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2004 Review

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FOREWORD

For over two decades, the United Nations has been contributing to the global debate on corporate transparency and disclosure issues through the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), which is serviced by UNCTAD. The twenty-first session of ISAR, which was held in Geneva from 27 to 29 October 2004, was its first session since UNCTAD XI, which took place in São Paulo, Brazil, in June 2004.

The outcomes of UNCTAD XI - namely, the Spirit of São Paulo and the São Paulo Consensus – emphasized the need for greater coherence between international processes on the one hand and the development strategies and policies of developing countries on the other hand. In particular, they stressed the central role of investment and the need to create an enabling environment for the facilitation of sustained investment flows to developing countries and countries with economies in transition and for deriving greater benefits from those investments. Accounting and reporting constitute a fundamental part of such an environment because sound and high-quality corporate reporting is essential for attracting and protecting investors, managing risks and returns and reducing financial volatility, enhancing accountability and ultimately enabling efficient allocation and use of economic resources.

Over the last two decades, we have witnessed a continuous trend towards the global harmonization of accounting and auditing standards, including those in the area of education and qualifications for professional accountants. The increasing pace of globalization of the world economy and the internationalization of investment flows have no doubt contributed to this process. There is a growing consensus that the application of a common set of global standards on corporate reporting will contribute to the reliability and comparability of financial information across markets and will facilitate international investment flows.

Given the growing complexity of business operations and the unfortunate series of corporate collapses that dominated the headlines in the last couple of years, the call for more reliable and relevant corporate reporting has never been louder. In recent years, financial, environmental and social scandals have raised the public's awareness of the fact that not all enterprises are willing or able to contribute positively to society's sustainable goals. At the 1999 World Economic Forum meeting in Davos, the United Nations Secretary-General, Kofi Annan, argued that economic globalization was at risk unless companies and other organs of society committed themselves to universal principles regarding human and labour rights, environmental protection and the rule of law. This commitment came to be embodied in the United Nations Global Compact and it provides a useful framework for the integration of ISAR's work on corporate transparency with the new mandate of UNCTAD in the area of corporate responsibility.

This volume presents the deliberations of the twenty-first session of ISAR. It addresses the comparability and relevance of existing indicators on corporate social responsibility reporting. It also discusses the implementation status of corporate governance disclosures. Contained in this volume are also studies and articles on the practical implementation challenges of international accounting and auditing standards.

Given the growing interest in corporate governance and transparency among policy makers, standard-setters, educators and the general public, I am confident that many readers will find this publication to be a useful source of timely information.

Carlos Fortin
Officer-in-Charge of UNCTAD
Geneva, December 2004

EXECUTIVE SUMMARY

This volume of the *Review of International Accounting and Reporting Issues* contains the proceedings of the twenty-first session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), which took place in Geneva from 27 to 29 October 2004. The session deliberated on two main agenda items: comparability and relevance of existing indicators on corporate responsibility reporting; and the implementation status of corporate governance disclosures. Summaries of the Group's deliberations on these agenda items and the related background papers are presented in chapters I and II respectively.

The first chapter provides an overview of major existing initiatives and regulations on corporate social responsibility (CSR) indicators and outlines the main issues raised by the examination of the comparability and relevance of those indicators. In particular, it discusses whether the comparability and relevance of CSR indicators could be improved by focusing on a limited number of fundamental common indicators, or "core indicators". The second chapter highlights developments in corporate governance disclosures that occurred after the twentieth session of ISAR and discusses challenges in implementing good corporate governance disclosure practices. In particular, it provides an overview of the main international initiatives in the area of corporate governance disclosures, including increasing trends towards convergence in the area of corporate governance disclosures, and discusses the status of implementation of good practices of corporate governance disclosures at the company level. The role of corporate governance disclosures in adding sustainable shareholder value is also addressed.

In the light of the unprecedented transition to International Financial Reporting Standards (IFRS) that many listed enterprises will be undertaking, particularly in the European Union, the secretariat organized a workshop on 26 October 2004, on the eve of the twenty-first session of ISAR, to discuss the implementation challenges of IFRS. Several high-ranking experts on these issues presented their views during the panel presentations. The World Bank granted us permission to publish in this volume its study on the implementation of international accounting and auditing standards on which their expert based his presentation at the workshop. This study addresses challenges to the successful implementation of international accounting and auditing standards which have been observed by the World Bank when carrying out the Report on the Observance of Standards and Codes (ROSC) accounting and auditing assessments. It highlights the lack of a strong institutional and regulatory framework as a critical challenge in the implementation of international financial reporting and auditing standards. This study is contained in the third chapter of this volume. Also the International Federation of Accountants (IFAC) granted us permission to publish in this volume a study entitled "Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and

ISAs" which it published at the end of 2004. The study addresses a number of questions, including the following: How do we move towards international convergence? What obstacles need to be overcome? What systems and processes can help facilitate international convergence? What roles can the IASB and IAASB and national standard-setters play in ensuring that international convergence is approached in a systematic and, where possible, consistent way? That study is presented in the fourth chapter of this volume. The last chapter contains articles that address selected issues on corporate transparency.

INTRODUCTION

The twenty-first session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) was held at the Palais des Nations in Geneva from 27 to 29 October 2004. It was attended by 190 participants from 57 member States. In accordance with the proposal made by the Group of Experts at its twentieth session, which was subsequently approved by the eighth session of the Commission on Investment, Technology and Related Financial Issues, the Group of Experts deliberated on two main agenda items.

The first item was a review of the comparability and relevance of existing indicators on corporate social responsibility. In its deliberations on this item, the Group of Experts addressed the need for social reporting with a view to making it more useful for decision-making, achieving comparability, and reducing the costs of corporate responsibility reports; methodology to improve the comparability and relevance of such reports; the possible target audience of such reports; the most important and comparable social topics to report on and criteria for their selection based the on common needs of users of such reports; and the need to include topics that reflect the developmental dimension of corporate activities. The Group considered how social reporting could supplement annual corporate reporting and how it could provide a broader view of an enterprise and its impact on society. The session also noted that the eleventh quadrennial conference of UNCTAD had provided a broader context within which the issue of corporate responsibility could be addressed. The Group of Experts concluded its discussions on this agenda item by agreeing to continue its work in the area of social reporting with a view to developing guidance on voluntary disclosure.

The second main agenda item was a review of the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value. A panel of experts provided updates on major developments in the area of corporate governance disclosures. Also, the Group of Experts deliberated on the findings of a survey that was conducted to assess, at the company level, the extent of implementation of the corporate governance disclosure elements that ISAR identified at its nineteenth session. During the deliberations, it was noted that various stakeholders were paying increased attention to corporate governance issues and that the trend towards convergence in corporate disclosure practices was growing. The Group of Experts also found that the survey results provided a useful snapshot of corporate disclosure practices at the company level. In addition, it discussed a number of implementation challenges that remain to be addressed in order to bridge the gap between existing codes and corporate governance disclosure practices. In concluding its deliberations on this agenda item, the Group of Experts agreed that in view of new developments in corporate governance disclosures, there was a need to update the disclosure elements that ISAR had identified in its report entitled "Transparency and Disclosure Requirements for Corporate Governance" and deliberated on at its nineteenth session.

During the "other business" segment of its agenda, the Group of Experts discussed the outcomes of UNCTAD XI and their implications for its work, the role of accountancy as regards economic development, updates on follow-up work on issues addressed at its previous sessions, and updates by other regional and international organizations on their respective activities.

Since the Group of Experts was meeting for the first time after UNCTAD XI, the secretariat briefed participants on the outcomes of UNCTAD XI, namely the Spirit of São Paulo and the São Paulo Consensus. Participants noted that the São Paulo Consensus reaffirmed the continuing relevance of the Bangkok Plan of Action that member States had adopted in February 2000 at the tenth quadrennial Conference of UNCTAD. Furthermore, the São Paulo Consensus provided additional areas of work. Reference was made to various paragraphs in that document that pertained to the work of the Group of Experts and the implications for the future work of the Group of Experts was discussed. Also, the secretariat reported on two parallel events that it had organized in São Paulo on the occasion of UNCTAD XI. These were a high-level roundtable on corporate transparency and investment jointly organized with BOVESPA, the São Paulo Stock Exchange; and a workshop on the role of accountancy in economic development. On the occasion of the latter, UNCTAD and the International Federation of Accountants announced their intention to sign a memorandum of understanding. The secretariat discussed the objectives and outcomes of the two parallel events and expressed its gratitude to the co-sponsors of the events, including BOVESPA, the Swiss Government, the Global Corporate Governance Forum and a number of Brazilian professional organizations that helped in organizing the two events.

Under the "other business" segment of the agenda, the Group of Experts conducted follow-up discussions on the positive role that accountancy plays in economic development. This subject was initially discussed at the workshop organized parallel to UNCTAD XI. The twenty-first session of ISAR noted the need for raising awareness of the importance of accountancy for economic development, particularly among policy makers in developing countries and countries with economies in transition.

With respect to follow-up on previous sessions of the Group of Experts, the secretariat updated participants on accounting by small and medium-sized enterprises (SMEs), the users and preparers' manual on eco-efficiency indicators and the revised ISAR model curriculum. The secretariat reported that publication work on each of these subject areas had been completed during the inter-session period. The secretariat also reported that Ciba Speciality Chemicals Company had implemented the manual on eco-efficiency indicators that the Group of Experts had issued. A representative of Ciba informed participants about the positive feedback his company had been receiving from investors and other stakeholders following the publication of his company's eco-efficiency indicators on the basis of the manual issued by ISAR.

On 26 October 2004, namely on the eve of the twenty-first session of ISAR, the secretariat organized a workshop on the practical implementation challenges of International Financial Reporting Standards (IFRS). The main objective of the workshop was to share views on the main challenges of the successful implementation of IFRS. Issues discussed included: the importance of IFRS for global financial stability and economic growth; regulatory and institutional requirements needed for the implementation of IFRS in national jurisdictions that differ in their overall preparedness for the introduction of such comprehensive, sophisticated and costly financial reporting systems; lessons learned from countries that are more advanced in the implementation of IFRS; and implications for developing countries and countries with economies in transition. About 100 experts from 40 countries representing regulators, standard-setters, the private sector, investors, civil society, academia and professional associations participated in the workshop.

In concluding its twenty-first session, the Group of Experts proposed that it works on two main agenda items at its twenty-second session: review of practical implementation issues of IFRS; and the comparability and relevance of existing indicators on corporate responsibility. Furthermore, under "other business" the Group agreed to consider corporate governance disclosures and other follow-ups. Further information on the twenty-first session of ISAR is available in the report of the session (TD/B/COM.2/ISAR/26).

UNCTAD would like to gratefully acknowledge the contributions of many experts to the success of the twenty-first session of the Group of Experts. It is grateful to Abbas Ali Mirza, Technical Advisor to the Gulf Cooperation Council and Chairperson of the twenty-first session of ISAR, and Professor Alicja A. Jaruga, Professor of Accounting at the University of Lodz, Poland, for their outstanding leadership role in guiding the twenty-first session of ISAR to a successful conclusion. UNCTAD appreciates the positive contribution of Dr. Nancy Kamp-Roelands and Richard Frederick as resource persons to UNCTAD on issues of corporate social impact reporting and corporate governance disclosures respectively. UNCTAD acknowledges with thanks the contributions of André Baladi, Co-founder, International Corporate Governance Network; Igor Belikov, Director, Russian Institute of Directors; Ivan Clark, Partner, PricewaterhouseCoopers, Brazil; Ndung'u Gathinji, Chief-Executive, Eastern, Central, and Southern African Federation of Accountants; Lars Vind Sørensen, European Commission; and Hazem A. Yassin, Board Member, Capital Market Authority, Egypt, for their valuable input into the review of recent developments in corporate governance disclosures.

UNCTAD express its gratitude to all members of the consultative group who contributed to the background paper on the comparability and relevance of existing indicators on corporate social responsibility that the Group of Experts considered at its twenty-first session. They are as follows: Roger Adams, Head of Technical Services, Chartered Association of Certified Accountants (ACCA), United Kingdom; Mallen Baker, Director of CSR and Reporting, Business in the Community, United Kingdom; André Baladi, Co-founder, International Corporate Governance Network (ICGN), Switzerland; Igor Belikov, Director, Russian Institute of Directors, Russian Federation; Heloisa Belotti Bedicks, Secretary-General, Instituto Brasileiro de Governanca Corporativa (IBGC), Brazil; Paul Dembinski, General Secretary, Observatoire de la Finance, Switzerland; Robert Garnett, Board Member, International Accounting Standards Board, United Kingdom; Ndung'u Gathinji, CEO, Eastern Central and Southern African Federation of Accountants (ECSAFA), Kenya; Richard Golding, Partner, PricewaterhouseCoopers, Switzerland; Kathryn Gordon, Senior Economist, Organisation for Economic Co-operation and Development, France; Rob Gray, Director, Centre for Social and Environmental Research, United Kingdom; Dwight Justice, Multinational Enterprises, International Confederation of Free Trade Unions, Belgium; Nancy Kamp Roelands, Senior Manager, Ernst & Young, Netherlands; Parveen Mahmud, Deputy Managing Director, Palli Karma-Sahayak Foundation (PKSF), Bangladesh; Julie McDowell, SRI Research Manager, Standard Life Investment, United Kingdom; Abbas Ali Mirza, Partner, Deloitte & Touche, United Arab Emirates; Jennifer Morris, Hermes Pensions Management Ltd, United Kingdom; Mokheti Moshoeshoe, Director, African Institute of Corporate Citizenship, South Africa; Amanda Pingree, Senior Manager, Public Advisory, Business Strategy & Operations, PricewaterhouseCoopers, Switzerland; Michael Urminsky, Programme Officer, International Labour Office, Switzerland: Peter Utting, Deputy Director, United Nations Research Institute for Social Development, Switzerland and Lene Wendland, Associate Human Rights Officer, Office of the High Commissioner on Human Rights, Switzerland.

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CONTENTS

CHAPTER I

REVIEW OF THE COMPARABILITY AND RELEVANCE OF EXISTING INDICATORS ON CORPORATE SOCIAL RESPONSIBILITY

SUMMARY OF DISCUSSIONS

A resource person introduced the agenda item. She noted that ISAR had previously recognized that corporations had environmental and social impacts that were not always reflected in corporate reporting. ISAR had recognized the weaknesses of non-financial reporting, such as the poor comparability of social indicators, and the potential burden that preparing reports placed on companies, especially SMEs. ISAR's work in this area was based on its mandate to promote the comparability and relevance of corporate reporting, and therefore the focus of the initiative was on the comparability of relevant corporate responsibility (CR) indicators.

ISAR recognized the work of the Global Reporting Initiative (GRI) as well as other organizations to develop specific social and environmental reporting indicators. ISAR's efforts were not meant to replace the work of other reporting organizations or discourage companies from producing more elaborate reports that extended the limits of best practice.

The resource person drew the attention of participants to the documentation that had been prepared for the agenda item. The main report "Review of the Comparability and Relevance of Existing Indicators on Corporate Social Responsibility" (TD/B/COM.2/ISAR/24) contained a summary of the deliberations of a Consultative Group of Experts created by the secretariat to facilitate the discussions. Her overview of this report covered the discussion of criteria for selecting social indicators, the consideration of potential users of social reports and their common needs, and other issues contained in the paper. The resource person then presented specific questions to the group to facilitate discussion of the subject.

The first question was whether CR reporting should be presented in annual reporting or in separate sustainability reports. Several delegates and invited experts were of the opinion that CR reporting should be presented in the annual report. These participants argued that CR reporting provided valuable information about the viability of a company and its quality of management. One representative of industry observed that a company should present only one face to the public (i.e. have one consolidated annual report).

It was also noted that some companies already included CR reporting in their annual reports and that the regulations of some countries required reporting on non-financial issues of a material nature.

Several delegates and invited experts expressed the view that CR reporting should not be included in the annual report of large companies.

Annual reports were already very long documents, and adding additional material would increase the difficulty for analysts reading these reports. Other participants observed that there might be advantages to separate CR reports, as they might allow greater emphasis on social and environmental issues, provide space for improved comparability of performance over time, and avoid any potential conflicts with existing national regulations regarding the content of annual reports. One delegate suggested that the decision of whether to locate CR reports in annual reports or in separate CR reports should be made on a country-by-country basis.

Others felt that, even if a separate CR report were made, at least some basic information on CR should be included in the annual report. With respect to SMEs, concern was also expressed regarding the potential burden on SMEs if CR reporting were to be included in annual reports. One delegate, who supported inclusion of CR reporting in the annual report, also suggested that TNCs report CR indicators for their subsidiaries.

The second question related to the common needs of the target audience and the purpose of CR reporting. Many delegates expressed a need to better identify the target audience of social reporting, as this could affect so much of the content and process of such reporting. One delegate indicated that his delegation did not find the purpose of social reporting very clear. CR reporting should be objectively oriented: how, for instance, would CR reporting help users of such reports make decisions, and what kind of decisions would be affected by CR reports? Once the objective of CR reporting was identified, the scope and target audience of such reporting could also be more clearly identified.

An invited expert pointed out that, in addition to external audiences, one must keep in mind the relevance of CR reporting for the firm itself: such reporting might assist the firm in its own management efforts by, *inter alia*, facilitating gap analysis of key corporate goals and commitments. It was suggested that not only should the firm itself be considered part of the target audience, but the quality of management benefits derived by the firm from CR reporting should also be included in the overall cost/benefit analysis of the reporting process.

Some delegates observed that governments should also be considered part of the target audience of CR reporting. One delegate suggested that governments could use social reporting information to evaluate companies and to decide whether to limit or promote particular activities of firms.

The third question related to whether the stakeholder or the accountability perspective should be adopted. Some delegates observed that in their countries there was already a substantial amount of data collected from companies about social and environmental issues that pertained to government requirements. Such data could be used, from an accountability perspective, in CR reporting.

Concerning the stakeholder perspective, an invited expert observed that the plethora of civil society groups that might demand data from a company could exceed a company's capacity to report. Despite some reservations about a stakeholder approach, many delegates and experts supported the idea of dialogue and partnerships between the private sector and civil society groups.

The fourth question concerned the criteria for selection of social indicators. Delegates and experts discussed the potential conflict between materiality and universality and, in much the same sense, between comparability and relevance. Several delegates suggested that materiality should take priority over universality, and that comparability, while an excellent objective, should not be overemphasized. There were several statements recommending a more sector-specific approach to CR indicators. The general concern expressed was that too great an emphasis on universality, or comparability, could undermine the materiality or relevance of a given indicator. Several other delegates and experts argued in favour of the use of universal and comparable indicators, at least in a limited way. Several suggested that a limited set of universal indicators could be developed and that these could be complemented by another set of more sector-specific indicators. Many delegates and experts supported the idea of a limited set of universal indicators supplemented by sector-specific indicators where questions of materiality were confined to a specific industry.

One delegate highlighted the potential for comparability across sectors to lead to "wrong" conclusions, since different industries could be expected to have different levels of performance vis-à-vis certain CR indicators. Employee turnover, for example, could be expected to vary significantly from industry to industry, and what might be "low" for one industry could be considered "high" for another. Another delegate said that the risk of drawing "wrong" conclusions from comparable indicators across sectors was not unique to the area of CR reporting. In financial reporting there were many comparable indicators, such as the price/earnings ratio, which varied significantly from sector to sector and from country to country. Nevertheless, analysts were able to interpret the indicators in the proper industry and country context and thus draw company-specific conclusions about performance within an industry, while also being able to draw industry- and country-level conclusions. Another delegate, who supported this idea of comparable indicators, suggested that there needed to be some "benchmark" indicators which could be harmonized internationally and allow cross-border comparisons.

The fifth question related to what issues should be reported on. Several delegates expressed concern about the implications of reporting on sensitive topics such as human rights and corruption.

Some delegates and experts questioned the role of corporate reporting on issues over which companies might have limited, indirect or even no control. An invited expert from the financial industry said that, while it was difficult to report on sensitive subjects such as human rights and corruption, it was not impossible. Several initiatives were underway (e.g. the Extractive Industries Transparency Initiative) that sought to address these particularly sensitive subjects.

Many delegates and experts expressed support for common topics in the field of CR, including working conditions (i.e. occupational safety and health), corruption and discrimination. One delegate suggested that the topic of skills transfer, or human capacity development, also be addressed by one or more indicators.

The sixth question concerned whether to use an incremental approach to CR reporting. Many delegates and experts supported this approach.

One delegate expressed concern about the potential for duplication of work within companies on reporting matters and supported an incremental approach that would build on existing procedures within companies. Another delegate supported the incremental approach but noted that in some countries where there was little current reporting on social issues, there might be a need for more substantial steps.

The Group commended the report (TD/B/COM.2/ISAR/24) for its quality and recognized that it provided helpful suggestions for future work in the area of social reporting. The Group agreed to continue the work on the comparability and relevance of social reporting in order to develop guidance on voluntary disclosure. The Group recognized that future work would need to focus, *inter alia*, on such issues as the principal users of social reporting, the criteria for selecting topics and indicators, and the ultimate use of information produced by social reporting. The Group reaffirmed the goal of improving the comparability and relevance of social reporting based on an incremental approach.

I. INTRODUCTION

At the eleventh quadrennial conference of UNCTAD, in the São Paulo Consensus, member States recognized that the objective of UNCTAD's work in the area of policy response is "to 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, *inter alia*, corporate responsibility, enterprise development and business facilitation (TD/410, para. 49). Since its eighteenth session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has identified reporting on corporate social responsibility (CSR) as one of the emerging issues in the area of corporate transparency. Furthermore, at its twentieth session ISAR concluded that, while the pressure for better reporting on social issues is increasing and enterprises are producing more information, the satisfaction of stakeholders with the quality of social reports remains low. Furthermore, concern was expressed that the lack of comparability in social reports makes such reports less useful for stakeholders. It was also observed that the lack of satisfaction with social reporting is imposing a growing burden on enterprises as they try to respond to the increasing demands of various stakeholders.

As a result of these discussions, ISAR agreed to “begin examining existing indicators so that corporate social responsibility reports would be comparable and would not impose unreasonable burdens on enterprises in developing countries”. It was also agreed that the needs of small and medium-sized enterprises should be considered.

During the discussions on ISAR's work in the area of social reporting, it was suggested that the work should be done in collaboration with the business sector, organized labour, civil society organizations, intergovernmental agencies and other UN or UN-sponsored initiatives such as the UN Global Compact, as well as with organizations undertaking specialized work in the area of CSR indicators such as the Global Reporting Initiative (GRI).

Following the recommendations of ISAR at its twentieth session, the UNCTAD secretariat invited a number of distinguished experts in the field of CSR and corporate disclosure to participate in an informal Consultative Group of Experts (CGE). The secretariat's objective was to solicit their views on the comparability and relevance of existing social indicators. (The list of members of the CGE is provided in annex I).

The objective of this report is to further facilitate ISAR deliberations in the area of social reporting. It presents the secretariat's findings on the main issues in the area of the comparability and relevance of social reporting, as well as the views of the CGE on these findings and other matters on CSR and social reporting. In particular, the report discusses possible criteria that could be used in selecting a limited number of comparable and relevant core social indicators.

The report builds on the report the secretariat prepared for the twentieth session of ISAR (TD/B/COM.2/ISAR/20), which discussed major issues of social reporting, and it is recommended that the two reports be read together

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Traditionally, issues of corporate responsibility include environmental concerns. In recent years, ISAR has addressed issues of environmental accounting and eco-efficiency indicators.[1] This work resulted in guidance for enterprises, regulators and standard-setting bodies on best practices in accounting and financial reporting for environmental costs and liabilities.[2] This was followed up with more detailed guidance on the estimation and use of eco-efficiency indicators.[3] In the present report, therefore, the secretariat focuses only on the social component of sustainability and CSR reporting.

II. OVERVIEW OF MAJOR EXISTING INITIATIVES AND REGULATIONS RELATING TO CORPORATE SOCIAL RESPONSIBILITY INDICATORS

A. Demand for, and challenges of, CSR reporting

Environmental and social scandals have raised the public's awareness of the fact that not all enterprises are willing or able to contribute positively to society's sustainability goals. CSR demands more accountability and transparency on the part of corporations. At the 1999 World Economic Forum meeting in Davos, UN Secretary-General Kofi Annan argued that economic globalization was at risk unless companies and other organs of society committed themselves to universal principles regarding human and labour rights, environmental protection and the rule of law. This commitment came to be embodied in the UN Global Compact. In the 2004 book

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[1] R. Gray and J Bebbington. *Sustainable Development and Accounting: Incentives and Disincentives for the Adoption of Sustainability by transnational corporations*. UNCTAD, Geneva, 1995.

[2] UNCTAD, *Accounting and Financial Reporting for Environmental Costs and Liabilities*, 1999, United Nations, New York and Geneva.

[3] UNCTAD, *A Manual for the Preparers and Users of Eco-efficiency Indicators*, 2004, United Nations, New York and Geneva.

Raising the Bar, Mr. Annan observed that, as more and more companies adopt the principles of the Compact, there is an increasing need for practical tools and information to give meaning to the universal principles the Compact represents.[4]

At the OECD, new corporate governance guidelines, such as the OECD Principles of Corporate Governance, recognize the necessity to inform not only investors but other stakeholders as well. Additionally, the 2000 update to the OECD's longstanding Guidelines for Multinational Enterprises include new sections regarding social and environmental issues. Within the European Union, a directive[5] was passed in 2003 which states that, to present a fair review of the development of the business in a manner consistent with the size and complexity of the business, reported information should not be restricted to the financial aspects of the enterprise. Rather, such information should also include environmental and social aspects.

The demand for social reporting comes in part from long-term investors such as pension funds, who demand information regarding intangible assets, risks and future prospects of enterprises. Demand also comes from stakeholders who are concerned about the accountability of enterprises, including Governments, civil society, trade unions and socially responsible investors. Stakeholders surveyed in the *Global Stakeholder Report 2003* by ECC Kothes Klewes GmbH, indicated that, among existing corporate reports, they have the lowest level of satisfaction with social reporting.[6]

One of the difficulties of social reporting seems to lie in the absence of a universally accepted reporting framework for sustainability reporting in general and for social reporting in particular. For financial reporting, such a framework has been developed by the International Accounting Standards Board (IASB). It sets out the concepts that underlie the preparation and presentation of general purpose financial statements for external users, i.e. financial statements that are directed towards the common information needs of a wide range of users who rely on financial statements as their major source of financial information. Revised standards of the IASB (International Financial Reporting Standards – IFRS) that deal with the presentation of financial statements also provide illustrative formats of financial statements to guide on the application of related IFRS.

It is debatable as to whether accounting criteria should be used in defining the content of a social report. Some CGE participants argued that accounting criteria are insufficient in the case of social reporting because of the greater intangibility of social issues compared to financial and environmental ones. They felt a need for an alternative way of reporting on social issues because of the impossibility of measuring and quantifying all aspects of social impact. On the other hand, other participants

[4] Fussler, C., A. Carmer and S. van der Vegt (2004). *Raising the Bar: Creating Value with the United Nations Global Compact*, Greenleaf Publishing, p. 4.

[5] Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003, on the annual and consolidated accounts of certain types of enterprises, banks and other financial institutions and insurance undertakings.

[6] *Global Stakeholder report 2003*, ECC Kothes Klewes GmbH, shows the following satisfaction among stakeholders with main issues covered: environmental 74,4%, economic 57,6%, social 48,7%.

argued that accounting criteria can be reinterpreted to fit social reporting, viewing social reports from the point of view of society and not that of investors.

Some guidance for applying accounting techniques to new areas has already been provided in the area of environmental reporting, but it is still lacking as far as social reporting is concerned. As a result, enterprises are left to their own devices to devise the format and content of such reports. Some pioneering enterprises are developing exemplary reports. However, many social reports are descriptive in nature and are about whether enterprises understand the issues, rather than quantitative accounting of the results of their policies. Few reports include performance indicators on social issues that can be tracked over time or form the basis of comparison between firms or sectors.

In addition, many reports are selective and partial, and review only some of the elements of social performance. The information disclosed is often aggregated to the level of the corporation as a whole, which while being helpful in some ways, reveals little about the impact of operations in specific locations or host countries. As a result, stakeholders may not have an accurate and complete view of a company's activities.

In recognition of such issues, a number of stakeholder and business groups have undertaken initiatives to improve CSR reporting. They have developed lists of environmental, economic and social indicators and devised guidelines on how to construct a sustainability report. An overview of some of these initiatives is provided below.

B. Governmental guidelines on sustainability reporting

A number of Governments, such as those of the Netherlands and Denmark, have devised guidelines on sustainability reporting, which make recommendations as to the format and content of reports. They give, *inter alia*, examples of the social issues that need to be covered, although they do not detail the indicators to be used. For example, in September 2003 the Dutch Advisory Board for Annual Reporting issued a special guideline for sustainability reporting (*Richtlijn 400 'Jaarverslag'*, or Directive 400 for Annual Reports). The guideline acknowledges that sustainability reporting is still in its infancy but provides the preparers of reports with recommendations as to which issues to take into account.

A French law passed in July 1977 (law N° 77-769) requires all companies with over three hundred employees to publish annually a *bilan social*, a collection of statistical data on the company's social performance over the previous three years. It includes information on employment, remuneration, health and safety, working conditions, training, labour relations and the living conditions of employees and their families. The December 1977 decree N° 77-1354 specifies the measures to be used in the report. After a review and comments by trade union representatives and the company's work council, the *bilan social* is made available to all employees, labour inspectors and shareholders.

[7] International Financial Reporting Standards, 2004, IASCF, London, UK

Since 2002, Article L225-102-1 of the French Code of Commerce requires listed companies to report on the manner in which they take into account the environmental and social consequences of their activities. Companies with foreign affiliates have to report on how they ensure respect for International Labour Organisation (ILO) conventions by their subcontractors and subsidiaries. The detail of the information on social impact to be provided is listed in Article 148-2 of the decree N° 67-236. Information on environmental impact is listed in the Article 148-3.

A Belgian law (Article 47) passed in December 1995 requires companies in Belgium with more than 20 employees to include in their annual accounts a *bilan social* including detailed information on employment, fluctuations of the workforce, measures in favour of employment taken by the company, and organized training. Some companies that are not required to publish annual reports are still required to produce a *bilan social*.

C. Civil society initiatives

The Global Reporting Initiative (GRI) is a multi-stakeholder initiative started in 1997 by the Coalition for Environmentally Responsible Economies (CERES). It became independent in 2002 and now works in collaboration with the United Nations Environment Programme (UNEP) and the UN Global Compact. GRI's mission is to develop and disseminate its Sustainability Reporting Guidelines.

The GRI guidelines contain reporting principles to be followed by preparers; the guidelines specify report content and suggest reporting indicators, including 50 core environmental, social and economic indicators and 47 additional ones. The core indicators are considered to be those "relevant to most reporting organizations and of interest to most stakeholders."[8] The GRI guidelines do not elaborate on how core indicators are distinguished from others, and warn that some core indicators might not be relevant to all report users or preparers.

The large number of GRI indicators can be explained by the GRI's laudable effort to be as inclusive as possible in its deliberations. Any interested and committed party had the possibility to participate in the development of the guidelines. To date, 19 of the 402 companies that refer to the GRI in social reports are considered "in accordance" with the guidelines. Other "GRI reporters" are those who mention the GRI initiative in their reports and choose to use only some of the indicators; this undermines the comparability of these reports.

[8] Global Reporting Initiative, *Sustainability Reporting Guidelines*, 2002.

[9] Organizations that wish to identify their report as prepared in accordance with the 2002 GRI Guidelines must meet five conditions: 1. Report on the numbered elements in Sections 1 to 3 of Part C; 2. Include a GRI Content Index as specified in Section 4 of Part C; 3. Respond to each core indicator in Section 5 of Part C by either (a) reporting on the indicator or (b) explaining the reason for the omission of each indicator; 4. Ensure that the report is consistent with the principles in Part B of the Guidelines; 5. Include the following statement signed by the board or CEO: "This report has been prepared in accordance with the 2002 GRI Guidelines. It represents a balanced and reasonable presentation of our organisation's economic, environmental, and social performance."

Business In The Community (BITC) is a non-profit organization based in the United Kingdom with about 700 members, including 75 of the FTSE 100 enterprises. BITC's Corporate Impact Reporting project recommends 44 indicators to measure an enterprise's impact on society. The indicators are subdivided into subsets related to the market place, environment, workplace, community and human rights.

The indicators used in the Corporate Impact Reporting framework offer progression over three levels: Level 1, for companies just beginning to measure progress, requires mostly baseline data; Level 2, for companies wishing to move beyond a basic commitment, requires some performance and impact data; and Level 3, for companies aiming at further improvement of their performance, requires qualitative as well as quantitative information.

A framework to measure and report on responsible business practices accompanies these indicators. BITC stresses that this reporting methodology provides a picture of enterprises' CSR activities and performances, but does not allow for comparison. Some of its core indicators are seen as being too sector-specific. To date, 18 UK-based enterprises have participated in this initiative.[10]

D. Corporate practices

Surveys of report preparers carried out by major accounting companies and consultancies[11] show that although health, safety and environmental (HSE) reporting is still the most prominent type of non-financial reporting among the Global Fortune Top 250 (GFT250) companies (73%), other types of reports are emerging, including triple bottom line reports (14%), combined environmental and social reports (10%), and social and combined social and financial reports (3%). The Top 100 survey mirrors this trend, showing that companies are increasingly incorporating social and economic issues into their HSE reports.[12]

The content of these reports is generally analysed in terms of economic, environmental and social issues. Environmental issues include the impact of production processes, products and services on air, land, biodiversity, and human health. Economic performance reporting spans wages and benefits, productivity, job creation, outsourcing expenditures, R&D investments, and investments in training and other forms of human capital.[13] Social issues typically include traditional reporting topics such as workplace health and safety, employee satisfaction and corporate philanthropy, as well as other topics such as labour and human rights, diversity of the workforce, and supplier relations. Table 1 shows that traditional reporting topics still rate higher than the newer topics.

[10] Thames Water, Coca-Cola Great Britain, Nestle, Flag, HBOS, Sainsbury's, GUS, Severn Trent, United Utilities, Marks & Spencer, CIS, Powergen, BAA, Jaguar Cars, BUPA, Zurich Financial Services, Carillion, Orange, EDF Energy.

[11] A number of assessments of social reports have been carried out by KPMG, UNEP/SustainAbility, ACCA, PricewaterhouseCoopers and others.

[12] KPMG, *International Survey of Corporate Sustainability Reporting*, 2002.

[13] PricewaterhouseCoopers, *Management Barometer Survey*, September 2002.

All surveys share the view that the content and quality of sustainability reports are not consistent. The number of and quality of environmental reports is generally higher than reports on economic and social issues, largely due to a number of recognized environmental metrics, for example ISAR's eco-efficiency indicators. Social disclosure often has an internal focus, with a smaller number of reports covering local community and wider social issues.

PricewaterhouseCooper's (PwC's) survey of 140 large US companies shows that companies are struggling to define what sustainability means to their business and to translate sustainability into metrics. Overall, the ability to develop and use concrete metrics to show progress over time is significantly lower in the areas of social performance than in economic performance.

