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Foreword

In November 2008, UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) held its twenty-fifth anniversary session at the Palais des Nations in Geneva. This event marked an important milestone in the history of the Group of Experts – quarter of a century of work towards reliable and comparable corporate reporting. Through ISAR, the United Nations has been providing member States with a unique and inclusive forum for exchanging views and experiences on a variety of issues pertaining to corporate financial and non-financial reporting.

Since its establishment in 1982, ISAR has been playing an important role in the global arena. The Group of Experts was a pioneer in taking up issues such as environmental accounting and reporting and reaching consensus. ISAR has also played a leading role in researching, deliberating, building consensus, and providing useful implementation tools on various topics. These include a model curriculum for the qualification of professional accountants, accounting by small and medium-sized enterprises, corporate governance disclosure, corporate responsibility reporting, and practical implementation of International Financial Reporting Standards (IFRS). ISAR has often been cited as a model for other UNCTAD expert meetings to emulate. The Group of Experts is to be commended for its exemplary dedication and contribution to this essential area of work.

Since the middle of 2007, world financial markets have been experiencing extreme turbulence. The centrality of reliable and comparable information for financial stability and for the ability of investors to assess risk and allocate resources to different investment opportunities has been painfully demonstrated by recent events. Since the onset of the financial crisis, accounting and reporting issues have gained unprecedented attention from major players around the world, including at the two G20 summits, the meeting of G8 finance ministers, the European Union's Council of Ministers and the United States Congress. There has been considerable discussion about "levelling the playing field". The main objective of a global set of financial reporting standards is to do precisely that. In this respect, it is important to note that at the United Nations Conference on the World Economic and Financial Crisis and its Impact on Development, member States encouraged major standard-setting bodies to enhance the representation of developing countries as appropriate. Now more than ever before, there is a need for transparency and clarity in corporate reporting. The risks of opacity and complexity, as is now obvious to all, are too great and pose too many dangers to the development of member States around the world, especially those States that can least afford it. In this respect, ISAR's role is highly significant.

This publication contains ISAR's deliberations at its twenty-fifth session on several topics in the area of corporate reporting. It is my hope that this publication will provide policymakers, regulators, standard-setters, boards of directors, researchers and other readers with insights into some of the timely issues on corporate reporting.



Supachai Panitchpakdi
Secretary-General of UNCTAD

Preface

The twenty-fifth anniversary session of UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) took place at the Palais des Nations in Geneva from 4 to 6 November 2008. The session brought together a record number of participants from all parts of the world. This document contains the proceedings of the twenty-fifth anniversary session.

In marking ISAR's twenty-fifth anniversary, the UNCTAD secretariat organized a high-level segment that featured prominent speakers, including ministers. The high-level segment discussed the positive contribution of international accounting and reporting standards and codes to financial stability and economic growth. As the twenty-fifth session of ISAR was taking place against the backdrop of a widespread financial crisis, the high-level segment provided an opportunity for a very timely exchange of views and perspectives among regulators, standard-setters and participants. The deliberations highlighted a need for concerted efforts by all parties involved in the corporate reporting supply chain to restore users' confidence in the international financial reporting architecture.

The main agenda item for the session was a review of practical implementation issues of International Financial Reporting Standards. Under this agenda item, the Group of Experts considered country case studies of Egypt, Poland, Switzerland and the United Kingdom. Furthermore, the session discussed a study on practical challenges and related considerations in implementing International Standards on Auditing (ISAs). The case studies illustrated various institutional, technical and capacity-building challenges that the respective countries encountered in implementing IFRS. The panel presentations enriched the deliberations and facilitated the exchange of views and experiences among delegates. An overview of the country case studies discussed above is presented in chapter 1 of this document. The individual country case studies are presented in chapters 2 to 5. The study on the implementation of ISAs is contained in chapter 6.

It should be recalled that ISAR began its deliberations on practical implementation issues of IFRS at its twenty-second session. At its twenty-third session, ISAR reviewed country case studies of Brazil, Germany, India, Jamaica and Kenya. Furthermore, country case studies of Pakistan, South Africa and Turkey were discussed at ISAR's twenty-fourth session. In concluding its twenty-fourth session, ISAR requested the UNCTAD secretariat to prepare a publication synthesizing the lessons learned in the practical implementation of IFRS by reviewing the country case studies that ISAR had considered at its twenty-third and twenty-fourth sessions. Accordingly, the UNCTAD secretariat prepared the publication *Practical Implementation of International Financial Reporting Standards: Lessons Learned*. This publication was disseminated at the twenty-fifth session of ISAR.

The session also considered a number of topics under other business, including the accounting and financial reporting needs of small and medium-sized enterprises (SMEs), capacity-building in corporate accounting and reporting, corporate governance disclosure and corporate responsibility reporting. In accordance with the agreement reached at the twenty-third and twenty-fourth sessions to update ISAR's publication *Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA): Level 3 Guidance*, the twenty-fifth session of ISAR considered the revised Guidance and requested the UNCTAD secretariat to finalize publication of the document and to disseminate it widely. The revised SMEGA Level 3 is contained in chapter 7 of this volume.

With respect to corporate governance and corporate responsibility, the Group of Experts reviewed a study on corporate governance disclosure entitled "2008 Review of the implementation status of corporate governance disclosures: an examination of

reporting practices among large enterprises in 10 emerging markets”. This study is reproduced in chapter 8 of this publication. The Group also reviewed two studies on corporate responsibility reporting: “2008 Review of the reporting status of corporate responsibility indicators” and “2008 Review of the corporate responsibility performance of large emerging market enterprises”. These studies are presented in chapters 9 and 10 respectively. Deliberations on this item were facilitated by a panel discussion. ISAR reiterated the importance of corporate governance disclosure and corporate responsibility reporting for meeting the increasing information demands of various stakeholders, and for promoting investment, stability and economic growth. ISAR commended the three studies and requested that UNCTAD continue to carry out such studies, in partnership with local institutions wherever possible, and with a focus on providing practical information to policymakers, investors and other stakeholders. A number of delegates requested that country case studies on this subject be conducted in their own countries; these included requests from the delegates of Brazil, Egypt, Pakistan and Thailand.

Delegates at the twenty-fifth session of ISAR elected Professor Nelson Carvalho (Brazil) as Chair and Mr. Syed Asad Ali Shah (Pakistan) as Vice-Chair-cum-Rapporteur. UNCTAD expresses its appreciation to Professor Carvalho and Mr. Shah for their excellent leadership of the special anniversary session and for guiding the deliberations to a conclusion with meaningful outcomes. For sharing their perspectives during the high-level segment on the relationship of corporate accounting and reporting standards to financial stability and economic development, UNCTAD expresses its appreciation to: H.E. Mr. Wang Jun, Vice-Minister, Ministry of Finance, China; H.E. Mr. Ibrahim Ashmawy, Deputy Minister of Investment, Egypt; H.E. Mr. Ngy Tayi, Under-Secretary of State, Ministry of Economy and Finance, Cambodia; H.E. Mr. Kwabena Baah-Duodu, Ambassador and Permanent Representative of Ghana to the United Nations in Geneva; Robert Garnett, Board Member, International Accounting Standards Board (IASB); and Jim Sylph, Executive Director, International Federation of Accountants. UNCTAD is grateful to Professor Nelson Carvalho (Brazil); Ato Gharthey (Ghana); Alicia Jaruga (Poland), Richard Martin (United Kingdom) and Rudolf Müller (Switzerland) for sharing their contributions to the discussion during the ISAR chairpersons’ roundtable.

UNCTAD acknowledges with appreciation the contributions of Reto Eberle and Thomas Schmid, KPMG, Switzerland; Professor Ashraf El-Sharkawy, Cairo University, Egypt; Robert Garnett, Board Member, IASB; Professor Malgorzata Jaruga-Baranowska, University of Lodz/Academy of Management, Poland; Nigel Sleigh-Johnson, Institute of Chartered Accountants in England and Wales; and Jim Sylph, Executive Director, International Federation of Accountants for their contributions during the panel discussion on practical implementation issues of IFRS and ISAs and for their contributions in preparing the studies discussed above.

UNCTAD would like to express its appreciation to the experts who contributed to revising the publication *Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA): Level 3 Guidance* by providing input during the ad hoc consultative meetings that were held in Geneva in July 2007 and May 2008, and by facilitating the discussions on this topic that took place during the twenty-fourth and twenty-fifth session of ISAR. These are: Giancarlo Attolini, Consiglio Nazionale dei Dottori Commercialisti (CNDI), Italy; Andrew Brathwaite, Institute of Chartered Accountants of Barbados; Piero di Salvo, Organismo Italiano Contabilità, Italy; Reto Eberle, KPMG, Zurich, Switzerland; Leyre Fuertes, European Federation of Accountants, Belgium; Robin Jarvis, Association of Chartered Certified Accountants, United Kingdom; David Morris, Financial Executives International, United States; Vickson Ncube, Eastern, Central, and Southern African Federation of Accountants; Wojciech Nowak, University of Lodz, Poland; Jim Osayande Obazee, Nigerian Accounting Standards Board; Mateo Pozzoli, CNDI, Italy; Gerhard Prachner, European Federation of Accountants, Belgium; David Raggay, Institute of Chartered Accountants of Trinidad and Tobago; Stefano Santucci, European Federation of Accountants and Auditors for SMEs, Italy; Syed Asad Ali Shah, Institute of Chartered Accountants of Pakistan; Marco Venuti, Organismo Italiano Contabilità, Italy; John Vincent, Association of Accounting Technicians, United Kingdom; Simon Wray,

PricewaterhouseCoopers, Netherlands. UNCTAD acknowledges with appreciation the contributions of Richard Martin, Association of Chartered Certified Accountants, United Kingdom, who chaired the two ad hoc consultative meetings and presented reports on these consultations to the twenty-fourth and twenty-fifth sessions of ISAR.

UNCTAD is also grateful to Nana Tweneboa Boateng, Empretec, Ghana; and Ashraf Gamal El-Din, Institute of Directors, Egypt for their contributions to the panel discussion on capacity-building in corporate accounting and reporting.

UNCTAD appreciates the contributions of the following panellists to the discussion on corporate governance disclosure and corporate responsibility reporting. These are: Stephen Hine, EIRIS, United Kingdom; Ernst Ligteringen, Global Reporting Initiative, Netherlands; and Alan Knight, AccountAbility, United Kingdom. For their contributions to the preparation of background documentation on corporate governance disclosure and corporate responsibility reporting, UNCTAD is grateful to the following resource persons: Nancy Kamp-Roelands and Stephanie Smith of Ernst and Young CSR Knowledge Centre, Netherlands; along with Bas Paauwe, Robert Tjin, Leonie Veldhuis and Ids Voerman of Erasmus University, Rotterdam, for research support for the 2008 Review of the reporting status of corporate responsibility indicators; Bill Baue for his contributions to both the 2008 review of corporate governance disclosure and the 2008 review of corporate responsibility reporting; and Stephen Hine, Stephanie Maier, Sonia Wildash and Shohko Iwami of EIRIS for preparation of the 2008 Review of the corporate responsibility performance of large emerging market enterprises.

UNCTAD is grateful to Lorraine Ruffing – retired UNCTAD staff member and special resource person – for her valuable contribution to the commemorative publication *Promoting Transparency in Corporate Reporting: A Quarter Century of ISAR*. UNCTAD acknowledges with appreciation the contributions of the authors of the various chapters of this publication, namely, Andre Baladi, Nelson Carvalho, Rainer Geiger, Robin Jarvis, Nancy Kamp-Roelands, David Moore, Mohamed E. Moustafa, Richard Martin and Peter Walton.

UNCTAD recognizes with appreciation the commitment and excellent contributions of members of the UNCTAD secretariat to the success of the milestone twenty-fifth anniversary session of ISAR. These are: Nazha Bennabbes Taarji-Aschenbrenner, Officer-in-Charge, Enterprise Development Branch; Yoseph Asmelash, Head, Corporate Transparency Unit; and Anthony Miller. The preparation of background documentation on corporate responsibility reporting and corporate governance disclosure, and the organization of the panel on these topics were conducted by Anthony Miller. UNCTAD is grateful to Albertine Azar and Natalie Djodat for providing essential research support for the 2008 review of implementation status of corporate governance disclosure. UNCTAD is grateful to Raimund Moser, Peter Navarrette, Karima Aoukili and Emma Malenab-Bataclan for their critical support in organizing the twenty-fifth anniversary session of ISAR.

Chapter 1

Review of practical implementation issues relating to International Financial Reporting Standards

Summary of discussions

The Chair of the session invited a member of the UNCTAD secretariat to introduce the main agenda item of the session. In his introductory remarks, the representative of the UNCTAD secretariat noted that ISAR had been working on the topic in view of the widespread adoption of IFRS in recent years. At its twenty-second session, ISAR had deliberated on a note prepared by the UNCTAD secretariat (TD/B/COM.2/ISAR/28). The note highlighted major practical implementation issues pertaining to institutional and regulatory arrangements, enforcement mechanisms, technical issues and capacity-building aspects of practical implementation of IFRS. On the basis of this framework, country case studies of Brazil, Germany, India, Jamaica and Kenya had been prepared and considered at the twenty-third session of ISAR. He further noted that country case studies of Pakistan, South Africa and Turkey had been discussed at the twenty-fourth session of ISAR.

In concluding its twenty-fourth session, ISAR had requested the UNCTAD secretariat to prepare a publication that synthesized the lessons learned in the practical implementation of IFRS by reviewing the country case studies that the Group of Experts had discussed at its twenty-third and twenty-fourth sessions. Accordingly, the UNCTAD secretariat had prepared the publication *Practical Implementation of International Financial Reporting Standards: Lessons Learned*. Copies of the publication were available in the meeting room.

Turning to background documentation for the twenty-fifth session, the representative of the UNCTAD secretariat drew delegates' attention to four country case studies on practical implementation of IFRS – covering Egypt, Poland, Switzerland, and the United Kingdom – which were circulated with symbols TD/B/C.II/ISAR/45, 46, 47 and 48 respectively. He also indicated that a study on the practical challenges and related considerations in implementing international standards on auditing (ISAs) had been circulated with the symbol TD/B/C.II/ISAR/49. Following the introductory remarks, a panel of speakers made presentations on the main findings of the studies noted above.

The speaker who presented the case study of Egypt elaborated on the approach the country had taken to implementing IFRS. In 2006, the country issued Egyptian Accounting Standards based on IFRS as issued by the International Accounting Standards Board (IASB) in 2005. Egypt had also issued auditing standards based on ISAs. The speaker discussed certain differences between Egyptian Accounting Standards and IFRS, including depreciation of property, plant and equipment; disclosure in the financial statements of banks and similar financial institutions; and leasing operations. The speaker highlighted translation of IFRS into Arabic as one of the practical implementation challenges in Egypt. This was particularly acute in terms of keeping up with frequent changes in IFRS. He discussed the regulatory framework in Egypt in the context of implementing international standards in accounting and auditing. He shared with delegates a number of lessons learned from the experience of Egypt pertaining to training and education, enforcement, professional codes of ethics, and amendments to some laws and regulations.

The next speaker presented a case study of Poland. She described the country's experience in transitioning to a market economy, and developments following the transition that affected accounting standards-setting in Poland. In 2004, Poland became

a member of the European Union, and as a result, the country had to comply with European Union Directive EC No. 1606/2002 requiring application of IFRS endorsed for use in the European Union. She presented the main findings of a study that looked into reconciliations of financial statements prepared by Polish companies when they had prepared their first set of financial statements under IFRS. Those findings underscored – as part of the implementation process – the need to provide investors, analysts and other market participants with adequate information to help them understand the difference between financial statements prepared under national accounting standards and those prepared under IFRS.

The next presentation was on a case study of Switzerland. The speaker provided background information on the legal framework and related accounting and financial reporting requirements of Switzerland. He continued his presentation with an elaboration on audit requirements, including ordinary audit, limited statutory audit and exemption. The speaker concluded his presentation by highlighting revisions to Swiss company and accounting legislation that were expected to occur in coming years.

This was followed by a presentation of the case study of the United Kingdom, where the transition to IFRS began in 2005 with the 1,200 companies listed in the London Stock Exchange. The overall assessment on IFRS implementation was that the process had been challenging and the experience of IFRS application continued to improve.

Another panellist discussed the study on practical challenges in implementing ISAs issued by the International Auditing and Assurance Standards Board (IAASB). In his update on the IAASB's Clarity Project, the speaker indicated that 39 ISAs written in the new clarity style would be completed by December 2008.

The next speaker addressed practical implementation of IFRS from the perspective of the IASB. In addition to some 113 countries and jurisdictions that permitted or required the use of IFRS, many others – such as Brazil, Canada, Chile, India, Malaysia and the Republic of Korea – had committed to implementing IFRS in the period leading up to 2012. Others – such as China, Japan, Mexico, the Philippines, Singapore and the United States – had committed to converging their national standards to IFRS.

After those presentations, the Chair of the session opened the floor for discussion. Some delegates elaborated on the status of IFRS implementation in their countries. Others clarified the approaches that their countries had taken to implementing IFRS.

In concluding their deliberations on this agenda item, delegates expressed their appreciation to the UNCTAD secretariat for finalizing the publication *Practical Implementation of International Financial Reporting Standards: Lessons Learned*, which ISAR had requested at its twenty-fourth session. They recommended wider dissemination of the publication. They also requested the UNCTAD secretariat to continue conducting studies on practical implementation of IFRS and ISAs.

I. Introduction

In view of the widespread adoption of International Financial Reporting Standards (IFRS) in recent years, UNCTAD's Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has been reviewing practical issues that arise in the course of implementing IFRS, with a view to facilitating the sharing of experiences and lessons learned among member States. At its twenty-second session, ISAR deliberated on a background note (TD/B/COM.2/ISAR/28) prepared by the UNCTAD secretariat that highlighted major practical implementation issues pertaining to institutional and regulatory arrangements, enforcement mechanisms, technical issues and capacity-building. On the basis of this framework, country case studies covering Brazil, Germany, India, Jamaica and Kenya were prepared and then considered at the twenty-third session of ISAR. Furthermore, country case studies of Pakistan, South Africa and Turkey were discussed at ISAR's twenty-fourth session.

In concluding its twenty-fourth session, ISAR requested the UNCTAD secretariat to continue conducting studies on practical implementation issues relating to IFRS, including on related topics, such as the implementation of International Standards on Auditing (ISAs). Accordingly, country case studies on practical implementation of IFRS covering Egypt, Poland, Switzerland and the United Kingdom – as well as a study on practical challenges and related considerations in implementing ISAs – were prepared for consideration by the twenty-fifth session of ISAR. The main objective of these papers is to facilitate the sharing of experiences among member States.

II. Overview of the case studies

The countries discussed above embarked on the IFRS implementation process at different points in time, adopting different approaches. Egypt started the process by establishing a permanent committee for accounting and auditing standards in October 1997. In Poland, starting in 1998, the Polish Securities and Exchange Commission permitted Polish companies listed in foreign capital markets to use IFRS. In Switzerland, listing requirements permitted the use of IFRS starting in 1995. In the United Kingdom, although companies were permitted to use IFRS prior to 2005, the take-up was low. The approach that Egypt took to implementing IFRS is different from that taken by the other countries. Although Egyptian accounting standards are based on IFRS, they are not exactly the same as IFRS, because the Egyptian standards are formulated by taking into account the national economic environment.

The case study of Switzerland illustrates the coexistence of multiple accounting and reporting standards in the same country. The listing requirements allow the use of IFRS issued by the International Accounting Standards Board; Generally Accepted Accounting Principles (GAAP) (from the United States); Swiss GAAP; and the Swiss Federal Banking Commission Guidelines on Bank Accounting and Financial Reporting Regulation (RRV-SFBC).

As members of the European Union (EU), Poland and the United Kingdom apply IFRS in accordance with EC Regulation No. 1606/2002. This regulation requires companies whose securities are admitted for trading on regulated markets in EU member countries to prepare their consolidated financial statements on the basis of IFRS endorsed for use in the European Union. The regulation also includes an option to extend IFRS for use for the preparation of individual (separate, legal entity) accounts, as well as for use by non-listed companies. In Egypt, all listed companies are required to apply Egyptian Accounting Standards that are based on IFRS. The case study of the United Kingdom presents a new dimension on the application of IFRS. The United Kingdom Central Government and the National Health Service bodies will apply IFRS, subject to some modifications, commencing with the year leading up to 31 March 2010.

The role of professional accountancy organizations in implementing IFRS is illustrated in the case studies. For example, in Egypt, the Society of Accountants and Auditors is responsible for drafting accounting and auditing standards, including the Egyptian Accounting Standards, which are derived from IFRS. The Accountants Association of Poland certifies training programmes on IFRS. The Swiss Institute of Certified Accountants and Tax Consultants (SICATAC) established a business school that prepares candidates for professional certification. The financial reporting module contains very significant coverage of IFRS. In the United Kingdom, the Institute of Chartered Accountants in England and Wales – along with another four legally recognized professional accountancy bodies – plays an important role in the implementation of IFRS.

III. Institutional issues

The case studies present different legal mechanisms for implementing financial reporting standards. For example, in Egypt, Act No. 133 – the Accounting Practices Act – was passed in 1951 to govern the role of professional accountants and auditors. In 2006, the Ministry of Investment issued Decree No. 243 requiring the implementation of the Egyptian Accounting Standards (derived from IFRS). In Switzerland, the Stock Exchange and Securities Trading Act of 1995 and related directives determine acceptable accounting and financial reporting standards, including IFRS. As discussed above, in Poland and the United Kingdom, IFRS implementation is governed by Regulation No. 1606/2002.

The case studies discuss the interaction between general purpose financial reporting and prudential reporting. For example, in Egypt, in addition to the Accounting Practices Act, the Banking Act No. 88/2003 requires banks to follow accounting and auditing requirements and guidelines set by the Central Bank of Egypt. The Egyptian Insurance Supervisory Authority requires insurance companies to apply IFRS in preparing their financial statements. The authority allowed insurance companies (on a temporary basis) to apply national by-laws for calculating insurance technical provisions. Furthermore, in Egypt, the Income Tax Act of 2005 (No. 91) requires that net profits for tax purposes be based on the general purpose financial statements prepared under the Egyptian Accounting Standards (which are based on IFRS). The numbers are then adjusted to bring them in line with the applicable tax rules.

In Poland, banks are required to prepare their legal entity financial statements in accordance with the accounting regulations of the Ministry of Finance. Similarly, insurance companies are required to prepare their financial statements in accordance with the Insurance Accounts Directive of the Ministry of Finance. In Switzerland, banks are required to comply with extensive financial reporting and auditing requirements stipulated in the Banking Act. The Swiss Federal Banking Commission (SFBC) set the framework for bank accounting and reporting at the federal level.

As elaborated in the case studies, the existence of multiple laws and regulations that govern different aspects of financial reporting – including for prudential regulatory purposes – requires ongoing coordination among different agencies in order to ensure coherence and consistent implementation of IFRS.

IV. Enforcement issues

The case studies illustrate the role of different agencies in enforcing financial reporting standards, including IFRS. In Egypt, the Capital Markets Authority (CMA) reviews annual financial statements filed by listed companies. The CMA has broad powers, including the delisting of companies that fail to comply with financial reporting requirements. The Central Bank of Egypt reviews the financial statements of banks. The Central Bank is authorized to take a number of measures against banks that fail to apply financial reporting requirements, including cancellation of the registration of banks.

In Poland, the Enforcement Department of the Polish Financial Supervision Authority reviews the financial statements of listed companies and determines whether the companies are in compliance with established accounting and disclosure requirements. The Enforcement Department brings cases of non-complying companies to the public prosecutor for action.

In Switzerland, the enforcement of financial reporting requirements is shared among different authorities. The Swiss Federal Banking Commission and the Swiss Private Insurance Agency are responsible for monitoring compliance by banks and insurance companies, respectively, with applicable financial reporting requirements. SIX Swiss Exchange is responsible for ensuring that listed companies (other than banks and insurance companies) are in compliance with the applicable financial reporting requirements, including IFRS. SIX Swiss Exchange selects company financial statements for review using a risk-based criteria. Some of these criteria are recent

restructurings, business combinations, changes in management, business activities and audit firms. SIX Swiss Exchange is empowered to impose sanctions against listed companies that fail to comply with applicable financial reporting requirements. SIX publishes press releases announcing measures taken against non-complying companies. SIX publishes on its website the full text of enforcement decisions, but withholds the names of the companies against which enforcement decisions have been taken.

In the United Kingdom, the Financial Services Authority is responsible for regulating financial services markets and exchanges. It implements its regulatory powers in cooperation with an independent body, the Financial Reporting Review Panel (FRRP). The financial statements of listed companies and large private companies are reviewed by FRRP to determine whether they are in compliance with the applicable financial reporting standards. The FRRP conducts its review by selecting companies' financial statements in consultation with the Financial Services Authority and its Standing Advisory Group. The selection of financial statements is mainly driven by an assessment of risk of non-compliance and the risk of significant consequences if non-compliance were to occur. In December 2006, the FRRP published a preliminary report outlining particular areas in IFRS reporting where improvements were needed.

As discussed above, the case studies show the different approaches that countries take in enforcing IFRS. While in some countries governmental agencies are responsible for the enforcement of financial reporting standards, in others, private sector or independent panels are in charge of reviewing financial statements to determine compliance.

V. Technical issues

The case study of the United Kingdom once again underscores the significant technical challenges that transition to IFRS poses. The general view was that due to the close resemblance of IFRS to UK Generally Accepted Accounting Principles (GAAP), the transition to IFRS would not be a challenging process for UK companies. However, in reality, a number of technical issues emerged. Some of the main ones were in relation to property, plant and equipment; intangible assets; impairment of financial assets; financial instruments; deferred taxation; leases; defined benefit pension schemes; and consolidation of group entities.

As noted above, in December 2006, the FRRP published a preliminary report on implementation of IFRS. The areas that the FRRP identified as requiring improvement included: description of accounting policies that did not give meaningful information; failure to disclose or inadequate disclosure in relation to subjective or complex judgements made by management; goodwill; disclosures with respect to the likely impact of new IFRS on initial application; and failure to identify key management personnel as related parties in accordance with IFRS; as well as other omissions in disclosures.

Based on its reviews of financial statements for the period 2002–2007, the Swiss Exchange published a list of erroneous applications of IFRS that became grounds for sanctioning the companies that failed to apply the IFRS correctly. The most frequent ones were in relation to statement of cash flows; interim financial reporting; financial instruments – recognition and measurement; segment reporting; impairment of financial assets; construction contracts; and related party disclosures.

The case study of Egypt discusses practical implementation challenges in relation to translation. The Accounting Standards Committee of the Egyptian Society of Accountants and Auditors identifies IFRS that could be applied in Egypt by taking into consideration the economic situation of the country. The IFRS are then translated into Arabic, forming the basis for drafting an Egyptian Accounting Standard. Egyptian Accounting Standards may not always be up to date (relative to the IFRS in effect) because of the time needed for translating standards into Arabic.

VI. Practical challenges and related considerations in implementing International Standards on Auditing

The country case studies indicate that in addition to IFRS, countries are also implementing International Standards on Auditing (ISAs). More than 100 countries or jurisdictions use auditing standards that are ISAs (either adopted as written by the IAASB or with essential jurisdictional changes) or national auditing standards that are compared to ISAs to eliminate differences. Chapter 6 elaborates on the following considerations for addressing practical challenges that arise in the implementation of ISAs: (a) a robust implementation strategy and action plan; (b) adequate implementation support infrastructure; and (c) training, education, and timely and high-quality translations of ISAs.

Chapter 2

Review of practical implementation issues relating to International Financial Reporting Standards: Case study of Egypt*

I. Introduction

Egypt has greatly benefited from reforms to open up and liberalize its economy in recent years, and has quickly become a dynamic market economy led by the private sector and well integrated in the global economy.¹ It has achieved excellent GDP growth rates of 7.1 per cent in 2006/07 (up from 4.6 per cent in 2004/05) and 6.9 per cent in 2005/06,² and a rate of about 7 per cent has been predicted by the International Monetary Fund (IMF) for the next few years. This performance was accompanied by record foreign direct investment (FDI) of more than \$6 billion in 2006. There have been improvements in most economic and social indicators. Private investment increased from an average of 8 per cent of gross domestic product (GDP) in fiscal years between 2001 and 2004, to 13.1 per cent in 2007. Moreover, FDI increased from an average of 0.6 per cent of GDP between 2001 and 2004, to 8.6 per cent in 2007.

Egypt has taken important steps to liberalize trade in financial services, in line with World Trade Organization (WTO) standards. Under Egyptian law, foreign investors are free to participate in the securities market without any ownership-related restrictions. The same administrative and legislative rules apply to both Egyptian companies and international financial organizations. Likewise, listing and trading rules are the same for both local and foreign securities. Finally, foreign investors are now free to engage in securities trading without any limitations on capital movement.

As a developing country with an emerging capital market, Egypt closely follows developments in international financial reporting and auditing. The Capital Market Authority (CMA) is fully committed to bringing the Egyptian capital market into line with international standards. It promotes adherence to the securities regulation rules established by the International Organization of Securities Commissions, the corporate governance principles of the Organization for Economic Cooperation and Development (OECD), securities numbering schemes set forth by the Association of National Numbering Agencies, as well as clearing and settlement best practices, Egyptian and international accounting and auditing standards, and the anti-money laundering recommendations issued by the Financial Actions Task Force.

This report presents the historical development of accounting and financial reporting in the country, and discusses recent regulatory developments following the attempts at convergence with the global set of financial reporting standards commonly referred to as International Financial Reporting Standards (IFRS). In doing so, this report details the Egyptian experience in adapting to IFRS and the lessons learned in the implementation process.

Egypt has an eventful history in the field of financial management and accountability. During the 1960s, with the move to economic management based on central planning, nationalization, and rapid expansion of the public sector, the Central

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¹ Organization for Economic Cooperation and Development (2007). *African Economic Outlook*.

² Embassy of the United States of America (2007). *Economic Trends Report: Egypt*. May.

Auditing Organization became the governmental agency responsible for auditing the public sector, including state-owned companies. In the mid-1970s, the Egyptian Government introduced an “open door” policy to liberalize the national economy; in 1991, the Government launched a comprehensive economic reform and structural adjustment programme supported by the World Bank and the IMF. Key international donor/lending institutions, such as the World Bank and the IMF, exert pressures on developing and transition countries to adopt IFRS as part of their reform programmes. They argue that the application and implementation of internationally accepted accounting standards is necessary in order to command the confidence of investors.

Egypt is aware that sustaining such a programme depends on the existence of a sound financial regulatory framework, the availability of credible corporate information, and the adoption of internationally accepted accounting and auditing standards. As part of these efforts, the Government of Egypt has launched several initiatives to reform corporate financial reporting and disclosure requirements, as well as accounting and auditing standards and practices.³

The Government of Egypt has made efforts to modify the law to achieve compliance with internationally accepted accounting and auditing standards. These modifications include drafting a new accounting practice law, and modifying the Company Act, the Capital Market Act and the Banking Act. Consequently, important improvements have been made to accounting and disclosure requirements for publicly traded companies and financial institutions, as well as to the Egyptian Accounting Standards (EAS), as benchmarked against the International Accounting Standards (IAS). Moreover, a new accounting practice bill has been drafted. As a result of various reforms and in order to improve the quality of financial reporting and disclosure, a new set of the Egyptian Accounting Standards, based on IFRS, was issued in 2006. Furthermore, a new set of Egyptian Standards on Auditing (ESA), based on ISAs, was prepared and issued pursuant to Decree No. 166/2008 of the Minister of Investment.

A. A brief history of accounting in Egypt

Historically, Egyptian accounting was not capital market oriented; it followed the principles of macro-accounting with strong government intervention to control the economy, and was closely connected with accounting for tax purposes. Economic liberalization in the 1990s – aimed at creating a guided free-market economy – involved the reactivation of the stock exchange market in 1995 and a privatization programme. The transition posed challenges for the Government, private sector institutions, and the accounting profession. The aim was to increase the role of the private sector. There was, therefore, a need for changes to and reforms of accounting systems to improve decision-making, attract investment, stimulate economic development through increased competition, and enhance the level of confidence of foreign portfolio investors in the Egyptian capital market.⁴

B. Egyptian accounting and auditing standards (1997–2002)

As part of the reform process, the Government of Egypt pursued a policy of harmonizing EAS with the IAS issued by the International Accounting Standards Board (IASB). Egypt decided to harmonize its national accounting standards with IAS, while ensuring that the specific characteristics of the Egyptian environment were taken into account. As a result of Ministerial Decision No. 503, in October 1997 Egypt established the Permanent Committee for Accounting and Auditing Standards to issue EAS that were to be based on IAS but adapted for local conditions. Although official responsibility for setting accounting and auditing standards rests with the permanent committee, the Egyptian Society of Accountants and Auditors has, in practice, the main responsibility for drafting accounting and auditing standards. The society’s standard-setting committee selects international accounting and auditing standards that are

³ World Bank (2002). *Report on the Observance of Standards and Codes, Egypt (Arab Republic): Accounting and Auditing*. 15 August.

⁴ Samaha K and Stapleton P (2008). Compliance with International Accounting Standards in a national context: some empirical evidence from the Cairo and Alexandria stock exchanges. *Afro-Asian Journal of Finance and Accounting*. 1 (1).

applicable to the Egyptian situation. Once the committee selects an international standard, it is translated into Arabic and becomes the basis for drafting an Egyptian standard that reflects specific requirements under Egyptian laws and regulations. The draft standard is submitted to the permanent committee for discussion, finalization and adoption. The final version of the standard is transmitted to the Ministry of Foreign Trade for issuance by a ministerial decree.⁵

As from 1998, all listed companies in Egypt were required to comply with the new EAS. By 2000, there were 22 EAS, most of which are comparable to the corresponding IAS with the exception of minor differences. The main aims of the approach taken were to enhance the quality of information issued by listed companies, to improve decision-making, to attract investors, to stimulate economic development through increased competition, and to enhance the level of foreign portfolio investors' confidence in the Egyptian capital market.

In 2002, Egypt had 22 accounting standards and 6 auditing standards. The ESA issued in 2000 deal only with reporting issues and ignore the other areas of ISAs. However, ISAs are applied in the absence of ESA, as stated in the ESA introduction.

C. Egyptian accounting and auditing standards (2002–2008)

The new Government that took office in June 2004 set a major agenda for macroeconomic and structural reform and modernization. As part of this agenda, it submitted a programme of financial reforms that was formally endorsed by the President of Egypt in September 2004. Known officially as the Financial Sector Reform Programme, it is to be implemented over the period 2005–2008. The programme represents the most far-reaching, substantive and comprehensive drive towards financial sector strengthening to have been launched in Egypt to date.⁶

As the need to improve the financial reporting and disclosure system had been recognized, a new set of EAS were issued, as a part of many other reforms, pursuant to Decree No. 243/2006 of the Minister of Investment, thus replacing the old standards issued under the two ministerial decrees Nos. 503/1997 and 345/2002. These standards are applicable to all listed joint stock companies.

The new EAS have been issued to comply with economic changes and scientific and technological developments either on the business performance level of the companies or on the level of the accounting systems that they apply. The issuance of these standards is an important step in improving the application of principles of good corporate governance by listed companies.

The latest Income Tax Act No. 91/2005 requires that net profits for tax purposes be based on the accounting profit in the audited financial statements that are prepared according to EAS, after adjustments by the tax inspectors, with some tax rules also being used for financial reporting purposes.

The 35 EAS were prepared on the basis of IFRS (2005 version), except for some departures and adaptations (see table below). Preparers of financial reports refer to IFRS in cases where EAS does not address specific issues.

The main departures and adaptations from IAS/IFRS are:

- (a) EAS 1 “Presentation of financial statements” (corresponding to IAS 1):
 - (i) Profit distribution to employees and members of the Board of Directors (employee benefits) are not recorded as expenses in the income statement, rather they are recorded as dividends distribution in accordance with the requirements of local law;

⁵ Ibid.

⁶ Ministry of Investment and Central Bank of Egypt (2006). *Programme Information Document: Appraisal Stage*. Report no. AB2097.

