustrate this point:

IAS 1 – Presentation of Financial Statements

In India, laws governing companies (e.g. the Companies Act of 1956), banking enterprises (e.g. the Banking Regulation Act of 1949) and insurance enterprises (Formats of financial statements for insurance companies as prescribed by IRDA regulations in the document “Preparation of Financial Statements and Auditor’s Report of the Insurance Companies” (2002), prescribes detailed formats for financial statements to be followed by respective enterprises. At this stage lawmakers/ regulators may not be willing to accept IAS 1 in its present form and change the existing law. Therefore, full adoption of IAS 1 may not be possible at this stage. However, it is proposed that the corresponding accounting standard being developed by ICAI, would have an Appendix containing suggested detailed formats of financial statements which, while complying with IAS 1, would also contain other disclosures prescribed in the formats laid down by various legislations to address the concerns of the legislature.

IAS 21 – The Effects of Changes in Foreign Exchange Rates

If IAS 21 is adopted in India it would result in violation of Schedule VI to the Companies Act of 1956. Schedule VI requires foreign currency fluctuations in respect of foreign currency loans raised to acquiring foreign assets to be reflected in the cost of the fixed assets, whereas IAS 21 requires the same to be charged to the profit and loss account. The corresponding Indian accounting standard prescribes the accounting treatment contained in IAS 21. However, through a separate Announcement issued by the ICAI, it is recognized that law will prevail.

IAS 34 – Interim Financial Reporting

The disclosures requirements of IAS 34 are not in accordance with the formats of unaudited quarterly/ half-yearly results prescribed in the listing agreement issued by the Securities and Exchange Board of India. The corresponding Indian standard prescribes disclosure as per IAS 34, but also recognizes that the law will prevail insofar as presentation and disclosure requirements are concerned.

Alternative Treatments

The IFRS allow alternative treatments a number of cases. The implications of adopting IFRS as they are would be that it would lead to presentation of incomparable financial information by various enterprises. The following examples illustrate this aspect:

IAS 23 – Borrowing Costs

IAS 23, Borrowing Costs, prescribes expensing of the borrowing costs as the benchmark treatment. However, it also allows capitalization of borrowing costs as an allowed alternative. If this standard is followed as it is, some enterprises would then charge borrowing costs to the profit and loss account, while others will capitalize these costs as part of the cost of the assets acquired/constructed using the borrowings. However, in India, the corresponding AS 16 does not allow any alternative and borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are to be capitalized. However, IASB has issued an exposure draft of proposed amendments to IAS 23 in May 2006, in which it has decided to eliminate the option of immediate recognition of the borrowings costs as an expense and to allow only capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the assets. Thus, once this exposure draft is finalized, no difference would remain between AS 16 and IAS 23.

IAS 19 – Employee Benefits

IAS 19 allows the following options with regard to the treatment of actuarial gains and losses:

- Immediate recognition in the profit and loss account in the year in which such gains and losses occur; or
- adjust against the retained earnings, whereby the current year's profit and loss account is not affected at all; or
- recognize a part of the actuarial gains and losses in the profit and loss account which exceeds the specified percentage (known as the 'corridor approach').

The corresponding Indian AS 15, Employee Benefits, however, requires only the first alternative, i.e. immediate recognition in the profit and loss account.

The above examples are only some of the examples that could be presented. To facilitate comparability, it is imperative that there should be no options in the accounting standards, otherwise the investors and other users of financial statements cannot take decisions based on comparable information. Indian accounting standards do not ordinarily permit any option, but prescribe one of the most appropriate options permitted by the corresponding IAS/IFRS.

IASB recently issued the 'Statement of Best Practice: Working Relationships between the IASB and other Accounting Standard-Setters', which states that removing optional treatments does not mean any non-compliance with IFRSs.

Economic Environment

The economic environment and trade customs and practices prevailing in India, may in a few cases not be conducive for adoption of an approach prescribed in an IFRS. For example, in a country whose markets do not have adequate depth and breadth for reliable determination of fair values, it may not be advisable to follow a fair value-based approach prescribed in certain IFRSs. Certain IASs/IFRSs assume an economic environment with mature markets. For example, IAS 41, Agriculture, is based on the fair value approach presuming that fair values are available for various biological assets such as plants, crops and living animals. The standard is relevant only if

the fair values are reliable, this may not be true in India as, in some instances, the market data may not be reliable in view of markets not being mature enough.

Conceptually, ICAI is in agreement with the fair value approach followed in various IFRSs. However, there is always the risk of misuse of this approach as alleged in the case of Enron. ICAI has so far been cautious in adopting the fair value approach in its accounting standards, although certain accounting standards recognize this approach, (for example, AS 28, Impairment of Assets), and ICAI has decided to follow this approach in its proposed Accounting Standard on Financial Instruments: Recognition and Measurement corresponding to IAS 39.

Level of Preparedness

In a few cases, the adoption of IFRSs may cause hardship to the industry. To avoid the hardship, some companies have gone to the court to challenge the standard, for example:

- When ICAI issued AS 19 on *Leases*, which is based on the corresponding IAS, leasing companies are of the view that it may cause hardship to them. To avoid this, the Association of Leasing Companies approached the Court to contest the standard.
- When ICAI issued AS 22 on *Accounting for Taxes on Income* to introduce the international concept of deferred taxes in India for the first time, a number of companies challenged AS 22 in courts as they were concerned about the effect AS 22 may have on their bottom lines.

In view of the above, to avoid hardship in some genuine cases, the ICAI has deviated from corresponding IFRS for a limited period till the preparedness is achieved.

Besides the above technical differences, there are a few conceptual differences between Indian accounting standards and the IFRSs. For example, IAS 37 deals with 'constructive obligation' in the context of creation of a provision. The effect of recognizing provision on the basis of constructive obligation is that, in some cases, provision will be required to be recognized at an early stage. For instance, in case of a restructuring, a constructive obligation arises when an enterprise has a detailed formal plan for the restructuring and the enterprise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. It is felt that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognize a provision since a liability cannot be considered to be crystallized at this stage. Furthermore, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument. In view of this, the corresponding Indian accounting standard, i.e. AS 29, does not specifically deal with 'constructive obligation'. AS 29, however, requires a provision to be created in respect of obligations arising from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. In such cases, general criteria for recognition of provision are required to be applied. The treatment prescribed in AS 29 is also in consonance with the legal requirements in India.

Frequency, Volume and Complexity of Changes to the International Financial Reporting Standards

It has clearly been a very challenging time for preparers, auditors and users of financial statements, following the publication of new and revised IFRSs. The following evidences the frequency, volume and complexity of the changes to the international standards:

- The IASB's Improvements Project resulted in 13 standards being amended, as well as consequential amendments to many others. In India, a project to examine of IAS revisions, pursuant to IASB's improvement project, has been launched to determine whether corresponding Indian accounting standards need revision.
- Repeated changes of the same standards, including changes reversing IASB's previous stands and changes for the purpose of international convergence.
- Complex changes on accounting standards, such as those on Financial Instruments, Impairment of Assets and Employee Benefits require upgrading of skills of those professionals who implement them, in order to keep up with the changes.

Challenges for small and medium-sized entities and accounting firms

In emerging economies like India, a significant part of the economic activities is carried on by small- and medium-sized entities (SMEs). Such entities face problems in implementing the accounting standards because of:

- Scarcity of resources and expertise with the SMEs; and the
- Cost of compliance is not commensurate with the expected benefits.

In order to address the issues of applicability of accounting standards to SMEs, ICAI has provided certain exemptions/ relaxations to such companies. For the purpose of applicability of Accounting Standards, enterprises are classified into three categories: Level I, Level II and Level III. Level I enterprises are large and publicly accountable entities. Level II enterprises are medium-sized enterprises; and Level III are small enterprises. Level II and Level III enterprises are considered as SMEs. Level I enterprises are required to comply fully with all the accounting standards issued by the ICAI. The relaxations/exemptions are provided to Level II and Level III enterprises from accounting standards. Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements such as AS 3, Cash Flow Statements, AS 17, Segment Reporting, AS 18, Related Party Disclosures and AS 24, Discontinuing Operations. In respect of certain other accounting standards, which also lay down disclosure requirements, Level II and Level III enterprises are exempted from some of its disclosure requirements such as AS 19, Leases, AS 20, Earnings Per Share and AS 29, Provisions, Contingent Liabilities and Contingent Assets. Generally, the ICAI does not favour exemptions to be given in respect of recognition and measurement requirements. However, considering rigorous measurement requirements in AS 15 (revised 2005), Employee Benefits and AS 28, Impairment of Assets, simplified measurement approaches have been allowed to the SMEs.

III. Capacity-building

The pace at which accounting standards have recently been issued and mandated in India is posing various accounting problems and has serious business consequences. Building the capacity of the preparers and the auditors is therefore a stiff challenge to the accounting profession. To enhance capacity-building and to ensure effective implementation of accounting standards, the Institute of Chartered Accountants has acted proactively by taking the following steps:

(a) Issuing accounting standards interpretations on matters related to accounting standards. With a view to resolve various intricate interpretational issues arising in the implementation of new accounting standards that have already been issued, the ICAI has issued thirty accounting standards interpretations.

(b) Issuance of background materials on accounting standards: To facilitate discussion at seminars, workshops, etc., ICAI has issued background material on newly-issued accounting standards. The background material deals, *inter alia*, with the key requirements of the accounting standards with examples and Frequently Asked Questions (FAQs), which accountants and auditors may encounter in the application of accounting standards.

(c) Issuance of guidance notes on accounting matters: ICAI has issued various Guidance Notes in order to provide immediate guidance on accounting issues arising due to issuance of new accounting standards and to provide immediate guidance on new accounting issues arising due to changes in legal or economic environment and/or other developments,. These guidance notes form an important part of the generally accepted accounting principles in India and need to be referred to on a regular basis by people involved in the preparation and presentation of financial statements, as well as by people involved in auditing these statements.

(d) Organizing seminars and workshops: ICAI has always been striving for excellence in terms of standards of professional services rendered by its members. To enable members to maintain high standards of professional services, ICAI is providing inputs to members by way of seminars, workshops and lectures.

(e) Responding to various queries raised by members: While performing their attest function members of the institute are often posed with certain tricky situations, particularly as they apply accounting standards to the specific situations of an enterprise, where an authentic view is required. For the purpose of assisting its members, the Institute's Council formed the Expert Advisory Committee to answer queries from the members of the Institute. The Committee deals with the queries on accounting and/or auditing principles and related matters.

Auditing issues involved in implementation of accounting standards

Independent auditors play a vital role in enhancing the reliability of financial information produced by companies, not-for-profit organizations, government agencies and other entities by providing assurance on the reliability of the financial statements. As mentioned above, the ICAI members are required to ensure compliance with the ICAI accounting Standards issued by the

ICAI while performing their attest function under certain legislations such as the Companies Act (1956), as well as by the ICAI itself.

The ICAI has established an Auditing and Assurance Standards Board (AASB) that formulates standards that are broadly in line with International Auditing Standards issued by the IAASB. In general the AAS text is based on the text of the equivalent ISA. Certain modifications are introduced into the AAS in order to adapt them to local circumstances when considered necessary.

Examples of audit issues arising as a consequence of adaptation of an IAS/IFRS

Some of the major issues that may have an impact upon the work of auditors in India in implementation of Indian accounting standards that have been formulated on the basis of the corresponding IAS/IFRS are as below:

IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 provides that financial statements do not comply with the IFRS if they contain immaterial errors that were deliberately included to achieve a particular presentation of an entity's financial position, financial performance or cash flows. The ASB of ICAI has also prepared the preliminary draft of the revised AS 5, corresponding to IAS 8. In the draft, the ASB has decided that since the above accounting treatment is conceptually correct, it should be adopted in AS 5 also. However, the ASB also feels that this requirement would be too onerous on the auditors since it would be difficult for the auditor to determine as to whether the errors had been intentionally made or not and that he may ignore such errors on the grounds of materiality. The ASB has, therefore, decided that once the standard is finalized, it may request the AASB of ICAI to look into the matter and provide necessary guidance.

IAS 19 - Employee Benefits

IAS 19 also deals with measurement of defined benefit plans which is complex as compared to measurement of defined contribution plans since actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. The ICAI has recently issued the revised AS 15, Employee Benefits, on the lines of IAS 19, including recognizing the role of a professional actuary. An auditing issue may arise about the extent of reliance that an auditor may place on the actuary's report, particularly in view of extensive disclosure requirements prescribed in the standard.

To effectively address the problem, ICAI has requested the Actuarial Society of India (ASI) to revise its guidance note on the subject, so that the actuary's report contains the relevant information as envisaged in the accounting standard, in order to guide actuaries, as has been done in certain other countries such as the United Kingdom. In any case, the responsibility of the auditor will continue to be determined under Auditing and Assurance Standard (AAS) 9, Using the Work of an Expert, which provides guidance on auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert, such as an actuary, as audit evidence.

IAS 27 - Consolidated and Separate Financial Statements

In accordance with IAS 27, a parent enterprise shall present consolidated financial statements in which it consolidates its investments in subsidiaries. Along the lines of IAS 27, IAS 21, Consolidated Financial Statements provides that a parent which presents consolidated financial statements should consolidate all domestic as well as foreign subsidiaries.

It is possible that the auditor of the parent enterprise is not the auditor of its subsidiary enterprises. Furthermore, the auditor of the consolidated financial statements may not necessarily be the auditor of the separate financial statements of the parent company, or one or more of the components included in the consolidated financial statements. However, a law or regulation governing the enterprise may require the consolidated financial statements to be audited by the statutory auditor of the enterprise. In such cases, the auditor will face the issues of reliability on the work performed by the other auditors. In India, the listing agreement requires financial statements to be audited apart from the audit of separate financial statements under the Companies Act (1956). ICAI recently issued a Guidance Note on Audit of Consolidated Financial Statements, which provides detailed guidance on the specific issues and audit procedures to be applied in an audit of consolidated financial statements.

Fair Value Issues

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. As mentioned in section 4 (Challenges involved in adoption of IFRSs and implementation issues), the economic environment in India may not be conducive for adoption of the fair value approach prescribed in various IFRSs. ICAI agrees on a conceptual level with this approach – it has used it in AS 28, Impairment of Assets, and has also decided to follow it in its proposed AS on Financial Instruments: Recognition and Measurement, corresponding to IAS 39 – but an auditor might face difficulties in satisfying himself that the fair values computed are reliable.

Although the International Federation of Accountants (IFAC) has recently issued a new International Standard on Auditing (ISA) 'Auditing Fair Value Measurements and Disclosures' to address the increasing number of complex accounting pronouncements containing measurement and disclosure provisions based on fair value, it still remains to be seen whether this ISA, in the Indian context, adequately addresses the auditing issues needs to be examined.

IV. Lessons learned

Convergence of accounting standards in all countries, including India, is duly recognized as the future of global accounting standards. In the past, different views of the role of financial reporting made it difficult to encourage convergence of accounting standards, but there now appears to be a growing international consensus that financial reporting should provide high quality financial information that is comparable, consistent and transparent, in order to serve the needs of investors. Convergence is possible in two ways, i.e. either by adopting or adapting a standard. As discussed in earlier sections, IAS and IFRS in India are being adapted while keeping in view the legal and other conditions prevailing in India. The major lessons learned during such adaptation are:

1. Implementation of certain requirements of IFRSs should be a gradual process: India has learned that adapting IFRSs is not just an accounting exercise. It is a transition that requires that everyone concerned has to learn a new language and new way of working. While formulating accounting standards on the basis of IFRSs, one should consider the fact that, in certain cases, it may cause undue hardship to the industry, at least to begin with. In other words, Indian industry may not be prepared to apply the provisions of the standards immediately and some transitional measures are needed to be introduced for them. For example, in the following cases, India has decided to implement Accounting Standards prepared on the basis of IFRSs gradually:

(i) AS 10 (revised) - Tangible Fixed Assets: This Standard is being revised on the basis of IAS 16. IAS 16 follows the components approach in accounting for property, plant and equipment. Under this approach, each part of a tangible fixed asset with a cost that is significant in relation to its total cost is depreciated separately. AS 10 (revised) also recognizes the components approach. However, it does not at present require full adoption of the said approach on the lines of IAS 16. Doing so may require an enterprise to segregate one asset into several parts, which may not be practicable in certain circumstances, at least to begin with. It is therefore proposed that the components approach may be followed as an option until the industry is ready. ICAI also proposes to discuss the matter with IASB to explore the possibility of providing guidance on the extent an asset can be divided into different components.

(ii) AS 15 - Employee Benefits (revised 2005): In respect of termination benefits, the revised AS 15 (2005), considering that industry in India is currently passing through a restructuring phase, specifically contains a transitional provision stating that where an enterprise incurs expenditure on termination benefits on or before 31st March 2009, it may choose to follow the accounting policy of deferring such expenditure over its pay-back period. However, the expenditure so deferred cannot be carried forward to accounting periods commencing on or after 1 April 2010. IAS 19 does not provide such a transitional provision. In India, these are given keeping in view the interests of the industry at large.

(iii) AS 22 - Accounting for Taxes on Income: ICAI issued AS 22 in 2001 to introduce the international concept of deferred taxes in India for the first time. A number of companies challenged AS 22 in the courts primarily because it affects their bottom line and the retained earnings particularly in the year in which the standard is introduced. It is an important lesson as it is a new concept which has been met with widespread acceptance as companies are prepared to go to the courts to obtain relief; such standards should be therefore introduced gradually so that their impact may be softened. The legal cases pertaining to AS 22 are still pending in the court.

2. Lessons learned in addressing differences in the accounting treatment prescribed in IFRSs and law: As a standard-setter, ICAI has learned a lesson that where the conceptually superior accounting treatments prescribed in various IFRS are in conflict with the corresponding legal requirements, there are various ways to deal with it, including the following:

(i) Change the accounting requirements as per the law: This approach has generally been followed in some of the earlier ICAI accounting standards. The disadvantage of this approach is that the correct accounting treatment does not even get recognised in the Country.

Furthermore, if this approach is followed it becomes difficult to persuade legal authorities to change the law subsequently on the basis of the conceptually superior accounting treatment prescribed in an IFRS. In view of this, this approach has not normally been followed in recent accounting standards and is followed sparingly when the legal position is so well entrenched that giving a different accounting treatment in a standard is considered totally unacceptable. Increasingly, the approach proposed in the paragraph (ii) below is currently being adopted.

Where the accounting treatment is conceptually superior in an IFRS compared to the treatment prescribed in a law, the standard lays down the approach recommended by the IFRS, while recognizing that until a change is made in the relevant legal requirements, the law will prevail. The advantage of this approach is that while the correct accounting treatment gets recognized in an accounting standard in the country, it also gets recognized that a change in law is imperative. For example, in the recently issued exposure draft of the proposed Accounting Standard on *Financial Instruments: Presentation*, while the exposure draft recognizes that certain financial instruments such as preference shares should be classified as equities or liabilities depending upon their substance, it is also recognized that until Schedule VI to the Companies Act (1956), which lays down the presentation and disclosure requirements for the companies, and accordingly requires that the preference shares to be classified as equity, will have to be followed by the companies until Schedule VI is amended.

3. Guidance needs to be provided in various cases for effective implementation of Accounting Standards: Adequate guidance needs to be provided for effective implementation of the accounting standards. In some cases, where accounting standards require management of the enterprises concerned to use judgement in making accounting estimates etc.; however, various issues arise in the actual implementation. To address those issues, ICAI has issued Accounting Standards Interpretations (ASIs), guidance notes and other explanatory material. For example, AS 16, *Borrowing Costs*, corresponding to IAS 23, defines the term ‘qualifying asset’ as “an asset that necessarily takes a substantial period of time to get ready for its intended use or sale”. The issue as to what constitutes ‘substantial period of time’ has been addressed by issuance of ASI 1, *Substantial Period of Time*.

Further, ICAI has also undertaken various projects for providing guidance on accounting matters arising from issuance of a new accounting standard, e.g., it has recently undertaken the project for preparation of a Guide on the manner of estimating future cash flows and discount rates in the context of AS 28, *Impairment of Assets*.

4. Capacity-Building required before issuance of some of the newer accounting standards or revision of accounting standards corresponding to IFRS: Nowadays, with the issuance of newer accounting standards or revision of existing ones on the basis of IFRSs, various new concepts are being introduced in India for which the preparers as well as the auditors need to be adequately trained by organizing workshops, conducting seminars, etc. It is being increasingly realized that the preparers and auditors should be given training even before final issuance of a new standard, i.e. at the exposure draft stage itself, so that when the standard is finally issued, they are ready to effectively implement the standard.

V. Conclusion

Irrespective of various challenges, adoption of IFRSs in India has significantly changed the contents of corporate financial statements as a result of:

- more refined measurements of performance and state of affairs, and
- enhanced disclosures leading to greater transparency.

With the rapid liberalization process experienced in India over the past decade, there is now a huge presence of multinational enterprises in the country. Furthermore, Indian companies are also investing in foreign markets. This has generated an interest in Indian GAAPs by all concerned. In this context, the role of Indian accounting standards, which are becoming closer to IFRSs, has assumed a great significance from the point of view of global financial reporting.

Indian companies using the Indian accounting standards are experiencing fewer difficulties accessing international financial markets, as Indian accounting standards are becoming closer to the IFRSs. Indian standards are expected to converge even further in the future, especially after the challenges mentioned in study are addressed over the next few years.

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Appendix A: Comparative Statement of International Accounting Standards/ International Financial Reporting Standards and Indian Accounting Standards

(As on June 8, 2006)

I. Indian Accounting Standards already issued by the Institute of Chartered Accountants of India (ICAI) corresponding to the International Accounting Standards/ International Financial Reporting Standards

S. No	International Accounting Standards (IASs) / International Financial Reporting Standards (IFRSs) ⁶⁷		Indian Accounting Standards (ASs)	
	No.	Title of the Standard	AS No.	Title of the Standard
1.	IAS 1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies ⁶⁸
2.	IAS 2	Inventories	AS 2	Valuation of Inventories
3.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 16 and IAS 38	AS 6	Depreciation Accounting ⁶⁹
4.	IAS 7	Cash Flow Statements	AS 3	Cash Flow Statements
5.	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies ²
6.	IAS 10	Events After the Balance Sheet Date	AS 4	Contingencies and Events Occurring after the Balance Sheet Date ²
7.	IAS 11	Construction Contracts	AS 7	Construction Contracts
8.	IAS 12	Income Taxes	AS 22	Accounting for Taxes on Income
9.	IAS 14	Segment Reporting	AS 17	Segment Reporting
10.	IAS 16	Property, Plant and Equipment	AS 10	Accounting for Fixed Assets ²
11.	IAS 17	Leases	AS 19	Leases
12.	IAS 18	Revenue	AS 9	Revenue Recognition ²
13.	IAS 19	Employee Benefits	AS 15	Employee Benefits
14.	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government Grants ²
15.	IAS 21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates
16.	IAS 23	Borrowing Costs	AS 16	Borrowing Costs
17.	IAS 24	Related Party Disclosures	AS 18	Related Party Disclosures
18.	IAS 27	Consolidated and Separate Financial Statements	AS 21	Consolidated Financial Statements

⁶⁷ It may be noted that International Accounting Standards nos. 3, 4, 5, 6, 9, 13, 15, 22, 25, 30 and 35 have already been withdrawn by the International Accounting Standards Board (IASB).

⁶⁸ Under revision.

⁶⁹ It may be noted that AS 10, Accounting for Fixed Assets, is presently under revision to bring it in line with the corresponding IAS 16. After the issuance of the revised AS 10, AS 6 is proposed to be withdrawn.

19.	IAS 28	Investments in Associates	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
20.	IAS 31	Interests in Joint Ventures	AS 27	Financial Reporting of Interests in Joint Ventures
21.	IAS 33	Earnings Per Share	AS 20	Earnings Per Share
22.	IAS 34	Interim Financial Reporting	AS 25	Interim Financial Reporting
23.	IAS 36	Impairment of Assets	AS 28	Impairment of Assets
24.	IAS 37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets
25.	IAS 38	Intangible Assets	AS 26	Intangible Assets
26.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 32, 39, 40 and IFRS 7	AS 13	Accounting for Investments ⁷⁰
27.	IAS 40	Investment Property	-	Dealt with by Accounting Standard 13 ⁷¹
28.	IFRS 3	Business Combinations	AS 14	Accounting for Amalgamations ⁷²
29.	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations. ⁷³ Further, AS 10 deals with accounting for fixed assets retired from active use.

II. International Accounting Standards/ International Financial Reporting Standards not considered relevant for issuance of Accounting Standards by the ICAI for the reasons indicated.

S. No.	International Accounting Standards/ International Financial Reporting Standard		Reasons
	No.	Title of the Standard	
1.	IAS 29	Financial Reporting in Hyper-inflationary Economies	The Institute notes that the hyper-inflationary conditions do not prevail in India. Accordingly, the subject is not considered relevant in the Indian context.
2.	IFRS 1	First-time Adoption of International Financial Reporting Standards	In India, Indian ASs are being adopted since last many years and IFRSs are not being adopted for the first time. Therefore, the IFRS 1 is not relevant to India at present.

⁷⁰ Indian Accounting Standard on *Financial Instruments: Recognition and Measurement* is presently under preparation. After the issuance of this Indian AS, AS 13 is proposed to be withdrawn.

⁷¹ Indian Accounting Standard corresponding to IAS 40 is also under preparation.

⁷² Under revision.

⁷³ IASB recently issued IFRS 5 and withdrew IAS 35, *Discontinuing Operations*, on which AS 24 is based. An Indian Accounting Standard corresponding to IFRS 5 is under preparation. After the issuance of this Indian AS, AS 24 is proposed to be withdrawn.

III. Accounting Standards presently under preparation corresponding to the International Accounting Standards/ International Financial Reporting Standards

S. No	International Accounting Standards/ International Financial Reporting Standards		Status
	No.	Title of the Standard	
1.	IAS 26	Accounting and Reporting by Retirement Benefit Plans	Under Preparation.
2.	IAS 32	Financial Instruments: Presentation	Under Preparation. Exposure Draft issued.
3.	IAS 39	Financial Instruments: Recognition and Measurement	Under Preparation.
4.	IAS 41	Agriculture	Under preparation.
5.	IFRS 2	Share-based Payment	Under preparation. At present, Employee-share based Payments, are covered by a Guidance Note issued by the ICAI, which is based on IFRS 2. Further, some other pronouncements deal with other share-based payments, e.g., AS 10, Accounting for Fixed Assets.
6.	IFRS 4	Insurance Contracts	Under preparation.
7.	IFRS 7	Financial Instruments: Disclosures	Under preparation.

IV. Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI) corresponding to the International Accounting Standards/ International Financial Reporting Standards

S. No	International Accounting Standards/ International Financial Reporting Standards (IFRSs)		Title of the Guidance Note
	No.	Title of the Standard	
1.	IFRS 6	Exploration for and Evaluation of Mineral Resources	Guidance Note on Accounting for Oil and Gas Producing Activities

**Appendix B. Reconciliation of the International Accounting Standards/ International Financial Reporting Standards with the Indian Accounting Standards
(As on June 8, 2006)**

A) International Accounting Standards/ International Financial Reporting Standards issued by the International Accounting Standards Board

Number of International Accounting Standards (IASs) issued by the International Accounting Standards Board	41
Number of International Financial Reporting Standards issued by the IASB	7
Less: Number of IASs since withdrawn	(11)
Add: IAS 4 has been withdrawn, but, included here for reconciliation purposes because corresponding Accounting Standard of the ICAI (i.e. AS 6) is still in force	1
	<hr/> 38 <hr/>

B) Accounting Standards (ASs) and other documents issued by the Institute of Chartered Accountants of India

1. Number of Indian Accounting Standards issued (excluding AS 8 which is withdrawn pursuant to AS 26 becoming mandatory)	28
2. IAS/IFRS not relevant in the Indian context	2
3. Guidance Note issued by the ICAI ⁷⁴	1
4. Number of Accounting Standards under preparation	7
	<hr/> 38 <hr/>

⁷⁴ Corresponding to IFRS 6 (effective 2006), Exploration for and Evaluation of Mineral Resources, Guidance Note of the ICAI titled 'Accounting for Oil and Gas Producing Activities', has been issued.

Chapter V

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS: CASE STUDY OF JAMAICA

I. Introduction⁷⁵

For many years, Jamaica's accounting standards comprised a mix of International Accounting Standards (IAS). These include IAS, IAS adapted to local peculiarities and locally developed standards to meet the needs of Jamaican companies. With the trend towards global harmonization of accounting standards, the International Accounting Standards Committee (IASC) issued a new directive that prohibited countries, such as Jamaica, from claiming to be in substantial compliance with IAS. This prompted Jamaica to reconsider its standard-setting practices.

Following the significant improvements IASC made to IAS to revise a number of them, to strengthen the standard-setting process, to reduce or eliminate alternative treatments and to meet the mandate of the International Organization of Securities Commission (IOSCO), Jamaica joined its Caribbean partners and an increasing number of countries to review its standard-setting practices and to ensure harmonization of its standards with IAS in all respects, except where comparable standards were not available.

Jamaica adopted International Reporting Standards and International Standards on Auditing with effect from 1 July 2002. All companies, listed and private are therefore required to apply IFRS in the preparation of their financial statements and to have these statements audited in accordance with ISA. Prior to 1 July 2002, Jamaican accounting standards and generally accepted auditing standards were used.

The change has yielded significant improvements in the quality of financial reporting and the regulatory framework in Jamaica. The financial statements have become significantly more complex, but the strong majority position is that Jamaican companies' financial reports are more comparable and consistent with best practice.

The Institute of Chartered Accountants of Jamaica has been a forerunner in promoting regulatory effectiveness and compliance with laws and regulations. The Institute provided important input and guidance in the preparation of the Companies Act (2004).

It sought and obtained the support of regulators, business community and Government in its efforts to raise the standard of accountability, quality of financial information and corporate transparency. Financial reports are now of international standards and the economic environment is more investor friendly. The Institute has responsibility for standard-setting and monitoring compliance with the standards.

⁷⁵ This chapter was prepared and edited by the UNCTAD secretariat with significant inputs from Dennis Brown, Institute of Chartered Accountants, Jamaica.

Rationale for adoptions of IFRS

The adoption of IFRS signified Jamaica's integration into mainstream accounting practice and aimed to ensure that the country's reporting is on par with global standards. As noted by Daley (2003),⁷⁶ the quest for organizational change, based on improved operational performance, is likely to be a key issue in financial markets following periods of distress and crisis. Standards must be relevant at all times to the environment. Where gaps exist, the value and impact of the standards are not maximized.⁷⁷

II. Regulatory framework

Jamaica's regulatory oversight has undergone significant changes, particularly in respect of the financial sector. The system has been reformed since the financial crisis of 1996-1997 and is governed by principles and guidelines. This is attributable to the strengthening of the institutional framework. The regulatory framework is also generally in line with international best practices and the oversight is effectively managed. The regulatory authorities actively monitor the system and implement further reforms as required. Regulatory capitalization limits have been established for most financial institutions to provide them with reasonable safeguards against abnormalities.

The financial system is, however, interrelated to what is described as conglomerate structures that consequently deepens the oversight requirements of the regulators. The relationship poses regulatory risk because of the likelihood of connected lending, conflicts of interest, multiple gearing and contagion in the event of an entity failure. In recent years, there has been a rapid emergence of securities dealers in response to the regulatory improvements and other market developments. The vulnerability of the dealers to interest rate shocks was, however, highly evident in 2003/2004 when the Bank of Jamaica significantly increased nominal interest rate – a move that resulted in those institutions being visibly exposed to near insolvency. The regulators responded by exercising decisive actions to require increased capital, operational accountability and monitoring of these sector entities.

To sustain their relevance and effectiveness, the regulators have embarked on a programme to strengthen their capacity by focusing on areas of weakness, adopting best practices and building staffing resources. The strengthening of inter-agency cooperation is also an improvement in the regulatory framework although more is required in this area. Another area the agencies with oversight responsibilities have focused on is regulatory convergence to reduce unevenness and minimize opportunities for regulatory arbitrage. The objective is to ensure a regulatory framework that accords with global standards and capable of promoting and sustaining a competitive economic environment.

The transition to a high quality financial reporting system must be accompanied by the underpinnings of efficient regulations and supervision and the strengthening of institutional capacity of oversight authorities.

⁷⁶ Jennifer A. Daley (2003). *The Adoption of International Accounting Standards (IAS) in Jamaica: Implication for Financial Stability*.

⁷⁷ International Financial Reporting Standards (IFRS) are developed by the International Accounting Standard Board (IASB). Standards developed by the International Accounting Standards Committee (IASC) are referred to International Accounting Standards (IAS). The full set of standards IFRS and IAS, including the interpretations are generally referred to as IFRS.

A substantial number of bodies with different regulatory power and functions make up the regulatory framework in Jamaica. These include the:

- a) Bank of Jamaica (BOJ);
- b) Financial Services Commission (FSC);
- c) Jamaica Deposit Insurance Corporation (JDIC);
- d) Financial Regulatory Council (FRC);
- e) Public Accountancy Board (PAB);
- f) Institute of Chartered Accountants of Jamaica (Institute/ICAJ);
- g) Companies Office of Jamaica (formerly, Registrar of Companies);
- h) Fair Trading Commission (FTC);
- i) Office of Utilities Regulation (OUR);
- j) Bureau of Standards of Jamaica (BSJ);
- k) National Environmental Protection Authority (NEPA);
- l) Jamaica Intellectual Protection Authority;
- m) Jamaica Stock Exchange (JSE).

The Bank of Jamaica, Financial Services Commission, Jamaica Deposit Insurance Corporation, Financial Regulatory Council and Jamaica Stock Exchange combine regulatory functions for the financial services in Jamaica. The Public Accountancy Board under the Ministry of Finance and the Institute of Chartered Accountants of Jamaica combine responsibilities for the accountancy profession. These responsibilities include entry, training, continuing education, monitoring of, and compliance with, professional standards and complaints and disciplinary issues.

Companies Act (2004)

All businesses and professionals, local and foreign, operating in Jamaica must adhere to the laws and regulations. The Companies Act (2004) is the primary source of legal requirements regarding the operation of a company, including corporate disclosures. The Companies Act (2004) is an act of Parliament that became effective 1 February 2005. It succeeded its predecessor, the Companies Act (1965), which was broadly based on the United Kingdom Companies Act of 1948. The Act prescribes the basis of incorporation, regulation and winding up of companies and other associations registered there-under and makes provisions for other matters relating thereto. There are approximately 40 000 active companies registered under the Companies Act. Forty-two of these companies are publicly listed on the Jamaica Stock Exchange.

The Companies Act requires considerable disclosure and compliance requirements as well as provides for increased penalties for compliance failure. The Act addresses disclosure and other regulatory requirements in relation to:

- incorporation and registration;
- disclosures to be made in a prospectus;
- capitalization minimums;
- management and administration;
- duties and responsibilities of directors and other officers;
- matters relating to winding-up;

- registration and inspections;
- accounts and audit;
- annual reports; and
- meetings and statutory filings.

The Companies Act requires specifically all registered companies to present financial statements in accordance with generally accepted accounting principles promulgated by the Institute of Chartered Accountants of Jamaica. The Institute promulgates IFRS as the national accounting standards since 2002. The Act defines the content and form of the financial statements and requires companies to maintain proper accounting records and documents to show a true and fair view of the company's affairs and explain its transactions. In the case of group companies, the Act provides that consolidated financial statements must be presented, except where the company is a wholly owned subsidiary of another company incorporated in Jamaica. The contents of a set of financial statements as defined as:

- a) a balance sheet;
- b) statement of changes in equity;
- c) a profit and loss account;
- d) statement of changes in financial position;
- e) notes to the financial statements.

The legal requirement for companies to prepare IFRS compliant financial statements facilitates an effective financial reporting system, as all companies are required to be in compliance. The Institute has the regulatory mandate to set accounting and auditing standards. It has, however, no jurisdiction to ensure compliance by non-members. The following organizations are key agents in support of the regulatory framework Entities regulated by them are therefore required to comply.

Bank of Jamaica

The Bank of Jamaica is established by the Bank of Jamaica Law (1960) and began operations in 1961 to formulate and implement monetary and regulatory policies to safeguard the value of the domestic currency and to ensure the soundness of the financial system. Under the Bank of Jamaica Act, the Bank of Jamaica legally has supervisory oversight over institutions governed by the following pieces of legislation:

- a) Commercial banks governed by the Banking Act;
- b) Near-bank deposit-taking intermediaries, such as merchant banks, trust companies and financial houses licensed under the Financial Institutions Act;
- c) Building societies and institutions operating under the Industrial and Provident Societies Act that either take deposits and/or make loans.

The key regulatory provisions are contained in the Banking Act, the Financial Institutions Act, the Building Societies Act and the Bank of Jamaica (Building Societies) Regulations 1995 that govern the licensing and "fit and proper" assessment in relation to shareholders, directors and management.

The regulatory provisions include:

- regulations of shareholding in licences;
- minimum capital requirement;
- compulsory creation of reserves and profits;

- adequacy of capital;
- credit exposure limit;
- investment and fixed assets limits;
- cash reserves and liquidity assets;
- loan classification and provisioning guidelines;
- prudential returns and publication of accounts;
- appointment of auditors;
- examination and sanctions.

Financial Services Commission

The FSC derives its legal jurisdiction from the Securities Act that came into effect in 1993 to make provisions for the securities industry. This FSC was established in 2001 with the mandate to regulate and supervise all financial services that do not involve the taking of deposits in accordance with the Financial Securities Act 2001, which created the FSC. This regulatory body is commissioned to protect users of financial services in the areas of insurance, securities and pension by fostering the integrity, stability and health of the financial sector.