Table 1. Social topics addressed in GFT250 reports

Topics	**%**
Community involvement	97
Health and safety	91
Equal opportunity / workforce diversity	88
Employee satisfaction	67
Human rights	55
Supplier relations	39
Child labour	36
Freedom of association	27
Fair trade / international development	18
Corruption	15

Source: KPMG, *2002 International Survey of Corporate Sustainability Reporting.*

Companies have started developing social indicators in order to be able to measure their social performance. Table 2 ranks the top five such indicators used by the GFT250. For those social issues for which it is more difficult to set a metric, the reporting remains qualitative.[14]

Table 2. Top five social performance indicators

Topics	**%**
Accident/injury frequency	76
Community spending	48
Women in staff/management	42
Staff diversity	27
Supplier diversity	12

Source: KPMG, *2002 International Survey of Corporate Sustainability Reporting.*

These top five indicators, however, may not fully meet stakeholder expectations. A recent survey of a broad range of stakeholders (the *Global Stakeholders Report 2003* by ECC Kothes Klewes GmbH) revealed that a significant

[14] PricewaterhouseCoopers, *Sustainability Survey Report*, 2002.

percentage of those surveyed expect to find the following issues covered in social reports: human rights (62.8%), health and safety (57.6%), business ethics (56.5%), standards in developing countries (55.4%), management of social issues (49.1%), bribery and corruption (49%), social policy statements or guidelines (47.5%), equal opportunities (45.9%), supply chain standards for social issues (45.5%), consumer protection/product labeling (44.6%), education and training (43.6%), freedom of association/workers rights (42.3%), community relations (40.1%), and corporate citizenship (31.0%).

III. MAIN ISSUES RAISED BY THE EXAMINATION OF COMPARABILITY AND RELEVANCE OF EXISTING SOCIAL INDICATORS

The secretariat examined a total of some 350 existing social indicators. With regard to their comparability, the secretariat prepared a list of possible criteria that could be used to improve comparability of social indicators proposed by major initiatives on social reporting.

The criteria were discussed at the CGE meeting in March 2004, and the results of those discussions and of further exchanges via e-mail and telecom are presented below.

A. Scope of social reporting

The CGE raised a number of issues regarding the context and scope of social reporting. The CGE agreed that information on sustainability should be classified as economic, environmental and social, but recognized that there was nevertheless a lack of consensus on how sustainability should be addressed in the context of social reporting. The CGE also debated whether this work should focus on reporting how corporations manage their social responsibilities, or on the social impact of corporations. These topics are interrelated, but focusing on one or the other would bring different results. A report on how corporations manage their social responsibilities would include policies, management systems and monitoring systems and their results pertaining to environmental, economic and social issues. A report on the social impact of corporations would focus in particular on social issues, and would include information on the impact of a company's activities, rather than its policies and management systems.

Some members stressed that social issues are often inextricably interwoven with political issues and therefore cannot simply be resolved by means of a technical solution.

B. Users of social reporting

The CGE addressed the issue of who would be the potential user of a social report. It generally felt that, in principle, social information should be disclosed for the benefit of all stakeholders. Stakeholders were understood as groups of persons that are affected by and/or can influence an enterprise, without necessarily holding an equity share of the enterprise. In the case of a social report, the users include, investors, shareholders, customers, employees, trade unions, suppliers, the local community and policy makers. Their actions can affect an enterprise's brand image, its financial performance, and even its license to operate. For example, some institutional investors are conscious of the potential for reputation risk and demand that enterprises manage these risks. Other groups of stakeholders can make decisions that have an impact on the value of an enterprise (for example, suppliers, customers, and trade unions).

This debate brought out two different perspectives. Some members of the CGE held an "accountability" perspective wherein social reports should address all issues of accountability, regardless of which stakeholder might use the information. Others held a "stakeholder" perspective wherein social reports should address issues raised through dialogue between enterprises and their stakeholders.

The stakeholder perspective sees social reports as a compilation of the information required by all stakeholders. This is currently a popular approach to corporate reports and reporting initiatives.

There are, however, downsides to the stakeholder approach. One lies in the identification of the stakeholders themselves. Identifying and conducting a dialogue with an enterprise's stakeholders is not a simple matter. The number of stakeholders a TNC has is potentially enormous. Thus dialogue is often carried out with representative interest groups. However, the legitimacy of some interest groups is sometimes questioned. Some NGOs, for example, may be financed by large businesses or religious or other groups with a separate agenda to that of the stakeholders the NGO purports to represent. Another downside to the stakeholder approach is that there may be a tendency among enterprises to restrict the dialogue to those stakeholders that can impact the enterprise. This leaves out weaker stakeholder groups whose well-being may be affected by the enterprise. A further downside to this approach is that enterprises can find it close to impossible to identify and fulfil the different information requests of all their stakeholders. In the absence of a consensus, report preparers disclose information on a selection of issues that they see as related to the enterprise's responsibilities. There is sometimes a gap, however, between the management's perception of what their enterprise's responsibilities are and civil society's expectations. As a result, major issues related to the enterprise's impact on society may be left out in social reporting.

It was argued that the accountability perspective addresses the weaknesses raised by the stakeholder perspective. Since corporate responsibilities are often, though not exhaustively, described in existing regulations, codes, etc., the dialogue between one particular enterprise and its stakeholders becomes largely unnecessary to their identification. Dialogues have already been held in defining responsibilities in laws, regulations and international agreements (e.g. the ILO Tripartite Declaration).

C. Criteria that may facilitate the development of comparable and relevant social indicators

On the basis of existing concepts of corporate reporting, the CGE discussed the following criteria for possible selection of social indicators.

Materiality

Material information is defined by the International Accounting Standards Board as "information whose omission or misstatement could influence the economic decisions taken by users of information". This definition is also used in the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance. In the new draft UK Company Law, material factors are defined as "matters including [the company's] employees, suppliers, customers as well as the impact of its operations on the community and on the environment."

Existing guidance relating to the concept of materiality in the financial reporting framework states that materiality must be determined in good faith by the enterprise's directors. For example, in the United Kingdom, the Operating and Financial Review Working Group on Materiality (OFRWGM) has recently attempted to give a definition of materiality in the context of non-financial reporting.[15] The Operating and Financial Review (OFR), which is part of the new draft Company Law, would require companies to report on several CSR issues to the extent that these issues are in good faith considered material by the company's directors. [16]

Most sustainability reporting guidelines indicate that an enterprise must establish a dialogue with its stakeholders in order to determine what information is material to them. This stakeholder approach, however, raises the issues mentioned above. Stakeholder consultation as a means of determining materiality is not only potentially costly but does not ensure correct, complete or comparable results.

[15] The OFRWGM proposes the following definition: 'In making their good faith, honest judgements about what information is material and should be included in their OFR, directors should be governed by the high level objective of the OFR, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. Information will be material to the OFR if failure to disclose it clearly, fairly and unambiguously might reasonably be expected to influence members' assessments of the company and hence the decisions they may take, either directly or indirectly as a result of the significance that the information has for other stakeholders and thus the company. Information that is material to the OFR may be quantitative or qualitative; and may relate to facts or probabilities, and to past, present or future events and decisions.'

[16] The two relevant sections of the OFR read as follows: section (v) An account of the company's key relationships, with employees, customers, suppliers and others, on which its success depends: including employment policies and practices (including disability and non-discrimination policies); policies and practices on employee involvement and compliance with international labour conventions and anti-discrimination laws; policies and practices on creditor payment; section (vi) Policies and performance on environmental, community, social, ethical and reputational issues including compliance with relevant laws and regulations: including any social or community programmes, policies for the business on ethical and environmental issues and their impact for the business, policies on international trade and human rights issues and any political and charitable contributions.

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Furthermore, many stakeholders challenge the idea that materiality be limited to a link to economic decisions, as this might exclude equally important social decisions. Stakeholders also argue that their best interest cannot be left to corporations to determine. In their view, the enterprise's and stakeholders' interests do not necessarily coincide, and identifying information that is material to stakeholders is beyond the capabilities of the enterprise director alone and needs to be done in cooperation with stakeholders.

Currently, a common method to determine materiality is to consider all disclosure demands formulated by stakeholders. Some stakeholders have produced lists of indicators they consider material, and the GRI is probably the most successful attempt to gather commonly required information. However, the quantity of such information might be unmanageable for a large proportion of enterprises. This suggests that a more limited selection may need to be made in order to achieve wide uptake and comparability. The main challenge is to assess whether there are indicators that are material to all or most stakeholder groups, rather than what is material to each of these groups.

During discussions of the CGE, it was suggested that ISAR could use a definition of materiality that would be limited to the impact of corporations on the development of countries. However, other members of the CGE argued that, while promoting development is a key component of CSR, CSR is not limited to promoting development.

Some experts expressed doubts about the ability to identify issues that would be material to all stakeholder groups. Other experts noted, however, that if indicators are based on universal values and universal values are by definition taken to be material, then identifying issues that are material to all stakeholders should be achievable.

Universality

Universality was another criterion suggested by the secretariat at the meeting of the CGE. The secretariat's initial view was that the identification of core indicators should be such that the indicators would apply to all enterprises, regardless of sector, size or location, the intention being to maximize the comparability of social indicators.

There seems to be friction between the concepts of universality and materiality. The Consultative Group felt that by selecting indicators that are universally applicable, social reports risk being too general to allow the right level of assessment of an enterprise's social performance. Indeed, a complete assessment of an enterprise's performance needs to be done through indicators specific to its type of business and the context in which it operates. Investors in particular are interested in sector-specific indicators, which make it possible to compare similar enterprises in order to identify better performers. In that sense, comparability can be opposed to materiality, i.e. sector-specific statistics, while material, are not universal and so not comparable across sectors.

Some members of the CGE stressed that, if universal values guide the selection of indicators, then in practice there may not be significant conflict between materiality and universality.

The CGE generally felt that, where comparability conflicts with materiality, precedence should be given to materiality. The indicators should be valued from the point of view of assessing impact on society rather than from the point of view of their ability to be compared or verified.

Impact-oriented rather than process-oriented

As mentioned above, current CSR reports are often process-oriented rather than outcome- or impact-oriented. The CGE felt that the social impact of business operations cannot be assessed solely on the basis of the policies and processes of enterprises regarding social responsibility.

The CGE generally felt that a social report's indicators should reflect the actual social performance of the enterprise and the extent to which it ensures that the rights of all stakeholders are respected. For reporting purposes, these indicators would have to be reported in the appropriate context, such as information on related policies, management systems, and past performance. It would also be helpful to make use of targets, both for measuring past performance relative to past targets and for providing forecasts of future performance.

Costs and benefits of social reports

The objective of the work carried out by the secretariat on social reporting includes ensuring that an unreasonable burden is not imposed on enterprises, particularly those in developing countries. It may be noted that the same principle applies in financial reporting: the costs incurred in preparing corporate social reports should not exceed the benefits derived from them.

In the case of social reporting, members of the CGE recognized that the issue of costs/benefits is not a simple one. Some members of the CGE observed that one of the challenges in this area is that the costs are borne by preparers, but most of the benefits seem to be for the users. Other members of the CGE argued that, while the costs of social disclosure are borne by the report preparers, the preparers can also derive benefits from it.

Members of the CGE felt, however, that in any case, precisely quantifying the benefits of social reporting and comparing them to the costs is difficult, if not impossible.

It was observed in the CGE's discussion that, whereas both the enterprise and its investors have an interest in minimizing costs to the enterprise, other stakeholders do not necessarily share the same level of concern about costs incurred by the enterprise. Some CGE members took the view that the varying degrees of concern expressed by the enterprise and its stakeholders over the issue of the cost of social reporting may be related to the relative value each viewpoint assigns to social reporting.

The CGE also recognized that one way of minimizing the cost of gathering and reporting information on the social impact of an enterprise is to make use of relevant and comparable data that enterprises already gather in their regular course of business. For example, International Accounting Standard 19 (IAS 19) prescribes accounting and disclosure for employee benefits. The scope of the Standard covers: wages and salaries; compensated absences (paid vacation and sick leave); profit sharing plans; bonuses; medical and life insurance benefits during employment; housing benefits; free or subsidized goods or services given to employees; pension benefits; post-employment medical and life insurance benefits; long-service or sabbatical leave; 'jubilee' benefits; deferred compensation programmes; termination benefits; and equity compensation benefits.[17]

Potential for verification

The CGE generally felt that social indicators should be verifiable in order to maximize the credibility of a social report. It is therefore necessary that an audit trail exist.

Some CGE members observed that CSR reports are often accused of being mere public relations tools that present partial, unverified and/or unverifiable information. The CGE recognized that this "credibility gap" is leading a growing number of enterprises to have their reports independently verified (29% and 27% for GFT250 and Top 100 enterprises respectively in 2002).[18] In the majority of cases, assurance reports are signed by one of the major audit firms (65% of cases in 2002).[19]

The CGE noted that, until recently, there had been no internationally accepted standards for providing assurance on corporate social responsibility reports. More recently, the Institute of Social and Ethical Accountability and its AA1000 series of standards have been gaining in international acceptance. The International Federation of Accountants also has issued guidance on providing assurance on non-financial information (ISEA 3000), and the European Federation of Accountants issued a discussion paper in 2002 on providing assurance on sustainability reports. The CGE noted, however, lack of consistency regarding the scope of the assurance engagement and verification methods. The CGE recognized that providing assurance on social data is still a significant challenge.

Confidentiality

The CGE recognized that confidentiality is an issue in social reporting and that there may be certain types of information that enterprises should not be expected to disclose. This should be considered in any development of social indicators.

[17] *International Financial Reporting Standards, 2004,* IASCF, London, UK.
[18] KPMG, *International Survey of Corporate Sustainability Reporting, 2002*.
[19] Ibid.

In some cases, confidentiality can counteract materiality. For example, information on wages distributed to employees, in particular in comparison to local average wages and cost of living, would be invaluable for certain stakeholders. Enterprises may be reluctant to disclose this type of information due to concerns about their competitive position. Some members of the CGE argued that materiality should take precedence over confidentiality.

Link to sustainable development

The international community recognizes that TNCs play a crucial role in the social and economic development of a country. Several members of the CGE recognized that the current demand for more transparency in corporations' social impact is based on the perception that the current model of economic development cannot be sustained in the long term. Addressing this perceived situation, a number of international organizations have listed norms or guidelines on how TNCs can contribute to sustainable development.[20]

As the notion of sustainable development is central to the idea of CSR, social indicators need to reflect how the enterprise contributes to sustainable development. There were questions among CGE members as to whether community programmes and other philanthropic activities undertaken by enterprises should be considered "sustainable". Such activities can be greatly beneficial to local communities, but they are not directly linked to the enterprise's business activities and can be called off at any time.

D. Means of communication for social information

The CGE discussed whether social information should be disclosed in annual financial reports, separate sustainability reports, or both. It was stated that the trend towards sustainability reporting was increasing. The financial reporting framework is mainly concerned with events that increase or decrease the value of an enterprise's assets and liabilities. Because the impact of most social issues on the results of an enterprise is difficult to assess, they tend not to be included in financial reports. Another reason to separate social information from financial reports is the amount of information generally disclosed in sustainability reports, which justifies the production of a stand-alone report.

Members of the CGE also saw benefits from adding social information to the financial report. All agreed that any social information that is material to investors should be included in the financial report, as investors are its prime users. The question remains, however, for information that, while it pertains to corporate accountability, may not be obviously or directly related to corporate financial results. Some members felt that this type of information may be of less interest to investors,

[20] They include the International Labour Organization's conventions, the United Nations High Commissioner for Human Rights Office's New Human Rights Norms, the United Nations Centre on Transnational Corporations' Code of Conduct on Transnational Corporations, the Organisation for Economic Co-operation and Development's Guidelines for Multinational Corporations, and the United Nations Global Compact.

and therefore would not belong in a financial report. Others felt that, just as corporate governance details provide important, if indirect, insights into enterprise value, so information regarding the social dimension of the enterprise would also contribute to a more complete picture of enterprise value. Another benefit from the inclusion of social disclosure in financial reporting would be increased visibility of social issues, which would improve the management of such issues.

The question was also raised as to the communication channels used when reporting on sustainability issues and their availability to all stakeholders. Publication of information on the Internet ensures widespread diffusion of information, but some stakeholders may still be excluded (e.g. the "digital divide" issue). Customized media might be needed to pass on the information to certain stakeholders, e.g. local communities without access to the Internet.

The CGE was of the view that the issue of the reporting unit should be discussed in order to determine the smallest reporting unit: the parent enterprise and/or its subsidiaries. Currently the information in many social reports is aggregated to the point that it can be meaningless for certain types of analysis.

E. Potential indicators for further consideration

The pool of existing indicators from which the secretariat carried out its preliminary selection included indicators used in national authorities' disclosure requirements (e.g. France and Belgium), multi-stakeholder initiatives (e.g. GRI and BITC) and corporate sustainability reports. The pool of existing indicators reviewed was considered by the secretariat to be representative, but by no means exhaustive, and further research could be carried out to establish a complete catalogue of indicators developed worldwide, should ISAR wish to pursue this.

It was noted by the secretariat that the suggested selected indicators were only intended to facilitate discussion within the CGE and to assess and illustrate how the suggested criteria could be applied to screening existing indicators. The list of indicators suggested to the CGE for discussion can be found in annex II.

Although it was agreed that more deliberations are needed on the framework of social reporting and the related criteria before advancing to the discussion of specific indicators, the CGE debated a number of issues related to indicators as such.

Members of the CGE, recognizing the complexity of defining the content of and producing a social report, suggested an incremental approach. Indicators should first address issues that the enterprise has control over and for which it already gathers information as part of its management system. This would concern, for example, workforce profile and turnover, employee remuneration (wages, pensions and other benefits), and health and safety issues. Once a satisfying reporting model on these issues is achieved, other social issues could be added for which data gathering and interpretation are more complex and over which the enterprise has no direct control but may be able to influence. Such issues could, for example, include human rights and corruption.

In particular, the CGE generally felt that issues such as workforce profile and turnover, employee remuneration (wages, pensions and other benefits), and health and safety are compulsory for a satisfying social report. On the other issues proposed, such as geographical spending, the supply chain and cases of non-compliance with regulations, opinions in the CGE varied. Although some CGE members saw value in each of them, in-depth work would be needed to ensure that the indicators used fall within the scope of the enterprise's accountability and are an accurate reflection of performance rather than a set of data. The point was made that information on taxation would also be useful as one of indicators of social reporting.

The CGE also recommended that ISAR give guidance not only on which indicators to use, but also on how to compute, report and benchmark them.

IV. SPECIFIC ISSUES OF SOCIAL REPORTING BY SMALL AND MEDIUM-SIZE ENTERPRISES

Small and medium-size enterprises (SMEs) may benefit from producing social reports. Although the discussion on the boundaries of TNCs' accountability has not yet reached a consensus, large enterprises are under increasing pressure to be aware and in control of the environmental and social performance of their supply chain. Being able to manage and report on its policies and performance can give a small enterprise a competitive advantage over other local enterprises. The CGE agreed, however, that producing social reports should have only marginal additional cost for SMEs, particularly those based in developing countries.

The CGE suggested that the indicators chosen for transnational corporations should be adapted to the capacities of small enterprises, possibly through a limited set of selected indicators. The choice of these indicators could be based on the information that TNCs already require from their suppliers. An easy way of keeping costs of reporting down would be to require from SMEs only the information they already gather in the normal course of business.

One member of the CGE noted that SMEs account for a large part of the global supply chain and that they can be seen as users of reports as well as report preparers. Certain social information can be of value to SMEs and inform their decision to enter a particular supply chain. The CGE suggested that the secretariat examine the type of information that would be useful for SMEs as report users.

V. CONCLUSION

The paper presents the results of UNCTAD's review of major existing initiatives on social indicators and the main issues raised by informal consultations with a number of distinguished experts in the area of corporate responsibility and social reporting. The results of this work suggest that further deliberations would be useful to explore the issue of harmonization of social reporting with a view to improve the comparability of social reports without imposing an additional reporting burden on enterprises.

The report highlights points raised during consultations regarding the scope of social reporting and the users of such reports. In particular it raises the question of whether common needs of different stakeholder groups could be identified so that harmonized reports that would contain a limited number of indicators might be useful to all such stakeholders. It also outlines a number of issues that could be further discussed regarding the criteria that could be used to improve the comparability of social reporting. ISAR may wish to further explore these and other issues to assess the feasibility of eventually producing a short list of core social indicators based on existing initiatives.

Annex I. Members of the Informal Consultative Group of Experts (CGE)

Roger Adams, Head of Technical Services, Chartered Association of Certified Accountants (ACCA), United Kingdom
Mallen Baker, Director of CSR and Reporting, Business in the Community, United Kingdom
André Baladi, Co-Founder, International Corporate Governance Network (ICGN), Switzerland
Igor Belikov, Director, Russian Institute of Directors, Russian Federation
Heloisa Belotti Bedicks, Secretary-General, Instituto Brasileiro de Governanca Corporativa (IBGC), Brazil
Paul Dembinski, General Secretary, Observatoire de la Finance, Switzerland
Robert Garnett, Board Member, International Accounting Standards Board, United Kingdom
Ndung'u Gathinji, CEO, Eastern Central and Southern African Federation of Accountants (ECSAFA), Kenya
Richard Golding, Partner, PricewaterhouseCoopers, Switzerland
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Rob Gray, Director, Centre for Social and Environmental Research, United Kingdom
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Nancy Kamp Roelands, Senior Manager, Ernst & Young, Netherlands
Parveen Mahmud, Deputy Managing Director, Palli Karma-Sahayak Foundation (PKSF), Bangladesh
Julie McDowell, SRI Research Manager, Standard Life Investment, United Kingdom
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Jennifer Morris, Hermes Pensions Management Ltd, United Kingdom
Mokheti Moshoeshoe, Director, African Institute of Corporate Citizenship, South Africa
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Michael Urminsky, Programme Officer, International Labour Office, Switzerland
Peter Utting, Deputy Director, United Nations Research Institute for Social Development, Switzerland
Lene Wendland, Associate Human Rights Officer, Office of the High Commissioner on Human Rights, Switzerland

Annex II. Indicators Suggested for Discussion at the CGE Meeting

A. Workforce profile

Breakdown by country of:

- Number of employees by gender and level of responsibility
- Number of employees by nationality and level of responsibility
- Number of employees by age
- Number of employees with disability
- Number of employees by type of contract
- Number of employees internal and outsourced

B. Workforce turnover

Breakdown by country of:

- Number of employees hired by status (full/part time), type of contract (permanent/temporary), gender, and education level
- Number of employees separated by status, type of contract, gender, and education level

C. Training

Breakdown by country of:

- Average hours of training per year per employee by category of employee

D. Employee representation

Breakdown by country of:

- Percentage of employees covered by collective bargaining agreements
- Percentage of employees represented by independent representative

E. Organization of working hours

Breakdown by country of:

- Weekly working hours
- Average number of annual leave days
- Overtime

E. Health and safety

Breakdown by country of:

- Number of occupational fatal accidents, including subcontractors, and cause
- Number of occupational non-fatal accidents, including subcontractors, and cause
- Number of occupational illnesses, including subcontractors, and cause
- Number of legal non-compliances on health and safety of workers and customers

G. Geographical spending

Breakdown by country of:

- Amount spent on goods and services inside the country - international contractors and suppliers
- Amount spent on goods and services inside the country - local contractors and suppliers

H. Supply chain

Breakdown by country of:

- Average time to pay bills to suppliers
- Number of contracts cancelled and joint ventures divested due to incompatibility with business principles
- Proportion of suppliers and partners screened for human rights compliance

I. Cases of non-compliance with regulations

Legal action taken against company concerning:

- Anti-union practices
- Discrimination
- Non-compliances with domestic human rights legislation
- Anti-competitive behaviour
- Late payment of bills
- Breaches of consumer privacy
- Breaches of advertising and marketing regulations
- Non-compliance with regulations concerning product information and labelling
- Breaches of anti-trust and monopoly regulations
- Cases of corrupt or unprofessional behaviour

CHAPTER II

REVIEW OF THE IMPLEMENTATION STATUS OF CORPORATE GOVERNANCE DISCLOSURES AND THE ROLE OF SUCH DISCLOSURES IN ADDING SUSTAINABLE VALUE

SUMMARY OF DISCUSSIONS

The chairperson introduced agenda item 4 as an area in which ISAR has long-standing involvement and one that continues to receive a high level of attention globally. The chairperson introduced a panel of experts in the area of corporate governance.

A resource person presented the background paper prepared by the secretariat (TD/B/COM.2/ISAR/25), which highlighted recent developments in corporate governance disclosures, presented the results of a survey of corporate governance disclosure practices at the company level, and outlined further challenges in improving disclosure in the area of corporate governance. The role of corporate governance disclosures in adding long-term value was also discussed in the report. The resource person noted that increased attention was being paid to governance issues by various stakeholders and that the trend towards convergence in disclosure practices in different parts of the world was growing. The resource person also highlighted recent developments, including the revision and strengthening of the OECD principles, developments in and global implications of United States corporate governance reforms, and the continued trend towards harmonization of disclosures, as demonstrated by increasing acceptance and application of International Financial Reporting Standards (IFRS), inroads by International Standards on Auditing (ISAs) and application of ISAR's guidance on corporate governance disclosures in national and regional codes.

The resource person discussed the results of the survey of corporate governance disclosure that was conducted by the secretariat based on its “Transparency and Disclosure Requirements for Corporate Governance” (TD/B/COM.2/ISAR/15), considered by ISAR at its nineteenth session.

The resource person said that, despite its limited scope, the survey provided a useful snapshot of disclosure practices at the company level. It revealed the most and least frequent company disclosures among the selected companies.

The most frequent disclosures concerned financial and operating results, basic governance structures (such as committees), and critical policies.

The least frequent disclosures concerned performance evaluation processes, the impact of alternative accounting decisions, and the availability and use of external advisors.

Other findings of the survey were that disclosure was better among companies with international listing than companies with only local listing; that companies from the North American and Northern, Southern and Western European regions performed relatively better than those in other regions; and that companies in developing countries and countries with economies in transition tended to score lower. At the companies in the survey, relatively few boards of directors stated that they had confidence in the integrity of the auditor and in the auditor's independence; disclosure of the process of selecting both external and internal auditors could be improved; there was relatively limited disclosure of internal control mechanisms; and there was limited discussion of risk management systems.

With respect to the association between corporate governance practices and sustainable value, the resource person noted that, while no widely accepted definition of sustainable value existed, studies indicated that poor corporate governance practices and non-transparency increased investment risk and raised the cost of capital. He also noted that the survey confirmed anecdotally the positive impact of corporate governance on company operations and performance.

In concluding his presentation, the resource person highlighted the gap between what corporate governance principles required and actual implementation, which indicated the usefulness of ISAR corporate governance disclosure guidance in raising awareness of good practices and the need for wider dissemination of such guidance.

A number of delegates and invited experts acknowledged the quality and usefulness of the report prepared by the secretariat, and various delegates affirmed the existence of gaps in implementing corporate governance requirements. One delegate commented that corporate governance was a culture of norms, not simply the application of rules. Various delegates agreed that implementation of good corporate governance practices was more complex than just obeying codes. It was generally felt that implementation required the existence of a cultural environment that recognized the economic benefits of good corporate governance practices for countries and companies and supported a viable system for monitoring and enforcement. One delegate felt that disclosure of the impact of alternative accounting decisions could be confusing to report users, as the alternatives often yielded different financial results. The same delegate also felt that requiring disclosure of performance evaluation and advisorship for board members might be inappropriate, as these activities might simply be a part of the routine of the board.

Certain delegates requested clarification on the methodology used for selecting companies and developing the checklist of disclosure items.

The resource person responded that company selection was limited to 30 companies and that the companies selected represented a range of countries, industries and firm sizes. Country selection was based on achieving regional representation, as well as levels of economic development, and levels of sophistication of capital markets.

Company selection was based on the following criteria: whether companies were publicly traded, companies' contribution to GNP and diverse industry representation. The resource person also clarified that the checklist was taken from the list of corporate governance practices developed by ISAR and deliberated on at its nineteenth session.

A panel member who represented the European Commission said that corporate governance was at the top of the European Commission's agenda, not only because of the corporate scandals in the United States and Europe in recent years but also because good corporate governance paid off – it helped companies perform better. It was important to recognize that corporate governance systems and practices varied not only within the European Union but also around the world. With respect to recent developments on corporate governance disclosures in the European Union, in 2004 the European Commission had adopted two recommendations to member states of the European Union. The first recommendation dealt with directors' remuneration and the second with the role of non-executive supervisory directors. The first recommendation called for disclosure of companies' policies on directors' remuneration and the earnings of individual directors. The second recommendation reinforced the presence and role of independent non-executive directors on listed companies' boards. Both recommendations were developed through extensive consultations. The representative discussed four key proposed revisions to the Accounting Directives that the European Commission announced at the end of October 2004. The revisions were proposed with a view to establishing that board members were collectively responsible for financial statements and key non-financial information; making unlisted companies' transactions with related parties more transparent; ensuring that all companies provided full information about off-balance sheet arrangements, including Special Purpose Vehicles that might be located off-shore; and making listed companies issue an annual corporate governance statement. The representative also discussed the objectives and composition of a 15-member European Corporate Governance Forum that the European Commission established in October 2004.

As example of a country case where national institutions assist in the implementation of good corporate governance practices, the panellist from the Capital Market Authority in Egypt discussed efforts in Egypt that affirmed the country's commitment to applying internationally agreed standards, including the issuance of Accounting and Auditing Standards that complied with internationally recognized standards, the establishment of an Egyptian Disclosure Framework and the role of the Capital Market Authority in standard setting, monitoring and enforcement. Further, the panellist noted an initiative of the Government of Egypt aimed at enhancing the quality of the accounting and audit profession.

The panellist from the Russian Institute of Directors presented the results of surveys on investor use of corporate governance disclosures in the Russian Federation.

In general, the results indicated that, of those surveyed, capital providers, financial analysts, banks and stock exchanges interested in Russian securities tended not to rely on or see little benefit in corporate governance disclosure. Gaps in implementation and use might result partly from a lack of understanding of the economic benefits associated with good corporate governance practices.

With respect to disclosures concerning, for example, ownership, board independence and corporate responsibility, the panellist noted cultural differences that currently tended to limit the disclosure of such elements of corporate governance.

A panellist from the Brazilian Institute of Corporate Governance (IBGC) briefed participants on activities in Brazil and elsewhere in Latin America in the area of corporate governance reform, and on IBGC's role as a leading advocate of corporate governance initiatives in Brazil. He outlined institutional frameworks to support sound corporate governance practices, such as Brazil's CVM (Securities and Exchange Commission) codes and the dissemination of an OECD white paper on corporate governance in Latin America. He also pointed out that the economies of the region shared certain challenges, such as pension reform and limited access to long-term capital, and that this affected the implementation of corporate governance disclosure practices.

The panellist from the Nairobi Stock Exchange noted the important role of the government in providing a viable framework to support the implementation of good corporate governance standards, and highlighted the focus of the New Partnership for Africa’s Development's (NEPAD) on corporate governance issues. The panellist also described national initiatives aimed at developing and disseminating corporate governance guidelines. He pointed out, however, that many companies were not interested in public listing owing to the burden of complying with listing requirements and the associated costs. At the same time, they were not convinced of the benefits of increased disclosures. He stressed the need to promote better disclosure through the distribution of information on the economic benefits of good corporate governance practices.

Following the presentations of the panellists, participants deliberated on implementation issues, such as the gaps that existed between principles or standards and practice; causes of these gaps; and challenges faced in bridging the gaps. Other specific issues discussed were availability, accessibility and applicability of internationally agreed corporate governance principles; the gap in implementation at the subsidiary level of a company; application and implementation of corporate governance practices for SMEs, non-publicly traded companies and state-run enterprises; and reconciliation of internationally recognized good practices with local culture.

Various delegates felt that new best practices in corporate governance disclosure that had evolved since the twentieth session of ISAR should be reflected, and they suggested updating the paper prepared by the secretariat for the nineteenth session, "Transparency and Disclosure Requirements for Corporate Governance".

Several participants stressed the role of the host government in a TNC subsidiary's adoption of corporate governance disclosure practices. It was also noted that in general subsidiaries that were not obligated to report to local regulators were not as transparent as those that were obligated to do so. In this connection, a number of participants noted the common practice among companies of reporting to shareholders, not stakeholders. This shareholder focus had strengthened reporting at the parent level, where the majority of the shareholders tended to be located, and reporting at the subsidiary level only if required by local authorities.

The issue of applicability was raised by several delegates, in particular as it related to SMEs and non-publicly-traded companies. While certain participants felt that sound corporate governance was the responsibility of all types of companies, other participants also recognized that the special needs and constraints of SMEs might limit their full adoption of best practices. One delegate commented that the culture of corporate governance extended beyond reporting to company shareholders to the realm of contributing to the public good. This delegate observed that, if not customized to fit local conditions, principles developed at the international level could fall short at the local level.

A number of participants underscored the effects of additional cultural and capacity development constraints on implementation, such as cultural scepticism, insufficient awareness about internationally recognized corporate governance principles, and lack of access to technical assistance. Several participants felt that these constraints could in part be overcome through the development and wide dissemination of guidelines on good practices, and that the guidelines should be supported by rationalizations of the benefits of good corporate governance practices. A number of delegates felt that national governments, by providing a supportive institutional framework, and international organizations, by providing guidance on implementation and with their wide distribution capabilities, could play an important role in promoting good corporate governance practices.

Participants thanked the secretariat for preparing the background paper and coordinating a panel of experts and indicated that the issue of corporate governance disclosure should continue to be considered at forthcoming ISAR meetings. It was also felt that if further study to assess the state of corporate governance disclosures at the company level was to be done, such study should cover a larger sample of companies and a wider geographical area than the initial survey.

I. INTRODUCTION

Over the years, different issues relating to corporate governance disclosure practices have been on the agenda of the Intergovernmental Working Group of Experts at its various sessions. At its seventh session in March 1989, the Group of Experts deliberated on information disclosure items in annual reports of Boards of Directors. At the tenth quadrennial conference of UNCTAD, which took place in Bangkok, Thailand, in February 2000, member States requested ISAR to “promote increased transparency and financial disclosure by encouraging the use of internationally recognized accounting, reporting and auditing standards and improved corporate governance”. The Group considered this request at its seventeenth session in July 2000, and at that session, it proposed reviewing existing corporate governance practices at the regional, country and company levels at its eighteenth session.

In concluding its eighteenth session, ISAR proposed conducting further work in the area of corporate governance. Accordingly, an ad hoc consultative group was formed and submitted its report (TD/B/COM.2/ISAR/15) to the nineteenth session of ISAR. The report offers global and comprehensive coverage of corporate governance disclosure practices, and identifies an extensive list of good corporate governance practices. At its nineteenth session, the Group proposed reviewing case studies on corporate governance disclosures at its twentieth session. In accordance with that request, case studies on transparency and disclosure on corporate governance were conducted on Brazil, France, Kenya, the Russian Federation and the United States of America (see TD/B/COM.2/ISAR/19 and addenda 1–5). The case studies focused on major implementation issues and used the guidance set out in TD/B/COM.2/ISAR/15 as a benchmark for the assessment. The findings of the case studies (TD/B/COM.2/ISAR/19) were discussed at the twentieth session of the Group of Experts in October 2003.

The Group of Experts proposed reviewing at its twenty-first session the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value (see TD/B/COM.2/ISAR/22). Accordingly, the secretariat prepared this paper and is submitting it for consideration by the Group at its twenty-first session. The objectives of this paper are to present an overall assessment of the common aspects of implementation of corporate governance disclosures, including the adequacy and extent of such disclosures and their role in adding sustainable value, as well as to provide an update on recent developments in the area of corporate governance in different parts of the world. Particular attention is drawn to the company level, companies being the entities responsible for implementing corporate governance practices.

As part of the assessment carried out in compiling this report, a checklist of disclosure items was developed on the basis of the practical guidance on corporate governance disclosures that ISAR initially deliberated on at its nineteenth session. This checklist was used in reviewing a sample of selected company annual reports and regulatory filings, where publicly available. In addition to facilitating the assessment exercise at the company level, the checklist provided valuable feedback on the practical use of the corporate governance disclosure items that ISAR has identified.

II. OVERVIEW OF MAIN RECENT DEVELOPMENTS IN THE AREA OF CORPORATE GOVERNANCE DISCLOSURE

During the ISAR intersession period of 2003/04, the issue of corporate governance and transparency continued to receive unmatched levels of attention.