(ii) This departure also affects two other standards, namely EAS 22 “Earnings per share” and EAS 38 “Employee benefits”;

(b) EAS 10 “Fixed assets and their depreciation” (corresponding to IAS 16):

Paragraphs 31–42 of this standard on the revaluation model have been modified, as this model cannot be used except in certain cases, and when it does not contradict the laws and by-laws. Otherwise, the entity should use the cost model as provided in paragraph 30 of IAS 16;

(c) EAS 19 “Disclosure in financial statements of banks and similar financial institutions” (corresponding to IAS 30 which has been superseded by IFRS 7):

Paragraphs 44, 51 and 52 of this standard have been omitted, as they prohibit forming a general provision for loans and borrowings as a deduction from profits and losses (expense item), instead stipulating that this provision must be formed as a deduction from the owners’ equity (reserve). According to the regulations of the Central Bank of Egypt and generally accepted Egyptian banking practices, however, this provision may be treated as an expense, and is therefore deducted from revenue before calculating profits and losses.

(d) EAS 20 “Accounting rules and standards for financial leasing operations” (corresponding to IAS 17):

This standard is different from IAS 17 for leasing, as the Egyptian Financial Leasing Act No. 95/1995 issued by the Minister for Economics and Foreign Trade stipulates a completely different accounting treatment from that widely used internationally (articles 24 and 25), under which the lessor records the leased asset in his books and depreciates it, while the lessee records the value of the payments of the leasing contracts in the profits and losses as expenses in the period in which they are paid.

D. Egyptian Standards on Auditing

In cooperation with the Egyptian Society of Accountants and Auditors, the CMA prepared the Egyptian Standards on Auditing (ESA), periodic reviews and assurance services that comply in form and content with ISAs issued in 2007. The draft was discussed among stakeholders; the final set of standards was issued in Arabic on 30 June 2008, and it will be applicable to all audit engagements starting from 1 January 2009. The set of standards includes a preface, the theoretical framework for assurance services, 32 Egyptian auditing standards, a standard for reviews, two Egyptian standards for assurance services, two Egyptian standards for other related services, and guidance on the issues that the auditor must consider in his audit for small entities. The new set of standards will replace the old set issued in 2000.

Egyptian Accounting Standards and corresponding IAS

| | Egyptian Accounting Standards | Corresponding IAS (IFRS) |
|--------|--|---------------------------------|
| EAS 1 | <i>Presentation of financial statements</i> | IAS 1 |
| EAS 2 | <i>Inventories</i> | IAS 2 |
| EAS 4 | <i>Statement of cash flow</i> | IAS 7 |
| EAS 5 | <i>Accounting policies, changes in accounting estimates and errors</i> | IAS 8 |
| EAS 7 | <i>Events after the reporting period</i> | IAS 10 |
| EAS 8 | <i>Construction contracts</i> | IAS 11 |
| EAS 10 | <i>Fixed assets and their depreciation</i> | IAS 16 |
| EAS 11 | <i>Revenue</i> | IAS 18 |
| EAS 12 | <i>Accounting for government grants and disclosure of government assistance</i> | IAS 20 |
| EAS 13 | <i>The effects of changes in foreign exchange rates</i> | IAS 21 |
| EAS 14 | <i>Borrowing costs</i> | IAS 23 |
| EAS 15 | <i>Related party disclosures</i> | IAS 24 |
| EAS 17 | <i>Consolidated and separate financial statements</i> | IAS 27 |
| EAS 18 | <i>Investments in associates</i> | IAS 28 |
| EAS 19 | <i>Disclosures in financial statements of banks and similar financial institutions</i> | IAS 30, superseded by IFRS 7 |
| EAS 20 | <i>Accounting rules and standards for financial leasing operations</i> | IAS 17 |
| EAS 21 | <i>Accounting and reporting by retirement benefit plans</i> | IAS 26 |
| EAS 22 | <i>Earnings per share</i> | IAS 33 |
| EAS 23 | <i>Intangible assets</i> | IAS 38 |
| EAS 24 | <i>Income taxes</i> | IAS 12 |
| EAS 25 | <i>Financial instruments: disclosure and presentation</i> | IAS 32, superseded by IFRS 7 |
| EAS 26 | <i>Financial instruments: recognition and measurement</i> | IAS 39 |
| EAS 27 | <i>Interests in joint ventures</i> | IAS 31 |
| EAS 28 | <i>Provisions, contingent assets and liabilities</i> | IAS 37 |
| EAS 29 | <i>Business combinations</i> | IFRS 3 |
| EAS 30 | <i>Interim financial reporting</i> | IAS 34 |
| EAS 31 | <i>Impairment of assets</i> | IAS 36 |
| EAS 32 | <i>Non-current assets held for sale and discontinued operations</i> | IFRS 5 |
| EAS 33 | <i>Segment reporting</i> | IAS 14 |
| EAS 34 | <i>Investment property</i> | IAS 40 |

| Egyptian Accounting Standards | | Corresponding IAS (IFRS) |
|--------------------------------------|---|---------------------------------|
| EAS 35 | <i>Agriculture</i> | IAS 41 |
| EAS 36 | <i>Exploration for and evaluation of mineral assets</i> | IFRS 6 |
| EAS 37 | <i>Insurance contracts</i> | IFRS 4 |
| EAS 38 | <i>Employee benefits</i> | IAS 19 |
| EAS 39 | <i>Share-based payment</i> | IFRS 2 |

II. Regulatory framework

A. Statutory framework

At present, the principal legislation governing professional accountants and auditors, particularly in the private sector, is Accounting Practice Act No. 133/1951 and its amendments. Under current law, individuals joining the public practice of accounting and auditing must register on the General Register for Accountants and Auditors, which is maintained by the Ministry of Finance and does not require a qualifying examination for entry. The current law provides a broad framework for accounting and financial reporting, and authorizes the Ministry of Finance to develop a standardized chart of accounts and detailed instructions on accounting treatments and reporting formats. The legal approach, which was taken in the early 1950s to establish a uniform accounting system, inhibited the development and application of accounting standards conducive to high-quality financial reporting in a market economy.⁷

In cooperation with the Ministry of Finance, the Commercials' Syndicate, CMA and the Central Auditing Agency, the Egyptian Society of Accountants and Auditors has prepared a draft law to regulate practice of the accounting and auditing profession in Egypt, as an amendment of the current Act No. 133/1951. The draft law was discussed at the State Council and was referred to the Government in preparation for forwarding it to the People's Assembly for approval.

Auditors have greater liability under the new law. Under article 46, the auditor will be liable to the company for which he/she audits financial statements, as well as to third parties, to compensate for any damage resulting from his/her work, which should be carried out with due care and in accordance with professional standards and practices.⁸ The draft law fails to address important elements, however, that could strengthen the auditing regulatory framework – for example the need for continuing professional education. These deficiencies can be covered in the law itself or in the executive regulation.⁹

The Company Act No. 159/1981 provides the framework for the establishment and operation of companies within Egypt. The law covers the main establishment procedures, the management and control responsibilities, the extent of liability of owners, the required accounting and financial control procedures and other issues that a company may encounter in the course of its business.¹⁰

All companies registered under the Company Act should maintain sound accounting records and present annual audited financial statements. Under the Company Act, the annual general meeting of shareholders should monitor auditor performance and appoint a new auditor or renew the appointment of the existing auditor. The Company Act also requires the auditor to report at the annual general meeting that: (a) all data and explanations for satisfactory fulfilment of duties have been obtained; (b)

⁷ World Bank (2002). *Report on the Observance of Standards and Codes, Egypt (Arab Republic): Accounting and Auditing*. 15 August.

⁸ Ibid.

⁹ Ibid.

¹⁰ Azab BI (2002). *The Performance of the Egyptian Stock Market*. Master's thesis. Birmingham Business School. University of Birmingham. September.

the company maintains satisfactory accounting records; (c) all relevant legal requirements have been reflected in the accounts; (d) the financial statements provide a true and fair view of the company's financial condition and results of operations; and (e) the inventory has been recorded in conformity with the applicable rules. The Company Act does not cover accounting and auditing standards, but requires that external audits should be conducted in compliance with the Accounting Practice Act No. 133/1951. According to provisions of the Company Act, the auditor or relatives of the auditor must not be a founder, director, permanent consultant or employee of the firm subject to the audit, but there is no restriction on shareholders being appointed as external auditor of the company.¹¹

A draft amendment to the Company Act, which is under discussion, includes provisions requiring all companies to observe the same accounting standards as are applicable for companies regulated by CMA. Moreover, these provisions specify the rights and duties of company auditors.

According to the Capital Market Act No. 95/1992, all listed companies are required to follow EAS. Egypt has had a stock exchange since 1882. In the 1990s, the Government of Egypt decided to refresh its capital market by recovering its status and the confidence of investors. The Government, encouraging new foreign capital and national capital, accordingly issued the new Capital Market Act No. 95 in 1992.¹²

The Capital Market Act requires all listed companies to prepare financial statements in compliance with IAS.¹³ The Ministerial Decree No. 503/1997 mandated the use of EAS by all enterprises and, in the absence of EAS regarding the accounting treatment, the requirements set under IAS. Subsequently, the Capital Market Act required all listed companies to publish financial statements in two widely circulated newspapers and establish an audit committee.

In 2002, CMA approved new listing rules that introduced enhanced administrative actions against those issuers who do not comply with the reporting requirements. As a result, hundreds of companies were delisted for failing to observe the new listing rules. The rules aim to ensure timely preparation and presentation of financial statements and full compliance by issuers with accounting, auditing and other legal requirements. According to these rules, CMA can impose an administrative penalty if the issuer failed to disclose information that resulted in losses to investors. The penalty could be doubled in cases of recurrent nondisclosure during the same year. Article 65 of Capital Market Act No. 95/92 states that a penalty of 2,000 Egyptian pounds per day is imposed on companies that do not file the required information within 45 days of the end of each quarter and 90 days after the end of each financial year. According to the new rules, all listed companies are required to establish an audit committee with the objective of strengthening corporate governance and improving financial reporting. Mandatory financial disclosure includes the balance sheet, income and cash flow statements, changes in stockholder equity and board composition, as well as the external auditor's report and directors' report. Companies are required to publish a summary of their semi-annual and annual reports in two newspapers, at least one of which is in Arabic. Companies are not required to publish a full annual report, although many actively traded companies do publish a detailed report (but without any standard form). It is worth mentioning that CMA recently issued Decree No. 96/2006 that clarifies the role of CMA in monitoring corporate financial reporting, including assessing the quality of auditors. Act No. 123/2008 which contains some amendments to Capital Market Act No. 95/92 states that CMA is responsible for establishing a register for public companies accountants and that CMA will set the requirement for listing and delisting auditors in that register.

¹¹ World Bank (2002). *Report on the Observance of Standards and Codes, Egypt (Arab Republic): Accounting and Auditing*. 15 August.

¹² Wahdan MA et al. (2005). *Auditing in Egypt: A study of the legal framework and professional standards*. Partners' conference. Maastricht School of Management.

¹³ Ministerial Decree No. 503/1997 was issued by the Ministry of Economy and Foreign Trade, which was the supervising ministry of CMA. The name of the ministry has been changed to the Ministry of Foreign Trade; it continues to issue accounting and auditing requirements for all enterprises falling under the CMA regulatory framework. Currently, the Ministry of Investment is responsible for issuing these standards.

The Banking Act No. 88/2003 requires all banks to follow accounting and auditing requirements and guidelines set by the Central Bank of Egypt. The Central Bank issues guidelines to banks on financial reporting and requires them to follow EAS. The Central Bank has not, however, released new guidance on reporting for the banking sector yet; banks therefore report under the guidance of the Central Bank on EAS, which are largely in line with the 2002 version of IAS. The Central Bank also requires banks to file annual, semi-annual and quarterly reports, including financial statements. Regulations which aim at ensuring audit quality state that two licensed auditors must audit bank financial statements and that individual auditors cannot sign audit reports for more than two banks per year. The two signatories may not be partners of the same audit firm. It is also worth mentioning that the Banking Act and its executive regulation require banks to have an internal audit department that reports to the bank's audit committees. The Central Bank is currently preparing a new set of financial reporting guidelines which are based on IFRS.

The Central Auditing Organization is responsible for the audit of state-owned enterprises. Central Auditing Organization Act No. 144/1988 governs the auditing of government departments and agencies, public sector enterprises and companies in which ownership interest of public investment is not less than 25 per cent. It controls government funds and those of other public corporate bodies. It helps Parliament to control financially both accounting and legal sections, check performance, follow up the implementation of the plan and review legally decisions issued on financial irregularities. The Central Auditing Organization submits its reports to the People's Assembly (Parliament), which remits them to specialized committees for review. The Central Auditing Organization has taken important steps towards harmonizing public sector accounting and auditing standards with the internationally accepted standards. The capacity of the Central Auditing Organization needs to be strengthened, however, to improve compliance with internationally accepted public sector accounting and auditing standards.¹⁴

Audit firms cannot be appointed as statutory auditors of companies. Under the current legislative framework in Egypt, only licensed individuals can act as auditors. In practice, companies appoint individual partners of audit firms.

B. Regulatory bodies

The three financial regulators in Egypt are: the Capital Market Authority (CMA), the Central Bank of Egypt and the Egyptian Insurance Supervisory Authority.¹⁵

CMA is the market regulatory agency responsible for ensuring the development of a transparent and a secure market for investors in Egypt and is subject to the supervision of the Minister for Investment.

CMA plays a major role in creating an environment that establishes public confidence in promoting investment in Egyptian companies. CMA promotes market transparency by monitoring compliance with disclosure rules of all listed companies and investment funds. CMA also reviews and analyses accounting, auditing and disclosure malpractice. CMA enforces the Capital Market Act, its executive regulations and related decisions by: (1) receiving and approving requests to issue new securities; (2) handling licensing of all companies in the securities industry; and (3) ensuring disclosure by market participants and adherence to EAS based on the IAS.¹⁶ CMA can draft new secondary regulations, which are then issued as decrees of the Minister for Investment. New executive regulations and rules have been issued to address a number of issues, including disclosure, stock exchange listing, tender offers, corporate

¹⁴ World Bank (2002). *Report on the Observance of Standards and Codes, Egypt (Arab Republic): Accounting and Auditing*. 15 August.

¹⁵ Bahaa-Eldin Z (2001). *Legal Constraints on the Role of Financial Regulators in Egypt*. January.

¹⁶ Dahawy K and Conover T (2007). Accounting disclosure in companies listed on the Egyptian stock exchange. *Middle Eastern Finance and Economics*. 1.

governance requirements, mutual funds, minority shareholder rights, and securitization.¹⁷

CMA reviews annual financial statements presented by listed companies. The main purpose of the review is to ensure timely filing of financial statements. This review uses a checklist that reinforces reporting and disclosure requirements and that helps monitor compliance with accounting and auditing requirements in preparing financial statements. With regard to compliance, it is the reviewers' task to focus on whether companies and auditors have resorted to accounting manipulations that distort the company's financial condition and operating performance. Reviewers also check whether audit reports that accompany financial statements follow the reporting format prescribed by ESA.

Where violations of standards are observed, CMA has wide administrative sanctioning powers, including to issue warning, delist, suspend and revoke licences, impose monetary penalties, cancel transactions (even after settlement if there has been an illegal act), inspect and suspend shareholder decisions. It can refer cases to the Prosecutor General to initiate proceedings.

In addition to the above legislation, the Cairo and Alexandria Stock Exchanges set a number of listing rules for companies wishing to be listed and traded on the exchange, in liaison with CMA.¹⁸

The Cairo and Alexandria Stock Exchanges (now known as the Egyptian Exchange), legally a self-regulatory authority, are managed by an elected board of directors under the supervision of CMA. The stock exchanges were established in 1883 and 1903, respectively, and reached their historic peak in the 1940s when together they constituted the fifth largest market in the world. After several decades of low market activity, the exchanges started growing again in 1992, under the impetus of economic reforms, privatization and changes in the regulatory environment. As a result of the economic reforms, market capitalization grew exponentially, from 5 billion Egyptian pounds in 1990 to 602 billion as of 30 June 2007.

CMA has the right to object to the decisions issued by the exchanges' board of directors. The exchanges are responsible for supervising commitment to registration rules, but have no authority for investigation and inquiries. The exchanges may impose sanctions that include downgrading listing status, trade suspensions, delisting, and (since the recent changes to the listing rules) monetary penalties.

The Central Bank of Egypt is the oldest of the three financial regulators. It is an autonomous public legal entity. Autonomy here refers to the fact that the bank is an independent legal entity, not under the direct administrative supervision of any government body.¹⁹ The Central Bank is authorized to undertake a number of steps against banks that violate the provisions of the law. These include the cancellation of the bank's registration, deduction of sums from the bank's account with the Central Bank if it does not maintain the required liquidity ratio, conveyance of a notice to the bank stating the violation, reduction of the credit facilities accorded to the bank, prevention of the bank from undertaking certain activities, the requirement that it deposits with the central bank additional funds, convening of a meeting for the bank's board of directors in order to discuss the violations, appointment of a supervising member to the bank's board and the dissolution of the bank.²⁰

The Egyptian Insurance Supervisory Authority was established in accordance with Insurance (Supervision and Regulation) Act No. 10 of 1981. This legislation was introduced in order to allow for private sector participation in the insurance industry and to restructure the supervisory framework.²¹ There are new accounting regulations

¹⁷ World Bank (2004). *Report on the Observance of Standards and Codes – Corporate Governance Country Assessment: Egypt*. March.

¹⁸ Azab BI (2002). *The Performance of the Egyptian Stock Market*. Master's thesis. Birmingham Business School. University of Birmingham. September.

¹⁹ Bahaa-Eldin Z (2001). *Legal Constraints on the Role of Financial Regulators in Egypt*. January.

²⁰ Ibid.

²¹ Ibid.

for insurance companies which require insurance companies to apply IAS/IFRS for general-purpose financial statements. On a temporary basis, national bylaws on the measurement of insurance technical business – mainly on calculating insurance technical provisions – are being applied.

The powers which the Egyptian Insurance Supervisory Authority can use against the violating insurance company include sending a notice, restricting the company's acceptance of new insurance operations, requesting that the company submit additional financial statements, requesting the convening of the company's board of directors, appointing a supervising member to the board, restricting the distribution of dividends to shareholders, amending the company's investment policies, removing some of the company's executive directors and dissolving the board of directors.²²

C. The profession

The Egyptian Society of Accountants and Auditors plays a central role in the accounting profession. It is an organization of chartered accountants and is responsible for developing educational and professional standards. It is a member of the International Federation of Accountants. It was established in 1946 and is managed by a board of directors.

The Egyptian Society of Accountants and Auditors admits members if they satisfy one or more of the following conditions: (1) membership in the Institute of Chartered Accountants in England and Wales or another acceptable foreign professional body; (2) doctoral degree in accounting or auditing with three years of full-time work experience in practice; and/or (3) at least three years of full-time work experience in the office of a practising member of the Egyptian Society of Accountants and Auditors or equivalent, and successful completion of the two-part examination. The first examination is taken after eighteen months and then the second part at the end of the three-year period.

The Registration Committee for Accountants and Auditors in the Ministry of Finance has a list of more than 30,000 registered accountants. Registration rules require a graduate to have a bachelor's degree in accounting to register as a trainee accountant. Trainees become licensed as first-level accountants after three years of work in an accountant's office, which authorizes them to work as auditors of sole proprietorships and partnership enterprises. After an additional five years of experience, accountants obtain a final registration certificate and become licensed to act as auditors of corporations. Auditors are not required to take any qualifying examinations before registration by the Accountant Registry. Auditors can also register directly in the Egyptian Society of Accountants and Auditors as a member, which qualifies them for a licence to audit corporations.²³

In 2002, a World Bank study reported that audit practitioners in Egypt were not required to follow a modern code of ethics in line with the Code of Ethics for Professional Accountants of the International Federation for Accountants (IFAC).²⁴ The Syndicate of Accountants Act No. 40/1972 discusses ethics breach criteria, such as fraud. Although the Ministry of Finance and the syndicate have been highlighting awareness of legal requirements, some accountants and auditors ignore the code of ethics to boost practical performance.

The Egyptian Society of Accountants and Auditors has drafted a new code of conduct that complies with all the aspects of the IFAC code. On the basis of this draft, CMA issued some rules that apply to all registered auditors and a communication is currently being prepared by the society and the Ministry of Finance to issue this code and apply it to all the members of the Central Auditing Organization.²⁵

²² Bahaa-Eldin Z (2001). *Legal Constraints on the Role of Financial Regulators in Egypt*. January.

²³ Wahdan MA et al. (2005). *Auditing in Egypt: A study of the legal framework and professional standards*. Partners' conference. Maastricht School of Management.

²⁴ World Bank (2002). *Report on the Observance of Standards and Codes, Egypt (Arab Republic): Accounting and Auditing*. 15 August.

²⁵ The Egyptian Society of Accountants and Auditors. *Annual Report 2007*.

All accounting degree holders are eligible for syndicate membership. The six jobs that are deemed equivalent to work in a practising accountant's office are: (1) Central Auditing Organization's auditor, (2) tax inspector, (3) social insurance inspector, (4) Ministry of Finance accountant, (5) inspector in the Ministry of Foreign Trade, and (6) staff member dealing with financial matters in government departments.

The legal framework surrounding the accounting and auditing profession in Egypt includes the basic Company Act, the Accounting Practice Act (1951) and the Banking Act (1957). A revision of the Company Act was proposed in 1997 but is yet to be finalized and implemented. The Central Accounting Organization Act (1988) and Capital Market Act (1992) have had considerable impact and influence on the practice of accounting auditing in Egypt. The combined set of laws represents the legal framework for the accounting and auditing profession in Egypt.²⁶

The audit profession in Egypt faces challenges in complying with professional standards of accounting and auditing. Some of the factors that contribute to the lack of compliance are: (1) the lack of experience and expertise; (2) the gap between accounting and auditing education and latest practices; and (3) the lack of competitiveness of the profession in terms of salaries and incentives.²⁷

III. Capacity-building

The Egyptian Capital Market Act No. 95 issued in 1992 has made it compulsory for corporations to prepare their annual and periodic financial statements and disclose them in accordance with IAS and EAS which are in compliance with IAS, with exception for a few adjustments. The law requires that annual audit reports and periodic review reports should be conducted by independent, competent and qualified auditor in accordance with ISAs.²⁸

The main components of the Egyptian disclosure and transparency framework are: (1) a legal framework to issue rules and regulations in accordance with international standards; (2) a regulatory agency enforcing the implementation of these standards; (3) an independent, competent and qualified auditor; and (4) a disciplined self-regulatory professional accounting association setting standards and monitoring implementation.²⁹

Standards alone do not guarantee the quality of financial information disclosed, rather institutional factors such as the incentives of preparers should also be considered, as well as building the capacities of the practitioners and developing independent, competent and qualified auditors.

A. Education programmes

Educational quality suffers from the lack of a modern syllabus and a very high student to teacher ratio. According to a World Bank study,³⁰ the teacher-student ratio in accounting and auditing departments of large public universities was about 1 to 1,000, which lowers educational quality and impedes essential teacher-student communication. Educational programmes are not improving students' critical thought and expertise. Traditional accounting and auditing courses focus on basic topics and not application of standards. As there are many new private universities and English sections in business schools in public universities, however, the teacher-student ratio is decreasing, while new international, up-to-date textbooks are being taught. At postgraduate level, the quality of accounting and auditing education is relatively high because the syllabus

²⁶ Wahdan MA et al. (2005). Auditing in Egypt: A study of the legal framework and professional standards. Partners' conference. Maastricht School of Management.

²⁷ Ibid.

²⁸ Yassin H. <http://www.cs.unimaas.nl/auditing-symposium/the%20new%20impact%20of.ppt#28>

²⁹ Ibid.

³⁰ World Bank (2002). *Report on the Observance of Standards and Codes, Egypt (Arab Republic): Accounting and Auditing*. 15 August.

includes international accounting and auditing standards and practices, and encourages development and empirical research.³¹

Although private universities introduce high-quality accounting education, the best students rarely join the public accounting profession in Egypt. The reason is that the accounting profession's rewards and fees are not competitive. In addition, while private universities offer English-language accounting programmes using an international syllabus and English textbooks, high tuition fees for private universities are restrictive. Although many public universities have established an English-language section in the accounting department, the impact on the accounting profession is likely to be limited.

New majors have been now introduced in public universities in cooperation with leading international universities; these majors lead to a bachelor degree with professional knowledge. One example is an accounting major which will give students the latest knowledge in accounting and auditing and enable them to sit the exam with the required knowledge.

B. Apprenticeship programmes

The registration requirements do not require adequate practical knowledge from novices to perform the audit. They are fulfilled by the applicant getting a letter from an accounting office stating that the applicant has work experience for the specific apprenticeship period. Furthermore, the knowledge gap of practitioners is increased by the absence of a continuous education system. The Egyptian Society of Accountants and Auditors has started a learning programme for candidates registering for its own examinations. Most practising accountants and auditors without society membership will, however, suffer from a lack of training and the proper knowledge for supporting high-quality financial reporting.

The Egyptian Society of Accountants and Auditors organizes seminars and workshops open to practitioners and academics on various issues of IFRS/EAS. In addition, the society will be providing a diploma course on IFRS starting in the second half of 2008.³²

In light of the increasing independence on the financial information and reports, which affects the role of the accountants and auditors, and the effect of the accountants and auditors performance of the economic level in general and both on the national and international level, the society has established a project to develop general rules of continuous professional development, in accordance with IFAC, after studying the systems applied in other international professional organizations. These rules aim at improving the educational and professional level of the society members to face the advancements in the field of accounting and auditing.³³

Training and education on IFRS are mostly provided by universities and academic organizations. Recently, universities have already incorporated IFRS courses in their graduate and undergraduate curricula as elective courses. In some universities, principles of accounting courses are covered using IFRS. Accounting textbooks are revised to reflect the changes that are brought about by the implementation of IFRS.

VI. Lessons learned

Egypt has undertaken a number of steps to improve its financial reporting and auditing system. To facilitate the implementation of IFRS and ISAs in Egypt, the Egyptian Accounting and Auditing Standards were issued in compliance with the international standards with few departures/adaptations.

³¹ Wahdan MA et al. (2005). Auditing in Egypt: A study of the legal framework and professional standards. Partners' conference. Maastricht School of Management.

³² The Egyptian Society of Accountants and Auditors. *Annual Report 2007*.

³³ Ibid.

The adoption of IFRS proved to be a gradual process. The first step was the early adoption of IAS in 1997. The process is now that, once the Egyptian Society of Accountants and Auditors selects the international accounting and auditing standards applicable to the Egyptian situation, it translates them into Arabic. These standards become the basis for drafting an Egyptian standard. The first version of such standards is introduced to the Permanent Committee for discussion and adoption, and then sent to the Ministry of Foreign Trade for issuance by ministerial decree.³⁴ The second step is the compulsory adoption of EAS which are considered to be the Arabic version of IAS. It is also stated in the preface to the Egyptian standards that IAS should be applied on issues for which no Egyptian standard is issued.

Despite the fact that EAS are based on IFRS, there is a delay in the implementation of new standards. There is also a delay in the issuance of implementation guidance for standards. This is due to a lengthy issuance process for local standards.

Significant amounts of training and education for financial-statement preparers and auditors of small local companies are needed. A lesson learned from the initial implementation is that these groups do not understand accounting standards sufficiently.

High-quality financial reporting depends on enforcement. Merely adopting internationally accepted accounting and auditing standards cannot ensure improvements in corporate financial reporting. There are three important links in the enforcement chain, and each must be strengthened. First, company directors, who have legal responsibility for preparing and presenting financial statements, must ensure that accounting staff members properly apply accounting standards. Second, auditors must act independently to provide assurance that financial statements comply with the established standards and portray a true and fair view of an enterprise's financial conditions and results of operations. Third, both self-regulatory organizations and statutory regulatory bodies must implement arrangements for efficient monitoring of regulatory compliance and consistently take action against violators.

CMA has been making efforts to raise awareness among the top management of listed companies on the requirements for compliance with accounting and financial reporting standards.

Continuing education requirements, which will need monitoring and enforcing, should conform to the IFAC guidelines/standards. Training programmes should enable practicing auditors and accountants to gain exposure to the practical application of IAS, ISAs and the IFAC-issued Code of Ethics for Professional Accountants. This matter can be addressed either within the new law or in regulations issued in accordance with provisions of the law. The Public Companies Accountants' Oversight Board of Egypt will be responsible for continuing professional development requirements of accountants who prepare financial statements of listed companies.

Egyptian public universities need to review and update their accounting curriculum to incorporate international accounting and auditing standards and include practical-oriented teaching at the undergraduate level in higher educational institutions. The ethical dimensions of business management, corporate finance, accounting, and auditing should be taught – with case studies – in the undergraduate programmes of business schools or commerce faculties.

Some laws and regulations need to be amended to allow full implementation of requirements in IFRS, for example, leasing. In the long term, it might be beneficial to refer to the accounting treatments and definitions outside the articles of law in order to allow for timely alignment and updating.

³⁴ Wahdan MA et al. (2005). Auditing in Egypt: A study of the legal framework and professional standards. Partners' conference. Maastricht School of Management.

V. Conclusion

This paper reviews practical implementation issues of IFRS in Egypt and describes the current accounting and auditing situation and the legal framework of the profession in Egypt.

In recent years, Egypt has made significant efforts (1) to align corporate financial reporting requirements with the IAS/IFRS and (2) to close the compliance gap in both accounting and auditing practice. Consequently, important improvements have been made to accounting and disclosure requirements for the publicly traded companies and financial institutions and in EAS, as benchmarked against IFRS. Moreover, the new Accounting Practice Act has been drafted and agreed upon by all stakeholders, though not yet been issued. Further improvements could be achieved by issuing a modern legislative framework that includes an appropriate regulatory framework for practising auditors, addressing weaknesses in professional education and training arrangements, introducing qualification examinations for auditor licensing, and developing an enforcement mechanism to ensure compliance with applicable accounting and auditing standards.

Notable steps have already been taken to build on the accounting reform. These steps include:

- (a) A new set of Egyptian accounting standards based on IAS/IFRS issued in 2006;
- (b) A new set of auditing standards based on ISAs issued in 2008;
- (c) New articles in the Capital Market Act that require establishing a register for Public Company Accountants' Oversight Board; and
- (d) A new unit in CMA for monitoring financial reporting.

Despite these steps, the financial reporting system in Egypt requires further improvements, especially in expediting the process of issuing new EAS after the release of any new IFRS, and reducing the gap between accounting education and practices in relation to international requirements.

Chapter 3

Review of practical implementation issues relating to International Financial Reporting Standards: Case study of Poland*

I. Introduction

Since 1989, Poland has undergone great political, social and economic changes. These developments have prompted important reform in the areas of accounting and reporting. This note presents Poland's experience of implementing IFRS. It also discusses the impact of IFRS on the financial statements of Polish companies immediately after adopting IFRS as their reporting basis.

Since 1990, Poland has attracted more than \$92 billion in foreign direct investment (FDI), principally from Western Europe and the United States. In 2007, the value of FDI inflow to Poland amounted to €12.834 billion. It is estimated that, in 2007, 85.3 per cent of direct investment flows were from European Union countries, mainly from France, Germany, Austria, Italy and Sweden. The most significant investment from outside the European Union came from the United States, the Netherlands Antilles, the Republic of Korea and Japan.

Poland's accession to the European Union (EU) in 2004 had a positive effect on its FDI. Polish officials estimate that FDI must reach \$10 billion yearly to maintain Poland's economic growth at a 5 per cent annual level. According to Polish official statistics, the United States is the fourth largest investor in Poland (a drop from third place in 2004) in terms of the volume of capital investment. Investors from OECD countries accounted for 95.6 per cent of the cumulative value of investment in the period 1993–2005, and those from EU States accounted for 81 per cent. Recently, companies from India, China, Hungary, the Czech Republic and Ukraine have shown interest in locating their operations in Poland.

Since 1997, the value of Polish investment abroad has risen 10-fold. According to data from the National Bank of Poland, through the end of 2005, Polish firms invested \$6.6 billion abroad. Poland's largest foreign investments are in Lithuania, the Netherlands, Germany, France, China, Malaysia and Ukraine.

In 2007, the economic growth rate and profitability of enterprises remained high. The situation in the labour market (further fall of the unemployment rate, rise in employment and increase in salaries and payroll fund) reduced the risk deriving from lending to households and led to a broadening customer base for financial institutions.

The Polish capital market was set up in 1991, and the experiences of other countries (particularly the United States and France) were taken into account. Moreover, the legal framework concerning public trading in securities was based on appropriate standards: United States law and EU Directives. The Warsaw Stock Exchange (WSE) operates based on the Law on Public Trading in Securities of 21 August 1997 (as amended), under the supervision of the Financial Supervisory Commission. The WSE is a joint-stock company created by the State Treasury. As of 1 April 2008, there were 359 companies listed on the WSE (including 24 foreign companies). Equity market capitalization accounted for €126 billion (domestic companies) and €260 billion (all companies).

* This chapter was prepared with substantive input from Professors Alicja Jaruga, University of Lodz/Academy of Management; Justyna Fijałkowska, Academy of Management; and Małgorzata Jaruga-Baranowska, Academy of Management.

On 1 July 1995, Poland became a founder member of the World Trade Organization (WTO). The Europe Agreement Establishing an Association Between the European Communities and the Republic of Poland (Europe Treaty) significantly widened the bases of earlier trade agreements, trade and economic cooperation (signed in 1988 between the then-Polish People’s Republic and the then-European Economic Community). The treaty established the foundations on which economic, political, scientific and cultural links between Poland and the EU could be developed.

On 1 January 2001, Poland – as a member of the Central European Free Trade Agreement – entered a free trade area comprising the Czech Republic, Poland, Slovakia, Hungary, Slovenia, Bulgaria and Romania. The main aim of it was removal of tariff and non-tariff trade barriers, as well as agreement on the free flow of goods: public procurement, State assistance, protection of intellectual property, rules of competition, State monopolies, etc. Since November 1996, Poland has been a formal member of OECD.

Poland became a member of the European Union on 1 May 2004. This membership made the Polish legal and financial framework more transparent, as it must meet EU requirements. Since Poland’s accession to the EU, investors’ interest and confidence in doing business in Poland has significantly increased.

A brief history of accounting in Poland

Four stages can be identified in the regulatory framework of Polish accounting:

- (a) 1945–1991: accounting corresponding to the requirements of the central planning system and subordinated to tax purposes;
- (b) 1991–1995: changes in the regulations as the result of economic restructuring, but still tax-dominated;
- (c) 1995–2002: Accounting Act based on the EU Directives;
- (d) From 2002: Amendment of the Accounting Act, largely incorporating provisions of EU International Accounting Standards (IAS).

Table 1 summarizes the major events in the international harmonization of Polish accounting regulations.

Table 1. Major events in the international harmonization of Polish accounting regulations

| Year | Event |
|-------------|--|
| 1990 | <ul style="list-style-type: none"> • Economic changes and transformation of centrally planned economy into market economy • Beginning of the mass privatization of State-owned companies • Beginning of the harmonization process with the provisions of European law |
| 1991 | <ul style="list-style-type: none"> • New legislation consisted of the Audit and Publication of the Financial Statements, Statutory Auditors and their Self-Regulation Act 1991 and the Decree of Ministry of Finance of 15 January 1991 on the principles of Accounting |
| 1992 | <ul style="list-style-type: none"> • Establishment of the National Chamber of Auditors, which issued the Polish Auditing Standards |
| 1994 | <ul style="list-style-type: none"> • Issuance of Act on Accounting, which suspended the provisions regarding financial reporting in the Audit Act 1991 • Issuance of the Statutory Auditors and their Self-Regulation Act 1994 |
| 2000 | <ul style="list-style-type: none"> • Issuance of the New Accounting Act, which superseded the Accounting Act from 1994 • Issuance of the new Audit Act, which superseded the Audit Act 1994 |
| 2005 | <ul style="list-style-type: none"> • The Regulation of the European Parliament and of the Council of 19 July 2002 on the Application the International Accounting Standards (IAS Regulation (EC) No. 1606/2002) |

The launching of economic reform for market economic transformation in the late 1980s was accompanied by the introduction of various market-oriented regulatory actions, including new rules on accounting and auditing. The process of economic reform has been expedited by the preparations for EU accession. New legislation consisted of the Decree of Ministry of Finance of 15 January 1991 on the Principles of Accounting and the Audit and Publication of Financial Statements, Statutory Auditors and their Self-Regulation Act 1991. The introduced changes reflected an attempt to comply with many of the requirements of the Fourth Directive of the European Commission (EC), bringing Polish accounting closer to the accounting of the EC member countries. Fixed assets and intangibles were regulated solely by fiscal acts. The accounting law was strongly tax-oriented.