The FSC administers the operations and activities of securities dealers, investment advisors, mutual funds, unit trusts, insurance companies, insurance brokers and agencies. Its mandate includes oversight of the registration, solvency and conduct of approximately 180 firms and 1 400 individuals. In doing so:

- it ensures compliance with the provisions of the Securities Act within the securities industry;
- it issues or refuses licences or registration upon application and suspends or cancels such licences or registration if so granted;
- it ensures compliance with the Insurance Act, Financial Services Act, Securities Act and regulates private persons.
- Specific regulations exist that govern the criteria for licensing and registration of securities dealers, investment advisors and their representatives. It is illegal to conduct business in Jamaica without the requisite licence under the Act.

The FSC implements its activities by the administration of a number of Acts, including the Insurance Act and regulations, Financial Services Act, Pensions Act, Securities Act and Unit Trusts Act. This addresses the solvency standards and actuarial guidelines, appointed actuary, market, conduct standards, fitness and propriety, corporate governance and sanctions and penalties for non-compliance.

Securities Act and regulations – Under this legislation, the FSC covers areas of corporate governance, responsible official, fitness and propriety, mutual funds, issuer registration and capital requirements.

Unit Trusts Act – This Act may be substituted for mutual fund legislation to be enacted in the near future. It provides for fitness and proprietary and corporate governance requirements.

It is expected that as part of the strengthening of the regulatory infrastructures there will be clear distinction between the regulation and supervision of deposit-takers and the regulation

and supervision of other financial services. This requirement is necessary to diminish areas of regulatory unevenness that currently provides opportunity for regulatory arbitrage.

Financial Regulatory Council

The Financial Regulatory Council was established and commenced meeting in 2000. It is a policy-setting body set up to facilitate convergence between the regulators to address evident unevenness of supervision, particularly between banking and other supervisors. Its aim is to ensure greater cohesiveness and efficiency of the financial system, as well as to eliminate regulatory gaps and arbitrage opportunities that can undermine financial stability. The FRC is chaired by the Governor of the Bank of Jamaica. Other members include heads of the FSC and JDIC and the Financial Secretary of the Ministry of Finance.

The FRC exercises its regulatory influence by the sharing of information, especially on dually-supervised entities and groups, including conglomerates and critically identifying supervisory gaps and coordinating responses to problems discovered in the financial system. It also has a mandate to promote harmonization of prudential norms and the underlying principle of safety and soundness regardless of the complexity, range and diversity of financial groups and products.

Jamaica Deposit Insurance Corporation

The source of the JDIC's authority is the Deposit Insurance Act of 1998 (DIA). Its legislated mandate is to provide protection to small savers and exercises a shared role in safeguarding the country's financial system. Its key functions are to establish and manage a scheme for insurance of deposits against loss. The Deposit Insurance Act prescribes an insurance cover limit for each depositor and provides for the establishment of a Deposit Insurance Fund from which depositors will be paid where a financial institution fails to do so because of regulatory intervention by the BOJ or the Minister of Finance.

The JDIC does not have regulatory or supervisory authority. It must therefore work closely with the Bank of Jamaica to discharge its responsibilities effectively. The JDIC is entitled to request and receive on-site reports and other relevant information from the BOJ. Arrangements for information sharing between the BOJ and JDIC are specified in the Deposit Insurance Act, although no such arrangements exist between the JDIC and international agencies. The company's policy is to consult with the insured financial institutions before introducing mandates of a substantial technical nature. The Board of Directors and employees of this institution are bound by the provisions of the Public Bodies Management and Accountability Act (PBMA).

The PBMA was established in 2001, modified 2003 to address the operations of government-owned companies and statutory bodies. The Act seeks to increase the accountability of all public bodies and provides for, inter alia:

- a) improvements in corporate governance and accountability in reporting;
- b) establishing a measure of duty of care, disclosure and general conduct of director and others;
- c) providing sanctions for non-compliance with the provisions relating to corporate governance and accountability;
- d) detailing the format and contents of reports to be generated by public entities.

The Ministry of Finance in 2005 set out in its strategic programme to achieve as an outcome the effective regulation of financial institutions. It noted that the continued stability in the financial sector is critical to the growth prospect of the country and in this regard, it reaffirms its intention through the BOJ, the FSC and the JDIC to continue to employ strategies to maintain this stability. Specific focus is on:

- a) expediting the development of an adequate regulatory framework for private pensions;
- b) reducing money laundering activities through improved legislation and closer partnership with international bodies;
- c) reinforcing the role of the regulatory agencies in the financial sector;
- d) continuing institutional strengthening of the regulatory bodies.

It recognizes also the need and is working to strengthen the financial management process of public entities by ensuring timely financial reporting.

Public Accountancy Board

The Public Accountancy Act 1968 established a regulatory framework for the accounting profession. The Act created the Public Accountancy Board, a statutory body to issue licences to registered public accountants and promote acceptance standards of professional conduct by registered public accountants. Decisions by this regulatory agency are subject to approval by the Minister of Finance who has authority to issue regulations relating to the profession. The Minister's authority includes the making of complaints against registered public accountants and regulations governing the disciplinary investigations undertaken by the Board and the procedure for approving applications for registration as a registered public accountant.

The PAB exercises its mandate by being the legal authority that issues licences to registered public accountants who must also hold a practicing certificate from the PAB. Only registered public accountants have the legal authority to sign audit reports on financial statements. Practicing certificates may be issued to:

- a) members of the Institute of Chartered Accountants of Jamaica who hold practicing certificates from the Institute;
- b) Jamaican citizens who are entitled to practice in another country by virtue of another professional qualification appraised by the Minister of Finance; and
- c) a few persons who are qualified by experience and who practiced as public accountants prior to 1968.

The Institute of Chartered Accountants of Jamaica (the Institute)

The Institute was established in 1965 to regulate chartered accountants in Jamaica. It has responsibility for setting accounting and auditing standards. Some of the broad objectives of the Institute are to:

- a) promote and increase professional knowledge through training;
- b) regulate the discipline and professional conduct of Jamaican accountants;
- c) develop and set standards to ensure the integrity and soundness of the accountancy profession.

The Institute has approximately 800 members of which 200 are practicing members authorized by it to carry out audits. Members authorized by the Institute to practice are entitled to practicing certificates from the Public Accounting Board (PAB). There is no requirement for all registered public accountants or accountants in general to become members of the Institute. The four major international professional services firms are represented in Jamaica. Three of the four are the auditors of virtually all listed companies operating in the country.

The PAB and the Institute entered into an agreement to share responsibilities to ensure unified standards for the control, monitoring and discipline of all registered public accountants in Jamaica and to improve the effectiveness of the PAB as the legal authority for the oversight of registered practicing accountants in Jamaica. The financial services regulators rely significantly on external auditors of the regulated entities to ensure compliance with accounting and financial reporting requirements and to report compliance failures. These firms are the primary source of knowledge on IFRS and ISA issues and share this knowledge routinely with the regulators. This is attributable to the fact that these regulators are still in the process of strengthening the standards and procedures and building capacity to monitor and enforce compliance.

Currently, financial reporting compliance is monitored by reviewing published financial statements of all publicly listed companies and regulated entities. With the support of the Inter-American Development Bank under a cooperation agreement, the Institute is in the process of establishing a more comprehensive monitoring and compliance programme. This programme will include peer reviews of auditing firms, practice management reviews and identifying resource gaps.

The Institute is also collaborating with The Institute of Chartered Accountants of the Caribbean (ICAC) to establish a regional monitoring unit with responsibility for the evaluation and assessment of the quality of audit and other public practice work in member countries. The implementation of this unit will ensure transparency of the quality of audits and other public practice work. The arrangement with the ICAC is intended to facilitate independence in the practice monitoring process.

The Institute is a member of International Federation of Accountants (IFAC) and requires its members to comply with IFAC's ethical, professional and educational standards. The standards issued by the Institute include the standards issued by the IFAC in addition to those promulgated by the Institute. Professional education requirements for becoming a member of the Institute are consistent with international standards and must meet continuing professional developments requirements of at least 35 hours of qualifying professional education annually, over three years. In response to this requirement, the Institute hosts a number of educational training programmes, which are also promoted to the wider community.

Companies Office of Jamaica (formerly, Office of the Registrar of Companies)

The Companies Office of Jamaica falls under the Ministry of Industry, Commerce and Technology with responsibility for the day-to-day administration of companies, trademarks, industrial designs, industrial and provident societies, business names and recording of patents.

The organization registers local and overseas companies, Industrial and Provident Societies and individuals carrying on business in Jamaica. Its mandate is to ensure that there is compliance with the Companies Act, the Registration of Business Names Act and the Industrial and Provident Societies Act. It also maintains up-to-date records of all companies and businesses registered.

All companies registered under the Companies Act must file prescribed returns including annual returns with the Companies Office of Jamaica. This agency is empowered to take legal action against delinquent entities to enforce compliance.

Jamaica Stock Exchange

The Jamaican Stock Exchange (JSE) was incorporated as a private limited liability company in August 1968 and commenced trading in February 1969. Its primary objectives are to:

- promote the development of the stock market in Jamaica;
- ensure the stock market and participants operate at the highest standard;
- develop and enforce rules designed to ensure public confidence in the market;
- provide facilities for the trade of stock; and
- conduct research and provide information to and on the market.

The company has a Board of Directors consisting of 18 members and facilitates trade in securities, shares, ordinary and preference and corporate bonds. Government bonds are not listed on the Jamaican Stock Exchange but by the Bank of Jamaica in an over-the-counter market. Listing of securities on the JSE is however, at the absolute discretion of the Council of the JSE. The minimum requirements for listing of a company's securities are:

- total issued share and loan capital of \$500,000 or more,
- minimum number of 100 shareholders for companies with ordinary shares.

Companies incorporated in Jamaica may be listed by a prospectus issue, an offer for sale, an offer by tender, a placing or an introduction. In 2000 the JSE established the Jamaica Central Securities Depository. Arising from this development share certificates are dematerialized. There has been increased global attractiveness of the stock market through adoption of generally accepted international standards.

Financial reporting and disclosure

Jamaica has a differential disclosure regime for financial reporting purposes. The types of companies may be classified as:

- a) Publicly listed and regulated companies;
- b) private companies;
- c) small companies.

All companies are required to prepare annual financial statements. These statements must be audited and circulated to the members, except for small companies that may claim exemption under the Companies Act. Companies are also required to file annually with Companies Office of Jamaica a true copy of the balance sheet and profit and loss account together with a copy of the auditors' report.

In addition to meeting the disclosure requirements, publicly listed companies are required to file with the Jamaica Stock Exchange and publish in the media quarterly abridged financial statements. These must be accompanied by a directors' report and signed by at least two directors.

Companies file their annual financial statements within ninety days of their financial year end and quarterly financial statements within forty-five days of the end of the quarter. Qualifying small companies may seek exemption under the Companies Act from audit of its financial statements and from preparing the financial statements to comply with IFRS.

There are three important areas of the Jamaican financial reporting framework that must be observed:

- a) IFRS must be used by all entities in their preparation of financial statements. Qualifying small companies that elect exemption to prepare these financial statements and accordingly may omit to do so, but must apply the standards issued by the Institute of Chartered Accountants of Jamaica that are applicable to their nature and complexity to show a true and fair view of their state of affairs and results of operations;
- b) International Standards on Auditing (ISA) must be used for the purpose of auditing financial statements;
- c) monitoring of the system to ensure there is compliance with the Companies Act and IFRS in the preparation of financial statements and that the financial statements are audited in accordance with ISA.

III. Capacity-building

One of the challenges confronting a developing country such as Jamaica is the creation of a sustainable economic environment that promotes adequate corporate disclosure and is supported by an effective legal and regulatory infrastructure. The benefits of underpinning the country's financial reporting system with a set of high-quality globally recognized financial reporting standards are considered significant in achieving this end.

Reporting under IFRS gives rise to expected outcomes of clarity, comparability and consistency, which are important elements for an investor in assessing a country's attractiveness. It was important therefore for Jamaica to build the capacity to sustain an improved financial reporting framework bolstered by an efficient and responsive legal and regulatory infrastructure. Some key elements that have been identified as critical underpinnings for the sustainability of this framework are:

- professional education and training;
- sound corporate disclosure to be achieved through an effective process of dissemination of corporate reports;
- allocation of resources;
- efficient monitoring and compliance.

The anticipated results from the implementation of these elements were:

- stimulation of a system of broader conformity;
- improved investor confidence;
- general public esteem; and
- enhancement of the profession's reputation.

The Institute of Chartered Accountants of Jamaica as a key driver in this process of change towards an enabling environment of legal and regulatory frameworks identified a number of challenges that require specific actions as part of this process of strengthening the institutional and human resource capabilities and contributing to a wider system of capacity-building.

The capacity-building agents identified are the:

- **Regulators:** These agencies were created and empowered by specific Acts and regulations to issue mandates and enforce compliance. Therefore, efficiency and effectiveness of the regulatory framework is influenced by how well regulatory agencies perform.
- **Investors:** Investors benefit when financial statements, accounting standards and auditing procedures are prepared on a consistent basis and are comparable across industry and countries. Investors must be empowered with adequate knowledge to be able to interpret the financial statements and understand the basis for fluctuations and swings in the performance of companies and the market.
- **Government ministries:** The government sets macro-economic policies that influence economic growth and national focus. The government is also responsible for the enactment of laws that create the legal system. The governments understanding of the relationship between an effective legal and regulatory system and economic growth is an important factor in capacity building.
- **Accountancy profession:** The critical capacity-building agent in the successful implementation of the IFRS in Jamaica is the Institute of Chartered Accountants of Jamaica. The accountancy profession, represented by its Institute, designed and championed the transition to IFRS to enhance the financial reporting system. This process includes peer-to-peer learning, institutional development, training, research and publishing.
- **Stakeholders:** financial analysts and other users. Financial analysts are expected to be able to assess the quality of a company's reported performance and evaluate the appropriateness of management's forecasts. Similarly, other users should have the competence to understand the company's business and whether the business model is consistent with reported results. The stakeholders include other sectoral interest groups, including academics.

Four key focus areas adopted as part of the programme of transition included:

- training;
- human resource development – equipping individuals with increased knowledge, information and training to ensure they are able to perform at a higher standard;
- organizational development – providing guidance in how to improve processes and structures to effectively apply the provisions of the new standards;
- institutional and regulatory framework – enhancing the resource capability of the Institute as a source of reference, collaborating with regulations by inviting their participation in committee discussions and assisting them with training; also, contributing to debates on legal and regulatory changes.

Some specific areas undertaken as part of the process to ensure the successful and sustainable effectiveness of the new reporting framework are as follows:

- a) **Build expertise and professional capacity within the accountancy profession.** This has been achieved through increased level of training, improved access to by-laws and accounting principles, as well as through a programme of improved collaboration and cooperation with regulators, particularly within the financial sector. Increased collaboration was also forged with professional and trade associations.
- b) **Strengthen the Institute’s oversight capabilities.** The interest was to establish “Expert Committees” on each major sectoral interest, including taxation, accounting and auditing, banking and other activities addressed under the Banking Act, near-bank and related activities covered under the Financial Institutions Act and Insurance Act. The Committee members were intensely trained in the relevant subject area to provide the appropriate guidance, as well as. Additionally, the intent has been to strengthen the investigative and disciplinary capabilities of the Institute to provide effective oversight over delinquent members and to be able to identify and report breaches of non-members, as appropriate. Significant improvements have been made by the regulators in enhancing their capacity to provide effective oversight over their sectoral areas. Laws have introduced or strengthened to increase the penalties for violations. The programme also included the creation of a resource/research centre as an information source to members of the Institute and the wider community.
- c) **Assist in strengthening the legal framework.** Efforts continue to be made to encourage the establishment of a regional monitoring unit to promote individual and firm-wide compliance with the standards. The Institute has been working with the relevant bodies to overcome the legal restrictions in some regional territories. The desire is to have a single regional monitoring unit that covers the eight major English speaking countries of the region.
- d) **Collaborate with trade associations and regulators to promote good governance practices.** The decision to adopt IFRS and ISA as the national accounting and auditing standards, respectively, was deemed an important step in enhancing the financial reporting capacity. It was however, also important to ensure that this capacity was further strengthened by rigorous interpretation and application of the standards on a country-wide basis. In this regard, the Institute entered into a technical cooperation agreement with Inter-American Development Bank for funding assistance. The broad areas of the Agreement are:
 - the dissemination of information on IFRS;
 - training and outreach;
 - building enforcement and compliance capabilities of IFRS;
 - building for sustainable training programmes.

Following the Institute’s decision to transition to IFRS, the World Bank sponsored an assessment of the implementation of accounting and auditing standards as part of a programme to determine the gaps in standards and compliance. The review was undertaken as part of a programme of the Reports on the Observance of Standards and Codes (ROSC) initiative.

Utilizing the results of the ROSC review and recognizing that elements of the gaps identified were due to human and institutional resource constraints, the Institute committed itself to building financial resources to ensure its capacity building efforts would be sustained.

- e) **Develop a Country Action Plan, setting out a logistic framework of targeted activities to be completed within a specified period.** This included having road shows to explain the objective, consequences and benefits of the change to global standards and the need for compliance, sensitizing government ministers of the potential impact of the conversion to IFRS, including the benefits and regulatory synergies to be derived, meeting with business leaders and guiding them on how to communicate the impact of the change on business performance and the market as a whole, including the need to review the effects on agreement covenants. Involve the auditing firms as channels for communicating to and assisting with the training programme, including specific training for their clients.
- f) **Design and implement a task-driven action programme that includes:**
- the Consultative Committee, comprising among others, sectoral experts to be fully functional to assist on an ongoing basis;
 - a strategic publicity and educational programme that addresses important IFRS and ISA issues in the media routinely, the Institute's website and communicated at specially arranged seminars and workshops;
 - strategic seminars and workshops conducted by internationally recognized experts to train users and preparers of financial statements, develop ability to interpret and apply the standards;
 - develop a programme of review of financial statements and communicate significant findings to the lead engagement auditors;
 - hosting 'train the trainer' sessions utilising international experts to build a cadre of targeted local trainers to ensure sustainability of a high quality of trainers;
 - promote efforts to legislate the requirement to prepare their financial statements using IFRS. This is achieved by participating in special review of Companies Act 2004 to include this requirement;
 - reliance on auditing firms to build and utilize their training skills and competence to assist in building stakeholders' awareness. The requirement also included hosting training sessions for their clients and provided them with helpful toolkits to guide them in the conversion process;
 - strengthening the Institute's by-laws and disciplinary committees to ensure sanctions are applied for major violations;
 - identifying a set of standards that are applicable to small entities and adopt them as the small company standards. Currently, these companies need to apply IFRS under the Companies Act.

IV. Lessons learned

The creation of an enabling environment that is bolstered by an effective regulatory framework is an important factor in the economic development of a country. To ensure investor attractiveness such an economy must have a strong financial reporting framework evident by high quality global standards.

The adoption of IFRS in 2002 helped to strengthen Jamaican financial systems by encouraging stronger regulation and supervision, greater transparency and more efficient and robust institutions, markets and infrastructure. It also represents a major change in the country's reporting structure.

The ethos of IFRS is fair value accounting and that presents interpretational and application challenges for most stakeholders. The underlying emphasis of this concept is the recognition of the substance over form of a transaction. The potential vulnerability in reported results arising from fluctuations in the value of assets and liabilities was consistently illuminated in discussions with market players. There are underlying fears that must be overcome. Many deemed IFRS as more relevant to multinational corporations and in most instances, inappropriate to smaller size entities as exist in developing economies such as Jamaica. However, the expected outcome that include increased financial stability, better investment and lending decisions, informed market integrity and reduced risk of financial distress and contagion outweigh the disadvantages.

Some key lessons learned from exercise are:

- (a) Effective implementation of IFRS requires careful planning and extensive public education, the allocation of resources, a legal and regulatory support system and institutional support with strong management systems. Unless stakeholders are integrally involved and included in development plans and how they are affected, they will be reluctant to support the change.
- (b) The communications system for informing users of the changes in reporting requirements must be effective and responsive. Users of financial statements have to be able to interpret financial reports and raise questions about an entity's performance. Efforts to build good corporate governance and enhance corporate transparency will be successful only when these key stakeholders have the desired knowledge to understand the financial reports and interrogate reported information.
- (c) Adequate resources must be put in place to support the sustainable implementation of IFRS and ISA. This includes having consultative groups available to respond promptly to concerns by users and to provide for their ongoing training. Assisting key stakeholders, including regulators with training to ensure they have the required resources to interpret and apply the requirements of IFRS is a critical element underlying the successful implementation of IFRS.
- (d) Many of the standards include complex and detailed disclosure issues applicable to larger companies. However, as the majority of companies in Jamaica are small- or medium-sized enterprises, alternatives have to be put in place to accommodate their needs. Suitable standards must, therefore, be developed to facilitate recognition of these companies.
- (e) Continuing training is an important factor in transitioning to IFRS. The continuous and wide scale changes present a significant challenge for a developing country with limited resources and available experts. It is however, important to ensure that training is available for auditors, regulators, analysts and other users necessary.
- (f) Strong institutional framework must be in place to champion and manage the change process.

- (g) The adoption of IFRS can have an impact on the country's national statistics. Data on productivity, efficiency and profitability are often times collected by the government statistical authority for national reporting.

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Chapter VI

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS: CASE STUDY OF KENYA

I. Introduction and background⁷⁸

This case study focuses on Kenya, which was one of the first countries to adopt the use of IFRS and IAS in 1999. Over the years, Kenya has developed a wealth of experiences in the use of IFRS which would provide useful insights in the development of strategies by ISAR to aid other countries in the implementation of IFRS.

There is one stock market in Kenya, the Nairobi Stock Exchange, in which the shares of about 50 companies are traded. In addition to these listed companies, there is also a sizeable number of companies which are either multinationals or owned privately by Kenyans, as well as a large number of small- and medium-sized enterprises (SMEs). In terms of financial reporting, all these companies are required to prepare financial statements based on International Financial Reporting Standards (IFRS). In most cases however, most SMEs would prepare financial statements for use by the tax authorities or by the banks for purposes of accessing credit.

Other public interest companies such as, among others, banks, insurance companies, cooperative societies, non-governmental organizations also prepare accounts in accordance with IFRS.

With respect to auditing, all companies are required to be audited in accordance with the International Standards on Auditing. In most cases though, it is the larger companies that would seek to be audited. SMEs are only audited when necessary for tax purposes or as a requirement to access credit. The auditing sector/industry in Kenya is fragmented with about 500 firms practising. Of these, four are considered as large with international linkages and they audit practically all the large multinationals, banks, insurance companies and the listed companies. There are about ten or so medium-sized firms with more than two partners and the rest of the audit firms are largely one or two-partner firms.

⁷⁸ This document was prepared and edited by the UNCTAD secretariat with substantive inputs from Caroline J. Kigen, Institute of Certified Public Accountants, Kenya.

II. Regulatory framework governing financial reporting in Kenya

Statutory framework governing the accountancy profession in Kenya

The accounting profession in Kenya is regulated by the Accountants Act Chapter 531, Laws of Kenya which was enacted on 1 July 1977. The Accountants Act established three bodies, namely the:

- a. Kenya Accountants and Secretaries National Examinations Board (KASNEB), which was given the responsibility of administering examinations for persons intending to qualify for registration as accountants and company secretaries. The Board administers the Accounting Technicians examinations as well as the higher level Certified Public Accountants (CPA) examinations.
- b. Registration of Accountants Board (RAB), which was to be responsible for the registration of those who have attained the specified qualifications after passing the relevant examinations administered by KASNEB. Persons holding designated foreign accountancy qualifications are allowed to be registered with the RAB after passing the examinations in company law and taxation administered by KASNEB. The RAB also issues practicing certificates to those who have met the requirements prescribed for issuance of a practicing certificate. These requirements include prior registration and membership of ICPAK as an accountant, as well as relevant experience in auditing for a minimum period of two years.
- c. Institute of Certified Public Accountants of Kenya (ICPAK), which is responsible for the oversight of the profession. Once someone is registered as an accountant by the RAB, he or she becomes eligible for membership of ICPAK. ICPAK is mandated by the Accountants Act to perform the following functions:
 - i. to promote standards of professional competence and practice amongst members of the Institute;
 - ii. to promote research into the subjects of accountancy and finance, and related matters, and the publication of books, periodicals, journals and articles in connection therewith;
 - iii. to promote the international recognition of the Institute;
 - iv. to advise the Examinations Board on matters relating to examination standards and policies;
 - v. to carry out any other functions prescribed for it under any of the other provisions of this Act or under any other written law; and
 - vi. to do anything incidental or conducive to the performance of any of the preceding functions.

Membership of ICPAK is voluntary. Currently the membership of ICPAK numbers about 3 500 whereas statistics available from KASNEB indicate that as at the end of 2005, there were a total of 10 500 persons who had completed the final level of Certified Public Accountants examinations.

The existing statutory framework described above provides for the regulation of the profession through three separate entities. This poses various challenges particularly when it comes to decisions that impact the whole spectrum of accounting profession. ICPAK is a member of the International Federation of Accountants (IFAC) and is responsible for the implementation of International Education Standards aimed at strengthening the CPA qualification process; the qualification process is, however, managed by KASNEB. There is need for the two institutions to work closely together and obviously the need for consensus-building means that there will be delays in undertaking any reforms impacting on the qualification process. There are also challenges in coordinating the work of ICPAK and RAB to ensure that quality standards are adhered to.

With respect to financial reporting and auditing, the Accountants Act is not explicit that the authority to issue standards of professional practice, including accounting and auditing standards which shall form the basis of accountancy practice in the preparation, verification and auditing of financial statements vests with ICPAK. Although financial statements are currently prepared in accordance with standards prescribed by ICPAK, there are currently no legal requirements for companies to comply with the standards issued by ICPAK.

The weaknesses in the Accountants Act are being addressed through a revision of the Act that is being undertaken by a taskforce appointed by the Minister of Finance in 2004. The proposed changes that will impact on financial reporting include giving ICPAK the legal authority to issue standards for use in financial reporting and auditing.

Statutory framework governing financial reporting in Kenya

In Kenya, the main legislation governing companies, including the financial reporting is the Companies Act. However, there are other legislations that impact on financial reporting. These deal with specialized sectors such as the insurance sector, banks and listed companies.

The Companies Act (CAP 486)

The Companies Act requires all limited liability companies to prepare and keep proper books of account as are necessary to give a true and fair view of the state of the companies' affairs and to explain its transactions. The Act further requires companies to present a Profit and Loss Account and a Balance Sheet each year during the Annual General Meeting and prescribes in detail what should be included in the Profit and Loss Account and in the Balance Sheet.

The Kenyan Companies Act, borrowed from the U.K. Companies Act of 1948, does not reflect the requirements set out in the Accountants Act and neither does it recognize the Institute's authority to oversee and prescribe the financial reporting framework to be adhered to by companies in preparing financial statements. The "true and fair view" concept is not defined in the Act.

The Companies Act prescribes in detail what should be included in financial reports but some of the requirements of the Act fall short of those of International Financial Reporting Standards. For instance the Act does not require preparation of a Cash Flow Statement among others.

With respect to audits, the Act requires companies to appoint auditors who must be members of the Institute and who meet the criteria for an auditor as laid out in the Accountants Act. The Act further specifies that the auditors' report should appear as an annex to the profit and loss account and balance sheet and prescribes the contents of the auditors' report. However, the

Act does not specifically require the auditor to conduct audits in accordance with International Standards of Auditing.

Industry specific legislation governing financial reporting

Various industries are governed by various specialized legislation and these make provisions with regard to financial reporting. Some of the legislation requires the use IFRS and International Standards on Auditing as the basis for preparation and auditing of financial statements. These include regulations issued by the Capital Markets Authority, governing the companies whose shares are listed and traded on the Nairobi Stock Exchange as well as those issued by the Central Bank of Kenya governing banks operating in Kenya. Thus listed companies and banks are specifically required to use IFRS in the preparation and audit of their financial statements.

In the case of the insurance sector in Kenya, while the Insurance Act requires preparation and audit of accounts, the Act does not specify the basis of preparing these accounts. The Act further specifies various schedules that must be filled by the companies containing prescribed financial information. These should be filled with the Commissioner of Insurance annually. With the issue of IFRS 4 on Insurance Contracts, it emerged that the provisions of the schedules as contained in the Act were contrary to the provisions of the standard. There were conflicts that emerged regarding how insurance companies would prepare their financial statements and after extensive discussions between ICPAK and the Commissioner of Insurance in Kenya, it was agreed that companies would prepare one set of financial statements that are IFRS compliant and would also fill the schedules as provided in the Act and send them to the Commissioner of Insurance. However, where the figures in the schedules prescribed by the insurance act differed from those in the financial statements that are prepared in accordance with IFRS, then companies were to prepare appropriate reconciliations which were to be certified by the auditor. This of course poses a burden on insurance companies in Kenya.

Other regulations impacting on financial reporting include legislation dealing with retirement benefit schemes, cooperative societies and local authorities. In some cases the provisions of these laws hinder the implementation of IFRS.

To deal with these regulatory challenges, ICPAK has adopted a policy of working with various regulators to sensitize them on the importance and the need for IFRS and ultimately promote ICPAK's role as the authority governing financial reporting. ICPAK continues to lobby for the incorporation of IFRS as the reporting framework in various legislation governing financial reporting in Kenya. In this regard, ICPAK recognizes that regulators may not have the technical expertise on financial reporting aspects, and therefore works with them in revising legal provisions to align them with IFRS provisions.

III. Implementation status: accounting and auditing standards

In 1998, the Council of the Institute of Certified Public Accountants of Kenya (ICPAK) made a historic decision to adopt International Financial Reporting and Auditing Standards for use in Kenya. Accordingly therefore, all companies were required to prepare financial statements based on International Accounting Standards (IAS) for periods beginning 1 January 1999 while the audits of all financial statements for period ending 31 December 1999 were to be carried out based on International Standards on Auditing (ISA).

Prior to this, ICPAK had issued Kenyan Accounting and Auditing Standards that were largely adopted from the IAS and ISA modified to suit the Kenyan environment. The decision to adopt international reporting standards fully was made at a time when the Kenyan business scene was reeling from numerous bank failures in the 1980s and 1990s. These failures raised questions as to the reliability of audited financial information and particularly the fact that the financial statements of these banks did not provide any early warning signs about these bank failures.

The 1990s were also characterized by privatization of companies that were previously wholly state-owned. Some of the privatization was through a sale of shares at the Nairobi Stock Exchange. There was beginning to be an interest in the capital markets and to sustain this interest there was a need to improve corporate governance practices that prevailed at the time.

ICPAK recognized that to promote confidence in the capital markets and in the business environment in general, the country needed a globally accepted reporting framework which would result in quality financial reporting that would address the expectation of the users of financial statements. Indeed, at this time there was pressure from various regulators including those charged with overseeing the capital markets and the Central Bank to adopt IAS as these reflected best global practices.

The Council also took into account the scarce resources available at the Institute. Rather than utilize these scarce resources in the development of standards, it was felt that it would be more useful to utilize these resources to interpret IAS and provide user support. In any event, most of the Kenyan standards that had been issued so far were to a large extent compliant with international standards, albeit with a few modifications. During this period, there were 18 Kenyan Accounting Standards and about 20 Kenyan Auditing Guidelines in use. At the time of adopting international standards, there were International Accounting Standards 1 to 39 and International Standards on Auditing numbers 100 to 930 and International Auditing Practice Statements numbers 100 to 1011. Of the Kenyan accounting standards, 6 of them had no material differences with the corresponding IAS, while the others had a few differences here and there. About 20 of the IASs had no corresponding or equivalent Kenyan standard.

Prior to adopting international accounting and auditing standards, the Institute through its Professional Standards Committee, undertook extensive consultations with ICPAK members, preparers as well as various regulators particularly those in charge of the stock exchange and the banks as well. The committee issued various technical guidelines aimed at educating members on the differences between the Kenyan standards that were in use at the time and the international standards. Various technical seminars were also held to prepare for the full-scale adoption of international standards. At the same time, a technical desk was set up to help deal with queries that may arise in the course of preparing financial statements. The Institute also made arrangements to avail the books on the standards at reasonable rates to members. Various videos on accounting and auditing standards were obtained and shared with members through joint video sessions, after which these videos were availed in a technical library. Members were free to borrow and make use of these videos amongst other resource materials that were assembled to aid in the adoption process.

Since the adoption of international standards, there have been various benefits. There has been enhanced comparability of financial statements and the provision of better financial information that facilitates analysis and decision-making by various users. The stock market has witnessed increased activity and there has also been increased cross border investments. The use of international reporting and auditing standards provides safeguards to the public and generally increases public confidence in financial reporting. There has been increased reliance by the regulators on financial reports which provide them a fairly reliable oversight mechanism.

Status of compliance with IFRS among Kenyan companies

In a bid to entrench and encourage the use of International Financial Reporting Standards (IFRS), ICPAK established an award known as the Financial Reporting (FiRe) Award in 2002. This award involves the evaluation of financial statements which have been voluntarily submitted by companies, to gauge their compliance with the requirements of IFRS. In 2005, six years after implementation of the IFRS in Kenya, there was no single company which exhibited 100 per cent compliance with IFRS out of a total of 84 companies who submitted their financial statements for review. The 2005 compliance levels are as shown in the table below, where 100 per cent denotes full compliance with all the requirements of IFRS including disclosure requirements and vice versa.

Compliance with IFRS recognized in the 2005 *FiRe* awards⁷⁹

Compliance levels achieved	Number of companies achieving the compliance levels				
	Insurance sector	Banking sector	All other companies	Total	
				No.	In per cent
Above 80 per cent	3	0	10	13	16
60 to 79 per cent	12	10	15	37	44
50 to 59 per cent	7	1	3	11	13
Below 50 per cent	3	15	5	23	27
Total No.	25	26	33	84	100

As can be seen from the above table, while Kenya adopted the use of IFRS in 1999, the levels of non-compliance are quite high. This is especially the case when you consider that the above companies were quite large and indeed about 45 of them are listed on the Nairobi Stock Exchange. These companies have the resources to recruit well-trained professionals and in the case of the listed ones are required to comply with IFRS when preparing financial statements. Given this, one can expect that the level of compliance among the other private companies and small and medium enterprises is likely to be quite low.

The FiRe Award helps ICPAK to understand the areas of weaknesses in financial reporting and to design mechanisms to address these weaknesses. In early 2006 for example, various training sessions were organized focusing on presentation of financial statements and disclosure requirements of IAS 1 and 8. This training attracted about 300 participants and was well received. However, it should be noted that ICPAK has adopted the approach to encourage compliance rather than institute disciplinary measures against those companies where there is non-compliance.

Areas of non-compliance with IFRS among Kenyan companies

From the evaluation of the Annual reports submitted for the 2005 FiRe awards, the following were the key areas where there was non compliance with the best practices as promulgated in the IFRS in preparing the financial reports;

⁷⁹ Based on data compiled by the Institute of Certified Public Accountants of Kenya.

IAS 1: Presentation of financial Statements

Offsetting: IAS 1 provides that assets and liabilities, and income and expenses should not be offset unless required or permitted by a particular standard or an interpretation. Offsetting may inhibit users' understanding of the substance of transactions and events that have occurred and prevent them from accurately assessing the entity's future cash-flows. It was observed that some companies were netting off various items in the income statement even where this was not permitted by any standard contrary to the above requirements

Identification of the financial statements: IAS 1 provides that financial statements as well as each component of financial statements should be identified clearly and distinguished from other information in the same published annual report or document. IFRS apply only to financial statements and it is therefore important that users are able to distinguish information prepared using IFRS from all other information presented in the annual reports that while useful to users is not subject to the requirements of IFRS. Annual reports should therefore clearly identify and distinguish what constitutes the financial statements either in the table of contents or elsewhere in the report. IAS 1 (p 46a) further provides that the name of the reporting entity or any other means of identification should be displayed prominently. It was observed that while companies generally included financial statements in the table of contents, it was not possible to distinguish these from other information in the annual report.

Information to be presented on the face of the balance sheet, income statement or in the notes and other disclosures: The following was information that should have been presented but in some cases was not:

Provisions: IAS 1 provides that provisions made in the current period are one of the line items that as a minimum must be included on the face of the Balance Sheet.

Reserves: IAS provides that the nature and purpose of each reserve within equity should be disclosed either on the face of the balance sheet or in the notes to the accounts.

Gross revenue: IAS 1 requires that as a minimum the face of the income statement must include a line item presenting the revenue for the period. Non-compliance of this requirement was noted mainly in the insurance sector.

Dividends: IAS 1 requires disclosure either on the face of the income statement, or the statement of changes in equity or in the notes, the amount of dividends recognized as distributions to shareholders during the period and the related amount per share. Further IAS 1 requires disclosures of the amounts of dividends that had been declared before the financial statements were authorized for issue but were not recognized as a distribution to shareholders during the period.

Domicile and country of incorporation: IAS 1 requires disclosure of the domicile, legal form of the enterprise and its country of incorporation.

IAS 2: Inventories

Inventories: IAS requires disclosures of the accounting policies that have been adopted including the cost formulas used in determining the cost of inventories. In addition, the carrying amount of the inventories carried at net realizable value should be disclosed.

IAS 7: Cash flow statements

Preparation of cash flow statements: IAS 7 requires preparation of a cash flow statement for the entity as a whole which shows how the company generates and uses cash and cash equivalents. It was observed that some companies presented cash flow information for only a section of the business rather than for the enterprise as a whole. For instance, an insurance company would present cash flows for only the general business and not the life business.