A major development since the twentieth session was the revision of the OECD Principles of Corporate Governance originally released in 1999. The revision relied on a series of global round tables that addressed countries with differing corporate governance traditions. The revised OECD Principles contain a new chapter on principles for the development of the regulatory framework necessary for underpinning good corporate governance to promote transparent and efficient markets.

The revised Principles also strengthen disclosure requirements. In particular, they give greater prominence to disclosure information about Board members, including independence, remuneration, qualifications and the selection process.

Further, the revised Principles underscore the responsibility of the external auditor to shareholders and also encourage analysts, brokers, rating agencies and others to ensure they are free from material conflicts of interest that might compromise the integrity of their analysis or advice.

In 2003, the European Commission (EC)[1] proposed an Action Plan covering proposals on corporate governance, capital maintenance and alteration, groups and pyramids, corporate restructuring and mobility, and other issues. Concurrently with the Action Plan, the EC established 10 priorities for improving and harmonizing the quality of statutory audit throughout the EU.[2] A new Prospectus Directive, which entered into force on 31 December 2003, offers common criteria for the acceptance of offering prospectuses throughout the EU.[3] In addition, a new Transparency Directive, which was agreed by the European Parliament on 30 March 2004, aims to upgrade transparency for securities issues and investors, and sets out a wide variety of disclosure requirements. The Committee of European Securities Regulators (CESR) is taking on an increasingly important role as an independent pan-European advisory group, and will assist the EC in preparing draft implementing measures.[4]

In 2003/04, significant reforms continued to be introduced in the United States. Reforms in the area of corporate governance in the United States are of considerable importance, as they can be expected to have international implications due to the many foreign listings on US exchanges, the influence of US investment funds globally and the fact that the Sarbanes Oxley Act (SOA) assigned the Securities and Exchange Commission (SEC) the authority to direct US stock exchanges to prohibit the listing of companies that do not meet their disclosure requirements.

In its continued efforts to implement the SOA, the SEC approved significant regulations, in particular with respect to Board members; in November 2003, it adopted rules to enhance the transparency of Board operations with respect to disclosure when nominating committees and how shareholders communicate with directors.[5] Also in November 2003, the SEC approved the new rules for corporate governance and disclosure proposed by the New York Stock Exchange (NYSE) and NASDAQ in 2002.[6] For companies listed at both of these exchanges, the new rules require that the Boards have a majority of independent directors. Generally, companies listed on both the NYSE and NASDAQ are requested to comply with the new rules by the earliest at their first annual meeting after 15 January 2004 or 31 October 2004.

Some other significant new rules for companies listed on the NYSE cover the following: disclosure by boards of specific information with respect to the presiding director, communication processes with the directors, nomination and remuneration committees, adoption and disclosure of corporate governance guidelines and committee charters, and the existence of an internal audit body.[7]

The new rules at NASDAQ require listed companies to disclose which directors are independent and that either a majority of independent directors or a remuneration committee composed solely of independent directors is to determine compensation for top executives. The NASDAQ rules also require that either a majority of independent directors or a nominating committee composed solely of independent directors select or recommend director nominees to the Board.

As part of a review of corporate governance reform, a 2003 study commissioned by the SOA found that an increase in audit independence could be achieved more effectively in ways other than through mandatory audit firm rotation. The US Government Accounting Office (GAO), which conducted the study, released its conclusions in November 2003[8], suggesting that the costs of mandatory audit firm rotation exceed the potential benefits. The report also finds that current requirements for audit partner rotation, auditor independence and other reform, once implemented, would be sufficient to meet the intended benefits of mandatory audit firm rotation.

Following months of international dialogue, in June 2004, under the auspices of the SOA, the Public Company Accounting Oversight Board (PCAOB) adopted rules related to the oversight of non-US public accounting firms that prepare or furnish audit reports with respect to US public companies.[9] The rules specify a framework under which, with respect to non-US firms, the PCAOB could implement the provisions of Section 106(a) of the SOA by relying, to an appropriate degree, on a non-US system. Section 106(a) of the SOA provides that any non-US public accounting firm that prepares or furnishes an audit report with respect to any US public company is subject to the SOA and the rules of the PCAOB.

The latest national corporate governance codes and guidelines are being written with a recognizable hardening of norms around commonly held governance principles.[10] Virtually all countries with equity markets, even those with small or emerging stock markets, have corporate governance codes or guidelines. Many of the newer second-generation practices are more rigorous than prior codes and require greater levels of detail in disclosure, for example, Aldama in Spain, AFEP-MEDEF[11] in France and the Higgs Report in the United Kingdom, all of which appeared in 2003. A common trend in corporate governance reform is to enhance the independence of the Board and managers with regard to their controlling interests, where independence may be impaired.

There have also been significant developments in corporate governance reform in other parts of the word. In this respect useful information can be found in the World Bank and IMF Reports on the Observance of Standards and Codes (ROSCs)[12] on corporate governance. These reports assess country compliance with each OECD Principle for Corporate Governance, and policy recommendations may be offered if a Principle is less than fully observed. So far, there are 27 ROSCs on corporate governance (including three on countries for which ROSCs were prepared for the second time). These reports provide valuable information with respect to corporate governance in general and implementation issues in particular.

Since the twentieth session of ISAR, three new ROSC reports have completed, i.e. on Egypt, India and Mexico. Recommendations vary and suggest, among other things, that annual reports be more standardized and include disclosure of ownership and related party transactions, and that there is a need for a framework regarding quality and independent audit processes.

While some criticize the growing costs associated with corporate governance reform, views on what is good corporate governance disclosure practices are converging,[13] and the type of information to be disclosed is becoming more similar.[14] This may be due to a number of factors, including global interest in corporate governance issues, the increasing influence of the OECD Principles of Corporate Governance and of the initiatives of the International Corporate Governance Network, international efforts to promote better securities market regulation, increasing acceptance of International Financial Reporting Standards (IFRS), and importantly, increased recognition of the added value of sound corporate governance practices. Despite very different legal origins and governance traditions, there appears to be a growing trend towards reliance on disclosure, a growing consensus on the contents of disclosure and broader agreement on the role of the Board in overseeing disclosure. For example, the audit committee is increasingly viewed as the most important tool to help the Board and companies achieve their goal of transparency, a view echoed by the EC in its Corporate Governance Action Plan in 2003.

The trend towards convergence was facilitated by the US SEC and the EU CESR dialogues on corporate governance issues. These centred on discussion on cooperation among regulators, and in particular on the issue of the oversight of public accounting firms. The PCAOB released a briefing paper outlining a cooperative approach with non-US accounting firms and engaged in dialogues with many of its foreign counterparts that demonstrate common objectives.[15] These include protecting investors, improving audit quality, ensuring effective and efficient oversight of audit firms, helping to restore public trust in the auditing profession and buttressing the efficient functioning of capital markets. These dialogues contributed to the development of a landmark EU proposal for an independent auditor oversight regime in Europe.[16]

International convergence also continued in the area of financial reporting. Since the twentieth session of ISAR, a number of developments have taken place in the areas of International Financial Reporting Standards (IFRS/IAS) and International Standards on Auditing (ISA).[17] At the end of 2003, the International Accounting Standards Board (IASB) completed its improvements project, under which it revised and issued 13 IAS. The completion of the improvements project brought the IASB closer to its commitment to have a platform of high-quality improved standards in place by March 2004. The timing was set in such a manner as to ease the implementation of the IFRS/IAS in many countries that have announced their transition to the IFRS, including the European Union, beginning from 2005.

It is to be recalled that in September 2003, the European Commission adopted a regulation endorsing IFRS/IAS, including related interpretations of all IAS that existed as of July 2003, with the exception of IAS 32 and IAS 39 and related interpretations. In July 2004, the European Financial Reporting Advisory Group (EFRAG)[18] recommended to the European Commission the adoption of IAS 32. However, the recommendation of EFRAG was silent on IAS 39. Certain preparers, particularly the banking sector, had expressed significant concerns with respect to fair value accounting requirements of IAS 39 for hedge accounting and demand deposits.

Another important development in the area of IFRS with implications for corporate governance was the issuing of IFRS 2, on Share-based Payments, in February 2004.[19] IFRS 2 specifies the financial accounting and reporting required by an entity when it decides to undertake a share-based payment transaction. It requires an entity to reflect in its statements of profit or loss and financial position the effects of share-based payment transactions. This includes transactions involving granting of share options to employees.

Early in 2004, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) issued a revised International Standard on Auditing (ISA 240), on “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”. The Standard requires the auditor to be more proactive in considering the risk of fraud in an audit of financial statements. It emphasizes the need for the auditor to maintain professional scepticism throughout the audit, notwithstanding the auditor's past experience with and professional judgment of management and those charged with governance.[20]

In the United States, securities regulators decided to propose amendments to Form 20-F that aim to reduce the financial reporting burden for foreign companies listed on US stock exchanges that are converting to IFRS. According to the US SEC, the proposals are addressed particularly to foreign issuers located in the EU, who, under current EU law, will generally be required to adopt IFRS for reporting on their 2005 financial year. Under the proposals, companies that convert to the international rules would have to report to US regulators only two years of financial results rather than he three required under current rules.[21]

III. STATUS OF IMPLEMENTATION OF GOOD PRACTICES ON CORPORATE GOVERNANCE DISCLOSURE AT THE COMPANY LEVEL

A. Background and methodology

In order to facilitate ISAR discussions of the implementation status of corporate governance disclosures, the secretariat undertook a survey of implementation of good practices of corporate governance disclosure in selected companies. The survey was carried out using as a benchmark a checklist of disclosure items developed on the basis of the paper prepared by the secretariat for the nineteenth session of ISAR, entitled “Transparency and disclosure requirements for corporate governance” (TD/B/COM.2/ISAR/15). The main outcomes of this survey are discussed below.

Thirty companies representing different geographical regions and industries were selected for the survey. Country selection for the survey was based on the following representation criteria: regional representation, various levels of economic development, and level of sophistication of the capital market. Company selection was based on the following criteria: publicly traded, company contribution to GNP, and diverse industry representation.

Since the objective of the survey is to assess the implementation status of corporate disclosure in general, the companies selected for the survey remain anonymous. Companies represent the following regions and subregions as classified by the United Nations: 4 from Africa, 7 from Asia, 4 from Latin America and the Caribbean, 7 from Eastern Europe, 4 from Northern, Southern and Western Europe, and 4 from North America.

Only publicly traded companies were included in the survey, as these companies are more apt to provide public access to company information. Nineteen of the selected companies were listed on a foreign securities exchange (international listing) in addition to a local exchange (local listing). Eleven companies were listed on a local securities exchange only. For the survey, the term "international listing" refers to companies that have both foreign and local listing.

The disclosure items checklist contained 40 items, and each was worth a point. The disclosure practices of selected companies are analysed as of 1 May 2004 (further referred to as the survey date).

The primary sources used for the survey include company annual reports and company filings with regulatory bodies, including proxy statements, available on company websites (further referred as the sources). Examples of regulatory filings included the US SEC 20-F and 10-K forms and Comissão de Valores Mobiliários (CVM) filings in Brazil. Ten companies posted regulatory filings with the US SEC on their company website. Of these 10, three are US companies. Five non-US companies posted a 20-F filing on the company website, and one non-US company (Asia region) posted a 10-K and an 8-K filing. One company posted, in addition to the 20-F and annual report, the filing submitted to the local securities regulator (Latin American region). Twelve companies made available most recent company sources as of 2002, while 18 made available most recent sources as of 2003.

While acknowledging that the survey is based on a relatively small sample of selected companies, the results of the analysis may provide a useful snapshot of disclosure practices and a possible starting point from which a more extensive company level review could be continued.

However, the checklist approach also has limitations. In particular, the quantitative analysis cannot capture the range and variations in content and quality between selected companies, and the point system does not reflect degrees of importance among the disclosure items; each item included in the checklist is given equal weighting.

Also due to their complexity, four disclosure practices were not included in the checklist at this stage. It was felt that a more rigorous analysis beyond a checklist format would be needed to assess disclosure on these items. These included disclosure practices on related party relationships where control exists; the decision-making process for approving transactions with related parties; rules and procedures governing the acquisition of corporate control in capital markets, and extraordinary transactions.

B. Main outcomes of the survey

General overview

While there is increasing convergence among national and international corporate governance codes and guidelines, the disclosure practices and the content of disclosures among the selected companies varied greatly.

The majority of the selected companies disclosed information that is consistent with the disclosure items checklist. In general, the highest scores are associated with those disclosure items that address financial results, accounting policies and the existence of various governance structures and mechanisms. At the high end of the range, all selected companies disclosed financial and operating results, and 97% disclosed the existence of governance structures to prevent conflict of interest (table I). Lower scores concerned various aspects of the board and key executives relating to transparency, independence and attestation of confidence in auditors, as well as professional development and performance evaluation processes. The disclosure items that got the lowest scores were disclosure of decision making and impact regarding alternative accounting decisions (17%) and, with respect to the board and key executives, availability and use of an advisor ship facility (23%), and performance evaluation processes (13%). Inconsistency with respect to these three items was prevalent among all selected companies, regardless of their geographical locations.

Table 1
Disclosure item rankings among the selected companies

Disclosure item	All selected companies	Local listing only	International listing	2003 sources	2002 sources
1. Financial and operating results	100%	100%	100%	100%	100%
2. Governance structures, such as committees and other mechanisms to prevent conflict of interest	97%	100%	95%	94%	100%
3. Critical accounting policies	93%	82%	100%	94%	92%
4. Nature, type and elements of related-party transactions	93%	82%	100%	94%	92%
5. "Checks and balances" mechanisms	93%	82%	100%	100%	83%
6. Ownership structure	87%	73%	95%	89%	83%
7. Composition of board of directors (executives and non-executives)	87%	64%	100%	94%	75%
8. Process for holding annual general meetings	87%	73%	95%	94%	75%
9. Changes in shareholdings	80%	55%	95%	83%	75%
10. Control structure	80%	73%	84%	78%	83%
11. Control and corresponding equity stake	80%	64%	89%	83%	75%
12. Mechanisms protecting the rights of stakeholders in business	80%	55%	95%	83%	75%
13. Composition and function of governance committee structures	77%	55%	89%	83%	67%
14. Company objectives	73%	64%	79%	72%	75%
15. Role and functions of the board of directors	73%	45%	89%	89%	50%
16. Policy and performance in connection with environmental and social responsibility	73%	55%	84%	78%	67%
17. Risk management objectives, system and activities	73%	45%	89%	89%	50%
18. Process for interaction with internal auditors	73%	27%	100%	89%	50%
19. Material interests of members of the board and management	70%	45%	84%	78%	58%
20. Qualifications and biographical information on board members	70%	45%	84%	78%	58%
21. Availability and accessibility of meeting agenda	70%	36%	89%	83%	50%
22. Duties of the directors	67%	18%	95%	83%	42%
23. Plan of succession	67%	27%	89%	83%	42%
24. Duration of directors` contracts	67%	27%	89%	83%	42%
25. Compensation payable clauses in directors` contracts	63%	27%	84%	83%	33%
26. Internal control systems and their effectiveness	63%	27%	84%	78%	42%
27. Determination and composition of directors` remuneration	60%	18%	84%	83%	25%
28. Impact of environmental and social responsibility policies on the firm's sustainability	60%	36%	74%	61%	58%
29. Process for interaction with external auditors	60%	36%	74%	72%	42%
30. Process for appointment of external auditors	60%	45%	68%	72%	42%
31. Maintenance of independence of the board of directors	57%	18%	79%	78%	25%
32. Number of directorships held by the directors	57%	18%	79%	72%	33%
33. Process for appointment of internal auditors	57%	18%	79%	72%	33%
24. Control rights	53%	53%	53%	53%	53%
35. Existence of procedure(s) for addressing conflicts of interest among board members	43%	18%	58%	61%	17%
36. Board confidence in independence and integrity of auditors	40%	9%	58%	61%	8%
37. Professional development and training activities	27%	9%	37%	44%	0%
38. Availability and use of advisorship facility during reporting period	23%	9%	32%	39%	0%
39. Impact of alternative accounting decisions	17%	9%	21%	28%	0%
40. Performance evaluation process	13%	0%	21%	22%	0%

Note: Caution should be exercised in making comparisons between types of companies, as there is not an even dispersion among the categories of companies.

In general, and recognizing that selected companies are not evenly dispersed among different countries and types of companies, international listing companies and companies that made available sources as of 2003 tended to score higher marks than local listing only companies and 2002 source companies, and selected companies from North America and Northern, Southern and Western Europe tended to score higher marks than the other regions. The reasons for this tendency may include more rigorous disclosure requirements for international listing regulation compared to local regulation, changes in disclosure regulations in the United States and Europe in 2002, and moves by more companies to voluntarily enhance their disclosure practices to meet the demands of stakeholders.

In particular, all international listing companies disclosed, in addition to financial and operating results, information on critical accounting policies, the nature, type and elements of related-party transactions (though these disclosures do not necessarily reflect decision-making processes concerning the transactions), "checks and balance mechanisms", the composition of the board of directors, and the process for interaction with internal auditors. At the low end, only 32% of the international listing companies disclosed the availability and use of an advisorship facility, 21% disclosed the existence of a performance evaluation process and 21% disclosed the decision-making process and impact with respect to alternative accounting decisions.

None of the local listing only companies or the 2002 source companies disclosed information regarding the existence of a performance evaluation process. Further, none of the 2002 source companies disclosed information on professional development and training activities, the availability and use of an advisorship facility, or the decision-making process and impact of alternative accounting decisions.

As seen in table 2, there is a significant range in the disclosure item scores among the selected companies. With a maximum of 40 disclosure items and the average score of 27, or 67%, two companies received the highest score of 38, or 95% (a US, international listing, 2003 sources company and an Asian, local listing, 2003 sources company). At the low end, a company received a score of 7, or 18% (Eastern Europe, local listing only, 2002 sources).

In addition to the widespread accessibility of corporate disclosures via the Internet, some of the encouraging findings of the survey are a high rate of disclosure on issues such as "checks and balances" mechanisms on key individuals in the enterprise; the nature of related-party transactions; ownership structure; internal control systems and their effectiveness; and composition of boards. However, the survey also highlighted important corporate governance issues on which disclosure is not yet a widespread practice. It is particularly a matter of concern to note that the performance evaluation process of boards is not being widely disclosed. Given the growing complexity of business operations and of issues that boards have to deal with, the investing public would be interested to know whether members of the board of the enterprises in which they have invested or plan to invest in have advisorship facility to seek external expertise, or have been undertaking professional development and training activities. The survey results also indicate that, in general, companies in developing countries seem to score relatively lower.

With respect to certain disclosure items, a number of more detailed findings were drawn from the survey, as discussed below.

Table 2
Selected company rankings based on the 40 disclosure items

Region	Company name	Most recent company reports[a]	Listing[b]	Summary results	
				Score	*Percent*
AFRICA					
Southern Africa	A1	2003	International	32	80%
Southern Africa	A2	2003	International	26	65%
North Africa	A4	2003	International	26	65%
East Africa	A3	2002	Local	13	33%
ASIA					
South-East Asia	AS6	2003	Local	38	95%
South-East Asia	AS4	2003	International	35	88%
South-Central Asia	AS3	2003	International	33	83%
East Asia	AS1	2003	International	32	80%
East Asia	AS5	2003	International	32	80%
West Asia	AS7	2002	Local	16	40%
South-Central Asia	AS2	2003	Local	10	25%
LATIN AMERICA					
South America	LA1	2002	International	32	80%
South America	LA3	2002	International	32	80%
Central America	LA4	2002	International	31	78%
South America	LA2	2002	Local	22	55%
EASTERN EUROPE[c]					
Eastern Europe	EE3	2003	International	31	78%
Eastern Europe	EE2	2002	Local	20	50%
Eastern Europe	EE6	2002	International	19	48%
Eastern Europe	EE1	2002	Local	15	38%
Eastern Europe	EE4	2002	Local	11	28%
Eastern Europe	EE7	2003	Local	9	23%
Eastern Europe	EE5	2002	Local	7	18%
NORTH, SOUTH & WESTERN EUROPE					
Northern Europe	N,S,W E1	2003	International	36	90%
Western Europe	N,S,W E2	2003	International	36	90%
Western Europe	N,S,W E3	2003	International	34	85%
Southern Europe	N,S,W E 4	2002	International	30	75%
NORTH AMERICA					
North America	NA3	2003	International	38	95%
North America	NA1	2003	International	37	93%
North America	NA2	2003	International	36	90%
North America	NA4	2003	Local	30	75%
			Mean	27	67%
			Median	31	78%
			Max	38	95%
			Min	7	18%

Notes: a Date of most recent company reports available, as of the survey date.
b Listing refers to the location of the securities exchange(s) where company is listed.
c Eastern Europe includes countries in Central Europe and the Russian Federation.

Financial disclosure

Financial and operating results and critical accounting policies: All selected companies provided easy access to financial and operating results via the company website on the Internet, but only 27 of the 30 disclosed complete annual reports or regulatory filings on the Internet.

Impact of alternative accounting decisions: Only 17% of selected companies made transparent the rationale that management used in deriving certain accounting figures and the financial impact. For example, only one selected company disclosed alternative fair value assessments and their impact. Companies did not receive a point if they only acknowledged that management makes assumptions when preparing financial statements.

Material interests: 70% of selected companies disclosed the material interests of the board and managers in related parties or other areas affecting the company, for example stock or debt holdings. For the purpose of the survey, managers were interpreted to include high-level managers and key executives.

Related party transactions: Disclosure of related party transactions varied among selected companies. For the purpose of the survey, the analysis focused exclusively on disclosure of a description of the transactions and the parties involved. The survey did not assess disclosure of the corporate rationale behind the decision to enter into these transactions, nor the decision-making process between the related parties. Selected companies received one point for disclosing the nature, type and elements of related party transactions. Ninety-three per cent of selected companies disclosed this information. Two companies that did not disclose this information had local listing only; one made available company reports from 2003, the other, from 2002.

Non-financial disclosures

Company objectives: More selected companies disclosed information on what the company does than information on company objectives, strategies and goals. While all the selected companies disclosed a description of the company and 73% provided business enterprise objectives, only 3 companies stated increasing shareholder value and only 2 stated increasing shareholder and stakeholder value as a company objective.

Ownership and shareholder rights: Ownership and shareholder rights results reveal a possible disparity between disclosure of ownership structure and disclosure of rights. From the set of selected companies, and based on the sources used, shareholders may be less aware of their rights than they are of the ownership structure. This implies that, while shareholders may be aware of the ownership structure, they are less aware of their rights with respect to the ownership structure. With respect to company ownership, 80% of selected companies disclosed information on changes in shareholdings, the control structure, and control and corresponding equity stake, but only 53% disclosed information on ownership control rights. It should be noted, however, that selected companies might disclose information on shareholder rights in other material not reviewed in this survey.

Rules and procedures governing acquisition of corporate control and corporate assets: While disclosure of rules and procedures governing the acquisition of corporate control in capital markets and extraordinary transactions were not included in the checklist analysis, it should be noted that, in line with companies' generally accepted accounting principles, selected companies disclosed the accounting policies and methods used for the transactions.

Governance structures and policies: The results of the survey indicate a disparity among selected companies between the disclosure of the existence of governance mechanisms and the disclosure of information on the transparency and effectiveness of these mechanisms. While 97% of the selected companies disclosed the existence of governance structures and 93% disclosed the existence of a system of checks and balances or accountability mechanisms between the board and key executives, 87% disclosed the composition of the board (including executives and non-executives), 77% disclosed the composition and function of the governance structure, 73% disclosed the role and functions of the board, and only 57% disclosed efforts toward maintenance of the independence of the Board, e.g. quota requirements for independent member representation and mandatory disclosure of conflicts of interest.

Members of the board and key executives: Results reveal different levels of transparency among selected companies with respect to the board and confirm a strong tendency on the part of international listing companies to score higher than local listing only companies. Seventy per cent of selected companies disclosed the qualifications and biographical information of each Board member, while 67% of selected companies disclosed the duties of the directors and 57% disclosed the number of directorships and other positions held by directors. Of the 21 companies that disclosed the qualifications and biographical information, 16 had international listing. Of the selected companies that disclosed the duties and number of directorships, only 2 had local listing only.

Eighteen (60%) selected companies disclosed information on the determination and composition of directors' remuneration at the individual or aggregate level, and of those companies that disclosed this information, 16 had international listing. Sixty-seven per cent of selected companies disclosed the duration of directors` contracts and the plan of succession for board members and key executives. A point was given for disclosing the existence or general description of a plan, not necessarily the details of the plan. Sixty-three per cent of selected companies disclosed the existence of compensation payable clauses related to remuneration (such as a stock option plan).

Only 43% of selected companies disclosed information on the existence of procedures for addressing conflicts of interest among members of the board, and 85% of the companies in question had international listing. Examples of such procedures include mandatory disclosure of conflicts of interest and non-participation in activities where conflict exists.

Overwhelmingly, and as shown in table 1, the selected companies, in particular local listing companies, received the lowest scores with respect to disclosure of professional development and training, an advisorship facility and performance evaluation for the Board.

Material issues regarding employees and other stakeholders: Eighty per cent of selected companies disclosed the existence of mechanisms that protect the rights of stakeholders in the business. This disclosure item was interpreted to include stakeholders in addition to equity shareholders, for example employees, customers, debt holders and suppliers. Examples of such mechanisms include union representation on the board, agreements with suppliers, debt covenants and employee stock ownership plans.

Environmental and social stewardship: Seventy-three per cent of selected companies disclosed the company policy and performance in connection with environmental and social responsibility, although in most cases relationships between a company's policy and performance and their impact could not be discerned. The content of disclosure varied among selected companies. A few companies disclosed specific natural environmental targets, while others disclosed more employee training and health programmes and/or contributions made to the natural environment and community. Sixty per cent of selected companies also stated that policies that promote corporate social and environmental responsibility impact firm sustainability. Examples of impact include cleaner natural environments, more efficient use of company resources, improved employee and supplier relationships, and community goodwill.

Material foreseeable risk factors: Seventy-three per cent of selected companies disclosed risk management objectives, systems and activities, e.g. corporate entities and financial instruments established to address market risks. Companies received a point if they disclosed the existence of specific corporate structures whose function is to manage risk, not for only disclosing various risk factors.

Internal control mechanisms: Sixty-three per cent of selected companies disclosed information on their internal control systems and their effectiveness. The 19 companies concerned disclosed that the effectiveness of the company's internal controls and procedures had been evaluated. Ten of these 19 companies disclosed this information in their US SEC filing posted on their company website. Eight of the 11 companies that did not disclose this information had local listing only.

Independence of auditors: Although only 12 selected companies (40%) disclosed in a statement that the board of directors had confidence that the auditors were independent and their integrity had not been compromised in any way, all selected companies, except one, disclosed the complete letter of the "Independent Audit Report" in their annual report or other source. Of the 12 companies that disclosed such a statement, 11 had international listing and 1 was a US local listing only company.

More selected companies disclosed a process for interaction with internal auditors (73%) than with external auditors (60%) and more selected companies disclosed the process for appointment of external auditors (60%) than of internal auditors (57%). Typically the company disclosed the processes under the roles and responsibilities of certain governance structures, the most common being the audit committee, and under the rights of shareholders. The process for the appointment of internal auditors concerned the approval process, often involving an audit committee, for the appointment. Interaction processes concern monitoring and evaluation activities in the form of meetings and reviews.

Annual general meetings: Among the selected companies, disclosure of the availability and accessibility of the shareholder meeting agenda was not always made. Seventy per cent of selected companies disclosed information on how to obtain the meeting agenda.

IV. THE ROLE OF CORPORATE GOVERNANCE DISCLOSURES IN ADDING SUSTAINABLE SHAREHOLDER VALUE

The implementation of good corporate governance practices and the disclosure of such practices would usually imply additional costs. Management and shareholders would be more willing to incur such additional costs if they were convinced that good corporate governance and disclosure practices increase shareholder value in a sustainable manner. It would be intuitive to assume that such a positive relationship exists. Demonstrating the existence of such a relationship on an empirical basis remains challenging, as it is difficult to determine which particular aspects of corporate governance and disclosure practices contribute more towards adding long-term value to the enterprise. Nevertheless, over the years, a number of studies have been conducted with that objective, and many provide evidence of a positive relationship.

A. Overview of findings of selected empirical studies

A 1998 study by Millstein and MacAvoy, on boards of directors of large publicly traded companies in the United States in the early 1990s, indicated that the performance gap between well and poorly governed firms exceeded 25% in terms of the return for investors. The difference in corporate value added performance between those firms where a professional board was present and those where such a board was absent, measured in terms of percentage annual return for a five-year period, amounted to 4.94%.[22]

The issue of opacity,[*] on which corporate governance and disclosure practices have a significant bearing, has important implications that extend beyond the micro level. In a study published in 2001, PricewaterhouseCoopers developed an opacity index that took into consideration several factors such as corruption, the legal system, economic policy and environment, accounting and reporting, and regulation.[23] The study indicated that opacity deterred a very considerable amount of foreign direct investment (FDI) from flowing to developing countries. The study estimated the cost of the adverse effect of opacity in the form of a hidden surtax equivalent on FDI. For example, a 20-point increase in the opacity factor was equivalent to about a 16% increase in corporate income taxes. The deterrence of FDI is likely to increase the cost of capital to enterprises in such economies and decrease the value added to shareholders, as well as the economy in general.

A study conducted by Credit Lyonnais Securities Asia (CLSA) on the corporate governance of 495 enterprises in 25 emerging markets and 18 sectors showed that, while the total average return (in US dollars) for the 100 largest enterprises across emerging markets was 127%, the return for those in the top

[*] Opacity is the lack of clear, accurate, formal, easily discernible, and widely accepted practices in the world's capital markets and national economies. The opacity index is an estimate of the lack of transparency on five dimensions, including opacity in accounting standards and information released by corporations, banks and Governments.

corporate governance quartile ranking was more than double, 267%.[24] This study further showed that stocks of companies with better corporate governance ratings performed better and that such companies had superior financial ratios and premium valuations.

A survey conducted by McKinsey and Company in 2002 reported that a significant majority of investors were willing to pay a premium for a well governed company.[25] As many as 73% of the respondents indicated that they were willing to pay a premium of as much as 27% for a well-governed company.

A study by Bhattachary et al (2003)[26] analysed disclosure practices in a cross-section of 34 countries from developed as well as emerging markets and demonstrated that lack of disclosure or opacity was related to an increase in the cost of equity capital and a decrease in trading volume in stock markets. It indicated that an increase in the overall measure of earnings opacity from the 25th percentile rank to the 75th percentile rank was associated with a 2.8% increase in the cost of equity when measured using dividend yields or 3.2% when an international asset pricing factor model was used. A similar move in percentile rank was also associated with an 8.8% decrease in annual trading volume in the stock market. The authors stated that these effects were economically as well as statistically significant.

A recent survey prepared by the OECD on corporate governance in its member countries discussed several studies on corporate governance practices and the economic performance of firms.[27] One study by Gompers, Ishii and Metrick cited in the survey analysed approximately 1,500 firms during the 1990s and provided evidence linking corporate governance and stock performance. According to the study, an investment strategy that bought firms with the strongest shareholder rights and sold firms with the weakest rights would have earned additional (abnormal) returns of 8½ %.

The studies discussed above presented different approaches towards gauging the impact of good corporate governance practices and disclosure of such practices on the performance of enterprises and on increasing shareholder value in the long term. Some considered micro level factors while others took into account macro level issues. To a varying extent the studies highlight the complexity of the issue and the limitations of their respective findings. However, the issue has important policy implications with a bearing on implementation. Given its importance, it may be worth further analysis and consideration.

B. Selected companies' feedback

As part of the company level survey, the selected companies were requested to complete an anonymous questionnaire that addressed added value and sustainability issues surrounding company disclosure practices. The questionnaire asked selected companies to report, *inter alia*, on changes to company disclosure practices, motivations for such changes, public access to disclosure information, the aspects of company disclosure that changed, and changes in operations or corporate financing since the implementation of changes in disclosure practices. Among the 30% of the selected companies that responded, the findings indicate positive company associations with increased company disclosure practices.

Seven of the selected companies that responded to the questionnaire listed external demand from stakeholders or regulators as reasons for increasing company disclosure practices. On an individual company basis, the questionnaire responses may throw light on the potential impact of increased corporate transparency and disclosure practices. All respondents reported that increased disclosure resulted in a net benefit to the company. The respondents provided examples of positive changes that the companies experienced subsequent to increasing disclosure practices. Examples of such changes include improved investor confidence, improved managerial capabilities, increased investment activity, better employee, supplier and customer relations, and improved and cheaper access to financing.

In general, the responses to the questionnaire indicate encouraging feedback with respect to the positive impact of good corporate governance disclosure practices on the performance of enterprises and increased shareholder value. To allow for more comprehensive conclusions, efforts may be made to build on the work of the questionnaire to include a much larger sample of companies.

V. CHALLENGES ON FURTHER IMPROVEMENT OF CORPORATE GOVERNANCE DISCLOSURES

Despite recent positive developments in the area of corporate governance disclosure reform, certain challenges remain with respect to implementation of reform.[28]

On the one hand, challenges and implementation timetables in corporate governance reform are different for each region and country. Among the countries with the most developed securities markets, there is a sense that both companies and regulators and other institutions need time to digest the significant changes that have occurred.[29] At the same time, in many developing countries, although considerable efforts have been made, some basic institutional capacities, for example in respect of law enforcement, still require attention.

On the other hand, given the mobility of global capital, developing markets can face the same types of challenges as those faced by the more advanced markets, which could have the effect of intensifying corporate governance reform processes in these developing market countries and facilitating international convergence in this area. In an increasingly integrating global economy, corporate governance developments in one part of the world are prompting similar changes in other parts of the world.

While there is a growing consensus on the benefits of good corporate governance practices, the challenge remains as to how countries and companies are to implement new corporate governance practices. In many developing countries, while laws and regulations contain the necessary fundamental elements, the gap between formal provisions and practice is often large, which suggests that these countries need to pay particular attention to enforcement bodies. For example, for publicly traded companies, IFRS are increasingly recognized as the norm. There are, however, substantial differences between what is required by the regulations – even if they are deemed IFRS-compliant – and actual practice. Closing this gap will need better oversight and self-regulation by the accounting and auditing professions, increased training for accountants, auditors and regulators, and better enforcement of stock exchange listing requirements.[30]

Implementation might be expected to be more of a challenge in countries and companies where corporate governance structures historically have had a high degree of concentrated ownership and where the securities markets are less developed. In these countries, there are greater concerns regarding shareholder rights and abuses resulting from a concentration of ownership combined with weak shareholder protection and insufficient disclosure.[31]

Companies' absorption capacity regarding an increasing number of regulatory changes is not unlimited. In 2003/04 regulators began to focus attention on two other key committees of the board, namely the nomination and compensation committees. This comes at a time when many companies are still adjusting to the new regulations concerning audit committees, director independence and transparency requirements.

Good corporate governance has costs, and these costs appear to be rising. Studies are beginning to quantify not only the benefits but also the costs of good governance. According to surveys conducted by Foley & Lardner LLP of Chicago, the average cost of being public, for public companies with annual revenue under $1 billion surveyed, more than doubled to almost US$ 3 million per annum after the passage of the SOA.[32] These surveys also found that as many as one in five companies surveyed are considering going private as a result of new corporate governance and disclosure reforms. Though no noticeable de-listings have occurred since the SOA, John Thain, Head of the NYSE, does partially attribute the drought in foreign listings, the red tape and the class action lawsuits to the SOA.[33] A small number of governance codes now recognize the important resource limitations that smaller companies, in particular, suffer from, and they modify their recommendations accordingly.[34]

Increased expectations concerning the board of directors make the job more challenging, and the consequences of personal failure more serious. It can be expected that proxy advisory firms and regulatory bodies will be tougher on boards, especially in the areas of independence and equity-based compensation.[35] As a result, individual board members are questioning their capacity to meet new expectations. Limiting board membership may become a practical necessity in the future and may also presage a scarcity of willing and able directors.