The Accounting Act 1994 and the Statutory Auditors and their Self-Regulation Act 1994 (hereafter Accounting Act 1994), in force since January 1995, superseded and expanded accounting and auditing regulations in Poland. The Accounting Act 1994 incorporated into the Polish accounting law mainly the European Union Directives but also issues from the Conceptual Framework of the International Accounting Standards Board (IASB).

The Accounting Act 1994 sets out the most important, fundamental accounting concepts, which have become a guideline for practice. It changed the tax-oriented accounting system into an autonomous system regulating business activity. It was a very important step in making Polish financial statements comparable. It enlarged their usefulness for investors and improved transparency of the economic transactions in Poland.

In the six years that have passed since the first Accounting Act was introduced, many changes have occurred in the Polish economy. Moreover, Poland was in the process of negotiations concerning joining the UE. Therefore, a broad modernization of the Polish Accounting Act was undertaken. The new act was accepted by Parliament in November 2000 and it came into force on 1 January 2002.

The changes to the Accounting Act generally followed two directions.³⁵ One was the improvement of the rules on preparation of financial statements, to align them with global standards such as IAS and to introduce regulations on new topics such as leasing, mergers and acquisitions, and financial instruments. The other direction was to simplify accounting requirements for smaller companies. The new Accounting Act appeals to fundamental definitions, methods of valuation of assets and liabilities, and qualitative characteristics of accounting information.

The Act on Auditing regulates the auditor profession. Based on the latest amendment ratified in September 2000, a new body of authority was established – the National Supervisory Committee – that exercises control over auditors' and auditing firms' compliance with auditing procedures.

Since 1998, the Polish Securities and Exchange Commission has permitted the use of IAS or United States GAAP as the basis for financial reporting of Polish companies listed on foreign capital markets. Since 2005, the Regulation of the European Parliament and of the Council of 19 July 2002 on the Application of the International Accounting Standards (IAS Regulation (EC) No. 1606/2002) requires companies whose securities are admitted to trading on regulated markets in EU member States to prepare their consolidated accounts on the basis of endorsed IAS/IFRS.

The regulation is directly applicable and mandatory to consolidated statements of publicly traded companies. It gives the option to extend the use of IFRS for the individual accounts of publicly traded companies, and to the accounts of non-publicly traded companies. Generally, companies that are not required to use IFRS base their accounting practices on the Polish Accounting Act and EU Directives.

The introduction of IAS/IFRS required major changes to the national financial reporting framework.

³⁵ Jaruga A, Kabalski P (2001). *Znowelizowana Ustawa o rachunkowości a standardy międzynarodowe*. Oddk, Gdańsk.

II. Regulatory framework

A. General rules for all non-financial entities

Business activities in Poland are subject to the new Commercial Companies Code, effective since January 2001, and the Law on Freedom of Economic Activity that came into force on 2 July 2004. These new laws replaced existing legislation – the 1934 Commercial Code and the 1999 Law on Economic Activity. A company registered in Poland acquires legal recognition upon being entered in the Register of Companies at the National Court Register of the Economic Court, which has jurisdiction over the seat of the company that is being formed. Under the 2000 Commercial Code (amended on 15 January 2004), companies can be established as joint-stock companies, limited liability companies, limited joint-stock partnerships, professional partnerships, registered partnerships and limited partnerships.

The accounting and reporting regulations are mainly covered by the accounting law of 1994 as amended in 2002, and since 2005 by IFRS. In addition, the various tax laws (including the tax ordinance) have their influence on accounting and reporting. Generally, what the law adds is that, where there is a lack of coverage of an area, then published Polish Accounting Standards (PAS) may be used. Where PAS are insufficient, then IAS can be applied.

The most important regulatory body of Polish accounting is the Parliament (Sejm). Accounting regulation depends primarily on legislative instruments (Act on Accounting); the accounting principles being issued by professional bodies are of secondary importance. Accounting in Poland has also been influenced by tax regulations. The basis of the income tax calculation of companies has been the income shown in the accounts.

B. Banks and financial institutions

The banking sector is dominated by 12 large banks, two controlled by the Ministry of Treasury and the remaining 10 by foreign commercial institutions.

The National Bank of Poland is the country's central bank. Its tasks are stipulated in the Constitution of the Republic of Poland, the Act on the National Bank of Poland and the Banking Act. One of the National Bank of Poland's main objectives is to maintain price stability.

The General Inspectorate for Banking Supervision is an autonomous body within the structure of the National Bank of Poland. It is responsible for the supervision of banks' operations. It collaborates and exchanges information with other Polish financial regulators, such as the Polish Financial Supervision Authority, the State Agency for Insurance Supervision, the Bank Guarantee Fund, the Polish Banking Association and the National Chamber of Certified Auditors rating agencies.

In September 2006, the Polish Financial Supervision Authority was established, taking over the duties of the Polish Securities and Exchange Commission, the Insurance and Pension Funds Supervisory Commission and, since 2008, the Banking Supervisory Commission. The Polish Securities and Exchange Commission participated in establishing the PAS through its representation on the Polish Accounting Standards Committee. The financial reporting and disclosure requirements set by the Polish Securities and Exchange Commission for the publicly traded companies were one of steps taken in order to reduce the gap between Polish accounting regulations and IAS.

Banks (both listed and non-listed) are required to prepare their consolidated financial statements in conformity with endorsed IFRS, and their legal entity financial statements in conformity either with accounting regulations set by the Minister of Finance, which are based on the Banking Accounts Directive, or with endorsed IFRS.

Insurance companies are required to prepare their financial statements in conformity with accounting regulations set by the Minister of Finance, based on the Insurance Accounts Directive. Insurance companies prepare two sets of financial statements, one for general purpose and another for fiduciary reporting.

C. The accounting profession and auditing

The Accounting Standards Committee (ASC) was established in April 2002.³⁶ It is made up of 10 experts on accounting and auditing representing auditors' companies, the Ministry of Finance, the Polish Financial Supervision Authority, the National Chamber of Statutory Auditors, and academics. The main task of the ASC is the issuance of Polish accounting regulations independently from tasks performed by the Minister of Finance. The ASC provided a forum for exchange of views on the most problematic issues that arise during the transition process from national accounting standards to IFRS. Almost all members of the ASC actively took part in the preparation of new the Accounting Act.

The National Chamber of Statutory Auditors (NCSA) sets auditing standards through a process that embraces consultation with the Ministry of Finance and the Polish Financial Supervision Authority. When drafting auditing standards, effort is made to adapt internationally recognized standards to country circumstances. If particular auditing issues are not covered by the local standards, the NCSA permits use of appropriate International Standards on Auditing.

In order to become a statutory auditor, it is necessary to meet many requirements. Generally, the certification of statutory auditors is largely based on the eighth EU Company Law Directive of 10 April 1984. Statutory auditors are required to undertake continuing professional education. Appropriate courses required for this purpose are defined annually by the National Council of Statutory Auditors.

Professional qualification and academic as well as practical training of accountants are carried out and supervised by the Accountants Association of Poland. The association certifies training programmes on international financial reporting.

D. Enforcement

In Poland, there are various authorities responsible for the enforcement of accounting and financial reporting requirements. These include the Polish Government, the Polish Financial Supervision Authority and the National Chamber of Statutory Auditors. However, to a large extent, enforcement mechanisms apply to large companies which, in accordance with the Accounting Act, should be audited. In all other companies where there is no duty to be audited, the enforcement comes mainly from the top management, which is responsible for financial statements.

The top management of the company is the first level of enforcement of accounting rules. It is responsible for the financial statements of the company. The board of directors must prepare annual financial statements that every member of the board and the accountant have to sign to indicate their agreement. Members of the board of directors must safeguard the proper application of accounting rules and principles for giving a true and fair view of the company.

Financial statements must be prepared within three months of the date on the balance sheet, and should be presented for approval at the annual general shareholders meeting within six months (eight months in the case of consolidated financial statements of a group). The audited financial statements, including the audit report and other information, should be filed with the registration court and published in the official gazette, *Monitor Polski B*, within 15 days of approval at the annual general shareholders' meeting.

For the Parliament, the governmental tools of enforcement are the commercial code, acts, and decrees that it issues.

The Act on Auditors, dated 13 October 1994, and its subsequent amendments regulate the audit profession in Poland. This act provides legal framework for the creation, governance and operations of the National Chamber of Statutory Auditors.

³⁶ For more information see the Report on the Observance of Standards and Codes (ROSC), Republic of Poland. Accounting and Auditing. 8 February 2005. World Bank.

With respect to enforcement of tax regulations, it is important to note that failure to comply could result in corrections on tax declarations and also in severe fines and interest payments.

One of the basic duties of the Polish Financial Supervision Authority is constant supervision over public trading in securities. It reviews financial statements of listed companies and other participants of the securities market, and seeks to identify violations of established accounting and disclosure requirements. Publicly traded companies are required to have semi-annual financial statements reviewed by independent auditors and to submit these statements to the Polish Financial Supervision Authority.

To make the market fair and transparent, the Polish Financial Supervision Authority has to supervise activities of investors. The Enforcement Department searches suspicious trading and brings to the public prosecutor activities such as insider dealing and price manipulation, which are criminal offences under Polish law. Moreover, all trades in large blocks of shares (exceeding 5 or 10 per cent of votes) require notification to the Commission, to the Competition and Consumer Protection Office, and to the shareholders of the company itself. Also, the amount of votes held by major shareholders (over 5 per cent) should be made public.

The Warsaw Stock Exchange Rules, Detailed Exchange Trading Rules, Rules of the Exchange Court and the Warsaw Stock Exchange Articles of Association contain sanctions concerning the accounting information presented by the companies quoted on the Polish Stock Exchange. Non-compliance with those rules is subject to a regulatory penalty.

The NCSA is a self-regulatory body of all Polish auditors. It plays an important role regarding the enforcement of accounting rules, and is legally authorized to set down requirements and grant the title of the statutory auditor. The main responsibilities of the NCSA also include assuring the professional development of its members. The NCSA's body of authority, the National Council of Statutory Auditors, confers on auditors the right to practice as professional auditors. The chamber, in agreement with the Minister of Finance, sets the rules of conduct. The chamber has the right to supervise whether auditors comply with the Auditing Standards and the Code of Ethics, and whether auditing firms comply with the Act on Auditors and their self-regulatory organization and other regulations concerned.

The National Supervisory Committee's responsibilities include ensuring that auditors and auditing firms are in compliance with auditing procedures. The amended Accounting Act has eliminated audit requirements for small-size enterprises. Statutory auditors are appointed at the general shareholders' meeting unless the articles of association provide for the supervisory board to make such appointments. Moreover, the Commercial Code provides shareholders of limited companies, who represent at least 10 per cent of the company's share capital, the right to appoint auditors to conduct an investigative audit.

The law sets out additional legal obligations concerning audit of insurance companies and credit institutions. It limits the tenure of audit firms to five years, after which they are required to rotate.

Audits of the financial statements are aimed at presenting a written opinion and report of an expert auditor, of whether or not the financial statements show a true and fair view of the financial position and financial result of the entity examined. An auditor should also indicate factors found during the audit, which may jeopardize the continuing of activities, by an entity (going concern). There are severe sanctions imposed on the auditors for non-compliance with professional rules. The NCSA may impose the following disciplinary penalties against them: admonishment, reprimand, suspension for one to three years from the auditing profession, and cancellation of auditing license.

Table 2 presents the main Polish accounting regulators and legal rules which are now in force.

Table 2. Polish accounting regulators and legal instruments

| Regulator | Instruments |
|--|--|
| Parliament | <ul style="list-style-type: none"> • Act on Accounting 2000 • Act on Auditing 2000 • Decrees of the Ministry of Finance |
| Accounting Standards Committee of the Ministry of Finance | <ul style="list-style-type: none"> • A newly established body for setting Polish Accounting Standards |
| The Polish Securities and Exchange Commission ³⁷ | <ul style="list-style-type: none"> • The Law on the Public Trading of Securities 1997 • Act on Investment Funds 1997 • Act on Bonds 1995 • Decrees |
| The National Chamber of Statutory Auditors | <ul style="list-style-type: none"> • Auditing standards |
| The General Inspectorate for Banking Supervision | <ul style="list-style-type: none"> • Regulation for the banking system, specifying norms for banking operations, guidelines for the banks, recommendations concerning standards for risk management and sound banking practice |
| The Insurance and Pension Funds Supervisory Commission ³⁸ | <ul style="list-style-type: none"> • Does not issue binding law, but may submit petitions to the Ministry of Finance to take appropriate actions in cases when they detect the infringement of the law by the insurance companies and pension funds |

III. The process of IFRS adoption

The EU, with the approval and incorporation of its Directives, has been an important agent in initiating the harmonization process. After their transposition to the national regulation, the Directives have become obligatory for companies which operate in EU member States.

The broader harmonization process began in 1995, when the IASB agreed with the International Organization of Securities Commissions (IOSCO) to develop a work programme with the aim to elaborate a set of “core standards” to be accepted by international financial markets. In May 2000, after the conclusion and evaluation of the set of standards (40 IAS), IOSCO decided to recommend the use of the core standards (30 IAS) by companies listed in international markets.

In March 2000, at Lisbon, the EU Heads of Government Council agreed that, from 2005 on, all listed companies should prepare consolidated accounts using International Accounting Standards, with a view to accelerating completion of the internal market for financial services. In this context, a measure taken by the EU was the issuance of IAS Regulation (EC) No. 1606/2002. The principal objective is to ensure a single set of rules to be used at an international level, facilitating the listing of companies in foreign markets, with the aim of improving the competitiveness in European capital markets.

Accounting reform in Poland has moved beyond compliance with EU Directives and towards the incorporation of IAS into domestic legislation. Recent amendments to the EU Directives have been incorporated as well (Dz.U. Nr 145, Poz. 1535, 30.04.2004). The implementation of IAS Regulation (EC) No. 1606/2002 has embraced IAS/IFRS within the Parliamentary Accounting Act (Nr 214, Poz. 2153, 27.08.2004) as follows:

³⁷ Since September 2006, the duties of the Polish Securities and Exchange Commission have been taken over by the Polish Financial Supervision Authority.

³⁸ Since September 2006, the duties of IPFSC have been taken over by the Polish Financial Supervision Authority.

- (a) IAS/IFRS adopted by the EU are required in consolidated accounts (financial reports) for listed companies and banks, from 1 January 2005 (Accounting Act, article 55, p. 6a, 2004);
- (b) IAS/IFRS are permitted in individual (separate) financial statements of issuers of securities admitted to public trading or trading on one of the regulated markets of the European Economic Area, as well as those of issuers of securities pending admission to public trading or trading on one of the regulated markets of the European Economic Area (Accounting Act, article 45, p. 1b);
- (c) IAS/IFRS are permitted in individual (separate) financial statements of members of a capital group where a parent company prepares consolidated financial statements under IAS (Accounting Act, article 45, p. 1c);
- (d) IAS/IFRS are permitted in consolidated financial statements of issuers of securities pending admission to public trading or trading on one of the regulated markets of the European Economic Area (Accounting Act, article 55, p. 6b);
- (e) IAS/IFRS are permitted in consolidated financial statements of entities that are part of a group in which a higher-level parent company prepares consolidated financial statements under IAS (Accounting Act, article 55, p. 6c);
- (f) All other enterprises are required to apply the principles of the Accounting Act and other specific governmental orders. IAS/IFRS may be applied by these enterprises when a given issue is not covered in the Accounting Act or in domestic accounting standards.

All IAS/IFRS adopted by the European Commission have already been translated into Polish and published in the European Commission's Official Journal. The parallel translation of IAS/IFRS was coordinated and published by the National Board of Association of Accountants in Poland and has been approved by a Review Committee appointed by International Accounting Standards Committee Foundation (IASCF). However, at the time of the first adoption of IAS/IFRS, most companies used the English version of IFRS.

The periodical articles of auditing companies were a useful source of information and a kind of practical guideline for the implementation of IAS/IFRS.

Regulations concerning IAS/IFRS are in place; however, implementation will require further technical and education support, both for managers and accountants.

There were several important issues that the companies had to take into consideration before introducing implementation mechanisms, for example, the changes to the chart of accounts, accounting procedures, information technology systems, changes to the systems of managerial reporting and budgeting, and systems of financial information recording.

The implementation called for much effort, substantial work, good coordination of implementation teams, strong support from management and support from specialized outside experts. It was necessary to prepare detailed action plans. A critical challenge was recalculation of financial data for 2004, which was previously prepared in accordance with Polish Accounting Standards.

Usually, the whole process required changes in the organization and demanded considerable human and financial resources.

On the basis of research and observation,³⁹ the preparedness of companies in Poland may be characterized as follows: companies that were obliged or permitted to incorporate IAS/IFRS from 1 January 2005 (IAS Regulation (EC) No. 1606/2002) at the time of the first-time implementation were familiar with these requirements and were acquainted with IAS of 2000 but not with the amendments to IAS and the new IFRS published during the first quarter

³⁹ Jaruga Alicja, (on behalf of the Accounting Standards Committee in Poland) in response to the questionnaire "IFRS in domestic legislation, IASB meeting with World Standard-setters". IASB. September 2004.

of 2004. IFRS 1, on first-time application of all IAS, needed a lot of effort, especially sections concerning reclassification of equity or impairment of assets. There were also challenges with the implementation of IFRS 2 and IAS 18, 27, 28, 31, 32 and 36.

IV. Research findings

Adoption of IAS/IFRS in 2005 heralded a new era in Poland. IAS/IFRS require new measurement models in many areas. The financial statements must explain how transition from previous national regulations to IAS/IFRS affected equity, and reported financial position, financial performance and cash flow. There are significant differences between what would have been reported under Polish GAAP and under IAS/IFRS.

Polish listed companies, in their consolidated financial statements for the first half of 2004 (at 30 June 2004), published only very basic and general information, usually only in narrative form. Most of them presented mainly impact on income.

According to requirements of IFRS 1, companies preparing their first financial statements under IAS/IFRS are required to present broad reconciliations of financial statements. Following that, most of the listed companies presented such reconciliations for financial data for 2004 in the form of comparative information for the 2005 figures.

There was no common way of communicating the differences between the IAS/IFRS numbers and those they reported using national standards. Some companies decided to present only main items changed, while others tried to prepare detailed information. The communication was often incomplete and usually only descriptive. The challenge for the companies was to avoid “surprise” changes when reporting for the first time under IAS/IFRS and to reduce the potential risk of adverse market reaction.

The differences between IAS/IFRS and Polish national principles concern mainly:

- (a) Pension funds;
- (b) Share-based payment;
- (c) Financial instruments and hedging;
- (d) Impairment of goodwill;
- (e) Intangibles assets;
- (f) Business combinations;
- (g) Valuation of receivables;
- (h) Valuation of revenues and liabilities;
- (i) Leasing; and
- (j) Property, plant and equipment.

An important challenge for companies was the communication and explanation of the IAS/IFRS information at a company’s date of transition and for the comparative period included in the first IAS/IFRS financial statements. Analysts remained concerned that it would prove to be difficult to specifically identify changes that were the result of the transition to IFRS. Adequate explanation of the newly reported amounts was essential. Interviewed analysts (40 per cent⁴⁰) stated that generally their knowledge of IAS/IFRS was not sufficient.

In order to show the impact of IAS/IFRS application on equity and net income in comparison to Polish Accounting Act rules,²⁵⁵ ⁴¹ financial statements were analysed (of companies which were obliged or had decided to use IFRS). The analysis revealed the following financial reporting areas in which significant changes have occurred:

⁴⁰ Surveys of PriceWaterhouseCoopers, KPMG, Mazars, and Ernest and Young.

⁴¹ Financial reports of nearly all companies listed on Warsaw Stock Exchange (including 171 consolidated financial statements).

- (a) Property, plant and equipment: Some Polish entities had many items of property, plant and equipment still used in business activity, but fully depreciated or of very low value. With the change of accounting policies, companies faced the problem of suitable recognition and measurement of such items in financial statements under IAS/IFRS. Many companies used fair value (accepted by IFRS 1 as deemed cost) set as at 1 January 2004 (date of transition of many companies). Amounts increasing the value of property, plant and equipment or investment properties were recognized. The increase of tangible assets has impact on accounting income, as these items are required to be depreciated. On the other hand, some companies increased their accounting income as they adjusted the amount of depreciation recognized after implementing IFRS;
- (b) Goodwill and negative goodwill: Many Polish companies had to derecognize negative goodwill and adjust amortization relating to goodwill and negative goodwill (previously recognized under the Accounting Act). This led to increase of goodwill and derecognition of negative goodwill and corresponding changes in equity;
- (c) Recognition and measurement of revenues: Some Polish companies faced the problem of suitable recognition of revenues and receivables, especially when they sell their products or services with long deferred payment. This caused a decrease of operating revenues and a decrease of receivables or increase of financial incomes;
- (d) Share-based payment: The Polish Accounting Act does not provide any rules (or requirements) relating to recognition of expenses resulting from share-based payments. Some companies after transition to IAS/IFRS had to adjust their expenses (which led to a decrease of accounting income of some companies, especially in 2005);
- (e) Financial instruments and hedging: Some Polish companies faced the problem of suitable recognition and measurement of financial assets and liabilities. This especially relates to companies that were exempted from applying applicable regulations of the Ministry of Finance;
- (f) Intangible assets: As in the case of property, plant and equipment, fully depreciated intangible assets had to be recognized in balance sheets of some companies;
- (g) Business combinations: Some companies, in order to comply with IAS/IFRS, had to adjust their financial data (for example, in relation to reverse acquisition or pooling method used);
- (h) Leasing: A lack of detailed regulation under the Accounting Act led in some companies to subjective assessment of lease agreements. Some Polish companies had previously based their accounting policies on tax law;
- (i) Investment properties: The Polish Accounting Act provides specific definition of investment property, based on the objective of acquisition and not present usage. Changing accounting policies, some companies had to reclassify some properties from items of property, plant and equipment to investments. Some companies, changing their accounting policies, decided also to change measurement rules for investment properties – to apply the fair value model.

The research and analysis covered consolidated financial statements of companies that applied IFRS for the first time in 2004. Companies that did not disclose the necessary information or those under the process of bankruptcy were eliminated. The final sample embraced 79 companies. The analysis was mainly focused on changes in total assets, equity and income.

Among the 79 companies, the value of assets increased in 51 instances, decreased in 25 cases and remained the same in 3 companies. Prevailing changes were increases and they were substantial, usually more than 10 per cent. The decreases were few and were very small. These changes indicated that the economic potential of companies was less apparent under national accounting standards, and IFRS brought the net value of the companies' assets closer to their market values. This was important information for investors, analysts and other market participants.

The biggest increase, by more than 63 per cent, was caused mainly by the changes in valuation of property, plant and equipment, long-term receivables, and investment properties. The decreases were caused mainly by a new method of valuation of short-term receivables.

Of the 102 companies analyzed, 78 showed an increase in the value of equity; only 21 companies showed decreases and 3 reported no changes. Most upward changes were substantial; 31 companies showed more than a 10 per cent increase, and 24 companies showed more than a 20 per cent increase. While analyzing decreased, it was noted that, in 50 per cent of such cases, the decrease was in the range of 0 to 1 per cent.

The biggest change (construction entity) was an almost 100 per cent increase in the value of equity. It was caused mainly due to reclassification of some assets of property, plant and equipment into investment properties and their valuation in fair value (those were often assets already mostly amortized). The biggest decrease (an information and communication technology company) accounted for -62 per cent and was attributable to accounting for business combinations.

The positive differences in equity valuation appeared mainly due to (a) recognition of items of property, plant and equipment fully depreciated or remeasured to fair value (deemed cost); (b) reclassification of lease agreements; (c) reclassification of real properties from property, plant and equipment to investments and their remeasurement to fair value; (d) reclassification and remeasurement of intangible assets (including goodwill); and (e) derecognition of negative goodwill.

The negative differences in equity valuation appeared mainly due to application of regulations of IFRS 3 (Business Combination), derecognition of intangible assets and decrease of accounting income as a result of recognition of:

- (a) Expenses relating to share based payments; and
- (b) Lower revenues (long-deferred payments).

Besides changes in equity, many companies presented changes in accounting income (after tax). Many companies showed substantial increases; however, some negative changes of net income were also observed. The decreases were generally small – more than 50 per cent of decreases were around 1 per cent – however, there were also a few big exceptions, mainly due to the recognition of additional provisions, adjustment of revenues (to requirements of IAS 18 (Revenues)) and to the recognition of expenses relating to share-based payments.

The positive differences appeared mainly as a result of (a) derecognition (reversal) of expenses (recognized under the Accounting Act) relating to lease agreement (impact of lease reclassification); (b) derecognition (reversal) of amortization of goodwill (recognized under the Accounting Act); (c) adjustment (decrease) of depreciation of property, plant and equipment (recognized under the Accounting Act); and (d) application of IFRS 3.

The research findings presented above show that transition to IAS/IFRS brought some significant changes in the financial position and performance of enterprises adopting IFRS. It is important to note that investors, analysts and other market participants could face some serious problems in understanding financial results of companies, especially when comparing financial statements prepared under IFRS with those prepared under national accounting standards.

V. Conclusions

The decision of the European Union to implement IAS/IFRS for all EU-listed companies from 1 January 2005 has brought greater international convergence of financial reporting.

This note has highlighted main challenges relating to implementation of IAS/IFRS in Poland. The limitations of the research and conclusions presented in this paper are caused by the short period of practical implementation of new standards.

Characteristic features of accounting practice based on IAS/IFRS in Poland can be summarized as follows:

- (a) Emphasis on the usefulness of information generated in financial reports in decision-making;
- (b) Prospective approach to the presentation of the economic situation of a company;
- (c) Economic content of transactions and events as the basis for their formulation;
- (d) Measurement based on economic value and fair value (the new value relevant model);
- (e) Application of balance sheet-based approach;
- (f) Increased professional “judgement” in measurement and disclosure;
- (g) Broad and interdisciplinary scope of information required for proper formulation and pricing (measurement) of transactions and events; and
- (h) Broad scope of both financial and non-financial information presented in financial reports.

There are also several business implications of the first-time adoption of IAS/IFRS:⁴²

- (a) Managers need to start planning as early as possible for the process of transition to IAS/IFRS. It will take time and may require training in and changes to and training in information systems. The organizational culture may be affected, too;
- (b) Accounting for certain items, such as hedges, will require decisions at or before the transition date;
- (c) Understanding the effect of the adoption of IAS/IFRS on the financial statements, and the effect on contracts and agreements – such as remuneration agreements and covenants – in finance agreements is critical;
- (d) Communicating to stakeholders and the financial markets about changes anticipated on financial statements is essential.

Implementation of IAS/IFRS will not only have a significant impact on financial reporting, but also on internal organization. It will bring harmonization of internal and external reporting, better comparability between companies, and greater reporting transparency, because the introduction of IAS/IFRS is a movement towards similarity in choices between alternative accounting treatments.

Polish companies that successfully overcome the practical implementation challenges of IAS/IFRS are most likely to reap the benefits of adopting globally recognized financial reporting standards. The transition is expected to have a positive impact on their competitiveness and their integration into capital markets in the European Union.

⁴² IASCF (2005). *IFRS: A Briefing for Chief Executives, Audit Companies and Board Directors*.

Chapter 4

Review of practical implementation issues relating to International Financial Reporting Standards: Case study of Switzerland*

I. Introduction

Switzerland is a highly industrialized country based upon a free enterprise economy. Tourism, commerce, banking and insurance have become significant elements in the Swiss economy and have a high degree of international interdependence. Switzerland was a founding member of the European Free Trade Association (EFTA). EFTA countries are associated with the European Union (EU) in many areas. However, Switzerland does not belong to the EU or the European Monetary System.

II. Legal requirements regarding financial reporting and auditing

Most business activity in Switzerland is conducted by limited liability companies, which have predetermined capital that is split into shares. Only the limited liability company's capital is liable for its commitments. Some 175,000 of these companies were listed in the commercial register at the end of 2006.⁴³ Over 99 per cent are privately owned, most of them by a single shareholder, whereas about 300 list their shares on a stock exchange (mainly SIX Swiss Exchange);⁴⁴

A. The Swiss financial reporting system

Switzerland has a system of codified law typical of continental European countries. Corporate law is based on the Code of Obligations. As in most continental European countries, Swiss accounting regulations are derived from the Napoleonic Code and have also been influenced by German law. These regulations impose certain requirements on all companies that are geared towards the protection of creditors. Continental European countries, especially Switzerland, have traditionally emphasized prudence as a key accounting concept underlying their legal accounting framework. Separate annual financial statements are the basis for determining taxes, since tax authorities use similar recognition and measurement principles and values as those applied in financial statements.

In Switzerland, accounting and reporting requirements differ depending on an entity's legal form within Swiss civil law. The most extensive requirements relate to limited liability companies, which are discussed below.

B. Accounting in accordance with the Code of Obligations

Establishing a limited liability company requires entry into a cantonal commercial register. All companies in the commercial register must comply with the

* This chapter was prepared with substantive inputs from Mr. Thomas Schmid, Partner, International Accounting and Reporting, KPMG, AG, Switzerland and Prof. Dr. Reto Eberle, Swiss-certified accountant, Partner, KPMG AG, Switzerland.

⁴³ http://www.bfs.admin.ch/bfs/portal/de/index/infothek/lexikon/bienvenue_login/blank/zugang_lexikon.Document.20935.xls (as of 6 June 2008).

⁴⁴ http://www.six-swiss-exchange.com/monthly_reports/productive_env/2008/05/Mb_swx_stat_200805.pdf (as of 20 June 2008).

general accounting records requirements embodied in articles 957–963 of the code. More stringent rules apply to limited liability companies (arts. 662–677).

The board of directors of a limited liability company must prepare a business report for each year. It consists of the audited separate financial statements, the annual descriptive report and the audited consolidated financial statements, if such statements are required by law. The statutory separate and consolidated financial statements include an income statement, balance sheet and notes.

Separate financial statements must be prepared in line with generally accepted accounting principles. The following creditor-oriented principles should be taken into account:

- (a) Completeness
- (b) Clarity and materiality of disclosures
- (c) Prudence (conservatism)
- (d) Going concern
- (e) Consistency in presentation and valuation
- (f) Prohibition of offsetting assets and liabilities, as well as expenses and income.

These principles are specified by development of theory and common practice and are not detailed in the law.

Separate financial statements should offer a reliable picture of the income and financial situation of the company. However, the existing statutory and tax regime permits the creation of hidden reserves, which the law encourages as a means of providing finance and avoiding undue variations in dividends. Hidden reserves are not disclosed in the statutory accounts: only when they are released must the net amount of hidden reserves released be disclosed.

Separate financial statements are used to determine the distribution of profit and over-indebtedness (art. 725) and for assessing both income tax and capital tax. Therefore, they must be produced according to generally recognized commercial principles. On the other hand, separate or individual financial statements drawn up in accordance with IFRS would not be compatible with legal requirements (e.g. unrealized gains on financial assets are not recognized under company law) and therefore would represent a breach of these requirements.

Company law prescribes when consolidation has to take place. There is a duty to consolidate in case of a majority of votes or control by other means, having one or more companies under uniform direction (art. 663e). Exceptions apply to intermediate holding companies and in circumstances where a company and its subsidiaries do not exceed two of the following criteria in two consecutive financial years:

- (a) Total assets of 10 million Swiss francs (SwF)
- (b) Revenues of SwF 20 million
- (c) A yearly average of 200 full-time employees.

Consolidated financial statements still have to be prepared if:

- (a) The company has bonds outstanding
- (b) The company's equity securities are listed on a stock exchange
- (c) Shareholders holding at least 10 per cent of share capital request them
- (d) A reliable picture of the income and financial situation of the company can only be obtained by way of a consolidation.

In practice, there are approximately 1,500 companies that are required to prepare consolidated accounts.

The rules governing the preparation of consolidated financial statements (art. 663g) are very limited, incorporating only a reference to the generally accepted accounting principles set out in article 662a of the Code of Obligations. An entity is required to disclose in the notes to the consolidated financial statements the specific consolidation methods and valuation principles applied. As consolidated financial statements are not used for profit distribution and are irrelevant for tax purposes, a company may deviate from statutory accounting requirements by applying a set of standards which provides a true and fair view (fair presentation). Therefore, IFRS as well as other standards resulting in a true and fair view may be applied to fulfil the legal requirement for consolidated financial statements. As a result of this liberal accounting framework, many Swiss companies listed on the Swiss Exchange have applied the International Accounting Standards (IAS)/IFRS for many years and long before the standards were introduced in the EU.

In general, the public has limited access to financial statements of Swiss companies since there is no requirement to publish or file them with the commercial register. The only exceptions are listed companies, banks, insurance companies and mutual investment funds. As only about 300 companies are listed, extremely limited information is available on all other companies, including the 175,000 limited liability companies whose accounts are not open to the public.

Given that only public companies must disclose financial statements, there are few sanctions that can be placed on a company that fails to prepare proper financial statements. The main articles of the Swiss Penal Code relating to accounting and accounting records are:

- (a) Article 146 “Fraud”
- (b) Article 152 “False information on businesses”
- (c) Article 163 “Fraudulent bankruptcy”
- (d) Article 166 “Negligent maintenance of accounting records”.

There have been only a few court decisions in these areas, mostly relating to bankruptcy cases and tax fraud.

C. Auditing provisions in Switzerland

Auditing requirements are found mainly in articles 727–731a of the Code of Obligations. Auditors have to confirm acceptance of their engagement in writing to, and are elected by, the general assembly of shareholders (annual general meeting). The letter of acceptance must be filed with the commercial register, which makes this information public. Under article 730a of the code, the maximum term of the engagement is three years. However, re-election is possible. An auditor may resign at any time and must communicate the reasons to the board of directors. Under article 663b (13) of the code, the board of directors must disclose in the notes to the statutory financial statements why an auditor resigned. An auditor may be replaced at any time by the annual general meeting.

1. Auditors (Admission and Oversight) Act

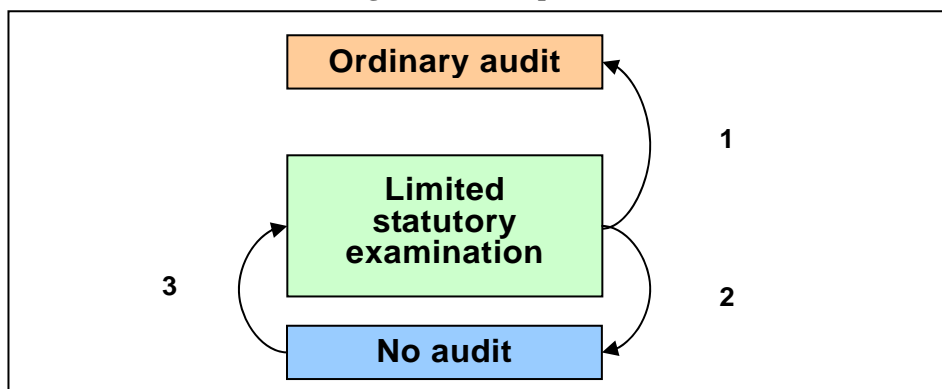
The Auditors (Admission and Oversight) Act governs the admission and oversight of persons providing auditing services. It is intended to ensure that auditing services are provided properly and that they meet certain quality standards. There are two implementing ordinances (Ordinance on the Admission and Oversight of Auditors and the Ordinance on the Supervision of Audit Firms) and one circular relating to the recognition of auditing standards that specifies the requirements of the Act.