Acquisition of a subsidiary: IAS 7 requires that where a subsidiary was acquired during the period, the cash flow statement should clearly indicate the portion of the purchase price that was paid by means of cash and cash equivalents as well as the amount of cash and cash equivalents in the subsidiary that was acquired. It was observed that there were instances when an acquisition had occurred but this information was not disclosed.

IAS 12: Income taxes

Deferred tax on revaluation: IAS 12 requires recognition of a deferred tax liability for all taxable temporary differences. IAS 12 further notes that at times an asset is revalued and this revaluation does not affect the taxable profit for the current period. In such a case, the future recovery of the asset's carrying amount will result in a taxable flow of economic benefits to the entity and the amount deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of the revalued asset and its tax base is a temporary difference and therefore gives rise to a deferred tax liability that should be recognized. This in most cases was not being done.

IAS 14: Segment reporting

Segment Reporting: IAS 14 establishes the principles for reporting financial information by segment and should be applied by all those entities whose equity or debt securities are publicly traded. Those entities whose securities are not publicly traded but choose to disclose segmental information voluntarily in financial statements that comply with the IFRS, should comply fully with the requirements of IAS 14. Many companies, both listed and non-listed, which presented segmental information failed to comply fully with the requirements of IAS 14.

IAS 16: Property, plant and equipment

Revaluation of property, plant and equipment: IAS 16 requires that an increase in the asset's carrying amount resulting from revaluations should be credited directly to equity under the heading revaluation surplus. This was sometimes not being done and instead the revaluation surplus would be credited to reserves.

Disclosures: IAS 16 requires that where items of property, plant and equipment are stated at revalued amounts, the following information should be disclosed: the frequency of revaluations, restriction on distribution of revaluation surpluses and the carrying amount of the revalued class of property, plant and equipment had the assets been carried under the cost model. In most cases it was observed that this was not being done by companies. The disclosures were

mainly regarding the effective date of revaluation as well the involvement of independent and professional valuers.

IAS 17: Leases

Operating leases: IAS 17 requires the following disclosures with respect to operating leases; the total of future minimum lease payments under non-cancellable operating leases for each of the following periods: not later than one year, later than one year and not later than five years, and later than five years. This was not being done.

IAS 19: Employment benefits

Retirement benefit obligations: IAS 19 sets out various disclosures that should be made with respect to defined benefit plans, which were not made by most companies.

IAS 24: Related party disclosures

Related party transactions: IAS 24 provides that if there have been transactions between related parties, then disclosures must be made on the nature of the related party relationships, the types and elements of transactions entered into so as to ensure better understanding of financial statements. In some cases, the disclosures that were made were not as complete and as comprehensive as they should be.

IAS 30: Disclosures in the financial statements of banks and similar financial institutions concentration of deposit liabilities

IAS 30 requires banks to disclose any significant concentrations of their assets, liabilities and off balance sheet items. Such disclosures should be made in terms of geographical areas, customer or industry groups or other concentrations of risk. In addition, the amount of significant net foreign currency exposures should also be disclosed. These disclosures are a useful indication of the potential risks inherent in the realization of the assets and the funds available to the bank. Many banks have not yet complied with this requirement.

Assets pledged as security: IAS 30 requires banks to disclose the aggregate amount of secured liabilities and the nature and carrying amount of the assets pledged as security. This is because at times banks are required to pledge assets as security to support certain deposits and other liabilities. The amounts involved are often substantial and may have a significant impact on the assessment of the financial position of a bank. Many banks have not yet complied with this requirement.

IAS 33: Earnings per share

Measurement: IAS 33 requires computation of basic and diluted earnings per share by dividing the profit or adjusted profit attributable to ordinary shareholders as the numerator by the weighted average number of ordinary shares outstanding or as adjusted during the period as the denominator. The computed basic and diluted earnings per share should be presented on the face of the income statement for each class of ordinary shares that has a different right to share in the net profit for the period in accordance with IAS 33. The amounts used as numerators and a

reconciliation of those amounts to the net profit or loss for the period as well as denominators should be disclosed in accordance with IAS 33.

IAS 32: Financial instruments: Disclosures and presentation and IAS 39: Financial instruments: recognition and measurement

Disclosures: IAS 32 requires various disclosures to be made so as to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash-flows associated with those instruments. As such companies should describe their financial risk management objectives and policies and provide information that will enable users assess the extent of market, credit, liquidity and cash flow interest rate risk related to financial instruments. This concept is further reiterated in IAS 39. Various disclosures as required by both IAS 32 and IAS 39 were not done. For instance it was observed that companies did not give information on how fair value was determined or the fair values of those financial assets and liabilities carried at amortized cost. Banks also did not disclose the interest income accrued on impaired loans and that has not yet been received in cash.

It was noted that most companies lacked clear policies on the recognition criteria, the classification for measurement purposes and the treatment of gains or losses on disposal of various financial instruments. Where there were policies these tended to be quite general and were therefore not useful in enhancing understating of the financial statements.

Accounting policies

IAS 1 requires disclosure of both the measurement basis used in preparing financial statements as well as all other significant accounting policies used by the company that would be relevant to an understanding of financial statements. In particular companies should disclose those policies that are selected from alternatives allowed in standards and interpretation. In addition those policies that have the most significant effect on the amounts recognized in the financial statements and any judgments used in applying such policies should be disclosed. As a general rule, disclosure of accounting policies used should be made where such disclosure would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position.

It was observed that there were areas where companies failed to disclose the accounting policies used even when the circumstances were such that disclosure was warranted. These areas included policies on consolidation principles; borrowings; components of cash and cash equivalents; leases; de-recognition of financial instruments and employee benefits where it was noted that most companies with defined benefit plans made no disclosures on the accounting policy for recognizing actuarial gains and losses.

Voluntary disclosures

Disclosures are usually of two types: mandatory and voluntary. Mandatory disclosures are those that are required by financial reporting standards. Voluntary disclosures are those that represent additional information over and above what is required by reporting standards. Such disclosures provide greater understanding of the financial position and liquidity of the enterprise.

During the 2005 FiRe Awards, recognition was given to those companies which had gone beyond the call of duty and made significant disclosures voluntarily. Some of the areas where voluntary disclosures were made included segment reporting by those companies that are not listed and for whom segmental reporting is therefore not mandatory. Other voluntary disclosures that were noted were with respect to property, plant and equipment where some companies disclosed the gross carrying amount of fully depreciated property, plant and equipment that is still in use as well as the carrying amount of temporarily idle property, plant and equipment. Some companies also made disclosures on those fully amortized intangible assets that were still in use. This was positive as it did enhance the value of the financial statements to users.

Reasons for the non-compliance with IFRS among Kenyan companies

One of the reasons of non-compliance includes the growing complexity of IFRS. IFRS have become increasingly more complex and subjective in recent years, requiring technical expertise to understand and implement. There have been frequent and rapid changes to various standards arising from improvements and convergence projects. The improvement project gave rise to simultaneous amendments to 13 standards while the Convergence project led to various changes to standards such as on presentation of financial statements; accounting policies; and changes in accounting estimates and errors.

The move towards the fair value model has also introduced complications. It is a subjective concept and is difficult to implement particularly in developing economies like Kenya. This has particularly been problematic for those in the financial services sector and as can be seen from the above table, the sector that seems to exhibit the highest levels of non-compliance is the banking sector. Fair value has been defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. However, while the concept is easy to understand, determination of fair value has been very difficult and at times impossible.

In Kenya, fair valuation of financial instrument including bonds, derivatives has been very difficult due to lack of reliable market information. The Kenyan capital market is still in its infancy stage and cannot be relied on to determine fair value for the financial instruments. Auditors in Kenya lack reliable accurate reference points for some instruments.

There are also cases where there are conflicts between the requirements of IFRS particularly with regard to fair valuations, and those of various regulations and legislation. In Kenya, there have been instances where the regulator has refused to accept fair valuations based on IAS. An example of this is the determination of provisioning using the methodology prescribed by the Central Bank for use by the banking sector and provisioning as per IFRS. The Central Bank of Kenya has issued a guideline CBK/guideline No. 10 on risk classification of assets and provisioning: Section 5 (d) on Minimum Provisioning allocations is very specific as to the minimum percentage amounts that Banks should use to compute provisions. As far as ICPAK can determine, these rates recommended by the Central Bank of Kenya seem arbitrary. ICPAK has recommended to the Central Bank that banks should be allowed to use IAS 39 to determine these provisions based on each bank's roll rates and recovery experiences for portfolio loans. In addition, for significant individual loans, impairment should be determined on a case-by-case basis using discounted cash flows from repayments and the security provided.

In general, there is need for further discussions on the use of fair values. Absence of accurate reliable data on discount rates volatility, industry or company data to support cash-flow trends, crop yields, loan yields, loan default rates and lack of markets or underdevelopment of the existing ones has made the situation worse. There is need to establish what items can be

measured at fair values and which items cannot. Establishing of sector benchmarks will also help in determining of fair values for some items.

The issuance of IFRS 4 on Insurance Contracts further introduced complication in financial reporting for the sector. Previously the Insurance Sector prepared separate income statements for the long term and short-term businesses. This practice was now challenged resulting in opposition from many players in the industry. The need to provide comparative information especially for some items also posed difficulties for the preparers.

There were conflicts between the reporting requirements of IFRS 4 and those of the Insurance Act. For instance, the Act is explicit on the methods to be applied by the insurance companies when calculating claims reserves in respect of general insurance business. Thus, when computing the amounts of provisions for claims incurred but not reported (IBNR), the Insurance Act prescribes certain minimum percentages to be used depending on the levels of net written premiums. These percentages are to be used by all Insurance Companies. In contrast, the IFRS 4 requires that the percentages to be used should be determined from the respective Insurance Company's past experience which may indicate lower rates.

Other areas where there were conflicts with the Insurance Sector regulator in Kenya was with regard to the IFRS 4 approach in the determination of taxable profit for life business, especially due to the difficulties posed by unbundling of contracts between the (deposit) investment component and the insurance component. Reporting surpluses in the Profit and Loss Account that are not available for distribution to shareholders has been a major concern in the industry.

To tackle the challenges being faced in the insurance sector, ICPAK prepared specimen financial statements demonstrating the application of IFRS 4 to the sector. In preparing these statements, ICAK involved the various stakeholders including the Insurance regulator and the Association of Kenya insurers, an umbrella that represents the various insurance companies. Nevertheless, because there are various reports to be made to the insurance regulator which are prescribed in the Insurance Act, the regulator did indicate that while in general, insurance companies would be expected to produce IFRS compliant financial statements, they would at the same time prepare returns to the regulator in accordance with the Act and where there are differences between the returns and the financial statements, appropriate reconciliations would be prepared and reviewed by the auditors.

Having said this, it should be noted that the Insurance regulator does not have the resources and capacity to review the financial statements submitted by the various insurance companies and determine the level of compliance with IFRS.

The other area where there were difficulties in enforcing compliance is the application of the requirements of IAS 17 on leases. The requirement to separate land from buildings was difficult to implement, particularly where the cost of land and the buildings were not carried separately in the books of the entity. The determination of which cost to apportion to land and what portion to buildings, especially where these had been bought for a single consideration and were carried at cost, was difficult. The recommended method of apportioning costs between land and buildings would entail additional costs such as use of professional valuers.

IAS 17 on Leases was also challenged by the regulators and the preparers due to a number of issues. In some cases, companies which had classified leasehold land as long term were required to reclassify them as operating leases given the lease terms. In such circumstances, these companies were required to write back revaluation gains. In addition, now that the leases had been reclassified, the prepaid operating lease rentals would have to be amortized over the life of

the lease whereas previously these leases were considered long term and not depreciated. The immediate impact of this was to reduce reported profits although this was minimal where the leases were for a period of say 999 years. The greater impact though was the implications on capital adequacy particularly for banks and insurance companies which had strict levels of capital adequacy that have been set by the various regulators. Indeed the impact on core capital for the banking institutions holding land on leases that were nearing termination was significant, since prior-period adjustments to reserves were for the entire cost of these leases. To reduce the impact some banking institutions had to dispose off non-core assets such as leasehold land and buildings particularly those that were being held as investments.

The treatment of unrealized reserves has also been of concern to regulators. For instance, IAS 40 on Investment Property does allow the gain or loss from the change in the fair value of investment property to be recognized in the profit and loss for the period in which it arises. This has prompted concerns by regulators that this may create a loophole through which companies may manipulate their performances. The insurance regulator was quick to issue a circular to all insurance companies which explained how the unrealized reserves should be treated. This circular indicated that only 50 per cent of unrealized reserves could be distributed as dividends and the remainder was to be capitalized.

At the same time, there were concerns by preparers that reflecting unrealized gains through the profit and loss may lead to taxation by the tax authorities. This is an area that has yet to be resolved and ICPAK has engaged the tax authorities on the taxation of such unrealized gains with a view to eventually developing an appropriate guideline on the matter.

Status of implementation of auditing standards

In 2004, ICPAK embarked on a quality review programme, the intention being to review audit firms to determine compliance with auditing standards by audit firms. A pilot review of seven firms was carried out by a team from the Institute in 2004 and early 2005. Eighteen additional audit firms were reviewed in 2005.

The results of the pilot reviews were not encouraging. There were significant deficiencies in the application of auditing standards by the audit firms. In particular, it was found that there was no documentation of the audit process and the audit files maintained were incomplete. There was also non-compliance with IFRS, notably: IAS 1 on presentation of financial statements, IAS 12 on income taxes, IAS 17 on leases, IAS 16, on property plant and equipment, IAS 39 on recognition and measurement of financial instruments and IAS 40 on investment property. The reasons for non-compliance in these areas have been discussed earlier.

Other weaknesses noted included a general lack of evidence to demonstrate understanding and application of quality control and little documentation of quality control policies and procedures as well as little evidence of compliance with professional auditing standards especially: ISA 300, 315, 400, 610, 250, 520, 505, 400 and 260 encompassing the entire planning process, ISA 220 and particularly as regards the review of the firm's independence, ISA 530 on sampling, ISA 545 as regards fair value, ISA 570 as regards going concerns and ISA 560 regarding post-balance sheet events. It was also found that there was poor documentation of entire audit process more so in gathering and recording of procedures and the audit evidence sought, conclusions arrived at and the reporting results. Generally, there was poor documentation of the basis of overall audit opinion and a failure to issue the various standard letters used in audit including engagement letters, letters of representation, official clearance from outgoing auditor, comprehensive audit plan among others.

The feedback received from the firms reviewed was that there was need for comprehensive training for audit practitioners to appreciate and understand the auditing process. A decision was therefore taken to develop a training module to be rolled out for audit practitioners and this was done in 2005. The programme targeting audit partners/ owners of audit firms was highly subsidized by ICPAK. The Institute was charging each participant an equivalent of \$150 for the three-day non-residential training. By the end of 2005, about 350 practitioners had undergone the training program and there was improvement in the results of the audit quality reviews.

Nonetheless, the practitioners requested the Institute to develop a similar program for their audit staff and also assist in producing audit manuals and even a sample audit file that the firms could use in their audit work. ICPAK embarked on these projects and it is expected that the training will commence in the latter half of 2006 as will completion of the manuals and reference materials.

In 2006, ICPAK also rolled out the fully-fledged audit reviews with a target of 130 audit firms slated for review this year. While there have been slight improvements, it is envisaged that the results of the training will be evident in 2007 and subsequent years. Only then can we gauge the level of compliance with auditing standards.

IV. Lessons learned in the implementation process

The key to increasing the compliance levels is to ensure that there are trained persons who understand the use of IFRS and ISA. This requires that the qualification process should emphasize proficiency in the use of the various standards. In Kenya, given that the body in charge of the qualification process is different from ICPAK, which is essentially the standard-setting body, there may be difficulties in ensuring the qualification process keeps up with the developments in the standards. Traditionally, it takes very long to change or review syllabuses to keep up with the changes that have been occurring in the standards over the past few years. The training of accountants is also two-fold; there are the academic programmes offered by universities and the professional programmes. In Kenya, there is no mechanism to coordinate the two different types of training and ensure that both keep up with changes in the accountancy profession. There is no linkage between the universities, KASNEB and ICPAK and this is an area that needs to be addressed. Having said this, it should also be noted that the number of qualified accountants is quite low in Kenya with only about 10 000 fully qualified accountants as at 31 December 2005.

In addition, a majority of preparers of financial statements do not have access to the standards and do not keep up to date with the standards and various developments. While ICPAK tries to provide the standards, the cost is prohibitive for most preparers and auditors. ICPAK requires its members to acquire a certain number of hours of learning per year. However, our statistics indicate that majority of our members do not adhere to these requirements. The reasons for non-adherence to the continuing professional education requirements are mainly to do with the cost of the various seminars and workshops organized by ICPAK. This is especially a problem for those whose employers do not meet the cost of the seminars and workshops. In addition, in prior years, ICPAK did not have the necessary mechanism to enforce learning requirements. There was no consequence to not meeting the minimum learning requirements. However with effect from 2006, the Institute's Council decided that one of the criteria to be used in evaluating a member's standing with the Institute would be attainment of the minimum

learning requirements prescribed by the Council. Thus, any member who requests a letter of good standing from the Institute and who has not fulfilled the minimum learning hours for 2005, is required to make a written commitment on how the member will make up for the deficiency in 2006. The institute has also embarked on a campaign to foster a commitment to lifelong learning amongst its members. This campaign includes making presentations during various institute events and publishing articles in the ICPAK bi-monthly journal that emphasize the importance of developing a culture of life long learning.

ICPAK has also provided increased training and user support to ensure that its members fully understand the standards and can implement them without difficulty. However, ICPAK has faced challenges in accessing competent resource persons and at the same time ensure that the training sessions are affordable to all. In 2005, for example, ICPAK rolled out a series of training sessions on audit quality assurance. These were aimed at providing basic understanding of auditing techniques to practitioners and were highly subsidized by ICPAK.

ICPAK itself needs to increase the technical support offered to members and has therefore committed itself to building its technical capacity. However, this process is constrained by a lack of resources. ICPAK strives to develop various guides and sample financial statements to aid in the understanding of standards. However, this process is sometimes slow given the scarcity of resource persons who understand the issues adequately to ensure production of guides that are simple yet comprehensive. This is an area where standard-setters can harness their collective resources and share the guides among themselves – even perhaps at a regional level.

In Kenya, the vast majority of companies can be considered to be SMEs. They are largely owner managed or controlled with financial statements produced largely for use by banks and tax authorities. In most cases, they lack a well-developed finance function and do not employ qualified accountants due to lack of resources. Since they are managed by their owners, SMEs are not motivated to adhere to the reporting requirements of IFRS. Indeed the more complex the standards, the less likely that SMEs will understand and the higher the levels of non-compliance. The IASB's project on reporting for SMEs should be hastened. However, due consideration should be made of the fact that SMEs are defined differently in developed countries than they are in developing countries. Perhaps we need a very simplified set of standards for SMEs in developing countries.

To anticipate changes in standards, there is need for Institutes to have increased participation in standard setting. This may not be possible at the individual institute level but can be done through regional bodies such as the Eastern, Central and Southern Africa Federation of Accountants (ECSAFA) in the case of African countries. Increased participation would ensure that implementation challenges are anticipated prior to finalization of standards. In fact, regulators should be involved where the proposed standards will impact on the industries they regulate at all stages of the standard setting process. This will, however, not be easy given that regulators themselves are constrained and do not have personnel who have the expertise to understand and appreciate reporting standards.

V. Conclusion

A financial reporting system supported by high quality standards such as the IFRS and the ISAs is central to economic development. Increased levels of globalization are underscoring the important role of a common financial reporting framework supported by strong globally accepted financial reporting standards. However, the implementation of the standards will continue to be

problematic. This can be attested by the fact that even after seven years since the adoption of IFRS and ISAs in Kenya, compliance levels remain quite low among companies in Kenya.

A multi-pronged approach is required to enhance adoption of international reporting and auditing standards. The focus should be on simplifying the standards themselves and creating a stable platform or period during which no new standards are issued until the existing ones have been well and thoroughly understood. The different reporting needs of various categories of companies, including those of SMEs must be recognized. These require a highly simplified set of standards to encourage compliance at these levels. For the developing economies, a majority of the population's interactions with the economy occurs at the micro- and small-size firm level and if there can be an appreciation of the importance of good financial reporting at these levels, albeit based on simplified but nevertheless high quality standards, then the impact of sound financial reporting will no doubt cascade to the rest of the economy.

The education process needs to be addressed, as this equips preparers and auditors with the tools they need to understand and participate in the financial reporting process using IFRS and ISAs. In this case, the education process should comprise both the pre- and post-accountancy qualification phases. Accountants need to continuously review and enhance their skills set so as to remain relevant. In this regard, professional bodies must be strengthened so as to ensure that their members remain relevant and committed to the adoption and compliance with international reporting standards.

Ultimately, those pursuing the implementation of IFRS need to be relentless, however daunting the challenge may seem.

Chapter VII

GUIDANCE ON CORPORATE RESPONSIBILITY INDICATORS IN ANNUAL REPORTS

Summary of discussions

The Chair introduced the agenda item and gave the floor to a resource person to present the topic in more detail. The resource person began with background information on ISAR's work in this area, providing a brief overview of developments from earlier sessions. It was noted that the Group of Experts had explored issues of users of corporate responsibility (CR) reporting and their information needs, developed selection criteria for a limited set of indicators, and identified a limited set of indicators.

This background information was followed by a presentation of the main elements of the background document "Guidance on Corporate Responsibility Reporting in Annual Reports" (TD/B/COM.2/ISAR/34). This document, it was explained, provided a draft methodology for compiling and reporting on the selected indicators on corporate responsibility. The purpose of the document was to establish a consistent measurement and reporting format to ensure comparable reporting. The document detailed the methodology for compiling and reporting each of the selected core indicators on corporate responsibility. This methodology includes two fundamental elements: (a) a description of how each indicator should be compiled; and (b) the definition of any technical terms required for standardizing preparation of each indicator. The resource person observed that, together, these factors created a practical and standardized definition for each of the indicators. The resource person also stressed that effort was taken to be as consistent as possible with existing guidance from other organizations, including the Global Reporting Initiative, the International Labour Organization (ILO), the OECD and other United Nations bodies.

The resource person also noted continuing work to further revise and refine the guidance on CR reporting, addressing both the content of the set of core indicators as well as the methodology. She highlighted, for example, the work of UNCTAD's 2005 expert meeting on Positive Corporate Contributions to Social and Economic Development in Host Developing Countries, and recognized the value of having an indicator on the contribution of an enterprise to the development of technology, which can boost the productivity and competitiveness of the country in which it operates. It was acknowledged that there may be different ways to address this subject, and that several were being explored. One potential indicator in this area that was suggested was enterprise expenditure on Research and Development. Another potential indicator that may be subject to further refinement, the resource person noted, was an indicator on local purchasing, which had previously been considered by ISAR as an indicator of contribution to economic development. The resource person concluded her presentation of the background document by reiterating the usefulness of a performance orientation in corporate responsibility reporting, in order to meet the demands of both users and preparers of such reports.

Following the presentation of the resource person, the Chair opened the floor for questions or comments on the background paper. Several comments were received, ranging from the more general to the more technical. The work was welcomed and in particular commended for its recognition of the increasing demand among both preparers and users of CR reports for more concise, comparable and performance-oriented reporting. The importance of recognizing user needs in order to avoid information overload was reiterated, as was the need for performance indicators to be presented with a broader context of corporate information, such as management discussions of strategy and policy. A number of technical refinements that could be made to further improve the methodology for compiling the CR indicators were suggested.

Following these initial comments on the background document, the Chair introduced a panel of experts to discuss the background document on corporate responsibility reporting. The panellists approached the subject from a range of professional and geographic perspectives. The work of ISAR on CR reporting was supported for its role in promoting corporate reporting on non-financial issues that are important to investors and other stakeholders. The performance orientation of the ISAR indicators was highlighted by one panellist who emphasized that providing a better understanding of an enterprise's performance to users is the ultimate goal.

Many of the panellists also highlighted the usefulness of ISAR's focus on a limited set of core indicators. One panellist explained that this focus on a core set of indicators helped to improve the comparability and relevance of CR reporting. The panellist also explained that a limited number of indicators helped to facilitate their incorporation into annual reports. Some experts who spoke from the perspective of preparers of corporate reports stated that the cost of preparing corporate reports needed to be taken into accounting when proposing additional reporting from enterprises. It was argued that the production of a separate CR report presented a burden for some enterprises, particularly in developing countries. The panellist supported ISAR's view that including CR core indicators in the annual report was both less burdensome to enterprises and more useful to investors and other stakeholders. A panellist, speaking from an investor perspective, added that one advantage of the ISAR work in this area is that it can provide enterprises in developing countries with a practical means of reporting on CR issues, which in turn could create the investor confidence needed to attract additional capital to these countries.

A panellist also reinforced the approach taken by ISAR of focusing on national reporting, rather than regionally or globally consolidated reporting. It was explained that in the panellist's country, a developing country, TNCs were mainly reporting CR information in globally consolidated reports, which made it difficult to determine what was relevant for that country.

A number of panellists stressed the usefulness of aligning ISAR's work with that of other United Nations initiatives, such as the United Nations Global Compact and the MDGs. A representative of the United Nations Global Compact highlighted the strong connection between the Global Compact and the contributions of ISAR towards the promotion of corporate reporting on CR issues. A panellist from a developing country emphasized the particular importance of reporting performance in the area of poverty reduction, in line with the MDGs.

Focusing on the development of the indicators, several panellists reinforced the importance of the principles used to select the indicators for ISAR guidance. Comparability, materiality, consistency, accuracy and reliability were among the principles highlighted as necessary for providing credibility to reports, as well as building value for enterprises and their stakeholders.

Discussions among the panellists and participants covered the range of issues above. Assurance of CR reporting was an issue raised, with questions about whether the assurance of a CR report should be viewed as a potential barrier to reporting for smaller firms, or a source of additional value by improving the creditability of the report. A discussion also occurred on the relationship between the subjects of corporate responsibility and corporate governance. Several participants discussed the need for national reporting to provide useable information to stakeholders within specific countries.

I. Introduction

In the São Paulo Consensus of UNCTAD XI, member States recognized that UNCTAD should "assist developing countries, in particular LDCs, to design and implement active policies for building productive capacity and international competitiveness based on an integrated treatment of investment, corporate responsibility, technology transfer and innovation, enterprise development and business facilitation (including transportation and information and communication technology), competitiveness, diversification and export capacity, to sustain a high level of growth and promote sustainable development" (TD/410, para. 49).

Since its 18th session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has viewed reporting on corporate responsibility as one of the emerging issues in the area of corporate transparency. ISAR recognized at its 20th session that more enterprises are producing reports and that the quality and the quantity of these reports continue to improve, and that peer and public pressure for further improving reporting on social issues was increasing. It was further noted that various groups and initiatives had begun to do a tremendous amount of work in this area. ISAR concluded, however, that the satisfaction of some stakeholders with the quality and comparability of such reports remained low and that the increasing demand for information in the area of corporate responsibility was imposing a growing burden on enterprises as they tried to respond to various stakeholders.

The 21st session of ISAR began to examine existing indicators so that corporate reports could be made more relevant and comparable. It noted that UNCTAD XI had provided a broader context in which the issue of corporate responsibility could be addressed, including an economic development dimension.⁸⁰ In particular, ISAR agreed that "such information could also reflect corporate contributions to the economic and social development of host countries, as well as the need for capacity building" (TD/B/COM.2/ISAR/26).

At its 22nd session, the Group of Experts suggested that follow-up work on measurement methodology for selected indicators could be conducted to ensure consistent reporting on these issues. The objective of this report is to provide detailed work on measurement methodology with a view to refining and finalizing ISAR's guidance on voluntary disclosures in this subject area. The report builds on earlier reports prepared by the secretariat for the 20th, 21st and 22nd sessions of ISAR. In particular, it develops measurement methodology for the 17 indicators (see table 1) identified during the 22nd session in paper TD/B/COM.2/ISAR/29 (ISAR/29) and it is recommended that the two reports be read together.

⁸⁰ The first intergovernmental meeting on this subject was held by UNCTAD from 31 October to 2 November 2. See the document "Positive Corporate Contributions to the Economic and Social Development of Host Developing Countries" (TD/B/COM.2/EM17/2).

ISAR/29 explored in detail the selection criteria for the indicators discussed below; the criteria were made up of quality criteria, guiding principles and constraints. The four quality criteria were:

- i. Comparability;
- ii. Relevance and materiality;
- iii. Understandability;
- iv. Reliability and verifiability.

The five guiding principles were:

- i. Universality to maximize comparability;
- ii. Incremental approach;
- iii. Capable of consistent measurement;
- iv. Impact-oriented rather than process-oriented;
- v. Link to sustainable development.

And the three constraints in selecting core topics and indicators were:

- i. Costs and benefits;
- ii. Confidentiality;
- iii. Timeliness.

It was recognized at the 22nd session of ISAR that these selection criteria, while necessary for producing relevant and comparable reports, may also exclude some otherwise useful topics such as technology transfer or country-specific social issues. Therefore, it has been the position of ISAR that enterprises are encouraged to provide additional useful information beyond the selected core indicators. The Group of Experts also recognized that users of social reporting would need to consider the broader industrial and national context of a reporting enterprise when interpreting the data in its reports.

While environmental issues are also recognized as an important feature of corporate responsibility, this report does not focus on environmental issues, as ISAR has previously conducted extensive work in this area. In 1989 ISAR took up the topic of corporate environmental accounting. In the following years several recommendations were published in this area: the 1999 report *Accounting and Financial Reporting for Environmental Costs and Liabilities* (UNCTAD/ITE/EDS/4); the 2000 report *Integrating Environmental and Financial Performance at the Enterprise Level* (UNCTAD/ITE/TED/1); and the 2004 manual *Eco-Efficiency Indicators* (UNCTAD/ITE/IPC/2003/7). The five eco-efficiency indicators identified in the 2004 manual are listed in annex III.

The present report is divided into two main sections and a conclusion. The first section provides a concise overview of the selected indicators in the form of a table. The second section provides detailed guidance on compiling each of the selected indicators and is organized around the following main points:

- i. *Compilation*: how to calculate and report the indicator;
- ii. *Definitions*: any specific terms that require clarification;
- iii. *Documentation*: the sources of data needed to compile the report.

Some indicators detailed below require a breakdown of the reporting enterprise's workforce by employment category. In order to ensure comparability in these cases, it is suggested that reporting enterprises could use the definition of "major group" of employment category set out in the International Labour Organization's guidance, "International Standard Classification of Occupations". This can be found in annex I at the end of this document. References to additional guidance or international standards that could usefully be consulted in compiling each indicator are noted in annex II.

II. Overview of selected indicators

The table below provides an overview of the selected indicators identified in document TD/B/COM.2/ISAR/29.

Table 1. Selected indicators

Group	Sub-group	Indicator
Contribution to Economic Development		Total sales Value of imports vs. exports Total workforce Employee wages and benefits Payments to government Labour productivity
Human Rights	<i>Security</i>	Number of enterprise operations with armed security
Labour Practices	<i>Equal Opportunity</i>	Number of female employees and ratio of male to female wages and benefits
	<i>Workforce Turnover</i>	Total number and rate of employee turnover
	<i>Collective Bargaining</i>	Percentage of employees covered by collective bargaining agreements
Human Resource Development		Average hours of training Expenditure on employee training
Health and Safety		Expenditure on employee health and safety Work days lost due to accidents, injuries and illness
Community Support		Voluntary contributions to civil society
Value Chain		Number of dependent enterprises in the value chain
Corruption		Number of convictions for violations of corruption-related laws or regulations and amount of fines paid/payable

III. Review of measurement methodology for selected indicators

To ensure consistent reporting of the selected indicators, a measurement methodology is described for each of the indicators in the sections below. To better reflect corporate contributions to social and economic development within host countries, the measurement methodology for each indicator is intended to be used to compile relevant data for the national reports of an enterprise, rather than consolidated global reports. The use of global reporting provides an important macro view of a TNC's operations; however, most indicators that reflect corporate contributions to economic and social development are primarily relevant in a national context.

As noted in TD/B/COM.2/ISAR/29, the selected indicators are drawn from a range of existing reporting principles, initiatives and standards, including financial reporting principles, the practices of specific enterprises, government reporting standards and the Global Reporting Initiative. Consequently, due care has been taken to use the same methodology as other organizations where the same indicator has been used.⁸¹ For some indicators, slight adaptations of existing methodologies have been made in order to ensure a focus on national reporting.

A. Contribution to economic development

1. Total sales

The total sales of an enterprise allow for an approximate calculation of the enterprise's contribution to GDP and its overall economic impact on the economy in which it operates. This indicator should reflect gross sales.⁸²

Compilation: Gross sales from products and services.

Definitions: None.

Documentation: Finance, treasury or accounting departments should have the information that this indicator requires.

2. Value of imports vs. exports

The value of an enterprise's exports in relation to its imports, as an indicator of the contribution of an enterprise to the balance of payments of the country in which it operates, could also give information about the economic contribution of an enterprise to that country's economy; this issue is of particular relevance for developing countries which must manage their "hard currency" reserves.

Compilation: The compilation of this indicator is based on generally accepted financial accounting principles:

- a) Identify all the transactions of the reporting company concerning its current, capital and financial account with economic units from a country where the company is not resident.

⁸¹ In the case of GRI indicators, the methodology referenced is based on the draft G3 technical protocols, as the final G3 technical protocols were still in production at the time of writing.

⁸² It was recognized in TD/B/COM.2/ISAR/29 that calculation of enterprise value added may also be an appropriate indicator for gauging an enterprise's overall economic impact on the economy in which it operates.

- b) Identify whether these transactions are exports or imports from the perspective of the reporting company.
- c) Calculate the contribution of the reporting company to the host country's balance of payments (CCBP) using the following formula: $CCBP = \sum \text{Export} - \sum \text{Import}$.

Transactions refer to:

- a) Current account: goods; services; income; current transfers;
- b) Capital and financial account:
 - i. Capital transfers; acquisition or disposal of non-produced, non-financial assets;
 - ii. Financial assets and liabilities.

Definitions:

- a. Economic territory: Economic territory may not be identical with boundaries recognized for political purposes. A country's economic territory consists of a geographical territory administered by a Government; within this geographical territory, persons, goods and capital circulate freely. For maritime countries, geographical territory includes any islands subject to the same fiscal and monetary authorities as the mainland.
- b. Residence of enterprises: An enterprise is said to have a centre of economic interest and to be a resident unit of a country (economic territory) when it is engaged in a significant amount of production of goods and/or services there or when it owns land or buildings located there. The enterprise must maintain at least one production establishment (goods and/or services) in the country and must plan to operate the establishment indefinitely or over a long period of time.

Documentation: Finance, treasury or accounting departments should have the information that this indicator requires.

3. Total workforce

One of the most significant positive economic contributions an enterprise can make to the country in which it operates comes through the creation of jobs. When reporting the number of employees, the enterprise should provide a breakdown by employment type (full-time or part-time) and by major employment category.

Compilation:

- a. When collecting data on the workforce, assess the full-time/part-time status of workforce members on the basis of definitions under the national laws of the country where they are based. Independent contractors and workers in the supply chain are not included in this indicator.
- b. State the number of individuals in the organization's employ at the end of the reporting period, with a breakdown by employment type (full-time or part-time) and by major employment category.
- c. State the number of expatriates (non-nationals) employed by the reporting organization, with a breakdown by employment type (full-time or part-time) and by major employment category.

- d. If applicable, describe any significant seasonal variations in employment numbers (e.g. in the tourism or agricultural industries).

Definitions of employment types:

- a. Employee: person with a direct employment relationship with the reporting enterprise, as recognized by national law.
- b. Full-time employment: a "full-time employee" is defined according to national legislation and practice regarding working time. The definition is often in terms of months per year or hours per week employed.
- c. Part-time: a "part-time employee" is an employee whose working hours per week, or months per year, are less than "full-time" as defined above.

Documentation: Payroll information should provide data for this indicator.

4. Employee wages and benefits

The creation of jobs and the payment of wages and other benefits to employees represent one of the most important positive economic impacts of an enterprise. The total payroll of an enterprise, through the multiplier effect, supports the economic activity and economic development of the community in which the employees live. This indicator should reflect the total monetary outgoings on the employee workforce during the reporting period. In order to better gauge the contribution to poverty reduction, the indicator should also include a breakdown by major employment category and by employment type (part-time/full-time).

Compilation:

State the total annual payroll of the reporting organization. Provide a breakdown of the total annual payroll by each major group of employment category across the organization's operations at the end of the reporting year. Provide a breakdown of the total annual payroll by employment type (part-time/full-time; see indicator 3 above).

State the total annual benefits of the reporting organization, together with a breakdown of the total annual benefits by each major group of employment category across the organization's operations at the end of the reporting year. Provide a breakdown of the total annual benefits by employment type (part-time/full-time; see indicator 3 above).

Definitions:

Total annual payroll: total of all employee salaries, including amounts paid to government institutions (employee taxes, levies and unemployment funds) on behalf of employees, paid within a calendar year. Non-employees working in an operational role should not be included within payroll but under Operating Costs as a service purchased.

Total annual benefits: total of all regular contributions, (e.g. to pensions, insurance, company vehicles, private health), as well as other employee support such as housing, interest-free loans, public transport assistance, educational grants and redundancy payments, paid within a calendar year. This does not include training, costs of protective equipment or other cost items directly related to the employee's job function.