There is increasing recognition of the need for mechanisms to protect company employee "whistle blowers", who risk their livelihood when reporting corporate wrongdoing. According to a study[36] cited in the "Findings and Recommendations" with respect to accounting and auditing issued in the United States by the Conference Board's Commission on Public Trust and Private Enterprise on 9 January 2003, 69% of whistle blowers lose their jobs or are forced to retire. Whistle blowers have an important role to play in ensuring the proper functioning of the corporate governance system. A growing number of countries now require companies to establish procedures to receive and respond to concerns of whistle blowers and to protect them form retaliation. Typical requirements range from requiring audit committees to have procedures for investigating corporate wrongdoing, to telephone lines and email addresses for employees to contact regulators.

Although new disclosure information is required, more attention must be paid to the clarity and presentation of information on corporate governance. Although present regulations have resulted in an increased amount of reporting, corporations and regulators have not given sufficient attention to clarity and the ability of users to process the information effectively. In the future, regulators and investors may require that business information be provided in plain and understandable language. Related to this is the challenge of making the additional information accessible and meaningful to those who use it. Increases in the amount of information disclosed may not translate into increased transparency if the users are not able to process and use the information effectively.[37]

In addition, demands for accelerated disclosure and filings and real-time investor information pose challenges for companies, boards and regulators. While most markets require listed companies to disclose material information as soon as it becomes available, there is considerable divergence in practice.

VI. CONCLUSIONS

The pace and extent of implementation of corporate governance disclosures are being affected by various ongoing developments. Corporate governance in general and its transparency and disclosure aspects in particular are undergoing continuous review and enhancement in most member States. At this moment, the implementation of corporate governance disclosures seems to be "work in progress".

The Group of Experts may therefore wish to continue reviewing the implementation status of corporate governance disclosures. In addition to the observations noted in this report, a broader survey of implementation of good disclosure practices on corporate governance, which were outlined by the Group at its nineteenth session, could provide a useful input for assessing the progress made in this area, as well as for revising the list of existing good practices. Also as discussed in this report, empirical feedback on the contribution of good corporate governance disclosure practices to the economic performance of the enterprise and to value added for shareholders in the long term may have a positive impact on the extent of implementation. The Group of Experts may wish to consider this issue further at its future sessions.

NOTES

[1] Communication from the Commission to the Council and the European Parliament, "Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward", COM (2003) 284 final.
[2] European Commission IP/03/715.
[3] Directive 2003/71/EC.
[4] In June 2001, the Committee of European Securities Regulators (CESR) was established by the European Commission as one of two key committees central to the implementation of the Financial Services Action Plan. CESR's objectives are to: (1) improve coordination among securities regulators; (2) act as an advisory group to assist the EU Commission in preparing draft implementing measures in the securities field; (3) work to ensure more consistent and timely implementation of EU legislation in the Member States. CESR is mentioned in the EU regulation on International Financial Reporting Standards (IFRS) as the body through which the EU Commission may liaise with the Member States on enforcement issues.
[5] Additional information on the activities and pronouncements of the US SEC can be found on its website at: http://www.sec.gov/.
[6] For an up-to-date collection of all US SEC rules, see the US SEC website at: http://www.sec.gov/. Rules can be found under Regulatory Actions: Final Rule Releases.
[7] For the new rules, see the NYSE website at: www.nyse.com/pdfs/finalcorpgovrules.pdf
[8] http://www.gao.gov/new.items/d04216.pdf
[9] See http://www.pcaobus.org/rules_of_theboard.asp
[10] *International Comparison of Selected Corporate Governance Guidelines and Codes of Best Practice: The Americas, Europe, Asia, Africa, Australia*, Weil, Gotshall and Manages, LLF, 2003.
[11] Association Française des Entreprises Privées (AFEP)-Mouvement des Entreprises de France (MEDEF). This code builds upon its predecessors Vienot I and II and the Bouton code.
[12] http://www.worldbank.org/ifa/rosc.html
[13] *International Comparison of Selected Corporate Governance Guidelines and Codes of Best Practice: The Americas, Europe, Asia, Africa, Australia*, Weil, Gotshall and Manages, LLF, 2003.
[14]*The Role Of The Board In Disclosure: An Examination Of What Codification Efforts Say*, Richard Frederick, OECD South-Eastern Europe Corporate Governance Roundtable on Transparency and Disclosure: Implementation and Enforcement, June 2004.
[15] PCAOB Briefing Paper, "Oversight of Non-US Public Accounting Firms", 28 October 2003, PCAOB release No. 2003-020.
[16] 24 June 2004 Testimony of William McDonough before US House of Representatives Panel, per US Mission to the EU website at: http://www.useu.be.
[17] International Accounting Standards Board (IASB) (2004), *International Financial Reporting Standards*, London.
[18] http://www.efrag.org
[19] International Accounting Standards Board (IASB) (2004), *International Financial Reporting Standards*, London.
[20] ISA 240 can be downloaded from the IFAC web site at http://www.ifac.org
[21] US Mission to the EU website at http://www.useu.be
[22] "The Active Board of Directors and Performance of the Large Publicly Traded Corporations", Millstein I and Paul W. MacAvoy, *Columbia Law Review*, Vol. 98:1238, pages 1283-1321, New York, United States of America, 1998.
[23] "PwC's Opacity Index: A Powerful New Tool for Global Investors", Lipsey, R , *The Journal of Corporate Accounting & Finance*, pages 35-44, Sept/Oct 2001, 2001.
[24] *Saints & Sinners: Who Has Got Religion?*, Credit Lyonnais Securities Asia, 2001
[25] *Global Investors Opinion Survey*, McKinsey and Company, July 2002.
[26] "The World Price of Earnings Opacity", Bhattacharya, U., H. Daouk, and M. Welker, *Accounting Review*, Vol. 78, No. 3, pages 641-678, 2003.
[27] *Corporate Governance: A survey of OECD countries*, OECD, Paris, 2004.
[28] For analysis of implementations issues on corporate governance disclosure, see also "Major issues on implementation of corporate governance disclosure requirements", Report of the UNCTAD secretariat, twentieth session of ISAR, October 2003.
[29] *Global Proxy Report*, Davis Global Advisors.
[30] ibid.
[31] ibid.

[32] *The Impact of Sarbanes-Oxley on Private Companies, and the Cost of Being Public in the Era of Sarbanes-Oxley*, Foley & Lardner, Chicago, 2004.
[33] *Wall Street Journal*, May 27, 2004
[34] "The Role of the Board in Disclosure: An Examination of What Codification Efforts Say", Richard Frederick, OECD South-Eastern Europe Corporate Governance Roundtable on Transparency and Disclosure: Implementation and Enforcement, June 2004.
[35] "Leading Proxy Advisory Firm to Scrutinize Executive Compensation and Board Responsibility" Press Release, Institutional Shareholder Services, 8 January, 2004. Rockville, Maryland.
[36] Rothschild J. and T. D. Miethe, "Whistle-Blower Disclosures and Management Retaliation," Work and Occupations, Vol. 26, no. 1, (February 1999), p. 120.
[37] Thomson Financial, CCBN, *Improving Corporate Transparency: More Data is Not the Answer*, J. Paul Carey & Jeffery P. Parker, 2002.

CHAPTER III

IMPLEMENTATION OF INTERNATIONAL ACCOUNTING AND AUDITING STANDARDS

Lessons Learned from the World Bank's Accounting and Auditing ROSC Program

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EXECUTIVE SUMMARY

This chapter addresses challenges to the successful implementation of international accounting and auditing standards which have been observed by the World Bank when carrying out the Report on the Observance of Standards and Codes (ROSC) accounting and auditing assessments.[****] It describes the ROSC program, outlines the methodological approach followed, identifies problems common across several jurisdictions, and makes suggestions for initiatives that could enhance the implementation of international standards. At present, the ROSC accounting and auditing assessments are undertaken in client countries of the World Bank. The results presented herein therefore do not purport to be reflective of the issues in developed market economies. It is arguably the case that before the recent accounting scandals in Europe and the United States, these issues were regarded, not least outside Europe and the United States, as unique to developing markets; after the accounting scandals, these issues are regarded as major causes of those financial scandals.

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[****] This chapter is based on a presentation at the Conference on "Challenges associated with the Implementation of International Accounting & Auditing Standards" held on October 15, 2004, at the Financial Stability Forum in Basel, Switzerland and on a presentation at the Conference on "Practical Implementation Challenges of IFRS" held on October 26, 2004 at the United Nations Conference on Trade and Development in Geneva, Switzerland. The findings, interpretations, and conclusions expressed herein are those of the authors, and do not necessarily reflect the views of the World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.

A full and balanced combination of capacity and institutionalized incentives for the rigorous application of international accounting and auditing standards incentives (both positive and deterrent) is the key to successful implementation of these standards. The ROSC results show that governments have primarily concentrated on adopting legislation mandating or allowing the use of international standards, and the private sector has sought to increase the competence of individuals and firms to apply international standards. However, governments, for the most part, have not addressed the need to put in place proper incentives to ensure that this competence is actually applied in practice. The ROSC results and recent accounting scandals in developed economies demonstrate that legal requirements and competence alone are not enough – the commitment to deploy such competence is also essential. Market forces provide certain positive incentives to comply with high standards, but experience in both developed and developing economies suggest that countervailing disincentives operate to discourage such compliance. More emphasis should be placed on the deterrent incentives of robust monitoring and enforcement regimes to achieve a full and balanced combination of capacity and incentives.

Effective accounting and auditing regulation is required to underpin such institutionalized incentives, but international accounting and auditing standards themselves do not set out requirements as to how such effective regulation should be exercised. Guidance is not provided on how to "import" international standards into national legislative and regulatory systems, on the design and operation of appropriate regulatory frameworks, or on the interfaces with other regulatory instruments and institutions (such as those for banking and securities regulation) which could contribute to the monitoring and enforcement of international standards. As currently drafted, international accounting and auditing standards implicitly assume the existence of legal, institutional and policy conditions ("preconditions") which are often undeveloped or absent in many countries. The structure of national economies, and the role played by high-quality external financial reporting, shape the extent to which these "preconditions" present themselves, and efforts to promote the implementation of international standards need to have regard to these specificities.

International standards are not necessarily appropriate to govern all financial reporting obligations, this being especially the case with International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS). There is an urgent need for the International Accounting Standards Board to specify the circumstances in which the use of "full" IAS/IFRS is appropriate, and to develop different standards that would meet the needs applicable to the users of financial statements of other entities, particularly small and medium-sized enterprises (SMEs). Many stakeholders continue to have misunderstandings with respect to the very nature of international standards, which complicates efforts to plan, define and measure progress towards successful implementation.

Lack of human and financial resources is a significant impediment to the implementation of international standards. Mobilizing the necessary resources on a sustainable, long-term basis is a major challenge.

Mechanisms for public oversight of the audit function, including the setting of auditing standards and the assurance of audit quality, are almost entirely absent in the countries assessed to date.[1] Models recently introduced in more developed jurisdictions may not always be applicable in situations where the relative importance of the various stakeholder groups is different, and national regulators do not always have easy access to emerging international best practice and consensus.

There are inherent limitations to the extent of reliance that can be placed on the international audit firm networks and their individual national member firms to compensate for weaknesses in domestic regulatory regimes. Given the governance and management arrangements of the networks, and the fact that the networks themselves are not regulated (only their member firms are, at a national level), the main determinant of audit quality is the strength of the relevant domestic regulatory regimes, rather than network membership.

To strengthen the regulatory arrangements essential for the successful implementation of international standards, countries should give greater attention to regulatory preconditions. The relevant international organizations should work together to develop a consensus on a comprehensive framework of principles for the regulation of accounting and auditing, and to support the adoption of such a framework by the competent national authorities. Special efforts should be made to strengthen and leverage the linkages between the various standards and codes that affect the implementation of international accounting and auditing standards (these include those related to the supervision of banking, securities markets and insurance, as well as corporate governance) and to fill any gaps that remain. Such principles should explicitly consider the regulatory implications of the diversity of financial systems and market structures across countries.

The World Bank stands ready to continue working with country authorities, standard-setters, regulators, private sector stakeholders, and the relevant international organizations (particularly those represented in the Monitoring Group) to address the issues identified in this paper.

[1] While the ROSC reports generally recommend the adoption of International Standards on Auditing (ISAs) because this is a more effective means of improving auditing standards in a given country than the alternative of re-writing the existing suite of national standards, the ROSC reports recognize that some international standards still need to be revised. The World Bank is contributing to that work, including as a member of the International Auditing and Assurance Standards Board (IAASB) Consultative Advisory Group. In the meantime, the ROSC reports recommend that countries take the ISAs as the foundations for national standards and supplement them with additional requirements that are believed to be appropriate for the domestic market.

ACRONYMS

A&A	Accounting and Auditing
EU	European Union
FoF	Forum of Firms
FSAP	Financial Sector Assessment Program
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ROSC	Report on the Observance of Standards and Codes

I. INTRODUCTION AND BACKGROUND

High-quality financial reporting contributes to promoting private sector growth and reducing volatility, through: (a) strengthening countries' financial architecture and reducing the risk of financial market crises, together with their associated negative economic impacts; (b) contributing to foreign direct and portfolio investment; (c) helping to mobilize domestic savings; (d) facilitating the access of smaller-scale corporate borrowers to credit from the formal financial sector by lowering the barrier of high information and borrowing costs;[2] (e) allowing investors to evaluate corporate prospects and make informed investment and voting decisions, resulting in a lower cost of capital and a better allocation of resources; and (f) facilitating integration into global financial and capital markets.

Financial reporting is also a building block of a market-based monitoring of companies, which allows shareholders and the public at large to assess management performance, thus influencing its behavior.

High-quality financial reporting also contributes to strengthening the financial discipline of Government Business Enterprises (GBEs).[3] The relative lack of capital-market related pressures on GBEs means that the shareholding Ministers need to rely on administrative monitoring procedures to hold GBE boards accountable. The general adoption of International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) by GBEs enhances shareholding Ministers' and the public's ability to assess the extent to which a GBE is creating or eroding value.

High-quality financial reporting may also contribute to improving the assessment and collection of taxes on corporate profits. Countries currently have fundamentally different approaches to the relationship between accounting and taxation. At one extreme (total independence), income determination for accounting purposes is completely separate from income determination for tax purposes. At the other extreme (total dependence), either financial statements are prepared in accordance with tax rules, or income determination for tax purposes is determined by the choices made in financial statements. The greater the level of dependency, the greater the importance of high-quality financial statements for the assessment and collection of taxes on corporate profits.

As an institution committed to the fight against poverty, the World Bank undertakes a number of activities to support the development and implementation of international accounting and auditing standards, as it recognizes the contribution that high-quality financial reporting can make to development. These activities include financial support to the relevant international standard-setting organizations; diagnostic work to benchmark countries' financial reporting standards and practices against international standards; policy advice and financial assistance to support the enhancement of these standards and practices; and participation in international

[2] This can be achieved by shifting gradually from collateral-based lending decisions to lending decisions which are based on the financial performance of the prospective borrower.

[3] Government Business Enterprises are defined within International Public Sector Accounting Standards, issued by the Public Sector Committee of the International Federation of Accountants (IFAC). This term generally includes State-owned enterprises (SOEs).

discussions and initiatives aimed at strengthening the regulatory environment, both nationally and globally, in which international standards are applied.

This paper provides an overview of the main program of Bank diagnostic work in the field of private sector financial reporting: the Reports on the Observance of Standards and Codes (ROSC) accounting and auditing assessment. It summarizes some of the main findings of the 38 assessments that have been carried out to date, with specific reference to the challenges to the successful implementation of international accounting and auditing standards. Attention is drawn to the need for international consensus on a comprehensive framework of principles for the regulation of accounting and auditing that also addresses issues of implementation, which is not covered by existing international accounting and auditing standards. The paper concludes by raising a number of other issues to be discussed and resolved going forward, if countries are to receive the support they need to successfully implement international standards and reap their full benefits.

II. IMPEDIMENTS TO THE SUCCESSFUL IMPLEMENTATION OF INTERNATIONAL STANDARDS

The common themes that emerge from the ROSC findings shed light on the impediments to successful implementation of international standards, even in countries that are positively committed to the process. Some of these obstacles are inherent to the standards themselves, but most are not. Hence, this points to the need for greater focus by policymakers—both national and international—on creating the conditions and instruments for successful implementation. The sections that follow describe the most common categories of obstacles encountered.

A. Misunderstandings as to the nature of international standards

Fundamental to the implementation of international accounting and auditing standards is a clear understanding of what these standards are, what they require, and what it means to adopt them. Failing this, countries are unable to set concrete implementation targets or to measure progress in reaching those targets. The ROSC findings suggest that clarity of understanding is not universal, which helps to explain the sometimes significant gaps between prior self-assessments of compliance—such as those published by the International Accounting Standards Board (IASB) and International Federation of Accountants (IFAC)—and the ROSC results.[4] The concept of adopting international accounting standards has been interpreted in various ways by transition countries, which may hamper rigorous and uniform application of IAS.[5] The

[4] For example, the International Accounting Standards Board's (IASB) "2004 International Financial Reporting Standards" states—based on information provided to the IASB by Deloitte Touche Tohmatsu (2004)—that there are 92 countries around the world that either permit or require the use of IAS/IFRS by at least some (if not all) domestically listed companies by 2007. The ROSC results suggest that the actual number of countries that either permit or require the use of full IAS/IFRS is much lower.

[5] Some interpretations of this concept include: the adoption of "Western" book-keeping methods; one-off transformations of financial statements prepared in accordance with local standards; the development of local standards "based on" IAS/IFRS; the adoption of IAS/IFRS in force as of a

ROSC results show, however, that the adoption of International Standards on Auditing (ISA) has been less contentious. Many transition economies have taken the ISAs as the foundations for national standards and supplemented them with additional requirements, believed to be appropriate to their domestic market. Still, some countries have adopted only selected standards or adopted ISA in force as of a particular date in the past, with no account taken of changes since then. These misunderstandings give countries, and various stakeholder groups within them, a false understanding of the actual standards gap and the true implementation challenges they face.

Illustrations[6]

Accounting Standards:

Country ABC claims that IFRS are required for all listed companies. The ROSC report shows that the law mandates the use of a translation of international accounting standards, as effective in 1999. In a number of economically significant enterprises, the differences between the then-applicable international standards and "full IAS/IFRS" had an adverse impact on the quality and transparency of financial statements.

Country XYZ claims that all consolidated financial statements must be prepared in conformity with IFRS. The ROSC report showed that Country XYZ has adopted IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, but failed to incorporate the body of international standards that together form IFRS. The authorities did not recognize that IAS 27 is merely one of the standards that are required when preparing consolidated financial statements. Other international accounting standards such as IAS 1, *Presentation of Financial Statements*, IAS 39, *Financial Instruments: Recognition and Measurement*, are equally important.

Auditing Standards:

Country ABC claims that ISA are required for all statutory audits. However, paramount standards such as ISA501, *Audit Evidence—Additional Considerations for Specific Items* (which covers auditing segment information), and ISA550, *Related Parties*, have not been adopted domestically.

B. Lack of appropriate mechanisms for granting national authority to international standards

To be effective in a national setting, international standards require the force of law or other regulatory backing. If not, compliance becomes a matter of non-transparent discretion on the part of preparers and auditors of financial statements, outside the constraints of any regulatory framework. In such cases, the standards should more properly be considered "offshore" rather than "international." There is currently no international consensus on what mechanisms should be used to provide

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particular date in the past, with no account taken of changes since then; and the adoption of a subset of IAS/IFRS (e.g., excluding interpretations, which are not endorsed and hence not effective).

[6] Illustrative examples are based on actual findings described in published ROSC reports, which are available at www.worldbank.org/ifa/rosc_aa.html.

regulatory backing, and different countries have adopted different approaches, many of which fail to achieve their stated objective. Countries are also bound by their constitutional and administrative law, which can limit significantly their ability to impart domestic legal force to international standards issued by non-official private sector organizations. Although the accountancy profession has played a major role in the development of international standards, and in their promotion at a national level, the profession itself does not have sufficient authority to ensure their successful implementation, unless acting in a regulatory capacity derived from specific legislation.

For countries with a tradition of reliance on laws and regulations (rather than standards) for the fixing of accounting and auditing requirements, specific issues arise. Rather than giving authority to a continuing process of standard-setting, new statutory measures are required whenever a new international standard is enacted, or an existing international standard is amended. Typically, such changes must be gazetted in the official language of the country. Such an approach can lead to delays in keeping the body of translated and gazetted IAS/IFRS up-to-date; this approach also entails significant costs and technical difficulties of carrying out translations. At the same time, preparers are also faced with difficulties, as they wish to comply both with domestic law and with current IAS/IFRS, which may not always be perfectly aligned. When such procedures are combined with an explicit endorsement mechanism to screen individual international standards for local adoption (as in the European Union), there is the further possibility that certain IAS/IFRS may not be accepted (either in full or in part). Due attention must also be given to the political significance of introducing a mechanism that may deprive a jurisdiction of the ability to have final say over the standards to which it grants legal authority.

Illustrations

Accounting Standards:

With respect to the European Union, the European Commission publishes in the Official Journal the translations of the individual "bare" international standards into the applicable languages of all Member States. However, several issues remain with respect to the translations of IFRS, which may have an adverse impact on compliance in EU Member States:

- Certain information contained in the IASB's bound volume of IFRS has not been translated and published in the Official Journal. Such excluded information includes the Appendices to the IAS/IFRS, which contain Application Guidance and Basis for Conclusions, which may be important to fully understand the application of, and reason for, particular IFRS.
- Currently, Exposure Drafts for new IFRS and Draft IFRIC Interpretations are not translated and published (and, thus, made readily available). In order to make it easier for interested stakeholders to provide input to the development of new IFRS (including IFRIC Interpretations), Exposure Drafts and Draft IFRIC Interpretations should be translated, and such translations published, at the time of release.

Auditing Standards:

In country ABC, it is not clear whether a court would hold a statutory auditor to the duty of care required by International Standards on Auditing—in cases where statutory audits are required to be conducted in accordance with ISA—since language requirements in judicial procedures before courts may require an official translation of ISA in the local language, which has yet to be published.

Substantially all countries that so far have been the subject of A&A ROSC assessments lay down their accounting and auditing requirements in legislation, which is applicable to the generality of companies. This differs from the tradition in the United States, for example, where state company law has usually been silent on issues of accounting and auditing, and where legal general-purpose financial reporting obligations are enshrined in federal securities requirements. Although there may be arguments in favor of instituting a special regime for publicly traded companies (for which IAS/IFRS are appropriate), care needs to be taken to avoid conflicts and overlaps. Company law is concerned with the regulation of companies and typically provides for the protection of a wide range of stakeholders; often, it also covers issues relating to corporate governance. In contrast, securities law is primarily concerned with the regulation of markets and with the protection of market participants. The mechanisms used to achieve these different policy objectives are not always aligned, and can have different impacts on how the role of accounting and auditing is shaped. Successful implementation of international standards necessitates due regard for these differences. The case may be made for requirements going beyond those contained in international standards (e.g., the concept of ISA-plus, or the addition of country-specific obligations to respond to specific audit reporting mandates).

C. Inconsistencies between international standards and the legal framework

Also fundamental to the implementation of international accounting and auditing standards is an unequivocal relationship between the legal framework (e.g., company law and securities law) and international standards. The ROSC results point to several stress areas between domestic laws and the standards, which could adversely impact compliance, as well as monitoring and enforcement efforts.

Illustrations

Accounting Standards:

In country ABC, company law does not authorize a company to account for the amount of the correction of an error retrospectively. IAS/IFRS require retrospective accounting so that the correction of an error is excluded from the determination of profit or loss for the period in which the error is discovered. Such inconsistencies result in difficulties for preparers and auditors, who may find themselves unable to comply with both domestic law and international standards.

Auditing Standards:

In country ABC, company law does not authorize a statutory auditor to disclaim his or her opinion. This conflicts with ISA, which requires an auditor to disclaim an opinion when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence.

D. Lack of appropriate linkages between general-purpose financial reporting and regulatory reporting

IAS/IFRS are standards for the preparation of general-purpose financial statements, aimed at meeting the needs of a wide range of users, but predicated on the assumption that placing primary emphasis on the needs of shareholders will result in measurement, recognition and disclosure requirements that also meet the needs of other users. However, significant other users of financial statements need not necessarily share this view, and where they have the power and authority to do so, frequently impose different special-purpose financial reporting obligations designed to meet their specific needs (e.g., reporting for taxation purposes, or reporting for prudential and supervisory purposes). Not all countries successfully manage this interface between general-purpose and regulatory reporting, and it is common to encounter cases where rules designed for the latter (e.g., on loan loss provisioning in the banking sector, or on the timing of income recognition) have an impact on the former, when a single set of financial statements is intended or required to meet both objectives. Hence, the requirements of regulatory reporting may conflict with those of IAS/IFRS, thereby precluding successful implementation. Companies may have the option of voluntarily preparing additional financial statements in which full compliance with IAS/IFRS can be achieved, but this has negative cost implications and also raises uncertainties among users as to which are the “real” figures. In addition, financial statements prepared and audited on a voluntary basis typically fall outside the scope of domestic regulatory regimes, thereby often reducing the reliance users can place on them. Progress is possible when the difference between general-purpose and special-purpose/regulatory reporting is understood, and when—instead of inserting special-purpose requirements in the rules governing general-purpose reporting—countries acknowledge the existence of parallel systems, and seek to minimize differences between them. This minimizes the incremental costs of multiple reporting and also leverages the enforcement role of regulatory bodies with respect to general purpose financial reporting.

Illustrations

Accounting Standards:

In country ABC, banks are required to present their financial statements in conformity with national accounting regulations and IAS/IFRS. In practice, most banks purport to prepare their consolidated financial statements in conformity with IAS/IFRS, since these are required by foreign shareholders, correspondent banks, and credit-rating agencies. The national bank has issued a number of regulations relating to the determination of loan losses, which require banks to calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed provisioning rates for the number of days a loan has been classified as nonperforming (for example, 0 percent if less than 30 days, 1 percent if 30-90 days, etc.). In preparing their IAS/IFRS financial statements, banks apply the national bank regulations, which may not always be appropriate to calculate the recoverable amount of originated loans and receivables under IAS 39, *Financial Instruments: Recognition and Measurement*. IAS 39 requires impairment or loan losses to be calculated as the difference between the asset's carrying amount and the present value of expected future cash flows, discounted at the financial instrument's original effective interest rate, which may differ significantly from the impairment or loan losses determined in conformity with the national bank regulations. The national bank does not accept the co-existence of two different reported net incomes, i.e., the net income determined in conformity with national bank regulations for purposes of prudential supervision, and net income determined in conformity with "full IAS/IFRS" for general-purpose financial statements.

Auditing Standards:

In country ABC, banks are required to prepare statutory financial statements in conformity with IFRS/IAS and prudential accounting rules, which may differ from "full IAS/IFRS requirements" (for example, with respect to loan loss provisioning, as illustrated above). Some banks elect to prepare an additional set of "full IFRS/IAS" financial statements and have them audited in accordance with ISA. However, these audits of IFRS-based financial statements fall outside the scope of the quality review system, which was established pursuant to the law on auditing, since the quality review system does not extend to "contractual" audits. It is unclear whether the users of IFRS-based financial statements understand this important distinction.

E. Inappropriate scope of application of international standards

Full IAS/IFRS are not appropriate for use by all reporting entities; full IAS/IFRS should be used unchanged as the standards for public interest entities, and separate standards should apply to other entities (the "Big GAAP/Little GAAP"[7] distinction). National standard-setters thereby become setters of "Little GAAP" until the IASB issues a separate set of standards suitable for use by such other entities. It will be interesting to monitor the experience of national standard-setters in the EU, subsequent to the introduction of IAS/IFRS in 2005, to determine whether a national

[7] Generally Accepted Accounting Principles (GAAP).

body limited to setting "Little GAAP" can continue to attract the human and financial resources necessary to do its job properly, as well as ensure that national concerns are properly considered in the IASB's standard-setting process.

Many countries have traditionally applied a single set of accounting requirements to all companies (or all companies using a specific legal form), irrespective of size. However, the use of IAS/IFRS as that single set of requirements has frequently led to unintended negative consequences, hindering successful implementation, as full IAS/IFRS are not appropriate for small- and medium-sized entities.[8] In such cases, the necessary capacity for proper application was often not in place, costs of compliance were disproportionate, and enforcement bodies either did not exist or were unable to cope with the volume of work required. Over time, the culture of compliance suffers, even among those companies that should be expected to have the resources to comply. Success is greater when the application of IAS/IFRS is confined to public interest entities only, and when limited resources are focused on ensuring compliance by these entities.

The situation with respect to auditing standards is more straightforward, given the international consensus that International Standards on Auditing are suitable for the conduct of all financial statement audits, subject to the need to improve ISA on particular issues as discussed above. Instead, the difficulty arises in the determination of the scope of legal requirements for audit. There are inherent limitations on the ability to perform a proper audit of many smaller entities because of the ability of owner/managers to override controls, and many countries have only limited audit capacity. As with IAS/IFRS, the application of ISA to excessive numbers and/or inappropriate types of entities almost always leads to problems of general compliance, even on those engagements where compliance should be possible.

Illustrations

Accounting Standards:

In country ABC, the accountancy law requires that all private sector enterprises present IAS/IFRS-based financial statements. This requirement significantly increased the accounting-related expenses with little benefit, generated a significant issue in terms of corporate income tax assessment and collection, and eventually resulted in pervasive noncompliance with financial reporting requirements.

Auditing Standards:

In country ABC with a population of approximately 10 million, over 15,000 companies are subject to annual statutory audit requirements. A significant number of them are family-owned small- and medium-sized enterprises in which there is little public interest in such a requirement to be audited. Also, although International Auditing Practice Statement (IAPS) 1005, "The Special Considerations in the Audit of Small Entities" provides guidance on auditing small entities, the quality of small entity ISA audits was determined to be low, and significant compliance gaps with ISA were found.

[8] The IASB is currently developing a set of standards applicable to small- and medium-sized enterprises.

F. Non-observability of compliance

Third-party users are usually unable to directly determine if a preparer or auditor has complied with the appropriate standards.[9] Instead, users must rely on a range of intermediary governance, regulatory and reputational agency bodies (e.g., auditors, underwriters, analysts), which may not function at the necessary level of quality in some countries. In such countries, it is effectively impossible for a third party that does not have special negotiating leverage (e.g., a major lender to the company) to gain any insight into actual levels of compliance and/or to exercise pressure for improvement, thereby reducing the incentives for preparers and auditors to comply. Particular problems of non-observability arise when audited financial statements are not easily available to stakeholders. In many countries, disclosure mechanisms foreseen in the law (e.g., company registries) do not function as desired. In others, disclosure by means of publication in official gazettes or newspapers is not effective, when disclosure is limited to the primary financial statements and does not include the notes to the financial statements.

Illustrations

Accounting Standards:

In country ABC, the ROSC assessment noted discrepancies between actual accounting policies followed by financial institutions and the “boilerplate” disclosures in their IFRS financial statements. A number of interviewed banks indicated that they calculate impairment in the unsecured portion of loans and receivables on the basis of a provisioning matrix that specifies a range of fixed provisioning rates for the number of days a loan has been classified as nonperforming (for example, 0 percent if less than 30 days, 1 percent if 30-90 days, etc.). However, the loan measurement accounting policy in their IFRS financial statements was word-for-word compliant with IAS 39, which requires impairment or loan losses to be calculated as the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate. Auditors and financial statement preparers often commented that disclosed accounting policies—reflecting comments from senior audit partners at IFRS desks abroad—differ from actual accounting practices within the audited company. The concern is that IFRS-based financial statements may be complying in form but not in substance.

Auditing Standards:

IFRS/IAS do not allow the carrying of assets at more than their recoverable amount. In country ABC, the resulting impairment charge is tax deductible. The ROSC results showed that impairment charges were mainly recorded by profit-making companies in an effort to reduce their taxable income, whereas loss-making companies generally refused to record impairment charges. Auditors have generally expressed an emphasis of matter audit opinion rather than a qualified audit opinion when they noted such instances of noncompliance.
This is a lenient and, most would argue, incorrect audit opinion under ISA. Such an audit opinion does not adequately protect the public. These overvalued assets present a rosier picture of the company’s financial position than actually exists.

[9] This particularly holds true regarding auditing standards. When a reader receives a set of financial statements with an unqualified audit report, the reader is rarely in a position to assess whether it is the result of a perfect audit or of an inadequate or acquiescent audit.

At this juncture, it is appropriate to highlight that the ROSC methodology is essentially a top-down approach and should not be considered as a substitute for a future ideal compliance model involving a bottom-up assurance approach. The ROSC methodology uses stratified random sampling to select audited financial statements and it cannot be considered to be representative of all companies and auditors. Hence, the ROSC findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the audited financial statements of specific companies.

G. Areas for improvement in the standards themselves

International standards are not always geared to protecting the public interest. While the governance of accounting and auditing standard-setting arrangements has been significantly improved in recent years and is still being improved, some standards – particularly auditing standards – remain to be revised. The ROSC reports support the adoption of IFRS/IAS for public interest entities and the adoption of ISA to avoid inefficient use of resources on standard-setting at national level around the world, as well as the subsequent inefficiencies caused by audit firms and their clients having to adhere to several sets of standards. At the same time, however, the ROSC results point to weaknesses in the standards, which adversely impact their implementation. Such weaknesses may result from efforts to compromise when setting the standards, undue political or lobbying influence in standard-setting activities, lack of detailed rules, and areas that are not yet covered by international standards.

For example, many stakeholders believe that fraud detection should be recognized as a responsibility of statutory auditors. They contend that the scope of audits must be expanded beyond the current requirements of International Standards on Auditing, and looking for fraud must be made an affirmative audit obligation. With respect to group audits, the International Standard on Auditing regarding the use of the work of another auditor permits – when the local regulations of a country also allow for this – that a principal auditor base his or her audit opinion on the financial statements taken as a whole *solely upon* the report of another auditor regarding the audit of one or more components. These weaknesses attest to the lack of adequate public oversight of the standard-setting process. Therefore, some countries that adopted ISA supplemented ISA with additional requirements (e.g., that the group auditor bear full responsibility for the audit report on the consolidated financial statements).

H. Mismatch between accounting and auditing requirements and market demands

International accounting and auditing requirements do not exist in a vacuum; they are designed to fit the needs of disclosure-based governance and regulatory regimes, where high-quality audited financial statements provide information that can be relied upon by a range of users external to the reporting entity for significant decision-making purposes. Where such disclosure-based environments exist, or are being put in place, the conditions for successful implementation of international standards are more favorable than in the absence of such environments, given the differences in incentives for concerned policymakers and stakeholders. Thus the relative importance of foreign direct investment flows, as compared with foreign portfolio investment flows, has an influence on shaping the conditions for implementation, as do patterns of share ownership. Where relatively concentrated blocks of equity ownership are in the hands of controlling shareholders (often the State, founding families, managers who have gained control of enterprises during privatization, or foreign "strategic" shareholders), the mechanisms of corporate governance are less reliant on external disclosure, since the controlling shareholders have alternative access to internal, non-disclosed information. The same can hold for providers of finance, who may place greater reliance on the value of collateral or add specific financial reporting requirements in loan covenants. Similarly, when regulators and other authorities have the power to impose their own reporting requirements (e.g. for tax or prudential reporting), they may not see the need to invest in improving the regime for general purpose financial reporting and auditing. The enhanced transparency that flows from the robust application of international standards may not be perceived by certain influential stakeholders as being in their interests, and public policy decisions may be skewed in a manner which is not welfare-maximizing for the economy as a whole. Formal requirements for the application of international standards may be introduced, perhaps in response to external pressure, but the likelihood of successful implementation must always be assessed against the backdrop of political economy realities.