To be able to provide auditing services, individuals must be licensed by the Federal Audit Oversight Authority. Different professional qualifications and independence requirements apply to auditing bodies depending on whether public companies (as defined in art. 727 of the Code of Obligations) are being audited or another ordinary or limited statutory examination is performed.

| | Ordinary audit | Limited statutory examination |
|--|--|---|
| Audit scope (arts. 728a and 729a of the code) | (a) Separate financial statements (b) Consolidated financial statements (c) Proposal of the board of directors relating to the appropriation of earnings (d) Existence of internal control system | (a) Separate financial statements (b) Proposal of the board of directors relating to appropriation of earnings |
| Scope of examination (arts. 728a and 729a of the code) | Comprehensive audit based on legal and statutory requirements, as well as Swiss Auditing Standards that are broadly in line with international standards on auditing | Brief, limited to specific audit procedures such as queries, analytical audit procedures and appropriately detailed tests in line with legal and statutory requirements |
| Communication (arts. 728b and 729b of the code) | (a) Comprehensive report to the board of directors with findings on financial reporting, internal control system and the performance and results of the audit (b) Audit opinion to the general meeting of shareholders about the result of the audit, including positive assurance: “The financial statements comply with Swiss law and the company’s articles of incorporation ...” | Review report to the general meeting of shareholders about the results of the limited statutory examination, including negative assurance: “... we have not come across any facts which would lead us to believe that the financial statements do not comply with Swiss law and the company’s articles of incorporation...” |
| Duties of notification (arts. 728c and 729c of the code) | (a) Notification of the board of directors in case of infractions of the law, statutes or the rules of organization (b) Informing the general meeting of shareholders about material infractions of the law and statutes as well as situations when the board of directors does not take appropriate measures after written notification by the audit firm (c) Notifying the judge of an entity’s obvious “over-indebtedness” when the board does not perform the notification | Notifying the judge of an entity’s obvious “over-indebtedness” when the board does not perform the notification |
| Independence (arts. 728 and 729 of the code) | (a) Comprehensive independence requirements (b) Rotation of the lead auditor (but not the firm) after seven years | (a) Reduced independence requirements (b) Permissible to provide accounting support (c) No rotation requirement |

Within the legal framework, shareholders dispose of certain options with regard to the audit, if any, to be performed, as shown below.

Figure 1. Audit options



- (1) “Opting up”: A group of shareholders representing at least 10 per cent of the share capital may request that an ordinary audit be carried out.
- (2) “Opting out”: Entities that employ less than 10 full-time employees on average may, with the consent of all shareholders, forgo an audit.
- (3) “Opting in”: Companies that are not required to provide an audit report may subject themselves voluntarily to a limited statutory examination.

D. Auditing standards, guidelines and education

The Swiss Institute of Certified Accountants and Tax Consultants (SICATC), member of the International Federation of Accountants (IFAC), is the professional association of the public accountants and tax experts. Its standard-setting body works to ensure a high-quality auditing practice in Switzerland.

As already mentioned, Swiss law provides only limited accounting guidance, based on generally accepted accounting principles (art. 662a of the Code of Obligations). Therefore, SICATC publishes the Swiss Auditing Handbook, which ensures a common understanding among preparers and auditors regarding the application of the legal requirements. The 1998 edition consists of the following four volumes:

- (a) Volume 1: Accounting records and financial reporting
- (b) Volume 2: Audit, reporting by the auditor and internal audit
- (c) Volume 3: Audit in the financial industry
- (d) Volume 4: Other examinations, audits in special industries, public administration and professional aspects

Although not legally binding, the handbook’s guidelines find wide acceptance among accounting, legal and auditing professionals. Due to the recent significant changes in the Code of Obligations and the Auditors (Admission and Oversight) Act, the handbook is currently under revision.

SICATC also publishes the Swiss Auditing Standards, which represent an adoption of international standards on auditing (ISAs). The current 2004 edition is based on ISAs as published on 30 June 2003. In addition, specific standards have been introduced to provide guidance on Swiss-specific topics, such as audit procedures and internal control systems. These standards must be followed by licensed audit experts when performing an ordinary audit.

In order to perform a limited statutory examination, licensed auditors must comply with the procedures found in the relevant specific standard.⁴⁶

In 1999, SICATC founded a business school, Educaris AG, which offers preparation for the Swiss-certified accountant exams.⁴⁷ The exams for obtaining this diploma fall under the supervision of the Federal Office of Professional Education and Technology. The exams are currently composed of two main parts. In the first part, five written exams have to be taken in the subjects of financial accounting, management accounting and controlling, corporate finance, tax and auditing. The importance of IFRS as a lecture subject has increased significantly in recent years. In fact, training related to the application of IFRS represents the most significant part of the financial accounting module. In the second part, after passing these theoretical exams and obtaining three full years of on-the-job training, the candidate may apply for the diploma exam. This demanding day-long exam consists of a written case study, oral exams on professional judgment and a short oral presentation on a current accounting topic.

After obtaining the diploma, SICATC requests that its members participate in auditing-related events and courses as part of their continuing professional education. Members must log an average 60 hours of continuing professional education annually in order to retain their qualification as a Swiss-certified accountant.

Responsibility of the auditors

All persons involved in audits of separate and consolidated financial statements are held responsible for any harm to the entity and its shareholders through deliberate or negligent infraction of their duties (art. 755 of the Code of Obligations). This includes failure to comply with the relevant auditing standards, which are not required by law, but generally taken into account by courts.

One of the most serious liability threats is the unique obligation of auditors to declare an audit client bankrupt if the client is “obviously over-indebted”. Over-indebtedness is defined by article 725, paragraph 2, of the code as the total loss of the shareholders’ equity, i.e. where liabilities exceed assets. “Obvious” means that the auditors have to notify the judge “only when the over-indebtedness is much clearer, much bigger, and when it can not be denied even if one looks at the company in an optimistic way”. If this duty is not observed properly, the auditor may be sued under article 755 of the code.

The Federal Audit Oversight Authority may also impose monetary fines of up to 100,000 Swiss Francs (SwF) for other infractions (art. 39 of the Auditors (Admission and Oversight) Act), such as violation of independence rules. Tort fines may amount to as much as SwF 1 million for violation of the documentation obligation, the obligation to retain records or refusal to provide information or access to the audit firm (art. 40 of the Act). Further sanctions provide for licence revocation by means of a professional ban on the senior auditor or audit firm in the case of a gross legal violation (art. 17 of Act).

III. International financial reporting standards in Switzerland

A. Moving towards a true and fair view

With the exception of banks, consolidated financial statements have long been prepared in accordance with IAS/IFRS on a more or less voluntary basis. The Code of Obligations has only required consolidated statutory financial statements since 1 July 1994. Furthermore, there did not used to be a federal stock exchange law, and the

⁴⁶ <http://www.treuhand-kammer.ch/pix/files/Standard%20zur%20Eingeschränkten%20Revision%20-%20final%20-%20Dez.%20071.pdf> (in German only, as of 6 June 2008).

⁴⁷ For more information on this topic refer to http://www.academies.ch/standard.cfm?ID_n=26&unter2=26&unter=25&haupt=2&language=1 (as of 20 June 2008).

cantonal stock exchanges in Zurich, Basel, Berne and Geneva did not require consolidated financial statements until 1996.

The practice of consolidation, however, began decades ago with large multinational companies that needed to obtain finance to fund mergers and acquisitions on domestic and international stock exchanges. There was a rapid increase in listings on Swiss stock exchanges and some companies sought listings in foreign markets. Although not required by the Code of Obligations or stock exchange regulations, consolidated information was demanded by market forces. Bankers, accounting professionals, auditors, financial analysts, business journalists and others put pressure on public companies to publish more meaningful information than that required by law. Most Swiss companies initially adopted the requirements of the Fourth (78/660/EEC) and Seventh (83/349/EEC) European Community (EC) Directives pending the European single market, thereby enhancing internationality and credibility.

In 1984, the Foundation for Accounting and Reporting Recommendations was set up by SICATC to improve financial reporting standards, in particular for consolidated financial statements, because the Code of Obligations limits itself to very basic principles. The general recommendation is that the consolidated financial statements have to provide a true and fair view of the group's financial position, its results of operations and cash flows. The resulting Swiss generally accepted accounting principles (GAAP) and recommendations relative to the presentation of accounts (FER) promulgated by the Foundation at that time followed internationally accepted accounting standards such as IAS (the predecessor of IFRS) and the Fourth and Seventh EC Directives.

When Switzerland voted against joining the European Economic Area in 1992, many public companies started to move away from the EC Directives and, depending on financing needs, adopted IAS, Swiss GAAP FER or GAAP of the United States of America as the basis for their consolidated accounts. The profile of IAS was growing rapidly; therefore, many companies opted to report in accordance with those standards.

In 1995, listing requirements demanded for the first time that financial reports of all listed companies give a true and fair view of company accounts. In material respects, the requirements were the same as Swiss GAAP FER. In the same year, listing requirements referred to international standards for the first time. Financial statements in compliance with IAS or United States GAAP were accepted for companies listed on Swiss stock exchanges, even if they did not comply with Swiss GAAP FER.

In 1998, a study⁴⁸ of a sample of 133 Swiss-listed companies showed the positive influence of size, internationality, listing status, auditor type and ownership diffusion on voluntary compliance with IAS.

Since 2005, the Swiss Exchange has required entities listed in the main segment to apply either IFRS or United States GAAP in their consolidated financial statements. Entities listed in the local caps, real estate and investment companies segments may still apply Swiss GAAP FER instead.

B. Regulatory framework

1. Banking and insurance industry

The banking and insurance industry is subject to extensive accounting, reporting and auditing regulations. Although banks have to comply with the accounting rules from corporate law (arts. 662–670 of the Code of Obligations), they are governed primarily by the provisions of article 6 of the Banking Act and the related articles 23–28 of the implementing ordinance. In order to specify these requirements, the Swiss Federal Banking Commission (SFBC) set up a framework of Swiss federal bank accounting and financial reporting regulations (RRV-SFBC). This framework was derived mainly from Swiss GAAP FER. In general, the requirements of Swiss banking law are much more comprehensive and specific than those of the Code of Obligations.

⁴⁸ Dumontier P and Raffournier B. Why Firms Comply Voluntarily with IAS: an Empirical Analysis with Swiss Data. *Journal of International Financial Management and Accounting*. 1998. 9: 3.

Banks and their auditors have to report to SFBC, which is responsible for enforcing banking law (the dual supervisory system). These reports are comprehensive and confidential, and therefore not published.⁴⁹ Banks with global operations like UBS and Credit Suisse make use of international financial reporting standards (IFRS and US GAAP). When applying these standards instead of RRV-SFBC, a bank must disclose any significant differences. Insurance companies are also subject to strict supervision by the Swiss Private Insurance Agency.

Banks and insurance companies that neglect their duty to file audited financial statements with the supervisory authorities may have their operating licence withdrawn. In the near future, SFBC and the Swiss Private Insurance Agency will be integrated into the recently formed Financial Market Oversight Agency.

2. Stock Exchanges and Securities Trading Act and requirements for maintaining listing on SIX Swiss Exchange

The Stock Exchanges and Securities Trading Act of 1995 and the associated ordinances are based on the principle of self-regulation. Within this framework, the Swiss stock exchanges (e.g. SIX Swiss Exchange, BX Berne Exchange) are responsible for issuing rules and regulations on the admission of securities for trading, as well as all implementing provisions (art. 8 of the Act). In this respect, internationally accepted standards are to be taken into account. The listing rules and regulations of the stock exchanges govern the admission of securities to trading (secondary market), but not the issuing and marketing of new securities (primary market). Any aspects concerning Stock Exchanges and Securities Trading Act primary market are covered in articles 652a, 752 and 1156 of the Code of Obligations.

Some of the key requirements issued by the SIX Swiss Exchange (the main Swiss stock exchange comprising the former cantonal stock exchanges of Basel, Geneva and Zurich) are discussed further below.

According to SIX Swiss Exchange, periodic reporting in compliance with applicable financial reporting and auditing provisions forms an integral part of the information that contributes to a properly functioning market in accordance with the provisions of the Stock Exchanges and Securities Trading Act and the listing rules. One of the tasks of SIX Swiss Exchange is to enforce the applicable transparency provisions.

Since 1995, the listing rules of SIX Swiss Exchange require the presentation of a true and fair view of the issuer's assets and liabilities, financial position and profits and losses (art. 66 of the rules). If the issuer publishes consolidated financial statements, then the requirement to provide a true and fair view applies only to the consolidated financial statements. The directive on requirements for financial reporting lays down the accounting and auditing standards that are accepted by SIX Swiss Exchange. Issuers of equity securities that are listed in the main segment must apply either IFRS or United States GAAP as their accounting standard. Companies listed in the local caps, the investment companies or the real estate segments may apply Swiss GAAP FER instead. Foreign companies may adopt their home country's accounting framework if it incorporates the presentation of a true and fair view (as per art. 66 of the listing rules) and provided that the framework has been formally recognized by the admission board of SIX Swiss Exchange.

Financial reporting standards must be applied without exception (IFRS as issued by the International Accounting Standards Board, Swiss GAAP FER as issued by the Foundation for Accounting and Reporting Recommendations and United States GAAP as issued by the Financial Accounting Standards Board).⁵⁰

There are additional requirements set up by the SIX Swiss Exchange concerning auditing standards that have to be followed when issuers' financial statements are audited. ISAs are applicable to financial statements prepared in

⁴⁹ More detailed information may be found in the SFBC Guidelines on Accounting Regulations (RRV-SFBC).

⁵⁰ Directive on requirements for financial reporting.

accordance with IFRS, Swiss Auditing Standards to financial statements drawn up in accordance with Swiss GAAP FER, and auditing standards generally accepted in the United States to financial reports prepared in accordance with United States GAAP.

C. Application of IFRS in Switzerland

The main source for information about the application of IFRS in Switzerland is provided by SIX Swiss Exchange, given that almost no information is available about non-public companies, since they are not required by law to publish their financial statements.

Listed companies on SIX Swiss Exchange

Financial reporting standards applied by companies with equity securities primarily listed on SIX Swiss Exchange for the years 2001–2007 are given below.⁵¹

Table 2. Annual reports and the standards applied

| Annual reports/standard | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| IFRS | 191 | 186 | 185 | 145 | 145 | 162 | 155 |
| United States GAAP | 17 | 20 | 18 | 19 | 17 | 15 | 14 |
| Swiss GAAP FER | 32 | 34 | 39 | 80 | 87 | 96 | 101 |
| RRV-SFBC | 20 | 20 | 20 | 21 | 20 | 20 | 20 |
| Home country standards | 2 | 1 | 1 | 1 | 2 | 2 | 8 |
| Total | 262 | 261 | 263 | 266 | 271 | 295 | 298 |

Note: The table shows that IFRS represents the predominant financial reporting standard applied by issuers listed on SIX Swiss Exchange. Between 2004 and 2005, some 40 entities changed their financial reporting standards from Swiss GAAP FER to IFRS in order to satisfy the more rigid requirements for listing on the main segment.

D. Non-public companies

There is little information about the application of IFRS for Swiss entities that have not listed their equity and/or debt securities. It is likely that a majority of preparers use Swiss GAAP FER for consolidation purposes. Fewer are assumed to apply IFRS; these encompass entities that are likely to go public in the near future or medium to large entities with an international set-up. Otherwise, it is probable that IFRS for small and medium-sized enterprises will not play an important role in Switzerland, as there may be more costs than benefits bearing in mind that Swiss GAAP FER provides an adequate framework for those entities.

E. Application guidance

No formal local interpretations of IFRS are issued in Switzerland.

With its published sanction decisions and media releases, SIX Swiss Exchange is likely to have an influence on issuers applying IFRS. The focus of such sanctions is on full compliance with IFRS, rather than interpreting IFRS.

SICATC disposes of an accounting working party that deals with questions related to IFRS, Swiss GAAP FER and the Code of Obligations. The debates take the Swiss legal environment into account when discussing international accounting standards and their application in practice. Significant findings and views may be published in the form of an article in the SICATC accounting journal.

In addition, SICATC organizes seminars on practical application of IFRS for auditors and preparers throughout Switzerland.

⁵¹ http://www.six-swiss-exchange.com/download/admission/being_public/financial_reporting/rle_introduction_en.pdf (as of 6 June 2008).

IV. Enforcement of international financial reporting standards in Switzerland

In Switzerland, there are various oversight authorities that monitor the quality of financial reporting and auditing. SFBC and the Swiss Private Insurance Agency (and, in the future, the Financial Market Oversight Agency) are in charge of monitoring financial institutions (banks and insurance companies) by law, whereas SIX Swiss Exchange monitors the financial reporting of issuers other than financial institutions. Auditing requirements are being supervised by the Federal Audit Oversight Authority.

A. Enforcement of international financial reporting standards by SIX Swiss Exchange

Given the vast importance of IFRS applied by issuers, most of SIX Swiss Exchange's enforcement activities in the area of financial reporting relates to this set of standards.

It is not the task of SIX Swiss Exchange to formulate and publish interpretations of specific accounting standards. SIX Swiss Exchange monitors whether the issuers comply with these standards. For this purpose, the regulator applies a risk-based selection of issuers based on criteria such as recent restructurings, business combinations and changes in management, operations, business activities or audit firm.⁵² Subsequently, a risk-based review of selected financial reports is performed. This review focuses on information relating to standards that have been defined as areas of focus, critical standards on the basis of the company-specific circumstances, standards that are particularly prone to errors and those that are applicable for the first time.

Areas of focus set by the Swiss Exchange with respect to IFRS financial statements for 2007 were as follows.

Table 3. Areas of focus set by the Swiss Exchange

| | |
|--|---|
| Financial instruments: disclosures (IFRS 7) | Completeness of disclosures on the nature and extent of risks arising from financial instruments, as well as for the evaluation of objectives, policies and processes for managing capital as per IAS 1p124A ff. With regard to the quantitative disclosures of the risk exposure required under IFRS 7p34(a), SIX Swiss Exchange reserves the right to request the relevant documentation that was provided to the board of directors and/or management committee. |
| Accounting policies (IAS 1) | Comprehensibility and relevance of disclosed accounting policies, as well as their adaptation to concrete, company specific circumstances. SIX Swiss Exchange focuses on a meaningful, sufficiently detailed disclosure of the accounting policies applied in recognizing revenue (IAS 18). |
| Income taxes (IAS 12) | Comprehensibility of the reconciliation of anticipated and actual tax expenses or tax rates. In this context, SIX Swiss Exchange pays close attention to the proper disclosure of unused tax losses as well as the application of the provisions of IAS 12p34 ff. in their recognition. |
| Related party disclosures (IAS 24) | Completeness and transparency of disclosures required under IAS 24p12 ff. (in particular, compensation paid to members of management, information on related party transactions, as well as on any outstanding balances from such transactions). SIX Swiss Exchange stresses the importance of quantitative and qualitative aspects in the disclosure. |
| Intangible assets from business combinations (IAS 38/IFRS 3) | Identification and valuation of intangible assets (e.g. brands, customer lists, recipes) in the purchase price allocation associated with business combinations. A meaningful and factual description of the factors under IFRS 3p67(h) that contributed to the recognition of goodwill. SIX Swiss Exchange reserves the explicit right to request detailed valuation documentation from business combinations. |



⁵² http://www.six-swiss-exchange.com/download/admission/being_public/financial_reporting/rle_introduction_en.pdf (as of 6 June 2008).

The Admission Division and the Sanction Commission of SIX Swiss Exchange may impose sanctions against issuers and auditing bodies for violation of the listing rules, especially in cases of non-compliance with financial reporting requirements.

Ongoing investigations in the area of financial reporting are not disclosed, whereas concluded agreements and sanctions are generally published in press releases which include the name of the entity. Most press releases relate to issues concerning financial statements drawn up in accordance with IFRS. In addition, SIX Swiss Exchange may submit comment letters to issuers where potential for improvement has been identified, while there are no material infractions of financial reporting requirements. These letters are not disclosed to the public.

SIX Swiss Exchange also presents full-text decisions on its website. They are published on a no-name basis in connection with agreements concluded and sanctions pronounced against issuers in the area of financial reporting.

Table 4. No-name decisions (excerpt)

| Decisions regarding financial reporting | | | |
|---|--------------------------|------|---|
| The Sanction Commission of the SWX has been publishing its decisions without revealing any names since 1 January 2007. | | | |
| The Admission Division publishes sanctions notifications against issuers and auditing bodies that were reached after 1 January 2007 and have become legally effective. Wherever possible, the full text is published. | | | |
| Before 1 January 2007, sanctions have been imposed by the Disciplinary Commission or the Executive Committee of the Admission Board. | | | |
| Sanctions are only published in their original language (i.e. German, French or English). No translations are produced. | | | |
| Decisions regarding Financial Reporting | Proposition of quotation | Body | Download |
| 12.11.2007: Inkorrekte Behandlung von zum Verkauf bestimmten Entwicklungsliegenschaften als Sachanlagen nach IAS 16 anstelle von Vorräten gemäss IAS 2. | GBZ/RLE/VII/07 | AD |  |
| 12.03.2007: Présentation incorrecte d'une autre unité d'exploitation vendue dans le table des flux de trésorerie consolidés ainsi que publication incomplète des informations à fournir y relative selon IAS 7. | SK/RLE/II/07 | SC |  |
| 28.02.2007: Nicht vorgenommene Bilanzierung einer Put-Option sowie inkorrekte Bewertung einer Beteiligung nach IAS 39 | SK/RLE/I/07 | SC |  |

Some erroneous applications of IFRS between the end of 2002 and the end of 2007 that led to sanctions are shown below.

Table 5. Erroneous applications of IFRS

| IFRS | Title | Number of occurrences |
|--------|---|-----------------------|
| IAS 7 | Statement of cash flows | 5 |
| IAS 34 | Interim financial reporting | 5 |
| IAS 39 | Financial instruments: recognition and measurement | 4 |
| IAS 14 | Segment reporting | 3 |
| IAS 36 | Impairment of assets | 3 |
| IAS 11 | Construction contracts | 2 |
| IAS 24 | Related party disclosures | 2 |
| IFRS 1 | First-time adoption of IFRS | 1 |
| IFRS 3 | Business combinations | 1 |
| IAS 1 | Presentation of financial statements | 1 |
| IAS 8 | Accounting policies, changes in accounting estimates and errors | 1 |

| IFRS | Title | Number of occurrences |
|-------------------------------------|--|-----------------------|
| IAS 12 | Income taxes | 1 |
| IAS 16 | Property, plant and equipment | 1 |
| IAS 32 | Financial instruments: presentation | 1 |
| IAS 35 | Discontinuing operations | 1 |
| IAS 37 | Provisions, contingent liabilities and contingent assets | 1 |
| Total number of occurrences: | | 33 |

SIX Swiss Exchange also publishes the Admission Board Circular No. 6 on an annual basis. This circular spells out the obligations of issuers that have chosen to apply IFRS and makes reference to the application of standards that has led to complaints by SIX Swiss Exchange. The standards covered by this circular, including further explanations, are shown below.

Table 6. Standards covered by Admission Board Circular No. 6

| |
|--|
| Materiality, understandability, relevance, completeness (IFRS Framework) |
| Presentation of financial statements (IAS 1) |
| Cash flow statement (IAS 7) |
| Accounting policies, changes in accounting estimates and errors (IAS 8) |
| Income taxes (IAS 12) |
| Employee benefits (IAS 19) |
| Related party disclosures (IAS 24) |
| Financial instruments: presentation (IAS 32) |
| Earnings per share (IAS 33) |
| Interim financial reporting (IAS 34) |
| Impairment of assets (IAS 36) |
| Provisions (IAS 37) |
| Intangible assets (IAS 38) |
| Financial instruments: recognition and measurement (IAS 39) |
| First-time adoption of IFRS (IFRS 1) |
| Share-based payment (IFRS 2) |
| Business combinations (IFRS 3) |
| Non-current assets held for sale and discontinued operations (IFRS 5) |
| Financial instruments: disclosures (IFRS 7) |

B. Enforcement of audit requirements by the Federal Audit Oversight Authority

The Federal Audit Oversight Authority, which began operating in late 2007, subjects audit firms under State oversight to a thorough inspection (art. 16 of the Auditors (Admission and Oversight) Act). At least every three years, it investigates whether auditing bodies under State oversight have complied with the procedures set out in the auditing standards regarding quality and documentation when providing auditing services to public companies.

The Federal Audit Oversight Authority defines the auditing standards that must be applied by audit firms under State oversight when providing auditing services to public companies. If there are no or insufficient standards, the authority may issue its own standards or amend and rescind existing standards (art. 28 of the Act). The authority publishes a list of admitted auditing standards (art. 6 of the Ordinance on the Supervision of Audit Firms), which is based on the circular relating the recognition of auditing standards.

Separate and consolidated financial statements that are drawn up according to the standards of the Code of Obligations or Swiss GAAP FER must be audited in accordance with the applicable Swiss Auditing Standards (art. 2 of the Ordinance on the

Supervision of Audit Firms and the circular relating the recognition of auditing standards). Separate and consolidated financial statements that are drawn up according to foreign accounting standards other than United States GAAP must be audited in accordance with ISAs issued by the International Auditing and Assurance Standards Board, as adopted by the Federal Audit Oversight Authority (framework, ISAs and international standards on review engagements). Furthermore, the audit of separate and consolidated financial statements drawn up in accordance with United States GAAP must be audited according to the United States generally accepted auditing standards of the American Institute of Certified Public Accountants and the Public Company Accounting Oversight Board. Audit-entity-related measures for quality assurance must comply with these standard's quality requirements (e.g. Swiss Auditing Standard PS 220, International Standard on Quality Control 1), depending on the auditing standards applied. The Federal Audit Oversight Authority supervises the quality of auditing services and compliance with auditing standards, notably based on the audit firm's working papers (art. 12 of the Ordinance on the Supervision of Audit Firms) and the quality assurance system implemented. To date, the Federal Audit Oversight Authority has not introduced its own standards, made amendments or rescinded existing standards.

SIX Swiss Exchange and the Federal Audit Oversight Authority are required by law to coordinate their oversight activities to avoid duplication (art. 23 of the Auditors (Admission and Oversight) Act). They inform each other about pending proceedings and potentially relevant decisions.

V. Summary and outlook

A. Summary

The regulatory framework regarding financial reporting, which is laid down in the Code of Obligations, is focused on the protection of creditors. For separate financial statements, there are no exemptions from applying the code, as it represents the basis for taxation, profit distribution and the determination of an entity's over-indebtedness. An exemption from legal requirements is available to entities applying IFRS or any other acceptable foreign standard in their consolidated financial statements.

The international exposure and a need to raise external capital drove Swiss entities increasingly towards international standards, the application of which results in a true and fair view. There is limited information available on the adoption of IFRS in Switzerland by entities other than those listed on SIX Swiss Exchange or any other exchange. IFRS are likely to be used by internationally oriented entities, whereas Swiss GAAP FER, originally developed on the conceptual basis of IAS and the Fourth and Seventh EC Directives, is likely to be used by locally focused entities, including small and medium-sized enterprises.

Domestic companies listed in the main segment of SIX Swiss Exchange are required to apply either IFRS or United States GAAP in their consolidated financial statements (or in their individual financial statements if consolidation is not applicable). Domestic companies listed in the local caps, investment companies or real estate segments of SIX Swiss Exchange may alternatively apply the Swiss accounting standard, Swiss GAAP FER. Foreign entities listed on SIX Swiss Exchange may use their home country GAAP provided that it has been formally accepted by SIX Swiss Exchange.

Enforcement of IFRS comes through SIX Swiss Exchange as well as audit-related requirements, including the supervision of auditing firms under State oversight by the Federal Audit Oversight Authority, which monitors quality assurance and audit documentation.

B. Outlook

A major revision of company and accounting legislation began in 2005 when the Federal Council opened committee hearings. So far the revision has resulted in an

opinion issued by the Federal Council regarding these topics⁵³ and a related draft of the amendments to the Code of Obligations.⁵⁴ The aim is to comprehensively modernize company law to align it with the needs of the economy. Corporate governance, in particular, is to be improved. In addition, there will be new rules on capital structures, provisions governing annual general meetings will be updated and new accounting and reporting requirements will be introduced.

A draft of the new accounting and reporting requirements (arts. 957–963b of the draft code of obligations) provides for a uniform concept that applies to all legal forms of enterprises of the Swiss civil law. Such new requirements are based on the economic importance of the enterprise and are expected to replace existing requirements that are based on the legal structure of an enterprise (arts. 662 ss. of the code). The requirements relating to the maintenance of accounting records and financial reporting will continue to depend on the requirement for entry in the commercial register.

It is expected that small and medium-sized enterprises will be required to prepare financial statements that are comprehensive and clearly structured, consisting of a balance sheet, income statement and notes (arts. 958 ff. of the draft code). There will be no obligation to compile a management discussion and analysis (commonly referred to as an annual descriptive report) or a cash flow statement. Additional requirements will apply to large-scale enterprises. The threshold criteria for those enterprises will be the same as those for the requirement of an ordinary (full-scope) audit: large-scale enterprises are those that exceed two of the three following criteria in two consecutive financial years: total assets of SwF 10 million, revenues of SwF 20 million and a yearly average of 50 full-time employees (art. 727 of the code). As a result, some 10,000 enterprises recognized by the commercial register (out of approximately 484,000 enterprises) are expected to be subject to more stringent rules, which will include preparation of a cash flow statement, additional disclosures in the notes and a management discussion and analysis.

According to the draft proposals, public companies, large-scale cooperatives, large foundations and entities subject to a consolidation requirement will have to draw up their (consolidated) financial statements in accordance with a recognized financial accounting framework (e.g. Swiss GAAP FER, IFRS or United States GAAP) that provides for a fair presentation. For all other enterprises, hidden reserves established on a systematic basis will continue to be allowed for tax planning purposes and/or based on an extended application of the prudence principle.

For tax purposes, only separate, statutory financial statements prepared in accordance with the Code of Obligations will prevail. However, the revised code will give an enterprise the option to prepare its separate statutory financial statements on a fair presentation basis only. Shareholders representing at least 10 per cent of nominal capital will have the right to require such financial statements on a fair presentation basis, which will enhance transparency and protection of minority shareholders. Separate financial statements drawn up in accordance with a recognized standard will not be required if consolidated financial statements are prepared.

Requirements related to the preparation of consolidated financial statements are also being amended. Small groups are exempted from preparing consolidated financial statements if, together with their controlled subsidiaries, two of the three criteria – total assets of SwF 10 million, revenues of SwF 20 million, a yearly average of 50 full-time employees – are not exceeded in two consecutive years, or if they are controlled by entities whose consolidated financial statements are prepared in accordance with Swiss or equivalent foreign requirements and are subject to an ordinary audit. Consolidated financial statements must be prepared, however, if required for a reliable assessment of the entity's financial position and income situation, or if one shareholder, 20 per cent of members of an association or the Foundation Oversight Authority requires it. Consolidated financial statements will have to be drawn up as required in accordance

⁵³ <http://www.admin.ch/ch/d/ff/2008/1589.pdf> (in German only, as of 6 June 2008).

⁵⁴ <http://www.admin.ch/ch/d/ff/2008/1751.pdf> (in German only, as of 6 June 2008).

with a recognized financial reporting framework that results in a fair presentation. The Federal Council will have the authority to define the recognized financial reporting frameworks (most likely IFRS, United States GAAP and Swiss GAAP FER).

Chapter 5

Review of practical implementation issues relating to International Financial Reporting Standards: Case study of the United Kingdom of Great Britain and Northern Ireland*

I. Introduction

The present report reviews implementation issues of IFRS by the approximately 1,200 United Kingdom companies with shares or bonds listed on the Main Market of the London Stock Exchange. Together with other companies listed on a European Union (EU)-regulated stock exchange, such companies were required under EU International Accounting Standards (IAS) regulations to apply IFRS as endorsed by the EU in its consolidated accounts for financial periods commencing on or after 1 January 2005.

EU law gave member States the option of permitting or mandating the use of IFRS for all other entities within their jurisdiction. In the United Kingdom, all companies were allowed to use IFRS for accounting periods beginning on or after 1 January 2005. The London Stock Exchange required companies listed on its Alternative Investment Market (AIM), its second-tier market comprising over 1,600 domestic and overseas companies, to comply with IFRS for financial periods commencing on or after 1 January 2007.

The Institute of Chartered Accountants in England and Wales (ICAEW) was commissioned by the European Commission to produce a study of the EU implementation of IFRS (<http://www.icaew.com/ecifrsstudy>). The study was published by the Commission and the Financial Reporting Faculty of the ICAEW in October 2007, and provided the basis for the Commission's formal report on IFRS implementation, submitted to the EU Council and Parliament in April 2008. That study throws light on the United Kingdom's experience of the transition to IFRS.

The main objective of the present report is to draw lessons from the United Kingdom experience in converting reporting systems and financial reports from generally accepted accounting practice (GAAP) to IFRS in 2005, in order to contribute to the sharing of experience among countries that are either currently implementing IFRS or intend to do so.

II. United Kingdom financial reporting system

A. Overall requirement to give a "true and fair view"

Company law in the United Kingdom for many years required all companies to prepare financial statements each year which give a "true and fair" view. This concept is not defined in the legislation but has been generally interpreted as giving a faithful representation of the financial performance of the company for the period, its financial position and, where relevant, its cash flows at the end of the period. Compliance with GAAP was generally seen as a prerequisite of giving a true and fair view. Although this requirement derives from European law in the shape of the accounting directives, its origins lie in the United Kingdom.

* This chapter was prepared with substantive input from the Institute of Chartered Accountants in England and Wales (ICAEW).

One effect of the introduction of IFRS was that financial statements complying with IFRS were no longer explicitly subject to an overriding requirement to give a true and fair view. Instead, the overriding requirement for such financial statements – in IAS 1 (Presentation of Financial Statements) – was to “present fairly”. This led to some concern among investors that the apparent loss of the overriding true and fair view requirement might lead to deterioration in the quality of financial reporting. Although the Financial Reporting Council (FRC), the United Kingdom’s independent regulator responsible for promoting confidence in corporate reporting and governance, in June 2005 published a legal opinion that the “present fairly” and “true and fair” requirements were in substance the same, concerns remained. To clarify the position, the Companies Act 2006 incorporates a requirement – which applies to all financial statements, whether or not they are prepared in accordance with IFRS – that the directors must not approve them unless they are satisfied that they give a true and fair view.

The FRC recently commissioned a review of the meaning of true and fair from an eminent lawyer, Martin Moore QC. His view, published in May 2008, was that compliance with GAAP was a means to the end of giving a true and fair view, not an end in itself. If it was necessary to depart from GAAP to give a true and fair view, then this should be done. Both company law and IFRS (in IAS 1) permit this, but only envisage its occurrence in extremely rare circumstances. In practice, departures under IFRS are far fewer than was the case under United Kingdom GAAP, but mainly because the override tended to be used to depart from out-of-date specific legal requirements related to accounting, whereas overrides of United Kingdom accounting standards were and are very rare.

Moore also opined that if an accounting standard gave a choice of treatment, the directors/officers should consider carefully which choice would give a true and fair view. IFRS in particular would seem to automatically confer a “fair presentation”. United Kingdom law makes it clear that financial statements prepared in accordance with IFRS must also comply with the requirement to give a “true and fair” view. This arguably leaves companies with an additional compliance burden when preparing their financial statements, although the updated legal opinion argues that the concepts of true and fair presentation are in effect identical. Thus, in practice, preparers are unlikely to feel they are bearing an additional burden of compliance.

B. Regulatory position in the United Kingdom

Since 2005, companies with shares traded on a regulated market must prepare their consolidated accounts under IFRS as adopted in the EU, through a complex endorsement process. The United Kingdom Government has also given all entities the option of using EU-endorsed IFRS in place of United Kingdom GAAP in their financial statements. This includes subsidiaries of stock market-listed parent companies, other private companies (of which there are over 2 million in the United Kingdom), partnerships and self-employed individuals (but not charities).