Documentation: Finance, treasury or accounting departments should have the information that this indicator requires.

5. Payments to government

Enterprises make a significant economic contribution to government finances in the form of taxes, royalties and other fees paid to Governments. This is particularly important for industries that do not have large payrolls or strong business linkages, and whose principal contribution to economic development is in the form of taxes.⁸³

Compilation: All company taxes (corporate, income, property, etc.) and related penalties paid at the national and local levels. Taxes included should be on a cash paid basis. This figure should not include deferred taxes because they may not be paid.

Definitions: None.

Documentation: Finance, treasury or accounting departments should have the information that this indicator requires.

6. Labour productivity

Enterprises often contribute to increases in labour productivity. This is especially true of TNCs that transfer knowledge and technology and invest in human resource formation. A measurement of an individual enterprise's labour productivity becomes an indicator of the enterprise's contribution to the overall economic efficiency and competitiveness of the country in which the enterprise operates.

Compilation: Labour productivity, based on gross output

$$\text{Labour productivity} = \frac{\text{Quantity index of gross output}}{\text{Quantity index of labour input}}$$

Price indices to deflate current-price series of inputs and outputs play a major role in productivity measurement. It is, for example, important that price statistics on inputs be generated independently from price series for outputs. Input-based indicators that are used to deflate output series generate an obvious bias in productivity measures. Occurrences of such input-based extrapolation are concentrated in activities where market output prices are difficult to observe. Difficult-to-measure industries include increasingly important activities such as banking, insurance and distribution.

Definitions:

Gross output: goods or services that are produced within a producer unit and that become available for use outside the unit. This is a gross measure in the sense that it represents the value of sales and net additions to inventories without, however, allowing for purchases of intermediate inputs.

Labour input: labour input is most appropriately measured as the total number of hours worked. Simple headcounts of employed persons will hide changes in average hours worked,

⁸³ For example, this issue is the subject of the Extractive Industry Transparency Initiative, an effort led by the United Kingdom Government and involving key enterprises in the extractive industry. It is also the subject of the "Publish What You Pay" campaign, which involves more than 300 civil society groups around the world.

caused by the evolution of part-time work or the effect of variations in overtime, absence from work or shifts in normal hours.

Documentation: Finance, treasury or accounting departments and the human resource department should have the information that this indicator requires.

B. Human rights

7. Number of enterprise operations with armed security

One of the most basic human rights is the right to life, liberty and security of person.⁸⁴ The United Nations Global Compact emphasizes that enterprises should avoid complicity in human rights abuses. Where such complicity has arisen in the past, it has often been associated with an enterprise's security arrangements and human rights abuses committed against members of a local community. Enterprises have a legitimate need to provide security for their personnel and equipment. In many situations this includes a need for armed security personnel. However, when armed security personnel are not properly trained and supervised this can become a human rights risk for an enterprise's surrounding community, as well as a reputation risk and potential legal liability for an enterprise. The first step in identifying such risks is identification of the locations where armed security is deployed, together with an indication of what type of security arrangements have been made.

Compilation:

Identify the total number of enterprise locations (number of distinct operating sites within a country) that employ armed security personnel. When reporting this number, indicate whether the armed security personnel employed are direct employees or contractors, or both.

If the use of armed security contractors is reported, the enterprise should further indicate whether the contractor is either a private enterprise or a government force. Examples of government forces that contract armed security include local police and national militaries.

The reporting enterprise should also indicate whether (i) enterprises are required by law to contract armed security, and (ii) whether enterprises are required by law to contract armed security from government forces.

Definitions:

Armed security: a person who carries or has immediate access to a firearm in the performance of his or her duties, and who is employed to safeguard and protect persons and property or prevent theft, loss or concealment of any tangible or intangible personal property on the premises hired to protect.

Contractor: a person who directly supplies work and services to the reporting organization but whose formal contract of employment is with another organization.

Documentation: A potential information source is the records of the reporting organization's human resources department or procurement department.

⁸⁴ Article 3 of the Universal Declaration of Human Rights (www.un.org/rights).

C. Labour practices

8. Number of female employees and ratio of male to female wages and benefits

An enterprise's contribution to eliminating discrimination is a central feature of corporate responsibility. The extent to which an enterprise reduces discrimination can also be considered a measure of the management team's ability to recruit and retain people on the basis of merit. Given the guiding principles for selecting indicators, and in particular the universality principle, the selected indicator focuses on the issue of gender discrimination.

Compilation:

State the total number of employees at year-end broken down by gender and major employment group.

Calculate the average annual wage and average annual benefits for each major employment group with a break-down by gender. State the ratio of average annual wages for males to females; and state the ratio of average annual benefits for males to females. Refer to indicator 4 above for calculation of wages and benefits.

Definitions: None.

Documentation: A potential information source is the reporting organization's human resources department.

9. Total number and rate of employee turnover

Workforce turnover rates serve to reflect the job security of employees, and the employment practices of an enterprise. Important issues can be initially reflected in an enterprise's turnover statistics, which can be compared with industry averages or best practice within the enterprise's industry, or even other industries.

Compilation:

Identify the total number of employees leaving employment during the reporting period.

State the absolute number and rate of employees leaving employment during the reporting period, broken down by gender and by age groups (e.g. <30; 30-50; >50).

Rates should be calculated using the total employee numbers at the end of the reporting period.

Definitions:

Turnover: number of employees who leave the organization voluntarily or because of dismissal, retirement or death in service.

Documentation: Potential sources of information, which include payroll information available at national or site level, should provide data for this purpose; also, operational plans and restatements of the organization's key strategic targets may provide reasons for large variations in these figures.

10. Percentage of employees covered by collective bargaining agreements

Employees have the internationally recognized rights to establish and join organizations of their own choosing, and to have representative organizations for the purpose of collective

bargaining. Whether or not employees exercise these rights in practice varies by location, industry and enterprise. For those stakeholders who are trying to assess the relationship between management and workers, it is helpful to know how many employees are covered by collective bargaining agreements.

Compilation:

Use data from indicator number 3 above (total workforce) as the basis for calculating percentages for this indicator.

This indicator refers to collective bargaining agreements signed by the reporting organization itself or by employer organizations of which it is a member. These agreements can be at the sector, national or regional level.

Identify the number of employees covered by collective bargaining agreements.

State the number of employees covered as a percentage of the total number of employees.

Definitions: None.

Documentation: Records of formal recognition agreements and signed collective agreements with independent trade unions will normally be held by the Human Resources/Personnel Department of the reporting organization, or in the office of the reporting organization's legal counsel. In cases of doubt about the independent nature of an individual trade union body, and in the absence of data to determine its independence according to the ILO criteria given above, the International Confederation of Free Trade Unions (ICFTU) is normally able to provide guidance (see www.icftu.org).

D. Human resource development

One of the ways in which companies can best contribute to local communities is to enable employees to develop their skills. Training local employees leaves them in a stronger position to obtain new employment or start their own businesses. In economic terms, training of employees represents the management's conscious effort to invest in its human resources. This training can be measured in two ways: by average hours of training per employee and by expenditure on training per employee.

11. Average hours of training per year per employee broken down by employee category

Compilation:

Identify the number of employees for each major group of employment category across the organization's operations at the end of the reporting year.

Identify total hours devoted to training personnel within each major group of employment category.

State the number of hours of training per year per employee by category of employee using the following formula:

$$\text{Number of hours of training per year per category} = \frac{\text{Total hours per category}}{\text{Total employees per category}}$$

Definitions:

Training: All types of vocational training and instruction; paid educational leave provided by the reporting organization for its employees; training or education pursued externally and paid for in whole or in part by the reporting organization; and training on specific topics such as health and safety. It does not include on-site coaching by supervisors.

Employment category: Major groups of employees as defined by the International Labour Organization's International Standard Classification of Occupations (see annex I).

Documentation: Potential sources of information include employee records and training schedules.

12. Expenditure on employee training per year per employee, broken down by employee category

Compilation:

Identify exact figures on training costs from the sources, which are known in the enterprise (accounts, data files, minutes etc.).

Identify estimates of the training costs only if these data are not available.

Calculate the expenditures using the formula below and state the resulting figure per employee with a break-down by each major group of employment category across the organization's operations at the end of the reporting year.

$$\text{Expenditure on employee training} = \text{Direct costs of training} + \text{indirect costs of training}$$

Direct costs:

\sum Costs described under definitions (a) to (f) below – \sum receipts described under definition (g) below.

Indirect costs:

$$\sum [(\text{Hourly labour costs} + \text{hourly potential output}) * \text{hours of training}]$$

Definitions: Costs of external and internal vocational training courses:

Fees and payments (to vocational training providers and external trainers). This refers to the total amount paid in fees for external courses or for external trainers or instructors (including those providing internal courses). It includes also payments made to external consultants, assessors or examiners for course-related activities. Any payments made by employers for courses that have been undertaken in employees' own time are included. Fees for training courses undertaken by apprentices or trainees are excluded. Fees and payments for learning material for open and distance courses, wherever possible, are excluded.

Travel and subsistence payments. This refers to actual payments made to cover the travel and subsistence costs of employees participating in vocational training courses. It includes also any additional payments made for time spent travelling to courses.

Labour costs of internal trainers exclusively involved in managing and delivering vocational training courses.

Labour cost of internal trainers, partly involved in managing and delivering vocational training courses. The staff engaged in designing, managing, conducting or supporting vocational training courses comprise:

- i. Internal trainers and staff of training centres;
- ii. Directors and other managers concerned with training policy;
- iii. Instructors and training managers or officers;
- iv. Clerical/administrative and other personnel supporting these activities;
- v. Anyone dealing solely with apprenticeship training and anyone who is not a member of the normal workforce of the enterprise are excluded. For staff engaged full-time in course-related activities, the figures quoted should be the total annual labour costs of all those identified. For staff engaged part-time in course-related activities, it should be a proportion of their labour costs, reflecting the proportion of time they spent on course-related activities.

Costs of premises. These costs include:

The cost of running a training centre (excluding staff labour costs) or any other premises used for vocational training courses;

Equipment or materials bought specifically for vocational training courses;

If the training centre or other premises or equipment are used only partly for vocational training courses, (e.g. if used also for training of apprentices) a proportion of the total cost should be included, representing the proportion of time they are used for vocational training courses.

Contributions to collective funding arrangements;

Receipts for vocational training courses. Receipts from collective funds, that is grants for vocational training courses, and from sources of revenue for vocational training courses such as the following: receipts from regional/sector funds; receipts from national funds; subsidies from EU sources; government subsidies; government rebates on expenditures; tax concessions on expenditures; external financial assistance from non-government sources, such as private foundations; royalty payments from external bodies and persons for the use of training resources developed by the enterprise; and receipts for vocational training courses provided to external bodies and persons.

Documentation: Finance, treasury or accounting departments or the human resource department should have the information that this indicator requires.

E. Health and safety

13. Expenditure on employee health and safety

Employee health and safety is one of the most important corporate responsibility issues confronting organizations. This is particularly true for companies operating in an environment with weak regulatory infrastructure. Poor employee health and safety records can undermine the social and economic development of a community. Occupational accidents can also negatively impact on enterprise development by lowering employee productivity, undermining human resource development and diverting management attention; underperformance in this area can be symptomatic of poor management.

Compilation:

Identify company expenditure on occupational safety and health related insurance programmes.

Identify company expenditure on health care activities financed directly by the company, either through self-insurance or in operating-company-owned health care facilities.

Identify company expenditure on working environment issues related to occupational safety and health (see "Employee safety" under definitions below).

Calculate total company expenditures on employee health and safety by adding up the figures obtained in identification steps (a) through (c). State the resulting figure per employee, with a break-down by each major group of employment category across the organization's operations at the end of the reporting year.

Definitions:

Employee safety: occupational safety, occupational health and working environment are related to the following fields (ILO R164, II, 3): design, sitting, structural features, installation, maintenance, repair and alteration of workplaces and means of access thereto and egress therefrom; lighting, ventilation, order and cleanliness of workplaces; temperature, humidity and movement of air in the workplace; design, construction, use, maintenance, testing and inspection of machinery and equipment liable to present hazards and, as appropriate, their approval and transfer; prevention of harmful physical or mental stress due to conditions of work; handling, stacking and storage of loads and materials, manually or mechanically; use of electricity; manufacture, packing, labelling, transport, storage and use of dangerous substances and agents, disposal of their wastes and residues, and, as appropriate, their replacement by other substances or agents which are not dangerous or which are less dangerous; radiation protection; prevention and control of, and protection against, occupational hazards due to noise and vibration; control of the atmosphere and other ambient factors in workplaces; prevention and control of hazards due to high and low barometric pressures; prevention of fires and explosions and measures to be taken in the event of fire or explosion; design, manufacture, supply, use, maintenance and testing of personal protective equipment and protective clothing; sanitary installations, washing facilities, facilities for changing and storing clothes, supply of drinking water, and any other welfare facilities connected with occupational safety and health; first-aid treatment; establishment of emergency plans; supervision of the health of workers.

Documentation: Finance, treasury or accounting departments and the human resource department should have the information that this indicator requires.

14. Work days lost due to accidents, injuries and illness

Compilation:

- a) This indicator should provide a breakdown according to:
 - i. The total workforce (i.e. total employees, plus supervised contract workers); and
 - ii. Independent contractors working on site in respect of whom the reporting organization assumes liability for the general safety of the working environment.

- b) Data on "lost days" should be based on the definitions under the national law of the country in which the "lost day" occurred. In calculating "lost days" it should be noted: (i) whether "days" means "calendar days" or "scheduled work days"; and (ii) at what point the "lost days" count begins (e.g. the day after the accident or three days after the accident).

State lost day rate (LDR) by calculating as follows:

$$\text{LDR} = \frac{\text{No. of lost days}}{\text{Total scheduled workforce working hours}}$$

Definitions:

- a) Injury: A non-fatal or fatal injury arising out of or in the course of work.
- b) Occupational disease: A disease arising from the work situation or activity (e.g. stress or regular exposure to harmful chemicals), or from a work-related injury.
- c) Lost day: Time ("days") which could not be worked (and is thus "lost") as a consequence of an employee being unable to perform his or her usual work because of an occupational accident or disease. Specific national definitions for the purpose of calculating "lost days" exist in the national labour laws of most countries.
- d) Lost day rate: Refers to the impact of occupational accidents and diseases, as reflected in time off work taken by the affected workers. It is expressed by comparing the total lost days against the total number of hours scheduled to be worked by the workforce in the reporting period.

Documentation: Employee records, employee contracts, attendance records and accident records will provide relevant data for this indicator.

F. Community support

15. Voluntary contributions to civil society

Many enterprises support the communities in which they operate through a variety of voluntary contributions, including the donation of cash, goods and services, and support for employee volunteerism schemes. These direct contributions can result in significant positive contributions to, for example, the sustainable development of local infrastructure such as schools and hospitals, as well as the provision of emergency relief in times of natural disaster. This indicator focuses specifically on an enterprise's voluntary contributions and investment of funds in the wider community, including donations.

Compilation:

- a) Voluntary donations and investment of funds in the wider community where the target beneficiaries are external to the company.⁸⁵ These include contributions to charities, NGOs and research institutes (not related to the company's commercial R&D), funds to support community infrastructure (e.g. recreational facilities) and direct costs of social programmes (including arts and educational events). The amount included should account for actual expenditures in the reporting period, not commitments.

⁸⁵ "External to the company" means that the recipients are non-related third parties, i.e. legally separate entities of the company. It does not mean that the funds donated cannot be used by third parties, at their discretion, to benefit the reporting enterprise's employees or family members of its employees.

- b) For infrastructure investments, the calculation of the total investment should include costs for goods and labour in addition to capital costs. For support of ongoing facilities or programmes (e.g. an organization funds the daily operations of a public facility), the reported investment should include operating costs.
- c) This excludes legal and commercial activities or where the purpose of the investment is exclusively commercial.
- d) Any infrastructure investment which is primarily driven by core business needs (e.g. building a road to a mine or factory), or is for the purpose of facilitating the business operations of the organization, should not be included. The calculation of investment may include infrastructure built outside the main business activities of the reporting organization, such as a school, or a hospital for employees and their families.

Definitions: None.

Documentation: Financial records will provide relevant data for this indicator.

G. Value chain

16. Number of dependent enterprises in the value chain

Since enterprises are able to influence only those members of their value chain which are in some way dependent upon the enterprise, the interpretation of corporate responsibility indicators related to suppliers and distributors begins with some understanding of the number of dependent suppliers and distributors within an enterprise's value chain.

The economic dependence of enterprises in a value chain is necessarily a matter of degrees of dependence, rather than a particular threshold. Therefore, this indicator is reported in three categories or ranges of dependence from 100% to >70% to >40%.

Compilation:

- a) Identify only those members of the value chain (suppliers and distributors) that have had an ongoing business relationship of at least 24 months or more with the reporting enterprise.
- b) Calculate the value of business with each member of the value chain (value of purchases from suppliers, value of sales to distributors).
- c) Calculate (as a percentage) the dependence of each member of the value chain in the following way:

i. Suppliers:

$$\text{Dependence} = \frac{\text{Total value of purchases from supplier}}{\text{Total sales of supplier}}$$

ii. Distributors:

$$\text{Dependence} = \frac{\text{Total value of sales to the distributor}}{\text{Total value of purchases by the distributor}}$$

- iii. List the number of dependent enterprises in the value chain, with a breakdown by suppliers and distributors, country of location and degree of dependence. The degree of dependence should be noted using the following three categories: 100% dependence; 70%-99% dependence; and 40%-69% dependence.

Definitions: None

Documentation: Purchasing and sales departments should have the information that this indicator requires. Additional information will be required from suppliers and distributors.

H. Corruption

17. Number of convictions for violations of corruption-related laws or regulations and amount of fines paid/payable

Corruption is internationally recognized as an obstacle to economic development and a hindrance to international trade and investment. Corporations can make a positive contribution to respect for anti-corruption laws and international norms by ensuring that they are not involved in corruption. A basic measurable performance indicator in this regard is the number of legal infractions that a company incurs as a result of corrupt practices. This indicator can provide useful information to stakeholders about legal liabilities and areas of the enterprise's internal control that require attention.

Compilation:

- a) Identify all convictions for violations of corruption-related laws or regulations.
- b) Identify the amount of fines paid/payable.
- c) State the reference number of the convictions and the amount of fines.

Definitions:

- a) Corruption: the OECD defines corruption as the “active or passive misuse of the powers of Public officials (appointed or elected) for private financial or other benefits”.
- b) Bribery: the offering, promising, giving or accepting of any undue pecuniary or other advantage to or by a public official at national, local or international level, a political party, party official or candidate, or a director, officer, employee or agent of a private enterprise; in order to obtain or retain a business or other improper advantage, for example, in connection with regulatory permits, taxation, customs and judicial and legislative proceedings.
- c) Extortion or solicitation: the demanding of a bribe, whether or not coupled with a threat if the demand is refused. “Bribery” as used in these rules shall include extortion.

Documentation: Records within an enterprise's legal department or financial accounting department should provide the necessary information for compiling this indicator.

IV. Conclusion

In accordance with the agreed conclusions of the 22nd session of the Group of Experts, the UNCTAD secretariat is presenting for consideration by the 23rd session of ISAR this detailed work on measurement methodology with a view to finalizing ISAR's guidance on voluntary disclosures in this subject area. On the basis of this work, ISAR may choose to carry out further work on the feasibility of this document as a tool for improving the comparability and relevance of corporate responsibility reporting in annual reports. Such further work could include conducting surveys on corporate disclosures on these issues, using this document as a benchmark.

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ANNEX I. CLASSIFICATION OF EMPLOYEE FUNCTION⁸⁶

Major Group	ISCO Code	Sub-Major Group ⁸⁷	Notes ⁸⁸
1: Legislators, Senior Officials and Managers	1210	Directors and Chief Executives	This group is intended to include persons who – as directors or chief executives – manage enterprises or organizations with 10 or more employees.
	1220	Production and Operations Department Managers	This group is intended to include persons who indicate a production and/or operational managerial specialism in enterprises or organizations with 10 or more employees.
	1230	Other Department Managers	This group should be restricted to persons who indicate a non-production/non-operational managerial specialism in enterprises or organizations with 10 or more employees.
	13	Managers of small enterprises	This group is intended to include persons who manage small enterprises, or organizations with 0-9 employees, on their own behalf, or on behalf of the proprietor, and may have some non-managerial help. Non-managerial staff should be classified according to their specific tasks.
2: Professionals	21	Physical, mathematical and engineering science professionals	This sub-major group includes occupations whose main tasks require a high level of professional experience in the physical, mathematical and engineering sciences (ILO, 1990; p. 47).
	22	Life science and health professionals	<i>Life science and health professionals</i> conduct research, improve or develop concepts, theories and operational methods, or apply scientific knowledge relating to fields such as biology, zoology, botany, ecology, physiology, biochemistry, microbiology, pharmacology, agronomy and medicine (ILO, 1990; p. 59).
	23	Teaching professionals	<i>Teaching professionals</i> teach the theory and practice of one or more disciplines at different educational levels, conduct research and improve or develop concepts, theories and operational methods pertaining to their particular discipline, and prepare scholarly papers and books (ILO 1990; p. 65).
	24	Other professionals	<i>Other professionals</i> conduct research, improve or develop concepts, theories and operational methods, or apply knowledge relating to information dissemination and organization of business, as well as to philosophy, law, psychology, politics, economics, history, religion, languages, sociology, other social sciences, arts and entertainment (ILO, 1990; p. 72). Depending upon the specific tasks and degree of responsibility, as well as on the national educational and training requirements, it may be appropriate to classify some of the occupations identified here into sub-major group 34 (<i>Other associate professionals</i>) (ILO, 1990; p. 72).

⁸⁶ Derived from the International Labour Organization (ILO) International Standard Classification of Occupations (ISCO-88).

⁸⁷ This proposal contains all of the 28 sub-major groups of ISCO88 except sub-major group “11 Legislators and senior officials”, as employees of this group are not expected to work in private enterprises.

⁸⁸ Source: Peter Elias and Margaret Birch: “Establishment of Community-Wide Occupational Statistics ISCO 88 (COM) A Guide for Users”, <http://www.warwick.ac.uk/ier/isco/isco88.pdf>.

3: Technicians and Associate Professionals	31	Physical and engineering science associate professionals	<i>Technicians and associate professionals</i> perform mostly technical and related tasks connected with research and the application of scientific and artistic concepts and operational methods, and government or business regulations, and teach at certain educational levels.
	32	Life science and health associate professionals	
	33	Teaching associate professionals	See notes for sub-major group 23 (<i>Teaching professionals</i>).
	34	Other associate professionals	<i>Other associate professionals</i> perform technical tasks connected with the practical application of knowledge relating to finance and sales, business enterprise administration, bookkeeping, legal, statistical and other services, government activities relating to customs, travel, tax, welfare, job placement, licensing, the police force, as well as with social work, entertainment, sport and religion (ILO, 1990; p. 113).
4: Clerks	41	Office clerks	<i>Clerks</i> record, store, compute and retrieve information, perform a number of clerical duties especially in connection with money-handling operations, travel arrangements, requests for information and appointments
	42	Customer services clerks	<i>Customer services clerks</i> deal directly with clients in connections with money-handling operations, travel arrangements, requests for information, appointments and by operating telephone switchboards (ILO, 1990; p. 139). Allocation of clerks between sub-major groups 41 (<i>Office clerks</i>) and 42 (<i>Customer services clerks</i>) will be performed with reference to job titles and/or job descriptions. Specific job titles/descriptions which indicate direct customer service interaction (e.g. counter clerk, receptionist, telephonist) will result in classification within sub-major group 42 (<i>Customer services clerks</i>).
5: Service Workers and Shop and Market Sales Workers	51	Personal and protective services workers	<i>Service workers and shop and market sales workers</i> provide personal and protective services related to travel, housekeeping, personal care, or protection against fire, unlawful acts, or they pose as models for artistic creation and display, or demonstrate and sell goods in wholesale or retail shops and similar establishments, as well as at stalls and on markets.
	52	Models, salespersons and demonstrators	See definitional notes to major group 5 (<i>Service Workers and Shop and Market Sales Workers</i>)
6: Skilled Agricultural and Fishery Workers	61	Skilled agricultural and fishery workers	Sub-major group 61 (<i>Skilled agricultural and fishery workers</i>) consists of those occupations which require skills at the second ISCO skill level (education which begins at the age of 14 or 15 and lasts about three years – a period of on-the-job training may be necessary, which may supplement or replace the formal education) (ILO, 1990; p. 157 & 3).
7: Craft and Related Trades Workers	71	Extraction and building trades workers	<i>Craft and related trades workers</i> apply their specific knowledge and skills to produce or process goods. The tasks call for an understanding of all stages of the production process, the materials and tools used and the nature and purpose of the final product. Most occupations in this group require skills at the second ISCO level (ILO, 1990; p. 173)
	72	Metal, machinery and related trades workers	

	73	Precision, handcraft, craft printing and related trades workers	
	74	Other craft and related trades workers	
8: Plant and Machine Operators and Assemblers	81	Stationary plant and related operators	<i>Plant and machine operators and assemblers</i> operate and monitor industrial and agricultural machinery and equipment on the spot or by remote control, drive and operate trains, motor vehicles and mobile machinery and equipment, or assemble products from component parts according to strict specifications and procedures. The work mainly calls for experience with, and an understanding of, industrial and agricultural machinery and equipment as well as an ability to cope with machine-paced operations and to adapt to technological innovations. "Stationary plant" should be interpreted primarily as "process plant".
	82	Machine operators and assemblers	
	83	Drivers and mobile plant operators	
9: Elementary Occupations	91	Sales and services elementary occupations	Elementary occupations consist mainly of simple and routine tasks which mainly require the use of hand-held tools and often some physical effort.
	92	Agricultural, fishery and related labourers	
	93	Labourers in mining, construction, manufacturing and transport	

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ANNEX II. REFERENCES

1. Total Sales: Applicable accounting standards, such as International Accounting Standard (IAS) 18 on Revenues, could be consulted.
2. Value of imports vs. exports: balance of payments manual of the International Monetary Fund; European Balance of Payments/International Investment Position Statistical Methods.
3. Total workforce: ILO International Classification of Status in Employment; ILO Key Indicators of the Labour Market; ILO Laborstat Internet Indicators.
4. Employee wages and benefits: Applicable accounting standards, such as International Accounting Standard (IAS) 19 on Employee Benefits, could be consulted.
5. Payments to government: Applicable accounting standards, such as International Accounting Standard (IAS) 12 on Income Taxes, IAS 7 on Cash Flow statements and IAS 19 on Employee Benefits, could be consulted.
6. Labour productivity: ILO Key Indicators of the Labour Market (KILM 18. Labour productivity and unit labour costs); OECD Manual on Measuring Productivity.
7. Number of enterprise operations with armed security: Commentary on the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights U.N. Doc. E/CN.4/Sub.2/2003/38/Rev.2 (2003) Section C Right to security of persons, para 4.
8. Number of female employees and ratio of male to female wages and benefits: OECD Guidelines for Multinational Enterprises, Chapter IV Employment and Industrial Relations, Article d); ILO C111 Discrimination (Employment and Occupation) Convention (1958), Article 1.
9. Percentage of employees covered by collective bargaining agreements: ILO Convention 87, "Freedom of Association and Protection of the Right to Organize", 1948; ILO Convention 98, "Right to Organize and Collective Bargaining", 1949; ILO Convention 135, "Workers' Representatives Convention", 1971; ILO Convention 154, "Collective Bargaining Convention", 1981 and Recommendations 91, "Collective Agreements Recommendation" 1951, and 163, "Collective Bargaining Recommendation", 1981; ILO Declaration on Fundamental Principles and Rights at Work, 86th Session, 1998, Article 2 (a); OECD Guidelines for Multinational Enterprises, Section IV, Paragraph 2 (a).
10. Average hours of training per year per employee broken down by employee category: ILO International Standard Classification of Occupations (ISCO-88); ILO Convention 142, "Human Resources Development Convention", 1975; ILO Convention 140, "Paid Educational Leave Convention", 1974; ILO Convention 155, "Occupational Safety and Health Convention", 1981; OECD Guidelines for Multinational Enterprises, Revision 2000, Articles II, 4 & IV, 2 (c), 3 and 5; ILO R117, "Vocational Training Recommendation", 1962.
11. Expenditure on employee training per year per employee broken down by employee category: ILO International Standard Classification of Occupations (ISCO-88); ILO Convention 142, "Human Resources Development Convention", 1975; ILO Convention 140, "Paid Educational Leave Convention", 1974; ILO Convention 155, "Occupational Safety and Health Convention", 1981; OECD Guidelines for Multinational Enterprises,

Revision 2000, Articles II, 4 & IV, 2 (c), 3 and 5; ILO R117, "Vocational Training Recommendation", 1962; European Commission, European social statistics continuing vocational training survey (CVTS2).

12. Expenditure on employee health and safety: OECD publication "A System of Health Accounts"; ILO C155 Occupational Safety and Health Convention, 1981; ILO P155 Protocol of 2002 to the Occupational Safety and Health Convention, 1981; ILO R164 Occupational Safety and Health Recommendation, 1981; International classification for health accounts (ICHA); World Health Organization "Guide to producing national health accounts", Annex B.
13. Work days lost due to accidents, injuries and illness: ILO Convention 155, "Occupational Health & Safety Convention" and Protocol 155, 1981; ILO Code of Practice on Recording and Notification of Occupational Accidents and Diseases, 1995.
14. Number of convictions for violations of corruption related laws or regulations and amount of fines paid/payable: OECD Convention on Combating Bribery of Foreign Public Officials; OECD Recommendation on Combating Bribery in International Business Transactions; OECD Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials; ICC Report on Extortion and Bribery in Business Transactions; ICC Commission on Anti-Corruption "Fighting Corruption: A Corporate Practices Manual"; United Nations Convention against Corruption.

ANNEX III. ECO-EFFICIENCY INDICATORS

Water consumption per net value added;
Global warming contribution per unit of net value added;
Energy requirement per unit of net value added;
Dependency on ozone-depleting substances per unit of net value added;
Waste generated per unit of net value added.

For more information on Eco-efficiency indicators, see the UNCTAD publication "A Manual for the Preparers and Users of Eco-Efficiency Indicators" (UNCTAD/ITE/IPC/2003/7).

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Chapter VIII

2006 REVIEW OF THE REPORTING STATUS OF CORPORATE RESPONSIBILITY INDICATORS

Summary of discussions

The Chair called upon a resource person to present the findings of the “2006 Review of the Reporting Status of Corporate Responsibility Indicators” (TD/B/COM.2/ISAR/CRP.2). The resource person began her presentation with an overview of the methodology employed in the survey and then provided a summary of the main findings. These findings include the observation that 25 per cent or more of the 105 enterprises surveyed provide at least partial information on 12 of the 17 selected indicators. The category “Contribution to Economic Development” was subject to the highest rates of reporting: four of the six indicators (excluding the test indicator on local purchasing) were addressed, at least in part, by more than 75 per cent of the enterprises surveyed, and five of the six by at least 50 per cent. The new test indicator “local purchasing” was reported on by a small group of enterprises, however, the survey did find slightly more enterprises in low and middle income countries reporting on this matter.

The resource person also identified a number of recent trends in the area of corporate responsibility reporting, including the increasing practice of including corporate responsibility information in annual reports, continuing growth in investor demands for corporate responsibility information, and the continuing demand for guidance on clear and concise corporate responsibility reporting indicators.

Following the presentation of the resource person, the Chair opened the floor for discussion. Many of the participants commended the survey and suggested that it may be a useful tool for further refining ISAR’s guidance on corporate responsibility reporting. Some suggestions were also made for additional analysis to explore some of the findings of the survey, including what factors influence different patterns of reporting in different countries, and what guidance or tools could be useful for providing assistance to enterprises.

I. Introduction

At its 20th, 21st and 22nd sessions, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) recognized the demand for improved comparability and relevance in corporate responsibility (CR) reporting. The Group of Experts also recognized the need to provide voluntary technical guidance on such reporting within corporate annual reports. At its 22nd session in the document TD/B/COM.2/ISAR/29 (ISAR/29), ISAR identified a limited set of core indicators that enterprises could use to report on issues of corporate responsibility. It was further emphasized that such reporting should be focused on national data rather than globally or regionally consolidated data, to better reflect corporate contributions to a specific host country's development. In the agreed conclusions of the 22nd session, the Group of Experts suggested that the UNCTAD secretariat should conduct a review of enterprise reporting practices based on selected indicators.

The objectives of this survey are to: (1) provide a brief overview of recent developments in the area of corporate responsibility reporting, especially as they relate to the work of ISAR in this area; and (2) to present and analyse the results of the secretariat's survey of corporate responsibility reporting.

II. Overview of recent developments in the area of corporate responsibility reporting

This section covers recent developments in the area of CR reporting, which have been marked by a continued increase in the number of enterprises issuing some form of CR report, and by a related increase in the number of investors that are integrating these issues into their investment decisions. However, it is observed that while more enterprises are producing CR reports, there is still a lack of clarity about the content and form of such reports. The "bulking up" or increasing length of CR reports, for example, is one recent trend that is seen by some as a product of the lack of clear and concise CR indicators. On the question of formats, a significant divergence in practices is observed in some countries, where a majority of enterprises are including CR information in their annual reports rather than, or in addition to, a separate CR report.

Another important development in CR reporting (discussed in more detail below) is the new draft guidelines from the Global Reporting Initiative, a multi-stakeholder initiative whose work on CR reporting is followed by a number of reporting enterprises. The new draft guidelines, known as "G3", are the first major revision to GRI guidance since 2002, and promise to address a number of weaknesses identified in the earlier 2002 guidelines.

Finally, this section examines the increasing use of CR reporting in investment decision making. A number of key developments are identified, including the launch of the United Nations Principles for Responsible Development, the continued growth of "socially responsible investment" (SRI), and the increasing incorporation of environmental, social and governance (ESG) information into the project financing approval mechanism of major financial institutions.

Growth in CR reporting

Two useful surveys on global CR reporting were published in 2005 and 2006, one produced by the accounting firm KPMG and one produced by Context, a United Kingdom-based consulting firm. In 2005, KPMG released its fifth international survey of corporate responsibility reporting, part of a series of triennial surveys begun in 1993. The survey examines the first 250 companies within the Fortune Global 500 (Global 250) as well as the largest 100 enterprises in 16 countries (National 100).⁸⁹ In 2006 the United Kingdom-based consulting firm Context, which has worked directly on a number of high profile CR reports, produced a survey based on the Financial Times Global 500 (FT 500), looking specifically at 300 companies grouped into the top 100 enterprises (FT 100) from each of the following areas: the United States, Europe and "the Rest of the World". Additional data and trends can also be identified from data obtained from the

⁸⁹ Company size is measured by sales for the Global 250, and revenues for the National 100. The National 100 group is made up of the largest 100 companies from 16 different countries (i.e. 100 x 16 = 1,600). The 16 countries are: the United Kingdom, Japan, Italy, France, Spain, the Netherlands, Australia, Denmark, Finland, Norway, Germany, South Africa, Belgium, Canada, Sweden, and the United States of America. KPMG, "International Survey of Corporate Responsibility Reporting 2005". Available from www.kpmg.com.

website: <http://www.CorporateRegister.com>, a searchable online database of thousands of corporate responsibility reports from enterprises countries around the world.

Both of these surveys found that CR reporting has become common among the enterprises in their respective survey samples. The 2005 KPMG survey found that 52 per cent of Global 250 companies, and 33 per cent of National 100 companies were issuing a CR report. These figures compare with 45 per cent and 23 per cent, respectively, in KPMG's previous 2002 survey. This suggests that the practice of CR reporting continues to grow at a significant rate and is increasingly a mainstream reporting practice.

The 2006 Context survey also found CR reporting to be widespread among the enterprises in its sample, especially those from Europe: 90 per cent of the European FT 100 produce a CR report, compared with 59 per cent of the United States FT 100 and 61 per cent for the "rest of the world". Context observes that "it is now extremely rare for a top European company not to produce some form of CR report."⁹⁰ The Context survey does note, however, that there are slightly more first-time reporters among the United States-based enterprises in the sample, and suggests that at the current rate of growth in CR reporting, it should only take a few years before United States-based enterprises and enterprises from other non-European countries, match the spread of CR reporting found in Europe.

Content of CR reports

With the existence of CR reports becoming more and more common, the attention of report preparers and users is increasingly being focused on the content and format of CR reports. The KPMG survey notes that the content of CR reports continues to broaden over time, from a relatively narrow focus on environmental reporting in the 1990s to coverage of wider issues of social and economic sustainability in the 2000s. And while attention to social and economic issues in CR reports continues to increase, KPMG's 2005 survey characterizes reporting performance on CR topics as "sketchy", suggesting that this is "possibly due to the lack of clear social indicators".⁹¹

This lack of clear and concise indicators has contributed to the increase in both the range of topics discussed as well as the overall size of CR reports. The Context survey found the average length of a European CR report to be 72 pages, while the length of the average United States CR report was only 44 pages, and the other enterprises in the survey fell somewhere in between with an average of 64 pages. In the United States, only one reporting company in the Context survey had a report over 100 pages, while in Europe almost 20 companies have reports that exceed 100 pages, and several have reports in excess of 200 pages. In 2006 the longest CR report was produced by BHP Billiton, a global mining company, weighing in at 380 pages. The Context report argues that, "this 'bulking' of CR reports has been encouraged by emerging standards, particularly from the GRI, and by demands that companies [...] address the full range of social, ethical and environmental issues."⁹² Context goes on to observe that "many companies are questioning the usefulness of these obese reports, judging them incapable of performing their basic purpose such as being read and understood." Consequently, there is renewed interest among CR reporters in creating more concise and useful reports; this includes a revived discussion on

⁹⁰ Context (2006). "Reporting in Context: Global Corporate Responsibility Reporting Trends 2006" www.econtext.co.uk, page 11.