I. Mismatch between accounting and auditing requirements and the capacity to comply

The application of international standards requires certain minimum levels of capacity (i.e., appropriately qualified individuals), which depends on the availability of opportunities for relevant and adequate education, training and experience. The greater the gap between existing national and international standards, and the shorter the period to complete the transition, the greater the capacity building challenge to overcome. The development and enhancement of capacity applies to educators, regulators and users as much as to preparers and auditors, and places demands on both institutions and individuals. Systems, methodologies, application guidance, curricula, teaching and training materials, examination and certification procedures, and much else must be adapted to support the new obligations. Differences in language can limit the application of resources developed elsewhere, as well as the transfer of knowledge and experience from one country to another. Where the number of entities subject to international standards is modest because of local specificities (e.g. few public interest entities), cost-benefit considerations may constrain investments to support the implementation of international standards, at least in the short- to medium-term. Mechanisms to apportion the costs of implementation to those stakeholders who will benefit may not function adequately due to free-rider problems often associated with the financing of public goods, and public financing may not be a viable alternative because of conflicting demands on scarce resources. Even where resources can be mobilized to launch the process of capacity development and enhancement (such as through development assistance), putting in place financing mechanisms that are sustainable in the longer term is more of a challenge. Unfortunately, there are many examples of reform initiatives that began well but collapsed when the initial pump-priming funding ran out.

J. Mismatch between accounting and auditing requirements and domestic enforcement capacity

The effectiveness of regulatory bodies in the monitoring and enforcement of accounting and auditing standards is a strong determinant of the quality of application such standards. This is true for a variety of reasons, among them: the inability of third party users to assess compliance with standards, agency theory problems that can lead to imperfect alignment of the interests of various stakeholders concerned with the quality of a company's financial reporting, and the public goods and coordination issues associated with the application of accounting and auditing standards. Recent scandals have drawn attention to weaknesses in previous approaches to monitoring and enforcement, as well as to the limitations of systems that place significant reliance of self-regulation. The risks of conflicts of interest now receive greater attention; steps have been taken to ensure greater segregation of functions between those involved in the financial reporting process. Significant efforts have also been made to enhance the capacity and powers of various regulatory bodies. The need for public interest oversight of the audit profession, setting of auditing and ethical standards, and audit quality assurance programs is acknowledged, as is the need for the various regulatory bodies concerned with different aspects of financial reporting to improve the coordination of their activities, all within a coherent and consistent legislative framework.

There is a progressive move away from complete self-regulation of auditing by the accountancy profession towards independent regulation within a statutory framework. Unfortunately, most of these reforms are taking place in relatively developed jurisdictions, while most countries that have been subject to ROSC accounting and auditing assessments are still struggling to put in place the basics of effective regulation. Existing regulatory institutions, including banking and securities regulators, frequently lack the mandate, resources and methodologies required to monitor and enforce accounting and auditing requirements. As a rule, though, given the greater role of the banking sector in financial intermediation in these countries, the performance of banking supervisors is better. However, where such regulators are concerned primarily with the respect of their own special-purpose requirements, the contribution of their activities to the quality of the general purpose financial statements made publicly available is constrained. Mechanisms for public oversight of the audit function are rare, and valid questions are raised about the applicability of models introduced recently in more developed jurisdictions, given the different relative roles of the various stakeholders. The robustness of self-regulatory bodies is questionable, especially in those jurisdictions where the record of dealing with conflicts of interest is not encouraging. Even where formally independent regulatory bodies do exist, regulatory capture is frequent, and the judicial system is not considered an effective mechanism for seeking redress in matters relating to accounting and auditing. The same applies to the enforcement of corporate governance measures, which can contribute to improvements in accounting and auditing. Additional problems arise in the case of public interest entities that do not operate in regulated sectors.

K. The special role of the international audit firm networks

As previous sections have demonstrated, the successful implementation of international accounting and auditing standards is very dependent on local conditions. At the same time, various stakeholders—e.g., users of financial statements prepared by companies seeking access to third-country financial and capital markets, investors wishing to diversify their portfolios internationally, and parent companies requiring assurance on the financial statements prepared by foreign subsidiaries—may wish to compensate for national weaknesses, in order to be able to rely on financial information for decision-making purposes. Purely domestic stakeholders may also hope to "import" assurance by turning to auditors which they consider to offer a degree of audit quality that goes beyond that which one could expect from the operation of local regulatory and enforcement mechanisms This explains the emergence of international audit firm networks, which operate using a common brand name globally. Since, as noted earlier, a third party user is usually unable directly to determine whether international standards have been complied with by an auditor, users place reputational reliance on these network brand names, even though the constituent member firms of these networks are typically owned, managed, controlled and regulated at national level, and the networks themselves are not subject to any regulatory oversight or supervision.

Despite the expectations that flow from the use of their global brands, the ROSC results and audit failures over recent years in several jurisdictions would suggest that international audit firm networks do not deliver consistent, high-quality audit services across the globe. International audit networks have not made explicit the service delivery assertion which underlies the use of a common network/firm name by different practices in different jurisdictions around the world, nor have they made clear how users of audit reports produced by these different practices are supposed to obtain assurance that this assertion is being delivered upon. In the aftermath of recent audit failures, the networks have undertaken a number of initiatives to respond to the criticisms that ensued. Among these was the creation of the Forum of Firms (FoF), in January 2001. The FoF is an organization of international firms that perform audits of financial statements that are or may be used across national borders ("transnational audits"). Members of the Forum voluntarily agree to meet certain requirements as detailed in the FoF Constitution. These include a commitment to the FoF "Quality Standard", which requires Member Firms to:

- have policies and methodologies used for conducting transnational audits (but not other audits which are nonetheless "branded" with the same network name) which as a minimum require compliance with International Standards on Auditing in addition to relevant national standards on auditing;
- comply as a minimum with the applicable sections of the IFAC Code of Ethics as determined by the Transnational Auditors Committee (TAC) of IFAC for inclusion in the Quality Standard, in addition to relevant national codes of ethics;
- maintain training programs, as appropriate, to keep partners and staff who perform transnational audits aware of international developments relevant to financial reporting including auditing and ethics; and

- maintain appropriate quality control standards in accordance with International Standards on Auditing and International Standards on Quality Control, as issued by the IAASB, in addition to relevant national quality control standards. In addition, conduct regular globally-directed internal quality assurance reviews to monitor compliance with the Member Firms' policies and methodologies for conducting transnational audits.

An International Quality Assurance Review (IQAR) process had originally been envisioned by the FoF to review Member Firms’ policies, methodologies and work undertaken in relation to transnational audits to assess whether they are in compliance with the Quality Standard, but this has now been deferred, given the major strengthening of national audit regulatory regimes in several major jurisdictions. However, the FoF has no mechanism for monitoring its members’ compliance with the Quality Standard.

The findings of the Accounting and Auditing ROSC assessments suggest that many member firms of networks, which are also FoF members, do not comply with the Quality Standard for transnational audits. These member firms may be unaware that their international network has made such a commitment and/or they may not consider themselves bound by it, since they are independently owned, managed and controlled. It is therefore unclear how audit report users are supposed to obtain reasonable assurance that the commitment to the FoF Quality Standard is actually delivered upon, at the level of individual network member firms and transnational audit engagements. Because of legal liability concerns, the international networks do not wish to exercise control, and/or to be seen to be exercising control, over their individual member firms. There are also doubts as to whether such control is even possible, given the network governance and management arrangements currently in place. Neither the networks nor their member firms make public the results of their internal quality assurance reviews to monitor compliance with network policies and methodologies for conducting transnational audits. This means that users cannot rely on the FoF, the networks, or individual member firms to provide any verifiable assurance, either *ex ante* or *ex post*, that the Quality Standard is delivered upon. Instead, users can only fall back on the quality of the local regime for the regulation of audit. It remains to be seen how sustainable this situation will be, in terms of managing the networks’ global brands.

III. THE NEED FOR INTERNATIONAL CONSENSUS ON A COMPREHENSIVE FRAMEWORK OF PRINCIPLES FOR THE REGULATION OF ACCOUNTING AND AUDITING

As evident from the earlier sections, effective regulation is the key to successful implementation of international standards, but international accounting and auditing standards themselves do not set out requirements as to how such effective regulation should be exercised. Guidance is not provided on how to “import” international standards into national legislative and regulatory systems, on the design and operation of appropriate regulatory frameworks, or on the interfaces with other regulatory instruments and institutions (such as those for banking and securities regulation) which could contribute to the monitoring and enforcement of international standards. As currently drafted, international accounting and auditing standards implicitly assume the existence of legal, institutional and policy conditions ("preconditions") that are often undeveloped or absent in many countries. The structure of national economies, and the role played by high quality external financial reporting, shape the extent to which these "preconditions" present themselves, and efforts to promote the implementation of international standards need to have regard to these specificities.

To strengthen the regulatory arrangements essential for the successful implementation of international standards, countries should give greater attention to regulatory preconditions. To do this, however, they need help in understanding what needs to be done to frame the appropriate legal and institutional requirements within a policy framework that ensures consistency with other related areas of regulation, including company law. For countries that have recently joined the EU, plan to do so, or otherwise have made a conscious decision to align themselves with the requirements of the *acquis communautaire*, reliance can be placed on the rapidly evolving approaches within the Union, which have the added benefit of being drafted to meet the needs of an integrated market comprising several countries. However, it is not evident that the *acquis* is appropriate to other countries. The relevant international organizations should work together to develop a consensus on a comprehensive framework of principles for the regulation of accounting and auditing and to support its adoption by the competent national authorities. Special efforts should be made to strengthen and leverage the linkages between the various standards and codes that affect the implementation of international accounting and auditing standards (e.g., banking supervision, securities markets, insurance, and corporate governance) and to fill any gaps which remain. Such principles should explicitly consider the regulatory implications of the diversity of financial systems and market structures across countries. A useful starting point would be the results of the International Organization of Securities Commissions (IOSCO)/Basel Committee/International Association of Insurance Supervisors (IAIS) Joint Forum Core Principles Cross-Sectoral Comparison.

APPENDIX: Overview of the Accounting and Auditing ROSC Program

Introduction

In the wake of the international financial crisis of the 1990s, the international community embarked on a range of initiatives to strengthen the international financial architecture. The objectives of these initiatives were crisis prevention, mitigation, and resolution. The agenda focused on weaknesses in the international financial system that could potentially contribute to the propensity for and magnitude of global financial instability, hence requiring collective action at the international level.

There is widespread recognition that global financial stability rests on robust national systems. In a world of integrated capital markets, financial crises in individual countries can imperil global financial stability. This provides a basic “public goods” rationale for enhanced measures at the country level that ultimately benefit international and national systems.

Role of the ROSC in the International Financial Architecture

At the international level, standards enhance transparency. They identify weaknesses that may contribute to economic and financial vulnerability. They foster market efficiency and discipline. At the national level, standards provide a benchmark to identify vulnerabilities and guide policy reform. To best serve both international and national objectives, the scope and application of such standards need to be assessed in the context of a country’s overall development strategy and tailored to individual country circumstances. The Financial Stability Forum and others have emphasized, in particular, the role of best practice standards and codes in strengthening the international financial architecture.

In this context, the World Bank and the International Monetary Fund (IMF) initiated the joint ROSC initiative, which covers twelve sets of internationally recognized core standards and codes relevant to economic stability and private and financial sector development.[10] Each core standard is assessed and reported on in an individual module. Under this modular approach, the IMF takes the lead in preparing assessments in the areas of data dissemination and fiscal transparency. Modules for the financial sector (transparency in monetary and financial policies, banking supervision, securities market regulation, insurance supervision, payments and settlements, anti-money laundering and the combating of financing of terrorism (AML/CFT),) are mostly derived from the Financial Sector

[10] The twelve sets of standards cover data dissemination, fiscal transparency, transparency in monetary and financial policies, banking supervision, securities market regulation, insurance supervision, payments and settlements, anti-money laundering and the combating of financing of terrorism (AML/CFT), corporate governance, accounting and auditing, and insolvency and creditor rights.

Assessment Program (FSAP).[11] The World Bank takes the lead in corporate governance, accounting and auditing, and insolvency regimes and creditor rights.

The ROSC and the FSAP programs are tools to assess financial sector vulnerability and development needs. They provide input to the IMF for its surveillance activities and are useful instruments to support the policy dialogue of international financial institutions, policymakers, and the private sector. They can contribute to the design of development lending operations, assist in the preparation of key policy documents, and provide benchmarks for the design and monitoring of technical assistance and capacity-building programs. To remain useful, assessments of progress in the implementation of standards are updated periodically.

The IMF and the World Bank have set up websites to disseminate the final ROSC assessments to the public.[12]

Objectives of the ROSC–A&A Module

The World Bank is responsible for assessing the accounting and auditing module of the ROSC, known as the Review of Accounting and Auditing Standards and Practices. The Review's objectives are to:

Assess the ***comparability*** of national accounting and auditing standards with International Financial Reporting Standards (IFRS)[13] and International Standards on Auditing (ISA),[14] respectively, and the degree to which corporate entities ***comply with*** established accounting and auditing standards in the country; [15] and

Assist the country in ***bridging the identified gaps*** between its current standards and practices, and internationally recognized accounting and auditing standards.

The ROSC-A&A module focuses primarily on financial reporting by *public interest entities*. "Public interest entities" are defined as entities of significant public interest because their business, their size, their number of employees, and/or their corporate status are such that they have a wide range of stakeholders. Examples of such entities include credit institutions, insurance companies, investment firms, pension firms and listed companies. However, the ROSC-A&A does also consider issues related to financial reporting by small and medium-sized entities (SMEs).

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11 The FSAP, a joint IMF and World Bank effort introduced in May 1999, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries. See http://www1.worldbank.org/finance/html/fsap.html.

12 The ROSC website, including details of the twelve core standards and country modules, is available at http://www.worldbank.org/ifa/rosc.html.

13 Within this document, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

14 International Standards on Auditing (ISA) are promulgated by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

15 Within this document, the term "accounting" refers both to accounting and reporting.

Comparability of National and International Standards and Compliance

The ROSC-A&A review entails an evaluation exercise that (a) assesses the strengths and weaknesses of existing *institutional frameworks* that underpin financial accounting and auditing practices; (b) determines the *comparability* of national accounting and auditing standards with internationally recognized standards (IAS/IFRS and ISA); and (c) examines the degree of *compliance* with national accounting and auditing standards, and evaluates the effectiveness of monitoring and enforcement mechanisms for ensuring compliance with existing national standards, rules, and regulations.

Institutional Framework

The institutional framework should promote high-quality accounting and auditing practices. The institutional framework, as examined by the ROSC-A&A in each country, includes (a) laws and regulations, (b) the history and current state of the accounting and auditing profession, (c) the strengths and weaknesses of accounting academic and professional education, (d) the accounting and auditing standard-setting process, and (e) arrangements for ensuring compliance with accounting and auditing requirements. The ROSC-A&A module focuses on the current state of the institutional framework and provides policy recommendations for strengthening the framework, in order to foster high-quality accounting and auditing practices.

While IAS/IFRS and ISA are the two benchmarks that the ROSC-A&A review uses to assess accounting and auditing standards and practices in any given country, there are no international regulatory standards for accounting and auditing. Efforts to address current gaps that have come to the fore in light of recent corporate governance and accounting scandals are still underway. In the absence of standards, World Bank staff draw on their own experience in assessing the institutional frameworks referred to above.

Comparability of National and International Standards

The benchmarks used in developing the methodology for this assessment are IAS/IFRS and ISA. Achieving conformity of national accounting and auditing standards with IAS/IFRS and ISA promotes sound financial reporting in an economy. For various reasons, the standards and regulations of different countries have reached various levels of conformity with comparable international standards. The ROSC-A&A module helps identify these gaps.

Compliance with National Standards

Corporate stakeholders depend on access to high-quality financial information. While setting accounting and auditing standards is an important step in developing a sound financial reporting environment, enforcement of these standards is even more important. The lack of an effective and efficient mechanism to ensure compliance with established accounting and auditing standards contributes to the weakness of a financial reporting environment.

Bridging the Gaps

With regard to the second objective of bridging identified gaps, the ROSC–A&A module also identifies areas for improvement that help policymakers and other country stakeholders to develop a strategy and an action plan for enhancing accounting and auditing standards and practices in a country.

ROSC–A&A Methodology

The ROSC-A&A module evolves from a participative approach with the strong involvement of policymakers and other country stakeholders. The World Bank has developed a diagnostic tool that captures a comprehensive review of accounting and auditing standards and practices in a country.[16] The World Bank also supplements the information from the diagnostic tool with a due diligence exercise in capturing primary experiences of practitioners and other facts on professional accounting and auditing practices in a country. Upon completion of the due diligence, World Bank staff prepare a report presenting the factual findings arising from the review and make policy recommendations to help the country enhance its accounting and auditing standards and practices. Country stakeholders review the draft report. World Bank staff then prepare a final report taking into account comments received from the stakeholders and submit it to the country authorities for approval and permission to publish. Once agreed, these reports are published on the World Bank's website.[17]

Country stakeholders and World Bank staff co-develop a country strategy and action plan based on the recommendations of the ROSC report, and ultimately, the country strategy and action plan are implemented.

Involvement of Policymakers and Country Stakeholders

At the inception of a ROSC-A&A review in a given country, the country authorities (policymakers) identify the country stakeholders who have an interest in accounting and auditing matters. These stakeholders may include representatives from the Ministry of Finance, Ministry of Justice, securities market regulator, banking regulator, insurance companies and other non-banking financial institutions regulator, higher accounting educational institutions, professional accounting and auditing bodies, auditing firms, and institutional investors.

The in-country stakeholders participate in assessing key factors during the ROSC-A&A process, including the strengths and weaknesses of the existing institutional framework that underpin accounting and auditing practices; the extent of compliance with national accounting and auditing standards in practice; and the effectiveness of enforcement mechanisms. They also assist in identifying areas for improvements in accounting and auditing standards and practices. They act as a counterpart to the World Bank in the preparation of the ROSC-A&A report and country action plan.

16 The diagnostic tool is available at www.worldbank.org/ifa/rosc_aa.html.
17 See http://www.worldbank.org/ifa/rosc_aa.html .

Progress in Assessments

As of end-June 2004, 38 A&A ROSC modules have been completed, of which 20 have been published. Regionally, Europe and Central Asia has completed the greatest number of assessments, with 17 completed; followed by Latin America and the Caribbean, and the Middle East and North Africa—both with seven completed assessments; the Africa region has completed five; and East Asia and Pacific, and South Asia have completed two each. So far, the majority of A&A assessments have been conducted in middle-income countries, 27 in all, compared to only seven in low-income countries and two in high-income countries. However, as growing numbers of low-income countries have accepted the importance of private sector-led economic development, the need for strengthening corporate accounting and auditing practices has been increasing in these countries.

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CHAPTER IV

CHALLENGES AND SUCCESSES IN IMPLEMENTING INTERNATIONAL STANDARDS: ACHIEVING CONVERGENCE TO IFRSs AND ISAs

This chapter contains a study published by the International Federation of Accountants at the end of 2004. It addresses a number of questions, including the following: How do we move towards international convergence? What obstacles need to be overcome? What systems and processes can help facilitate international convergence? What roles can the IASB and IAASB and national standard-setters play in ensuring that international convergence is approached in a systematic and, where possible, consistent way?

Introduction

by Peter Wong

A financial reporting system supported by strong governance, high quality standards, and sound regulatory frameworks is key to economic development. Indeed, high quality standards of financial reporting, auditing, and ethics underpin the trust that investors place in financial and non-financial information and, thus, 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 themselves 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 auditing 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.

Before these benefits can be fully realized, however, there must be greater convergence to one set of globally accepted high quality standards. International convergence is a goal that is embraced in IFAC's mission, shared by IFAC member bodies, the international standard setters, and many national standard setters, and supported by international regulators. Achieving international convergence, however, requires more than theoretical support. It requires reaching consensus as to the international standards that will serve as the foundation for financial reporting and auditing globally, determining how to facilitate the adoption of those standards, and, ultimately, taking the actions necessary to encourage implementation. This report is a significant step in that process.

In November 2003, the IFAC Board agreed that there was a need to identify more clearly the challenges to adopting the international standards and to communicate successful examples of how the international standards have been and are being implemented. As a former IFAC Board member, past president of the Hong Kong Institute of Certified Public Accountants, and a Chartered Accountant who has worked with both national and international standards for many years, I was asked to lead this project.

The project, defined in more detail on page 77 entailed the collection of views from a cross-section of the international financial reporting community: representatives from regional and national professional accountancy organizations; IFAC committees and permanent task forces; national standard setters; users of financial statements; regulators; and professional accountants from a variety of backgrounds.

This report details my findings and proposed actions for addressing the identified challenges.

The objective of this report is to stimulate further discussions and actions on the adoption and implementation of the international standards so that we may move closer to the goal of international convergence. Based on the successes of adoption and implementation in some countries, I believe it is a goal that is achievable over time. Given the significant public interest benefits, it is also a goal that I believe we cannot afford to put aside.

Serving the public interest is one of the greatest challenges facing our profession. To do so effectively, we must all demonstrate that we follow high professional standards. The public will not and should not accept anything less. If there are any impediments to our ability to follow professional standards, IFAC, together with international and national standard setters, regulators, governments, and others identified in this report, must work together to address them head-on.

I am grateful for the help of the regional and national professional accountancy organizations that assisted in the arrangement of discussion groups, for those who took the time to participate in the discussions or to complete written submissions, and for the dedication of the IFAC staff in supporting me in this project.

Finally, I must state that the views in this report are my personal views and do not necessarily reflect the views of any of the organizations with which I am affiliated.

PETER H.Y. WONG
Peter Wong was a member of the Board of the International Federation of Accountants from 2000 to 2003 and is currently a member of the Board of the Global Reporting Initiative, which sets the Guidelines for Sustainability (Environment, Social & Economic) Reporting. He retired as Senior Tax Partner of Deloitte Touche Tohmatsu – Hong Kong in May 2002 and is currently a consultant to the firm. A past president of the Hong Kong Institute of Certified Public Accountants, he is now the chairman of the Business & Professionals Federation of Hong Kong.

Background

As the world continues to globalize, discussion of convergence of national and international standards has increased significantly. Most major capital markets are now actively discussing or pursuing efforts of convergence towards single sets of globally accepted accounting and auditing standards. IFAC, in an effort to facilitate international convergence, commissioned this study to explore the challenges and successes involved in adopting and implementing international standards. It is joined by international regulators, including the Basel Committee on Banking Supervision, the European Commission, the Financial Stability Forum, the International Association of Insurance Supervisors, the International Organization of Securities Commissions, and the World Bank, in recognizing that global capital markets require high quality, globally consistent, and uniform regulatory and standards regimes.

The Benefits of Globally Accepted International Standards

Globally consistent and uniform financial systems provide cost-efficiencies to business and greater safeguards to the public. The public is entitled to have confidence that, regardless of where a business activity occurs, the same high quality standards were applied. It is widely recognized that investors will be more willing to diversify their investments across borders if they are able to rely on financial information based on a similar set of standards. Thus, adherence to international standards, such as those developed by the International Accounting Standards Board (IASB) and the International Auditing and Assurance Standards Board (IAASB), can ultimately lead to greater economic expansion.

Support for International Convergence

The Financial Stability Forum (FSF)[1] included the International Financial Reporting Standards (IFRSs) issued by the IASB and the International Standards on Auditing (ISAs) issued by the IAASB in its *12 Key Standards for Sound Financial Systems*. The FSF indicated that these 12 Key Standards are most likely to make the greatest contribution to reducing vulnerabilities and strengthening the resilience of financial systems.

The report on *Rebuilding Public Confidence in Financial Reporting – An International Perspective*, issued in July 2003, provided further support for IFRSs and ISAs becoming the worldwide standards. The report was developed by the Task Force on Rebuilding Public Confidence in Financial Reporting – an independent group commissioned by IFAC to address, from an international perspective, the loss of credibility in financial reporting and approaches to resolving the problem. The task force recommended that convergence of national and international standards be achieved as soon as possible, viewing this as a significant public interest issue.

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[1] The FSF is an organization that brings together senior financial representatives of national financial authorities, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank to promote international financial stability.

IFAC has committed itself to the achievement of global convergence of national standards with IFRSs and ISAs. This is evidenced both in its mission statement and in its Statements of Membership Obligations. Published in April 2004, the Statements of Membership Obligations formally capture IFAC's longstanding requirement that its member bodies support the work of the IASB and IAASB by using their best endeavors to incorporate the IFRSs and ISAs in their national requirements (or where the responsibility for the development of national standards lies with third parties, to persuade them on a best endeavors basis to do so) and to assist with the implementation of IFRSs and ISAs, or national standards that incorporate IFRSs and ISAs.

As countries increasingly commit to converging national standards with IFRSs and ISAs, there is a need to ensure international convergence is approached in a systematic and, where possible, consistent way across jurisdictions. It also has made it necessary for interested parties, such as IFAC, the international and national standard setters, and international regulators, to understand the challenges in adopting and implementing the international standards so that they can be addressed at an early stage.

Scope and Project Methodology

This study seeks to explore those issues that affect the adoption and implementation of IFRSs and ISAs, provides examples of successful adoption and implementation to serve as models for other countries, and proposes actions to be taken by relevant stakeholders.

Numerous questions were addressed as part of this study. How do we move towards international convergence? What obstacles need to be overcome? What systems and processes can help to facilitate international convergence? What roles can the IASB and IAASB and national standard setters play in ensuring that international convergence is approached in a systematic and, where possible, consistent way? This report attempts to answer these questions based on input from a cross-section of the international financial reporting community.

Peter Wong, a former IFAC Board member with extensive international experience, was appointed by the IFAC Board to oversee the development of this study and address these questions among a variety of groups: those that develop the international and national standards, those that use the standards, and those that rely on work performed based on the standards.

The major fact-gathering process was as follows:

- A series of focus group meetings with members of regional and national professional accountancy organizations;
- A series of interviews with representatives of national standard setters, preparers, auditors, and users of financial statements, including regulators, and other interested parties;
- An invitation to IFAC member bodies to submit written responses; and
- Limited library research, focused on recent studies undertaken with regard to the adoption and implementation of the international standards.

Nine focus group meetings were held, approximately 20 interviews were conducted, and 29 responses to the invitation were submitted to IFAC. Those who participated in focus groups or interviews or submitted written responses are hereinafter referred to as "participants" in this study. The participants represented a broad range of perspectives – regulators, standard setters, preparers from entities of various sizes, auditors from large and small accounting firms, and investment professionals – and shared a combination of organization-wide and personal views.

Appendix 1 contains a list of focus groups, interviews, and respondents to the invitation to submit written responses. Appendix 2 contains a list of questions covered in these meetings, interviews, and the invitation to submit written responses.

Peter Wong, with the assistance of senior IFAC staff members, engaged in discussions regarding the following potential challenges in adopting and implementing the international standards:

- Issues of incentives – the various factors which might encourage or discourage national decision-makers from their adoption.
- Issues of regulation – regulatory challenges in their adoption.
- Issues of culture – challenges arising from cultural barriers in their adoption and implementation.
- Issues of scale – implementation barriers associated with the relative costs of compliance for small- and medium-sized entities and accounting firms.
- Issues of understandability – their complexity and structure.
- Issues of translation – the ease of their translation and the resources available to undertake the translation.
- Issues of education – the education and training of students and professional accountants in the international standards.

Subsumed in the above are issues related to the legitimacy and authority of the international standards and the integrity of those who have to implement them, i.e., to comply with the substance and form of the standards.

These challenges are explored throughout this report. The report also reflects reported successes in adopting and implementing the international standards. As more countries seek to adopt the international standards, experiences from those countries already well advanced in their adoption and implementation are of immense value to those that are still in the process, or are considering the steps to be taken.

The evidence contained in this report is anecdotal, as opposed to quantitative. Given the diversity of groups involved in the study and the consistency in responses, the study provides a clear indication of the challenges to be addressed to facilitate the adoption and implementation of the international standards.

It should be noted that the project focused on the adoption and implementation of IFRSs and ISAs. Where participants noted matters relating to the pronouncements issued by IFAC committees other than the IAASB, for example, matters relating to ethics, education, or financial reporting in the public sector, these matters have been communicated to the relevant committee.

Summary of Principal Findings and Basic Assumptions

Generally, participants were positive about the adoption and implementation of the international standards and confirmed that the IASB and the IAASB were the appropriate bodies to develop them.

Participants cited similar challenges related to the adoption and implementation of both IFRSs and ISAs. They were inclined to spend more time, however, discussing the international accounting standards than the international auditing standards. A participant (from industry) gave the following explanation for this: *"The international accounting standards have a direct effect on far more people than the international auditing standards. The complexity of the international auditing standards might flow through into the audit fee an entity pays, but the entity does not itself have to read, interpret, and implement the standards."*

The principal challenges identified by those involved in adopting and implementing IFRSs and ISAs are described in the following sections of this report:

- Understanding the Meaning of International Convergence
- Translation of the International Standards
- Complexity and Structure of the International Standards
- Frequency, Volume, and Complexity of Changes to the International Standards
- Challenges for Small- and Medium-sized Entities and Accounting Firms
- Potential Knowledge Shortfall
- Implications of Endorsement of IFRSs

This report explores these challenges in detail and includes success factors demonstrating how some countries and organizations have addressed or overcome some of the challenges. Additionally, proposed actions that are based on an analysis of the findings and participants' recommendations are included for each of the challenges. A list of proposed actions by each stakeholder group is featured at the end of the report. Although not agreed or endorsed by any formal group of IFAC or any other international organization, these proposed actions have been developed to further the goal of international convergence.

The proposed actions are premised on the following:

- Successful adoption of the international standards is dependent on the development of high quality standards.
- Integrity in the application of the international standards is essential. Preparers, auditors, and users of financial statements must encourage and support compliance with the substance and form of the international standards.
- The adoption and implementation of the international standards require action at both the national and international levels. At the national level, it is important that governments, regulators, and national standard setters place international convergence as a priority on their agendas. At the international level, it is important that the international standard setters establish processes and procedures that facilitate national input and lead to the development of high quality standards that are globally accepted.

Finally, it is clear that to achieve international convergence, action is necessary at all points along the information supply chain that delivers financial reporting. Boards of directors and management, who have the primary responsibility for financial reporting, as well as auditors, standard setters, regulators, and other participants in the financial reporting process, such as lawyers, investment bankers, analysts, credit rating agencies, and educators, all have important roles to play in achieving international convergence.

Understanding the Meaning Of International Convergence

What Does "Adoption" Mean?

The question, *"To what degree do you consider that the international standards have been adopted in your country?"* gave rise to varied responses largely because there was no universally accepted definition of "adoption." Participants referred to "adoption," "harmonization," "transformation," etc. without clearly defining what those terms meant. For example, what does it mean to be "largely harmonized?" One written submission noted that the national standards have been "based on" the international standards, and that the national accounting standards are at least 80% identical to IFRSs and the national auditing standards are at least 95% identical to ISAs. International convergence is a process, with adoption as the end result. However, without a universally accepted definition of "adoption," it is difficult to measure progress towards international convergence.

The World Bank, in preparing the *Reports on the Observance of Standards and Codes*, encountered similar diversity regarding the concept of adoption. It found that the adoption of IFRSs could be categorized as: full adoption of IFRSs; full adoption of IFRSs, but with time lag; selective adoption of IFRSs; and national standards "based on" IFRSs. The adoption of ISAs could be categorized similarly, but with one addition: adoption of a summarized version of the ISAs. Furthermore, in all the ISA categories the adopted ISAs may contain additional national requirements.

The time lag in adopting the international standards is due mainly to translation of the standards. For example, in one country a five-year time lag was experienced due to the need for translation of the ISAs.

Selective adoption of the international standards is due mainly to the complexity of the standards, the incompatibility thereof with national culture, or potential implementation problems. For example, in one country the ISAs were summarized in 33 pages, as the complete standards were felt to be "overwhelming." The implementation of these summarized ISAs was intended to be a first step to full adoption; however, that country is now in the sixth year of this temporary stage.

According to paragraph 14 of International Accounting Standard 1, *Presentation of Financial Statements*, financial statements shall not be prescribed as complying with IFRSs unless they comply with all the requirements of IFRSs. Paragraph 53 of the exposure draft of the proposed revised ISA 700, *The Independent*

Auditor's Report on a Complete Set of General Purpose Financial Statements, states that the auditor's report should only refer to the audit having been conducted in accordance with ISAs when the auditor has complied fully with all of the ISAs relevant to the audit. This leaves the preparers and auditors of financial statements in countries that have not fully incorporated the IFRSs and ISAs in their national standards with a dilemma. Although the national standards have been developed with reference to the international standards, they may not fully incorporate them and, consequently, the financial statements and auditor's report should not refer to compliance with IFRSs and ISAs.

Furthermore, a reference to national standards that are "materially the same" or "substantially the same" as IFRSs or ISAs is confusing and potentially misleading.

A MODEL OF CONVERGENCE

In March 2004, the Accounting Standards Board (ASB) in the United Kingdom issued a discussion paper, *UK Accounting Standards: A Strategy for Convergence with IFRS*. The paper sets out the ASB's views on the future development of national accounting standards. Specifically, it states that the ASB believes that there can be no case for the use in the United Kingdom of two sets of wholly different accounting standards in the medium term, and it should not seek to issue new standards that are more demanding or restrictive than IFRSs. These propositions require a concerted effort from the ASB to bring national accounting standards into line with IFRSs. The ASB intends to achieve this as quickly as possible while avoiding the burden of excessive changes in any one year and, in particular, minimizing the cases in which an entity using national accounting standards may be required to make successive changes of accounting policy in respect of the same matter.

Amendments for National Specificities

The adoption and implementation of the international standards in a country takes place in an environment that is affected by factors unique to that country, for example, the economy, politics, laws and regulations, and culture. A reason cited by participants for not fully incorporating IFRSs and ISAs is that countries find it necessary to amend the international standards to provide for national specificities. Projects undertaken by the Fédération des Experts Comptables Européens (FEE), the Auditing Practices Board (APB) in the United Kingdom, and the Australian Accounting Standards Board (AASB) further confirm this situation.

In March 2004, FEE issued a paper on *ISA+ in the EU: A Summary of Country-Specific Audit Requirements*, which categorizes additional national requirements as: additional explicit reporting required by law or regulation; additional exception reporting required by law or regulation; additional reporting required by national auditing standards; and significant additional procedures required by national auditing standards. National law, regulation, and auditing standards gave rise to many divergences from ISA 700, *The Auditor's Report on Financial Statements*. In addition, 11 of the 30 countries included in the summary identified one or more significant procedures not contained in the ISAs.

In June 2004, the APB issued an exposure draft on proposed *International Standards on Auditing (UK and Ireland)*. The APB is proposing to revise the existing national auditing standards to ensure that they, at a minimum, meet the requirements of the ISAs. In developing the exposure draft, the APB reviewed all the national standards to identify differences between the national standards and ISAs. Where identified differences were considered to be relevant and helpful, such material was incorporated in the ISAs for application in the United Kingdom.

The AASB has adopted the IFRSs with minimum amendments to accommodate national laws and regulations, eliminate some options, make the standards private and public sector neutral, make conforming amendments to the terminology in some of the IFRSs that have not recently been revised, and retain a small amount of guidance that is in the existing AASB standards.