Voluntary take-up of IFRS has been rare, meaning that many groups have had to maintain both United Kingdom GAAP and IFRS accounting records. This is generally considered to be principally due to two factors: (a) uncertainty over the impact on tax liabilities, given that the starting point for United Kingdom tax on trading profits is the accounting profit computed according to either United Kingdom GAAP or EU-endorsed IFRS; and (b) the effect of IFRS adoption on distributable profits. The ICAEW, with the Institute of Chartered Accountants of Scotland (ICAS), published definitive guidance on this latter topic.

The low take-up of IFRS needs to be viewed, however, in the context of a commitment to convergence of United Kingdom GAAP with IFRS. For many years, the Accounting Standards Board (ASB) has sought to mirror developments in international accounting, and the most recent United Kingdom financial reporting standards (FRSs) and Urgent Issues Task Force (UITF) interpretations (known as “abstracts”) have been largely (although not exclusively) taken directly from IFRS and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC).

Before making further substantive moves towards convergence with IFRS, the ASB is awaiting the outcome of the International Accounting Standards Board (IASB) project on

small and medium-sized entities (“private entities”). It is likely that this will form the basis of United Kingdom GAAP. The use of full EU-endorsed IFRS will probably – depending on the results of further public consultation later in 2008 – be expanded to cover “publicly accountable” entities, with the IFRS for private entities likely to replace the GAAP for at least the larger private sector companies. For the time being, the United Kingdom’s Financial Reporting Standard for Smaller Entities is likely to be retained, albeit after further alignment with IFRS. GAAP is thus likely to continue to be segmented in the United Kingdom according to public interest and size.

The United Kingdom Central Government and the National Health Service bodies will be adopting EU-endorsed IFRS – subject to some modifications – in their financial statements, commencing with the year leading up to 31 March 2010. The United Kingdom’s “Whole of Government Accounts” will also migrate to IFRS from the same date. This is a year later than originally planned, reflecting the amount of time and work involved in converting from local GAAP to IFRS. The date for the transition of local Government to IFRS is the year leading up to 31 March 2011. The United Kingdom Central Government sector will produce “shadow” accounts under IFRS for periods ending on 31 March 2009, which will be subject to review by their statutory auditors. This represents a significant expansion of the use of IFRS in the United Kingdom.

C. Sources of United Kingdom generally accepted accounting practice

The Companies Act 2006 and related regulations (together referred to below as company law and substantially derived from the requirements of the EU accounting directives) require companies to prepare financial statements in accordance with either “international accounting standards” (i.e. IFRS) or company law.

Company law requires the application of generally accepted accounting principles or practice (i.e. United Kingdom standards and other sources of United Kingdom GAAP). It sets out detailed formats which a company should follow – in contrast to IFRS – when presenting an income statement and balance sheet (there are four permitted formats for the former, two for the latter).

Company law also sets out a number of accounting principles which must be followed by United Kingdom GAAP reporters:

- (a) It is presumed that the company is a going concern;
- (b) Income and expenditure must be included in the period to which it relates regardless of when received or paid (the accruals concept);
- (c) Accounting policies must be applied consistently within the same accounts and from one period to another; and
- (d) The amount of any item must be determined on a prudent basis, in particular only realized profits must be included in the profit and loss account.

The law then goes on to set out rules on:

- (a) Fixed assets (those with limited useful lives must be depreciated, investments must be written down if there has been a permanent diminution in value, and goodwill must be depreciated over its useful economic life);
- (b) Current assets (which must be recorded at purchase or production cost but written down to net realizable value if lower) and the determination of production cost of inventories;
- (c) Alternative accounting rules (that intangibles but not goodwill may be carried at current cost, tangible fixed assets may be carried at market value as at the date of the last valuation or at current cost, investments may be carried at market value, and current asset investments and inventories may be carried at current cost);
- (d) Use of fair value for financial instruments; and

- (e) Required disclosures, including information on average number of employees, staff costs, dividends, accounting policies, off-balance-sheet arrangements, and share capital.

There are separate regulations for larger companies and quoted companies which supplement the requirements applicable to all companies.

Most of the above requirements apply to United Kingdom GAAP reporters only. However, companies that prepare their financial statements under IFRS must also consider a number of company law requirements that apply to all – such as the requirement to disclose off-balance-sheet arrangements not otherwise disclosed in the financial statements and narrative reporting requirements.

In addition to the law are accounting standards and other pronouncements which together comprise United Kingdom's GAAP. These are:

- (a) Statements of Standard Accounting Practice, issued from the 1970s by the councils of the United Kingdom's principal accountancy bodies and prepared by the original Accounting Standards Committee (operated by the accountancy bodies, but replaced by the independent ASB in 1990);
- (b) Financial reporting standards prepared by the current standard-setting body (the ASB); and
- (c) UITF abstracts, prepared by the UITF and issued by the ASB.

As noted above, many of the most recent FRSs have been close copies of the equivalent IFRS and many of the recent UITF abstracts have been based on the equivalent IFRIC interpretations. Some of these United Kingdom standards are only mandatory in certain circumstances.

United Kingdom GAAP was widely regarded as being similar to IFRS, but the implementation process highlighted that:

- (a) There were (and still are) a significant number of differences between the two, in terms of both recognition and measurement, and in disclosure requirements; and
- (b) Similar – but not identical – language and requirements could add to uncertainty during the transition from national GAAP to IFRS.

D. Auditors

Only registered auditors are permitted to carry out the audit of a company's financial statements. Audit firms must be registered with a recognized supervisory body (RSB).

In the United Kingdom, the ICAEW is one of a number of professional bodies registered as RSBs. Members of these bodies can apply for registered status and must satisfy various conditions laid down by the RSB.

In addition, any individual who signs an audit report must hold an audit qualification as granted by the RSB (this normally involves special training requirements) and must hold a practising certificate issued by the RSB.

Companies meeting certain size criteria are exempt from a mandatory annual audit. Broadly speaking, the audit exemption conditions are met if a company meets both of the criteria for small companies relating to turnover and balance sheet total in its first financial year, or in the case of a subsequent year, in that year and the preceding year. These criteria are for accounting periods beginning on or after 6 April 2008 – turnover of not more than £6.5 million and balance sheet total (i.e. total gross assets) of not more than £3.26 million. For companies forming part of a group, the size of the group is the important factor.

E. Other features

Financial reporting in the United Kingdom also benefits from two additional features of the United Kingdom environment: a robust system of corporate governance, and a strong and well-respected accountancy profession.

Listed companies, subject to the United Kingdom's Combined Code on Corporate Governance, should have an audit committee comprised of independent non-executive directors, at least one of whom should have recent and relevant financial experience. The responsibilities of the audit committee include monitoring the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgements contained in them. The audit committee should also review the company's internal financial controls and often the committee also reviews the company's internal control and risk management systems.

The six accountancy bodies chartered in the United Kingdom and in Ireland are estimated to have, in the United Kingdom, some 270,000 members and nearly 160,000 students. There are also estimated to be about 50,000 members of other accountancy bodies in the United Kingdom and Ireland. On 1 January 2008, the ICAEW alone had over 130,000 members.

III. IFRS implementation issues

This part of the report considers two aspects of implementation by United Kingdom-listed companies in 2005:

- (a) Technical issues – the key differences between IFRS and United Kingdom GAAP which gave rise to major adjustments; and
- (b) Project issues – resourcing, timescales and communication.

Reference is then made to early assessments of the experience of AIM companies, which were required to apply IFRS for financial periods commencing on or after 1 January 2007.

A. Technical issues

As mentioned above, there was a widespread and understandable belief in the United Kingdom that because GAAP and IFRS were similar (each United Kingdom FRS contains a brief comparison to IFRS in an appendix), the conversion process would not be onerous. For many straightforward manufacturing or service businesses, this may have been the case, but issues emerged which for many United Kingdom-listed companies – often international and complex organizations – took a great deal of time to resolve.

Some of the principal differences between United Kingdom GAAP and IFRS in 2005 are highlighted below.

1. Property, plant and equipment

IFRS requires residual values to be re-estimated at least at the end of each period. GAAP only requires a residual value estimate to be made at purchase time. In practice, this did not create a significant implementation issue for most United Kingdom companies, but was important for those with major investments in real estate and other significant assets, such as ships or aircraft.

Computer software assets had to be reallocated from tangible fixed assets under GAAP to intangible fixed assets under IFRS.

2. Intangible assets

The major potential issue in relation to intangibles was in the context of business combinations, where IFRS explicitly requires many more intangibles to be identified than does GAAP.

Virtually all United Kingdom-listed companies took advantage of the exemption of IFRS 1 (First Time Adoption of International Reporting Standards) on moving to IFRS, and did not restate business combinations prior to the transition date (the start of their comparative year). These companies still had to review business combinations that had occurred in 2004 and 2005. It was notable that, in most cases, over 50 per cent of the purchase price was

allocated to goodwill – notwithstanding the IFRS view of goodwill as the residual amount that cannot be allocated to identifiable tangible and intangible assets such as customer contracts and customer relationships, back orders and beneficial service contracts. In addition, companies were required to switch from amortization of goodwill to an impairment-only approach (subject to transitional relief under IFRS 1), which in many cases had a significant effect on the financial statements.

Some companies, particularly in the pharmaceutical sector, were required to capitalize development costs under IFRS, where previously they had been expensing them as permitted by GAAP. No transitional relief was available under IFRS 1 in this respect.

3. Impairment of financial assets

GAAP permitted the calculation of a general provision for bad debts for which most companies used a flat percentage of good book debts. IAS 39 (Financial Instruments: Recognition and Measurement) requires an analysis for each group of financial assets with similar credit risk characteristics. This analysis may have been prepared routinely by financial services entities, but for some in other sectors represented a major change to the way the provision was calculated. There is anecdotal evidence that many did not change their methodology on the grounds of materiality.

4. Financial instruments

Financial instruments represented perhaps the most challenging area for many United Kingdom companies. This was partly because the United Kingdom did not have comprehensive recognition and measurement standards in place for financial instruments, but in part because of the complex nature of the relevant international standard, IAS 39, which was widely criticized by first-time adopters of IFRS. Virtually all United Kingdom-listed companies took advantage in 2005 of the exemption in IFRS which was available at the time not to restate their comparative information for the effects of adopting IAS 32 (Financial Instruments: Presentation) and IAS 39. The focus was therefore only on the current period in the first IFRS financial statements, but there was still substantial work required to restate the opening balance sheet at the start of the current period.

Under GAAP, most companies were familiar with reporting derivatives on an accruals or realization basis with a requirement to disclose the fair values in the notes to the financial statements. Banks and similar entities had long been reporting their derivative positions at fair value through earnings, although typically only for their trading portfolio, not for derivatives used for hedging activity.

It was also the prevailing practice under GAAP to record foreign currency sales or purchases using a forward rate of exchange where the exposure was covered by a forward contract. This meant that currency exchange differences did not arise. The move to recording the transaction at the “spot rate” and dealing with the forward contract as a separate derivative was a major change, especially when combined with the onerous requirements for the forward contract to qualify for hedge accounting treatment to avoid earnings volatility.

Much time and cost was spent by United Kingdom companies in securing, or trying to secure, hedge accounting status for their positions. Discussion with auditors, especially concerning how and how often to test for hedge effectiveness, was an important aspect of activity in this area for most companies. The documentary requirements of IAS 39 to secure hedge accounting (applicable at the time the hedging transaction was entered into, not just at transition) were also much greater than United Kingdom companies were used to, adding to the cost of implementation.

One of the biggest challenges for United Kingdom companies, however, was a new concept – the identification and analysis of embedded derivatives. The guidance in IFRS was mainly (but not exclusively) applicable to financial services entities, and companies in other sectors struggled to find the relevance to their transactions of the examples in IFRS. In the end, many companies did not identify many positions requiring the separation and valuation of these embedded derivatives, but a significant amount of resource was often needed to establish that there was not an embedded derivative that needed to be separated from the host contract.

5. Deferred taxation

GAAP only requires deferred tax to be recognized when there is an obligation to pay tax or a right to recover tax as a result of a past transaction. IFRS requires a deferred tax provision in virtually all cases when there is a difference between the accounting book value and tax base. This led to some significant increases in deferred tax balances, in respect of previously-revalued assets, gains on previous sales which had been deferred by replacing the assets concerned and unremitted foreign profits. IAS 12 (Income Taxes) was found to be a complex standard and in some respects difficult to interpret.

6. Leases

One of the most frequently occurring adjustments to United Kingdom accounting was in relation to the benefit of operating lease incentives. IFRS requires these to be spread over the lease term, whereas the United Kingdom's GAAP requires them to be spread over the period until the next rent review. As there are no transitional exemptions in IFRS on first-time adoption, those incentives where the lease term had not expired needed to be restated on adoption. This led to the reinstatement of some of the benefit which is now being recognized as a reduction of rent expense until the lease term expires. In many cases, the lease incentives had already been fully recognized in income under GAAP.

The definition of a finance lease under IFRS led to some reclassifications of leases which were classified as operating leases under GAAP, though this was not a common adjustment. Property leases were the main source of concern as IFRS explicitly includes them within the scope of lease accounting and contains detailed guidance on them. Some United Kingdom companies had to bring property leases on to the balance sheet (such as racecourse owners and bar owners), resulting in increased financial gearing. One consequence was that some companies had to renegotiate loan covenants with their lenders.

7. Defined benefit pension schemes

United Kingdom GAAP required all defined benefit pension scheme actuarial gains and losses to be recognized, but in a statement of total recognized gains and losses outside the income statement. IFRS was amended before 2005, in part to allow this treatment – preferred in principle by the IASB – to continue adoption of IFRS by United Kingdom-listed companies. Most of these companies continued to follow the GAAP approach.

Most of the other United Kingdom-listed companies adopted the “corridor” approach to recognition, meaning that most actuarial gains and losses are not recognized in the financial statements. To the extent they are recognized under IFRS, they must be included as part of net income/profit for the year.

8. Consolidation of group entities

Some United Kingdom-listed companies found that the number of entities they were required to include in their consolidated accounts changed on the adoption of IFRS. This was primarily because IFRS has different principles from GAAP on the exclusion of subsidiaries from the consolidation with IFRS being more restrictive on when exclusion is appropriate. Another reason for the change was the difference between the definitions of a “quasi-subsidiary” under GAAP and a “special purpose entity” under IFRS.

B. Project issues

Several important issues emerged from the implementation process, discussed below under the following headings: timing, cost, IFRS expertise and systems.

1. Timing

In a 2003 survey of business by the ICAEW undertaken to highlight the state of readiness for IFRS, less than half of respondents were aware of the impact IFRS would have on their company or its financial statements. Only a third of respondents rated their organization's understanding of the implications of IFRS as “very” or “fairly” good. Only 70 per cent of respondents stated that they would definitely be prepared in time for 2005.

In a 2004 survey, 81 per cent of respondents were aware of the publication of the EU's IAS Regulation (compared to 66 per cent in 2003). Just over half were aware of the IASB timetable for delivering the promised "stable platform" of 2005 standards (33 per cent in 2003) and only a third were aware of the EU endorsement process. Forty-five per cent rated their organization's understanding as good and 39 per cent believed their organization was ready for IFRS.

These statistics suggested that work to prepare for IFRS was well underway, but that greater effort was needed, especially by the time of the 2004 survey, given the requirement to restate comparatives for 2004. The survey results indicate that – despite the encouragement of regulators, auditors and the ICAEW – many companies left the process of preparation and communication until a later stage than was ideal, perhaps as the volume of work required was underestimated. In some cases, this may have added to the costs and pressures of implementation, although external reporting deadlines were rarely missed.

2. Cost

It is clear that the cost of implementation was substantial, although this varied significantly between companies. Evidence on truly incremental costs is limited. However, the ICAEW survey of EU implementation of IFRS indicates that incremental implementation costs for EU-listed companies ranged from an average of €0.5 million (for companies with a turnover of less than €500 million) to €3.4 million (for companies with a turnover in excess of €5 billion). Incremental recurring costs of implementation were estimated at between €0.1 million and €0.6 million for these turnover ranges. The survey indicated that costs were proportionately higher for smaller listed companies than for their larger counterparts.

3. IFRS expertise

Most companies faced a lack of practical IFRS expertise within their financial reporting teams. This was not surprising given that United Kingdom companies had not previously needed to possess any IFRS knowledge, but it undoubtedly slowed the conversion process and led to a greater reliance on external advisors, adding to the cost of implementation.

Larger listed companies invested heavily in staff training to enable them to tackle the conversion exercise with confidence and to minimize the risk of material errors. Smaller listed companies tended to place the conversion process in the hands of a few key staff, reducing training costs, but increasing the demands on those involved.

Companies also found that auditors were sometimes slow to respond on technical issues, as a result of a desire to ensure a consistent message was conveyed to clients with common problems. In many cases, issues had to be referred to audit firms' technical committees, slowing the process further.

4. Systems

Many companies upgraded their systems to deal with IFRS conversion. Some instituted a system of shadow accounts which would maintain individual financial statements in United Kingdom GAAP for statutory reporting and taxation purposes. Others decided that their accounting system would be used solely for IFRS compliance and that any adjustments back to local GAAP would be managed "offline". A third approach was to keep the existing systems producing United Kingdom GAAP information and build a consolidation module that would control the adjustments required to produce IFRS-compliant consolidated accounts of the group. In each case, substantial costs were incurred in connection with the systems upgrades.

C. The AIM experience

It is too early to assess rigorously the experience of companies listed on AIM of migrating to IFRS. It would appear anecdotally that, like many companies listed on the Main Market, a significant number of AIM companies started their preparations at a late stage but, even so, the process ran remarkably smoothly, with reporting deadlines met. AIM companies are, however, often listed as owner-managed businesses, with fewer resources available, and

consequently many are thought to have found the challenge of IFRS implementation particularly daunting.

AIM companies did enjoy some advantages over the first wave of United Kingdom IFRS adopters. First, they were helped by the greater familiarity of the whole financial community with IFRS concepts and vocabulary, and in particular with the greater familiarity of auditors, gained since 2005. Thus, advisors were able to anticipate where the problem areas would be. Second, the transactions entered into by many AIM companies are relatively straightforward; in particular, they are likely to have needed to account for fewer complex financial instruments.

IV. IFRS enforcement issues

The United Kingdom regulatory authorities have a policy of seeking to avoid authoritative interpretations of IFRS. There is a strongly held view that the IASB is the standard setter and that in a principles-based system it would be inappropriate to provide local variations for United Kingdom companies through regulatory decisions.

A. Securities regulators

The Financial Services Authority (FSA) regulates most financial services markets, exchanges and firms in the United Kingdom. The FSA cooperates with the Financial Reporting Review Panel (FRRP – discussed below) over monitoring and enforcement in relation to financial information published by United Kingdom-listed companies, and is a member of the Committee of European Securities Regulators (CESR).

Whilst CESR does not issue guidance or interpretation of IFRS, it coordinates the approach to enforcement within the EU, publishing standards on enforcement activity and recommendations for action by national enforcers, such as the recommendation for additional guidance regarding the implementation of IFRS, published in December 2003 (www.cesr.eu). It is, however, left to independent administrative authorities in each EU member State to carry out the enforcement activity. In the United Kingdom, this task falls principally to the FRRP.

CESR's role extends to maintaining a database of enforcement decisions, including decisions not to take enforcement action, for reference by national enforcers.

B. Auditors

The statutory audit requirement in United Kingdom company law is a powerful tool in the enforcement process and minimizes the risk of material misstatement. Under company law, auditors must state in their report whether the financial statements show a true and fair view, and whether they follow the relevant financial reporting framework.

Accounting policies in practice tend to be agreed with the auditors. The auditors must be satisfied with the presentation of the financial statements, including, for example, the disclosure of unusual items, line items used in the primary financial statements and the level of disclosure in the notes to the financial statements.

C. Financial Reporting Review Panel

In the United Kingdom, an independent body, the FRRP, reviews the financial statements of publicly quoted and large private companies for compliance with company law and with applicable accounting standards. Reviews are carried out on a sample basis, according to certain risk criteria, so not all financial statements are examined each year. As explained below, the FRRP also reacts to direct complaints and press comments. The FRRP can ask directors to explain apparent departures from requirements. If the FRRP is not satisfied by the directors' explanations, it aims to persuade the directors to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their financial statements and issue a replacement set that corrects the matters in error.

Depending on the circumstances, the FRRP may accept another form of remedial action – for example, correction of the comparative figures in the next set of annual financial statements. Failing voluntary correction, the FRRP can apply to the court for an order to secure the necessary revision of the financial statements although to date it has never had to do this.

The FRRP selects financial statements for review in a number of ways. First, it discusses with the FSA and its own Standing Advisory Group about which sectors of the economy are under strain or likely to give rise to difficult accounting issues. It then chooses a number of sectors and reviews a selection of accounts in each. The FRRP is also developing its own risk model to identify cases where accounting problems are more likely – for example, because of poor corporate governance. The FRRP looks at specific topical accounting issues and also responds to complaints from the public, the press and the financial community. In all cases, other than those precipitated by a complaint, the selection is based on the FRRP’s assessment of the risk of non-compliance and the risk of significant consequences if there is non-compliance.

D. Report on IFRS implementation

In December 2006, the FRRP published a preliminary report on implementation of IFRS in the United Kingdom (FRRP Press Notice 98). This reported a good level of compliance, but identified a number of areas for improvement which might be useful for other countries to be aware of prior to their implementation of IFRS. These are summarized in the table below.

Areas for improvement in implementation of IFRS

| | |
|----------------------------|--|
| Accounting policies | There was a tendency to use descriptions for disclosure of accounting policies which had been copied word for word from the standards. In some cases, the accounting policies disclosed had not been applied in the accounts as they were not relevant to the company. |
| Judgements | Disclosures relating to subjective or complex judgements made by management were often bland and uninformative (disclosure of key areas of judgement and estimation uncertainty is a requirement of IFRS). In some cases, there were no disclosures. |
| Goodwill | Many financial statements did not disclose the factors that gave rise to goodwill as required by IFRS. |
| New standards | Not all companies reviewed disclosed new standards and interpretations which had been issued – but which were not yet effective – and their likely impact on initial application. |
| Related parties | There was a failure to recognize that, under IFRS, key management personnel were related parties for disclosure purposes in a wider set of circumstances than under GAAP. |
| Other disclosures | Recommendations were also made regarding various less serious omissions in disclosures. |

The report was based on the review of a sample of financial statements. There is no perceived need for a mechanism within the United Kingdom to check all financial statements that are filed with the London Stock Exchange.

V. Some lessons learned

The adoption of IFRS by all EU-listed companies provides valuable information for other countries introducing IFRS, even though the experience of individual companies varied substantially.

A. The process

A key message for preparers of accounts is that it is never too early to start the transition process, especially because, when they present their first IFRS financial statements (which for listed companies are likely to be interim statements), they will need to present comparative IFRS information for the prior year. The process should therefore begin no later than the start of the year before IFRS adoption is mandated, and preferably earlier, to ensure that all data required is captured. In the United Kingdom, and presumably in other EU member States, this was frustrated to some degree by the fact that the EU had to endorse the IASB's standards and interpretations, and this was not completed until a relatively late stage. Where such an endorsement process is established, the time required to endorse existing and pending standards should be factored into any implementation timetable by the relevant authorities.

The IFRS conversion process should be treated like any other major business project, and not as a technical accounting issue. A robust project plan from the outset was invariably a prerequisite for a smooth transition to IFRS. Companies typically had initial meetings with their auditors at which likely significant issues were identified, leading to production of a table of the items in their financial statements showing the degree to which these would be impacted by IFRS adoption using an "ABC" (or similar) grading – "A" representing items likely to have major issues and or impact on conversion to IFRS, "B" representing modest impact or issues, and "C" representing items which were unlikely to be significantly affected. This was designed to focus the company's attention on the key areas affecting them and to enable them to budget the time needed in each case.

A dedicated project manager needs to be given the appropriate authority to undertake the work, and appropriate resources need to be provided to meet the costs and time of conversion, including IFRS expertise. The choice is between recruiting experienced, IFRS-knowledgeable employees or relying on external advisors – the auditors, subject to independence constraints, and other professional and training firms. As IFRS knowledge is needed on an ongoing basis after implementation, recruitment or the thorough training and retention of existing employees may be regarded as the most desirable option. Using in-house expertise also means that the ability to take quick corrective action as delays and problems are identified is enhanced.

All staff involved in the accounting process need to be made aware of how the change to IFRS will impact their work. Meetings held at an early stage were successfully used to inform staff of what was expected of them and to listen to their views. Often, staff will have valid operational points to make, such as system limitations, which can then be investigated.

As fair value plays a significant part in IFRS, there needs to be an early assessment of whether external non-finance expertise is required to produce the necessary valuations.

In some industries, there was a sharing of thoughts and issues through regular meetings of representatives from leading companies in the same sector, sometimes including their auditors. This helped to ensure some consistency of approach for industry-specific issues and assisted those charged with implementation.

B. Systems

Systems may well need to be upgraded, for example to deal with the extensive fair value data required under IFRS, particularly in the area of financial instruments. If systems changes are to be made, these need to be specified very early on in the project, to allow time for development, testing and corrective action, and to ensure that the system is ready for operation when required. The time taken to achieve this should not be underestimated.

Many companies met project deadlines by “workarounds” – the use of spreadsheets to produce certain figures and disclosures which were not embedded in the accounting systems. Whilst this may have been necessary in the first instance, it is generally not desirable because companies had to do more work the following year to bring information within their normal accounting systems. There is also an increased risk of error.

C. Training

It is important to train all staff affected by the adoption of IFRS. This is not limited to finance teams but extends to budget holders and any other internal or external stakeholder who needs to understand and interpret IFRS accounting information, or who is rewarded based on such information. The early involvement of the human resources department is likely to be necessary to ensure training is carried out efficiently and comprehensively.

D. Governance

The board of directors/officers should be engaged from the start of the process. IFRS adoption has the potential to significantly affect earnings and net assets, and senior management needs to be aware of this early on. There are indications that directors of many EU-listed companies are more involved in financial reporting decisions than under previous national accounting regimes.

The company’s auditors should also be consulted early on in the process, where key judgements and estimations will be required, to ensure that no last-minute revisions of the financial statements will be necessary.

In the United Kingdom, listed companies appoint audit committees to liaise with the external auditors, consisting primarily of non-executive directors. The audit committee will be involved in the selection of appropriate accounting policies and – as IFRS permits alternative treatments in many cases and requires significant exercise of judgement – this will be a time-consuming task, requiring an initial training period in IFRS principles for the committee members.

E. Business issues

The company must consider the effect that IFRS adoption will have on, among other things:

- (a) Management compensation structures (profits may become more volatile under IFRS adoption, especially if the company is exposed to the extensive use of fair values for financial instruments);
- (b) Taxation implications;
- (c) Debt covenants based on financial statement ratios; and
- (d) Key performance indicators, which may need to be amended as a result of the switch to IFRS.

F. Communication with stakeholders

The regulatory authorities encouraged United Kingdom-listed companies to indicate the impact of IFRS on their 2005 results and on their financial position in their 2003 financial statements, and to publish restated numbers for 2004 at the time of, or soon after, the publication of the GAAP financial statements. It was particularly important to explain very clearly to the Board differences between the IFRS numbers and the figures previously reported under national GAAP, analysts and other stakeholders, because of their unfamiliarity with IFRS concepts, vocabulary and requirements.

G. Disclosures

The priority of many companies preparing for IFRS in 2005 was applying the recognition and measurement requirements of IFRS and ensuring that their systems were capturing the accounting information needed. Once faced with producing the first annual report and accounts under IFRS, it became evident that the disclosure requirements of IFRS

were far more extensive than those of GAAP and, as discussed above, the FRRP survey showed that many companies did not fully comply with IFRS requirements. It is generally recognized that the quality of disclosures improved in the second year of IFRS implementation.

H. Audit firms

Auditors need to be fully trained in IFRS, with exposure to likely implementation issues, to ensure that client questions and suggested accounting policies can be responded to in good time and with robust supporting arguments. In the United Kingdom, trainee accountants had begun to study IFRS before the United Kingdom implementation, but inevitably lacked the practical experience and depth of knowledge necessary to be confident in dealing with clients' questions. Qualified accountants had attended courses in IFRS, but understandably lacked the depth of knowledge and application experience.

Now that IFRS is used much more widely around the world, it may be feasible for local audit teams to gain IFRS experience before assisting companies in their jurisdictions with implementation issues. This could be achieved by secondment, or where this is impracticable, by case studies based on the experience of IFRS conversion in other countries.

VI. Overall assessment of IFRS implementation

Notwithstanding the various issues highlighted earlier in this note, 2005 financial statements were produced to a high standard by United Kingdom IFRS reporters and, without exception, within the time frames required. Fund managers and other analysts in the United Kingdom are generally of the opinion that IFRS financial statements provided better and more transparent information for decision-making. A survey by PricewaterhouseCoopers in June 2006 found that almost two thirds of 75 United Kingdom fund managers surveyed believed that IFRS adoption had improved company reporting. These fund managers were responsible at the time for £2 trillion worth of funds, representing nearly 50 per cent of the market.

The ICAEW study for the European Commission supports this favourable assessment. Its conclusions, all applicable to the United Kingdom market, included the following:

- (a) There was widespread agreement that IFRS had made financial statements easier to compare across countries, across competitors within the same industry sector and across industry sectors; and
- (b) IFRS implementation had been challenging but successful. There was no general loss of confidence in financial reporting and IFRS implementation was generally seen as a positive development for EU financial reporting.

The ICAEW report also noted that at round tables used to test and explore the preliminary findings of the project:

- (a) Success tended to be expressed more in terms of measurement rather than disclosure;
- (b) The experience of smaller quoted companies was often very different from larger companies because, for example, of limited resources and a lack of prior experience of IFRS; and
- (c) Participants – who included auditors, preparers and regulators – expressed concern about the complexity of the standards and over the likely increase in the pace and direction of change in IFRS, referring in particular to the greater use of fair values. These concerns, coupled with awareness of the scale of the effort involved in IFRS implementation and concerns about some aspects of current IFRS, were reflected in a general lack of appetite at the time for any wider application of full IFRS.

Academic research also supports the conclusion that United Kingdom companies' financial statements prepared in accordance with IFRS show increased value relevance (i.e. a stronger correlation between share prices and the information in the accounts). The presumption is that value-relevant information is helpful to investors in making buy, sell or hold decisions. A study prepared for the ICAEW report to the European Commission – Value relevance of the IFRS: investigations of the transitional documents for United Kingdom, Spanish, French and Italian companies, by Joanne Horton (London School of Economics) and George Serafeim (Harvard Business School) – looked at the information provided by United Kingdom companies when they first adopted IFRS. At this point, companies had to provide reconciliations of their last published financial statements prepared using GAAP with the revised numbers using IFRS. It was therefore possible to check the value relevance of the additional IFRS information. The study found that the IFRS earnings adjustment was value relevant to the share price and to the stock return (i.e. the change in the share price) and that the IFRS equity (i.e. net assets) adjustment was value relevant to the stock return.

A further assessment of the capital market impacts of IFRS – provided in July 2008 for the purposes of this report prepared for the twenty-fifth session of ISAR by Joanne Horton and George Serafeim, and available from the ICAEW – refines the conclusions of their earlier report.

VII. Conclusion

The process of transition to IFRS was challenging, and involved substantial efforts, particularly by preparers and their auditors. The switch to IFRS was nonetheless achieved successfully by both fully listed and, as far as can be ascertained at the time of writing, by AIM-listed companies. It has in general received a favourable response from analysts and other users, and has improved the comparability of United Kingdom financial statements with those of other EU companies and non-EU IFRS reporters.

Experience of IFRS application continues to improve, and enforcement activities have so far not identified significant problems in the quality of application of the new standards. Much remains to be done, however, for example to (a) embed IFRS within systems and reporting processes; (b) build up understanding of IASB standards, their principles, scope and shortcomings; and (c) develop common sector practice.

Debate continues in the United Kingdom over the wider application of IFRS, principally through the convergence of GAAP with IFRS (and in particular, by using the pending IFRS for private entities), and the process of extending IFRS to the public sector is now underway. There is little doubt that IFRS will one day form the basis of all United Kingdom financial reporting.

Chapter 6

Practical challenges and related considerations in implementing International Standards on Auditing*

I. The benefits of globally uniform systems of financial reporting

As the world continues to globalize at a rapid pace through trade and investment, the credibility of financial information is becoming ever more important. Entities' securities offerings are no longer confined to their home jurisdictions, but are now often made in multiple jurisdictions. Similarly, investors and other providers of capital are increasingly looking beyond their own borders in making investment and other capital allocation decisions. The free movement of capital both within and across borders depends on credible, consistent and reliable financial reporting, which in turn rests on high quality standards of financial reporting.

However, the standards that govern financial reporting in a given jurisdiction need to be regulated at the national level, and these must therefore be national standards. Consequently, an entity with securities listed in more than one jurisdiction will be subject to the rules of both its home jurisdiction and the other jurisdictions where it is listed. The availability of different sets of financial information for the same entity, each of which is purporting to be a fair presentation, undermines the overall credibility of the financial information and makes the market inefficient. Equally, foreign investors looking to invest across borders face unnecessary costs in having to reconcile the financial information of potential investees in the local jurisdictions to the standards of the investors' home jurisdictions for investment appraisal purposes.

The way to lower the barriers to the free flow of credible financial information is not to choose a specific jurisdiction's standards and seek to impose them on every other jurisdiction – which would not be acceptable politically – but to agree on a “neutral” set of standards that can be accepted by every jurisdiction, either adopted as the jurisdiction's own standards or incorporated into them. That was the conclusion of the Financial Stability Forum when it selected in March 2000 its 12 Key Standards for Sound Financial Systems.⁵⁵

The benefits of globally uniform standards of financial reporting are numerous and include:

- (a) Greater comparability and transparency of financial information for investors;
- (b) Greater willingness on the part of investors to invest across borders;
- (c) Lower cost of capital;
- (d) More efficient allocation of resources; and
- (e) Higher economic growth.

Thus, adherence to international standards such as those developed by IAASB and the International Accounting Standards Board (IASB) can ultimately lead to greater economic growth around the world.

* This chapter was prepared with substantive input from the staff of the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

⁵⁵ See http://www.fsforum.org/cos/key_standards.htm.

II. Towards global acceptance of ISAs

Fundamental to the global acceptance of ISAs issued by IAASB is that they are developed through a comprehensive and transparent due process that all stakeholders recognize and accept. Equally important is the need for IAASB to build strong relationships with its stakeholders through which appropriate communication can be developed and mutual understanding enhanced.

This section explains the roles of IFAC and IAASB in establishing a single set of globally accepted auditing standards, and describes support around the world for global convergence with ISAs.

A. The role of IFAC

IFAC is the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC is comprised of 157 members and associates in 123 countries and jurisdictions, representing more than 2.5 million accountants in public practice, education, government service, industry and commerce.⁵⁶ IFAC, through its independent standard-setting boards, sets standards on auditing and assurance, education, ethics, and public sector accounting. It also issues guidance to encourage high quality performance by professional accountants in business.

Major reforms initiated five years ago have transformed IFAC and its international standard-setting processes. In March 2005, the most fundamental change in IFAC's 30-year history was announced: the formation of the international Public Interest Oversight Board (PIOB) to oversee, firstly, international standard-setting in the areas of auditing, education and ethics; and secondly, the IFAC Member Body Compliance Programme.⁵⁷ The formation of PIOB was one element of a comprehensive reform package that IFAC's leadership and the Monitoring Group of regulators⁵⁸ developed over a two-year period.

PIOB, which operates independently of IFAC, plays a key role in several ways:

- (a) It evaluates the due process in IFAC's standard-setting activities and reports publicly.
- (b) It approves the process for nominating members to IFAC's standard-setting boards,⁵⁹ and the appointment of the chairs and other members of these boards;
- (c) It has the right to require that the work programme or agenda of an IFAC standard-setting board include a specific matter;
- (d) It has the right to be an observer, with floor privileges, at meetings of the IFAC board and those of IFAC's standard-setting boards.

B. The role of IAASB

The objective of IAASB is to serve the public interest by setting, independently and under its own authority, high-quality standards for quality control, auditing, review, other assurance and related services engagements, and by facilitating convergence with those standards. This enhances the quality and uniformity of practice throughout the

⁵⁶ A list of IFAC members and associates can be accessed at: <http://www.ifac.org/About/MemberBodies.tmp>.