⁹¹ KPMG and the Universiteit van Amsterdam (2005). "KPMG International Survey of Corporate Responsibility Reporting 2005". www.kpmg.com, page 5.

⁹² Context, *op. cit.*, page 5.

issues of materiality. KPMG argues that "the decision making process for defining materiality, and therefore the content of sustainability reports, needs further attention if future reports are to fulfil the information needs, and therefore the consequent actions, of investors, customers, neighbours and the public."⁹³

Complementing the demand for more concise and material reports, is the demand for more performance oriented reports. The Context survey argues that the latter issue is also the subject of increasing focus. Strengthening the link between reporting and performance on CR issues, Context argues, "...will be done by focusing reporting more closely on what companies are actually doing (rather than what they are thinking or how they are managing) and how well they have performed in the main areas. That will work more effectively as an internal tool to drive progress, as well as making it easier for analysts and others outside the company to make judgments about performance."⁹⁴

Concerning the development dimension of CR, the KPMG survey finds that while a majority of CR reports include financial information about the enterprise, such as profits, only a minority of enterprises report on their economic impacts within a broader sustainability context. This finding is supported by the Context survey, which observes that the reporting of economic impacts is undertaken by only a minority of reporters. This is particularly true for non-European based CR reporters, of whom only about 20 per cent or less report on economic impacts, compared to the approximately 40 per cent of European CR reporters that include economic impacts in their reports.

The KPMG survey also finds that the guidelines of the Global Reporting Initiative (GRI) are cited by 40 per cent of reporters in the Global 250. However, KPMG notes that only 30 per cent of the Global 250 actually report in the form of a GRI table. The discrepancy, KPMG suggests, indicates that reporters have not fully considered GRI's reporting principles on relevance, inclusiveness and completeness. The 2006 Context survey finds that a large number of enterprises (51 per cent of the top 100 in Europe and 41 per cent in the United States) include in their CR reports a GRI content index, while a further 10 per cent in Europe and 2 per cent in the United States are actually reporting "in accordance" with GRI, i.e. fully complying with the GRI guidelines. While the GRI guidelines remain the most common means for reporting enterprises to select topics, these guidelines have not been adopted by a majority of large enterprises: more than two thirds of the enterprises in the Context survey, for example, do not provide a GRI contents index.

Form of CR reports

Concerning the form of CR reports, the majority of CR reporting enterprises in most countries continue to produce separate CR reports. However, there has been a noticeable increase in the number of enterprises including CR information within their annual financial reports. Of the 2,008 CR reports in the CorporateRegister.com database for the year 2005, 93 per cent consisted of separate CR reports, while 7 per cent were sections within an annual financial report. This compares with 2002 figures, where 97 per cent consisted of separate CR reports, and 3 per cent were sections within an annual financial report.⁹⁵ The KPMG survey only began tracking the inclusion of CR sections in annual financial reports in its 2005 survey, so while it cannot make

⁹³ KPMG, *op. cit.*, page 20.

⁹⁴ Context, *op. cit.*, page 9.

⁹⁵ The CorporateRegister.com tracks CR sections in an annual financial reports if the CR section is at least six pages long.

comparisons to earlier surveys, it does find a significant number (12 per cent of Global 250 companies) are including CR information as part of their annual financial reports. In some countries this practice is particularly widespread. Of the 16 countries examined in the KPMG survey, South Africa stands out by a wide margin as a leader in the incorporation of CR reporting into annual financial reports: while 18 per cent of South Africa's largest 100 enterprises issue a separate CR report, a further 62 per cent report on CR issues within their annual financial reports. This is compared to the 8 per cent average for the National 100 in all 16 countries in the KPMG survey. South Africa is also an interesting example as it is the only developing country among the 16 in KPMG's survey. Including the CR information presented in annual financial reports, 80 per cent of South African's top 100 companies are reporting on CR issues. This is among the highest of any country in the survey, and almost double the average for all 16 countries. This may reflect the strong emphasis that the South African government has put on the role of corporations in social and economic development. For member states of the EU, more CR information in annual reports can be expected as a result of the European Modernization Directive, which requires that non-financial performance indicators be included in annual reports beginning with reports for the year 2005.

The Global Reporting Initiative's new guidelines "G3"

As noted above, the sustainability guidelines of the GRI remain one of the most common sources of guidance for enterprises producing CR reports. In October 2006 the GRI will be launching its third version of its guidelines. Known by the abbreviation "G3", these will be the first major revision to the guidelines since 2002. Prior to the October 2006 launch, the G3 guidelines were available in draft form for review. The format of the draft G3 are similar to GRI's earlier guidelines and generally recommend a narrative style of disclosure, largely focused on management policies and procedures. The content of the draft G3 guidelines, however, represents a thorough revision of the original 2002 Sustainability Reporting Guidelines: only 5 of the original indicators were left unchanged in the new draft guidelines. In some cases the revision of an indicator was to improve clarity as to what companies were expected to report. In other cases, indicators were substantially rewritten. The overall number of GRI indicators has been reduced from the 97 indicators in the 2002 Guidelines, down to 79 indicators in the draft G3 guidelines. The number of "core indicators" has been reduced from 50 down to 47. In the making of the draft G3 guidelines, 27 indicators were deleted from the 2002 guidelines and 9 new indicators were added. This includes instances where several indicators were combined into just one indicator, and instances where one indicator was separated into multiple indicators. The deletions were made on the basis of several factors, including: significant overlap with other GRI indicators, difficulty in application across different countries, and lack of clarity.

Integration of corporate responsibility reporting into investor decision-making

Environmental, social and corporate governance (ESG) issues continue become increasingly integrated into investor decision making, both for large institutional investors in the equity markets, and financial institutions in the lending markets. Investment managers surveyed for Mercer's "2006 Global Fearless Forecast Survey", especially in Europe, expect that an increasing proportion of their institutional clients will want ESG issues integrated into investment decision-making over the next three years.⁹⁶ This supports the prediction found in the earlier 2004 survey⁹⁷ of Deloitte Touche Tohmatsu ("In the dark – What boards and executives don't know about the health of their business") which found that the majority of fund managers and

⁹⁶ Mercer Investment Consulting (2006). "2006 Global Fearless Forecast Survey" www.merceric.com.

⁹⁷ Deloitte Touche Tohmatsu and the Economist Intelligence Unit. (2004). "In the dark – What boards and executives don't know about the health of their business". www.deloitte.com.

equity analysts they surveyed agreed that the consideration of these issues would become an important aspect of mainstream investment decision making by 2007. These surveys reflect a general trend towards the inclusion of non-financial reporting as a supplement to financial information, particularly reporting that incorporates ESG considerations into long-term risk and performance assessments.

A key milestone in this trend toward incorporating corporate responsibility information into investor decision making came in April 2006 when United Nations Secretary-General Kofi Annan launched the Principles for Responsible Investment (PRI). The PRI were the product of a year long consultation process convened by the United Nations Secretary-General and coordinated by the United Nations Environment Programme Finance Initiative (UNEP FI) and the United Nations Global Compact. The PRI cement ESG considerations as material risk factors to be incorporated by signatories on a voluntary basis into mainstream investment and engagement practices. Early signatories, with over \$4 trillion in managed assets, comprise a large portion of global pension assets; these signatories include CalPERS, the Norwegian Government Pension Fund, Canada Pension Plan Investment Board, ABP, and the Guardians of New Zealand Superannuation Fund, among others.⁹⁸

The launch of the PRI has had the effect of broadening what was once considered the niche area of socially responsible investing (SRI), a practice that incorporates ESG as well as other non-financial considerations into investment decisions. Because this investing approach bases its investment decisions on CR information as well as financial information, the growth of SRI leads to greater demand for non-financial information on CR issues. In recent years, the practice of SRI has continued to grow among both large pension funds and retail investment houses. According to the Social Investment Forum's 2005 report on SRI, 9.4 per cent of the \$24.4 trillion in total assets under professional management in the United States are now involved in socially responsible investing.⁹⁹ The report also notes that SRI assets in the United States have grown 4 per cent faster over the last ten years than the entire universe of managed assets in that country; this growth includes both asset appreciation and new assets entering the market. In absolute terms, SRI assets have grown from \$639 billion in 1995 to \$2.29 trillion in 2005, an increase of 258 per cent; during the same years, the total universe of managed assets in the United States grew from \$7 trillion to \$24.4 trillion, an increase of under 249 per cent.

While the United States is the largest equity market, and has the largest SRI segment, socially responsible investing continues to grow in other parts of the world. Elsewhere in North America, the Canadian Social Investment Organization in its last survey in 2004, observed that Canadian SRI assets were valued at C\$65.46 billion (approximately \$58.25 billion), and had grown some 27 per cent between 2002 and 2004.¹⁰⁰ In Europe, which contains the largest equity markets outside the United States, SRI is also a significant segment of the equity market. According to the European Social Investment Forum (EuroSIF)'s 2006 survey,¹⁰¹ the broad European SRI market is up to €1 trillion (approximately \$1.3 trillion) and represents between 10 to 15 per cent of the total European funds under management in 2006. EuroSIF observes that SRI assets in the nine countries¹⁰² surveyed have grown by 36 per cent since its last survey published

⁹⁸ United Nations Principles for Responsible Investment, www.unpri.org.

⁹⁹ SIF (2006). "2005 Report on Socially Responsible Investing Trends in the United States: 10 Year Review". Social Investment Forum. www.socialinvest.org.

¹⁰⁰ Please see www.socialinvestment.ca.

¹⁰¹ EuroSIF (2006). "European SRI Study 2006", European Social Investment Forum, www.eurosif.org.

¹⁰² The countries included in the EuroSIF survey are: Austria, Belgium, France, Germany, Italy, the Netherlands, Spain, Switzerland and the United Kingdom.

in 2003. The report contends that the driving force behind SRI growth in Europe is the increasing use of ESG information by institutional investors, especially pension funds, in the management of their assets. In Australia, managed SRI portfolios grew by 70 per cent between June 2004 and June 2005, from A\$4.5 billion to A\$7.67 billion (approximately \$5.76 billion).¹⁰³ Australia has also witnessed the launch of the world's first certification program for managers of SRI funds. Launched in September 2005 by the Ethical Investment Association, (a professional body of fund managers and financial advisors working in the area of SRI), the certification program provides a unique logo to help investors distinguish SRI funds from other investment products.

SRI is also becoming more common in developing countries with securities exchanges. The Johannesburg Stock Exchange (JSE) of South Africa, for example, is a pioneer in this respect, having launched the first SRI index in a developing country. The JSE's SRI index was introduced in May 2004 and is composed of companies from the FTSE/JSE All Share Index that voluntarily apply for inclusion in the index. Applicants are judged based on their environmental, social, economic and governance performance. CR reporting plays an important part in this process, with the JSE advising potential participants to report regularly, clearly and comprehensively on CR issues. The resulting index has helped to promote investment in South Africa, as noted by an executive from one enterprise in the JSE SRI index, who says that the index has helped by "...raising the profile not only of companies that embrace the practice [of sustainability], but also of South Africa as an investment destination for responsible investors."¹⁰⁴

In Brazil, BOVESPA, the principal stock exchange, launched its own SRI index in late 2005. The Corporate Sustainability Index, or *Índice de Sustentabilidade Empresarial* (ISE) in Portuguese, was launched in December 2005. The index is composed of a maximum of 40 enterprises selected from among the BOVESPA's 150 most actively traded securities in terms of liquidity. The criteria for selection are similar to those of the JSE's SRI index, and include an evaluation of performance on environmental, social, economic and governance issues. The quality of enterprise reports on CR issues is an important consideration in this process.

Brazil and South Africa are two pioneering examples of SRI in developing countries, but other examples do exist and new SRI funds and indices in developing countries continue to be developed. The International Finance Corporation (IFC) estimates that SRI assets in developing countries have already reached \$2.7 billion.¹⁰⁵ The growth of SRI can be expected continue to grow in emerging markets, as well as demand for improved reporting on issues of corporate responsibility. The Association for Sustainable and Responsible Investment in Asia (ASrIA) in a 2006 report, concluded that one of the principle obstacles to the development of SRI in developing countries is the lack of credible, standardized data on business practices related to social and environmental concerns.¹⁰⁶ In an attempt to meet this need for improved information, the IFC launched in 2006 its "Capturing Value Programme". This program provides grants of up to \$500,000 to research houses, rating firms, index providers, and similar organizations, to develop new specialized environmental and social information services geared to sustainable and responsible investment in publicly listed emerging market firms. The aim of this programme is to

¹⁰³ EIA. (2005). "Sustainable Responsible Investment in Australia – 2005". Ethical Investment Association. www.eia.org.au.

¹⁰⁴ JSE. (2006). "SRI Index: Quotes from Some of the Constituents". Johannesburg Stock Exchange, April 25. Quote by Adv Selby Baqwa, Group Executive, Enterprise Governance and Compliance, Nedbank Group. www.jse.co.za/sri.

¹⁰⁵ IFC estimate quoted in SIF (2006). See note 6 above.

¹⁰⁶ ASrIA. (2006). "Taking Stock: Adding Sustainability Variables to Asian Sectoral Analysis". Association for Sustainable and Responsible Investment in Asia. www.asria.org.

facilitate an increase in investment in emerging markets from pension funds and other investors worldwide. By meeting the information gap identified by the ASrIA's report, this IFC programme could be expected to lead to further growth of SRI in developing countries.

Financial institutions in the lending markets also continue to increase their integration of ESG issues into decisions to extend financing to enterprises. In February 2006, the IFC adopted new environmental and social standards for its activities. The new standards build upon the environmental and social requirements that the IFC previously applied to private sector projects it finances in the developing world. A new policy on disclosure was also adopted at the same time and will increase the disclosure of ESG information by the IFC itself, as well as its client companies. Lars Thunell, the IFC's Executive Vice President, said, "We aim, with these new policies, to increase the development impact of projects in which we invest. We also seek to give companies operating projects in emerging markets the capacity to manage fully their environmental and social risks and to compete better in a global economy."¹⁰⁷

The IFC's standards are closely linked to those of the Equator Principles. These are a set of environmental and social guidelines, based on the IFC's standards, that are now applied by leading commercial financial institutions which collectively represent approximately 80 per cent of global project finance. Participating financial institutions commit to financing only those projects that comply with the ESG standards of the Equator Principles. Following the announcement of the revised IFC standards, the Equator Principles were themselves updated in July 2006. Among the new revisions, each of the financial institutions that adheres to the Equator Principles will now be required to report on an annual basis on the progress and performance in implementing the principles. The Managing Director of Employee Relations and Social and Environmental Responsibility for Banco do Brasil, a major Brazilian bank that has adopted the Equator Principles, said of the new revision: "Society expects the financial agents to make sure that the allocation of resources takes into consideration the integration of the business aspects related to the preservation of the environment and the respect of social matters. The revision of the Equator Principles is, therefore, an important landmark in compliance with society's increasing expectations of the social and environmental responsibility of the financial sector."¹⁰⁸

III. Status of implementation of corporate responsibility reporting at the company level

A. Background and methodology

The purpose of the survey is to evaluate the level of reporting on the corporate responsibility indicators identified during the 22nd session of ISAR in the paper TD/B/COM.2/ISAR/29 "Guidance on Corporate Responsibility Indicators in Annual Reports" (ISAR/29). That document selected 17 core indicators that enterprises could use in reporting on corporate responsibility issues in annual reports. A summary of these 17 core indicators can be found in Table 1 below. In addition to the indicators found in this table, the survey also includes one additional test indicator, "local purchasing", that reflects the value of goods or services purchased by an enterprise within the host economy. During the initial stages of the survey, it was noticed that a number of enterprises were reporting this information, and therefore it was decided to include it in the survey to determine the extent to which it was being reported.

¹⁰⁷ IFC (2006). "IFC Adopts New Environmental and Social Standards". Press release. www.ifc.org.

¹⁰⁸ July 2006. "Financial Institutions Announce Revision of Equator Principles". www.equator-principles.com.

Table 1. Selected indicators on corporate responsibility

Group	Sub-Group	Indicator
Contribution to economic development		1. Total sales. 2. Value of imports vs. exports. 3. Total workforce. 4. Employee wages and benefits. 5. Payments to government. 6. Labour productivity.
Human rights	<i>Security</i>	7. Number of enterprise operations with armed security.
Labour practices	<i>Equal Opportunity Workforce Turnover Collective Bargaining</i>	8. Number of female employees and ratio of male to female wages and benefits. 9. Total number and rate of employee turnover. 10. Percentage of employees covered by collective bargaining agreements.
Human resource development		11. Average hours of training. 12. Expenditure on employee training.
Health and safety		13. Expenditure on employee health and safety. 14. Work days lost due to accidents, injuries and illness.
Community support		15. Voluntary contributions to civil society.
Value chain		16. Number of dependent enterprises in the value chain.
Corruption		17. Number of convictions for violations of corruption related laws or regulations and amount of fines paid/payable.

These 17 indicators, plus the one additional indicator on local purchasing, were tested against the actual reporting practices of a large sample of enterprises from around the world. The sample of enterprises examined in the survey was comprised of leading enterprises making a significant contribution to the economy in which they are based. The survey examined 105 enterprises from 71 economies, with a broad regional distribution (see Figure 1 below).

Enterprises selected for the survey were drawn from the top ten largest enterprises found within each region; the relative size of the enterprises was determined using sales and market capitalization data. The enterprises included in the survey represent a wide range of industries including: energy, financial services, telecommunications, pharmaceuticals, manufacturing, and retail, among others. The survey included publicly listed enterprises, privately held enterprises and SOEs. The enterprises were based in both high income and middle and lower income countries, and represent both locally listed enterprises as well as internationally listed ones (see Figure 2 below). The sample includes a significant number of state owned enterprises (See the inner box of Figure 2). Nine of the enterprises in the survey (all from low or middle income countries) were not listed and therefore do not appear in Figure 2; of these, seven were privately held, and two were non-listed SOEs.

Figure 1. Distribution of the 105 enterprises by region
(Number indicates the number of enterprises surveyed)

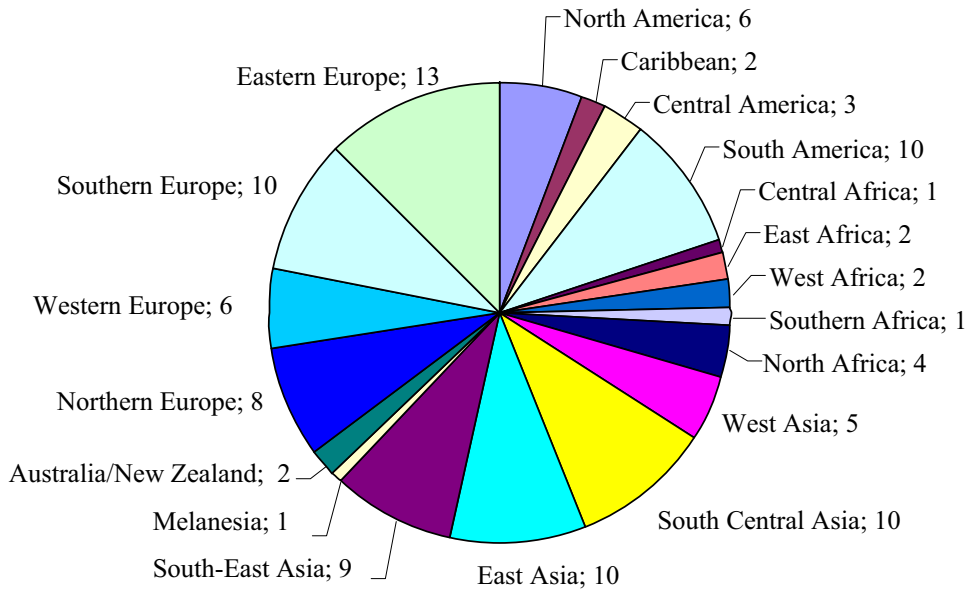


Figure 2. Distribution of the 96 listed enterprises by type of listing and country income

	OECD and other high income	Low and middle income				
Only local listing	5	23				
	<table border="1"> <thead> <tr> <th>SOE</th> <th></th> </tr> </thead> <tbody> <tr> <td>1</td> <td>8</td> </tr> </tbody> </table>		SOE		1	8
SOE						
1	8					
International listing	33	35				

The review of corporate reporting is based primarily on three sources of corporate reporting: separate CR reports, annual financial reports, and additional information provided on company websites. As noted below, the reporting of the CR indicators was classified as either “full” or “partial”. This classification reflects the different ways in which enterprises report on the same matters, with some enterprises reporting more completely on each indicator, and others that

provide some but not all of information. For example, when considering the indicator "employee wages and benefits", an enterprise that reports on the total amount of employee wages, but not on the value of benefits, would be considered to have had partial disclosure. Another methodological approach affecting the survey was that the focus of the survey was on 'national' reporting. This focus on national reporting in the area of CR follows from the deliberations of the 22nd session of ISAR, where it was emphasized that globally consolidated figures that do not allow for disaggregation, are of little value to users of the reports who require information on an enterprise's activities in a particular country.

B. Main findings of the survey

General overview

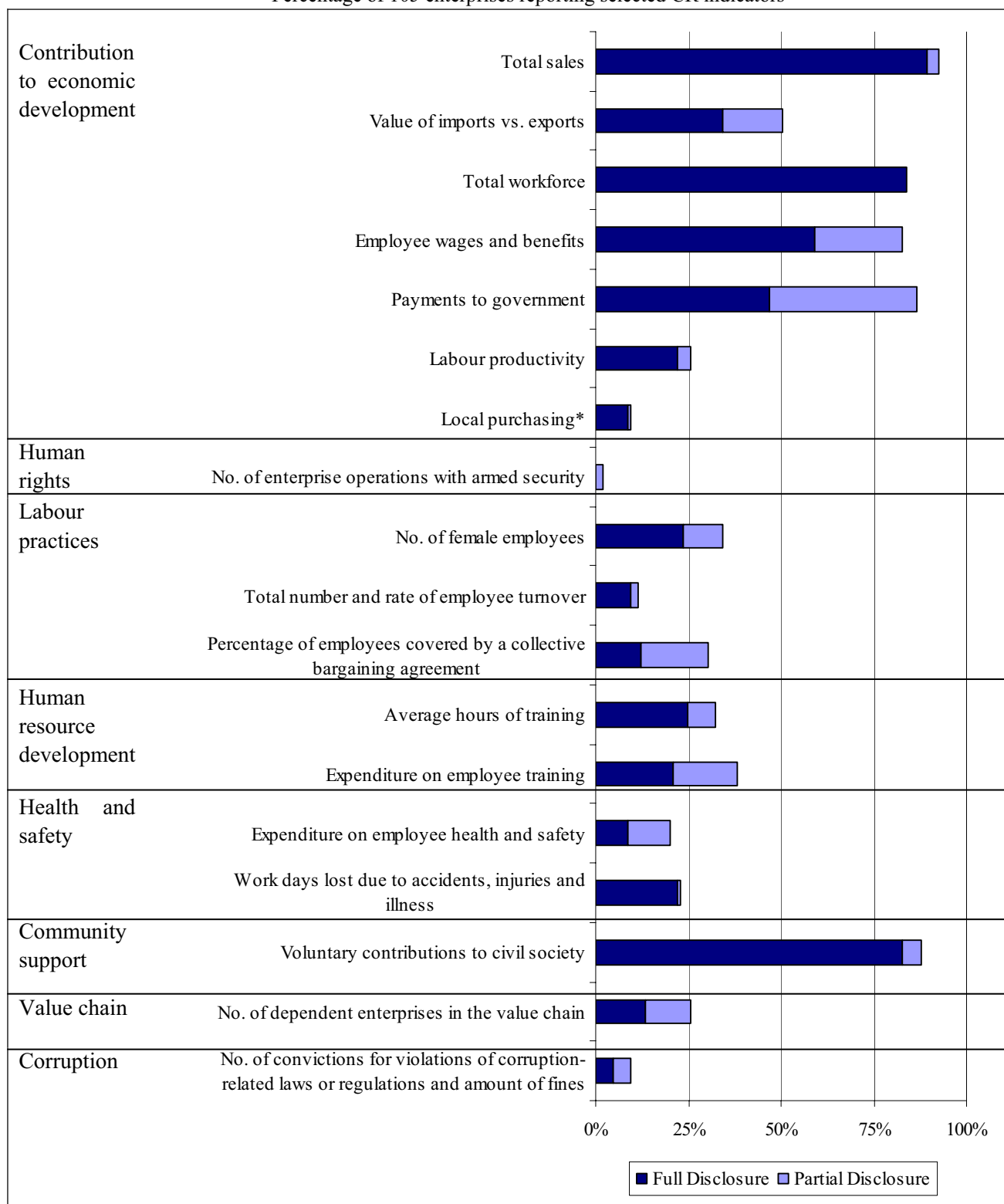
The main findings of the survey are displayed in Figure 3 (below) which provides an overview of the prevalence of each of the selected CR indicators. Complete details of the findings can also be found in Annex I.

The main findings of the survey show that 25 per cent or more of the 105 enterprises surveyed provide at least partial information on 12 of the 17 indicators originally identified in ISAR/29. The rate of reporting is much higher in the case of the selected indicators in the category "Contribution to Economic Development", where 4 of the 6 indicators (excluding the test indicator on local purchasing) are addressed, at least in part, by more than 75 per cent of the enterprises surveyed, and 5 of the 6 by at least 50 per cent. The lowest reported indicator in this category "labour productivity" was still the subject of reporting for 25 per cent of the enterprises surveyed. The new test indicator "local purchasing" was not widely reported on, however, as discussed in more detail below, there were slightly more enterprises in low- and middle-income countries reporting on this matter.

It is useful to explain the lack of 100 per cent disclosure for the first indicator "total sales", as it has relevance to the issue of nationally-oriented reports. Given the nearly universal reporting of financial and operating results, it is curious to see that less than 100 per cent of enterprises report on "total sales". The answer, however, lies in the methodology of the CR survey, which focused specifically on national reporting, and the reporting practices of some subsidiaries of TNCs. While many of these subsidiaries produce a range of nationally oriented corporate reporting, in a small minority of cases (less than 10 per cent of the survey sample) national sales figures are not provided. This was found in particular among some companies in the natural resource extraction business, which reported the *volume* of material sold but not the actual *value* of the material sold.

Figure 3. Main findings of survey on corporate responsibility reporting

Percentage of 105 enterprises reporting selected CR indicators



*New indicator tested in survey

Outside of the category of “contribution to economic development” the most commonly reported indicator was “voluntary contributions to civil society”, which was reported on by more than 80 per cent of enterprises in the survey. Among the least commonly reported indicators were three which were reported on by less than 10 per cent of the enterprises in the survey. These three were: “number of enterprises with armed security” with only 2 per cent of enterprises reporting partial information for this indicator; the indicator “number of convictions for violations of corruption-related laws or regulations and amount of fines” which was reported on by 5 per cent of the enterprises; and “expenditure on employee health and safety”, which was reported on by 9 per cent of the enterprises, but was partially reported on by a further 11 per cent. The information behind these indicators has not traditionally been the subject of public reporting, therefore the results of the survey may reflect the relatively small number of leading companies in CR reporting that are developing best practice on these matters.

C. Comparison of CR reporting between internationally listed companies and only locally listed companies

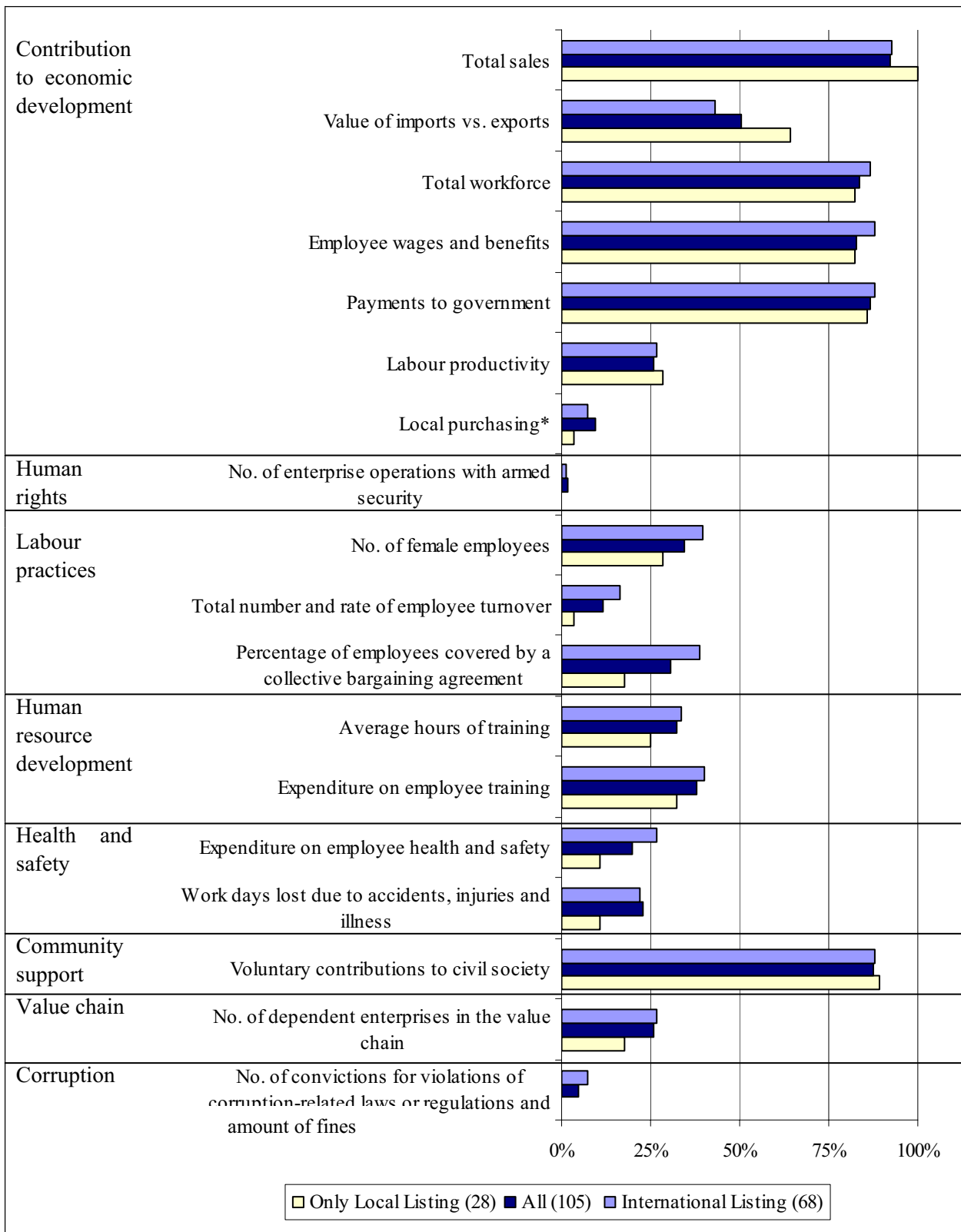
Figure 4 presents the average frequency of disclosure within each category and compares the reporting practices of enterprises listed on international exchanges with those listed only on a local or national exchange. For this figure, full and partial reporting have been combined as one figure to facilitate a general comparison. The dark centre line in Figure 4 represents all enterprises in the survey and provides an overview of the reporting practices for the different categories.

One general observation is that while internationally listed enterprises tend to have higher rates of reporting for *most* of the selected indicators, they do not have higher rates of reporting for *all* of the indicators. Specifically, locally listed enterprises tend to have significantly higher rates of reporting on the indicators “total sales” and “value of imports vs. exports” found in the category “contribution to economic development”. This difference in reporting practices may be the result the difference between companies that focus primarily on one national market, and companies that focus on multiple markets around the world. Locally listed enterprises tend to focus on one national market, and therefore tend to provide more nationally oriented economic data. In contrast, internationally listed enterprises are often globally active TNCs and therefore tend to provide more globally or regionally consolidated reports.

Outside of the category “contribution to economic development” the internationally listed enterprises tend to have significantly higher rates of reporting for all indicators, except “voluntary contributions to civil society”, which is reported on by nearly the same number of enterprises in both groups. For some of the indicators, at least part of the higher rate of reporting for enterprises listed on international exchanges is due to the listing requirements of the major international financial markets: the indicator on “percentage of employees covered by a collective bargaining agreement” for example, is often reported by enterprises listed in the United States, due to a United States Securities and Exchange Commission requirement to report on “information regarding the relationship between management and labor unions” (Item 6-D in Form 20-F).

Figure 4. Comparison between internationally listed companies and only locally listed companies

Percentage of enterprises reporting selected CR indicators; both full and partial disclosure
(Number in parentheses indicates sample size)



D. Comparison of CR reporting between enterprises from high-income and low- and middle-income countries

Figure 5 compares the reporting practices of enterprises based in high income countries with those based in middle and lower income countries. For this figure, full and partial reporting has been combined as one figure to facilitate a general comparison. The dark centre line in Figure 5 represents all enterprises in the survey and provides an overview of the reporting practices for the different categories.

Analyzing enterprise reporting based on country income level produces a much more mixed set of findings than those found in the analysis based on type of listing. For many indicators, countries from low and middle income countries have a higher rate of reporting. This is particularly true for the indicators in the two categories “contribution to economic development” and “human resource development”. At the same time, enterprises from high-income countries tend to have a higher rate of reporting for the indicators in the three categories “labour practices”, “health and safety” and “corruption”. This difference in reporting practices may reflect differences in demands among stakeholders: in low and middle income countries, there may be more demand for information on contribution to economic development, while in high income countries, there may be greater demand for information on the non-economic impacts of enterprises. These differences in stakeholder demands, may in turn may reflect different developmental priorities, with developing countries having a greater focus on economic development issues (e.g. job creation and poverty reduction), and developed countries having a greater focus on social and environmental issues (e.g. labour practices and emissions).

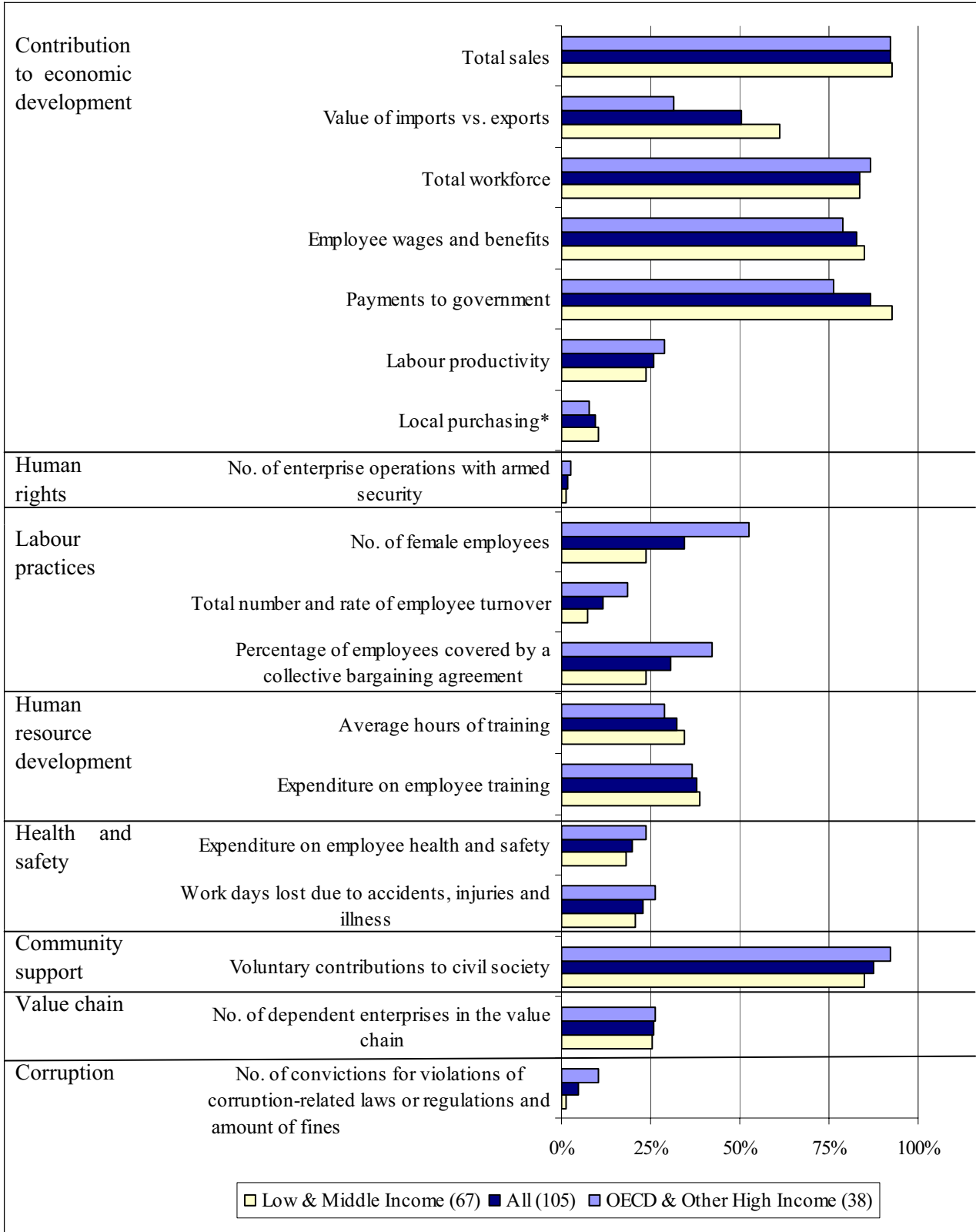
E. The reporting context: prevalence and forms of CR reporting

In order to better understand the overall rate of CR reporting as well as the location of that reporting, Figure 6 below provides an overview of the percentage of enterprises in the survey reporting CR information, along with the location of that information, e.g. CR reports separate from the annual report, CR sections in the annual report, and CR sections on the website only.¹⁰⁹ This analysis shows that most of the enterprises in the survey are reporting on CR issues, with a large portion of them reporting on these issues either in a separate CR report (most common for enterprises from high income countries) or in a section of the annual report (most common for enterprises from low and middle income countries). Reporting CR information only on a company's website is most common among only locally listed enterprises.