Similarly, many other countries are finding it necessary to incorporate national legal and regulatory requirements and national practice in their adopted international standards or to eliminate international requirements because of “legal obstacles.” In the future, however, this practice may no longer be acceptable.

In accordance with the European Commission’s *Proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council Directives 78/660/EEC and 83/349/EEC* (March 16, 2004), European Union (EU) member states will be allowed to impose additional audit procedures only if these follow from specific requirements relating to the scope of the statutory audit. Furthermore, EU member states will have to communicate these additional procedures to the Commission.

In addition to national specificities such as national laws, regulations, and practice, the tax-driven nature of the national accounting regime was also identified as a barrier to international convergence. For example, in some countries one of the primary objectives of the national accounting standards traditionally has been to determine taxable income. Financial statements prepared in accordance with IFRSs are intended primarily to serve the needs of the capital markets, which may differ significantly from the needs of the tax authorities.

Date of International Convergence and Effective Dates of Adopted International Standards

In some instances, participants reported that their countries have adopted the international standards in issue at a particular date, but have not kept up-to-date with new and revised international standards issued subsequent to that date.

In other instances, it was found that the national standards have different effective dates and transitional provisions from those of the international standards on which they are based.

This leaves the preparers and auditors of financial statements in the same dilemma as discussed earlier. Any reference to compliance with the international standards should be made only if there was full compliance with all the international standards effective at that date.

Access to the International Standards

Limited access to some or parts of the international standards was identified as a barrier to international convergence. Some participants, particularly those from developing countries, were concerned that fees are being charged to obtain the IFRSs. Similarly, participants from the EU, who will have free-of-charge access to parts of the IASB literature, were concerned that guidance essential for proper implementation of IFRSs would not be available free of charge and, as a result, might not be considered by entities implementing IFRSs.

Conclusions and Proposed Actions

It is evident that international convergence is a process. This process could be enhanced by IFAC through greater clarification of the end result, i.e., the meaning of "adoption," and by the development of a more consistent and globally recognized measurement of international convergence. While consideration needs to be given as to how best to accommodate national laws and regulations, greater consistency in approach by those adopting the international standards is needed. Governments and regulators are encouraged to establish legal and regulatory environments that provide for compliance with the international standards, with no or very limited additional national requirements. Governments are also encouraged to acknowledge the differing roles of tax accounting and financial reporting.

National standard setters are encouraged to make international convergence the core of their work and the focus of their resources, and to interface with the international standard setters on behalf of their national constituencies. International standard setters need to continue to recognize the unique challenges faced by national standard setters and to provide sufficient opportunity for national standard setters to provide input to the international standard-setting processes. Of note is the joint effort by the Financial Accounting Standards Board (FASB) in the United States and the IASB to eliminate differences between the national accounting standards and IFRSs. (Many participants were of the view, however, that, when entering into such agreements, the international standard setters' focus should remain on the development of globally accepted high quality standards.)

National standard setters are encouraged to publish formal international convergence strategies, addressing matters such as the fundamental principles of convergence, the convergence process, the roles and responsibilities of the various stakeholders, and a timeframe for implementing their strategies. Translation issues (see next section) should also be addressed.

National standard setters are further encouraged to cover the criteria for additional national requirements as a fundamental principle in their formal international convergence strategies. Such additional requirements should be limited to those necessary as a result of national laws and regulations. National best practices not dealt with in the international standards should be communicated to and considered by the international standard setters.

In addition, national standard setters should consider how best to incorporate the additional national requirements in the adopted international standards. Varied approaches have been reported. For example, the exposure draft of the UK APB clearly differentiates additional material from the ISA content, while in the case of the French and German auditing standards, which incorporate the ISAs, the additional material is not separately differentiated. Clear differentiation of the additional national requirements is preferred since it facilitates easy maintenance of the adopted international standards and of the additional national requirements, and enables preparers or auditors who wish to comply with IFRSs or ISAs to distinguish the additional national requirements from the IFRSs or ISAs.

It is also recommended that regional professional accountancy organizations take actions to facilitate the adoption and implementation of the international standards. It has been recognized that the adoption and implementation of the international standards often has similar consequences for countries in the same region, and thus, solutions may be found at a regional level.

Well-organized and resourced regional professional accountancy organizations could assist national professional accountancy bodies and national standard setters by combining efforts to adopt and implement the international standards. They could facilitate input to the international standard-setting processes, translation of the international standards, and the education and training of preparers, auditors, and users of financial statements.

IFAC member bodies have an important role to play as well. IFAC has created a Member Body Compliance Program, which is designed to encourage IFAC member bodies to adopt and implement the international standards. The Statements of Membership Obligations are the foundation of the Member Body Compliance Program. They are designed to provide clear benchmarks to current and potential IFAC member bodies to assist them in ensuring high quality performance by professional accountants worldwide.

Additionally, IFAC has established the Developing Nations Permanent Task Force to support the development of the accountancy profession in developing nations by aiding their participation in the international standard-setting process and their efforts of seeking resources from other IFAC member bodies and other organizations in developing nations.

SUCCESS FACTORS

Factors that contributed to national standard setters' success in adopting and implementing the international standards include:

- The development of and commitment of all stakeholders to a formal international convergence policy that clearly states the fundamental principles of international convergence, the convergence process, the roles and responsibilities of all stakeholders, and the timeframe for international convergence.
- The establishment of good relationships with and cooperation among all stakeholders, including preparers, auditors, users of financial statements, governments, and regulators.
- The consideration of the effect that international convergence may have on small- and medium-sized entities and accounting firms.
- The establishment of a formal translation process, which involves both professional translators and professional accountants.
- The alignment of national standard-setting agendas and processes with those of the international standard setters.
- The devotion of significant resources to working with and influencing the work of the international standard setters.

Translation of the International Standards

The translation of the international standards is a major challenge in the adoption and implementation of the standards. Translators often find it difficult to convey the real meaning of the English text in the translated standards. Issues that were noted by participants as contributing to the difficulty of translation were the following:

- The use of lengthy English sentences;
- Inconsistent use of terminology;
- The use of the same terminology to describe different concepts; and
- The use of terminology that is not capable of translation. For example, international standards use words such as "shall" and "should" and the present tense to indicate different levels of obligations, while many languages are not capable of using the same indicators.

Most participants also felt that the international standards should be written in simple English that can better accommodate translations.

Another issue with respect to translations is the consistent use of terminology in the translated standards. To address this issue, some translators, in the first instance, have translated the international standard setters' glossary of terms, or some other list of key words. Some participants, however, were of the view that the IAASB's glossary of terms did not contain all the words that were thought to be "key." Mention was made of such concepts as "significant" or "material" which might well have different nuances in different languages, as well as being concepts that might be subject to cultural differences and influences.

Impact of Funding

Participants reported that donor funding is frequently used to support the translation of the international standards. Since this funding sometimes covers a one-time or specific project, organizations do not always have the resources to support the translation of new and revised international standards. Considering the frequency and volume of changes to the international standards, the translated standards soon become outdated, and preparers and auditors of financial statements can no longer claim compliance with the IFRSs and ISAs respectively.

Timetable for Translations

Concern was expressed that IFRSs endorsed by the European Commission and effective in the EU on January 1, 2005 may not all be translated in a timeframe that will allow for proper implementation. The Commission has indicated that it may take nine months from the publication of an IFRS by the IASB until the translated standard is available in the Official Journal of the Commission.

Participants also raised timing issues with respect to the international exposure drafts. Some national standard setters issue the international exposure drafts, or national exposure drafts incorporating the international exposure drafts, at the same time that they are issued by the international standard setters. This enables them to consider the comments received on a national level and to respond to the international standard setter. However, this may not be possible where the time allowed for submitting comments is short and does not take account of the time required to translate these exposure drafts.

Involvement of Professional Accountants

The majority of participants emphasized the importance of involving professional accountants in the translation of the international standards. There was also a concern that, should a translation of the international standards not involve the developers or users of the international standards, it may compromise the quality of the translation.

Conclusions and Proposed Actions

The International Accounting Standards Committee (IASC) Foundation has established a translation process for IFRSs, and in July 2004, the IFAC Board approved a Policy Statement on *Translation of Standards and Guidance Issued by the International Federation of Accountants*. It is hoped that these initiatives will facilitate high quality translations of the international standards. In addition, it was recommended that IFAC establish on its website a forum through which issues pertaining to translation might be reported and solutions shared, and that future exposure drafts of proposed international standards ask whether any issues might arise regarding translation of the standards.

To ensure consistency in translations and maximize available resources, countries that speak the same language are encouraged to coordinate their efforts and, over time, eliminate the existence of multiple translations of international standards into the same language. The French translation of the ISAs led by the Instituut der

Bedrijfsrevisoren – Institut des Réviseurs d'Entreprises (Belgium) and involving representatives of its counterparts in France, Canada, and more recently Luxembourg and Switzerland, have proved beneficial to all parties in achieving a common understanding and translation of key words.

With respect to translations of international exposure drafts, it was recommended that consideration be given to adding a 30-day period between when an international exposure draft is made available to national standard setters and when it is issued both internationally and nationally. This would allow national standard setters to translate the international exposure draft, insert a preface, and incorporate the necessary additional national requirements. Comments received on the exposure draft could then be considered at both a national and international level.

A national standard setter reported that it makes "rough" translations of proposed ISAs before final approval of the ISAs by the IAASB. This facilitates earlier implementation.

Finally, it is recommended that regional professional accountancy organizations take an active role in the facilitation of translations. Their involvement could help prevent duplication of effort and contribute to the release of timely and high quality translations. Additionally, efforts on their part to secure funding for translations could help make translated standards more broadly available.

SUCCESS FACTORS

Factors that contributed to national professional accountancy bodies' success in translating the international standards include:

- The development of a formal translation plan and establishment of a translation team that includes professional accountants.
- To ensure the consistent use of terminology, the translation of a list of key words in the first instance and, where appropriate, obtaining the input of translators of the international standards in other countries that speak the same language.
- Actively seeking and securing donor or other funding that not only covers the initial translation of the international standards, but also the translation of new and revised standards.
- The establishment of a translation process that provides for the early translation of proposed and final international standards, enabling earlier implementation of the standards.

Complexity and Structure of the International Standards

Participants were of the view that the international standards are increasingly becoming longer, more complex, and rules-based, and that the structure and complexity of the standards are affecting, largely in an adverse way, both their adoption and implementation. In particular, reference was made to the international accounting standards on financial instruments and the international auditing standards on audit risk, fraud, and quality control. Despite the comments on length and level of detail, a need for more implementation guidance was generally supported.

The international regulators, however, appeared to be supportive of the longer and more detailed ISAs issued recently. The length of and detail in the ISAs provide for a tighter regulatory environment and consistent application of the ISAs.

Participants emphasized the importance of applying a principles-based approach in international standard setting. It was felt that standards that are long, complex, and rules-based are difficult to implement and are likely to result in a compliance and avoidance mentality.

Participants reported that the international standard setters appear to have little or no sympathy for the fact that some countries need to incorporate their adopted international standards in national law or regulation. The international standards are not written in the form of law or regulation and, therefore, have to be "transformed" by the national standard setters. Or, as is the case in a country that incorporates the ISAs in its national auditing standards, the obligations are incorporated in national law or regulation and the explanatory text is incorporated in pronouncements issued by the national professional accountancy body.

A participant cautioned national standard setters against the above-mentioned approach since it may affect the authority of the national standards. For example, the obligations incorporated in national law or regulation may be authoritative, while the explanatory text published elsewhere may not be authoritative. It is, therefore, important to consider the hierarchy of national standards in comparison with the authority attached to the international standards.

Some participants also had difficulties understanding the ordering of text in the international auditing standards since the logic of the structure was not always clear to them. An example cited was the practice in ISAs of placing an obligation on the auditor, followed by definitions of terminology included in the obligation, and then explaining the obligation. Some participants felt that these steps should be treated in a different order.

Adding to the complexity of IFRSs is the IASB's move towards a fair value model. Many participants were of the view that fair value is a subjective concept and is difficult to measure accurately – different interpretations could lead to different conclusions. However, the investment professionals, who believe that the IASB is not going far enough in its fair value model, were of the view that the matter could be overcome by explaining the effect that fair valuation has on the financial position and results of operations in the financial statements. For example, the volatility caused by fair valuation could be disclosed in a separate section of shareholders' funds. The market (and regulators) will then know how to deal with this.

Conclusions and Proposed Actions

It is recommended that the international standard setters become more attuned to the challenges national standard setters and preparers, auditors, and users of financial statements face in adopting and implementing the international standards. In particular, participants recommended that international standard setters develop standards that continue to be principles based, the text of which is not complex, and the structure of which lends itself to incorporation in national law or regulation and to implementation.

The IAASB has taken a first step in this regard. It has undertaken a project to clarify the language and style of its pronouncements. The objective is to issue pronouncements that are understandable by those who perform the relevant engagements and are clear and capable of consistent application.

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

It has clearly been a very challenging time for preparers, auditors, and users of financial statements – not only as a result of new and revised international standards, but also because of the many new requirements emanating from parties other than the accounting and auditing standard setters. Participants questioned whether the cumulative effect of these changes on the preparers, auditors, and users of financial statements is being monitored by those who set the requirements. A participant recommended that the following question should be asked about every change: Will the value added exceed the cost to implement the change?

The frequency, volume, and complexity of the changes to the international standards are evidenced by the following:

- The IASB's Improvements Project, which gave rise to 13 standards being amended simultaneously with consequential amendments to many others (598-page document issued by the IASB in December 2003).
- Repeated changes of the same standards, including changes reversing IASB's previous stand and changes for the purpose of international convergence. These include changes to the international accounting standards on presentation of financial statements; accounting policies, changes in accounting estimates and errors; property, plant and equipment; the effects of changes in foreign exchange rates; and financial instruments.
- Complex changes requiring considerable technical expertise. These include changes to the international accounting standards on financial instruments, impairment of assets, and employee benefits.
- Changes to the IAASB's audit risk model, which gave rise to three new international auditing standards and consequential amendments to many others.
- New international standards on quality control, dealing with quality control at the accounting firm and audit engagement levels.
- A revised international auditing standard on the auditor's responsibility to consider fraud in an audit of financial statements, published in February 2004, while a previous revision of the same standard became effective for audits of financial statements for periods ending on or after June 30, 2002.

Given the above, national standard setters may decide not to adopt international standards that are subject to change in the near future. For example, the UK ASB proposes not to incorporate certain IFRSs in its national accounting standards. There are a number of different reasons for its decision. On cost/benefit grounds it does not wish to issue a national accounting standard that incorporates a relevant international standard, which is likely to change significantly in the near future.

Furthermore, as discussed earlier, in some countries the adopted international standards are incorporated in national law or regulation. Consequently, national law or regulation has to be revised every time the international standards are revised.

Also, due to frequent changes to the international standards, "real life examples" of best practice are not readily available to users of these standards.

Participants acknowledged that the international standard setters are working diligently to improve the international standards as soon as possible, with January 1, 2005 as an important target date for the IASB. However, they reported that it is equally important for the international standard setters to strike a balance between the need to improve the international standards on a priority basis and the need to address the practical issue of providing countries with the time they need to adopt and implement these standards. For example, allowing a short period of time to implement a complex IFRS that requires significant changes to an entity's financial reporting system or a complex ISA that requires significant changes to audit methodologies and training can undermine progress towards international convergence.

Conclusions and Proposed Actions

It is recognized that the international standards need to be responsive to market changes, the needs of investors, and diverse and complex financial products. However, given the frequency, volume, and complexity of changes to the international standards, the international standard setters should consider how they can effectively and efficiently accommodate national efforts to adopt and implement these standards.

The IASB achieved its target of issuing new standards and revising existing standards intended to apply to accounting periods beginning on or after January 1, 2005 by March 31, 2004. This allows entities in the EU, and in other countries that have committed to the adoption of IFRSs in 2005, at least some lead-time to transition to this IFRS "stable platform."

Furthermore, the IAASB is considering a "quiet period" for adoption and implementation of IASs. This quiet period would provide users of IASs a time during which no new or revised IASs will become effective. While the IAASB will continue to develop new or revise existing ISAs, those issued during the quiet period will not become effective before the end of the quiet period.

Going forward, it is recommended that the international standard setters collect information regarding a realistic adoption and implementation timetable for national standard setters and preparers, auditors, and users of financial statements. This should be factored into their standard-setting processes and the determination of the effective dates of new and revised international standards.

Furthermore, the implementation of the international standards is not only an accounting issue – it is also a business issue. Consequently, anticipated changes to the international standards should be considered at an early stage by the preparers of financial statements and the potential effect thereof discussed with all interested parties, including those charged with governance of the entity.

SUCCESS FACTOR

Matters relating to the frequency of changes to the international standards are being addressed. In preparing their international convergence timetable, national standard setters delay the adoption of those international standards that are under revision until such time as they are finalized. This prevents changes to a national standard shortly after incorporation of an international standard.

Challenges for Small- and Medium-sized Entities and Accounting Firms

In most countries, many or even all entities are required by national law or regulation to prepare financial statements that conform to a required set of generally accepted accounting principles, and for these financial statements to be audited in accordance with a required set of generally accepted auditing standards. These audited financial statements are normally filed with a government agency and thus are available to creditors, suppliers, employees, governments, and others. A large number of these entities are small- and medium-sized entities. In Europe, for example, it is estimated that there are about 7,000 public interest entities and more than one million private entities. (While the European Commission is calling for only listed entities that prepare consolidated financial statements to comply with IFRSs, it is possible that all public interest and private entities will be audited under ISAs beginning in 2007.)

Virtually all participants raised issues concerning the relevancy and appropriateness of the international standards to small- and medium-sized entities and accounting firms. Key concerns expressed were as follows:

- Length and complexity of the international standards;
- Cost of compliance with IFRSs versus benefits obtained;
- Inconsistent application of the international standards;
- Perceived focus on large-entity issues; and
- Lack of sufficient small- and medium-sized entity and accounting firm representation on the international standard-setting boards.

Comments on these issues are described further below.

Some national standard setters already seem to be working individually to determine how best to provide for financial reporting by small- and medium-sized entities in their national laws, regulations, or standards. These individual national approaches were not viewed as efficient and participants suggested that they would only pose a risk to international convergence. Additionally, comparability and consistency would be compromised if alternative approaches exist. Consequently, participants felt that it was very important for the IASB’s project to develop international accounting standards for small- and medium-sized entities to progress rapidly, with sufficient and appropriate input from small- and medium-sized entities.

With respect to ISAs, participants were of the view that the focus of ISAs has changed from the audits of financial statements of entities of all sizes to the audits of financial statements of large, complex, public interest, and often multi-national entities. The ISAs are progressively becoming more difficult to apply to the audits of financial statements of small- and medium-sized entities. The international auditing standards dealing with audit risk were mentioned as an example.

There was also a sense that the international standard setters do not recognize or appreciate the effect that changes in the fundamental principles of the international standards have on small- and medium-sized entities and accounting firms. The financial statements of small- and medium-sized entities are often used as the basis for tax preparation, banking covenants, and other reporting requirements. A whole re-education process, which extends beyond the preparers and auditors of financial statements to users, such as investors, lenders, tax authorities, and regulators, is necessary as a result of these changes.

A participant indicated that the small- and medium-sized segment needs to be further segmented to distinguish the very small from the rest. “IFRS light” or “ISA light” may not be appropriate for very small entities. Consequently, a different set of standards may have to be developed for a third segment – where financial reporting is mainly for tax authorities and banks.

Conclusions and Proposed Actions

In June 2004, the IASB issued a discussion paper on *Preliminary Views on Accounting Standards for Small- and Medium-Sized Entities*. The purpose of the discussion paper is to invite comments on the IASB’s preliminary views on its basic approach to develop international accounting standards for small- and medium-sized entities.

The IASB’s project was recognized as a significant step in addressing the needs of small- and medium-sized entities and participants encouraged the IASB to progress this project rapidly.

National standard setters and preparers, auditors, and users of financial statements of small- and medium-sized entities are encouraged to respond to the above-mentioned IASB discussion paper and to comment on relevant proposed pronouncements issued by the IASB and IAASB.

The IAASB has established a process to obtain the input of IFAC’s Small and Medium Practices Permanent Task Force on small- and medium-sized entity audit considerations to be incorporated in new and revised pronouncements.

The October 2004 European Congress for SME and SMP Accountants, organized by FEE, with the cooperation of Arc Méditerranéen des Auditeurs (hosted by Instituto de Censores Jurados de Cuentas de España), and featuring speakers from the IASB and IFAC, along with European leaders, is another important action. Activities such as these that provide a forum for dialogue between the international and national standard setters and small- and medium-sized entities and accounting firms are encouraged and much needed.

Finally, but most significantly, on an ongoing basis, the international and national standard setters should ensure that the needs of small- and medium-sized entities and accounting firms are addressed in the development of the international standards. For example, a participant recommended that ISAs be written with the simplest audit in mind and considerations for large, complex public interest entities should be added where necessary. Involving representatives from small- and medium-sized entities and accounting firms in the standard-setting process is seen as critical.

SUCCESS FACTORS

Factors that contributed to addressing successfully the needs of small- and medium-sized entities include:

- National standard setters including representatives from small- and medium-sized entities and accounting firms on their boards.
- National standard setters and professional accountancy bodies liaising with governments, regulators, and other interested parties to provide for differential reporting by small- and medium-sized entities.
- Small- and medium-sized accounting firms using the longer and more detailed ISAs to train their staff and to implement the ISAs.

Potential Knowledge Shortfall

Awareness, Knowledge, and Skills

The increasing proliferation and complexity of global issues, transactions, financial products, and standards present new challenges to the accountancy profession to ensure that it has the requisite knowledge and skills to carry out its responsibilities. In particular, there appears to be a potential knowledge shortfall with respect to the international standards.

Education and training were considered major challenges by most of the participants. They were of the view that only very few professional accountants have a detailed knowledge of IFRSs and the requisite skills to apply them.

For example, the results of a survey of members from business and practice conducted by the Institute of Chartered Accountants in England and Wales in June 2003 on the awareness of, and preparation for, the introduction of the international accounting standards revealed the following:

- A third of the respondents were either “not very aware” or “not aware at all” of the publication of the European Union’s regulation on the application of the international accounting standards;[2]
- Less than half of the respondents felt they were aware of the effect that the international accounting standards would have on their organization or its financial statements;
- Two thirds of the respondents were either “not very aware” or “not aware at all” of the IASB’s project timetable; and
- Only a quarter of the respondents knew what the UK ASB’s views and aims were in relation to the international convergence process.

[2] Regulation (EC) No 1606/2002, July 19, 2002.

The results of a recent PricewaterhouseCoopers survey[3] of more than 300 European companies show that just 10% of survey participants are confident they have the right people and skills in place to complete the transitions to IFRSs in the EU on time. Smaller entities, in particular, are finding it difficult to commit full-time resources to the implementation of IFRSs. The concern for entities is whether the people they need will be available as the demand for IFRS specialists reaches its peak in 2004/2005.

The World Bank, in preparing the *Reports on the Observance of Standards and Codes*, found that developing and emerging economies with no existing national standards find it most easy and appealing to adopt the international standards. However, due to a lack of knowledge of the international standards, and often capacity, they find it most difficult to implement them.

Some participants were concerned about over-reliance on the technical expertise in accounting firms. Entities that do not have the technical expertise are becoming more dependent on their auditors to interpret the IFRSs.

Implementation of the ISAs by networks of accounting firms should be easier due to the development and implementation of global audit methodologies and training programs incorporating ISAs as well as global internal inspection programs to monitor compliance with the standards.

Although many countries have incorporated the international standards in the education and training of students, a participant was concerned about educators' knowledge of the international standards since they normally are not involved in the implementation of these standards.

Another participant was of the view that the volume and speed of changes made it impossible for students to develop the skill and ability to apply the international standards. This participant reported a decline in students' ability to deal with problems critically and analytically. Students should be taught how to apply a framework of principles to different circumstances – for the detail, they could refer to the handbooks of international standards.

Participants were also concerned about the knowledge of analysts and the media. Participants representing professional investors, however, were of the view that analysts will be prepared for the transition to IFRSs.

A Need for Interpretations

There is a need for an easier and quicker way to resolve matters of interpretation of IFRSs. Participants commented on the need for the IASB and, in particular, the International Financial Reporting Interpretations Committee (IFRIC), to be more cooperative in this regard.

Participants were of the view that, at present, some IFRSs are open to varying interpretations and competitors are "shopping" for more favorable interpretation on

[3] International Financial Reporting Standards: Ready to Take the Plunge?, May 2004.

common issues. To prevent this, some industries have started to organize forums where leading entities could discuss their approaches to common issues.

A Need for Implementation Guidance

Participants reported a need for implementation guidance. They were of the view that implementation guidance is of particular importance when the international standards are applied for the first time, when there are translation issues, and when there is a lack of technical expertise and "real life examples" of best practice. In addition, reference was made to the implementation of the international standards in the context of, for example, national legal and regulatory frameworks and cultures.

Conclusions and Proposed Actions

National professional accountancy bodies are encouraged to continue to create an awareness and expand the knowledge of professional accountants and others of the international standards.

Educational institutions are encouraged to provide the educators with education and training in the international standards. They should also offer programs of accounting and auditing that produce accounting graduates familiar with the international standards.

For entities that are implementing IFRSs, an understanding of the standards is necessary from the top down – from those responsible for the governance of the entity to those responsible for financial and operational reporting by individual business units. Consequently, training programs should involve individuals at all levels of the entity and should continue after the initial transition to IFRSs.

There is also a need to make analysts and journalists aware of the effect that the transition to IFRSs may have on entities' financial statements. Participants encouraged entities to provide analysts with the information necessary to interpret their entities' financial positions and results of operations.

The international standard setters are encouraged to establish processes, or enhance existing processes, to respond to requests for interpretations in a timely manner.

Furthermore, urgent attention should be given to the development of implementation guidance that is widely available to all in need of such guidance.

There was no consensus as to who should develop the implementation guidance. Possibilities include: the international standard setters, national standard setters, national professional accountancy bodies, and large accounting firms. However, if the guidance is developed by anyone other than the international standard setters, there may be a lack of international coordination and a corresponding lack of consistency.

SUCCESS FACTORS

Factors that contributed to addressing successfully the potential knowledge shortfall include:

- National professional accountancy bodies offering training to their members by way of seminars, and large entities and accounting firms providing compulsory training to their staff.
- National professional accountancy bodies educating analysts and journalists on the effect that the transition to IFRSs may have on an entity's financial statements. This includes the issuance of press releases and posting of information on websites.
- Educational institutions involving staff from accounting firms in teaching the international standards.
- International organizations that represent industries, such as financial institutions, providing training to their members by way of seminars.
- Industries organizing forums where leading entities can discuss challenges and solutions to implementing specific IFRSs.
- Entities, viewing the transition to IFRSs as a business issue and not just an accounting issue, training staff at all levels, including those outside the financial reporting system, for example, staff responsible for determining the effect of new international accounting standards on an entity's remuneration policies.

Implications of Endorsement of IFRSs

As those in the EU and other countries continue to prepare to meet their upcoming deadlines for the adoption of the international accounting standards, they are faced with unique challenges, some of which are discussed in more detail below.

Two Sets of Accounting Standards

It is possible that after January 1, 2005 two very different sets of accounting standards may apply in the same EU member state, i.e., IFRSs and national accounting standards. The European Union's regulation on the application of international accounting standards[4] limits the mandatory adoption of IFRSs to listed entities that prepare consolidated financial statements. However, it provides for EU member states to decide whether to adopt IFRSs for other entities.

Some EU member states are amending national law or regulation to provide for compliance with IFRSs or national accounting standards by other entities, while others have decided to continue to require compliance with national accounting standards.

Although national laws or regulations and the irrelevancy and inappropriateness of IFRSs to small- and medium-sized entities were cited as some reasons for maintaining national accounting standards, the existence of two sets of standards has potential negative implications. Most obvious is the use of national accounting standards in the individual financial statements and IFRSs in the consolidated financial statements of the same entity. Also, students and preparers, auditors, and users of financial statements will have to know two sets of accounting standards.

[4] Regulation (EC) No 1606/2002, July 19, 2002.

Limited Application to Listed Entities

As discussed earlier, the European Union's regulation limits the adoption of IFRSs to listed entities that prepare consolidated financial statements. Participants were concerned about other public interest entities, such as financial institutions, that may not be listed.

Potential Late Endorsement or Non-endorsement of IFRSs

Participants indicated that the European Commission's potential late endorsement or non-endorsement of the international accounting standards on financial instruments is creating uncertainties for preparers, auditors, and users of financial statements.

There are serious implications if non-endorsement of some IFRSs result in a European standard in one or more areas. FEE cites the following implications in *its FEE Position – Call for Global Standards: IFRS* (June 2004):

- Extra disclosures to explain differences from IFRSs, for reasons of transparency.
- Entities would no longer be able to claim that their financial statements were prepared in accordance with IFRSs, with related consequences for the audit and the auditor's report.
- The effect that any unique European standard may have on financial reporting systems. For example, changes with regard to the recognition, measurement, and disclosure of complex financial instruments.
- A risk that some entities, such as financial institutions, that apply or want to apply the non-endorsed IFRS will be seriously disadvantaged.
- Access to capital markets could be restricted or made more expensive.
- A loss of opportunity to converge IFRSs and U.S. accounting standards and possible effect on other elements of transatlantic dialogue.
- A risk of setting a precedent.

Referring to the potential late endorsement or non-endorsement of the international accounting standards on financial instruments, participants were concerned about the politicians' role in international standard setting. This concern is well summarized in a speech of Bob Herz, chair of the U.S. FASB at a conference of the American Institute of Certified Public Accountants and the U.S. Securities Exchange Commission held in December 2003 (his references are to both the IASB and FASB): "*All our constituents, including politicians, have a very legitimate interest in our activities. But I believe that interest must be in our properly fulfilling our mission of establishing sound, neutral accounting standards and not in trying to bias our activities and decisions through pressure and threatened intervention into our independent and, we believe, objective process … Standard setting should not be a political process because the primary objective must be on the relevance, reliability, and usefulness of reported information and not on trying to satisfy the favored economic, business, social, or political goals of particular interest groups …*"

Preparedness for the Adoption of the International Standards

The results of the recent PricewaterhouseCoopers survey[5] of more than 300 European companies indicate that, given the greater risks involved, large entities have made more progress towards implementation of the IFRSs than smaller ones. Also, financial services companies were slightly further advanced with their preparations. According to the survey results, this could be because they are intensely affected by the international accounting standards on financial instruments.

The results of the survey set out seven steps that entities need to work through in order to embed IFRSs, and indicated the degree to which those surveyed have achieved them.

STEP	ACTION	PROGRESS
1	Assess the high-level impact of IFRSs on the business (at least preliminary assessment)	75%
2	Decide on accounting policies (at least for high priority areas)	46%
3	Identify the missing data	26%
4	Enhance systems to collect data (at least for high priority areas)	11%
5	Put processes in place to ensure data collected is robust	10%
6	Design internal controls to demonstrate reliability of data	10%
7	Embed IFRSs and use for internal management reporting	11%

In Australia, which is also working towards the implementation of IFRSs on January 1, 2005, a survey of 122 corporations conducted by the Institute of Chartered Accountants in Australia (ICAA) in July 2004, has revealed that less than half of those surveyed (49%) have commenced the implementation process for IFRSs. However, the percentage of respondents preparing for the implementation of IFRSs would grow to 84% within the next six months.

One of the most critical issues for entities will be explaining to investors and analysts how their financial position and results of operations will differ under IFRSs compared with their previously applied national accounting standards. The PricewaterhouseCoopers survey found that 80% of entities had not organized their communications plans. According to the ICAA survey, only 35% of respondents have started to communicate to stakeholders the effect of IFRSs on the financial position and results of their entities.

The Committee of European Securities Regulators (CESR) has recommended that entities provide markets with appropriate and useful information in a phased process. For example, it is recommended that a narrative of IFRS transition progress and key accounting differences between previously applied national accounting standards and IFRSs be included with the 2003 financial statements.

Conclusions and Proposed Actions

As the deadline for the adoption of IFRSs approaches in the EU and other countries, such as Australia, it is critical for all stakeholders to identify and address any outstanding matters.

[5] International Financial Reporting Standards: Ready to Take the Plunge?, May 2004.

Referring to the discussion paper on *UK Accounting Standards: A Strategy for Convergence with IFRS* as an example, a participant recommended that national standard setters in countries that offer entities other than listed entities the option to comply with IFRSs or national accounting standards should have formal international convergence strategies. Working towards one set of accounting standards, they should evaluate their national accounting standards to identify differences between the national accounting standards and IFRSs, and actively contribute to the international standard-setting process. (This could equally be applied to countries that do not offer the option, as the ultimate goal should be international convergence – i.e., one set of globally accepted accounting standards.)

Governments or regulators should consider the application of IFRSs to public interest entities that are not listed and that do not prepare consolidated financial statements.

Ongoing dialogue regarding any delay in the endorsement or non-endorsement of a particular international standard is necessary so that all stakeholders could plan accordingly and a contingency plan, addressing concerns of regulators and the relevant international standard setter, could be developed and agreed.

Furthermore, entities that are planning to or have adopted IFRSs are encouraged to actively contribute to the international standard-setting process, in particular to identify practical implementation issues.

Entities that are planning to adopt IFRSs are encouraged to identify differences between the previously applied national accounting standards and IFRSs, design and implement an IFRS transition program, and address required financial reporting system changes. They should also provide training to staff at all levels.

Additionally, professional accountancy bodies, national standard setters, and entities that are planning to or have adopted IFRSs should clearly communicate to the users of the financial statements, including analysts and journalists, the effect of the adoption of IFRSs on entities' financial positions and results of operations. Local seminars could be held in this regard.

Proposals for Actions by Stakeholders

Action is necessary at all points along the information supply chain that delivers financial reporting. Governments, regulators, international and national standard setters, reporting entities, and auditors, as well as other participants in the financial reporting process, have important roles to play in international convergence.

Actions needed to support international convergence are highlighted below.

Governments and Regulators

- Establish legal and regulatory environments that provide for compliance with all the international standards, with no or very limited additional national requirements.
- Write or revise laws and regulations to reflect the international standards and international best practice.

- Designate financial reporting laws and regulations as a high priority and act within a reasonable period of time.
- Establish efficient and effective enforcement mechanisms to increase the consistency and quality of compliance with the international standards.

International Standard Setters (IASB and IAASB)

- Establish a process, or enhance the existing process, whereby national standard setters, in aligning their agendas with that of the international standard setters, have an opportunity to actively contribute to the international standard-setting processes.
- As a matter of urgency, develop standards in a manner that takes account of small- and medium-sized entity financial reporting and audit considerations. In addition, provide for greater small- and medium-sized entity and accounting firm representation.
- Address concerns about the complexity and structure of the international standards.
- Write standards in simple English that is understandable, clear, and capable of translation and consistent application.
- In developing the international standards and setting effective dates, be cognizant of the fact that proposed and final standards are being translated in some countries that are adopting them.
- In considering changes to the international standards, be cognizant of the cost vs. the benefits of the proposed changes.
- Establish a process, or enhance the existing process, to respond in a timely manner to requests for interpretations.
- Consider the development of implementation guidance.
- Provide, or continue to provide, unlimited access to all authoritative pronouncements and implementation guidance.
- Institute a “quiet period” for the adoption and implementation of the international standards.

National Standard Setters

- Develop a formal international convergence strategy and obtain the commitment of all stakeholders.
- Develop an active standard-setting agenda, which is aligned with that of the international standard setters and aimed at eliminating existing differences with the international standards. This should be achieved within a reasonable period of time.
- Establish a process, or enhance the existing process, to actively contribute to the international standard-setting processes, including the development of international standards for small- and medium-sized entities and accounting firms.