⁵⁷ The IFAC Member Body Compliance Programme, which is overseen by IFAC's Compliance Advisory Panel, helps to support the development of the accountancy profession worldwide by encouraging IFAC members and associates to converge national standards with international standards, and to establish quality assurance and investigation and discipline programmes for their individual members.

⁵⁸ The Monitoring Group of regulators is comprised of the Basel Committee on Banking Supervision (Basel Committee), the European Commission, the Financial Stability Forum, the International Association of Insurance Supervisors, the International Organization of Securities Commissions (IOSCO) and the World Bank.

⁵⁹ IAASB, the International Accounting Education Standards Board, and the International Ethics Standards Board for Accountants.

world, and strengthens public confidence in the global auditing and assurance profession.

IAASB consists of a full-time chair and 17 volunteer members from around the world. IAASB's composition is equally balanced between practitioners⁶⁰ and non-practitioners (including three public members).⁶¹ This broad membership is intended to ensure that a range of experiences from different environments are brought to bear in IAASB's deliberations, and helps IAASB identify the best approaches when setting its standards. The appointment of IAASB members is made by the IFAC board and approved by PIOB. IAASB meets four or five times per year.

On the basis of IFAC reforms, IAASB has implemented a number of changes to its processes with a view to becoming one of the most transparent standard-setters in the world. IAASB's meetings are open to the public, and agenda papers, meeting summaries, and final pronouncements are freely available on its website.⁶² Visitors can download audio recordings of IAASB meetings, exposure drafts of proposed standards and other consultative documents, and view all comments received on those documents.

IAASB has made public interest input into its standard-setting process a priority. It has established a formal Consultative Advisory Group (CAG)⁶³ to provide it with broad-based and continuous input on its work programme, project priorities and technical issues.

IAASB also has three official observers, with floor privileges, from the European Commission (EC), the Japanese Financial Services Agency and the United States Public Company Accounting Oversight Board (PCAOB).

In addition, IAASB makes it a priority to reach out to other stakeholders. It holds an annual meeting with major national auditing standard-setters⁶⁴ (NSS), at which standard-setting matters of international relevance are discussed. IAASB also engages in ongoing dialogue with the EC and European national auditing standard-setters, principally to facilitate the process of convergence to ISAs in Europe. In addition, IAASB representatives regularly:

- (a) Meet representatives of IOSCO,⁶⁵ the Basel Committee, and the Forum of Firms;⁶⁶ and
- (b) Participate in meetings of the PCAOB Standing Advisory Group.

C. IAASB's Clarity Project

In 2003, IAASB initiated a review of the drafting conventions used in its international standards to identify ways to improve the clarity, and thereby the consistent application, of those standards. After extensive public consultations, IAASB approved new drafting conventions in 2005 and launched a comprehensive programme to redraft its standards and to develop new standards using the new style ("Clarity Project"). This project marks one of the most important changes to international auditing standards in many years.

The project has a number of goals, of which the main one is the removal of any ambiguity in the language used in the standards that might affect the interpretation of

⁶⁰ Practitioners are professional accountants in public practice with significant experience in the field of auditing and other assurance services.

⁶¹ Public members are expected to act in the public interest and must be seen to be independent of any special interests and seen to be acting to represent society as a whole.

⁶² <http://www.iaasb.org>.

⁶³ The IAASB CAG is currently comprised of representatives from 28 different organizations around the world, including regulators, investor and stock exchange organizations, regional accountancy organizations, and other professional bodies: <http://www.ifac.org/IAASB/CAG.php>.

⁶⁴ The countries currently represented in the IAASB–NSS liaison are Australia, Brazil, Canada, China, France, Germany, India, Japan, the Netherlands, New Zealand, South Africa, the United Kingdom and the United States.

⁶⁵ IOSCO issued a press release on 9 November 2007 to confirm that it is evaluating under what conditions it could endorse ISAs for use for cross-border purposes, and the form of such endorsement.

⁶⁶ Established in 2002, the Forum of Firms (FoF) is an association of international networks of accounting firms that perform audits of financial statements that are or may be used across national borders. Details of the FoF can be accessed at: http://www.ifac.org/Forum_of_Firms/.

the requirements. In addition, to help users understand clearly what the standards require, IAASB is introducing objectives into each standard, followed by separate sections that include respectively requirements and guidance. IAASB believes that applying the new conventions will assist in the adoption of the ISAs around the world and facilitate translation and global convergence. IAASB expects to complete the Clarity Project by the end of 2008.⁶⁷

D. Meaning of global convergence

In any discussion about global convergence, the debate usually concerns whether to adopt or adapt the international standards. Adoption refers to the incorporation of international standards into the national standards or to nationalize these standards through a national process that could include additions that do not conflict with the international standards. On the other hand, adaptation implies significant modification through rewriting. IFAC believes that the approach of rewriting the standards does not permit the greatest benefit of convergence to be achieved, which is to be able to state that the international standards have been applied. This was the conclusion that the United Kingdom reached, for instance, when it chose to adopt the ISAs for all audits of financial statements for periods commencing on or after 15 December 2004.⁶⁸

The introduction of modifications to the international standards because of particular legal reasons or circumstances should be an exception, not the norm.⁶⁹ It should be relatively convenient to adopt the international standards in their totality and then make any exceptions considered necessary. Generally, this is much more efficient and permits conserving a large part of the advantage of applying the international standards, for the ease of reconciling both national and international standards. For this reason, IFAC promotes adoption of ISAs rather than their adaptation.

To minimize the potential for conflicts with national circumstances, IAASB tries to promulgate ISAs that are “jurisdictionally neutral”. IAASB, however, accepts that some changes, if only in terminology, may be necessary to make ISAs readily applicable at the national level. For instance, the term “those charged with governance” as used in ISAs could be amended in an adopting jurisdiction where there is only one category of such individuals, for example, directors. In such a case, the national standard-setter might find it appropriate to use the term “directors” throughout the converged national standards, perhaps with an explanatory note in an appropriate place. Similarly, some options in ISAs that do not work locally (such as resignation of the auditor if this is prohibited) might be deleted for simplicity. Nevertheless, there needs to be recognition that the ISAs apply to all audits, including contractual ones. Therefore, what may seem like a good simplification to a statutory audit regulator may not work so well for the profession at large.

E. Support for global convergence

IFAC has committed itself to achieving global convergence of national standards with international standards. This is evidenced both in its mission statement and in its Statements of Membership Obligations (SMOs). Published in April 2004, SMOs formally capture IFAC’s longstanding requirement that its member bodies support the work of IAASB and IASB by using their best endeavours to incorporate the

⁶⁷ The ISAs issued under the Clarity Project will become effective for audits of financial statements for periods beginning on or after 15 December 2009. To allow time for translation and implementation, IAASB will not issue new ISAs between the date the Clarity Project is completed and the effective date of the Clarity ISAs.

⁶⁸ See press release from the United Kingdom national auditing standard-setter, the Auditing Practices Board, at <http://www.frc.org.uk/apb/press/pub0530.html>.

⁶⁹ Where domestic considerations require changes to the international standards, either because of a conflict of law or some other local circumstance, it is for the national standard-setter to ensure that such matters are appropriately dealt with at the local level. But care is necessary to ensure that the ISAs are not undermined by country changes. IAASB has developed a policy statement – *Modifications to International Standards of the International Auditing and Assurance Standards Board (IAASB): A Guide for National Standard-Setters that Adopt IAASB’s International Standards but Find it Necessary to Make Limited Modifications* – to help national standard-setters that adopt the ISAs to decide what type of variation might be permitted, while preserving the ability to deem the resulting standards compliant with ISAs: http://www.ifac.org/IAASB/downloads/Modification_Policy_Position.pdf.

respective international standards in their national requirements and to assist in implementing the international standards, or national standards that incorporate the international standards.

Widespread support for global convergence with ISAs is evidenced in ways such as the following:

- (a) The latest IFAC survey conducted in 2006 indicates that more than 100 countries or jurisdictions use auditing standards that are ISAs, either adopted as written or with essential jurisdictional changes, or national standards that are compared with ISAs to eliminate differences. Examples of these countries or jurisdictions include the following:
 - (i) ISAs adopted as written: Barbados, Chile, the Dominican Republic, Hong Kong (China), Jamaica, Kenya, Luxembourg, Malaysia, Namibia, Trinidad and Tobago, Uganda and Zambia;
 - (ii) ISAs adopted as national standards but with essential jurisdictional changes to address legal or regulatory conflicts: Australia, Bangladesh, the Czech Republic, Denmark, Finland, France, Germany, Haiti, Israel, Italy, the Netherlands, New Zealand, Norway, the Republic of Korea, South Africa, Sri Lanka, Sweden, Switzerland and the United Kingdom;
 - (iii) National standards compared with ISAs to eliminate differences: Japan, Mexico, Portugal and Saudi Arabia;
- (b) An independent report – Rebuilding public confidence in financial reporting: an international perspective⁷⁰ – has recommended achieving convergence of national and international standards as soon as possible, viewing this as a significant public interest issue;
- (c) The International Organization of Supreme Audit Institution's⁷¹ (INTOSAI) Guidelines for Financial Audit, which provide INTOSAI members with practical guidance on the application of the INTOSAI Auditing Standards to public sector audits, are based upon ISAs;
- (d) Many of the world's major capital markets accept the use of ISAs for the audit of financial statements of foreign issuers. A recent IAASB survey indicates that 20 of the 23 largest capital markets, with overall market capitalization of 56 per cent of the world total, accept ISAs for this purpose;
- (e) The World Federation of Exchanges⁷² has formally endorsed the processes for establishing ISAs and recognized their importance, viewing them as key to the development of a globally uniform financial reporting system;
- (f) The World Bank, which jointly with the International Monetary Fund has instituted a programme of Reports on the Observance of Standards and Codes (ROSC) by countries, uses ISAs as the benchmark for assessing the quality of national auditing standards;
- (g) The members of the Forum of Firms have committed to have policies and methodologies for the conduct of transnational audits that are based, to the extent practicable, on ISAs.

At the country or jurisdictional level, convergence with ISAs is occurring rapidly in many parts of the world. Recent developments include, for example, the following:

⁷⁰ <http://www.ifac.org/Store/Details.tmp?SID=1186509159170528&Cart=1214922730491403>.

⁷¹ INTOSAI is the representative organization of supreme audit institutions, which are central government auditors.

⁷² The federation represents 57 securities and derivative markets accounting for more than 97 percent of world stock market capitalization.

- (a) The Statutory Audit Directive in the European Union specifies that ISAs will be used for all audits in all member States. The EC is currently considering the endorsement of ISAs as those international standards;
- (b) The Canadian Auditing and Assurance Standards Board, after careful consultation, has decided to move its standards to ISAs. These will be adopted in Canada in concert with IAASB's Clarity Project and will come into effect for audits of financial statements for periods beginning on or after 15 December 2009;⁷³
- (c) The American Institute of Certified Public Accountants' Auditing Standards Board has announced a formal convergence plan with ISAs for audits of non-public entities in the United States. The board has stated its belief that the IAASB's clarity effort will provide an excellent basis for improving United States generally accepted auditing standards applicable to audits of non-issuers (non-listed companies).⁷⁴
- (d) The major emerging BRIC (Brazil, Russian Federation, India and China) countries have established convergence policies to bring their national auditing standards closer to ISAs. For instance, Brazil and India have developed action plans to achieve convergence by 2010.

III. Addressing the practical challenges in implementing ISAs

As organizations and countries increasingly commit to convergence of national auditing standards with ISAs, predominantly through adoption mechanisms, there is a need to ensure that global convergence is approached in a systematic and, where possible, consistent way across jurisdictions. Also, interested parties such as national standard-setters, regulators and firms need to understand the challenges in implementing ISAs, so that these can be met at an early stage.

While adoption and implementation are two distinct matters, it is difficult to discuss one without considering the other. Adoption, as explained earlier, involves the incorporation of ISAs into national standards or the process of nationalizing them. Implementation, on the other hand, refers to the effective introduction and application of ISAs by practitioners. The adoption of ISAs is generally the more straightforward part, although adoption timetables do need to have regard to practitioners' ability to implement effectively. Implementation, by contrast, is the more difficult task, and the practical challenges are often greatly underestimated. Effective implementation requires, among other things, the availability of ISAs, time to learn them and to make necessary changes to audit systems and methodologies, and the existence of adequate monitoring. While implementation itself is a challenge, it will be enormously facilitated if it is backed by a decision to adopt ISAs based on firm convictions.

To foster debate on, and awareness of, the challenges to implementing international accounting and auditing standards, IFAC in September 2004 published an international study – Challenges and successes in implementing international standards: achieving convergence to IFRS and ISAs (the Wong report) – that identifies the challenges to adopting and implementing IFRS and ISAs. The Wong report also provides examples of successful adoption and implementation to serve as models for other countries, and recommends actions to be taken by all those in the financial reporting supply chain to achieve convergence to international standards.⁷⁵

The following sections discuss what it takes for successful implementation of ISAs, focusing on some of the main implementation challenges identified in the Wong

⁷³ <http://www.cica.ca/4/1/0/8/8/index1.shtml>.

⁷⁴ http://www.aicpa.org/download/auditstd/Clarity_Project_Explanatory_Memorandum.pdf.

⁷⁵ The Wong report was prepared by former IFAC board member Peter Wong:
http://www.ifac.org/Members/Source_Files/Other_Publications/Wong_Report_Final.pdf.

report (some more concrete than others), bearing in mind that the implications will vary with national circumstances.

A. The need for a robust implementation strategy and action plan

1. Understand the nature and scale of changes required, and plan accordingly

A critical success factor in implementing ISAs is the existence of a robust strategy and action plan backed by adequate resources to carry them through. Often, difficulties arise because of the lack of a coherent implementation strategy at the national level. This, in turn, can be the result of a misunderstanding as to the extent of the challenge and the scale of changes required, leading to inadequate planning and preparation for the actual implementation effort. Misunderstandings may also arise regarding the nature of the ISAs to be implemented and what it means to assert compliance with them.⁷⁶ For example, the World Bank noted in its September 2004 report – Implementation of international accounting and auditing standards: lessons learned from the World Bank’s accounting and auditing ROSC programme⁷⁷ (ROSC report) – that some countries have adopted only selected ISAs, or those in force at a particular date in the past, with no account taken of changes since then.

Selective adoption of ISAs may also be due to their perceived complexity, their incompatibility with national culture, or other potential implementation problems. As the Wong report noted, 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.”

Clearly, the nature of the required changes to national auditing standards will vary from country to country, depending on the extent of similarity between these and the ISAs. The challenge, however, is to fully understand the scale of the changes and time-frame needed for appropriate implementation, and to develop and implement an appropriate strategy and action plan accordingly. In this regard, IFAC, through its Compliance Advisory Panel, is working closely with its member bodies to facilitate this process. From the latest data available from part 3 of IFAC’s Compliance Programme,⁷⁸ some jurisdictions, such as mainland China, appear to be further along in the process of developing concrete action plans than others.⁷⁹

Decisions to implement other international standards – such as IFRS and IFAC’s Code of Ethics – may also affect the development of an appropriate strategy and action plan to implement ISAs, particularly if the implementation of all the international standards occurs more or less concurrently. Consistent implementation strategies will be required across the different sets of standards to ensure that the overall approach is coherent and efficient.

2. Plan to obtain the commitment and engagement of all relevant stakeholders

The implementation of the ISAs should not be solely a practitioner burden. Successful implementation requires the commitment and engagement of all relevant stakeholders, and the key to achieving it may be through a top-down approach.

⁷⁶ For national auditing standards to be regarded as being in compliance with ISAs at a given time, they should include all of the requirements and guidance of the latter that are effective at the time.

⁷⁷ http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/01/22/000333037_20080122014815/Rendered/PDF/419530WP0Lesso1ned1ROSC1AA01PUBLIC1.pdf.

⁷⁸ Part 3 of IFAC’s Compliance Programme requires IFAC member bodies to develop action plans to address identified performance and quality gaps in their compliance with IFAC’s SMOs, including convergence with IAASB standards.

⁷⁹ A copy of mainland China’s action plan for converging with and implementing ISAs, which was prepared as part of IFAC’s Chinese member body’s efforts to comply with IFAC’s SMO 3, can be accessed at <http://www.ifac.org/ComplianceAssessment/published.php>.

3. Obtain regulatory backing

First and foremost, a robust implementation strategy needs to incorporate regulatory backing for granting national authority to international standards. This may require changes to the legal and regulatory frameworks in many jurisdictions that only recognize nationally-developed standards. As the World Bank noted in its ROSC report:

“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. 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.”

In some jurisdictions, a legislative process may be required for adoption, which can itself be lengthy, especially if the ISAs must go through an endorsement process. The Russian Federation, for example, is in the process of enacting necessary amendments to its legal framework and has established an endorsement process for Russian Standards of Audit, which are the translated versions of ISAs. In the EU, the EC is considering the establishment of an endorsement mechanism for the adoption of ISAs under the Statutory Audit Directive, although the legislation has not set a deadline for the EC to make a decision regarding adoption.

4. Assign specific roles for implementation and establish accountabilities

For the implementation effort to be successful, key parties should be identified to lead it. While national standard-setters will be primarily responsible for the process of converging national standards with ISAs, responsibility for providing implementation support will often rest with the national professional accountancy bodies, as they are the ones that are closer to their member-practitioners. In some cases, that responsibility may be shared. The challenge is making sure that responsibilities for the various aspects of implementation are identified and communicated early, through dialogue among all the relevant parties, and that these parties accept to be accountable for such responsibilities.

One example of an approach taken in this regard is the ISA Implementation Group that the United Kingdom established when it adopted ISAs. This group comprised regulators, professional accountancy bodies, practitioners, training consortia, examiners and publishers, with the national standard-setter acting as observer. Division of responsibility has worked out reasonably well in the United Kingdom in specific respects. For instance, the national standard-setter has developed implementation guidance addressing specific areas of ISAs, such as audit documentation, while the local accountancy bodies have taken charge of arranging road shows, facilitating training or providing other support for practitioners.

In other countries – such as Canada, China and India, where the local accountancy bodies also have responsibility for standard-setting – there may be a need for these bodies to shoulder the task of both converging the national standards with the ISAs and implementing the standards.

5. Engage practitioners and the public

Often, a significant challenge to effective implementation of ISAs is simply practitioners' resistance to change. There may be a number of reasons for this. For example, cultural barriers may exist whereby practitioners are reluctant to embrace practices that encourage greater probing and transparency, especially in countries where a significant proportion of businesses are family-owned and controlled. Practitioner inertia may also be an impediment in itself, especially at the smaller end of the market, where the audit of financial statements may not be the main revenue generator and

where capacity constraints exist. Recent surveys in Australia and New Zealand, for example, have consistently revealed a lack of awareness of developments in international standards within the smaller practitioner community.

The key to addressing this challenge is to engage practitioners at all levels. An effective implementation strategy will incorporate initiatives to involve practitioners in the implementation process, through training and active consultation on exposure drafts and implementation issues,⁸⁰ and to raise their awareness of the changes to the standards⁸¹ and the changes needed to such matters as audit systems and methodologies.

Equally important will be the need to publicize widely the implications of implementing the ISAs in order to manage the public's expectations, especially given that some of the start-up costs that will be incurred in the first year of implementation may need to be borne by businesses and, ultimately, their shareholders. One of the lessons learned from the United Kingdom's implementation of ISAs is that the process should involve more investors. The United Kingdom now has a high level Audit Quality Forum that engages all audit stakeholders, and this has helped promote greater understanding among them. It has also experienced the need to better engage the professional media in the implementation process, as damage can be caused by uninformed comment.

By and large, however, anecdotal evidence from the United Kingdom's adoption of ISAs suggests that businesses have generally been receptive to the added value provided by audits under the new standards because of the focus on business controls and the greater probing required in relation to risks and fraud. In particular, weaknesses in systems that client management were not previously aware of have been brought to light by the new audit procedures.⁸²

6. Plan an appropriate transition strategy

Another key factor for an effective implementation of the ISAs is the development of an appropriate transition strategy. There are three particular aspects to this. Firstly, a decision needs to be made as to whether to take a "big-bang" or piecemeal approach to convergence. With the former, all ISAs are adopted at the same time, whereas with the latter, they are adopted in drip-feed fashion. A piecemeal approach will generally be difficult to implement because of the close interrelationship among the ISAs, the difficulty of running two sets of standards concurrently, and the issue of practitioners having to make constant adjustments as new ISAs are adopted. Examples of jurisdictions that have chosen a big-bang approach to convergence include Australia, Canada, Hong Kong (China) and the United Kingdom.⁸³

Secondly, to give practitioners ample time to plan and prepare for implementation, a clear and early communication is needed regarding when the new standards will become effective, what the transitional provisions, if any, will be, and how these relate to the corresponding provisions in the ISAs. A model to follow in this regard is Canada, where national standards will make the transition to ISAs issued under the IAASB's Clarity Project and will become effective at the same time as the revised ISAs.⁸⁴

⁸⁰ An example of a consultative channel is the IFAC SMP Committee's SMP/SME discussion board at: <http://web.ifac.org/forum/SMP/1>.

⁸¹ An example of an initiative to raise awareness is CPA Australia's fact sheets at: https://www.cpaaustralia.com.au/cps/rde/xchg/SID-3F57FECA-6DDB40C7/cpa/hs.xsl/1019_22187_ENA_HTML.htm.

⁸² See the paper Audit-exempt companies – beyond the threshold, developed by the Institute of Chartered Accountants in England and Wales (ICAEW) at <http://www.icaew.com/index.cfm?route=141483>.

⁸³ The United Kingdom experience of adopting ISAs is described in the ICAEW's November 2006 report Audit quality fundamentals – making global auditing standards local: <http://www.icaew.com/index.cfm?route=143423>.

⁸⁴ To assist Canadian auditors in preparing for the transition to ISAs, the Canadian Institute of Chartered Accountants has issued a guide, The CICA's guide to ISAs in Canada, to explain the expected impact of the adoption of ISAs in Canada and how practitioners can prepare for the transition: http://www.cica.ca/download.cfm?ci_id=44176&la_id=1&re_id=0.

Thirdly, once the national standards have converged with the ISAs, there is a need to keep the body of those standards current with the ISAs to derive the benefit of the latest improvements to international practices.

Evidence from the Wong report indicates that the above matters often present practical difficulties. For example, it noted that, in some cases, countries have adopted the international standards at issue at a particular date but have not kept up to date with new and revised international standards issued subsequently. In other cases, the national standards have different effective dates and transitional provisions from those of the international standards on which they are based. These issues undermine the ability of practitioners in these countries to make positive statements regarding compliance with the international standards.

B. The need for an adequate implementation support infrastructure

For the implementation of the ISAs to be effective, there needs to be an adequate support infrastructure. There are a number of different aspects to this.

1. The need for adequate dissemination channels

First and foremost is the need for adequate channels to disseminate the standards, whether through print-based media or via the Internet. While IAASB endeavours to facilitate dissemination to the greatest extent possible by making the ISAs accessible and downloadable from its website free of charge, this is not, in itself, sufficient to ensure that the standards reach all practitioners around the world. This is because the ISAs are written in English, and for them to have the widest possible distribution they need to be translated and disseminated on a national basis in jurisdictions where English is not the national language. This issue is likely to be most acute in developing countries and countries with economies in transition (“developing and emerging economies”) that lack the resources and capacity to ensure timely dissemination of the standards. Research undertaken in Jordan, for example, indicates that ISAs have not been widely available and that many audit practitioners have not had access to ISA-based practice manuals. Knowledge deficiencies therefore constrain most Jordanian auditors in ensuring sound auditing practice.⁸⁵

2. The need for implementation guidance and related support tools

A further challenge is the lack of implementation guidance and other support tools to assist practitioners in understanding and applying ISAs. This issue affects practitioners in developed countries, but even more so in developing and emerging economies, due to the lack of capacity. One option in addressing the challenge is to share knowledge and resources with other countries that face similar challenges. Thus, through collaboration, common implementation guidance and related support tools could be developed and, if necessary, subsequently customized nationally. Another option is for national standard-setters and professional accountancy bodies to seek assistance from their counterparts in other countries that are further along in the implementation process.

Through its annual liaison with the major national standard-setters, IAASB is working to facilitate cooperation among those standard-setters in developing relevant implementation guidance and other support tools. Further, in response to demands from many of its stakeholders, IAASB has agreed to undertake a number of initiatives as part of its recently released Strategy and Work Programme 2009–2011⁸⁶ aimed at providing further implementation support for practitioners. While it is too early at this stage to indicate what form such implementation support might take, IAASB and IFAC recognize the importance of their roles in contributing to the successful implementation of ISAs.⁸⁷

⁸⁵ Obaidat AN (2007). Auditors compliance with international standards on auditing: evidence from Jordan. *Journal of Social Sciences* 3 (4): 185–189. Tafila Technical University.

⁸⁶ <http://www.ifac.org/store/Details.tmpl?SID=1216051339304536&Cart=1216062762308775>.

⁸⁷ IFAC’s International Center for SMPs has various resources, including a catalogue of useful links offering access to free materials, including implementation tools, at http://www.ifac.org/SMP/relevant_links.php. IFAC has also

3. The need for an adequate oversight and quality assurance infrastructure

An effective implementation strategy should address the challenge of putting into place an adequate oversight and quality assurance (QA) infrastructure. Work in relation to this should develop on three distinct fronts. First is the need to establish effective monitoring and enforcement mechanisms managed by a recognized oversight body nationally to ensure a high quality of application of ISAs. Often, these mechanisms will need to be coordinated with other oversight programmes in relation to other aspects of financial reporting to ensure a consistent and coherent regulatory framework. Second is the need for the national accountancy profession to institute strong self-enforcement practices, including the establishment of adequate investigation and disciplinary mechanisms to ensure compliance with ISAs. And third is the need to implement adequate quality control systems at the audit firm level. Policy and goal setting should be exercised on each of these fronts simultaneously, as synergies exist, and should be exploited for the achievement of an effective overall result.

Although significant efforts have been made in recent years to enhance the capacity and powers of various regulatory bodies in a number of developed countries, findings from the World Bank's ROSC programme indicate that monitoring and enforcement practices in many developing and emerging economies remain inadequate and need to be strengthened. In addition, one of the findings of part 2 of IFAC's compliance programme is that only 40 per cent of developing and emerging economies responding have any form of QA programme. Clearly, this is an area where much work remains to be done. Perhaps a solution might be found on a regional basis, or at least a common project on the design, development and implementation of appropriate QA systems.

Further challenges that responsible bodies face in establishing appropriate QA systems include access to experienced and trained reviewers, developing appropriate guidance so that audit firms have a basis for good practice,⁸⁸ and providing training so that practitioners can continuously improve on matters identified as part of the QA process. Through its membership obligations, IFAC already requires each of its members and associates to establish a QA programme or assist in the development and implementation of such a programme.

C. Addressing the challenges of training and education

Once the decision to converge with ISAs has been made, significant logistical challenges need to be addressed in training and educating users in applying the new standards.

1. The capacity-building issue

The ability to address the challenges of training and education effectively depends on the availability of an adequate pool of appropriately qualified individuals. This in turn depends on the availability of opportunities for relevant and adequate education, training and experience. As the World Bank's ROSC report noted, "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... 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." Naturally, the time needed to plan for and implement these changes acts as a drag on the process of capacity-building. For example, when it

developed a search tool for practitioners at www.ifacnet.com.

⁸⁸ Recognizing the need that exists, IFAC's Small and Medium Practices (SMP) Committee is currently developing a guide for release in early 2009 to assist SMPs in implementing IAASB's International Standard on Quality Control. The guide is primarily aimed at IFAC member bodies and, through them, their members working in SMPs and in countries where the profession is in a developmental phase.

adopted ISAs, the United Kingdom identified the time lag for new ISAs to be introduced into university and professional education curricula as a specific issue.

The challenges of training and education will be greatest in developing and emerging economies that lack the capacity, both human and financial, to lead the implementation effort. A coordinated response at the national level involving Government, the national standard-setter, local accountancy bodies, academic institutions, private sector training and other support organizations, and audit firms, is therefore critical to ensure that adequate levels of capacity can be built up over time. Where appropriate, donor funding should be sought for purposes of capacity-building. Consideration should also be given to collaborative arrangements with other jurisdictions that have developed expertise. Such arrangements may take the form of, for example, train-the-trainer courses designed to equip individuals with the skills and knowledge necessary to train others in their home jurisdictions.

One model of a cooperative approach to the challenges of training and education is the United Kingdom. Although United Kingdom auditing standards were substantially aligned with previous versions of ISAs, planning for adoption and implementation of ISAs took place over a period of more than three years and required cooperation among the United Kingdom auditing standard-setter, the national accountancy bodies, private sector training consortia and software providers, and practitioners. This cooperation helped to ensure that when the change to ISAs was implemented, practitioners were adequately prepared and ready for the change.⁸⁹

It is also worth mentioning the important but often underappreciated role of the global audit firms in developing and emerging economies in building capacity and promoting higher levels of training, professional education and competence through their commitment to using ISAs.

2. Addressing the technical challenges

Challenges also arise from a technical standpoint in relation to the interpretation of new requirements introduced by ISAs, especially given that significant changes do not always get absorbed immediately. Even in a developed market such as the United Kingdom, evidence from monitoring undertaken by ICAEW indicates that some requirements of ISAs have not been consistently interpreted, especially in the areas of risk assessment, internal control testing and audit documentation.

The technical challenges are often significant for smaller audit firms around the world that often lack in-house expertise to support implementation of ISAs. It is at this end of the market that the needs for implementation support are likely to be most felt. Recognizing this, IFAC has been working to provide practical support to SMPs to raise their capacity to implement ISAs efficiently and effectively. This includes the development of a Guide to using international standards on auditing in the audit of small and medium-sized entities (ISA Guide),⁹⁰ and the provision of Web-based information resources (see footnote 33). However, even the global audit firms that are generally up to date with ISAs may experience challenges in training and educating their audit personnel to ensure consistent application across their international networks, especially in relation to ISAs that have been redrafted, or revised and redrafted, under IAASB's Clarity Project.

A related issue in raising the quality and consistency of application of ISAs worldwide is the effect that the cultural environment may have on the interpretation of the requirements. In particular, key concepts such as professional skepticism and judgment may not be interpreted as intended by IAASB, especially in jurisdictions that do not have a culture of questioning authority. Other important concepts such as "tone

⁸⁹ See footnote 29.

⁹⁰ Published in December 2007, the ISA Guide (<http://www.ifac.org/Store/Details.tpl?SID=1197644225547443&Cart=1215023902253>) is primarily intended to help practitioners around the world understand, comply with and apply ISAs in small and medium-sized entity audits. IFAC has distributed an electronic version to all its member bodies free of charge, which they will be able to use for their own local adaptations and as a basis for developing other support products, e.g. audit software, checklists, forms and training materials.

at the top,” ethical values and independence may also be relatively new or not clearly appreciated, especially in environments where moral integrity is not prized and corruption is commonplace. The challenge, therefore, is in educating practitioners not only to understand the technical meaning of the requirements in ISAs, but also to embrace the appropriate mindset when applying them.

Some early evidence of improvements in audit quality comes from countries that have already adopted ISAs. For example, respondents to a survey carried out as part of a project commissioned by IFAC on the financial reporting supply chain reported seeing improvements in the auditing process, such as a more systematic approach and analytical reviews with emphasis on risks and controls.⁹¹ They also indicated that more demanding standards require auditors to gain a better knowledge of the audited entities and a deeper understanding of these entities’ financial reporting processes.

D. The need for timely and high-quality translations of ISAs

Successful implementation requires a significant commitment to the translation of ISAs, to assure that the translation is adequate from the technical point of view, that it is timely and that it is readily available. The task of translation is not simple, and it requires the mobilization of adequate and appropriate resources. Two specific issues need to be considered.

Firstly, the translation of ISAs cannot be made in literal form. The translation process must involve individuals with the proper knowledge of the language, and who are also knowledgeable about the technical aspects of the standards, to assure that the concepts included in the standards are adequately translated. This, however, is not always the case, especially in those countries where translation is undertaken by the regulator or a government body. In such cases, interpretative guidance and additional translations may be required.

Secondly, the version of the body of ISAs being adopted in some countries relative to the latest effective ISAs issued by the IAASB leaves room for concern. For example, the Wong report noted that one country had a five-year time lag in adopting ISAs, due to the need to translate the standards.

Depending on the processes followed, some countries translate the standards issued by IAASB in groups at appropriate dates. Other countries issue the standards quickly following each IAASB meeting. Some countries have to get space on a legislative agenda to make changes to auditing standards. The varying timing of translation in different countries results in the implementation of different sets of ISAs around the world, which undermines the goal of global convergence. It is therefore particularly important that countries remain up to date in their translation efforts.

It should be noted that translation challenges also arise for the larger audit firms that need to use the same audit systems and methodologies based on ISAs across their international networks.

3. Opportunities for collaboration on translation

Translation is an area in which agreements of collaboration should be sought between professional accountancy bodies or other organizations in different countries, to minimize duplication of effort and to ensure consistent translations. One example of this is the 2005 agreement that IFAC signed with two of its member bodies – Compagnie Nationale des Commissaires aux Comptes (CNCC) in France and Institut des Réviseurs d’Entreprises (IRE) in Belgium – to translate ISAs into French. CNCC and IRE worked with other French-speaking professionals from Canada, Luxembourg and Switzerland to build on existing translations and develop a single French version of ISAs for implementation throughout the world.⁹²

⁹¹ *Financial Reporting Supply Chain: Current Perspectives and Direction*: http://www.ifac.org/Members/Pubs-Details.tmpl?PubID=12047550542246268&Category=_Other_.

⁹² To increase accessibility worldwide, the IFAC Board has approved a proposal to move to one quality translation of IFAC standards per language and to consult publicly on the process to achieve this:

IV. Conclusion

The implementation of ISAs presents significant practical challenges that require a coordinated response at the national level involving all relevant stakeholders, including Government, regulators, national standard-setters, professional accountancy bodies, audit firms and practitioners, training organizations and third-party suppliers. An effective country strategy should establish priorities, responsibilities for planned actions (including communication), and a realistic timeframe for implementation. It should also specify the human and financial resources required, and how these should be mobilized on a sustainable basis to initiate and continue the implementation effort.

IFAC and IAASB are contributing to the implementation effort in a variety of ways, such as through the provision of Internet resources that others can leverage, and initiatives to assess both the impact of proposed new ISAs and the effectiveness of implementation of ISAs. Equally significant is the high level of outreach to stakeholders that both IFAC and IAASB are committed to undertaking to ensure that the challenges of implementation are understood and addressed, and the benefits fully appreciated.

IFAC recognizes that developing and emerging economies will not have the financial and technical means to achieve all the actions necessary for successful implementation of ISAs. The support of relevant organizations in developed countries, or those with regional mandates, acting as mentors to those in developing and emerging economies, and the development of implementation support and tools, will increasingly become very important. In addition, it will be crucial to encourage national Governments to make convergence to and implementation of ISAs a priority on their agendas, and donor agencies to invest in the development of implementation support. Ultimately, the success of developing and emerging economies in effectively implementing ISAs will depend on their ability to clearly communicate their challenges, required actions and need for resources, and the willingness of Governments, donor agencies and developed countries to provide assistance wherever possible.

Chapter 7

Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA) – Level 3 guidance

Summary of discussions

After a brief introduction of the agenda item, the Chair of the session invited a representative of the IASB to provide delegates with an update on the accounting standard for SMEs (IFRS for SMEs) that the IASB had been developing. The IASB representative presented a comprehensive update on the status of this IASB project and also discussed remaining steps. In comparison to the ISAR approach to accounting by SMEs, the IFRS for SMEs was aimed at Level 2 enterprises. Following the exposure draft and field-testing of the IFRS for SMEs, the IASB was in the process of re-deliberating the standard. Some of these issues pertained to (a) making the standard fully stand-alone; (b) naming the standard; (c) anticipating changes to the full IFRS; (d) deciding whether historical cost should be the default basis of measurement; (e) fair value; (f) consolidation; (g) amortization of goodwill; (h) impairment; (i) income taxes; (j) operating leases; (k) pensions; (l) share-based payment; and (m) debt equity classification and further simplifications on disclosure requirements.