¹⁰⁹ Enterprises that publish separate CR reports typically make reference to these reports in their annual reports and their websites. The distinction made here is between enterprises that use a separate CR report and those that publish CR information in their annual report *without* a separate CR report. Website-only publication indicates that the company does not publish CR information in a separate CR report or its annual report, but does publish such information on its website.

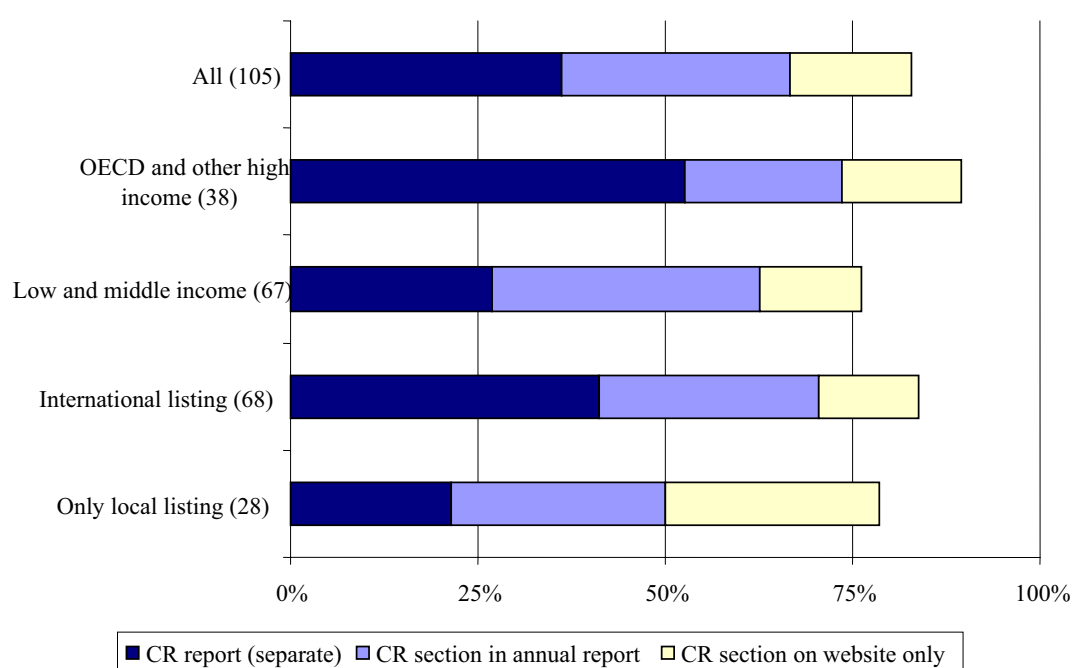
Figure 5. Comparison between enterprises from high-income countries and low- and middle-income countries

Percentage of enterprises reporting selected CR indicators – both full and partial disclosure
(Number in parentheses indicates sample size)



This finding is similar to the results of KPMG and the Corporate Register discussed above. According to the KPMG data, 52 per cent of Global 250 enterprises produce a separate CR report, with an additional 12 per cent producing a CR section in their annual financial reports. As most of the Global 250 originate from high income countries, this finding compares closely with the result of this survey, where 53 per cent of enterprises in high income countries were found to have separate CR reports and a further 21 per cent were found to have CR sections within their annual financial reports. It should be noted, however, that methodological differences between this survey and those of KPMG and the Corporate Register can account for some significant differences. For example, the CorporateRegister.com website only tracks CR sections in annual reports if those sections are at least six pages in length. In this survey, CR sections within annual reports were counted regardless of length, as long as they appeared as distinct sections focused on an established topic of CR.

Figure 6. Enterprises reporting CR information and the location of that information
(Number of enterprises in parentheses)



IV. Conclusions

This report is the first ISAR review of the reporting status of corporate responsibility indicators based on the indicators identified during the 22nd session of ISAR in the paper TD/B/COM.2/ISAR/29 “Guidance on Corporate Responsibility Indicators in Annual Reports” (ISAR/29). The corporate reports of 105 enterprises from 71 economies were surveyed to identify the prevalence of the corporate responsibility indicators identified in ISAR/29. The resulting data has been analyzed based on type of enterprise listing and country income. The survey also includes an analysis of the location of that information.

Recent trends indicate that CR reporting has become a mainstream practice among large enterprises, and that social issues, along with environmental and governance issues, are

increasingly being integrated into investment decision making, especially among large institutional investors. Both reflecting and reinforcing this trend are a number of new international instruments, such as the United Nations Principles for Responsible Investment. One area of ongoing weakness, however, is the lack of harmonization of existing reporting practices and the need for improvement in the areas of comparability and materiality.

The findings of this analysis of the reporting practices show that 12 of the 17 selected indicators in ISAR/29 are reported, at least partially, by a 25 per cent or more of the enterprises in the survey. Reporting rates for the selected indicators in the category of “Contribution to Economic Development” were generally the highest among all enterprises, with 5 out of 6 of the selected indicators being reported on, at least partially, by 50 per cent or more of enterprises.

Further analysis on the CR reporting practices of enterprises can serve as a useful tool for refining and finalizing the selected indicators found in ISAR/29, and the methodology for reporting the indicators found in ISAR/34. This detailed examination of reporting practices also provides valuable examples of good practices that could be highlighted in case studies to assist enterprises in the practical application of reporting the selected indicators.

ANNEX: DETAILS OF FULL AND PARTIAL DISCLOSURE FOR CR INDICATORS
(Number of enterprises in parentheses)

Indicator	All (105)		International listing (68)		Only local listing (28)		OECD and other high income (38)		Low and middle income (67)		SOE (24)						
	Full	Partial	Full	Partial	Full	Partial	Full	Partial	Full	Partial	Full	Partial					
Contribution to economic development (in per cent)*																	
Total sales	90	3	93	1	93	7	92	0	88	4	96	4					
Value of imports vs. exports	34	16	32	10	43	21	18	13	43	18	38	21					
Total workforce	84	0	87	0	82	0	87	0	84	0	88	0					
Employee wages and benefits	59	24	59	28	68	14	39	39	70	15	83	17					
Payments to government	47	40	44	44	54	32	32	45	55	37	75	17					
Labour productivity	22	4	21	6	29	0	21	8	22	1	29	0					
Local purchasing*	9	1	7	0	4	0	8	0	9	1	8	0					
Human rights (in per cent)																	
No. of enterprise operations with armed security	0	2	0	1	0	0	0	3	0	1	0	0					
Labour practices (in per cent)																	
No. of female employees	24	10	26	13	25	4	37	16	16	7	13	0					
Total number and rate of employee turnover	10	2	15	1	0	4	16	3	6	1	13	0					
Percentage of employees covered by a collective bargaining agreement	12	18	18	22	4	14	18	24	9	15	4	17					
Human capital development (in per cent)																	
Average hours of training	25	8	26	7	14	11	26	3	24	10	17	8					
Expenditure on employee training	21	17	22	19	18	14	13	24	25	13	21	13					
Health and safety (in per cent)																	
Expenditure on employee health and safety	9	11	9	18	11	0	5	18	10	7	8	8					
Work days lost due to accidents, injuries and illness	22	1	22	0	11	0	26	0	19	1	8	4					
Community support (in per cent)																	
Voluntary contributions to civil society						83	5	84	4	82	7	84	8	82	3	58	17
Value chain (in per cent)																	
No. of dependent enterprises in the value chain						13	12	16	12	7	11	18	8	10	15	0	29
Corruption (in per cent)																	
No. of convictions for violations of corruption-related laws or regulations and amount of fines						5	0	7	0	0	0	11	0	1	0	4	0

*Due to rounding errors, the numbers in this table may not match exactly the charts in the main body of the document.

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Chapter IX

2006 REVIEW OF THE IMPLEMENTATION STATUS OF CORPORATE GOVERNANCE DISCLOSURES

Summary of discussions

The Chair introduced the agenda item and gave the floor to a member of the UNCTAD secretariat, who presented the findings of the “2006 Review of the Implementation Status of Corporate Governance Disclosures” (TD/B/COM.2/ISAR/CRP.3). He explained the methodology of the survey and highlighted the key findings, including good disclosure of financial information, relatively poor disclosure on auditing issues, the tendency of enterprises with an international listing to have better disclosure than enterprises with a local listing only, and the tendency of enterprises based in higher income countries to have better disclosure than enterprises based in lower income countries. The secretariat also highlighted the new UNCTAD publication “Guidance on Good Practices in Corporate Governance Disclosure” and explained that it served as a basis for the “2006 Review of the Implementation Status of Corporate Governance Disclosures”.

The Chair introduced a panel of experts to discuss corporate governance disclosure. The panellists commended the 2006 survey and raised several important issues. These included: emphasis on the importance of good corporate governance disclosure for attracting investment and accessing foreign capital markets; the corporate governance disclosure practices of State Owned Enterprises; the necessity to improve transparency of remuneration and executive payment; the importance of timely disclosure; country examples in implementing corporate governance rules at stock exchanges; and the impact that different legal systems have on different corporate governance codes.

The Group further discussed the challenges and problems in enforcing rules on corporate governance disclosures. Related to this question was a discussion on the best means of ensuring that companies comply with rules on corporate governance disclosures, for example, through market mechanisms, listing requirements or regulatory requirements. The Group also identified a number of questions raised by the survey, such as why auditing issues are subject to lower disclosure rates in low- and middle-income countries. The Group's discussion also included consideration of corporate governance issues related to enterprises in the informal sector. On the subject of the impact of legal systems on corporate governance disclosure, participants discussed conflicts that may arise when an enterprise faces both contractual obligations requiring confidentiality, and demands from investors and other stakeholders for good practices in corporate governance disclosure.

I. Introduction

ISAR has considered corporate governance an important area of work since 1989 (E/C.10/AC.3/1989/6). During the 21st and 22nd sessions of ISAR in 2004 and 2005 respectively,

the Group of Experts supported an annual review of the implementation status of corporate governance disclosure.

The 2006 third annual review, uses as a benchmark ISAR's deliberations on corporate governance disclosure found in the 2006 UNCTAD publication "Guidance on Good Practices in Corporate Governance Disclosure". The 2004 and 2005 Reviews were based on earlier versions of that document, namely TD/B/COM.2/ISAR/15 and TD/B/COM.2/ISAR/30, respectively. Compared to the 2004 Review, the 2005 Review employed a significantly enhanced methodology with a much larger sample size consisting of 105 enterprises from 70 economies. The methodology and survey sample of the 2006 Review is largely the same as the 2005 Review, with some additional improvements to research methods and some minor changes to the population of enterprises surveyed. These are described in more detail in Section II below.

The objectives of this survey are to: (1) provide a brief overview of recent developments in corporate governance since the 22nd session of ISAR, and; (2) to present and analyse the results of the 2006 survey of corporate governance disclosure practices. The overview of recent developments is provided in Section I, which also examines the emerging trend of corporate governance indexes, funds and information services for investors. Section II analyses the survey results based on the type of the company's listing (i.e. local or international) and the income level of the country in which the firm operates (OECD and other high income, or low and middle income). It also discusses disclosure practices of state-owned enterprises (SOEs).

The findings of the 2006 Review are relatively consistent with those of the earlier reviews. In particular, it is observed that enterprises from low- and middle-income countries tend to have lower rates of corporate governance disclosure compared to enterprises in high income countries; and enterprises that have only a local stock market listing tend to have lower rates of disclosure than enterprises that are listed internationally. Important nuances within these broader patterns are discussed in Section II below.

II. Overview of recent developments in the area of corporate governance disclosure

The trends identified in ISAR's 2005 Review as applying to the 2004/2005 ISA intersession period have continued to be relevant in shaping disclosures in the 2005/2006 period.

An overarching theme within recent developments in corporate governance disclosure is the increased global emphasis on the exercise of shareholder ownership rights, especially voting rights, as vitally important to good governance. This is found in a number of recent developments, including: more timely and accessible information about general meetings and proxy materials, the removal of regulatory barriers and use of available technologies to facilitate voting, promoting accountability of large institutional investors, the growth of an industry aimed at providing proxy advice, remuneration disclosure tailored to investors and increased shareholder power with respect to director elections and remuneration.

Developments over the past year reflect the double-sided approach of many governments to improving corporate governance practices and promoting investor confidence in the stock market: (1) regulation strengthening shareholder rights, whether more of a 'rules-based' or a 'comply or explain' approach; and (2) pressure on institutional investors to exercise their ownership rights in the long-term interest of their beneficiaries. Another continuing trend is the convergence of governance practices and regulatory approaches to good corporate governance. This overview begins with a review of recent developments in the convergence of corporate governance practices. It continues with an examination of new developments in Asia with respect

to disclosure and regulatory changes that strengthen shareholder rights, with particular focus on China. The review then considers major themes that have dominated developments internationally, including: share voting reform in Europe and the United States; majority voting rules; shareholder control over executive remuneration; and fund governance and disclosure, among others.

Convergence of governance practices

The United States and the United Kingdom, due to their large capital markets, continue to stand out as dominant influencers of international governance practices and therefore developments in these countries would appear to deserve special attention. The corporate governance model that prevails in these two countries (often referred to as the Anglo-American model) includes dispersed ownership, a strong role for investment institutions, emphasis on director independence and the oversight role of the board, and the primacy of shareholders relative to other stakeholder groups.

However, the disclosure regimes in the United States and United Kingdom differ somewhat, with the United Kingdom's 'comply or explain' disclosure regime more similar to that of Continental Europe than to the 'rules-based' style of the United States regime. The 'comply or explain' disclosure style places greater emphasis on full voluntary disclosure, often narrative, guided by principles and enforced through market scrutiny, whereas the 'rules-based' style places greater emphasis on compliance, standardized disclosure and legal enforcement and litigation.

In assessing prospects for international conversion in governance disclosure, the European 'comply or explain' model, given its flexibility and lower enforcement costs, is considered by some to provide a more viable alternative to the "rules-based" United States approach for many countries. However, its success depends on the responsiveness of the market to non-compliance. Standardized disclosures, more characteristic of the 'rules-based' approach exemplified by the Sarbanes-Oxley Act of 2002, provide for greater transparency in specified areas, such as compensation disclosure, and appear to be more suitable for reporting to a single stakeholder group, namely, shareholders.

Developments with respect to disclosure regimes internationally indicate United States influence in the development of rules requiring disclosures to shareholders, and European influence in the spread of the 'comply or explain' approach to governance disclosure and enforcement. However, the most recent changes to the United Kingdom company law and to EU regulation also require regulators and governments to exercise compulsion, for instance, with respect to improving shareholder rights.

In the past year Belgium, Estonia, Jamaica, Latvia, Portugal and Spain have produced new governance codes and Denmark, Italy, Singapore, Sweden and the United Kingdom have revised their Codes. A number of countries base their codes on the United Kingdom code.¹¹⁰ The most recent amendments to the United Kingdom's Combined Code on Corporate Governance were published in June 2006 and will come into effect towards the end of 2006. They allow for greater use of corporate websites to disclose committee remits and convey proxy information to shareholders. The revisions also suggest companies include a 'withhold vote' option on proxy forms to allow investors to express reservations about a proposal by abstaining from it without voting for or against. This practice is already widely used by United Kingdom listed

¹¹⁰ Financial Reporting Council (2006). The Combined Code on Corporate Governance, June. Available at: <http://www.frc.org.uk>.

companies.¹¹¹ The ‘comply or explain’ model predominates as the model for disclosure: all new codes, except for that of Belgium, are based on the ‘comply or explain’ model.

Regulatory reform in Asia

According to the annual report¹¹² by CLSA (a financial services firm based in Hong Kong, China) and the Asian Corporate Governance Association (ACGA), there continues to be a split among large Asian companies in their commitment to transparency and accountability, in particular with respect to disclosure of internal controls and mechanisms for addressing conflicts of interest. However, the report does observe a considerable improvement in financial reporting standards and practices in most markets. It views rules on disclosure of ‘material transactions’ and other price-sensitive information as having become stricter. It also notes that ‘voting by poll’ (whereby votes are fully counted and the results published) is moving onto the agenda of leading companies in some Asian markets, notably Hong Kong (China), and argues that this is likely to become more of an issue in the future. And, the report finds that the best companies are responding to market demands for quicker release of annual and interim results. The report concludes, however, that due to inconsistent enforcement of rules, there tends to be a wide variation in compliance within markets, with larger companies tending to have better compliance.

One significant development in Asia during the intersession period was the new Company Law of the People’s Republic of China, which came into effect in January 2006. It contains shareholder protections which compare to global best practice in many respects. These include, for example, conditions under which a company must repurchase shareholders’ shares, conditions under which shareholders can put forward resolutions and petition the Peoples’ Court to liquidate the company, and new shareholder rights to view and make copies of the company’s articles of association, accounts and minutes of board and shareholders’ meetings. The new law also establishes conditions for personal liability of insiders (including directors) and stipulates that directors of listed companies cannot vote on matters in which they have an interest. However, ownership rights of foreigners may differ from those of domestic investors where laws governing foreign investment differ from the new Company Law.¹¹³ China also recently announced its intention to adopt International Financial Reporting Standards, which will improve the quality of disclosure. The Institutional Shareholder Services (ISS) 2006 Institutional Investor Survey found that better disclosure, transparency, and reporting were amongst the most desired corporate governance reforms cited by Chinese investors.

Share voting reform in Europe and the United States

In strengthening shareholder rights, there has been considerable international attention on share voting reform. Recognizing the complexity of voting procedures across Europe as well as the increasing base of foreign institutional ownership, in 2003 the EC embarked on a consultation process aimed at removing obstacles to the exercise of domestic and cross-border shareholder rights¹¹⁴. The European Commission’s official proposal¹¹⁵ for a directive on shareholder rights

¹¹¹ Watson, S. & Bateman, P. (2006) United Kingdom: FRC publishes revised version of the Combined Code, Mondaq, 5 July 2006, www.mondaq.com.

¹¹² CLSA Asia-Pacific Markets (2005). CG Watch 2005. Corporate governance in Asia. Available at: <http://www.acga-asia.org> or www.clsa.com.

¹¹³ Norton Rose (2005). PRC law update – China’s New Company Law, December 2005, www.nortonrose.com.

¹¹⁴ Commission of the European Communities (2006). Annex to the Proposal for a Directive of the European Parliament and of the Council on the exercise of voting rights by shareholders of companies having their registered

was released in January 2006 and proposes: removing the practice of share blocking¹¹⁶ and replacing this with record date¹¹⁷ (as in the United States); removing restrictions in national laws that make cross-border proxy voting costly and difficult;¹¹⁸ allowing electronic voting and voting by proxy; and facilitating the timely distribution of information on general meetings using available electronic technologies. The ISS 2006 Institutional Investor Survey notes that cross-border voting is increasing internationally with investors in the United States, Canada, and the United Kingdom being the most likely to cast proxy votes outside their home market, and investors in other markets also increasing their cross-border voting.

In April 2005, the New York Stock Exchange (NYSE) created the Proxy Working Group to review rules regulating the proxy voting process.¹¹⁹ This panel focused in particular on the rule which allows brokers to vote on certain ‘routine’ proposals on behalf of beneficiaries if no instructions have been received from the beneficiary by a specified date. The panel recommended that the uncontested election of directors be made a ‘non-routine’ matter and therefore not eligible for broker voting, recognizing the value of board elections to good governance. With brokers typically controlling up to 25 per cent of the vote, this could have a significant impact on the level of support for board nominees in future director elections.

In the United Kingdom, the voting rights of shareholders are being strengthened through recent amendments (introduced in May 2006) to the Company Law Reform Bill¹²⁰ (and still before parliament in mid-2006), which extend voting power to holders of nominee accounts, since an increasing number of private investors’ shares are held this way. While these investors already have voting rights, they are rarely exercised. The amendments therefore require that companies include in the notice of their general meeting an explanation of how such rights can be exercised and nominee companies are allowed to split their vote to reflect underlying investors’ proxy votes.¹²¹

While some have argued that if the one-share-one-vote principle is to gain any standing in EC regulations in the future it will probably be in the form of a recommendation in line with the ‘comply or explain’ governance regimes prevalent throughout Europe. However, other bodies e.g. the International Corporate Governance Network (ICGN), consider that, while the ‘comply or explain’ approach works best in most respects, this is one area that would require legislation and enforcement from the perspective of shareholder rights as fundamental to good governance.¹²²

office in a member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC – IMPACT ASSESSMENT, 17 February 2006, <http://ec.europa.eu>.

¹¹⁵ Commission of the European Communities (2006). Proposal for a Directive of the European Parliament and of the Council on the exercise of voting rights by shareholders of companies having their registered office in a member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC, 5 January 2006, <http://ec.europa.eu>.

¹¹⁶ Share blocking: the practice of halting the trading of a company's shares ahead of a shareholder vote.

¹¹⁷ Record date: the practice of only allowing voting by shareholders who owned shares on a specified date. The EU proposed directive requires that this date should be no earlier than 30 days before the general meeting.

¹¹⁸ Sweden, Denmark, and Finland require proof of ownership by having custodians to register their clients’ shares into local accounts at an institution designated by the company several days prior to the date of the general meeting (p. 14 of Annex to the Proposal).

¹¹⁹ NYSE (2006). NYSE Rules, <http://rules.nyse.com>.

¹²⁰ Department of Trade and Industry (2006). Company Law Reform Bill, www.dite.gov.uk.

¹²¹ Jean Eaglesham (2006). “Nominee account holders to get enhanced voting rights”, *Financial Times*, 7 July 2006, www.ft.com.

¹²² Wilcox, J. C. (2004). ICGN response to *Fostering an Appropriate Regime for Shareholders’ Rights*, 14 December. www.icgn.org.

Majority voting on director elections

Key legal impediments to the election of directors by a majority affirmative vote of shareholders have been dealt with in the United States during the first half of 2006. While the plurality vote standard remains the default, recent changes to the Model Business Corporation Act and to Delaware General Corporation Law now enable shareholders to make binding changes to the bylaws of companies to install a majority voting system for the election of directors. On 20 June, the American Bar Association's Committee on Corporate Laws adopted a change to the Model Business Corporation Act regarding voting by shareholders for the election of directors to enable boards or shareholders to vote to amend corporate bylaws to provide for a majority vote standard. On 27 June legislation amending the Delaware General Corporation Law was enacted and became effective in August 2006, giving shareholders the power to introduce changes to director elections by-laws requiring the resignation of directors who fail to get a requisite number of votes.¹²³

Institutional Shareholder Services reports that by 21 June 2006, shareholder support for proposals seeking to apply a majority vote standard in director elections had averaged 47 per cent support for 80 resolutions on this subject during the 2006 proxy season. This is up from 44 per cent for the 60 resolutions in 2005.¹²⁴ Shareholder pressure is also driving adoption of director elections by majority vote in Canada. The Canadian Coalition for Good Governance (CCGG), a coalition of institutional shareholders, made majority rule a top priority for 2006 and many companies, including all the large banks, are voluntarily adopting this standard.¹²⁵

Remuneration

Efforts to enhance shareholder control can also be seen in recent rules and proposals regarding remuneration. In July 2006, the ICGN released new remuneration guidelines, which include guidelines on remuneration disclosure.¹²⁶ The ICGN standards recommend a shareholder vote on the remuneration report. The French Clement-Breton law, enacted in July 2005 and coming into effect in 2006, creates a binding simple majority vote at AGMs for golden parachutes and managing directors' retirement schemes.¹²⁷ Britain and Australia now require corporations to put remuneration committee reports to an annual non-binding vote. Following a number of years of debate in the United States, the Financial Accounting Standards Board (FASB) has directed companies to start expensing stock option grants against earnings effective as of fiscal year 2006. Guidance has been issued by the International Accounting Standards Board (IASB) in the form of IFRS 2, which requires companies to start expensing share based payments for fiscal periods after 1 January 2005. In June 2006 the CCGG updated its 'Guidelines for Principled Executive Compensation' working paper, first published in June 2005.¹²⁸ Important trends reflected in these disclosure rules and guidelines are giving shareholders more

¹²³ Millstein, I.M. (2006). *The Board – Governing Beyond Where the Law Ends*, Paper presented at ICGN 2006 Annual Conference, 5 July 2006, www.icgn.org. Tumas, M.B.; Grossbauer, J.F. and Houtman R.L. (2006) *Delaware Addresses Majority Voting: The 2006 Amendments to the General Corporation Law*, Potter, Anderson & Corroon LLP, June 2006, www.pacdelaware.com.

¹²⁴ Cohn, S. (2006). *Growing Support for Majority Vote Proposals*, Institutional Shareholder Services (ISS), <http://blog.issproxy.com>.

¹²⁵ Canadian Coalition for Good Governance (2006). *Guidelines: Majority Voting*, May 2006, www.ccg.ca.

¹²⁶ ICGN (2006). *ICGN Remuneration Guidelines*, July 2006, www.icgn.org.

¹²⁷ See relevant excerpts from the French Clement-Breton law (2005) at www.proxinvest.fr.

¹²⁸ Canadian Coalition of Good Governance (CCGG) (2006). *Guidelines for Principled Executive Compensation*, May 2006, www.ccg.ca.

power to approve the remuneration policy, promoting standardized disclosures and allowing shareholders to vote on the remuneration report.

The United States Securities and Exchange Commission (SEC) adopted new compensation disclosure rules to take effect on 15 December 2006.¹²⁹ The SEC's new disclosure rules build on the existing approach to compensation disclosure, (which emphasize standardized, quantitative data presented in tables), by broadening the amount of information required, as well as requiring fuller narrative disclosure in a special section on 'Compensation Discussion and Analysis'. The three categories of standardized compensation disclosure proposed are: compensation for past fiscal year compared to two previous years; equity-related holdings; and post-employment compensation, including retirement and deferred compensation plans. Two new pieces of information required are: disclosure in one place and in a single figure of the total amount of compensation paid to CEO, CFO and the three other highest paid executive officers and directors (where director compensation is higher), and inclusion of a Director compensation table.¹³⁰ The new SEC rules on compensation disclosure also require more comprehensive disclosure by companies on how stock option grant dates are chosen and how valuations are set.¹³¹

Fund governance and disclosure

Fund governance (i.e. how large institutional funds such as pension funds or mutual funds are governed) is seen as a key element in promoting good corporate governance globally. Two areas being addressed internationally are voting disclosure and the ability of the board of trustees to provide oversight. A number of national and international initiatives are taking place in this area. In an earlier initiative, investment companies registered with the SEC in the United States were required for the first time to disclose their voting records in reports filed with the SEC by 31 August 2004. More recently, new securities rules issued by the Canadian Securities Association (CSA) require Canadian mutual funds to disclose their 2005/2006 proxy voting records by 31 August 2006. Draft legislation before Parliament in 2006, in the Netherlands would require pension funds, insurance firms and banks to disclose their voting records, in addition to releasing voting policies.¹³² While disclosure of voting records by institutional investors in the United Kingdom has up to now been voluntary, both the Combined Code and the Institutional Shareholders' Committee (ISC), representing a number of British institutional investor associations, recommend disclosure of proxy voting by institutional investors, as well as voluntary disclosure levels are increasing from year to year.¹³³ Changes to the ISC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents, announced in the United Kingdom in September 2005, strengthen the call for institutions to engage with investee

¹²⁹ SEC (2006). Executive Compensation And Related Party Disclosure, FILE NO. S7-03-06, 27 January 2006, www.sec.gov.

¹³⁰ A Director Compensation Table is a tabular, three-year summary providing a comprehensive, formatted presentation of compensation information regarding a company's directors. It provides an overview of executive compensation from which investors can review director compensation for the last three fiscal years, identify trends, and compare those trends with industry trends. The Director Compensation Table is then followed by tables containing more specific data on the components of compensation for the last completed fiscal year.

¹³¹ Bloomberg News (2006). SEC expands executive pay rules, Boston Globe, 26 July 2006, www.boston.com.

¹³² Preesman, L. (2006). Netherlands to force funds to disclose voting, Investment & Pensions Europe (IPE), 28 June 2006, www.ipe.com; Walmsley, S. (2006). No excuse for secrecy, F&C tells pension funds, Investment & Pensions Europe (IPE), 7 July 2006, www.ipe.com.

¹³³ See Hosking, P. (2006). "More fund managers open up about their votes", Times Online, 22 June 2006, <http://business.timesonline.co.uk>.

companies and vote on governance matters.¹³⁴ If the voluntary approach fails, a clause in the United Kingdom Company Law Reform Bill, which is before Parliament in 2006, would allow the government to at some point in the future mandate disclosure on whether and how institutional investors exercised their voting rights. The German ‘Corporate Governance Code for Asset Managers’, a voluntary code released in April 2005, calls for funds to disclose how they vote on all contentious AGM items.¹³⁵

At the international level, a governance code specifically directed at institutional investors, called ‘Statement of Principles on Institutional Shareholder Responsibilities’, may soon be adopted by the ICGN. This code promotes the exercise of ownership rights by institutions (including engagement and considered voting of shares) as essential to external governance. According to the principles, Institutional investors have the responsibility to report to beneficiaries on how they exercise governance rights. The principles also recommend an annual summary of how voting policies are implemented, an annual summary of voting records and full voting records in ‘important cases’.¹³⁶

At the same time as requiring proxy voting disclosure, efforts to tighten fund governance are directed at the role and composition of the board of trustees. In the United Kingdom and Australia member representation on trustee boards has been practiced for some time. The German Corporate Governance Code for Asset Managers requires that at least one member of the supervisory board should avoid any contacts with management. A SEC rule, which came into effect in January 2006, imposed a 75 per cent independence requirement on funds’ board of trustees and the requirement that the board chairman be an independent trustee.¹³⁷ These requirements were overturned by a United States Court in April 2006 and, although the SEC has initiated another consultation process on these requirements, it appears unlikely that they will be imposed by the SEC in the near future.¹³⁸ Internationally, the ICGN draft Statement of Principles on Institutional Shareholder Responsibilities recommends representation of pension plan beneficiaries on the board of trustees, especially where the board of trustees is dominated by the employer or sponsor of the plan.

Reinforcing fund governance, new ratings are emerging that grade funds based on their governance practices and the degree to which they exercise their rights and responsibilities as shareholders. With the increased disclosure of proxy voting policies and decisions, a new opportunity has been grasped by the private sector to rate fund managers’ execution of their ownership responsibilities. Services established in recent years include Morningstar’s ‘Stewardship Grades’¹³⁹ and Planet Ratings’ evaluation of 480 European funds.¹⁴⁰ In October 2005 Mercer Investment Consulting began rating United Kingdom-based asset managers on their

¹³⁴ Association of Investment Trust Companies (AITC) (2005). Institutional Shareholders’ Committee Publishes Updated Statement Of Investment Principles, 30 September 2005, www.aitc.co.uk.

¹³⁵ Wagner, J. (2005). German asset managers get governance code, *Investment & Pensions Europe (IPE)*, 28 April 2005, www.ipe.com.

¹³⁶ International Corporate Governance Network (ICGN) (2006). Statement of Principles on Institutional Shareholder Responsibilities, www.icgn.org.

¹³⁷ SEC (2006). Investment Company Governance, File No. S7-03-04, 27 July 2004, www.sec.gov.

¹³⁸ Scalia, E. (2006). Chairman Cox's Opportunity, *Wall Street Journal*, 17 July, www.wsj.com.

¹³⁹ Kathman, D. (2006). ‘Is Your Fund Company Looking Out for You?’, *Morningstar*, 6 April, <http://news.morningstar.com>.

¹⁴⁰ See Global Proxy Watch (GPW) (2005). Briefings, Vol. 9(12), 25 March, www.davisglobal.com.

voting behaviour, and the environmental, social and governance (ESG) criteria that they apply to screening their portfolios and their propensity for engagement.¹⁴¹

Governance-related funds and indices

The 2005 Review highlighted the growing trend in the number of stock indices and funds which select companies for inclusion in the fund or index based on good corporate governance. This trend continues into the present review period. Corporate governance engagement funds launched in the 2005/2006 intersession period include: the Audley European Opportunities Fund¹⁴²; a new Governance for Owners (GO) focus fund targeting under-performing European public companies¹⁴³; and a fund targeting underperforming companies of the Republic of Korea called the Korea Corporate Governance Fund (KCGF).¹⁴⁴ In Brazil a number of funds focused on corporate governance engagement have outperformed the Bovespa index and in May 2006 Banco Fator launched a third corporate governance activist fund, Fundo Fator Sinergia III.¹⁴⁵ In late 2005 three influential institutions, the Florida State Board of Administration (SBA), the Canadian Pension Plan Investment Board (CPP)¹⁴⁶, and the Norwegian Petroleum Fund (the world's largest pension system), individually committed to shareholder engagement.¹⁴⁷

Ratings agencies

The 2005 Review also highlighted the growth of the private sector in the area of corporate governance ratings. While private providers of corporate governance research and ratings have been around for a number of years, the market for these services appears to continue to expand globally as reflected in a number of alliances, some new entrants and moves to consolidate market share by larger players during the 2005/2006 intersession period. However, attention to the conflicts inherent in providing proxy voting advice and research and corporate governance ratings has recently been spotlighted.¹⁴⁸ A recommendation of the NYSE Proxy Working Group is that the United States SEC investigate the role of third party (non-owner) institutional advisory services and proxy voting groups, making voting recommendations and/or decisions with respect to the potential for conflicts of interest.¹⁴⁹

Collective engagement

The ISS 2006 Institutional Investor Survey notes that collective engagement by associations of investors on behalf of its members is likely to increase and is already well-established for Canadian and Australian and New Zealand institutions. Collective engagement is seen by member institutions as a way of lowering costs and increasing the effectiveness of

¹⁴¹ Ambachtsheer, J. (2005). What gets rated gets reviewed, Mercer Investment Consulting, 17 October, www.merceric.com.

¹⁴² Global Proxy Watch (GPW) (2005). Briefings, Vol. 9(42), 25 November, www.davisglobal.com.

¹⁴³ Governance for Owners (GO), a fund and shareholder engagement service started in 2004. Besides offering engagement funds, the GO Stewardship Service offers voting and underlying engagement services covering 700 European and 500 United States quoted equities. See www.g4owners.com.

¹⁴⁴ Global Proxy Watch (GPW) (2006). Tiger, Vol. 10(9), 3 March, www.davisglobal.com.

¹⁴⁵ Global Proxy Watch (GPW) (2006). Briefings, Vol. 10(18), 5 May, www.davisglobal.com.

¹⁴⁶ See Global Proxy Watch (GPW) (2006). Herds, Vol. 9(45), 16 December, www.davisglobal.com.

¹⁴⁷ See Global Proxy Watch (GPW) (2006). Giant Awakes, Vol. 9(41), 18 November, www.davisglobal.com.

¹⁴⁸ Rose, P. (2006). The Corporate Governance Industry May 17, 2006. Northwestern Public Law Research Paper No. 902900. Available at SSRN: <http://ssrn.com/abstract=902900>.

¹⁴⁹ NYSE (2006). Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, 5 June 2006, www.nyse.com.

engagement with companies on governance issues. Most large Canadian investment institutions are represented through the CCGG. Australian and New Zealand pension funds are represented through the Australian Council of Superannuation Investors (ACSI). Pension funds in the Netherlands are represented through a coalition known as Eumedion. Each of these coalitions has been active in 2006: CCGG in highlighting majority voting in director elections; ACSI in the shareholder vote on 'poison pill' anti-takeover measures at News Corp.; and Eumedion in pressing for approval of companies' corporate governance statements by shareholder vote.

Cross-border shareholder activism has become a reality with a groundbreaking case led by ACSI. Thirteen funds from Australia, the Netherlands, the United States and United Kingdom filed a lawsuit in Delaware to compel News Corp. (a transnational enterprise active in the media industry) to put the company's takeover defence policies to a shareholder vote. They recently won a settlement in which the management of News Corp. agreed to a vote on these policies at its October 2006 AGM.¹⁵⁰ In recognition of its success in this initiative, ACSI was honoured for its role in promoting cross-border activism and engaging a multinational company at the 2006 awards of the ICGN.

XBRL and electronic reporting

Development and adoption of eXtensible Business Reporting Language (XBRL), an open standard eXtensible Markup Language (XML) protocol for electronic communication of business and financial data, continues to be promoted by XBRL International, an international consortium of regulators, audit and accounting firms, technology vendors, data providers, academics and professional associations.

On 1 July 2006, the Swedish Companies Registration Office, Bolagsverket, launched a service that can accept full annual accounts from small- and medium-sized enterprises. Recently the Spanish Senate has called on the government to promote the use of XBRL following the successful introduction of XBRL by the Spanish Central Bank and the Spanish Securities Regulator. The Canadian Securities Administrators (CSA), representing Canadian securities regulators, is seeking comment on the use of XBRL to improve provision of information to investors. The government-led Dutch XBRL project has recently released its taxonomy and XBRL data will be accepted from companies by at least three government departments on 1 January 2007, with plans for the extension of XBRL reporting into more areas after that. The International Accounting Standards Committee Foundation (IASCF) is building an International Financial Reporting Standards (IFRS) XBRL taxonomy and also exploring ways of promoting IFRS and US-GAAP XBRL taxonomy convergence. The United States SEC is encouraging more of its filers to adopt XBRL this year in exchange for quicker processing of reports as a pilot project.