Reporting Entities

- Design and implement an IFRS transition program and allocate the necessary resources. This includes obtaining the commitment from the top down, i.e., from those charged with governance to those responsible for financial reporting by individual business units. Also consider the interdependencies between the

transition to IFRSs and other financial reporting projects, such as compliance with national laws and regulations.
- Prepare to implement IFRSs by identifying differences and addressing required financial reporting system changes.
- Design and implement plans to change management reporting used to monitor the performance of the business from the previously applied national accounting standards to IFRSs.
- Provide IFRS training for staff at all levels affected by the transition to IFRSs.
- Develop an external communications strategy.
- Actively contribute to the international standard-setting process, in particular, to identify practical implementation issues.
- Consider at an early stage anticipated changes to the international standards and discuss with all interested parties the changes' potential effect on the financial statements.

Auditors

- Raise an awareness of the international standards among clients.
- Align audit methodologies and training with the international standards.
- Provide IFRS and ISA training to staff at all levels.

Analysts and Investors

- Promote convergence of the national standards with the international standards.
- Actively contribute to the international standard-setting processes, in particular to identify users' needs.
- Provide IFRS training to staff at all levels.

International Federation of Accountants

- Study and further develop the concept of "international convergence," i.e., when has a country achieved convergence of its national standards with the international standards.
- Establish a process that facilitates translation of the international standards.
- Monitor and enforce compliance with IFAC's Statements of Membership Obligations.
- Assist member bodies with the development of action plans to ultimately achieve compliance with the Statements of Membership Obligations.

Regional Professional Accountancy Organizations

- Coordinate contributions to the international standard-setting processes, translations of the international standards, and training in the international standards at a regional level.

National Professional Accountancy Bodies

- Facilitate the adoption and implementation of the international standards through compliance with IFAC's Statements of Membership Obligations.
- In line with the Statements of Membership Obligations, assist government, regulators, and the national standard setters in formulating and enacting

convergence of the national and international standards, and in addressing impediments to international convergence (e.g., tax reporting vs. financial reporting).
- Support the preparation of high-quality translations of the international standards.
- In line with the Statements of Membership Obligations, create awareness and expand the knowledge of students, professional accountants, and others of the international standards.
- Establish processes that facilitate maximum contribution to the international standard-setting processes – representing the views of professional accountants and others on all relevant issues.

Educational Institutions

- Educate and train the educators in the international standards.
- Offer programs of accounting and auditing that produce accounting graduates familiar with the international standards.

Summary and Conclusions

Listening to national standard setters and preparers, auditors, and users of financial statements, it is clear that there are many challenges to achieving international convergence. As mentioned earlier in the report, all those involved in the financial reporting process will need to take action. Much of this action is highlighted in the Proposals for Actions by Stakeholders section on pages 100-103.

As progress on international convergence continues, particularly in the EU, it is vital that there be frequent open and ongoing dialogue between regulators, international standard setters, and national standard setters and that these groups continue to listen to the concerns and needs of those who will have to implement the standards. Significant consideration should be given to the effect of international convergence on small- and medium-sized entities and accounting firms.

The greatest challenge for the participants was "preparing or preparedness for the adoption of the international standards." What must be done nationally? What support, if any, can be expected from the international standard setters? How will national initiatives to achieve international convergence affect the reporting entities in a country, and what actions should be taken nationally to address these effects, and who should take these actions? How can the education and training of professional accountants keep pace with the changing environment in which the international standards are being set? Who will keep investors, analysts, journalists, and members of the public informed of these changes and their consequences?

As international convergence progresses, questions like these will continue to be raised. All those working to achieve international convergence – from IFAC to regional and national professional accountancy organizations to international and national standard setters and international and national regulators – can and should help to resolve the challenges.

Most importantly, we all need to remember that convergence to a single set of globally accepted high quality standards is ultimately in the best interests of the public, contributing to efficient capital flows within countries and across borders. In the views of the majority of participants, international convergence is vital to economic growth. Thus, while the challenges are great, the rewards are potentially even greater.

Appendix 1: List of Focus Group Meetings, Interviews, and Respondents

Written submissions were received from:

Association of Chartered Certified Accountants
Association of Professional Accountants and Auditors of the Republic of Moldova
Auditing Standards Committee of the Institute of Chartered Accountants in Ireland
Britannia Building Society (United Kingdom)
Certified General Accountants Association of Canada
Chartered Institute of Public Finance and Accountancy
Consiglio Nazionale dei Dottori Commercialisti (Italy)
Federación Argentina de Consejos Profesionales de Ciencias Económicas (Argentina)
Föreningen Auktoriserade Revisorer (Sweden)
KHT-yhdistys - Föreningen CGR ry (Finland)
Hong Kong Institute of Certified Public Accountants
Howarth Central America
HTM-tilintarkastajat ry (Finland)
Institut der Wirtschaftsprüfer (Germany)
Institute of Certified Public Accountants in Israel
Institute of Certified Public Accountants of Singapore
Institute of Chartered Accountants in Australia and CPA Australia
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants of India
Institute of Professional Accountants of Russia
Instituto de Censores Jurados de Cuentas de España (Spain)
Instituto Mexicano de Contadores Públicos, A.C. (Mexico)
Instituut der Bedrijfsrevisoren – Institut des Réviseurs d’Entreprises (Belgium)
Japanese Institute of Certified Public Accountants
Koninklijk Nederlands Instituut van Register-accountants (Netherlands)
Malaysian Institute of Accountants
Malaysian Institute of Certified Public Accountants
National Board of Chartered Accountants of the Accountants Association in Poland
PricewaterhouseCoopers

Focus group meetings were arranged by the following:

Chartered Institute of Management Accountants
Confederation of Asian and Pacific Accountants
Eastern Central and Southern African Federation of Accountants
Fédération des Experts Comptables Européens – Audit Working Party
Fédération des Experts Comptables Européens – Financial Reporting Policy Group
IFAC Small and Medium Practices Permanent Task Force
Instituto dos Auditores Independentes do Brasil (Brazil)
Inter-American Accounting Association
United Kingdom Resident Members of the Analyst Representative Group

Interviews were held with representatives from the following:

Accounting and Auditing Standard Setters in Australia
Accounting and Auditing Standard Setters in Canada
Accounting and Auditing Standard Setters in Denmark
Accounting and Auditing Standard Setters in South Africa
Accounting Standard Setter in the United Kingdom
Basel Committee on Banking Supervision
Professional Oversight Board for Accountancy (United Kingdom)
Transnational Auditors Committee
World Bank

Appendix 2: List of Questions Covered in FOCUS GROUP Meetings, Interviews, and Written Submissions

These questions were asked in relation to both the pronouncements issued by the IASB and the pronouncements issued by the IAASB.

- To what degree do you consider that the international standards have been adopted in your country?
- Has the structure or complexity of the international standards affected their adoption or implementation? If so, how?
- Does the legal process for adoption of the international standards in your country cause any impediment to adoption? If so, to what extent?
- Is there enough lead time to allow for adoption of the international standards?
- If you have had to translate the international standards from English, have there been issues of clarity of the original text? If so, how have these been addressed?
- Are there any issues pertaining to the applicability of the international standards to listed entities, small- and medium-sized entities, and not-for-profit organizations? What issues have been raised and how have they been addressed?
- To what extent do you think that professional accountants are knowledgeable of the content of the international standards? Are there any concerns that need to be addressed? If so, how?
- Are there any concerns regarding students' knowledge of the content of the international standards? How is this being addressed?
- Are the consequences of adopting the international standards acceptable to users?

CHAPTER V

CORPORATE DISCLOSURES: SELECTED ISSUES

This chapter contains articles on selected issues on corporate transparency. The first article discusses corporate governance practices in companies based in the Russian Federation. The second and third discuss the implementation challenges of IFRS in Brazil and Thailand respectively.

Corporate Governance Practices in Russian Companies[1]

Igor Belikov

Positive changes in the Russia Federation in recent years have made a tangible impact on Russian companies' development strategy. More companies began moving from a short-term strategy of benefiting from control over financial flows to the long-term development of their business in the climate of stronger political stability, sustainable growth and developing competence.

In 1998–2001, the largest Russian business groups barred major foreign investors from the Russian Federation as rivals in the buying of assets. The situation began to change in 2002. More groups are evolving into something like investment funds that lend to companies or buy them in order to restructure them, increase their market value and eventually sell them to a new investor. Unlike in the first post-1998 crisis years, these groups tend to invest in the companies that control a substantial market share, set the development tendencies in their sectors and have a large capacity for value growth. Business groups helped to start leader companies in the sectors that are new to the Russian Federation. They include MTS (majority shareholder: AFK Sistema) and Vympelcom (one of the largest shareholders is Alfa Group), which are the leading CEE telecommunications companies. They were from the start based on a model used by the top Western companies, which included investments through the regular issue of shares and their placement in the largest international exchanges.

The largest integrated business groups are separating ownership and management. The controlling owners are gradually distancing themselves from direct management of assets and are focusing on control and strategic management. The largest owners (shareholders) leave their CEO offices to take up the chairmanship of the boards of directors of the companies that they control, and of the governance bodies in charge of the general oversight of the group. As a result, business groups

[1] This article was contributed by Dr Igor Belikov, CEO, Russian Institute of Directors (belikov@rid.ru).

are building a governance framework that helps them design a uniform strategy and oversee its implementation by the subsidiaries.

There is a point to be made here: in most cases, owners are not separated from management even in the largest companies. Most large Russian owners are still very active in the day-to-day management of their companies.

The high concentration of ownership in the largest Russian companies may be expected to continue in the medium term. As a rule, owners try to retain control even when they sell some of their stake to outside investors. A survey by Standard & Poor's in October 2003 showed that 30 out of 45 companies with the highest market capitalization had the controlling shareholder (owner of more than 50% of the voting shares) and 44 companies had large stock owners. The actual ownership concentration level might be higher because of the affiliation of the formal owners.

Some Russian companies that started as medium-sized or even small private firms, with few owners, made a breakthrough in the post-crisis years, took leading positions in their industries and entered the Russian and international stock markets.

Wimm-Bill-Dann Foods is the most prominent example. It started with a single juice-bottling line and annual returns of $30,000 in 1992 to become the biggest Russian producer of juice and milk products, with the returns of about $1 billion. In 2002 WBD placed shares on the New York Stock Exchange. Experts project that the share of the 10 largest integrated business groups in the Russian Federation's total industrial output will be declining by 1-2% a year as a result of the vigorous growth of medium-sized companies.

Consolidation of assets in the parent companies registered in the Russian Federation, with the prospects of moving to a single share, plays a large role. Consolidation greatly improves corporate transparency for investors and minority shareholders. According to experts, a large share of the proceeds that Russian companies exported in 2003 was related to the assignment of ownership from offshore companies to companies registered in the Russian Federation. However, these companies, too, have a high ownership concentration in a small group of shareholders who take part in management.

About 20-25 companies announced intended IPO in the next year or two. They operate in the metallurgical sector (Severstal, Mechel, Magnitogorsk Metallurgical Combine, VSMPO-Avisma, Ural Mining and Metallurgical Company), wood and woodworking (Ilim Pulp Enterprise), machine engineering (Power Machines), food (Cherkizovsky Plant), defence (aviation association Irkut), trade (Perekrestok [Crossroads] trading house) and energy (Belon); and there are also some multi-industry holding companies, (AFK Sistema). Many more companies are planning the initial private placement.

These factors enhance the role of corporate governance as an important component of companies' overall development strategies. The advanced corporate governance standards take root very unevenly in different groups of companies and face considerable restrictions. However, one can say already at this point that the Russian Federation is forming a group of large owners who realize that a functional corporate governance platform helps achieve a sustainable balance of different groups' interests. It provides for a higher corporate value and the protection of shareholder rights, and helps them oversee the management's work.

The Russian business community has recognized the need to improve corporate governance practices. This recognition has been demonstrated in the ways described below.

Positive changes have occurred over the past few years in the practice of preparing and conducting the annual general meeting (AGM) in Russian companies. This is particularly true with regard to such aspects as regularity, notification of shareholders, drafting the agenda, compliance with the AGM authority, voting procedure and vote count. The practice of conducting the meetings in locations that were difficult to access for most shareholders, common in the 1990s, became an exception even for the companies that operate in remote regions. Greater opportunities for preparing for a discussion are allowed to the shareholders. The general meeting agenda usually includes issues on which the shareholders have been notified in advance. Agenda items initiated by managers or large shareholders after the notice has been sent out are not eligible for discussion.

Concurrent general meetings held by the conflicting shareholder groups remain an acute problem. This is allowed by the legislation in force. It envisions an extraordinary general meeting at the request of shareholders who own more than 10% of the voting shares if the board in office has declined their request. Clearly, this problem is directly related to expanding the minority shareholders' capacities to protect their rights in cases where most seats on the boards represent the controlling shareholders, while the judicial system is not yet functioning properly. One solution could be to amend the law on joint-stock companies. Amendment could provide for a dispute resolution in court if the board of directors refuses to convene a general meeting at the request of shareholders who own up of 10% of the voting shares.

Candidates for the board of directors are nominated by the shareholders themselves, and this does not require their approval by the board in office. Most minority shareholders, particularly international ones, use this right broadly and nominate their candidates. The practice of making a pool of minority shareholders' votes to elect their candidates to the board has been spreading increasingly.

The results of audits carried out by the regulators show that the positions of CEO and chairman of the board are separated in all large Russian companies and in many medium-sized ones. According to RID data, the share of non-executive directors on many boards has also increased.

An IFC survey shows that the boards of 32% of medium-sized regional companies do not have executive directors. On the whole, executive/non-executive directors in the companies polled correlate as 1:4. At least three quarters of all board members are non-executive directors, which is consistent with the requirements of Russian law.

Boards of directors, particularly in the large companies, have strengthened their role in control over management. This is mostly true with regard to such aspects as the approval of strategy and implementation oversight, approval of large transactions, and restructuring. Practice shows that companies comply with the statutory requirements for the minimum number of board members and election of the board by cumulative voting.

Most seats in Russian boardrooms are still taken by people who are related to the management in one way or another. There is, however, clearly stronger representation of minority shareholders and independent directors. These include prominent foreign businessmen – namely, Mark Mobius, Guy de Selier, Mark O'Neil, Richard Mazke, Rudolf Birhoff, Roderick Braithwait, Ronald Freeman, Heinz Schimmelbusch, Michael Winer and Seppo Remes. United Heavy Machinery became the first Russian company to have a majority of independent expatriate directors on its board.

In January 2004, an US analytical agency – Energy Intelligence – published a corporate governance rating based on evaluation of the board performance in the top transnational oil and gas companies.[2] YUKOS was rated second, Sibneft was eighth, and LUKOIL was eleventh. The average score was 59.7 for the US companies, 53.9 for the European ones and 52.8 for the Russian ones. Typically, these three Russian companies were ahead of several leading Western corporations. Russian companies had a lower average score because the quality of corporate governance in such companies as Gazprom and Surgutneftegaz was substandard.

A small number of companies established special internal committees, for example audit, corporate governance, nominations and remuneration committees, which were further proof of the board's increasing importance. Before 2002, only four or five companies traded on foreign exchanges had such committees in their boards.

Corporate secretaryship is developing as an institution. Corporate secretaries should provide for much better communication between the company and its shareholders.

Companies establish collective executive bodies, namely management boards, mandated to make decisions on issues that most affect the interests of shareholders. In particular, they approve large transactions with corporate assets. According to IFC, management boards were established in 21% of the surveyed Russian regional companies with shareholders ranging in number from 50 to 1,000, and in 33% of companies with the number of shareholders exceeding 1,000.

Disclosure of information about companies' performance is an important factor in improving corporate governance. A resolution issued by the Federal Commission on the Securities Market (May 2002) required joint-stock companies to disclose the following information to shareholders while preparing general meetings: the company's position in the industry; development priorities; the board report; the main risk factors; biographies of the board members, executive manager and members of the collective executive body, and their share ownership; criteria for defining the

[2] The rating evaluated the board on the basis of several indicators, each scored by the 100-point scale: number of members; separation of chair and CEO positions; size of stake owned by directors; independence of the board and its committees; and regular re-election of board members.

amount of remuneration paid to these persons (case-by-case or gross); and compliance with the Code of Corporate Governance. The annual report should be signed by the person who acts as the single-person executive body and by the chief accountant.

Companies have reported some progress in their disclosure practices. In September 2002 and 2003 Standard & Poor's surveyed the transparency of 45 Russian companies, including 18 companies on S&P/IFCI. The companies surveyed account for about 98% of the total capitalization in the Russian stock market. S&P experts reviewed the quality of disclosures, particularly as perceived by an international investor, by using 98 parameters related to the structure of ownership, relations with investors, financial and industrial figures, and the board and management membership and procedures. On the basis of the 2002 findings, experts concluded that the transparency level in the Russian companies was consistent with the figures reported by Latin American companies. The 2003 survey found further positive changes in some areas. While the level of disclosing information about the survey issues reached or exceeded 50% of the maximum in only three Russian companies in 2002, the 2003 survey identified 12 such companies. The average level of disclosures by the Russian companies surveyed was 40% in 2003, as against 34% in 2002.

The survey showed that the disclosure levels were very uneven in this group of Russian companies. Thus, the quality of disclosures by several corporations that top the ranking list (Wimm-Bill-Dann, MTS, Rostelecom) makes them equal to many Western companies in this respect. However, the companies that follow them in the list disclose much less information, while the disclosures by the bottom companies are clearly insufficient. The most acute problems remaining unsolved regarding disclosure are disclosure of beneficiary ownership and executives' remuneration.

Certain positive changes have occurred in the past few years in giving effect to the legal rights and interests of shareholders during major corporate actions (large transactions; transactions with interest; restructuring; consolidation; mergers and acquisitions; payment of dividends). Under the current law, large transactions are those that affect at least 25% of the company's assets and require compliance with special procedures. Many companies extend these procedures to the transactions that affect much smaller assets. Transactions that affect up to 5% of total assets are treated as large, and this practice is becoming common. Some companies set this threshold at a much lower level. For instance, Svyazinvest and its subsidiaries have internal corporate standards that require large transaction procedures for all operations with assets exceeding 0.5% of the total asset value.

A shareholder's basic right is to receive an adequate share in the company's profits. The level of its observance strongly affects a company's attractiveness for investors. Russian companies usually seek to minimize dividend payments. Many do not pay dividends at all. This is partly reasonable because of economic considerations. Many companies, particularly medium-sized ones, need large funds to modernize their worn-out fixed assets. However, companies that had posted large profits and seek to attract investors have begun paying sizable dividends in recent years. Ninety-five Russian companies that reported the largest profits paid the total of Rub 31.1 billion in dividends in 2001 and Rub 82.7 billion in 2002. Most oil companies paid 15-22% of their net yearly profit in dividend. Uralkalii paid over 40% of its net profit as dividends in 2002. Norilsk Nickel and Severstal also paid large dividends at the end of nine months in 2003. Analysts say that the leading companies will pay over 40% of net profit in dividends in the period immediately ahead.

According to IFC, less than 30% of regional Russian companies with turnover below $10 million and more than 50% of companies with turnover above $10 million paid dividends. The share of net profit spent on dividends increased from 16% in 2000 to 21% in 2001.

The largest companies – Norilsk Nickel, LUKOIL, YUKOS, SUAL-Holding, Rusal, Severstal and Vympelcom – have much expanded their work in the social sphere in the past years. Their programmes include an environmental agenda, scholarships for talented students, support to museums, theatres and children's creativity centres, donation of computers and modern school equipment to rural schools, housing loans to employees and pensioners, and corporate pensions.

According to the UK-based charitable organization Charities Aid Foundation (CAF Russia), Russian corporations spend about $500 million a year on corporate philanthropy and social programmes (80% goes to the municipal and local authorities, and 20% to orphanages and arts centres). According to the companies themselves, Norilsk Nickel spent $100 million in 1997-2003 alone on relocation of Norilsk residents from the Arctic regions to European Russia. Severstal spent $30 million on social projects in 2002.

In April-May 2003, the independent Center for Economic and Financial Studies, the Helsinki School of Economics and the Institute of Economies in Transition of the Bank of Finland polled 404 large and medium-sized industrial companies (except fuel ones) in 40 Russian regions. The poll showed that companies spent 8.4% of their payroll to finance social services in 2002. This totals Rub 97 billion (0.9% of GDP) across the industrial sector. Experts also note that many companies are granted tax discounts in exchange for funding social programmes.

The first steps toward applying the advanced corporate governance standards of the securities issuers were taken by the Russian stock exchanges. In 2003 they introduced the new rules for listing securities. Under these rules, issuer companies whose securities are on the high-level quotation lists must comply with the key provisions of the national Code of Corporate Governance. It should be mentioned, however, that the formulations of these requirements are not always clear and watertight, and the requirements themselves are not always identical. While building up their portfolios, the unit investment funds are not yet required to heed the status of corporate governance in the companies whose securities they buy.

The professional manager community has been proactively consolidating, drafting and putting in place professional standards. The Association of Managers publishes semiannual rankings of 1,000 leading Russian managers evaluated on the basis of seven criteria. Managers' good performance in corporate governance is a key criterion. The Association of Specialists in Investor Relations has been operational in Russia since 2002. It drafts standards in this field and works towards improving its members' qualifications.

The Russian Institute of Directors, established in late 2001, has carried out a number of surveys of corporate governance practices.[3]

A system of alternative dispute resolution is being built in the Russia Federation. In 2002 RUIE adopted the Charter of Corporate and Business Ethics and established an arbitration panel. It has a membership of 60 comprising the leading Russian businessmen, government officials and experts. The arbiters initially discussed only breaches of corporate ethics where both parties voluntarily agreed to take part in the conflict resolution. In November 2003, they decided to consider a complainant's petition in the absence of the other party to the conflict if it refuses to attend meetings. The board may penalize businessmen who have breached the norms of business ethics by putting them on a list of unreliable partners and by having these cases covered in the media and on the websites of the leading business associations.

Industrial and professional associations have activated the drafting of codes for the best corporate governance practices and business ethics. Ice cream, confectionery and alcohol producers may be cited as examples. The Russian Code of Advertisement was adopted in late 2002. It is designed to regulate the relations of different parties in the advertising business. Work is in progress on the professional codes of auditors and accountants. Their effectiveness will greatly depend on how consistent all parties prove to be in their compliance with the codes' principles.

Large assets, mostly holdings in different companies, remain in federal and municipal ownership. One key task for the representatives of the Government on the boards is to promote the advanced norms of corporate governance. The Ministry of Property Relations and FCSM co-drafted directives for the representatives of the Russian Federation on the boards of directors (supervisory councils) of open joint-stock companies with federal ownership. These directives guide implementation (use) of the Code provisions. In general, however, representatives of the federal and regional governments in the joint stock companies' management/governance bodies are not doing a good job. Their weak motivation for sitting on the boards is particularly noteworthy. If the situation is to be changed, coordination should be strengthened among agencies that handle corporate governance issues. Secondly, there is a need to focus efforts on companies whose strategy is based on using the stock-market capacity.

The scope of positive changes in corporate governance practices of private Russian companies is still limited to a small number of companies. There is a group of large companies whose management and controlling investors seek to increase capitalization and make their business more attractive for investors by improving corporate governance. The goal of their efforts is the possible sale of large stakes to strategic investors, better terms of borrowing, entry into the external market and joint projects with foreign companies. Company management views the national Code of Corporate Conduct as important, albeit not the only, guidance when it drafts the internal standards of corporate governance. However, these companies also are improving corporate governance and introducing the Code of Corporate Conduct very unevenly. A small group have achieved changes for the better in some fields, and

[3] See the RID website www.rid.ru.

only a few leaders comply with many best practice recommendations and the Code provisions.

The main outstanding issues are as follows:

- Developing a clear information policy, describing it in the company's internal documents and implementing it;
- Increasing the volume of information disclosed about the company's performance, particularly with respect to the structure of ownership, boardroom work and remuneration paid to top managers;
- Drafting the performance evaluation criteria and procedures, and regularly evaluating the board, its members and top managers;
- Providing for the oversight functions of the board: establishing internal committees, having them chaired by non-executive directors, and drafting documents that describe the committees' functions and authority;
- The need for boardroom work to be guided by clear and transparent professional and ethical standards;
- The need for Internal control systems to be build with due regard for the board's priority role;
- The need for procedures to be in place to identify and resolve conflicts of interests;
- Developing special criteria to define the amount of remuneration paid to the board members and top managers, and disclosure of information about remuneration packages;
- The need for procedures for preparing and implementing the key corporate decisions to be more effective; and
- Developing and implementing a clear dividend policy.

Improvement of corporate governance in Russian companies requires not just greater efforts by the Russian regulatory authorities, executives and controlling shareholders, and greater consciousness on their part, but also support by other parties involved and solution of some fundamental problems beyond the reach of Russian business and government.

Specifically, so far, speculative portfolio investors that seek short-term profit dominate in the Russian stock market. An analysis of the investment market in the Russian Federation shows that its main players are speculative foreign and Russian portfolio investors seeking to invest in seriously undervalued assets with a high potential for short-term growth. In years past some investment companies have achieved three-figure annual returns. Their investment horizon is usually very short – from several days to several weeks or sometimes months. This category of investor seeks high returns through significant growth in stock price and is willing to take big risks, including bad corporate governance. However, the willingness of short-term portfolio investors to take such risks is not unlimited. Therefore, they advocate improving the system of corporate governance in the companies they invest in. To varying degrees, they monitor and assess the risks of corporate governance in these companies. Only 15-20 Russian companies ("blue chips") have been targets of transactions by this category of investors.

The quality of corporate governance in these companies that is acceptable to these investors is much lower than best practice standards and is inextricably linked to the specific characteristics of these companies – their very large size, their dominant position in their industries (and often their leading positions in the world markets for copper, nickel, rare metals, oil, aluminum, etc.), and the high degree of government regulation of their business. In other words, not only do investors in this category accept rather low quality of corporate governance in these companies in exchange for the very high return on investment, but also they view the company characteristics described above as additional guarantees. A large premium was paid for the transition from a primitive to a higher level of corporate governance, which is still below the foreign best practice recommendations. This transition was made by a group of the largest Russian companies, particularly in the resource sector (e.g. YUKOS, Sibneft, and later LUKoil).

A review shows that this new level of corporate governance includes such policies as the consolidation of ownership in the parent company, disclosure of the main beneficiary owners, discontinuation of asset stripping, a move to IAS-consistent reporting, the adoption of a code/declaration of corporate conduct, election of a few foreign businessmen of good reputation as independent directors (by the controlling shareholders(s)), establishment (or announcement) of two or three board committees (in the first place, such as the audit, remuneration and nominations committees), payment of sizable dividends, payment of interim dividends (although their timelines are not necessarily the same for all shareholders), and issue (or announcement) of ADRs. But having paid the premium to the named small group of companies, these investors to pay it for further improvement in them because of their limited financial capacities and orientation at very high profit margin. While advocating the refinement of corporate governance in Russian companies, speculative investors are not prepared to pay a sizable premium for moving towards best-practice standards. The higher prices for the shares issued by the most attractive companies do not match these investors' limited resources, and the possible yield growth does not appear attractive enough.

In 2003, the Russian Institute of Directors (RID) conducted a study, in which it compared changes in stock prices of companies with the lowest and highest corporate governance practices disclosure rates. In general, the study showed an overall positive correlation between good corporate governance and changes in stock price on the leading Russian stock exchanges. However, this conclusion is mostly applicable to a small group of 10-12 blue-chip companies. With respect to others, it was not so clear that investors voted with their money in favour of better corporate governance. The study revealed that in most cases it was actually the size of the company and its market share that are the main or, perhaps, even the exclusive factors that investors rely on when deciding whether to buy stock of a Russian company.

Major promoters of good corporate governance, namely large Western institutional investors, have not operated in the Russian securities market so far. The leading Russian companies might expect recognition of their corporate governance achievements from long-term portfolio investors that manage pension and insurance funds. Their entry into the Russian market and/or the larger purchases of Russian stock abroad might be a powerful incentive for the companies to improve corporate governance and move toward best practices.

The fact that the blue-chip companies have mainly exhausted the interest of speculative portfolio investors creates a good opportunity for other companies. Such companies would include primarily large companies that have maintained a closed strategy until now, such as Russian Aluminum, Sistema Joint Stock Financial Corporation, ALROSA, a number of metallurgy and mining companies, and some of the larger companies that are medium-sized by world standards, but have leading positions in such industries as forest products (for example, Ilim Pulp), food (Cherkizovskiy meat processing plant), and machine-building (Power Machinery, United Heavy Machinery). RID estimates that at least 40 to 50 companies in this category have already acquired the necessary characteristics to allow them to begin attracting regular investments from speculative investors within the next two to three years.

The priority task for Russian regulators, business community and investors is to help make a group of 150-200 companies become attractive for investment in terms of their performance indicators and the level of corporate governance. A breakthrough beyond the limited group of “blue chips” (10-15 companies) will give investors much broader opportunities for risk diversification and make the Russian market more liquid and sustainable. Improvement of corporate governance in these companies, in the event of their continuous growth, could open up new opportunities for portfolio investors, especially speculative ones, and provide a steady boost to the securities market. The target for these companies should be not an “ideal company”, usually advocated by consulting companies and some other stock market intermediaries, but a transition from "taiga" corporate governance to the one which is currently practised by a few leaders in the Russian market (which is far from ideal). Their corporate governance performance should be measured as assessed against this yardstick.

The high ownership concentration in large and most medium-sized Russian companies changes the operating mechanisms of corporate governance as compared with those countries that have a diversified ownership structure, particularly the United States. The priority objective of corporate governance in the Russian Federation is not so much to ensure sound control over hired management by the minority shareholders as to build relations between the controlling (or very large) shareholders and the minority ones. In recent years the focus has shifted to the relations between the controlling shareholders of the parent company and managers and minority shareholders of subsidiaries within business groups. The existing board practices are largely related to the high concentration of ownership in Russian companies and to the large owners’ participation in management. The core standards of international best practices with respect to the boardroom work, are based on the experience of companies with diversified ownership, require that control and the authority to make the key decisions be delegated to the independent directors who do not have pecuniary links with management. As a rule, they represent numerous small shareholders who do not take part in management/governance and oversee the hired managers on their behalf and instructions. Clearly, the problem will hardly be solved if this oversight model is simply replanted in an environment where the CEO is often the controlling shareholder. In this case, the manager disposes of assets that belong to shareholders but also assumes higher owner’s risks than other shareholders. He has the strongest motivation for making efforts towards the company’s long-term development. But he is also greatly tempted to use the advantages only to his own benefit or shift the largest costs onto other shareholders, particularly in crises. Seeking a solution to this problem is a "front-burner" issue not for the Russian Federation alone but for all countries with a high concentration of shareholder ownership.

Given the acute lack of well-trained managers with experience of working in a market economy, a company's successful development could be advanced if there is a balance of different categories of directors in its boardroom – that is, if there a significant number of executives sit on the board, though not absolutely "independent" of the company. The board with formally fully "independent" directors with little or no experience whatsoever in managing real business under market economy conditions will hardly be an advantage in the Russian context.

Consulting companies, including the largest ones, and other market intermediaries use high-powered rhetoric about the need for Russian companies to disclose information on an ever-growing scale as a basic precondition for attracting investment. However, their actual behaviour and investment decision-making quite often do not match that rhetoric. An analysis shows that most analysts of investment companies operating on the Russian stock market hardly pay attention to anything beyond the EBITDA, the size of the company and its market share.

Foreign portfolio investors, while vociferously calling for disclosure of beneficiary ownership of Russian companies, often refuse to disclose their own identity or the identity of their customers. Very often portfolio investors are hidden behind nominal holdings, including those in leading Western banks, and offshore companies and Russian companies can do little to ascertain their identity. Thus, the problem of beneficiary ownership disclosure cannot be solved without international cooperation, particularly with regard to regulating offshore business.

Russian and foreign banks could contribute to significantly the advancement of corporate governance in the industrial companies. They could assess corporate governance in issuer companies among the risk factors and link the cost of credits to this factor. Russian banks, however, do not pay attention to it when assessing the borrower's risks. A survey of corporate governance practices in Russian banks, which IFC carried out in late 2003, reaffirmed this. Nor do foreign banks that operate in the Russian Federation pay any systematic attention to borrower companies' corporate governance. Furthermore, they do not correlate the cost of credit with the level of corporate governance in the borrower company. The RID failed to obtain any confirmation from other IFIs and foreign banks in the Russian Federation that the credit rate correlated with the level of corporate governance in the borrower company in late 2003 and early 2004.

Investors, including foreign ones, operating in the Russian Federation do not seem to pay any attention whatsoever to the social responsibility of companies whose stocks they select for investment purposes, despite the insistence of consulting companies on the importance of this factor and their offers to provide services for the drafting of reports. Moreover, financial analysts consider expenses for social programmes as reducing the EBIDTA and thus as a pure deduction from the shareholders' wealth. It is remarkable that experts at Standard & Poor's, while awarding Corporate Governance Scoring to Russian companies, criticized Russian telecom companies (Sibirtelecom, S&P CG Scoring Report, July 2003; Rostelekom, S&P CG Scoring Report, December 2003) for investing in the extension of telephone and communication lines in remote and less-populated regions. This contrasts sharply with the rhetoric about the positive effect of social responsibility on corporate image, and particularly with the “UNCTAD Report On Electronic Trade and Development in 2003”, which praised such investment as very positive for the telecom companies of India, Chile, Brazil and some other emerging markets.

Evidently, since the objective indicators of corporate governance practices in Russian companies and companies of Eastern European countries, Baltic States, Brazil, Chile, Thailand and a number of other countries are approximately similar, the practices of Russian companies will be awarded lower grades owing to the "political discount".

Most medium-sized and small businesses have a corporate governance agenda which is different from that of large companies. Russian and international experience proves that the medium-sized companies’ main sources of investments are bank credits and cooperation with direct investors, rather than the placement of securities on the stock market. Evaluation of corporate governance in these companies will be addressed through negotiations between the owners and prospective new shareholders. It was thus very surprising to see a survey of corporate governance carried out by the International Financial Corporation (World Bank Group) in 2002 in the Russian regions among 307 companies with an average annual turnover of just $1 million, an average of 255 shareholders and average of 250 employees. Forty per cent of those companies seek to attract investment of less than $1 million and seek to attract investment of 30% - between $1 and $3 million within next 3 years. The survey concluded that improvement of corporate governance up to the international “best practices” standards is at the top of those companies' development agenda, a conclusion that is very much open to doubt.

For example, the Regulation on Additional Requirements for the Procedure of Preparing, Convening and Holding a General Meeting of Shareholders was adopted by the Russian Federal Commission for the Securities Market in May 2002. It requires joint-stock companies to disclose, in their annual reports, information about the company’s position in the industry its priority areas development prospects and the main risk factors related to its operations. The rules for listing the securities in A-level quotation lists at MICEX and RTS require the issuer companies to disclose information about changes in their key financial and business figures and development trends relative to information in the periodic reports or in the prospectus of securities. They must also disclose breaches of terms and conditions of a debt or credit obligation, which might make a creditor eligible to require that these obligations be honoured before their due date; substantial deterioration of the company’s financial and economic situation; restructuring of debt obligations; plans related to reorganization or restructuring of the company; changes in implementation or termination of business projects that are substantial for the company; and a large contraction of consumer demand related to a large contraction of the company’s total earnings. Clearly, the implications of such disclosures will be different (to put it mildly) for the companies that report sales of billions or dozens of billions of dollars, have a single-digit number of competitors and expect to borrow hundreds of millions or billions of dollars on the stock market, and for companies that report earnings of a few dozen (or even hundreds) of millions of dollars but often have more than a hundred competitors.