The speaker advised delegates that the International Accounting Standards Committee Foundation (IASCF) was in the process of developing training materials for the IFRS for SMEs. The material would have 38 modules corresponding to the 38 sections of the IFRS for SMEs and would be available after mid-2009. The training material would be available in multiple languages free of charge and the IASCF would train trainers.

The Chair introduced a panel of experts comprised of members of the consultative group tasked with finalizing the publication *Accounting and Financial Reporting Guidelines for Small and Medium-sized Enterprises (SMEGA): Level 3 Guidance* by incorporating amendments suggested at the twenty-fourth session of ISAR. The Chair of the consultative group informed delegates that the document TD/B/C.II/ISAR/50 contained revised SMEGA Level 3 Guidance. He indicated that limited changes were made to the version of the document presented at the previous session. The main change was the introduction of an optional cash-flow statement as agreed at the twenty-fourth session of ISAR.

Following the presentation, several delegates provided comments and raised questions. These pertained to the formats of illustrative financial statements provided in the document and historical cost-based measurement. The Chair of the consultative group informed participants that formats provided in the document were meant for illustrative purposes. He also informed delegates that the measurement base in SMEGA Level 3 was historical cost, since SMEs were very likely to find it easier to apply.

In concluding their deliberations on this item, delegates welcomed the revisions proposed and requested the UNCTAD secretariat to finalize publication of the document and disseminate it widely. Furthermore, delegates requested the UNCTAD secretariat to compile feedback on practical implementation of the revised SMEGA Level 3, which member States would send in the coming years. Such feedback could be utilized for revising the document at an appropriate time in the future.

I. Background

At its seventeenth session in July 2000, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) identified a number of obstacles that small and medium-sized enterprises (SMEs) were facing in applying accounting standards that had been issued by various standard-setting bodies, both national and international. It was agreed that a project should be undertaken to identify possible approaches that would meet the accounting and financial reporting needs of such enterprises.

ISAR has supported and continues to support the International Accounting Standards Board (IASB) as the international standard setter of reference for accounting and reporting standards. The international financial reporting standards (IFRS) issued by the IASB, however, have been created largely with the financial reporting needs of listed companies in mind. Consequently, it has often been difficult to apply them to SMEs, particularly those in developing countries and countries with economies in transition. For many businesses in these countries, professional help may also be disproportionately expensive.

The IASB recognizes that the IFRS are less suitable for meeting the needs of users, preparers and owners of SMEs. To address this deficiency, IASB issued the exposure draft of the IFRS for SMEs in February 2007. The IFRS for SMEs has been developed from the IFRS.

ISAR recognizes that it is likely that the IFRS for SMEs may not be suitable for smaller enterprises, as such enterprises may not produce general-purpose financial statements. In general, their financial statements are not designed to meet the needs of a wide group of users.

To meet the needs of smaller enterprises, sometimes referred to as microenterprises, ISAR has developed a single set of guidelines – Level 3 – which meet the needs of those enterprises that do not produce general-purpose financial statements. The Level 3 Guidelines have been developed using a “bottom-up” approach rather than being integrated into the “top-down” approach which characterizes the proposed IFRS for SMEs. The bottom-up approach starts with a realistic consideration of the needs of users and preparers of the financial statements of smaller enterprises.

Therefore, in order to meet the financial reporting needs of all enterprises, ISAR is proposing that a three-tiered structure be adopted, as follows:

- (a) Level 1. This level would apply to listed enterprises whose securities are publicly traded and those in which there is significant public interest. These enterprises should be required to apply the IFRS issued by the IASB.
- (b) Level 2. This level would apply to significant business enterprises that do not issue public securities and in which there is no significant public interest.
- (c) Level 3. This level would apply to smaller enterprises that are often owner-managed and have no or few employees. The approach proposed is simplified accruals-based accounting, closely linked to cash transactions. National regulators may permit a derogation for newly formed businesses or new entrants to the formal economy to use cash accounting for a limited time.

How exactly the boundaries between the three levels should be specified is a matter that cannot be dealt with adequately without knowledge of the specific economy in which the enterprises operate. The recommendation of ISAR is that there should be a system with at least three levels, but how these levels are defined must be determined by each member State that chooses to apply this approach. The SMEGA Level 3 Guidance that ISAR has developed is set out in the material that follows.

II. Introduction

A. Scope

The SMEGA Level 3 Guidance is designed for financial statements of smaller enterprises that are often owner-managed and have no or few employees. Such enterprises should generally follow a simplified accruals-based accounting system that is closely linked to cash transactions.⁹³ The SMEGA Level 3 Guidance is intended to meet the needs of users and preparers of financial statements for these enterprises.

B. Level 3 accounting framework

The income statement and the balance sheet are based on a simplified accruals accounting approach, closely linked to cash transactions. This guidance uses the historical cost measurement basis.

Level 3 financial statements will normally be prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

C. The objectives of Level 3 financial statements

The objective of Level 3 financial statements is to provide information about the reporting enterprise's financial performance and financial position that will be useful to users in assessing the performance of the enterprise and the stewardship of the enterprise's management.

D. Users and their needs

Financial statements are designed to reflect user needs. The principal users of financial statements of Level 3 enterprises are likely to be:

- (a) Owners and management:
 - To assess and confirm the performance of the enterprise during the year or period under review (including the levels of income, revenues and costs);
 - For applying for external financing;
 - For financial management purposes (e.g. deciding what portion of profits to retain); and/or
 - As a tool for succession planning and management of wealth.
- (b) Lenders and other creditors:
 - To assess risk in the credit decision; and
 - To monitor the performance of enterprises that have been given credit.
- (c) Government: for macro- and microeconomic planning purposes.
- (d) Taxation authorities: for tax assessment purposes.
- (e) SME agencies: to assess support requests from enterprises (e.g. grant applications, training requests and subsidized business services).
- (f) Credit agencies: to facilitate the assessment of the advancement of credit from an independent organization that keeps records of the credit status of enterprises.

⁹³ National regulators may permit a derogation for newly formed businesses or new entrants to the formal economy to use cash accounting for a limited time.

E. Qualitative characteristics

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal characteristics are:

- (a) *Understandability*: It is essential that information provided in financial statements be readily understandable by users.
- (b) *Relevance*: To be useful, information must be relevant to the decision-making needs of users.
- (c) *Reliability*: Information is considered to be reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it purports to represent.
- (d) *Comparability*: Users must be able to compare the financial statements of an enterprise over time in order to identify trends in the enterprise's financial position and performance.

The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially judgemental.

In practice, trade-offs between qualitative characteristics are often necessary. Determining the relative importance of the characteristics in different cases is a matter of professional judgement.

F. Elements

Asset: An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

Liability: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Equity: Equity is the residual interest in the assets of the enterprise after all its liabilities have been deducted.

Income: Income encompasses both revenue and gains. It includes increases in economic benefits during the reporting period in the form of inflows or enhancements of assets, as well as decreases of liabilities that result in increases in equity, other than those relating to contributions from owners.

Expenses: Expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to owners.

G. Recognition

An item that meets the definition of an element should be recognized if, (1) it is probable that any future economic benefit associated with the item will flow to or from the enterprise, and (2) the item has a cost or value that can be measured with reliability.

H. Measurement

The measurement basis most commonly adopted in preparing financial statements is historical cost.

I. Level 3 enterprises and financial management

In the day-to-day running of the enterprise, it is widely recognized that managing cash is critical to the survival of an enterprise and to managing relationships with banks and other providers of finance. It is recommended that owner-managers keep cash records that will be a source of prime entry for the financial statements.

These records will be an important component in the financial management of Level 3 enterprises.

III. Basic requirements

The following paragraphs set out the basic guidance for Level 3 enterprises.

The minimum set of primary financial statements includes the following components:

- (a) A balance sheet;
- (b) An income statement; and
- (c) Explanatory notes.

Enterprises may wish to include other statements that are likely to enhance the overall transparency and quality of the information they provide to users; for example, a cash flow statement.

Financial statements should be prepared on a going-concern basis unless management either intends to liquidate the enterprise or cease trading, or has no realistic alternative but to do so.

An enterprise should prepare its financial statements using simplified accruals-based accounting, closely linked to cash transactions.

The following information should be prominently displayed:

- (a) The name of the reporting enterprise;
- (b) The balance sheet date and the period covered by the income statement; and
- (c) The presentation currency.

Financial statements should be prepared at least once a year.

Financial statements should include comparative figures for the previous period.

The enterprise should present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet.

An asset should be classified as a current asset when it is:

- (a) Expected to be realized in, or held for sale or consumption in, the normal course of the enterprise's operating cycle; or
- (b) Held primarily for trading purposes or for the short term, and is expected to be realized within 12 months of the balance sheet date; or
- (c) Cash.

All other assets should be classified as non-current assets.

A liability should be classified as a current liability when it is:

- (a) Expected to be settled in the normal course of the enterprise's operating cycle; or
- (b) Due to be settled within 12 months of the balance sheet date.

All other liabilities should be classified as non-current liabilities.

As a minimum, the face of the balance sheet should include the line items shown in annex I.

An enterprise should disclose the movement of owners' equity during the reporting period.

As a minimum, the face of the income statement should include the line items shown in annex II. A more detailed presentation using the same structure is shown in annex III.

Additional line items, headings and subtotals should, if relevant and material to the enterprise, be presented on the face of the balance sheet or the income statement.

An item of property, plant or equipment should initially be measured at its cost. The cost of an item of property, plant or equipment comprises its purchase price, including import duties and non-refundable purchase taxes, and any directly attributable costs of bringing the asset to working condition for its intended use. Any trade discounts and rebates are deducted when arriving at the purchase price.

The depreciable amount (cost less expected proceeds from disposal) of an item of property, plant or equipment should be allocated on a systematic basis over its useful life. Straight-line depreciation is the simplest method.

If an item of property, plant or equipment becomes impaired, in that it is unlikely to generate cash flows to absorb the carrying amount of the item over its useful life, its carrying value should be reduced to the cash flows to be recovered from the asset. Cash flows need not be discounted and could come from either the disposal value of the asset or from its continuing use. Indicators of impairment would include a significant decline in market values or obsolescence.

Land normally has an unlimited life and, therefore, is not depreciated. Buildings have a limited life and, therefore, are depreciable assets.

The financial statements should disclose for each class of property, plant and equipment a reconciliation of the carrying amount at the beginning and end of the period showing:

- (a) Additions;
- (b) Disposals;
- (c) Depreciation; and
- (d) Other movements.

Lease payments, whether deriving from an operating or finance lease, should be recognized as an expense as they become payable. If the payments are material, these should be disclosed in the notes to the financial statements.

The value of the lease should not be shown either as an asset or a liability on the balance sheet. However, if the total remaining payments on the lease are material, this should be disclosed in the notes to the financial statements.

Inventories should be measured at the lower of cost and net realizable value (the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale).

The cost of inventories should comprise all costs of purchase and other costs incurred in bringing the inventories to their present location and condition (such as for transport and manufacturing).

The cost of inventories should be assigned by using specific identification of the individual costs of items whenever possible. Otherwise, the cost of inventories should be assigned by using the first-in first-out (FIFO) or weighted average cost methods.

Revenue should exclude taxes on goods and services, but should include commissions receivable.

Revenue from the sale of goods should be recognized when the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods.

Revenue from the rendering of services should be recognized to the extent that the service has been provided.

Where there is uncertainty as to the receipt of payment for a trade receivable, a reasonable provision should be made against trade receivables.

Any significant gains or losses should be disclosed separately.

The tax shown in the income statement should be the estimated tax due on the profit or loss for the reporting period.

The explanatory notes to the financial statements should also include;

- (a) A description of the enterprise's operations and its principal activities;
- (b) A reference to the accounting framework under which the financial statements have been prepared;
- (c) Disclosure of significant accounting policies used;
- (d) A description of contingencies (possible assets or liabilities whose existence will only be confirmed by the occurrence or non-occurrence of uncertain future events); and

Any other information relevant to understanding the financial statements.

For material transactions or events not covered by this guidance, reference should be made to the appropriate requirements in the guidance for Level 2 enterprises.

IV. Model financial statements

A. The financial statements

The balance sheet and the income statement are based on a simplified accruals accounting approach.

In many cases, Level 3 enterprises will not have the in-house resources to prepare these statements and, in these cases, the statements will need to be prepared by an external party.

The formats take into consideration the cost/benefit issues of Level 3 enterprises. In order to ensure that the statements are useful to owner-managers and other users of financial statements of typical Level 3 enterprises, the costs of preparing the statements need to be weighed against the benefits.

The objective of the financial statements is to help owner-managers obtain information that can be helpful in developing the business and also to help other users make decisions and monitor the progress of the enterprise. Therefore, the design of these statements is intended to reflect these users' needs.

B. Balance sheet – annex I

The relevance of the headings will to a certain extent depend on the nature of the enterprise, but the main structure and headings should be applicable for most enterprises at this level.

C. Income statement – annexes II and III

The structure of the income statement has been designed primarily to meet the needs of owner-managers. It is recognized that the income statement is used by owner-managers to see whether they have correctly anticipated the level of costs and profit margins in their pricing.

It is assumed that most enterprises at this level will price goods and services on a cost-plus basis. Thus, the "contribution" reflects the difference between the sales and

those costs on which the mark-up is calculated, which are described in the statement as “direct operating costs”.

Direct operating costs will vary from enterprise to enterprise. For example, annex III illustrates an income statement for a typical retail business where the mark-up is likely to be made just on purchases. Other types of enterprises may have different definitions of direct operating costs.

The cost structures of enterprises at this level are likely to be very different from those of large businesses. The reason for this is that the majority of these enterprises’ costs are likely to be direct. In contrast, the majority of the costs of large enterprises are indirect (i.e. related to overheads).

The headings under “indirect costs” are to reflect the materiality of the costs in relation to the total indirect costs and their importance with regard to disclosure for users in general. Therefore, there is likely to be some variation between different types of enterprises.

D. Cash flow statements – annex IV

The primary purpose of a cash flow statement is to provide relevant information about the cash movements of an enterprise in a given period. Although it is not required under this guidance, a model cash flow statement is provided in annex IV.

Annex I. Model balance sheet

XYZ Ltd.
balance sheet
as of December 20X2
(in currency units, CU)

| | 20X2 | 20X1 |
|---|----------------|----------------|
| | CU | CU |
| Assets | | |
| <i>Non-current assets</i> | | |
| Property, plant and equipment | 190,000 | 190,000 |
| <i>Current assets</i> | | |
| Raw materials | 18,200 | 9,100 |
| Finished goods | 34,000 | 21,000 |
| Trade receivables | 26,000 | 34,000 |
| Cash and bank | 6,800 | 11,500 |
| | 85,000 | 75,500 |
| Total assets | 275,000 | 265,600 |
| Owners' equity and liabilities | | |
| Owners' equity as of 1 January | 132,900 | 114,700 |
| Earnings for the year | 55,600 | 48,200 |
| Owners' drawings for the year | (45,000) | (30,000) |
| Owners' equity as of 31 December | 143,500 | 132,900 |
| <i>Non-current liabilities</i> | | |
| Loans | 105,500 | 117,000 |
| Current liabilities | | |
| Bank borrowings | 2,500 | 12,500 |
| Taxes payable | 4,600 | 2,200 |
| Trade payables | 18,900 | 1,000 |
| Total liabilities | 131,500 | 132,700 |
| Total owners' equity and liabilities | 275,000 | 265,600 |

Annex II. Model income statement format

XYZ Ltd.
income statement
for the year ended 31 December 20X2
(in CU)

| | CU |
|--|----|
| Revenue | |
| Direct operating costs | |
| | |
| Contribution | |
| Indirect costs | |
| | |
| Profit before interest and other financing costs | |
| <i>Less:</i> | |
| Interest and other financing costs | |
| Profit after interest and other financing costs | |
| <i>Less:</i> | |
| Tax | |
| Profit after tax | |
| | |
| | |

Annex III. Model income statement

XYZ Ltd.
income statement
for the year ended 31 December 20X2
(in CU)

| | 20X2 | 20X1 |
|--|----------------|----------------|
| | CU | CU |
| Revenue | 325,000 | 283,000 |
| Direct operating costs | | |
| Opening inventories | 21,000 | 00.0 |
| Cost of goods produced | 205,600 | 189,000 |
| | 226,600 | 189,000 |
| Closing inventories | 34,000 | 21,000 |
| Total direct operating costs | 192,600 | 168,000 |
| Contribution | 132,400 | 115,000 |
| Indirect costs | | |
| Salaries | 39,350 | 35,700 |
| Depreciation – office equipment | 1,500 | 0.00 |
| Lease rent | 15,600 | 13,500 |
| Motor vehicle expenses | 6,500 | 5,700 |
| Insurance | 1,300 | 1,100 |
| Telephone | 1,700 | 1,500 |
| Light and heating | 1,150 | 900 |
| Total indirect costs | 67,100 | 58,400 |
| Profit before interest and other financing costs | 65,300 | 56,600 |
| Interest expense | 1,300 | 1,200 |
| Profit after interest and financing costs | 64,000 | 55,400 |
| Tax | 8,400 | 7,200 |
| Profit after tax | 55,600 | 48,200 |

Annex IV. Model cash flow statement (optional)

XYZ Ltd.
cash flow statement
for the year ended 31 December 20X2
(in CU)

| | 20X2 CU | 20X1 CU |
|--|---------------------|----------------------|
| Profit after tax | <u>55,600</u> | <u>48,200</u> |
| Adjustments for: | | |
| Interest expense | 1,300 | 1,200 |
| Tax | 8,400 | 7,200 |
| Depreciation | 13,500 | 12,000 |
| (Increase) decrease finished goods inventory | (13,000) | (21,000) |
| (Increase) decrease raw materials inventory | (9,100) | (9,100) |
| (Increase) decrease receivables | 8,000 | (34,000) |
| Increase (decrease) trade payables | 17,900 | 1,000 |
| Total adjustments | <u>27,000</u> | <u>(42,700)</u> |
| Cash generated from operations | 82,600 | 5,500 |
| Interest paid | (1,300) | (1,200) |
| Income taxes paid | (6,000) | (5,000) |
| Net cash from operating activities | 75,300 | (700) |
| Cash flow from investing activities | | |
| Purchase of equipment | (13,500) | |
| Net cash used in investing activities | (13,500) | |
| Cash flows from financing activities | | |
| Payment to loans and borrowings | (21,500) | |
| Owners' drawings | (45,000) | (30,000) |
| Net cash used in financing activities | (66,500) | (30,000) |
| Net increase (decrease) in cash and bank | (4,700) | (30,700) |
| Cash and bank balance on 1 Jan | 11,500 | 42,200 |
| Cash and bank balance on 31 Dec | <u><u>6,800</u></u> | <u><u>11,500</u></u> |

Chapter 8

2008 Review of the implementation status of corporate governance disclosures: an examination of reporting practices among large enterprises in 10 emerging markets

Summary of discussions

The Chair introduced the agenda item and gave the floor to a member of the secretariat who presented the findings of two new studies: the 2008 Review of the implementation status of corporate governance disclosures: an examination of reporting practices among large enterprises in 10 emerging markets (TD/B/C.II/ISAR/CRP.1); and the 2008 Review of the reporting status of corporate responsibility indicators (TD/B/C.II/ISAR/CRP.2). The papers provided useful insights into the current state of corporate reporting on environmental, social and governance (ESG) subjects in emerging markets.

Following this presentation, the Chair introduced an invited expert from the research firm Ethical Investment Research Services (EIRIS), who presented the findings of the joint UNCTAD and EIRIS paper, 2008 Review of the corporate responsibility performance of large emerging market enterprises (TD/B/C.II/ISAR/CRP.3). The paper examined the corporate reporting of 40 leading companies in 10 emerging markets and provided an assessment of each company against key ESG indicators. The analysis illustrated how some of the largest emerging markets companies were addressing ESG issues, as well as the methodologies used by ESG analysts to measure company performance in this area.

The Chair introduced two additional panellists, one from the reporting standard setter Global Reporting Initiative (GRI) and one from the assurance standard setter AccountAbility. The GRI representative gave an overview of the driving forces behind ESG reporting, and of the demand among users of corporate reports for more relevant and comparable data. The GRI representative also announced the signing of a memorandum of understanding between UNCTAD and GRI which focused on promoting in developing countries and economies in transition greater understanding of, and greater participation in, the processes that set internationally recognized sustainability reporting standards in order to foster sustainable development in those countries and facilitate investment and business linkages. The representative from AccountAbility provided an overview of the use of assurance standards in company ESG reports, highlighting the important role that assurance plays in strengthening the credibility of sustainability reporting and in helping enterprises to understand and improve their ESG performance.

After the panellists had made their presentations, the Chair opened the floor and a broad discussion on the subject of ESG disclosure ensued. Several delegates commented on the secretariat's 2008 review of corporate governance disclosure, recognizing its usefulness and making suggestions for future research in this area.

Broad discussion was also sparked by questions about the relationship between ESG performance and financial performance. The panellists expressed similar views on this subject. Several observed that some studies showed a positive correlation between ESG performance and long-term financial performance. Other panellists pointed out that there were a large number of factors that influenced long-term financial performance, including industry trends and economic circumstances external to the firm, thus isolating the impact of ESG performance alone on such financial indicators as sales growth was difficult. The panellists observed that ESG performance could play a key role in delivering other mission critical features of enterprise development. The group concluded their discussion with calls for the secretariat to continue its work in this area.

I. Introduction

Corporate governance has been a key area of work for the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) since 1989 (E/C.10/AC.3/1989/6). Since the twenty-first session of ISAR, the group of experts has requested an annual review of the implementation status of corporate governance disclosure. Annual reviews were presented at the twenty-first, twenty-second, twenty-third and twenty-fourth sessions of ISAR. At the twenty-fourth session, ISAR considered the document 2007 Review of the Implementation Status of Corporate Governance Disclosures: An Inventory of Disclosure Requirements in 25 Emerging Markets (TD/B/COM.2/ISAR/CRP.6, hereafter the “2007 Review”).

UNCTAD’s studies on this subject use as a benchmark ISAR’s conclusions on corporate governance disclosure found in the 2006 UNCTAD publication *Guidance on Good Practices in Corporate Governance Disclosure* (UNCTAD/ITE/TEB/2006/3). This 2008 Review complements the data presented in the 2007 Review. While the 2007 Review examined the corporate governance disclosure requirements of government and stock exchange regulations, this 2008 Review looks at the actual reporting practices of enterprises, based on their public reports, in 10 of the largest economies studied in the 2007 Review. Thus, while the 2007 Review studied what publicly listed enterprises were required to report, this present study is an examination of what enterprises are actually reporting. This line of enquiry is expected to provide policymakers and other interested parties an indication both of what enterprises are reporting and the compliance of enterprises with corporate disclosure rules and regulations.

The objectives of this Review are to (a) provide a brief overview of recent developments in corporate governance since the twenty-fourth session of ISAR; and (b) present and analyse the results of the 2008 review of corporate governance disclosure practices. The overview of recent developments is provided in section II, which examines significant developments in the area of corporate governance disclosure. Section III presents the findings of the 2008 Review, along with detailed analysis.

The findings of the 2008 Review show that on average, the enterprises in the study are disclosing more than half the items in the ISAR benchmark of good practices in corporate governance disclosure. Further analysis indicates that, while required disclosure items are reported more frequently than non-required disclosure items, there are still significant gaps in compliance among enterprises vis-à-vis the reporting requirements of their home markets.

II. Overview of recent developments in corporate governance disclosure

Over the 2007/08 ISAR intersession period, corporate governance (CG) disclosure requirements continued to be strengthened in countries around the globe the United States, new disclosure rules related to the area of risk management have been proposed and in Europe, a number of CG disclosure changes made by the European Commission in recent years have been put to the test as they come into implementation in European Union member States. In emerging economies, trends continue in the area of strengthening of CG disclosure requirements as these countries further integrate into an increasingly competitive global economy.

Shareholders and other stakeholders remain concerned about disclosures and corporate governance controls in the area of executive compensation. Mounting evidence suggests that complex pay packages reward executives regardless of whether they perform well or poorly, draining shareholder value. Regulators are trying to address this by requiring greater transparency in executive compensation, while shareholders are seeking “say on pay,” or retrospective approval of pay packages

A. Emerging markets

1. Brazil

At the October 2007 Meeting of the Latin American Corporate Governance Roundtable, the OECD issued a report on the Code of Best Practice, first published by the Brazilian Institute of Corporate Governance in 1999, with subsequent editions released in 2001 and 2004. Market players were accustomed to dealing with hard law and regulations, so voluntary adoption of best practice was novel and adoption of the Code developed slowly over time, according to the report.⁹⁴ The 2000 launch of the Novo Mercado by the Bovespa stock exchange, with its focus on transparency, was one of many factors that drove uptake. A new edition of the Code is expected to be released in 2008.

2. China and Hong Kong (China)

Both China and Hong Kong (China), have adopted the “comply or explain” corporate governance model practiced in the United Kingdom, which calls for abiding by CG guidelines or describing the reasoning behind deviations. Hong Kong (China) has a longer history as a financial centre, allowing more time for its rules to develop than the China Securities Regulation Commission (CSRC) Code. The latest Hong Kong (China) Code, released in January 2005, requires publication of a corporate governance report containing “comply or explain” disclosures; failure to issue such a report constitutes a breach of the listing rules.⁹⁵ According to a RiskMetrics report comparing CG between China and Hong Kong (China), the CSRC regulations are not as developed, though the report does note “some improvements have been made following the release of the “Regulations on Information Disclosure of Listed Companies” by the CSRC in December 2006.”⁹⁶

The RiskMetrics report argues that enforcement of these rules faces challenges in both China and Hong Kong (China). The Asian Corporate Governance Association (ACGA) supports this view in its *CG Watch 2007* report saying, “Enforcement powers of both the main securities commission and the stock exchange [in Hong Kong (China)] are insufficient.” The report gives Hong Kong (China) an aggregate score of 67 on a 100-point scale, while China scores 45, against an average of 52 for all countries in the ACGA study.⁹⁷ According to the ACGA report, enforcement and disciplinary proceedings experience lengthy delays in both regions. In China, regulators lack resources for proper enforcement, according to *CG Watch 2007*. As in Japan, China lacks voting by poll, and the influence of the market investors is “extremely limited,” according to the ACGA report.⁹⁸

3. India

In his 2008 book *Billions of Entrepreneurs: How China and India Are Reshaping Their Future and Yours*, Harvard Business Professor Tarun Khanna opines that Indian companies demonstrate better corporate governance than Chinese companies. He characterizes the Indian marketplace as “noisy,” in part because Indian companies are accountable to shareholders *and* stakeholders.⁹⁹ India also has a

⁹⁴ Viegas L (2007). Country Report: Voluntary Corporate Governance Code in Brazil, OECD. 10 October. <http://www.oecd.org/dataoecd/4/47/39741021.pdf>

⁹⁵ Ibid.

⁹⁶ *Corporate Governance in Greater China: What to Expect When Investing in China vs. Hong Kong (China)*. RiskMetrics Group, April 2008. http://www.riskmetrics.com/pdf/Corporate_Governance_HK_China_Final.pdf. See also: *Regulations on Information Disclosure of Listed Companies*. China Securities Regulatory Commission, 30 January 2007. <http://211.154.210.238/en/jsp/detail.jsp?infoId=1183523778100&type=CMS.STD&path=ROOT%3EEN%3ELaws+and+Regulations%3ECommission+Regulations>.

⁹⁷ Gill A and Allen J (2007). *CG Watch 2007: Corporate governance in Asia*, CLSA Asia-Pacific Markets and Asian Corporate Governance Association, 17 September.

⁹⁸ Ibid.

⁹⁹ Holstein W (2008). Corporate governance in China and India. *BusinessWeek*, 6 March. http://www.businessweek.com/managing/content/mar2008/ca2008036_282896.htm.

“vibrant” business media in which “no opinion is forbidden to be expressed” and “information is noisy and unbiased,” according to Khana.¹⁰⁰

With an aggregate score of 83.6 per cent, India tops a January 2008 Florida International University study of corporate governance in eight Asian countries that aggregates findings of several World Bank studies.¹⁰¹ While India places in the “observed” category on almost all CG elements, including “Access to Information,” the country places in the lower category of “largely observed” for “Disclosure Standards”.¹⁰² In February 2008, the IFC Global Corporate Governance Forum announced a research project surveying 500 publicly traded companies in India to identify opportunities to improve corporate governance practice.¹⁰³

4. The Middle East and North Africa

In July 2008, the Hawkamah Institute for Corporate Governance and the International Finance Corporation (IFC) released a report on corporate governance in the Middle East and North Africa (MENA). The report, based on a survey of 1,044 banks and listed companies from 11 countries across the MENA region, found over three quarters of banks (76 per cent) and over two-thirds of listed companies (67 per cent) citing corporate governance as important (or very important) for their businesses. Despite the fact that many of the respondents value CG reform, many did not have the required understanding to implement the necessary changes, according to the report.¹⁰⁴

The dialogue on corporate governance in the region is moving from more general CG issues “to specific issues related to the composition and the role of the board in implementing transparency and disclosure,” according to H.E. Dr. Mahmoud Mohieldin, Minister of Investment for the Arab Republic of Egypt.¹⁰⁵ He made this comment at the Second Annual International Conference on Corporate Governance hosted by the Egyptian Institute of Directors (EIoD) in June 2008. The Minister stressed the importance of building capacity to implement CG best practice exemplified by institute’s training of about 1,000 executives.¹⁰⁶

5. Pakistan

In March 2002, the Securities and Exchange Commission of Pakistan (SECP) issued the Code of Corporate Governance. In June 2005, the World Bank released an assessment that found Pakistan making “significant strides in improving corporate governance over the last few years.” However, the report also identified a number of shortcomings, and recommended the SECP build its enforcement capacity to improve compliance with the code, particularly around disclosure and reporting.¹⁰⁷

In 2006, the IFC launched the Pakistan Corporate Governance Project. In late 2006 through early 2007, the project surveyed 111 Pakistani companies on their implementation of the code, as well as their attitudes toward it. The project also held two roundtables on CG in Pakistan in July 2007 that informed the resulting report conveying survey results. The survey found 98 per cent of surveyed companies complying with the code, but 89 per cent said they did so simply because it’s mandatory.¹⁰⁸

¹⁰⁰ Ibid.

¹⁰¹ McGee R (2008). *Corporate Governance in Asia: Eight Case Studies*. Working paper. January. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1081954.

¹⁰² Ibid.

¹⁰³ International Finance Corporation. (2008) IFC Global Corporate Governance Forum Partners with SEBI and NISM to Promote Awareness of Governance Reform in India. 22 February. <http://www.ifc.org/ifcext/media.nsf/content/SelectedPressRelease?OpenDocument&UNID=BDD7D32AC0397E9D852573F70057DDB7>.

¹⁰⁴ Hawkamah Institute for Corporate Governance and International Finance Corporation. (2008) “Hawkamah/IFC Report Highlights Growing Awareness of Corporate Governance. 14 July. http://www.hawkamah.org/news_and_views/archive/2008/41.html.

¹⁰⁵ Good corporate governance key to accessing finance. UNCTAD. <http://www.unctad.org/isar>.

¹⁰⁶ Ibid.

¹⁰⁷ *Report on the Observance of Standards and Codes (ROSC) Corporate Governance: Country Assessment – Pakistan*, June 2005. http://www.worldbank.org/ifa/ros_cg_pak.pdf.

¹⁰⁸ *A Survey of Corporate Governance Practices in Pakistan 2007*. International Finance Corporation, Securities and

6. Russian Federation

According to RiskMetrics analyst Aneta McCoy, standards of corporate governance in the Russian Federation have improved dramatically since the 2002 introduction of a voluntary CG code.¹⁰⁹ RiskMetrics, a corporate governance rating and proxy services firm, observes that listed companies in the Russian Federation disclose more information and are much more responsive to investor requests than they used to be. However, the RiskMetrics analyst notes a number of lingering challenges, including the lack of a sufficient number of independent directors on company boards.

In addition to the code driving improvements, so too does the quest for capital in the global marketplace, which places a premium on strong CG. For example, the European Bank for Reconstruction and Development (EBRD), a major lender to Russian Federation companies, attaches strong corporate governance conditions to its loans. “The more Russian Federation companies seek access to international capital markets, the more they realize that transparency and corporate governance are sine qua non conditions demanded by investors,” said EBRD spokesman Richard Wallis.¹¹⁰ Injecting further momentum into improvements is the October 2008 meeting of the Russian Corporate Governance Roundtable. Established by the OECD in June 1999, the roundtable last met in June 2005.¹¹¹

7. South Africa

King I (1994) and King II (2002), the codes on corporate governance in South Africa named after the chair of the drafting committee, Mervyn King, set useful examples for CG best practice globally. A third King Committee is currently drafting a third iteration of the codes, and King III, originally scheduled for release in late 2007, is now slated for issuance in January 2009.¹¹² From a disclosure perspective, the new code will break new ground by including a chapter on “Stakeholder Relationship Management,” since stakeholder relations hinges on disclosure and access to information.¹¹³

“Respondents were not very keen to adopt other corporate governance improvements that are not considered mandatory by the Code of Corporate Governance but are advocated by the OECD Principles of Corporate Governance.” Indeed, about half of surveyed companies responded that they did not have a corporate governance improvement plan (55 per cent), had not implemented a formal remuneration system for executives (53 per cent), had not established conflict of interest and related-party transactions administration procedures (54 per cent), and had not introduced independent non-executive directors to the board of directors or established general shareholder meeting procedures (50 per cent). While almost all respondents (92 per cent) considered CG practice important (or very important), 14 per cent “did not see any benefit in adopting such practices.”¹¹⁴

Exchange Commission of Pakistan, Pakistan Institute of Corporate Governance, Association of Certified Chartered Accountants Pakistan, 2007.

[http://www.ifc.org/ifcext/mena.nsf/AttachmentsByTitle/ASurveyofCGPracticesinPakistan2007/\\$FILE/A+SURVEY+OF+CORPORATE+GOVERNANCE+PRACTICES+IN+PAKISTAN.pdf](http://www.ifc.org/ifcext/mena.nsf/AttachmentsByTitle/ASurveyofCGPracticesinPakistan2007/$FILE/A+SURVEY+OF+CORPORATE+GOVERNANCE+PRACTICES+IN+PAKISTAN.pdf)

¹⁰⁹ Ethical Corporation, “Strategy and Management: Russia – Fitting ethics into economic expansion,” September 2008. http://www.ethicalcorp.com/content_print.asp?ContentID=6062.

¹¹⁰ Ibid.

¹¹¹ OECD, “The Russian Corporate Governance Roundtable.” http://www.oecd.org/document/11/0,3343,en_2649_34813_2351179_1_1_1_1_00.html.

¹¹² Naidoo S (2007) SA faces corporate governance crunch. *Business Times*. 17 June. <http://www.iodsa.co.za/downloads/sunday%20times.pdf>.

¹¹³ Steyn B (2008) King Report III on Corporate Governance institutionalises Stakeholder Relationship Management. *PR Conversations*. 24 August. <http://www.prconversations.com/?p=466>.

¹¹⁴ Ibid.