Conclusion

The main regulatory developments shaping corporate governance internationally over the past year have aimed to strengthen shareholder rights and have placed particular emphasis on shareholder voting rights. Regulation has been motivated by the recognition of the value of corporate governance to market confidence. Key conditions necessary for the exercise of voting rights are information and access. Proposed regulation in both Europe and the United States promotes the use of electronic technologies, both for proxy dissemination and for voting.

¹⁵⁰ Chaffin, J. (2006). News Corp settles 'poison pill' lawsuit', *Financial Times*, 6 April 2006, www.ft.com.

International attention on fund governance and voting disclosure, coupled with examples of successful campaigns by institutions, may inspire institutional investors to become more active on issues of corporate governance.

III. Status of implementation of good practices on corporate governance disclosure at the company level

A. Background and methodology

The purpose of the survey is to evaluate the level of implementation of good practices in corporate governance disclosure highlighted in UNCTAD's 2006 "Guidance on Good Practices in Corporate Governance Disclosure" (based on the ISAR document TD/B/COM.2/ISAR/30).

Compared to the 2005 Review, several changes were made to the benchmark list of indicators used in the 2006 Review following the discussions at the 22nd session of ISAR. The changes include the addition of four disclosure items, the removal of one item, and the revision of seven others. The four items that were added are:

- a. Duration of current auditors;
- b. Rotation of audit partners;
- c. Auditors involvement in non-audit work and the fees paid to the auditors; and
- d. The role of employees in corporate governance.

The disclosure item that was subtracted was the "identification of the 'financial expert' in the audit committee" as this issue was covered under the disclosure item on "Qualifications and biographical information on board members". Seven disclosure items were also subject to revisions which ranged from minor to significant; these are listed below, with a comparison to how they appeared in the 2005 Review:

Table 1. List of revised disclosure items

2006 Review: revised disclosure item	2005 Review: item before revision
Board responsibilities regarding financial communications	CEO/CFO certification of financial statements
The scope of work and responsibilities for the internal audit function and the highest level of leadership to which it reports	Process of appointment of internal auditors
Internal control systems	Internal control systems and their effectiveness
Mechanisms protecting the rights of other stakeholders in business	Mechanisms protecting the rights of stakeholders in business
Types and duties of outside board and management positions	Duties of the directors

Existence of a plan of succession	Plan of succession
Compensation policy for senior executives departing from the firm as a result of a merger or acquisition	Compensation payable clauses in directors contracts

The additional disclosure items are marked with a star (*) and the revised disclosure items are marked with a double-star (**) in Table 2 below. The complete set of disclosure items are grouped into five broad categories, or subject areas, of corporate governance disclosure, and are presented and analysed by category in section B below. These categories are:

- (a) Financial transparency and information disclosure;
- (b) Ownership structure and exercise of control rights;
- (c) Board and management structure and process;
- (d) Corporate responsibility and compliance; and
- (e) Auditing.

As in the previous annual reviews, the sample of enterprises examined in the 2006 Review was comprised of leading enterprises making a significant contribution to the economy in which they are based. The 2006 Review examined 105 enterprises from 70 economies, with a broad regional distribution (see Figure 1 below). Enterprises selected for the survey were drawn from the top ten largest enterprises found within each region; the relative size of the enterprises was determined using sales and market capitalization data. The survey included publicly listed enterprises, privately-held enterprises and SOEs. The enterprises included in the survey represent a wide range of industries including: energy, financial services, telecommunications, pharmaceuticals, manufacturing, and retail, among others.

In an effort to continually improve the research methodology of the survey, an expanded range of corporate reports were surveyed for the 2006 Review including: annual reports, corporate governance reports, exchange filings, and other information available from financial databases and enterprise websites. These included: Company website; Annual Report; Financial Report; Management Report; Proxy Circular/Proxy Statement; Articles of Association; Company By Law; Corporate Social Responsibility Report / Sustainability Report / Corporate Citizen Report / HSE Report / Environmental Report; Corporate Governance Report / Corporate Governance Charter (Code); Codes of Ethics / Code of Conduct / General Business Principles; Board of Directors Charter; Constitution; Institutional Report; Risk Management Policy; Audit and Risk Management Committee Charter; External Audit Independence Policy / Audit Committee Policies (Codes); Shareholders Charter; United States Securities and Exchange Commission filings (20-F Form; 10-K/10Q/Form DEF 14A).

Where information on an enterprise was not available electronically, enterprises were contacted directly in an effort to obtain paper reports. As in the previous annual reviews, this report is not intended as a measure of the quality of disclosure of individual items, rather it is a measure of the existence of the selected disclosure items.

The enterprises in the survey are based in both high income and middle and lower income countries, and represent both locally listed enterprises as well as internationally listed ones (see figure 2 below). The enterprises in the survey include a significant number of state owned enterprises. The inner box of figure 2 indicates how many companies in the larger box are SOEs.

Therefore, these companies received additional analysis (see section F). Four of the enterprises in the survey (all from low or middle income countries) were not listed and therefore do not appear in figure 2; of these two were privately-held, and two were non-listed SOEs.

Figure 1. Distribution of the 105 enterprises by region

(Number indicates the number of enterprises surveyed)

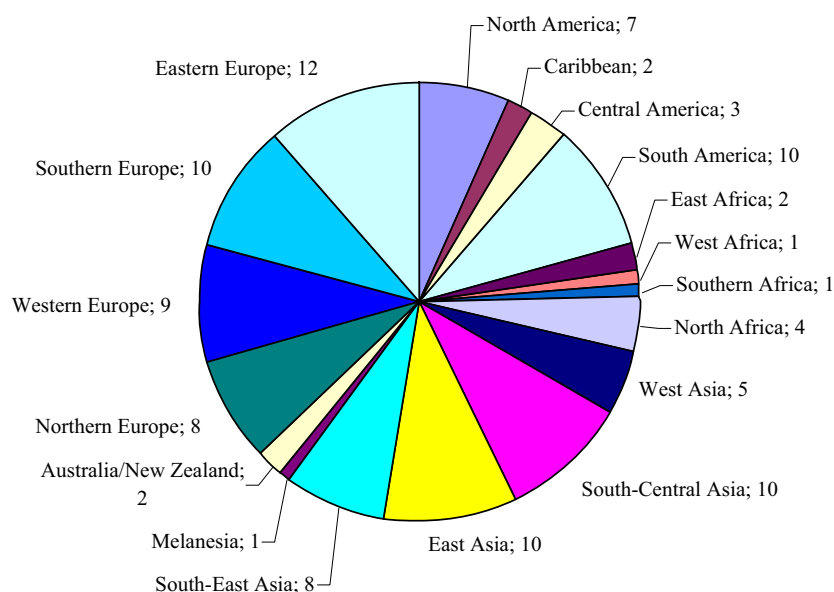


Figure 2. Distribution of the 100 listed enterprises by type of listing and country income

	OECD and other high income	Low and middle income
Only local listing	5	24
	SOE 1	7
International listing	4	10
	37	35

B. Main outcomes of the survey: overview of all disclosure items

Table 2 (below) displays the results of the survey within each of the five broad categories discussed in section A above. This allows readers to draw their own conclusions based on the importance they assign to a particular category or subject area, and within that category, a particular disclosure item. It also facilitates the analysis that follows on the relative level of disclosure within each category.

Table 2. Main findings of survey on corporate governance disclosure
(Number of enterprises in parentheses)

Disclosure items by category	All (105)	Type of listing		Country income		Special focus
		Inter-national listing (72)	Only local listing (29)	OECD & other high income (42)	Low & middle income (63)	SOEs (24)
Financial transparency and information disclosure (in per cent)						
Financial and operating results	100	100	100	100	100	100
Nature, type and elements of related-party transactions	94	99	90	100	90	88
Company objectives	92	96	86	95	90	88
Critical accounting estimates	90	96	79	98	84	83
Board responsibilities regarding financial communications**	80	89	66	90	73	88
Impact of alternative accounting decisions	75	82	66	86	68	67
Rules and procedure governing extraordinary transactions	59	65	48	62	57	75
The decision making process for approving transactions with related parties	53	57	48	52	54	63
Disclosure practices on related party transactions where control exists	47	51	41	52	43	50
Ownership structure and exercise of control rights (in per cent)						
Process for holding annual general meetings	91	96	86	98	87	92
Ownership structure	90	93	90	93	89	96
Control structure	86	86	86	86	86	92
Control rights	82	88	76	90	76	79
Availability and accessibility of meeting agenda	78	89	62	98	65	83
Control and corresponding equity stake	75	88	52	88	67	58
Changes in shareholdings	69	78	52	74	65	63
Rules and procedures governing the acquisition of corporate control in capital markets.	30	35	21	36	25	38
Anti-takeover measures	30	39	10	40	22	25
Board and management structure and process (in per cent)						
Composition of board of directors (executives and non-executives)	99	100	97	100	98	96
Risk management objectives, system and activities	89	96	76	95	84	83
Governance structures, such as committees and other mechanisms to prevent conflict of interest	88	96	72	98	81	83

Disclosure items by category	All (105)	Type of listing		Country income		Special focus
		Inter-national listing (72)	Only local listing (29)	OECD & other high income (42)	Low & middle income (63)	SOEs (24)
“Checks and balances” mechanisms	88	93	79	93	84	83
Composition and function of governance committee structures	86	94	66	90	83	75
Role and functions of the board of directors	84	92	69	93	78	83
Qualifications and biographical information on board members	83	93	66	86	81	79
Number of outside board and management position directorships held by the directors	79	90	59	90	71	71
Duration of director's contracts	76	88	55	98	62	63
Types and duties of outside board and management positions**	74	88	48	93	62	58
Determination and composition of directors' remuneration	68	81	41	88	54	75
Independence of the board of directors	68	82	38	88	54	67
Existence of procedure(s) for addressing conflicts of interest among board members	67	75	55	81	57	63
Performance evaluation process	67	75	52	81	57	71
Material interests of members of the board and management	57	68	34	64	52	58
Existence of plan of succession**	52	63	28	62	46	50
Availability and use of advisorship facility during reporting period	41	47	28	52	33	33
Compensation policy for senior executives departing the firm as a result of a merger or acquisition**	38	54	3	55	27	21
Professional development and training activities	36	43	24	50	27	33
Corporate responsibility and compliance (in per cent)						
Policy and performance in connection with environmental and social responsibility	91	96	79	98	87	83
Impact of environmental and social responsibility policies on the firm's sustainability	78	82	66	88	71	63
A code of ethics for the board and waivers to the ethics code	73	88	45	88	63	63
A code of ethics for all company employees	72	86	45	83	65	67
Mechanisms protecting the rights of other stakeholders in business**	57	67	38	71	48	46
Policy on "whistle blower" protection for all employees	50	64	21	71	35	33
The role of employees in corporate governance*	25	25	24	36	17	29
Auditing (in per cent)						
The scope of work and responsibilities for the internal audit function and the highest level of leadership to which it reports**	84	92	69	95	76	75
Process for appointment of external auditors	81	92	62	90	75	75
Internal control systems**	75	89	48	88	67	75
Process for interaction with internal auditors	74	82	59	95	60	63
Process for interaction with external auditors	70	82	48	90	57	54
Board confidence in independence and integrity of external auditors	58	69	34	83	41	50
Auditors involvement in non-audit work and the fees paid to the auditors*	56	71	28	79	41	46

Disclosure items by category	All (105)	Type of listing		Country income		Special focus
		Inter-national listing (72)	Only local listing (29)	OECD & other high income (42)	Low & middle income (63)	SOEs (24)
Duration of current auditors*	32	38	21	55	17	33
Rotation of audit partners*	21	24	14	33	13	17

* New disclosure items included in the 2006 survey.

** Revised disclosure item.

General overview

The main findings of the 2006 Review remain consistent with those of the 2005 Review. As shown in Figure 3, the financial transparency category is subject to the highest level of disclosure while the auditing category is subject to the lowest. The level of disclosure for internationally listed enterprises remains generally higher than the level of disclosure for only locally listed enterprises. As Figure 4 indicates, the rates of disclosure of enterprises from high income countries remain higher than those of lower income countries. The special focus on SOEs reveals a change from the findings of the 2005 Review, showing good disclosure among many of the SOEs surveyed, and again confirming that SOEs with international listings tend to have very good disclosure practices. These general observations are the subject of more detailed analysis in sections C to F below.

Table 2 also shows that the average disclosure rate for all enterprises fell below 50 per cent for nine of the disclosure items, though these nine items were not concentrated in any one category: one item was in the category financial transparency, two were in ownership structure, three were in board and management structure, one in corporate responsibility, and two in auditing. The least prevalent item in the 2005 Review, the disclosure of anti-takeover measures, still remains one of the five least disclosed items (see Table 3 below).

Table 3. Most prevalent and least prevalent disclosure items
(in per cent)

Top 5 most prevalent disclosure items among all 105 enterprises surveyed	Disclosure rate	Bottom 5 least prevalent disclosure items among all 105 enterprises surveyed	Disclosure rate
Financial and operating results	100	Duration of current auditors*	32
Composition of board of directors (executives and non-executives)	99	Rules and procedures governing the acquisition of corporate control in capital markets	30
Nature, type and elements of related-party transactions	94	Anti-takeover measures	30
Company objectives	92	The role of employees in corporate governance*	25
Process for holding annual general meetings	91	Rotation of audit partners*	21

* New disclosure items included in the 2006 survey

Of the four new disclosure items added to the 2006 Review, three are among the least disclosed items in Table 3 above. Two of these reflect new disclosure practices which were

created in the wake of the Enron-style problems of the early 2000s; these two items both relate to the auditing category, and are the disclosure on the *duration of current auditors* and the disclosure on the *rotation of audit partners*. The third item found among the least prevalent disclosures, *the role of employees in corporate governance*, while not prevalent, is found to be disclosed among enterprises in 20 different countries across all major world regions. This suggests that the disclosure item, while not common, is also not limited to a particular region or model of corporate governance. The fourth new disclosure item added to the 2006 Review, *auditors involvement in non-audit work and the fees paid to the auditors*, is found among 56 per cent of all the enterprises surveyed; this number however, rises to 71 and 79 per cent, respectively, for internationally listed enterprises and enterprises in high income countries. The difference suggests that this item has already become the subject of widespread disclosure in the more developed markets, and may be in the future become the subject of increased disclosure among all enterprises.

Concerning the most prevalent disclosure items, four out of the top five remain the same as in the 2005 Review. The addition to the top five is the disclosure item on *company objectives*. The *critical accounting estimates*, which appeared in the top five in the 2005 Review does not appear in the top five for the 2006 review. It should be noted however that *critical accounting estimates* achieved a nearly identical disclosure rate in the 2006 Review as in the 2005 Review, yet the disclosure rates for other items were found to have increased, thus pushing it out of the top five. Three of the top five disclosure items are from the category financial transparency, which is similar to the 2005 Review, where four of the top five were from this category.

C. Comparison of disclosure items between internationally listed companies and only locally listed companies

Figure 3 presents the average frequency of disclosure within each category and compares the disclosure practices of enterprises listed on international exchanges with those listed only on a local or national exchange. The figure displays an average for each category of disclosure items: to produce an overview of the rate of disclosure for that subject area, this category average is calculated by taking the average of each disclosure item within a category. Disclosure rates for individual disclosure items within a category can be found in Table 2 above.

The dark centre line in Figure 3 below represents all enterprises in the survey and provides a clear overview of the disclosure rates for the different categories. The category of auditing, on average, remains the subject of lower rates of disclosure than all of the other categories. This finding, and the relative rates of disclosure for each category, are both consistent with ISAR's 2004 Review and 2005 Review.

Figure 3 also provides a view of the difference in disclosure rates between enterprises based on their type of listing. The results presented in Figure 3 support earlier observations that companies with an international listing demonstrate a higher rate of corporate governance disclosure across all categories. This result is also consistent with the comparison of these two categories in ISAR's earlier surveys. This suggests that listing requirements for the more prominent international exchanges continue to demand higher rates of disclosure than those found in many national securities markets.

The category of accounting continues to be an area of consistent large differences between the disclosure rates of internationally listed enterprises and enterprises with only a local listing. Examining the details for accounting disclosure in Table 2 (above), one finds that for 7 out of the 9 disclosure items, there is a greater than 20 per cent disparity in disclosure rates. Table

4 below highlights the highest disparities in disclosure rates for the two types of listings across all 53 disclosure items.

Figure 3. Comparison between internationally listed companies and only locally listed companies

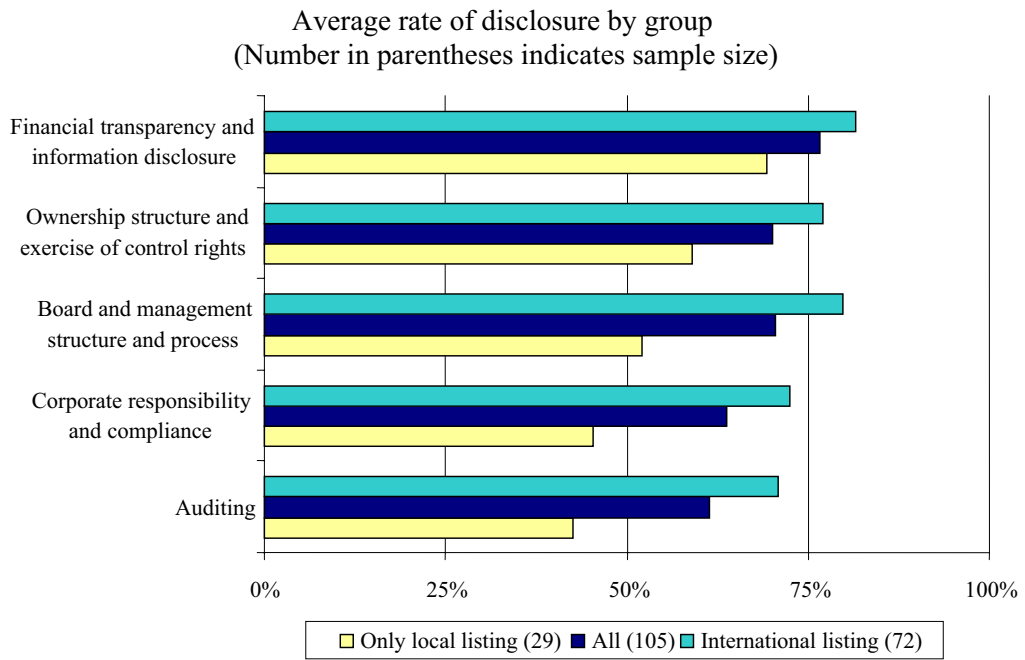


Table 4. Top 5 greatest disparities in disclosure rates, by type of listing
(Number in parentheses indicates sample size)

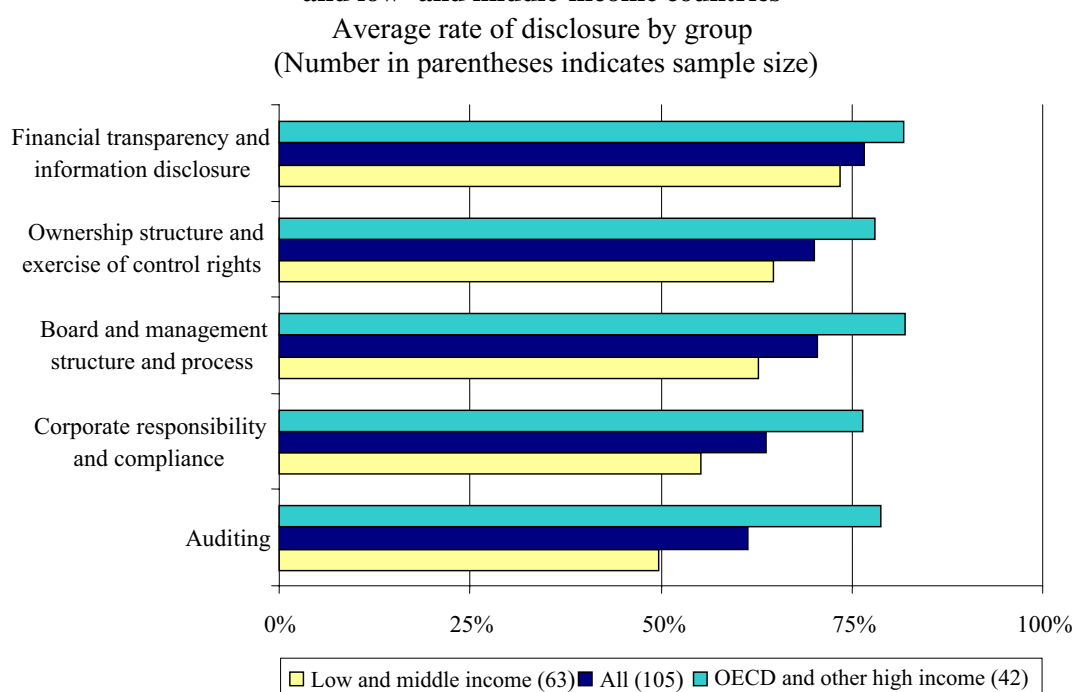
Disclosure item	Disclosure rates (in per cent)		
	International listing (72)	Only local listing (29)	Disparity
Compensation policy for senior executives departing the firm as a result of a merger or acquisition	54	3	51
Independence of the board of directors	82	38	44
Auditors involvement in non-audit work and the fees paid to the auditors	71	28	43
Policy on "whistleblower" protection for all employees	64	21	43
A code of ethics for the board and waivers to the ethics code	88	45	43

D. Comparison of disclosure items between enterprises from high-income and low- and middle-income countries

Figure 4 compares the disclosure practices of enterprises based in high income countries with those based in middle and lower income countries. The figure displays an average for each category of disclosure items: to produce an overview of the rate of disclosure for each subject area, this category average is calculated by taking the average of each disclosure item within a category. Disclosure rates for individual disclosure items within a category can be found in Table 2 above.

The findings of the 2006 Review presented in Figure 4 are consistent with the findings of ISAR's earlier surveys. On average, enterprises based in high-income countries demonstrate a higher rate of corporate governance disclosure across all categories than do enterprises based in middle- and lower-income countries. The analysis presented in Figure 4 also reveals an exception to the general pattern previously noted of financial transparency being the most prevalent and auditing being the least prevalent. While this pattern remains strong among enterprises from low- or middle-income countries, enterprises from high-income countries display a different pattern: for these enterprises, the categories of financial transparency, board and management structure and process, and auditing are all subject to nearly equal and relatively high rates of disclosure, while the categories of ownership structure and corporate responsibility, lag somewhat. Even these lagging categories for the enterprises from high income countries, however, still exceed the average level of disclosure for the entire survey sample.

Figure 4. Comparison between enterprises from high-income countries and low- and middle-income countries



The largest disparity in reporting practices between country income groups can be found in the Auditing category, which is the only category where less than 50 per cent of enterprises from low- and middle-income countries, on average, disclose the selected items. Among the largest disparities between country income groups, differences in disclosure rates for auditing items make up 3 out of the top 5 for all disclosure categories (see Table 5 below).

Table 5. Top 5 greatest disparities in disclosure rates, by country income
(Number in parentheses indicates sample size)

Disclosure Item	Disclosure Rates (Per cent)		
	OECD and other high income (42)	Low and middle-income (63)	Disparity
Board confidence in independence and integrity of external auditors	83	41	42
Auditors involvement in non-audit work and the fees paid to the auditors	79	41	37

Duration of current auditors	55	17	37
Policy on "whistleblower" protection for all employees	71	35	37
Duration of director's contracts	98	62	36

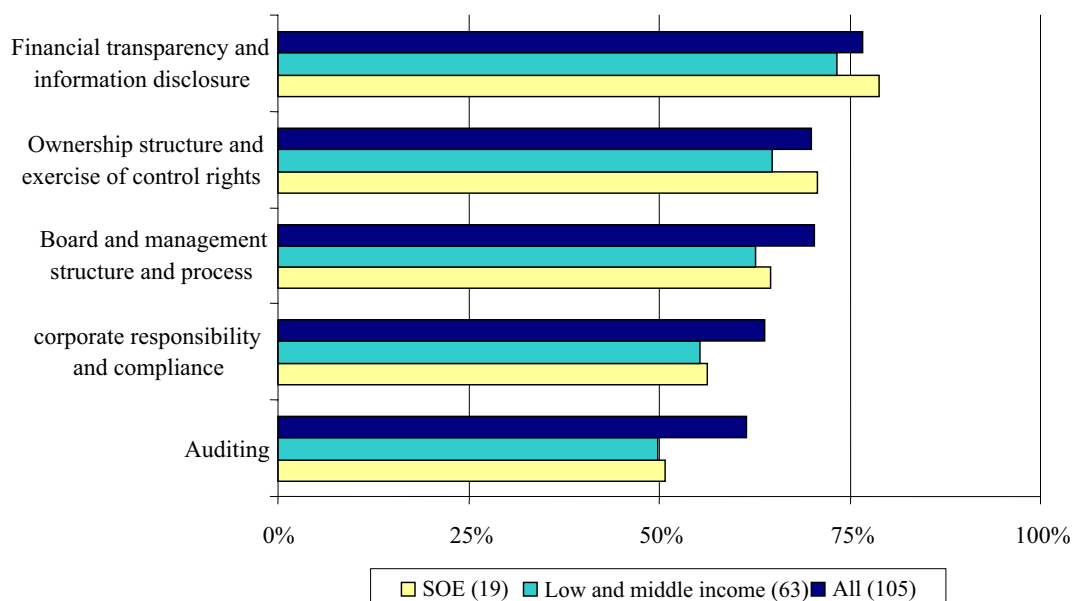
E. Special focus: State-owned enterprises

Nearly one quarter of the enterprises in the 2006 Review were SOEs: 24 out of 105 enterprises surveyed. As in the previous year's review, the significant number of SOEs has allowed a special focus on this type of enterprise. As indicated in Figure 2 above, most of the SOEs in the survey were from low or middle income countries (19 out of 24). The SOE model continues to be a common feature of the industrial strategy of many developing countries, and as this survey has found, SOEs are often among the largest enterprises found in developing countries.

One of the major differences in the findings of the 2006 Review, compared to the 2005 Review, is the higher disclosure rates of SOEs. Figure 5 below, provides an overview of disclosure rates by category specifically for SOEs from low and middle income countries. When viewed as a group, SOEs in the 2005 Review tended to under perform the average rate of disclosure for enterprises from low and middle income countries and significantly under perform the average rate of disclosure for all the enterprises surveyed. The 2006 Review presents a different picture: in all categories, the SOEs surveyed in the 2006 Review *outperform* the average rate of disclosure for enterprises from low and middle income countries. In two categories, the SOEs also outperform the average for all enterprises in the survey.

Figure 5. Comparison of disclosure between SOEs from low- and middle-income countries and all enterprises from low- and middle-income countries

(Number in parentheses indicates sample size)



This change in the survey's view of the relative performance of SOEs is attributable in part to slight changes in the survey sample. The sample of SOEs from low- and middle-income countries has changed only slightly, from 23 in the 2005 Review down to 19 in the present

survey. This change, however, reduced the number of SOEs without an international listing, while keeping the number of SOEs with an international listing the same. This creates a shift in the sample towards SOEs with an international listing. As was recognized in the previous survey, SOEs that list on international exchanges typically display a disclosure rate that is similar to all internationally listed enterprises in the survey (see Table 6 below). Thus the higher rates of disclosure for SOEs in the 2006 Review can be attributed in part to the higher number of internationally listed SOEs in the sample. This again reinforces the strong correlation between higher rates of disclosure and an international listing.

Table 6. Detailed analysis of SOE disclosure rates
(Number in parentheses indicates sample size)

SOE from low- and middle-income countries (19)	Avg. rate of disclosure (Per cent)	"Score" out of 53			
		Min.	Max.	Avg.	Median
International listing (72)	77				
SOE with international listing (10)	75	16	50	40	44
Low and middle income (63)	62				
Other SOEs (9)	53	9	41	28	30

IV. Conclusions

This report is the third annual survey of corporate governance disclosure prepared by the UNCTAD secretariat for ISAR. The methodology of this survey continues to be the subject of refinement and improvement, but is substantially consistent with the methodology employed in the 2005 Review.

Given the similar nature of the survey sample and methodology between the 2005 Review and the 2006 Review, a number of comparisons between the two sets of data have been made. In particular, the 2006 Review provides further support to two central findings of the 2004 and 2005 Reviews: that enterprises in low- and middle-income countries, on average and as a group, tend to have lower rates of disclosure when compared to enterprises in high income countries; and enterprises with only a local listing have a general tendency towards lower rates of disclosure than enterprises that are listed internationally. The 2006 Review also supported the finding of last year's survey regarding SOEs from developing countries: that internationally listed SOEs tend to have rates of disclosure comparable to global best practice, while non-listed and only locally listed SOEs tend to be among those enterprises with the lowest rates of disclosure.

An important difference in the findings of the 2006 Review compared to the 2005 Review was in the area of SOE disclosure. In the 2006 Review, SOE disclosure rates were noticeably higher, slightly exceeding the average of enterprises from low- and middle-income countries in every category, and slightly exceeding the average of all the enterprises in the survey in two categories. This is in part a reflection of the change in the survey sample, with the 2006 Review having a higher proportion of internationally listed SOEs in its sample; as noted above, these internationally listed SOEs tend to have relatively high rates of disclosure. But it is also recognized that some enterprises have displayed real and significant improvement in the number of disclosure items being reported, in some cases more than doubling the number of items reported.

With regard to disclosure rates within specific subject categories, the findings of the 2006 Review was consistent with the 2005 Review. A continuing area of weakness is the relatively

lower level of corporate governance disclosure regarding auditing functions. The large disparities between the disclosure rates of enterprises that are internationally listed, or based in high income countries, compared with the disclosure rates of enterprises that are only locally listed or based in low- and middle-income countries, suggests that access to capital on international exchanges and or high income countries, requires increased attention to auditing disclosures.

One issue that was noted in Section II A, is the location of corporate governance disclosures within enterprise reports. As noted, these disclosure items are often spread across a range of different reports. While consolidating all of the benchmark corporate governance disclosures into a single report would be helpful, this may not be practical for some enterprises. However, a useful and practical tool that could be recommended to enterprises would be the inclusion of an "index of corporate governance disclosure". Such an index would list all 53 of the disclosure items recommended in the ISAR guidance, and next to each disclosure item give the location where it is reported (e.g. report name and page number). This index could be published in the enterprise's annual report, corporate governance report, or on the enterprise's website. (If done on the website, the index could include links to each disclosure item). A sample of such an index has been prepared based on the actual results of the one of the enterprises in the 2006 Review and can be found in Appendix I below. The location of disclosure items is an important component of the overall transparency of an enterprise: the easier it is for users to find the information for which they are looking, the greater the transparency of the enterprise.

The preparation of these annual reviews of corporate governance disclosure has provided a number of insights into the actual disclosure practices of enterprises. Further work on this subject could build on the findings of these surveys through case studies of individual enterprise reporting practices and the challenges faced. Such case studies could serve to answer some of the questions raised by the survey, such as why disclosure in the category of auditing is relatively low in developing countries, or why enterprises with an international listing perform so much better in terms of disclosure than enterprises without an international listing.

APPENDIX: Index of corporate governance disclosure

Company Name: *Example*

Reports: Annual Report 2005 / Citizenship Report 2005/ Proxy Statement 2006

Disclosure item	Report	Page No.
Ownership structure and exercise of control rights		
Ownership structure	Citizenship Report	5
Process for holding annual general meetings	Proxy Statement	4
Changes in shareholdings	Proxy Statement	52
Control structure	Proxy Statement	52
Control and corresponding equity stake	Proxy Statement	51
Availability and accessibility of meeting agenda	Annual Report	113
Control rights	Proxy Statement	51
Rules and procedures governing the acquisition of corporate control in capital markets	Annual Report	46, 47
Anti-takeover measures	Proxy Statement	60
Financial transparency and information disclosure		
Financial and operating results	Annual Report	2, 50
Critical accounting estimates	Annual Report	61, 71
Nature, type and elements of related-party transactions	Annual Report	71
Company objectives	Annual Report	6, 10, 13
Impact of alternative accounting decisions	Annual Report	64
Disclosure practices on related party transactions where control exists	N/A	N/A
The decision making process for approving transaction with related parties	Annual Report	20-21
Rules and procedure governing extraordinary transactions	Annual Report	48, 90
Board's responsibilities regarding financial communications	Annual Report	113
Auditing		
Process for interaction with internal auditors	Annual Report	39
Process for interaction with external auditors	Annual Report	39
Process for appointment of external auditors	Annual Report Proxy Statement	43 41
Process for appointment of internal auditors	Annual Report	39, 43
Board confidence in independence and integrity of external auditors	Annual Report Proxy Statement	43 41
Internal control systems	Annual Report	43-44
Duration of current auditors	Proxy Statement	38
Rotation of audit partners	Annual Report	40
Auditors' involvement in non-audit work and the fees paid to the auditors	Proxy Statement	39-40
Corporate responsibility and compliance		
Policy and performance in connection with environmental and social responsibility	Annual Report Citizenship Report	7, 34, 37, 54 32-34
Impact of environmental and social responsibility policies on the firm's sustainability	Annual Report Citizenship Report	34, 37, 54 32
A code of ethics for the board and waivers to the ethics code	Annual Report Proxy Statement	22 12

Disclosure item	Report	Page No.
A code of ethics for all company employees	Annual Report Proxy Statement	22 12
Policy on "whistle blower" protection for all employees	Citizenship Report	7, 23
Mechanisms protecting the rights of other stakeholders in business	Citizenship Report	14-15, 23, 73
The role of employees in corporate governance	Annual Report	84
Board and management structure and process		
Governance structures, such as committees and other mechanisms to prevent conflict of interest	Annual Report	39
"Checks and balances" mechanisms	Proxy Statement	54-55
Composition of board of directors (executives and non-executives)	Annual Report	40-41, 111-112
Composition and function of governance committee structures	Annual Report	39-41, 111-112
Role and functions of the board of directors	Annual Report	39
Risk management objectives, system and activities	Annual Report	48-49
Qualifications and biographical information on board members	Proxy Statement	6-11
Types and duties of outside board and management positions	Proxy Statement	6-11
Material interests of members of the board and management	Proxy Statement	19
Existence of plan of succession	Proxy Statement	54, 59
Duration of director's contracts	Proxy Statement	55, 57
Compensation policy for senior executives departing the firm as a result of a merger or acquisition	N/A	N/A
Determination and composition of directors' remuneration	Proxy Statement	15-16, 34
Independence of the board of directors	Annual Report	13, 39
Number of outside board and management position directorships held by the directors	Proxy Statement	6-11
Existence of procedure(s) for addressing conflicts of interest among board members	Proxy Statement	12, 58
Professional development and training activities	Citizenship Report Proxy Statement	18 60
Availability and use of advisorship facility during reporting period	Citizenship Report Proxy Statement	18 60
Performance evaluation process	Annual Report Proxy Statement	49 13

Note: N/A = Not Available

Chapter X

CORPORATE REPORTING: SELECTED ISSUES

This chapter contains two articles on fair value measurement requirements in IFRS. These were contributed by two panellists who addressed participants at the UNCTAD secretariat in Geneva on 9 October 2006. The first article presents the perspective of investors and the second approaches the issue from the standpoint of the preparers of financial statements.

I. Fair Value Financial Reporting: Investors' Perspective

By Rebecca McEnally¹⁵¹

Introduction

Financial reporting standards issued by major standard setters increasingly require that companies report their financial positions and the results of their operations using fair value measurement for certain categories of items.¹⁵² Indeed, more than two dozen standards now require or permit such information and more fair value measurement-based standards are in progress. Consequently, it is reasonable to inquire why the principal users of financial statements, investors and creditors, would desire fair value measurement and how such information is used in making financial decisions.

This paper addresses several issues surrounding the use of fair value measurement by investors, including the questions investors must answer before making their investments the information they need to answer those questions, the fundamental characteristics that render information useful for financial decision-making, why fair value measures are an important characteristic of the information set, and how investors analyze the information.

What issues do investors need to address?

Investors require answers to a variety of questions in order to analyze the potential risk and return distributions of companies, and to properly price their securities. These questions include¹⁵³:

- How do companies create value?
- How sustainable is the value-generation process?

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¹⁵² See, for example, International Accounting Standards Board's (IASB) International Financial Reporting Standard (IFRS) No. 39, *Financial Instruments: Recognition and Measurement*; Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivatives and Hedging Activities*; IASB IFRS 2, *Share-Based Payment*; and FASB SFAS 123(R), *Share-Based Payment*.

¹⁵³ For additional discussion of these issues, see *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, CFA Institute Centre for Financial Market Integrity, Charlottesville, Virginia, United States of America, forthcoming 2007.

- How is the value dispersed to the various superior stakeholders? and
- How does value accrue to the last residual claimants, the ultimate risk-bearers in the company, who are generally the common shareowners?

Investors use a variety of methods for evaluating the investment-worthiness of securities.¹⁵⁴ However, regardless of the particular model or approach used, the investor must evaluate the potential for the company to generate future returns and the risk associated with those returns. The investor must also understand the relative standing of the securities in the claims hierarchy of the company, the possible effects on the value of a particular security from returns shortfalls, and the claims against returns by superior claimants.