Building a comprehensive system of corporate governance consistent with the international best practice recommendations is scarcely expedient economically in the medium-sized companies. It entails substantial costs and risks. Accordingly, regulator requirements concerning the scope of disclosed information and corporate governance practices should be much less stringent than those applied to the companies traded on the market. It is equally doubtful whether corporate governance practices in such group of companies can be used correctly in order to assess corporate governance practice at the national level.

The experience of other countries shows that the main sources of capital for medium-sized companies are bank loans and direct investors rather than securities put out on a stock market and intended for portfolio investors. Currently, the Russian banking system does not meet the requirements for economic growth. The need for banking reform is obvious, and the task of creating a functional banking system cannot and should not be supplanted by unfounded hopes that the stock market can replace the banking system, especially for medium-sized companies.

The Brazilian Challenges of Implementing IAS/IFRSs: The Analyst's View [4]

I would like to first say a few words about APIMEC – the Brazilian Association of Investment Analysts and Professionals.

APIMEC was founded in 1970 as ABAMEC – the Brazilian Association of Capital Markets Analysts, and in 2003 changed its name and scope, and included all investment professionals as members – that is, all professionals that in some way or another are involved in the investment decision-making process in financial institutions and corporations. The Association has a national reach and has six regional offices: in São Paulo, Rio de Janeiro, the Northeastern Region, the Federal District, Minas Gerais and the Southern Region.

In 2000, working in conjunction with EFFAS – the European Federation of Financial Analysts Societies, and ASAF – the Asian Financial Analysts Federation – the Association co-founded ACIIA (the Association of Certified International Investment Analysts). ACIIA is a not-for-profit organization established in the United Kingdom. Its role is to promote and oversee professional admission tests for the Certified International Investment Analyst (CIIA) diploma, and to grant this qualification to the investment professional, both internationally and locally. Associations from 22 countries/territories are part of ACIIA: Germany, Austria, Belgium, Brazil, China, the Republic of Korea, Spain, France, the Netherlands, Hong Kong (China), Hungary, India, the Islamic Republic of Iran, Italy, Japan, Luxembourg, Poland, the Russian Federation, Sweden, Switzerland, Thailand and Ukraine.

The main objectives for APIMEC are the following:

- To foster and develop financial and capital markets (courses, seminars, round tables, speeches);
- To prepare investment professionals (courses, discussions on technical commissions, certification);
- To improve the relationship between all participants in the market (meetings with companies, visits to manufacturing plants, partnerships with other market organizations and regulatory agencies);
- To advocate and/or suggest measures that update and improve financial and capital market regulations (taking part in public hearings on regulations, committees and commissions of regulatory agencies and other organizations);
- To stimulate and monitor the application of best practices in ethical conduct and professional standards (Ethics Committee, Code of Ethics,

[4] This article was contributed by Haroldo Reginaldo Levy Neto, Vice-President, APIMEC, SÃO PAULO (haroldo.levy@apimecsp.com.br).

Certification and Registration at the CVM – the Brazilian Securities and Exchange Commission).

THE BRAZILIAN CHALLENGES OF IMPLEMENTING THE IAS/IFRS

The world was sadly made aware of the importance of the accounting system only after the recent scandals in the United States. The positive result is that accounting is now seen as an important component in the worldwide economy.

Since I am an economist and analyst, I am of course, not writing to teach you accounting. What I am trying to do is to give you the view of someone who uses the accountant's work as a tool in the development of his own work.

Let me remind you that in Brazil we have around 600 public companies. Some 300 of them are required to file reports regularly, and only around 60 publish more information than is required by law. Additionally, there are a little over 30 companies that also publish their statements according to the US GAAP because they have ADRs issued in the United States. We also have the multinational non-public companies that as a rule publish their statements according to the US GAAP, and a few publish them according to the IFRs. Therefore, very little is known in Brazil about international accounting rules.

Let me focus on a very important issue in the view of financial and capital market participants: what they require from companies to be able to invest or advise others to invest in securities, and to fund the development of such companies.

These requirements are:

Transparency: everything that can be transmitted to the market should be;

Clarity: transmit always in a simple and direct form;

Plain language: make it easy for all users to understand;

Timeliness: always transmit timely information;

Simultaneity: at the same time for all participants in the market;

Consistency: maintain consistency between all accounting statements and explanation notes;

Comparability: making it possible to make comparisons in time and with other organizations in the same industry to avoid user misinterpretation of projected trends;

Be essential: make the essential rule over form as regards the allocation of accounts;

Stability: of rules;

Reality: mirror the true position as close as possible if complete precision is unattainable;

Ethical principles: do not favour any particular group; always do the best for the company and therefore for all shareholders; and, obviously, do so in accordance with the accounting rules and principles currently in force;

Corporate governance: be equally accountable to all stakeholders;

Social responsibility: show greater concern with human beings than with material assets;

Sustainability: transmit information that shows the possibility of long-term sustainability of businesses;
TRUST – all this translates into what is the most important asset in every market: **credibility.**

There are some **issues that still hinder the work we all do in Brazil**. Let me mention some of them to you:

The main challenge is the transition from local customs towards international rules. The Brazilian accounting rules follow the fiscal rules, for most of the time going against best practices. Companies under-report their profits in order to avoid paying hefty taxes. Accounting should be focused on end users, with no tax or any other bias, and should always be adjusted to mirror the true assets of an organization, clearly demonstrating the causes of any changes in order to allow the assessment of its operating conditions.

Depreciating assets without properly taking into account their service life, may lead to a situation where such assets are accounted for at values significantly lower than their actual market value. Such a situation may result in to recognition of unrealistic gains on the disposal of assets accounted for in this manner.

All leasing operations may be accounted for as operational expenses, generating expenses to decrease taxes, and can be left unrecorded as assets.

The lack of monetary correction is another important distortion with which we live today and that gives rise to other distortions made to bring results closer to reality. This seems to be a worldwide problem which is not being dealt with.

Present value has also been discussed in some cases, but there is as yet no conclusion in this regard.

Legal aspects

APIMEC, as well as other market organizations, has since 1990 studied the reform of the Public Companies Act of 1976, which is the law that regulates all aspects pertaining to the Brazilian accounting rules.

The requirement for presenting a statement of cash flow instead of statement of sources and applications, for example, was part of the changes that the 1976 law brought about. In 1991, a project was developed on this requirement and was discussed in APIMEC with the participation of representatives from the main financial institutions, in addition to accountants and auditors, and of Abrasca, the Brazilian Association of Public Companies. Afterwards it went to the CVM's Consultative Commission on Accounting Rules, and from there it was delivered to the CVM for examination. Approval was granted, but the project was shelved. It was decided that it would be best to include this part in the full reform of the Act, which is forthcoming. As a result, nothing has yet been done about accounting in terms of the law.

The present preliminary Act that modifies the parts of the law related to accounting took a new strategic route:

- By being sent to the Consultative Commission at the beginning of 1995, in an attempt to achieve the necessary reforms of the Act;
- This preliminary Act was delivered from the CVM's Consultative Commission to the CVM (May 1996) and to the Minister of the Economy, Pedro Malan (August 1996);
- The preliminary Act was immediately issued for public consultation until December 1996;
- The CVM then reviewed all suggestions from its various areas, from Accounting Rules to Legal;
- July 1999, the bill was finally delivered in an official act in Brasilia by the CVM president, the representatives of the Consultative Commission and the representatives of the capital markets to the Minister of the Economy, who should have sent it to Congress for approval;
- However, that did not happen, and the bill is still in Congress since some of its issues still meet with resistance from some representatives of large non-public companies who do not wish to publish their information and from the representatives of the Federal Board of Accounting, which regulates the profession and does not accept the creation of an entity or a committee to independently unify the publication of accounting norms.

Practical aspects

The following issues should be taken into consideration:

Obstacles:

- To approve the change in the law;
- Some time must be provided to allow the adaptation to the new rules, especially with regard to companies;
- There will be an increase in costs to be absorbed by everyone who will be preparing and using the accounting statements;
- There is a need to disseminate knowledge about the new regulations to accountants, auditors, analysts in general, company directors, etc..

Advantages:

- Provide greater flexibility to the CVM in regulating the use of local norms more compatible with international standards;
- Greater ease and quality in comparing accounts and economic and financial indicators between industries and companies throughout the world, increasing trust and as a consequence lessening risk; and most importantly, the decrease in capital costs would generate increased investments and growth for the economy.

There are many ways in which we can try and improve the quality of the information provided by companies to the market:

- One of them, the most complex, is through **changes in the legislation**. Among the 50 actions established by the Capital Markets Plan initiated by APIMEC, which today groups together over 90 organizations, is to work for the approval of the accounting section of the Public Companies Act, currently being discussed in Congress. Since the bill is stalled, we (CFC, IBRACON, APIMEC, ABRASCA and FIPECAFI) are already working on a new private entity that will establish best practices in Brazilian accounting;
- Another way is through **changes in the rules under which the CVM can operate**, and that can help to achieve this goal more rapidly;
- A third possibility, and surely the one that may yield the best results, is a **change originating in the market**, whereby participants demand, discuss and reach a common denominator, and companies and market entities abide by it.

Therefore, in addition to improved quality of the present instruments, we can voluntarily obtain a series of other instruments that can help investment professionals and investors in general to better evaluate their investment options, until an adequate harmonization of accounting standards has been achieved. These are for example:

- The **Cash Flow Statement**, used for many years as one of the main instruments to assess and project fair company prices;
- The **Added Value Statement**, which shows the amount of wealth that has been generated for shareholders, employees, the community and the Government, and how much has been invested in the company itself;
- The **Social Statement**, which can show corporate social behaviour with an objective view of the social performance of the company and the perception of its social values and practices;
- The **Global Reporting Initiative**, which is a much wider instrument to visualize the principles of a company's sustainability with regard to the environmental, social and economic aspects.

Therefore, it is important that those that prepare accounting statements and those that issue them are fully integrated and prepared to provide the information the users of these statements want and need to know. To that end, those who prepare the statements must be closer to market participants in order to understand their needs. This can be achieved either directly or through third parties who work with them daily, such as investor relations professionals from their companies, that are the ones who issue the statements.

All this will allow investment professionals to make use of the adequate accounting basis accompanied by additional, backward and especially forward analysis, complemented with their macro and microeconomic assumptions, and other issues such as corporate governance practices, disclosure and dividend policies.

Therefore, if the accounting base is not a good and trustworthy one, which mirrors the truth, all the work based on it may be lost. Alternatively, it will not be taken into account and therefore there will be no investment and/or financing for the company, or the investment professional will be misled in interpreting the future outcomes for the company, and the investor will suffer a loss. This could jeopardize the development of the financial and capital markets, and consequently the economy as a whole.

In conclusion, it is necessary that:

- The accounting system be compatible with the necessities of the market, which is becoming ever more rapid and sophisticated;
- The accounting professional be knowledgeable not only about accounting principles and the best techniques and practices, but also about the needs of all users;
- The investment professionals know accounting, but also become aware of any difficulties in applying the best accounting practices, especially owing to interference by the Brazilian tax legislation, which comples companies to adhere to it for obvious reasons;
- The Executive, the Legislative and the Judiciary know the matter in greater detail and also the needs of all users of the Brazilian accounting system.

There is a worldwide movement towards the use of harmonized accounting rules, such movement may become fully developed in 2005 in most countries. However, although we are making progress, we need a greater engagement by all parties to allow our own process to move forward at a faster pace.

This movement of Brazilian accounting norms towards the IFRS may help the work of analysts in the following ways:

- Greater transparency;
- Increased quality;
- More comparability, both local and international;
- Greater consistency with the current analytical view;
- Greater flexibility and, with the existence of a Steering Committee on Norms, greater independence in the formulation of statement models and their rules.

It is important that all parties involved in this process make an effort to allow the process to continue towards the harmonization of accounting norms, which, if accompanied by the flexibility to cope with local particularities, will most surely generate increased confidence and in turn accelerate the development of the capital market, whose credibility is in a state of crisis. This will ultimately contribute to the sustainability of the world's economies.

A Convergence of International Financial Reporting Standards: The Case of Thailand[5]

Executive summary

Thailand, faced with economic downturn and devaluation of its currency in 1997, was forced by the International Monetary Fund and the World Bank to change its accounting standards to International Accounting Standards (IAS). The changes in accounting standards were influenced by the United Kingdom's standards, the United States' standards and International Accounting Standards, and were effected within a period of two years. Confusion, controversy, conflict, and criticism were apparent during that time. The strategy was then changed to slow down the process and select only the necessary standards to be implemented. The criticism has been dying down.

With the new improvement projects of IAS in December 2003 and new International Financial Reporting Standards (IFRS), Thailand confirms its intention of ensuring that its own standards are consistent with the IFRS and the amended IAS. The question is when this should be done. There are several problems at the moment, ranging from how to make the information about the changes in accounting standards available to the public, to a better understanding of English the version of IFRS and IAS. Thailand has spent time clearly understanding the concepts of "fair value and balance sheet approach". Those countries where as in Thailand, English is not the first language have the same interpretation problem. Also, the changes in IAS were not publicly available, and there were few or no implementation guidelines and examples. No reason for the changes was apparent. Although the new IFRS and recently amended IAS have been improved through the inclusion of some examples and some for reasons change, there are still many problems that need to be resolved before full implementation.

Developing countries have to make their own efforts to move their standards toward IFRS. Immediate changes could cause chaos; too slow a process, however, could postpone implementation for ever. National standard-setters have to be stronger and up to date, and so do accountants and business-persons.

1. Country overview

Historical background

Thailand is situated in the centre of the South-East Asian mainland and covers an area of 513,115 sq. km. It's inhabitants, the Thais, are said to have originated in the southern part of China about 4,500 years ago and later migrated south to their present homeland. However, according to recent evidence, it now appears that Thais might have originated in Thailand and later dispersed to various parts of Asia, including some parts of China.

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"Siam" is the name by which the country was known to the world until 1939 and again between 1945 and 1949. On 11 May 1949, an official proclamation declared that the country would henceforth be known as "Thailand". The word "Thai" means "free," and therefore "Thailand" means "land of the free." Thailand is the only country in the region that has always been an independent country, whereas the others were once British or French colonies. The official language is Thai.

Overall economy

Prior to 1997/98, Thailand enjoyed a double-digit rate of GDP growth for a decade. During 1997/98, the Asian financial crisis resulted in the devaluation of the Thai currency and had a significant impact on business and society owing to heavy borrowing of US dollars and Japanese yen with the advantage of lower interest rates. Many enterprises collapsed, including several banks and financial institutions.

After 1997/98, Thailand started to recover from the economic downturn. In 2001, the Thai economy expanded, largely driven by expansion of private consumption and investment. As such, this made the Thai economy in 2001 grow at the rate of 1.8 percent. The recovery of the US economy in the second half of 2002 became more pronounced, and the Thai economy benefited from the recovery of the world economy in 2002 and 2003, and continued to expand in 2004. It expanded at the rate of 4.9 per cent in 2002 and 5 per cent in 2003.

Thailand's economic stability remains intact. The rate of inflation is expected to be 1.6 per cent. The current account is likely to register a surplus of US$ 5 billion. Capital inflow into securities market is likely to continue throughout 2004, while the private sector's debt repayment continues and the Bank of Thailand's IMF credit repayment was completed in 2003. As a whole, the balance of payments is expected to register a slight deficit. International reserves at the end of 2003 totaled over US$ 40 billion, which is equivalent to more than six months of imports.

Political stability

Thailand is a democratic country. The first constitution was enacted in 1932 after King Rama VII had handed over the absolute power to his people. During the first four decades (1932-1973), the Government and Parliament were not stable and most of the time dominated by non-civilians. i.e. As a result of the bravery of student protesters and their supporters in 1973, civilians began to play a major role in Thai politics. Prior to 2001, the Government and Parliament were composed of politicians from various parties and coordinated in an unstable manner. Between 2001 and the present time, Thai politics have changed significantly. Two major parties play a significant role in the Government and the Parliament: the Thai Rak Thai and Democrat parties. Thai Rak Thai won a majority in the Parliament and formed a Government whose policy was solve the economic problem by stimulating private consumption and encouraging the manufacture of local products. Thai politics from 2001 onward are seen as stronger and more stable. They are moving in the same direction as US politics.

Business in Thailand

As in most countries, there are four kinds of business organizations in Thailand: sole proprietorships, partnerships, limited companies and public companies. The most popular form of business organization among foreign investors is the private limited company. The companies listed on the Stock Exchange of Thailand are required to be public companies.

Private limited companies must follow accounting procedures specified in the Civil and Commercial Code, the Revenue Code and the Accounting Act. Financial statements must be prepared once a year and filed with the Revenue Department and the Department of Business Development. In addition, companies are required to deduct income tax from the salary of all regular employees and from services received.

2. The Thai capital market

The Securities Exchange of Thailand was founded in 1974 under the Securities Exchange of Thailand Act, BE 2517 (1974), or the SET Act, enacted on 20 May 1974. In 1992, the replacement of the Securities Exchange of Thailand Act, B.E. 2517 (1974), by the Securities and Exchange Act, BE 2535 (1992), or the SEA, became the next step towards the development of the modern Thai capital market, with regard to the creation of a concrete legal framework, progressive secondary markets and the improvement of securities business regulations.

Foreign investment has played an important role in the rapid growth of SET. Prior to 1986, investment in SET by foreign investors was small and accounted for roughly 8 per cent of total turnover or the market. The main restrictions faced by foreign investors were the various statutory limitations placed on foreign ownership by the business laws. Recently, statutory restrictions on foreign ownership have been relaxed in order to attract foreign investment in Thailand.

Like every major international stock market, the SET is governed by a set of rules and regulations designed to make the market fair and open to all investors. The SET's regulations are based on the US model. Together with the SET, the Securities and Exchange Commission of Thailand (SEC) has assumed responsibility for developing the domestic stock market, and seeks to prevent unfair trade practices, such as insider trading. Indeed, provisions to provide greater investor protection exist under both SET rules and the Securities and Exchange of Thailand Act (1992).

That Act, names Securities and Exchange Commission, a single unified supervisory agency, as the regulator of the Thai capital market. While the SEC oversees the development of the Kingdom's capital market, the Bank of Thailand (BOT) is responsible for the country's money market. The SEA also provides a clear separation between the primary and the secondary markets to facilitate their successful development. Both primary and secondary markets are regulated by the SEC.

SEC or SET requirement

Specifically, the SET requires its corporate members to make quarterly and annual financial statements and to disclose certain accounting information.

Quarterly return. These must be audited by a certified auditor within 45 days from the end of each quarter, and typically such returns include income statements and balance sheets for the most recent quarter and equivalent calendar quarter of the previous year.

Annual reports. These must also be audited by a certified auditor and submitted to the SET within two months from the end of the accounting period. The SET requires that the annual report contain two consecutive years' financial information prepared in accordance with the requirements of Ministerial Regulation No. 7, the Public Companies Act (1978). Under SET rules, the notes to financial statements must also disclose other information, such as collateral for loans, restrictions imposed by debt covenants, related party transactions and other company obligations affecting shareholders' benefits. The annual reports prepared by SET members should also incorporate a report from the chairperson of the company, including details of business activities and key financial results for the year.

The Thai SEC also requires listed companies to file their annual disclosure statements (Form 56-1). Contained in those statements must be extensive information on risk factors that the companies are facing, management discussion and analysis of past performance, and the financial position as reflected in the financial statements. In cases where there is any negative effect on the performance of the companies, discussion in the annual statement should also provide a detailed description of plans to deal with the problems. Discussions on the level of internal control and management control over the companies through audit committees, whose composition includes independent directors, must also be disclosed. The Thai SEC conducts random reviews of approximately a quarter of the total number of such disclosure documents. Any company that fails to disclose information are the subject of sanctions by the Thai SEC.

3. Accounting standards and practices in Thailand

Accounting regulations

Accounting regulations and practices in Thailand do not have a long history, unlike in countries such as the United Kingdom and the United States. Prior to the 1960s. accounting in Thailand was largely a simple bookkeeping function performed for the internal use of managers and to satisfy the purposes of taxation legislation. However, this state of affairs is changing as a result of recent economic growth and industrial development.

Accounting Regulations in Thailand are derived from the following sources:
The Accounting Act of 2000, which authorizes the Ministry of Commerce and the Director General of the Department of Business Development, Ministry of Commerce, to issue regulations regarding the books of account and supporting documents that must be maintained by business enterprises;

Accounting and regulatory requirements prescribed by the Civil and Commercial Code;
Statements of Thai Accounting Standards and Statements of Thai Auditing Standards issued by the Institute of Certified Accountants & Auditors of Thailand (ICAAT);
Pronouncements issued by the Stock Exchange of Thailand (SET) as applicable to companies listed on the Thailand Stock Exchange; and pronouncements issued by legal bodies which apply to specific businesses, prominent among which are the pronouncements issued by the Bank of Thailand for banks and financial institutions, and the Securities Exchange Commission (SEC) for listed companies and securities companies.

Recently, the Government enacted the new Accounting Profession Act, which took effect on 23 October 2004. This Act superseds the old Auditor Act (B.E. 2505). There are several major changes that could have a significant impact on the Thai accounting profession. These include the establishment of an accounting profession council, a Thai accounting standard board, and a Thai accountant ethics board. This new Act will incorporate all accounting professions (not only auditors as previously covered by the Auditor Act, (B.E. 2505) under the control of the accounting profession council, whose members are a mixture of elected professional members and appointed government agency representatives.

Reporting requirements

Businesses must keep books and follow accounting procedures specified in the Civil and Commercial Code, the Revenue Code and the Accounting Act. Documents may be prepared in any language, provided that a Thai translation is attached. In addition, the Revenue Code contains rules that require businesses to keep accounting documents, records, and certain reports related to sales, purchases, and inventory.

The Accounting Act of 2000 requires directors to prepare accounting in accordance with the generally accepted accounting principles. The Act also requires that company accountants be qualified; they generally have an accounting degree.

Thailand’s taxation legislation requires that certain documents, records and reports be kept by the business, such as those pertaining to VAT input tax and output tax, and reports for inventory. It also requires consistency between financial and tax reporting if any allowances are to be claimed back from the Revenue Department. Thus, as in some European countries, such as France and Germany, taxation regulations can have an important influence on the financial reporting practices of Thai businesses because many aspects of Thai law appears to have been influenced by Franco-German practices. The accounts produced, especially by private companies, are sometimes of more use for tax purposes than for financial analysis.

Annual accounts

A newly established company or partnership should close accounts within 12 months from the date of its registration. Thereafter, the accounts should be closed every 12 months. The performance record is to be certified by the company’s auditor, approved by shareholders, and filed with the Commercial Registration Department, Ministry of Commerce, within five months of the end of the fiscal year, and with the Revenue Department, Ministry of Finance, within 150 days of the end of the fiscal year.

If a company wishes to change its accounting period, it must obtain written approval from the Director General of the Revenue Department.

Accounting principles and auditing standards

ICAAT is the authoritative group promoting the application of generally accepted accounting principles and auditing standards. Generally accepted accounting standards followed in Thailand are the International Accounting Standards, with the exception of the complicated standards such as IAS 39, Recognition and Measurement of Financial Instruments. At present, the new Accounting Profession Act 2004 will transfer the work of accounting standards from ICAAT to the Thai accounting standard board under the control of the accounting profession council.

Auditing standards conforming to international auditing standards are, to a great extent, recognized and implemented by authorized auditors in Thailand. Audited financial statements of legal entities (that is, a public company, a limited company, a registered partnership, a branch, or representative office, or a regional office of a foreign corporation, or a joint venture) must be certified by an authorized auditor and submitted to the Revenue Department and (except for joint ventures) to the Department of Business Development for each accounting year.

Ministerial regulation

Thailand's Ministry of Commerce requires all corporations and registered partnerships to establish proper accounting records, and to have their annual financial statements audited by certified (i.e. licensed) auditors. In 1976 and 1978, the Ministry of Commerce issued Regulation No. 2 (for private companies) (BE 2519) and No. 7 (for public companies) (BE 2521), which prescribe formats and minimum disclosures for the profit and loss accounts and balance sheets, but do not cover the treatment of accounting items. This regulation seeks to standardize the financial reporting practices of Thailand-based companies, and thereby promote the confidence of investors, particularly those from overseas. This Ministry of Commerce Regulation No. 2 is now superseded by the announcement by the Department of Business Development in 2002. The announcement updates the format to be in compliance with the accounting standards.

Exemption for small and medium-sized enterprises

In order to facilitate small and medium-sized enterprises (SMEs), the Board of Supervision of the Accounting Profession announced that it would allow private companies to exempt themselves from using certain accounting standards. This announcement followed the guideline issued at the eighteenth session of UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) in 2001. As a consequence, for private companies (the majority of which are family-owned businesses), the following standards have been specifically excluded:

- Cash flow statement;
- Segmentation information;
- Consolidated accounts;
- Disclosure of related parties' transactions;
- Financial instruments disclosure;
- Impairment of assets;
- Equity accounting.

Accounting standards and guidance

Thailand's early accounting standards were influenced by the standards of developed countries with which Thailand had a trade relationship. The influence of the United Kingdom’s standards were evidenced at the earlier stage. Later, the influence of the United States’ standards came to the force. Finally, IAS began to play a more important role with regard to Thai accounting standards.

Prior to 1997/98, Thailand had enjoyed a double-digit rate of GDP growth for a decade. There were rarely any doubts about the quality or transparency of accounting standards and practices. During 1997/98, the Asian financial crisis resulted in the devaluation of the Thai currency and of the yen, with the consequent advantage of lower interest rates. Many enterprises collapsed, including several banks and financial institutions. There was criticism with regard to lack of good governance, transparency, accountability, and accounting standards and practices did not escape such criticism. There was pressure for full adoption of international accounting standard in 1998. Between 1998 and 2000, many standards were issued. The sheer volume proved indigestive for some. The issuances over that two-year period cover almost all of the international accounting standards then issued by the International Accounting Standard Board (IASB). There were only a few standards missing, mostly those not relevant to the Thai economy, for example the standard on hyperinflation accounting and effects of changing price.

Prior to 1997/98, there were 31 Thai accounting standards. They had been developed and issued mostly during the years 1976 through 1990, and basically adopted from the US generally accepted accounting principles or International Accounting Standards during that time and rarely changed afterwards. Between 1991 and 1997, there was no active standard. For those that were not issued, users were instructed by the Thai SEC to follow the IAS and, if not available in the IAS, then to follow the US accounting standards issued by the Financial Accounting Standard Board (FASB). After 1997/98, the number of standards issued or modified amounted to 48, with 18 standards being superseded. They were based on the IAS updated version with some minor modifications. The minor modifications were in the area of limiting alternatives of choices, for example change in accounting policy adjustable only through retained earnings and not allowed to charge or credit against earnings; no choice for the equity method is allowed; the cost concept on investments in associates in a separate financial statement is not allowed as an alternative to the equity method; and there is no choice for available-for-sale equity or debt securities to charge to earnings. The following are the few conflicts with IAS: depreciation on excess value from property revaluation required to charge off against retained earnings and not against current year's earnings; and minority interest upon consolidation is required to be shown as part of the shareholders' equity and not as a mezzanine item.

Currently there are a further 11 drafts in process: Intangible Assets, Post Balance Sheet Events, Accounting for Provision, Contingent Liabilities and Contingent Assets, Discontinued Operations, Government Grant and Assistance, Accounting for Deferred Tax, Recognition and Measurement of Financial Instruments, Employment Benefits, Investment Properties, Agriculture and Hedge Accounting for Derivatives.

On the whole, our accounting standards follow the IAS. But if there is no pronouncement by IAS and IFRS, we follow the US GAAP.

4. Impacts of sudden changes in accounting standards

ICAAT, prior to 2000, had issued the accounting standards with automatic approval from the Ministry of Commerce to become Thai accounting standards and effective on the date as specified in those standards. In 1999, it had issued 10 new standards based on the IAS. Those standards included accounting framework, accounting for property plant and equipment, borrowing costs, impairment of assets, earning per share, net profit and accounting change, troubled debt restructuring, investment in debt and equity security, and presentation of financial statements. Another eight standards were issued in 2000. Those standards included interim financial statements, investment in associated company, subsidiary and joint venture, business combination, related party transactions and disclosures of financial instruments. Another eight standards were to become effective in 2001. Those standards had to be applied to all companies in Thailand. Businesses started to complain that accounting standards were being issued too rapidly. Many arguments between companies and their auditors about the interpretation of certain standards arose.

Authorities' involvement

As mentioned earlier, prior to 2000, ICAAT had sole power to issue accounting standards, and, because of pressure from the IMF and the World Bank, to move Thai accounting standards to international accounting standards, many standards were changed in a short period of time. After realizing the problems that these changes were going to cause, the Ministry of Commerce interfered and blocked certain standards before they became effective. The standards that were planned to become effective in 2001 were postponed and certain standards such as accounting for troubled debt restructure were recalled for review. Seven standards were exempted for non-public companies.

ICAAT, with a new president and team in 2002, has changed its strategy on issuance of the standards by slowing down the process. From 2001 to 2004 only one new standard was issued. More procedures are established, including public hearings, approval by the ICAAT board, and approval by the Ministry of Commerce before the accounting standard become effective.

When the schedule for issuance of the new standards is delayed, the SEC issues certain guidelines for some critical transactions such as related party transactions, accounting for allowance for doubtful accounts for consumer finance, purchase of intangible assets, revenue recognition for real estate development, and liability incurred from group companies' guarantee.

Analysis of the problems

The main problems that Thai businesspersons and accountants faced as a result of sudden changes in accounting standards can be summarized as follows:

1. Understanding of the new concept. The concept of balance sheet approach was newly implemented. This new concept is totally different from the old one: income approach. At the beginning of implementation, many accountants had been strict with the matching concept, and so were the financial analysts. Any adjustment to income statements was subject of a great deal of argument and cannot be done easily.

2. Interpretation problems. Several IASs used ambiguous words such as "must", "ought", "may" and "should". Such words have a different meaning when translated into Thai. "Ought", "may" and "should" sounds voluntary while "must" sounds compulsory.

3. Understanding the reason behind the standards. Several standards introduced a new concept or accounting treatment that contradicted the old standards. There was no explanation for changing to such standards. For example, the capital maintenance concept was mentioned in the accounting framework standard without any explanation of it.

4. Implementation issues. A number of new standards caused problems in implementation, for example:

   (a) Impairment of assets required the recognition of impaired loss in the income statements. The problems of how to calculate the recoverable amounts resulted in the commissioning of independent appraisal and created a burden for business.
   (b) Amortization of the surplus of revalued assets cannot be offset with its depreciation, and this caused a reduction in net profit. Under the old standards, however, it can be offset. Many companies want to change back to the cost method, but the auditors do not allow it. This issue creates another problem between the company and its auditor.
   (c) Consolidation and accounting for equity method required strong support from the subsidiaries and the associated companies. Those companies had to finish their audited or reviewed financial statements before the parent company. With regard to listed companies, it is required that they submit the quarterly financial statements within 45 days. Some companies have companies in their group consisting of more than 50 companies. Therefore, they

need to have an effective plan and good coordination. In addition, it was whether consolidation should be done when the ultimate parent company was situated outside Thailand.

(d) Fair value is difficult to find in certain situations. For example, fair value of investment in debt security can be obtained from the debt market. However, the market is not liquid owing to a low trade volume. Therefore, accountants and auditors raise the question whether market can provide meaningful fair value information.

(e) When using an independent appraisal, the question is the quality that appraisal. At the implementation stage, appraisals may not have much idea about accounting standards and use methods that may not be suitable for recording in the financial statements. For example, the independent appraisals always provided two or three values based on different approaches (market price, replacement cost, or depreciated replacement cost). If the company used replacement cost to record its appraised assets, the financial statements can show overstated assets.

(f) Certain disclosures are required without official verification. Those disclosures include the number of employees and their compensation, names of all related parties, and fixed assets that are fully depreciated but still in use.

Further problems

Although Thailand still has some standards to be issued in order to comply with IAS such as accounting for employment benefit, financial instrument, deferred tax, and others, IASB have recently amended 13 IASs and issued five new IFRS. This could cause even more problems for accountants and businesspersons in updating those standards. Several areas need to be carefully reviewed before the current standards can follow such changes. Those concerns include legal issues, tax issues and political issues.

For legal issues, the format of financial statements requires consolidated and company – only financial statements presented in the four-column format (with a comparison with last year's statements). The dividend is paid from the net income under the equity method. Under the improved IAS, the company – only financial statements have to be presented separately using the cost method. Compliance may require changes in certain laws and regulations.

For tax issues, deferred tax assets required assurance that the assets will have future benefits. If the tax regulation is unclear, implementation of deferred tax accounting may have problems. Certain accounting treatments such as accounting for derivative financial instruments require that the change in the fair value of derivative financial instruments be recognized in the income statement. The tax authority may collect tax based on net income. However, the company may face a problem because that net income derives from non-cash transactions. The same problem arises in accounting for agriculture products with fair value and recording in the income statements without cash inflow.

For political issues, accounting treatment that has an impact on net income may be difficult to implement. IFRS 2 requires recording the share-based payments with fair value. Many companies will not be willing to accept this treatment.

Although the improved IAS and IFRS are more readable and understandable, Thailand still has problems with interpretation and implementation. Thai accounting standards will follow IFRS except where it is inappropriate to do so it should be possible to identify the reason. The question is when should be the appropriate time to implement the new IFRS or amended IFRS.

5. Lessons to be learned

Many questions are raised and need to be answered before the convergence of IFRS:

- Implement the standards for all types of business? Without businesses being separated into large and small and medium-sized enterprises, the standards will be used for all types of business. In 2000, all companies in Thailand had to follow the same standards. It was widely accepted that small and medium-sized enterprises were not ready to implement the new standards in such a short period, and many accounting procedures and disclosures may not be necessary, such as consolidation and accounting for the equity method. ISAR has done an excellent job in identifying this problem and putting issue before IASB.

- Time frame? IFRS 1 provides accounting treatment if a country chooses to adopt full IFRS at one and the same time. In the case of developing countries, the national standard-setters have to decide whether to gradually adopt the standards or adopt all at the same time. The key factors are business and authority.

- Availability of IAS & IFRS in local languages? The correct translation is necessary, but it is difficult to obtain. IASB has no working group available to answer the questions. Therefore, personal judgement may be required during the translation process.

- Comprehensibility of the standards? The principle-based approach is accepted as a good approach. However, without clear interpretation and examples, many issues have been treated differently in different companies, such as the issue of consolidation where the ultimate parent company is situated outside the country.

- Respond to the change? Set out in each standard is the date on which it is to become effective. The question is whether the national standards should be brought into conformity with the IFRS using the same time line or a relaxed time line. Whether all changes should be automatically applied to national standards is the big question in developing countries.

- Availability of the standards? IFRS are not publicly available. Countries where English is not the first language have to issue their own national language version. The translation process may take some time and as a result, the national version may be issued far behind the time when the public becomes aware of the English version of a new IFRS.

- Political and tax issues? Certain standards, if implemented, require changes in laws and regulations, such as separate company only financial statement using cost method. In addition, certain standards require clear tax treatment such as fair value in agriculture business where there is no cash inflow to pay tax.

Certain suggestions are recommended for convergence of IFRS:

- Strong accounting standard-setting body. This body needs to be independent and up to date. It has to be available to answer questions and make judgements about implementation problems.

- Make available information. Standards should be publicly available, especially to those who will be affected by the standards. The media to promote the standards, and the costs involved therein, should be clearly identified.

- Immediate action versus a slow-down process. Immediate action can create chaos in implementation. However, a slow-down process may not meet the needs of an authority such as SEC or the needs of an international organization such as the World Bank. The strategy has to be carefully determined by the standards-setting body.

- Train the trainer. The standards can have an impact on society at large. "Train the trainer" can be a good approach to allow the public, and not only accountants, financial analysts and businesspersons, to understand the standards and their implementation.

- Keep abreast of trends. Accountants and parties involved in the standards need to update themselves in order to be ready for the new standards.