What information do investors need to answer these questions?

In order to address these issues, an investor will need to collect and analyse information regarding the:

- Resources the company currently controls;
- Obligations the company has to transfer resources to others;
- Company's ability to generate long-term, sustainable net inflows of resources;
- Company's ability to convert resources to cash; and
- Risks to which these resource-generating activities and cash flows are exposed, both short- and long-term.

Different investors, depending upon the securities they hold or are contemplating holding, may require different types of information. For example, a short-term bank creditor may be more concerned with a company's current holding of liquid resources that can be quickly converted into immediate cash to service the bank's claims. In contrast, a pension fund manager with a three- to five-year investment horizon may be much more interested in the company's long-term ability to generate *new* resources and to convert those to cash.

What characteristics render information useful for investment decision-making?

Financial reporting exists to serve the needs of investors who cannot otherwise command the detailed financial information they need to make investment decisions. Thus, all events that can reasonably be expected to affect the value of investors' investments, such as changes in assets, liabilities and equities, should be *recognized in the primary financial statements*, including much information that is currently disclosed only outside of the financial statements, such as off-balance sheet financing vehicles.

Standard-setters and regulators alike must understand investors' information needs when determining what financial statement recognition of transactions and events to require, how the items should be measured and displayed, and how much footnote disclosure should be provided. Specifically, they must understand what characteristics make the information useful for financial decision-making.

¹⁵⁴ The term, "investor," is used broadly in this paper to mean any external capital supplier to the company. Thus, the term would include outside creditors such as purchasers of bonds and other debt securities, as well as equity investors, including the last residual claimants, usually the common shareowners.

One general attribute of useful information is relevance. Specifically:

- Information is **relevant** when it can influence an economic decision.

In many cases, the ultimate decision regarding what information recognition and disclosure to require has come to revolve around (1) a determination of what might be easiest to measure and (2) the certainty of the resulting measurement, rather than the ultimate usefulness of the information and its relevance for decision-making. Such recognition criteria have led to the provision of information with dubious value to the investment decision-making process and a waste of resources for those who must provide it.

For example, it may be relatively easy to determine how much the company paid for an asset 30 years ago, and the measurement may be highly verifiable if the original invoice is still available. Unfortunately, investors would find little use for the information in deciding how much to pay for the company's securities today, how much to lend, or on what terms. The amount paid for an asset 30 years ago, or five chief executives ago, is of little or no *relevance* to economic decision-making today.

A second, very closely-related issue is the concept of the *reliability* of information and an appropriate meaning for the term. Investors would maintain that:

- **Reliable** information is that which faithfully represents what it purports to represent.

In many cases, reliability of information has come to be equated with certainty of measurement. This is a considerable shift from the original concept of reliable information as that which provides a clear and faithful representation of the economic event or transaction. Put slightly differently, the value of information to investors is diminished in direct proportion to the degree that it fails to faithfully represent the company's underlying operations, financial position, transactions and events.

Reliable and useful information may not be measurable with certainty. Indeed, very few if any items in the financial statements *are* so determinable. The fact that the items appear as numbers sometimes is construed as indicating a precision and certainty that is not generally in evidence. Most numbers in the financial statements are estimates; some with a reasonable degree of precision, perhaps in some cases the collectibility of receivables, and others that make no pretence of precision or reliability, such as depreciation of long-lived assets or potential payments that are contingent on the outcome of litigation. But the ultimate issue is and must be which information is most useful for investors' decision-making. Sometimes, information that is highly relevant to investors' decision-making has been moved out of the company's financial statements because it is less certain.

Just as certainty of measurement should not be a test for recognition and disclosure, so too should predictability of occurrence in the future not be the criterion for inclusion in the financial statements. Some future events, such as the amount to be settled for a contract with contingent provisions, may have a wide range of possible outcomes. In some cases, the outcomes could affect the future viability of the company. It is critical that investors be provided with full disclosure of such information in the financial statements. The statistical expected value should be used as the point estimate for financial statement recognition and the range of possible

outcomes, along with managers' associated probability estimates, should be provided in the notes to the statements.

Finally, to be useful for investment, decision-making information must be current and up to date. Information declines in value in direct proportion to the age or staleness of the information. Hence:

- To be relevant for investment decision-making, information must also be **timely**.

In a hypothetical perfect world with perfectly efficient and effective markets, information useful for investors' decision-making would be continuously provided to the market through a variety of information channels. Unfortunately, many obstacles, some of which are human based, exist to the continuous provision of up-to-date and reliable information. As a consequence, some regulatory jurisdictions have chosen to provide a partial solution to the problem of providing timely, reliable information to investors by requiring that public companies issue interim financial statements and related disclosures to their investors and potential investors. Such an approach is certainly to be preferred to a single annual provision of information to investors in which some of the information may well be 16 or 17 months old. In any event, investors will place greater value on the most current information that can be made available to them.

What is the role of fair value information in investment decision-making?

Based upon the preceding discussion, it becomes clear that if up-to-date information that faithfully represents the underlying transactions and events of a company is more valuable for investment decision-making than other information, including stale historical cost information, then a general principle can be stated:

- **Fair value information** is the most relevant information for financial decision-making.

Investors' buy, sell, and hold decisions, just like company managers' acquisition and divestiture decisions, are based on fair values and changes in those values, not outdated historical costs. By definition, fair value measures impound all of the most current assessments about the value of an asset or liability and any future changes in that value, including the amounts, timing, and risk of the future cash flows attributable to the asset or obligation. Such expectations lie at the heart of all asset exchanges. Consequently, financial statements primarily based on outdated historical costs, measures that are removed by time and constantly changing markets from current conditions are less useful for making such assessments. In the last decade, an increasing number of global financial reporting standards have been based upon fair values, a trend we would wish to see accelerate.

This position is not a new one for investors or for CFA Institute. For example, in 1993, a predecessor organization of CFA Institute, the Association of Investment Management and Research, observed:¹⁵⁵

It is axiomatic that it is better to know what something is worth now than what it was worth at some moment in the past... Historic cost itself is in reality historic

¹⁵⁵ *Financial Reporting in the 1990s and Beyond*, CFA Institute (the Association for Investment Management and Research), 1993, p. 39.

market value, the amount of a past transaction engaged in by the firm... Historic cost data are never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms (or even within a single firm). There is no financial analyst who would not want to know the market value of individual assets and liabilities.

An objection to the incorporation of fair value information in financial statements is that fair values may cause the volatility of statement numbers to increase. We would argue to the contrary:

- If fair value measures result in greater volatility than historical cost measurement, then the fair values have merely unmasked the underlying economic volatility already present in the company's operations.

Since the early 1980s, financial reporting standard setters have tended to base new standards on fair value measurement. Recently, FASB, working on its own behalf and that of IASB, has developed a new standard for the fair value reporting of assets and liabilities¹⁵⁶. This standard does not require that all financial statement items be reported at fair value. Rather, it specifies how fair value measurements should be made *for those standards that currently, or will in the future, permit or require fair value*.

This standard represents a major step forward for investors, but it also provides clarity for preparers and those who audit their statements. However, the majority of standards comprising the bulk of current GAAP are currently not based on fair value principles but on historical cost measurement. The mixture of the two measurement bases, fair value and historical cost, in financial statements results in the so-called "mixed (measurement) attribute system". Much work remains to be done to bring these older standards into compliance with the FASB's fair value standard. In the interim, the CFA Institute Centre for Financial Market Integrity has proposed modifications to the current financial reporting model that will better serve the investment analysis needs of investors and accommodate the mixed attribute system during what is expected to be a lengthy transition period to a full fair value financial reporting model.

How can investors more efficiently and effectively use the mixed attribute information currently available to them?

The statement of changes in net assets available to common shareowners

The proposed new reporting model would expand and transform the current income statement that is commonly provided in most financial reporting systems. While retaining all of the information currently available in the statement, the changes would more clearly:

- Distinguish among items with different measurement attributes;
- Reflect the activities of the different types of business activities: operating, investing, and financing;
- Display items in the statements by the economic nature of the item rather than the function for which it is used; and
- Reflect and incorporate the obligations to the various claimants to the net assets of the company, and the transfer of assets to settle those claims.

¹⁵⁶ SFAS No. 157, *Fair Value Measurements*, Financial Accounting Standards Board, Norwalk, Connecticut, 2006.

As currently measured, net income is the result of the recognition of *some* revenues and gains on accounting transactions less *some* expenses and losses. In contrast, the Statement of Changes in Net Assets Available to Common Shareowners is designed to include timely recognition of all changes in the fair values of assets and liabilities that are currently required or permitted to be recorded at fair value, while continuing to accommodate the separate display of historical cost information, including managers' estimates. That is, the model will separate the various measures by attribute so that investors can make better use of the information. Furthermore, the statement will not require information that is not currently required to be reported.

If investors are to be able to evaluate how the value of their investment in a company is increasing or decreasing, one of the most important questions an investor must address, then they must be able to fully understand how the company's operations and activities are increasing or decreasing the values of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or consuming patterns are changes in the fair values of these assets and obligations. This statement highlights the information investors need to make these assessments.

A schematic diagram of the Statement of Changes in Net Assets Available to Common Shareholders is provided in figure 1. The first column of the statement indicates the general layout of the items. Separate categories are established for operating, investing and financing items. A line is provided for the net change in net assets before transactions with owners. One particular innovation is the inclusion of information in this expanded form statement that is currently available only in the statement of shareowners' equity: payments of assets and distributions of equity interests to the various categories of owners of the company, including minority interest and common shareowners. The final line is the net change in net assets available to common shareowners.

The second column, current period transactions, provides for separate display of the effects of all transactions and events occurring during the period that affect the company's activities. The third column, estimates, provides separate display for managers' estimates and allocations of items such as depreciation and amortization of assets, provisions for bad debts and the like. Managers' estimates are somewhat different in nature from transactions and events, requiring a greater or lesser degree of judgement in their development. Investors would tend to place a different valuation multiple on such estimates than they would on transactions and events, so they have been separated for greater clarity and to enhance usefulness of the information.

The fourth column displays changes in the fair values of assets and liabilities that are currently required to be reported, or those that managers have chosen to report when standards provide such elections. Hence, changes in the fair values of derivative instruments, share-based compensation, portfolios of trading securities and the like would be given separate recognition. Investors will be able to make use of the information much more readily than they can in the current reporting framework, where all of the information about changes in a single line item, effects of transactions, changes in estimates, and fair values, are aggregated together in a single number. This separate display for the fair value components of line items may also assuage the concerns of those who are less than comfortable with the concept of introducing fair value remeasurement into the accounts.

The fifth column accumulates and summarizes the net changes in net assets. Note that this column is somewhat similar to the limited and highly aggregated display that is normally provided in the income statement today.

One of the major features of the statement is that it unbundles the various items by measurement attribute, permitting users of the statements to directly evaluate the items. Because the current financial reporting model provides for such items to be aggregated together by line item and also by function, investors must expend considerable effort to attempt to develop the information they need to value their investments. This analytical process involves substantial estimation, is subject to significant error, and results ultimately in incomplete information. Given that such information is readily available currently in most companies' general ledgers, the provision of the information to investors in the new model will result in little or no additional cost to companies. It is far more efficient and effective for company managers, who already possess the needed information, to provide it directly to investors. Since they have the information, the cost of providing it will be minimal. The only other alternative is for the thousands of individual investors in the company to expend the considerable resources necessary to try to generate as much of the information as they can, a waste of resources that could be better channelled directly to investments.

The CFA Institute Center for Financial Market Integrity is of the view that the company itself will benefit from the improved disclosure, and the greater clarity and reduced uncertainty that investors will have about the company's operations will result in lower risk premiums the company must pay to obtain needed capital, and greater pools of available capital. This latter outcome has been well established in academic research over the years. That is, the more complete and clear the company's disclosures, the better market prices the company is able to obtain.

Reconciliation of Balance Sheet, Cash Flows, Estimates and Valuation Adjustments

A proposed statement that is entirely new is the Reconciliation of Balance Sheet, Cash Flows, Estimates and Valuation Adjustments, which is provided in figure 2. Indeed, this is likely to be the most useful statement of all for investors. It is based directly upon the analyses that investors must undertake to value their investments and the types of information they try to generate from the limited disclosure currently available. It is worth noting that such reconciliations are also a common feature of the analytical work undertaken by managerial accountants as well as independent auditors when conducting their analyses of the company's accounts to ensure that the accounts are complete and accurately stated.

In brief, the Reconciliation traces individual line items from one balance sheet to the next, separating the information by pure measurement attribute, cash flows, managers' non-cash estimates, and fair value adjustments. Note that, to prepare such a reconciliation, it is necessary that the cash flow information be reported using the *direct method*. This method represents the cash flow cognate to the income statement currently in use in most reporting jurisdictions. The indirect method, in contrast, begins with reported net income and "patches" the net income number for two major categories of items: (1) non-cash items appearing in income in the current period, such as depreciation and amortization and non-cash revenues recognized; and (2) items with cash consequences that have not yet appeared in income, such as additional purchases of inventory, or payments on prior period obligations, for example, compensation accrued at the end of the prior period. The direct method provides much clearer information on cash receipts and payments, information critical for evaluating the ability of the company to convert resources into

cash flows, and for determining the distribution of cash flows to the various claimants on the company's resources.

Note that in the Reconciliation, any transactions and events that have been recognized in the second column of figure 1, Current Period Transactions, of the Statement of Changes in Net Assets Available to Common Shareowners, but that have not yet either been converted into cash or consumed cash, would be displayed in the Estimates column. That is, both non-cash accruals, such as non-cash revenues, and other estimates, such as depreciation, would appear in the Estimates column. This display highlights the fact that, until items such as revenues are collected in cash, they are estimates of the cash flows that will occur in the future, and only that.

The format throws into sharp relief the nature of the company's various value-generating activities, shows how new resources are generated and claims against those resources arise, how the company converts resources into cash and distributes the cash to claimants, and how the value of the residual claimants' investments is changed as a result of these activities. Importantly, too, the statement provides clear insight into the underlying riskiness of a company's operations by displaying the information needed to evaluate both the company's short-term and long-term prospects. As was made clear in the beginning, financial reporting serves investors by providing the information needed to answer all of these questions.

Some managers have observed that if they do not currently produce a direct method statement of cash flows, then they would have to bear increased costs in order to do so. However, we would counter that such information currently resides in their own internal cash management and treasury operations. Indeed, investors would be concerned to learn that the managers of a company were not able to determine how much cash had been paid to employees for their services, how much to retire debt, and how much for interest on the debt, for example.

One might question why the issue of cash flow reporting is given such prominence in discussions focused on fair value reporting and measurement. The answer is direct and straightforward: cash flows are the *ultimate* fair value measures. That is, by definition they are current at every moment and therefore are continuously measured at fair value. One way of understanding this notion is to recognize that at the last split second before an item is received or paid in cash, it is measured or remeasured at fair value. Any difference between the accrual amount recorded in the books and the amount to be received or paid in cash must be recognized as a gain or loss at the time the cash flow is recorded. To do otherwise is to misstate the accounts.

Conclusions

This brief discussion has had as its objective to explain the importance of fair value financial reporting for investors and its role in the investment decisions they must make. It also provides discussion of a simplified model for presenting fair value information, including cash flows, and information based on other measurement attributes. The model does not require information that is not currently mandated by standard-setters for financial reporting, or that is not already available in the company accounts for purposes of managerial decision-making and control. Hence, it should be relatively straightforward for standard-setters to move toward such a display model. The benefits to companies that present such information will be immediate.

Figure 1. Statement of changes in net assets available to common shareowners

	Current Period Transactions	Estimates	Valuation Adjustments	Net Change In Net Assets
Operating				
Investing				
Financing				
Net Change in Net Assets before Transactions with Owners				
Net Change in Net Assets				

Figure 2. Reconciliation of balance sheet, cash flows, estimates and valuation adjustments

Balance Sheet: 31 December 200X	Cash Flow Statement, Direct Method	Estimates	Valuation Adjustments	Balance Sheet: 31 December 200X + 1

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II. Were they thinking about us when they wrote the standards?

By Geoffrey Townsend¹⁵⁷

Overview

- Financial reporting is just one way of looking at complex economic “reality”; it is a two-dimensional depiction of a four-dimensional world.
- IFRS is an attempt to move financial reporting to a better depiction of economic reality. Comparability is a desire of users in an increasingly globalized economy; but comparability entails compromise; compromise involves balance.
- The IASB has limited resources and cannot do all things at once. Progress is piecemeal. Prioritization takes place, and the prioritization is driven by the OECD economies.
- IFRS may be the best game in town, but it is not the golden bullet. We should have realistic expectations.
- Users should be careful when comparing IFRS financial statements from different economies.
- Are users as sophisticated as we are told?

Introduction

The purpose of general purpose financial statements is “to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making financial decisions” (IAS 1.7). Such financial statements could be seen as a “logical view” of the entity at a point in time and of the events which have occurred in the reporting period.

The “real situation” is multi-dimensional and is influenced by:

- Events within the entity; and
- Transactions between the entity and the outside world (suppliers, customers, workforce, government agencies, etc.).

However, the real situation is also influenced by:

- Developments in the industry (competitors, development of alternative products);
- The actions and plans of suppliers, customers, employees;
- The status of the national economy(ies) in which the enterprise is active; and
- The status of the global economy.

Many of the “things” which the entity buys, owns or sells have their primary unit of measurement not in monetary units, but in physical units such as ton, litres and metres. Thus, a milling machine which is a fixed asset “is” primarily “a machine” which has certain performance characteristics rather than a certain sum of money.

¹⁵⁷ Geoffrey Townsend was formerly a Partner of KPMG in Frankfurt and Moscow. He is an English Chartered Accountant (ICAEW) and was a German licensed auditor (Wirtschaftspruefer). He now works as an independent consultant.

In addition to the physical characteristics, the “things” may involve a time dimension, for example “for delivery on...”

The entity also has legal rights and obligations which may be measured in money or in some other physical units, often also including a time dimension.

And then we have intangible “things” which may be of great value to the entity such as, for example, a trained workforce, know-how and intellectual rights.

All of these “things” can be subject to a further variable, which is “probability”. However, when we draw up financial statements, we use a currency unit as a method of depicting the position and performance. The balance sheet, profit and loss account, and cash flow statements are essentially tables of numbers; in theory, if the direct cash flow method is used, then the items shown in the cash flow statement have monetary units as their prime unit of measurement, but the other two “tables” contain items for which the primary unit of measurement is not money. The notes to the financial statements, whilst containing narrative explanations, also tend to be full of money values.

In creating the financial statements, we have carried out “a transformation” in which all sorts of “things” are represented by monetary amounts. The methods used for transformation form part of the definition of the “logical view”. The definition of the logical view may also partially or wholly exclude certain “things” from the view; for example, financial statements generally ignore events which have not yet happened.

An analogy can be made to an architect’s drawings of elevations of a building; he will design a three-dimensional object, but will depict it through a series of two-dimensional elevations. An elevation is a logical view which truly represents the reality according to various conventions; a floor plan will afford a further logical view. To obtain a good understanding of the plans, it is necessary to see several logical views.

Looking at the past, or looking at the future?

We are told that investors, advised by financial analysts, base their calculations of the amount they are willing to pay for a company on a calculation of future cash flows, which is then adjusted for existing debt and cash; the whole is discounted using a rate which reflects the risk-free cost of capital plus a series of premiums for various risk factors, some of which are under the control of the company and some of which are associated with the industry, the country in which it operates and some global considerations.

This is a logical view which is very much biased towards the future. The mechanics are very much influenced by business models which are used to evaluate various scenarios, and which are used in the preparation of business plans and budgets.

Traditionally, financial reporting has taken a logical view which almost totally ignores the future element. One could paraphrase the conceptual framework of financial reporting systems by saying that the income statement reflects events which have taken place in the past and which have been completed (ruled off), whereas the balance sheet represents events which have one foot in the past and one foot in the future (unfinished business). The cash-flow statement is a past-oriented statement, although loans received and made do have a future dimension in the form of repayment.

If this is true, why is so much emphasis placed on financial reporting? There is a huge volume of laws, standards, professional infrastructure, regulation and even litigation dealing with

the preparation and verification of a historically-oriented logical view, whereas what the punters want is a future-oriented logical view; an area which is subject to comparatively light regulation. Is this a successful confidence trick perpetrated by the accounting and auditing profession? “We are very important, and you should appreciate our status and pay us lots”?

Historic cost, fair value, and hybrids

Historic cost accounting has been with us a long time. In its purest form, it is driven by recording monies paid and monies received. Fixed assets purchased, loans made and received, capital contributed or withdrawn are treated separately because the cash flows are expected to have consequences in the future. The advantage of historic cost accounting is that it is largely about events in the past which can be easily verified. It has the benefit of low production cost and a high degree of objectivity and verifiability.

Historic cost accounting has then been “improved” by use of the accruals principle. A profit is deemed as realized when the goods have been delivered, and not when they have been paid for. It is deemed that the settlement of the debt can be assumed with a high degree of probability, and therefore it is “safe” to already account for the profit.

It is worth mentioning at this point the concepts of realization and recognition. A profit is realized when the transaction is over and the fruits have been gathered; it is recognized when it appears in the profit and loss account. It has become generally accepted that you can recognize a profit on a sale when you have delivered the goods, and the delivery becomes not only the point of recognition, but also of realization. This can be seen as a first step on the way from “pure” historic cost accounting to fair value accounting; the accountant has taken a view that the customer’s debt will be paid.

(As an aside, I note that under Soviet accounting and the early years of post-Soviet Russian Federation accounting, sales were realized when the cash was received, with goods despatched but not yet paid for held on a sort of “consignment” account at cost until payment had been made.)

At the other extreme, we have what the users of financial statements would probably really like — an estimate of future cash flows for all time, including transactions which have not even yet been budgeted to customers who have not yet been identified for goods from plants which have not yet been built.

Such transactions do find their way into company valuations. They are absolute anathema to accountants and auditors because of the huge amount of judgement required. We are out of the realms of verifiability and into plausibility. I think I can buy something for \$5 and sell it for \$10; can I book the profit now, please?

Fair value accounting is a little more objective than that. The balance sheet includes things which have at least some root in the past, but this can be a little tenuous. At the more solid end of the objectivity scale we have, say, the valuation of a futures contract which will be marked to market, and this represents the market expectation of the contract value when it matures. Somewhat flakier is the valuation of a fixed asset on the basis of the net cash flows which it will generate — this probably does involve taking a view on future transactions with people we do not know yet; great care has also to be taken to ensure that there is not a double or multiple counting of the same “cash margins” when various stages in a production chain are evaluated (a problem known today when evaluating an upgrade of a production facility).

So at one extreme we have historic cost accounting which is very objective and easily verifiable, though maybe not very useful when considering future performance. But it does provide a solid base of verifiable facts. (And we must remember that accounting has objectives other than just the production of financial statements, including providing a record of stewardship and meeting a number of legal needs; historic accounting may be appropriate for these purposes.)

Over the decades, we have seen amendments to financial reporting standards and accepted practices which have introduced elements of fair value accounting; these amendments have gone a little way towards meeting the requirements of the users as represented by the financial analysts. The process has been slow, and there have often been objections.

Maybe one could make the case that financial reporting has introduced fair value methodologies when there has been a large consensus that this is a good thing to do — but not before.

The result could be seen as a hybrid system based on the concepts of historic cost accounting with certain elements of fair value accounting when the historic cost convention has produced results which are “clearly daft”.

Pressure against the fair value reforms has typically come from:

- The preparers of financial statements, who usually complain about the costs of preparation and sometimes argue that there are no real outside users who require this information. Financial statements are usually prepared by accountants, and generally speaking, they are nervous about making judgements which may well turn out after the event to be wrong.
- The auditors of financial statements, who are usually worried about the subjectivity of the application of judgement. They fear an increased risk of litigation.
- The justice authorities, who may be concerned about recognized but unrealized profits being used to pay dividends with negative effects for creditors should circumstances change. This can be seen as a capital maintenance argument.
- The tax authorities, who may worry that the aggressive use of judgement can lead to a deferral of taxation, and, on a more philosophical basis, that the use of judgement undermines the principle of equality of taxpayers.

The concerns of the taxation bodies and the capital maintenance lobby can be relatively easily addressed by using the concept of logical views. It is possible to present different logical views to various users designed to fit their purpose. The capital maintenance lobby can be given a logical view in which profits are recognized when they are realized and not before; the tax authorities can be offered a logical view defined by the taxation legislation (i.e. tax return), for example, using tax depreciation rates or capping the amount of provisions. This would allow the investors and analysts to be presented with their own logical view, which is closer to their requirements. (Please note that the European Union (through the Regulation on Consolidated Financial Statements) and the Russian Federation (through its draft law on consolidated financial statements currently under consideration by the Duma) have both accepted that the logical view presented to the users of consolidated financial statements can be different from that used in statutory financial statements of legal entities which may be used in the control of capital maintenance.)

By way of historical note, I list some items which introduce elements of fair value accounting into a newer hybrid financial reporting (Some of the older changes have now become “so generally accepted” that one may wonder why they were ever controversial.):

- Accruals;
- Bad debt and inventory provisions;
- Translating foreign currency balances at closing rates;
- Fixed asset impairment;
- Revaluation of fixed assets;
- Marking forward contracts to market; and
- Marking financial instruments to market.

Setting the reform agenda

Financial reporting reform is usually a reaction to a demand from users for more relevant and/or comparable information. The demand may arise from:

- Scandals;
- Changes in business practices (e.g. increasing use of financial instruments); or
- Changes in the economic environment (e.g. widespread inflation in the 1970s).

The IASB has to prioritize its work, and it is natural that it will take a global view when setting those priorities; it will normally give a lot of consideration to the global capital markets. And the global markets are dominated by companies operating in the OECD countries.

Thus, problems which can be very important to a non-OECD country, but which are of lesser importance from an OECD perspective, may get placed at the end of the IASB agenda. I would argue that there are aspects of the Russian economy which have a very material impact on the IFRS financial statements of Russian companies, and which lead to extreme effects or strange situations which may not appear frequently in the financial statements of companies from OECD countries. The problems are, of course, not limited to the Russian Federation.

I am not suggesting that national standards are the solution. The problems described below, whilst maybe being inadequately addressed by IFRS are even less adequately addressed by Russian standards of financial reporting.

Specifics of the Russian Federation situation

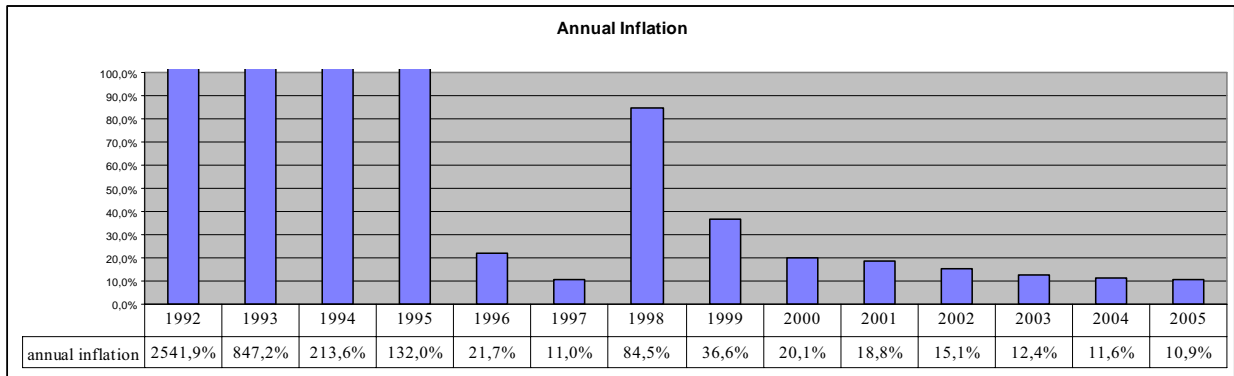
- Two bouts of hyperinflation and continuing high, but not hyper-inflation;
- Post-Soviet price realignment (still ongoing);
- Ongoing effects of privatization — atomization and the subsequent formation of industrial groups;
- Dominance of resource extraction and basic industries;
- Developments in investor confidence — improved performance or improved perception?

Two bouts of hyperinflation and continuing high, but not hyper-inflation

Since 1991, the Russian Federation has experienced inflation in which prices have multiplied by a factor of around 15,000. The periods 1992–1995 and 1998–2001 were

hyperinflationary and all of the other years up to 2005 have experienced annual inflation rates in excess of 10 per cent.

Figure 1.



Inflation distorts financial statements; the higher the inflation, or the higher the throughput times, the higher the distortion in the profit and loss account. Also, over time fixed asset values get even more out of line with book values than in the OECD countries.

IFRS offers no solutions if the inflation is less than hyper-inflation.

Post-Soviet price realignment (still ongoing)

Decades of state control in the economy led to relative prices being distorted from what they would have been in a market economy. Remaining state controls of politically sensitive prices (e.g. energy, rail transport) mean that even after 15 years of transition, relative prices are still distorted. This is an economic fact and does not in itself require an accounting solution. However, the continuing realignment means that the prices of some things inflate faster than others (indeed, this is the main reason for the stubbornness of the general inflation rate, i.e. there are some things (e.g. energy, municipal charges, etc.) with high inflation rates and “normal” items with “normal” inflation rates).

Ongoing effects of privatization — atomization and the subsequent formation of industrial groups

In general, privatization was carried out at plant level; industries and supply chains were “atomized”. Since then there has been a process of consolidation through mergers, both horizontal and vertical. This made it possible for some individuals, often the management, to acquire the enterprises personally, often using offshore holding companies. Ownership structures were not clear, and it was difficult to identify the new groups emerging because of the absence of a clear corporate holding structure. Only recently have logical group structures emerged through “reorganization under common ownership”, an area which is specifically excluded from the scope of IFRS 3; the pooling of interest method is commonly used in such mergers. The resulting consolidated balance sheets can look very strange.

This comment does not criticize IFRS 3. What is different about the Russian Federation is not the nature of the problem of accounting for reorganization under common ownership, but the frequency with which it occurs.

Dominance of resource extraction and basic industries

Resource extraction and basic industries are major players in the Russian economy. Resource extraction is an area in which current IFRS are generally regarded as inadequate. From a Russian perspective, development of IFRS for the extractive industries is far more important than it is in the OECD countries.

The closer one gets to basic extraction, the bigger are the cyclical swings in prices. Whilst this effect is biggest in the extractive industries, it is still large in the basic industries. IFRS has probably “gone backwards” through the withdrawal of IAS 15 (Changing Prices).

Developments in investor confidence — improved performance or improved perception?

The value of many Russian companies has mushroomed in recent years as indicated by the prices achieved in initial public offers (IPOs) in the Russian Federation and London. This has been driven partly by improved performance and partly by improved perception.

The Russian Federation has benefited in particular because of its strength in the extractive and basic industries, which have both fared well in the current global economy. In addition, the quality of management has improved and companies are increasingly focussing on what they do best. Major new investment of the highest standard is being made in industries where the Russian Federation has a natural advantage; one could say that resource allocation has improved immensely as management has gained experience in working under market conditions.

However, another significant reason for the increase in market values of companies is the sharp fall in discount rates used by prospective purchasers to value Russian companies, and also in the much lower interest rates being offered by banks for loan finance. Both can be seen as a corporate governance bonus. It is still more expensive for a good Russian company to raise debt than for a good company in an OECD country, but the difference has shrunk considerably.

One of the effects of the “corporate governance bonus” is that the market capitalization of companies has grown very fast indeed, and has outstripped the growth of the balance sheet equity. Groups have created a large amount of “self-generated goodwill” which is not reflected in IFRS balance sheets. The debt/equity ratio is not a meaningful ratio for such companies. Balance sheets are not intended to reflect the market value of a company (it is a different “logical view”); however, the difference between book equity and market capitalization can be particularly high in the Russian environment.

Two Illustrations

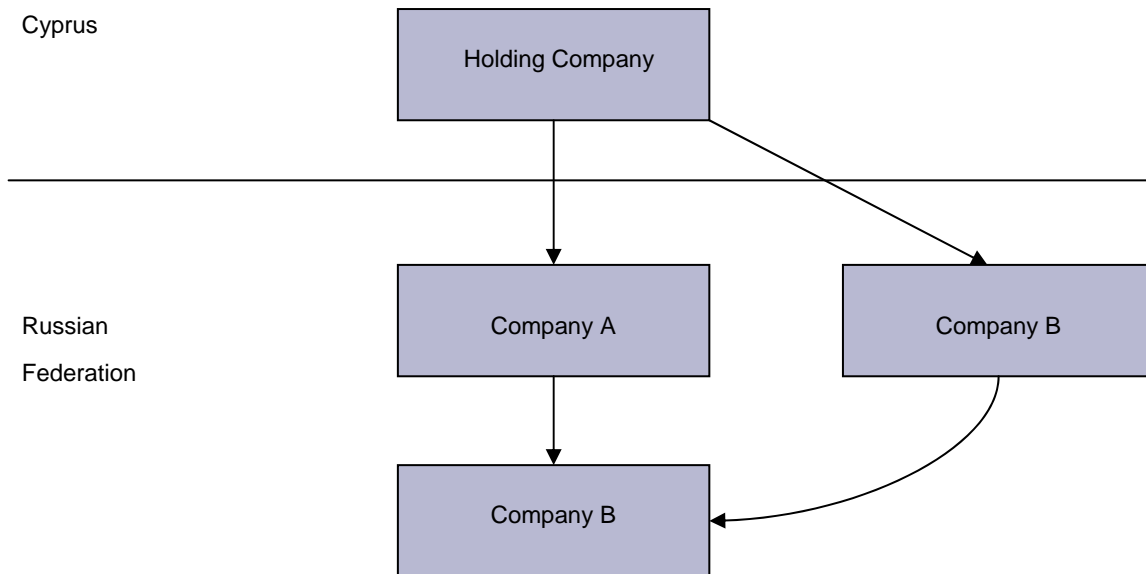
Caveat

I have taken two examples which show how Russian circumstances can exacerbate the “strangeness” of IFRS financial statements. The examples have been synthesized from experiences I have gained over the years. The examples are not real companies, but illustrate the problems which will be found in practice.

Illustration 1 — Negative Equity

The first story is a very simplified example of a reorganization of the type typically undertaken in preparation of an IPO.

Figure 2.



A Cyprus holding company has acquired over the years two Russian companies; the two companies trade with each other considerably because they represent two steps in the production chain. Indeed, it is difficult to think of the two companies leading independent lives. Related party transactions are always very difficult to explain to investors, and there is often a lot of suspicion. The investors in the holding company have a long-term plan to enter the global financial markets and raise money for future expansion, and also to realize some of the value they have built up in the business.

Perhaps the most obvious thing to do is to float the Cyprus holding company. However, it wants the flotation to be a Russian flotation; its business is Russian, and both investors and maybe also the Russian Government get “a funny feeling” when an offshore vehicle is used as the IPO vehicle. So they decide that the Cyprus holding should sell company B to company A, and they hire a respectable valuer to assess the fair value of the transaction. The intention would be to use A as the flotation vehicle for an IPO at some later date.

Before the reorganization, both A and B have the balance sheets shown in table 1:

Table 1.

Net Assets	100	Equity	100
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Before the reorganization, A and B have identical balance sheets. The valuer values company B to be worth 300 on a fair value basis. So company A borrows 300, purchases all of the share capital of B and pays 300 to the Cyprus holding company. The balance sheet of A becomes as shown in table 2:

Table 2.

Net assets	100	Equity	100
Investment in B	300	Loan	300
Total Assets	400	Total Equity and Liabilities	400

If the acquisition method were applied to the consolidation, the result would be as shown in table 3:

Table 3.

Net assets (A+B)	200	Equity	100
Goodwill	200	Loan	300
Total assets	400	Total Equity and Liabilities	400

However, this is reorganization under common control, and IFRS excludes such reorganizations from its scope. The normal practice is to use the pooling of interests method. That gives the result shown in table 4:

Table 4.

Net assets (A+B)	200	Equity	-100
		Loan	300
Total assets	200	Total Equity and Liabilities	200

The equity figure is calculated as $100 + 100 - 300$; equity of A plus equity of B minus payment to shareholders.

And that is strange! After the Russian banking crisis of 1998, I saw lots of companies with negative IFRS equity, but they were all bankrupt! But A and B are very profitable.

What would have happened if the valuer had also valued A and arrived also at a value of 300? The fair value of A and B is 300 each, so maybe one would expect the value of the new group to be $300 + 300 - 300 = 300$, the minus 300 being the cash returned to the Cyprus holding company.

The logical view used by IFRS does not result in the balance sheet equity representing the fair value of the company; it is not intended to. Yet investors may consider that both the consolidated balance sheets shown above are “not useful”.

developments in the Russian Federation are different from those in the OECD, the “fit” of IFRS to those economic developments may be less “comfortable”. This is not an argument for not implementing IFRS; it is something which users should be aware of when comparing potential Russian investments with, say, OECD investments.

- Accountants and auditors tend not to like fair value accounting because it is difficult and costly to implement, can be very subjective, and is very volatile.
- Are investors as sophisticated as some financial analysts tell us? Advanced analysts say that they need lots of clear and reasonably reliable information representing various logical views, and that valuation depends upon careful consideration of all of these factors. I have the impression that a lot of investors would like the “golden bullet”. One important number (profit? Earnings Before Depreciation, Interest, Taxes and Amortization (EBDITA)? Operating cash flow? Balance sheet equity?) would be very nice. Accountants and auditors are comfortable with their two-dimensional view of the world. Do the investors want to understand the four-dimensional world, or would they like a two-dimensional representation?