B. Developed markets

1. United States

In a July 2008 research report, Marc Siegel of RiskMetrics Group cited the example of Merck to illustrate anomalies in how companies report loss contingencies. Siegel pointed out that on page 39 of Merck's Third Quarter 2007 10-Q, filed on November 1, 2008, the company noted that it "cannot reasonably estimate the possible loss or range of loss with respect to the *Vioxx* Lawsuits," referring to litigation on its painkiller linked to heart attacks. "The Company has not established any reserves for any potential liability relating to the *Vioxx* Lawsuits or the *Vioxx* Investigations," it continued. A week later, the company announced a \$4.85 billion settlement of the lawsuits.¹¹⁵

"Well, you have to think they had some idea of how much this was going to cost them a week before they offered a \$4.85 billion settlement," said Sanford Lewis of the Investor Environmental Health Network, a coalition of shareholder activists focused on product toxicity.¹¹⁶ Lewis cited this example in discussing strengths and shortcomings of the June 2008 "FASB Exposure Draft on *Disclosure of Certain Loss Contingencies*" proposing new rules.¹¹⁷ According to Lewis, companies routinely claim they "cannot estimate" possible losses, so he applauds the proposed rule for requiring companies to "disclose the amount of claims that are against them, or what they view as the worst-case scenario."¹¹⁸

However, Lewis identified a number of shortcomings in the proposed rules and made recommendations on addressing them. FASB proposes requiring companies to disclose severe liabilities that may be remote and develop over time – but only if the issue would be resolved within a year. "[I]f investors are going to have a complete picture, there ought to be disclosure regardless of when the issue will resolve," Lewis opined, and recommended removing the one-year limit given that many complex liabilities, such as asbestos or tobacco, develop over a longer time horizon.¹¹⁹

FASB also proposed allowing companies to withhold information deemed "prejudicial" by its lawyers, in other words, if the information could be used against the company in a lawsuit. A misalignment of interests arises however, as investors are typically interested in the disclosure of potential risks that may lead to litigation liability for a company, while company lawyers are typically interested in keeping such risks confidential because disclosure itself may lead to lawsuits. "[I]f you're an investor in these companies you need a full picture painted of the risks the company is taking – and therefore it shouldn't be an option to conceal the information," Lewis said. He recommended removing the prejudicial exemption, or circumscribing it, clearly describing "the very limited circumstances" in which company lawyers can use it.¹²⁰

2. European Union

In May 2003, the European Commission unveiled its Action Plan to enhance corporate governance in the European Union (EU).¹²¹ In February 2008, the IFC Global Corporate Governance Forum released a study surveying the EU approach to corporate governance, including disclosure mandates. The IFC paper identifies the example of Article 41 of the 2007 Directive on Company Law, Accounting and Auditing Rules requires "public interest entities" (essentially listed companies, credit institutions and

¹¹⁵ Siegel M (2008) *Accounting for Contingencies -- When Are Financial Statement Users Entitled to Information?* RiskMetrics Group, 7 July. "Similar situations occurred at Northrop Grumman (NOC) and Xerox Corporation."

¹¹⁶ Baue B (2008) Sunshine is the Best Disinfectant: Shareholder Activists Promote Corporate Transparency. *SocialFunds.com*, 23 July. <http://www.socialfunds.com/news/article.cgi/2533.html> Disclosure: Bill Baue collaborated with Sanford Lewis in producing Corporate Watchdog Radio from 2005 through 2007, and co-wrote two reports with him in 2008.

¹¹⁷ FASB Issues Exposure Draft on *Disclosure of Certain Loss Contingencies*. Financial Accounting Standards Board, 5 June 2008. <http://www.fasb.org/news/nr060508.shtml>

¹¹⁸ *Op. cit.* 15.

¹¹⁹ *Op. cit.* 15.

¹²⁰ *Op. cit.* 15.

¹²¹ *Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*. European Commission, May 2003. http://ec.europa.eu/internal_market/company/modern/index_en.htm.

insurance companies) to have audit committees that include at least one member who is independent and competent in accounting and/or auditing by June 2008.¹²²

By September 2008, listed companies must have complied with the amended Fourth and Seventh Accounting Directives by publishing a discrete corporate governance statement, either in their annual report or separately. The 2006 amendments also require companies to describe the main features of their internal control and risk management systems in relation to financial reporting, provide information on the composition and operation of the board, and determine the procedures of shareholders' meetings and how shareholders' rights are to be exercised.¹²³

Also in Europe, the French bank Société Générale announced in January 2008, that a rogue trader had mounted 4.9 billion euros (or \$7.2 billion) in trading losses.¹²⁴ Société Générale addressed the situation promptly, disclosing it and selling the problem investments at a significant discount, accounting for its big losses. However, the bank raised questions among accounting and reporting experts in March 2008 when it claimed these January 2008 losses against the bank's 2007 earnings.¹²⁵ The company explained that it was invoking the "true and fair" provision of International Accounting Standards Board (IASB) rules allowing exceptions in certain circumstances, and its auditors approved the move. Some accounting experts, however, disagreed with this interpretation of the rules. "There is nothing true about reporting a loss in 2007 when it clearly occurred in 2008," said John Smith, a member of the IASB. "This raises a question as to just how creative they are in interpreting accounting rules in other areas."¹²⁶

3. Australia

Australian companies improved their corporate governance disclosure in their 2007 annual reports, according to a June 2008 Australian Securities Exchange (ASX) analysis. The report surveyed compliance with ASX's 10 "Principles of Good Corporate Governance" encompassing 28 "Best Practice Recommendations," first released in March 2003 (and revised in August 2007 for implementation in 2008.) For example, Principle 10 calls for recognizing the legitimate interests of stakeholders, and the associated recommendation asks companies to "establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate stakeholders."¹²⁷

The analysis, the fourth annual assessment, found "slightly higher" levels of adoption of the recommendations in 2007 than in previous years, and "significantly higher" than the first year of review. For all entities reviewed (listed companies and listed trusts), the number of recommendations with overall reporting levels over 80 per cent increased from 23 of 28 recommendations in 2006 to 26 of 28 in 2007. ASX attributed the continuing improvement in CG disclosure to better understanding of and more familiarity with the Principles and Recommendations, as well as ASX's monitoring of compliance.¹²⁸

4. Japan

In May 2008, the Asian Corporate Governance Association (ACGA) produced a report which identified a number of idiosyncrasies in Japan's corporate governance regime that impede companies from achieving internationally recognized best practice.

¹²² *The EU Approach to Corporate Governance: Essentials and Recent Developments*, International Finance Corporation Global Corporate Governance Forum, February 2008.

[http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/EU+Approach+to+CG/\\$FILE/IFC_EUApproach_Final.pdf](http://www.gcgf.org/ifcext/cgf.nsf/AttachmentsByTitle/EU+Approach+to+CG/$FILE/IFC_EUApproach_Final.pdf).

¹²³ Ibid.

¹²⁴ Bloomberg, "Societe Generale Reports EU 4.9 Billion Trading Loss," 24 January 2008.

<http://www.bloomberg.com/apps/news?pid=20601087&sid=a.qZ3gOMOXhE&refer=home>

¹²⁵ See note 40 on page 247 of the Société Générale 2007 annual report. New York Times, "Loophole Lets Bank Rewrite the Calendar," 7 March 2008. <http://www.nytimes.com/2008/03/07/business/07norris.html>.

¹²⁶ Ibid.

¹²⁷ *Australian Securities Exchange, Analysis of Corporate Governance Disclosures in 2007 Annual Reports*, 18 June 2008.

http://www.asx.com.au/about/pdf/analysis_of_cg_in_2007_annual_reports.pdf

¹²⁸ Ibid.

“While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large,” according to the ACGA report. “Improved corporate governance is not a panacea for the problems of Japan’s stock markets or economy, but it will be an essential element in the rebuilding of confidence. It is in Japan’s national interest, therefore, to converge towards global best practice in corporate governance – and this trend will become more important as the government seeks to turn Tokyo into a leading international financial centre.”¹²⁹

One such idiosyncrasy is the clustering of annual general meetings (AGMs) in June, an issue addressed in UNCTAD’s 2007 review. The majority of AGMs happen in the third week of June, impeding shareholder attendance. Exacerbating this problem is the short notice in issuing proxy ballots (a mere two weeks before AGMs) creating a rush in proxy voting.¹³⁰

RiskMetrics Group’s Director of International Research in Japan, Marc Goldstein, noted that the 2008 Japanese proxy season pitted shareholder activists against companies for the second straight year, with companies using “every weapon in their arsenal” to fight back, according to Goldstein.¹³¹ “Perhaps the most notable weapon in managements’ arsenals is the all-out effort to attract management-friendly shareholders from among the ranks of companies’ lenders and business partners,” Goldstein said, referring to the practice of cross-shareholding, or reciprocal stock ownership between companies. “Cross-shareholding rates rose in 2007/08, the second consecutive increase after 15 straight years of decline, and news reports indicate that the increase is continuing in 2008-09.”¹³²

Goldstein contended that cross-shareholding resulted in a “drop in latent profits amount[ing] to several hundred billion yen,” citing data from the Nikkei newspaper indicating that “the unrealized gains on shares held by Japan’s listed companies plunged 47 per cent in the 2007/08 fiscal year.”¹³³ Nevertheless, companies continue the practice which, critics charge, results in reinforcing management power while weakening the relative power of shareholders. Criticism of corporate governance practices at Japanese companies extends to a number of other issues. According to the ACGA report, Japanese companies typically do not conduct proxy voting by poll, nor do they publish “clear and detailed vote results that state the total number of votes for and against each resolution, and any abstentions.”¹³⁴ “We believe that voting by poll and the immediate publication of results would significantly enhance the quality and transparency of shareholder meetings in Japan and the reputation of companies for good governance,” says the ACGA report. “Given the considerable increase in foreign ownership of Japanese shares in recent years, and the subsequent rise of cross-border voting, we believe that the common practice of not fully voting by poll and not disclosing AGM results is disrespectful to these shareholders. It is also disrespectful to domestic investors who take the trouble to vote their shares.”¹³⁵

C. Subprime mortgage market crisis

In July 2008, the United States Securities and Exchange Commission released an examination of shortcomings in disclosure to investors by credit rating agencies in their ratings of financial institutions involved in the subprime mortgage market meltdown that triggered the global credit crisis. The report found a lack of documentation of committee actions and decisions. For example, one rating agency rarely documented the vote tallies of rating committee votes despite being a required item in the rating committee memorandum or addendum. The report also reprints e-mail

¹²⁹ Allen J, Connors M, Krutikov A (2008). *White Paper on Corporate Governance in Japan*, Asian Corporate Governance Association, May.

http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf.

¹³⁰ Ibid.

¹³¹ Goldstein M (2008). Global Roundup. *Risk and Governance Weekly*. RiskMetrics Group, 10 July.

http://www.issproxy.com/governance_weekly/2008/148.html.

¹³² Ibid.

¹³³ Ibid.

¹³⁴ *Op. cit.* 27.

¹³⁵ *Op. cit.* 27.

exchanges between rating company analysts expressing concern over shortcomings in the rating of subprime deals.¹³⁶

“One analyst expressed concern that her firm’s model did not capture ‘half’ of [a particular] deal’s risk, but that ‘it could be structured by cows and we would rate it,’” the SEC report stated.¹³⁷ While disclosure of such opinions would give investors a much more accurate understanding of the real risks of AAA-rated investments that subsequently went bankrupt, it took a probe to reveal this information.

An April 2008 white paper by the Subprime Working Group at the United States-based law firm Gibson, Dunn and Crutcher notes that investors are also filing lawsuits holding companies accountable for withholding information on subprime investments. The paper identified a number of “theories of liability” for disclosure shortcomings that lawsuits were already advancing in court, including false financial statements, misleading disclosures regarding loan practices, undisclosed risk of subprime market collapse, and undisclosed sell-off of subprime securities. “Although these theories will be hotly contested by defendants in these cases, they are representative of the sweeping nature of the civil litigation claims being advanced,” stated the Gibson, Dunn and Crutcher lawyers, who represented some of these defendants.¹³⁸

Yale Center for Corporate Governance Programme Director Stephen Davis and Investor Responsibility Research Center Institute Director Jon Lukomnik point out that investors are also filing shareholder resolutions asking companies to disclose further information on their accountability for the subprime debacle. For example, some ask credit rating agencies such as Moody’s and Standard and Poor’s to address perceived conflicts of interest. “These are steps in the right direction, but we have long maintained that the single biggest conflict in the credit markets today is that ratings are paid for by the issuers of debt, rather than the users of the ratings,” stated Davis and Lukomnik.¹³⁹

The second fix Davis and Lukomnik suggest is for executive compensation based on illusory financial gains to be returned. To support the idea, they quote renowned economist Paul Krugman: “Executives are lavishly rewarded if the companies they run seem successful... But if the excess turns out to have been an illusion – well, they still get to keep the money... Not only is this grossly unfair, it encourages bad risk-taking, and sometimes fraud.”¹⁴⁰ So when companies restate earnings, executive pay must likewise be recalculated based on the true earnings.

RiskMetrics Group evaluated the governance structures of 11 financial institutions, including six that became targets for potential vote-no campaigns by pension funds. The report surveyed investors, a substantial majority of whom said that improved disclosure would have been effective in helping investors evaluate risk exposure. Among the range of corporate governance factors related to the subprime meltdown, surveyed investors were most concerned about lack of transparency (38 per

¹³⁶ Staff of the Office of Compliance Inspections and Examinations, Division of Trading and Markets and Office of Economic Analysis, United States Securities and Exchange Commission, *The Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies*, July 2008.
<http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

¹³⁷ Ibid. E-mail No. 1: Analytical Staff to Analytical Staff (Apr. 5, 2007, 3:56 PM). In another e-mail, an analytical manager in the same rating agency’s CDO group wrote to a senior analytical manager that the rating agencies continue to create an “even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.” E-mail No. 2: Analytical Manager to Senior Analytical Manager (Dec. 15, 2006, 8:31 PM)."

¹³⁸ *Subprime-Related Securities Litigation: Where Do We Go From Here?* Subprime Working Group, Gibson, Dunn and Crutcher, 1 April 2008 <http://www.gibsondunn.com/Publications/Pages/Subprime-RelatedSecuritiesLitigation.aspx>.

¹³⁹ Davis S and Lukomnik J (2007). How the Sub-prime Mess Hits Governance. *Compliance Week*. 11 December. Davis and Lukomnik also co-authored *The New Capitalists: How Citizen Investors Are Reshaping The Corporate Agenda*, Harvard Business School Press, 2006.
http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3815.

¹⁴⁰ Krugman P. Banks Gone Wild. *New York Times*. November 23, 2007.
<http://www.nytimes.com/2007/11/23/opinion/23krugman.html?hp>.

cent), followed by poor pay practices encouraging short-term performance (29 per cent).¹⁴¹

D. Executive compensation and environmental risks

1. Executive compensation

In July 2006, the United States Securities and Exchange Commission (SEC) adopted new rules on executive compensation disclosure, introducing a new “Compensation Discussion and Analysis” (CD&A) requirement to “put into perspective for investors the numbers and narrative that follow it.”¹⁴² A year and a quarter later, the commission issued a report assessing 350 first-year CD&As.¹⁴³ “We saw a great deal of detail this year, but what was missing was a discussion of how and why those philosophies and processes resulted in the numbers the company presented in its tabular disclosure,” said SEC Division of Corporate Finance Director John White in a speech on the day of the report’s release. “Far too often, meaningful analysis is missing – this is the biggest shortcoming of the first-year disclosures. Stated simply – Where’s the analysis?”¹⁴⁴

The SEC report also urged companies to use plain English in explaining executive compensation arrangements – a specific requirement of the new rules that wasn’t followed very well, according to the report. In a letter to SEC Chair Christopher Cox two weeks earlier, Council of Institutional Investors Executive Director Ann Yerger pointed out that CD&A statements ran over 6,000 words and “readability metrics” studies found them extraordinarily difficult to read, according to a 2007 Mercer Human Resource Consulting study. “Lengthy CD&As filled with jargon and legalese obfuscate the key analysis of executive compensation philosophies and practices that allow investors to make informed decisions,” Yerger said.¹⁴⁵

Shareholders are taking this a step further by seeking not only disclosure, but also approval of executive compensation packages. As of August 2008, a majority of voting shareholders supported the measure at 10 United States-based companies, up from 8 in 2007, according to RiskMetrics, which covers proxy voting at over 38,000 companies worldwide.¹⁴⁶ As well, 9 companies had committed to implement say on pay.¹⁴⁷ In its own proxy, RiskMetrics management goes even further with three pay-related proposals, asking shareholders whether they approve its compensation philosophy, how it was applied in 2007 and how the company plans to apply it in 2008.¹⁴⁸ This gives a glimpse of the diversity of solutions being proposed.

2. Environmental disclosure

The case for more robust disclosure of environmental risks dates back more than a decade. For example, a 1998 United States Environmental Protection Agency

¹⁴¹ “RiskMetrics Group Studies Find an Increase in Shareholder Activism and Litigation as a Result of the Credit Crisis: Weak Risk Management Practices Seen as Key Cause of the Mortgage Meltdown and Subsequent Rise in Subprime-Related Lawsuits,” RiskMetrics Group, 9 April 2008. http://www.issproxy.com/pdf/CgandCreditCrisis20080409_PR.pdf.

¹⁴² “SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters,” United States Securities and Exchange Commission, 26 July 2006. <http://www.sec.gov/news/press/2006/2006-123.htm>.

¹⁴³ *Staff Observations in the Review of Executive Compensation Disclosure*, United States Securities and Exchange Commission Division of Corporation Finance, 9 October 2007. <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>.

¹⁴⁴ White J (2007). “Where’s the Analysis?” U.S. Securities and Exchange Commission, Tackling Your 2008 Compensation Disclosures: The 2nd Annual Proxy Disclosure Conference, San Francisco, California, 9 October 2007. <http://www.sec.gov/news/speech/2007/spch100907jww.htm>.

¹⁴⁵ Yerger A (2007). Council of Institutional Investors, Letter to United States Securities and Exchange Chair Christopher Cox RE: *Compensation disclosure compliance review process; Shareowner perspective on improving the Compensation Discussion and Analysis (CD&A)*, 27 September 2007.

¹⁴⁶ Walton L (2008). ‘Say on Pay’ Gets Ninth Majority. *Risk and Governance Weekly*, RiskMetrics Group, 20 June. http://www.issproxy.com/governance_weekly/2008/128.html, and L. Reed Walton, *Risk and Governance Weekly* “Tenth Majority for ‘Say on Pay,’” August 2008. http://www.issproxy.com/governance_weekly/2008/165.html.

¹⁴⁷ Ibid.

¹⁴⁸ Tomoeh Murakami Tse, ‘Say-on-Pay’ Movement Loses Steam. *Washington Post*, 6 May 2008. <http://www.washingtonpost.com/wp-dyn/content/article/2008/05/05/AR2008050502470.html>.

study documented significant under-disclosure of corporate environmental liabilities. Specifically, 74 per cent of companies failed to comply with SEC regulations governing the disclosure of environment-related legal proceedings that could result in sanctions exceeding \$100,000.¹⁴⁹ In August 2002, the Rose Foundation for Communities and the Environment filed a petition with the SEC proposing a new rule to govern corporate disclosure of environmental liabilities.¹⁵⁰

A coalition of state treasurers, investors and NGOs coordinated by Ceres and the Environmental Defense Fund, submitted a petition asking the SEC to require companies to disclose their climate-related risks in securities filings. The coalition simultaneously sent a letter asking the SEC Division of Corporation Finance to enforce existing law applying to climate disclosures.¹⁵¹

“Recent scientific, legal and regulatory developments make it unavoidably clear that the risks and opportunities many corporations face in connection with climate change fall squarely within the category of material information that is required to be analyzed and disclosed in many corporate filings,” say the petitioners. “Yet corporate disclosures of the risks and opportunities created by climate change lag behind these developments, and investors are left with little or in some cases no useful information about corporate exposure to these risks.”¹⁵²

States and voluntary initiatives are taking a leading role on this issue. In April 2008, the California Public Employees Retirement System (CalPERS) added environmental disclosure to its guidelines for proxy voting and corporate engagement, the *Global Principles of Accountable Corporate Governance*.¹⁵³ The new disclosure guidelines are based in part on the *Global Framework for Climate Risk Disclosure*, which CalPERS helped develop and release in October 2006 as part of the Climate Risk Disclosure Initiative, a collaboration with other investors and organizations around the world.¹⁵⁴

CalPERS also endorsed the California Senate Bill 1550 that would require the California Controller, in consultation with the investment community, to develop a climate change disclosure standard for use by listed companies doing business in California. In May 2008, the California Senate passed the bill, and it went to the California Assembly for consideration.¹⁵⁵

The Carbon Disclosure Project has also stepped into the fray to request voluntary climate risk transparency from companies around the world. The project has grown from 35 institutional investors managing \$4.5 trillion asking the world’s 500 biggest companies for information on their greenhouse gas emissions in 2003 to 385 investors managing \$57 trillion asking 3,000 companies about their carbon emissions in 2008.¹⁵⁶

Alongside the growing recognition of climate risk, investors and others are acknowledging the risks of toxic chemicals in products and manufacturing processes. In

¹⁴⁹ Baue W. “SEC Urged to Strengthen Rules Governing Corporate Disclosure of Environmental Risks,” *SocialFunds.com*, August 21, 2002. <http://www.socialfunds.com/news/article.cgi/article911.html> EPA report entitled *Guidance on Distributing the Notice of SEC Registrants’ Duty to Disclose Environmental Legal Proceedings in EPA Enforcement Actions*.

¹⁵⁰ Ibid.

¹⁵¹ Rheannon F (2007). “Investors, States, and Activists Petition Securities and Exchange Commission To Mandate Climate Risk Disclosure.” *SocialFunds.com*, 8 October 2007. <http://www.socialfunds.com/news/article.cgi/2388.html>.

¹⁵² *Petition for Interpretive Guidance on Climate Risk Disclosure*. Ceres, Environmental Defense Fund, et al, 18 September 2007. <http://www.incr.com/NETCOMMUNITY/Document.Doc?id=187>.

¹⁵³ “CalPERS Expands Environmental, Diversity Corporate Governance Guidelines - Supports State Legislation on Climate Change. California Public Employees Retirement System, 21 April 2008. <http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2008/apr/environmental-diversity-guidelines.xml>.

¹⁵⁴ *Global Framework for Climate Risk Disclosure*, Climate Risk Disclosure Initiative, October 2006. <http://www.calpers-governance.org/alert/initiatives/global-framework.asp>.

¹⁵⁵ “Investors Praise California Senate Leaders for Passing Historic Climate Disclosure Bill,” Ceres, 22 May 2008. <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=905&srcid=705>.

¹⁵⁶ *CDP Chronology*, Carbon Disclosure Project, <http://www.cdproject.net/cdpchronology.asp> (accessed 15 August 2008).

April 2008, the Investor Environmental Health Network released a report entitled *Toxic Stock Syndrome*, examining how companies fail to report toxicity risks in the securities filings.¹⁵⁷ The report spotlighted how toy companies neglected to inform investors of the dangers of lead paint in toys, despite ample evidence of a growing trend in product recalls since the early 2000s. Also discussed are the impacts of European toxics regulations on United States-based companies that go largely undisclosed in their securities filings.

E. Section conclusion

Disclosure plays a pivotal role as corporate governance gains relevance, functioning as the window into company operations. Global trends lead toward greater disclosure of corporate governance practices, responding to market disruptions such as the subprime market collapse and resulting credit crisis on the one hand, and attracting investors by enhancing access to information on the other hand. In a globalizing economy, country markets competing for increasingly mobile pools of capital can benefit from strong assurances of good practices in corporate governance disclosure.

III. Status of implementation of good practices in corporate governance disclosure

A. Background and methodology

1. ISAR benchmark

The purpose of this study is to evaluate the level of implementation of good practices in corporate governance disclosure highlighted in the 2006 UNCTAD publication *Guidance on Good Practices in Corporate Governance Disclosure* (based on the ISAR document TD/B/COM.2/ISAR/30). This 2006 UNCTAD guidance forms a benchmark (hereafter the “ISAR benchmark”) of 53 disclosure items on corporate governance. This benchmark was used in earlier ISAR studies on this subject in 2005, 2006 and 2007, as well as in country case studies of Egypt and China (both in 2007). The complete set of 53 disclosure items are grouped into five broad categories, or subject areas, of corporate governance disclosure, and are presented and analysed by category in section B below. These categories are:

- (a) Financial transparency;
- (b) Board and management structure and process;
- (c) Ownership structure and exercise of control rights;
- (d) Corporate responsibility and compliance; and
- (e) Auditing.

2. Sample studied

The present study uses the ISAR benchmark to measure the disclosure practices of 100 leading enterprises from 10 emerging markets. The sample used in this study is comprised of 10 of the top enterprises¹⁵⁸ from each of the top 10 most heavily weighted United Nations member States found in the Emerging Markets Index produced by

¹⁵⁷ Sanford Lewis et al., *Toxic Stock Syndrome: How Corporate Financial Reports Fail to Apprise Investors of the Risks of Product Recalls and Toxic Liabilities*, April 2008. <http://iehn.org/publications.reports.toxicstock.php>. Disclosure: Bill Baue contributed two case studies to this report.

¹⁵⁸ Note that in some countries, some of the top 10 enterprises by index weighting, were related enterprises. This study sought to avoid reviewing the reporting practices of different entities within the same industrial conglomerate, and for this reason the “selected top 10” described in this paper may not correspond exactly with the top 10 by index weighting for each country; in some cases the selected top 10 enterprises consists of 10 enterprises selected from among the top 15 largest enterprises by index weighting.

Morgan Stanley Capital International (hereafter the “MSCI EM Index”).¹⁵⁹ The current MSCI EM Index tracks more than 900 publicly listed enterprises, which account for roughly 85 per cent of the market capitalization of 25 emerging markets.¹⁶⁰ Table 1 below provides a list of the economies included in the MSCI EM Index.

Table 1. The 25 economies included in the MSCI EM Index

| | |
|------------------------------|------------------------|
| 1. Argentina | 14. Republic of Korea |
| 2. Brazil | 15. Malaysia |
| 3. Chile | 16. Mexico |
| 4. China | 17. Morocco |
| 5. Taiwan, Province of China | 18. Pakistan |
| 6. Colombia | 19. Peru |
| 7. Czech Republic | 20. Philippines |
| 8. Egypt | 21. Poland |
| 9. Hungary | 22. Russian Federation |
| 10. India | 23. South Africa |
| 11. Indonesia | 24. Thailand |
| 12. Israel | 25. Turkey |
| 13. Jordan | |

The top 10 United Nations member States, by index weighting, within the MSCI EM Index are listed in table 2 below, along with their total index weighting. In addition, table 2 shows the weighting of the top 10 enterprises selected for this study. The top 10 enterprises from each country account for between 45 per cent and 84 per cent of their respective country’s index weighting. These enterprises were selected due to their economic significance within their home countries, and as samples of leading companies in each country. As a group, the 100 enterprises from emerging markets represent 46.5 per cent of the market capitalization of the entire MSCI EM Index. Thus, as a group, this sample represents a large portion of the investable universe of emerging market enterprises. Additionally, as indicated in figure 1 below, the selected enterprises represent a diversified range of industrial sectors.

Table 2. Top 10 United Nations member States included in the MSCI EM Index, by index weighting¹⁶¹

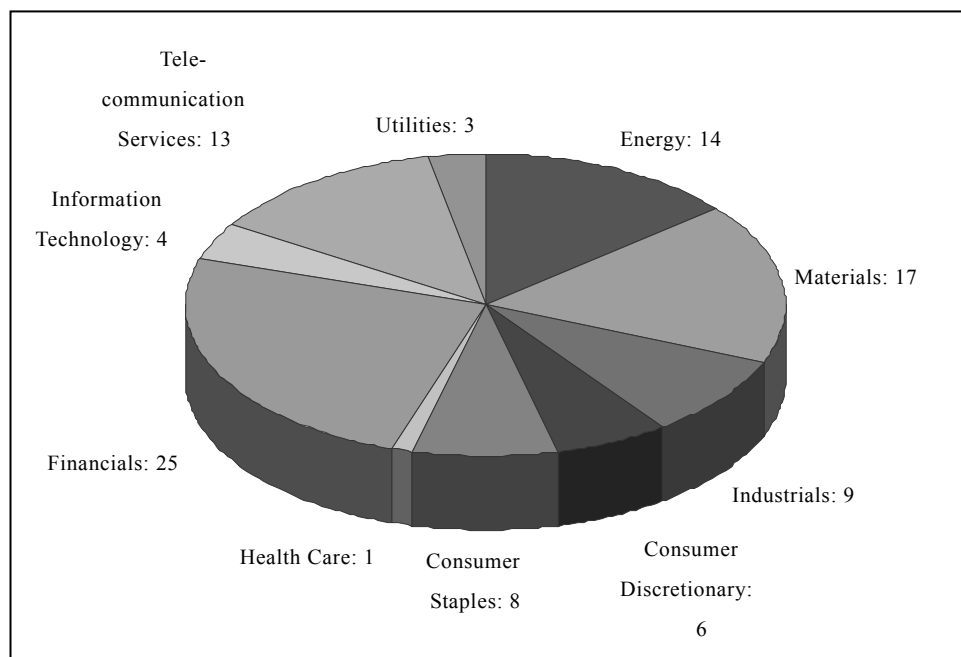
| Country | Index weighting of country (per cent) | Number of companies from this country in the index | Selected top 10 companies as per cent of country weighting | Selected top 10 companies as per cent of index total market capitalization |
|--------------------|---------------------------------------|--|--|--|
| Brazil | 14.9 | 72 | 50 | 7.5 |
| China | 14.2 | 112 | 56 | 8.0 |
| Republic of Korea | 13.2 | 114 | 45 | 6.0 |
| Russian Federation | 10.0 | 32 | 82 | 8.2 |
| India | 7.2 | 67 | 52 | 3.7 |
| South Africa | 6.7 | 50 | 63 | 4.2 |
| Mexico | 4.8 | 28 | 84 | 4.0 |
| Israel | 2.4 | 32 | 84 | 2.0 |
| Malaysia | 2.4 | 57 | 59 | 1.4 |
| Indonesia | 1.7 | 22 | 83 | 1.4 |
| Total | 77.4 | | | 46.5 |

¹⁵⁹ MSCI is a commercial provider of financial information, including equity indices tracking publicly listed enterprises around the world. The MSCI EM Index is considered by institutional investors to be the industry standard to gauge emerging markets performance, and is an important tool for facilitating foreign portfolio investment to developing countries and countries with economies in transition.

¹⁶⁰ All MSCI EM Index data used in this study is based on the index as of 12 March 2008.

¹⁶¹ This study focuses on the disclosure practices of United Nations member States; if all markets had been included then Taiwan Province of China, which makes up 11.3 per cent of the MSCI EM Index, would have been part of this top ten sample.

Figure 1. Sample of 100 emerging market enterprises by sector¹⁶²
(number of companies)



The 100 emerging market enterprises described above form the core sample and primary focus of this study. To provide some context and comparison to developed market practices, a secondary sample was created of 10 leading enterprises, each from two of the largest financial markets in the world: the United Kingdom and the United States. These secondary samples were created by taking the top 10 enterprises by index weighting from the Standard and Poor's 500 index (for the United States) and the FTSE 100 (for the United Kingdom). A complete list of enterprises included in the study is found in annex I.

In total, the review considered 6,360 individual data points. This is comprised of the 53 disclosures in the ISAR benchmark multiplied by the 120 enterprises that make up both the primary and secondary samples.

3. Research questions

The primary research question applied to the sample enterprises was: How many of the items comprising the ISAR benchmark of corporate governance disclosures are reported by each of the enterprises? To answer this question, the study examined a range of publicly available corporate reports including: annual reports, corporate governance reports, corporate responsibility reports, exchange filings, and other information available from financial databases and company websites.¹⁶³ These reports were then compared with the 53 items in the ISAR benchmark to gauge what, within the benchmark, these enterprises were disclosing. The main findings of this research question are presented in section B below. An analysis of these reporting practices by market is also presented in section C below.

An additional research question applied to the sample enterprises was: How do the actual reporting practices of the selected enterprises compare with the reporting

¹⁶² Based on Global Industry Classification Standard (GICS) as of 29 August 2008. Source: www.msccbarra.com.

¹⁶³ Wherever possible, the enterprises in the study were contacted to allow them to review the preliminary findings of their reporting; a number of replies were received and their comments and suggestions were incorporated into this study. In total, 93 of the 100 enterprises were contacted, and 19 of these replied. The replies ranged from brief to detailed, involving both written and telephone communication. This engagement with the enterprises provided additional information and in some cases highlighted one or more disclosure items that had not previously been identified. Seven of the 100 enterprises were not contacted due to a lack of contact information, faulty contact information, or unanswered telephone calls. As the study consists of a review of publicly available information, it is not necessary to speak with each company to carry out the study; however, the effort was made in order to engage enterprises in a dialogue on this subject, and to obtain additional insights where available.

requirements of their home countries? To answer this question, the main findings of the review of disclosures were compared with the inventory of disclosure requirements that was the subject of UNCTAD 2007 review of corporate governance disclosure (TD/B/COM.2/ISAR/CRP.6). The main findings of this research question are presented in section D below, as well as in annex II.

B. Disclosure practices of 100 emerging market enterprises

Table 3 below displays the results of the study, giving the number of enterprises disclosing each item from the sample of 100 emerging market enterprises. The information is presented within each of the five broad categories discussed in section A above. This grouping of the disclosure items allows readers to draw their own conclusions based on the importance they assign to a particular category or subject area and, within that category, a particular disclosure item. It also facilitates the analysis that follows on the relative level of disclosure within each category. The categories are presented in order of highest to lowest average rate of disclosure, and within each category, the disclosure items are presented in order from most often disclosed to least often disclosed. It is again noted that the findings below make no indication of the quality of disclosure found among the enterprises, only whether or not some disclosure exists for each of the disclosure items listed below.

Table 3. Information disclosed by 100 emerging market enterprises
(Number of enterprises disclosing this item)

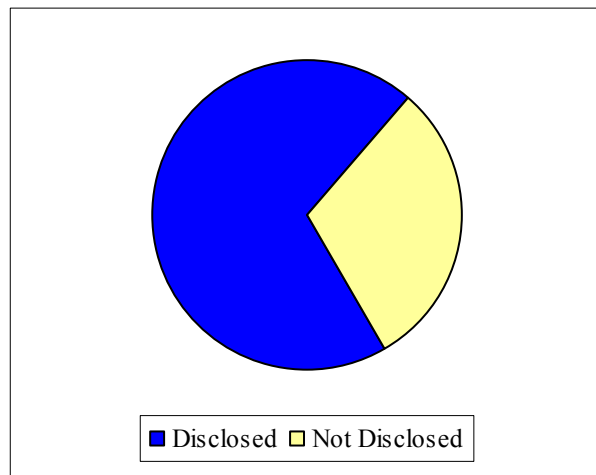
| Disclosure items by category | No. of enterprises (max = 100) |
|--|---------------------------------------|
| Financial transparency | |
| Financial and operating results | 100 |
| Company objectives | 100 |
| Nature, type and elements of related-party transactions | 94 |
| Critical accounting estimates | 88 |
| Board's responsibilities regarding financial communications | 85 |
| Disclosure practices on related party transactions where control exists | 78 |
| Impact of alternative accounting decisions | 76 |
| Rules and procedure governing extraordinary transactions | 59 |
| The decision making process for approving transactions with related parties | 53 |
| Board and management structure and process | |
| Composition of board of directors (executives and non-executives) | 99 |
| Governance structures, such as committees and other mechanisms to prevent conflict of interest | 96 |
| Role and functions of the board of directors | 93 |
| Composition and function of governance committee structures | 92 |
| Risk management objectives, system and activities | 88 |
| Duration of directors' contracts | 87 |
| Qualifications and biographical information on board members | 86 |
| Number of outside board and management position directorships held by the directors | 85 |
| Types and duties of outside board and management positions | 84 |
| Independence of the board of directors | 82 |
| "Checks and balances" mechanisms | 78 |
| Determination and composition of directors' remuneration | 76 |
| Material interests of members of the board and management | 69 |
| Performance evaluation process | 66 |
| Availability and use of advisorship facility during reporting period | 59 |
| Existence of procedure(s) for addressing conflicts of interest among board members | 54 |
| Existence of plan of succession | 51 |

| Disclosure items by category | No. of enterprises (max = 100) |
|---|-----------------------------------|
| Professional development and training activities | 43 |
| Compensation policy for senior executives departing the firm as a result of a merger or acquisition | 3 |
| Ownership structure and exercise of control rights | |
| Ownership structure | 87 |
| Availability and accessibility of meeting agenda | 84 |
| Control structure | 78 |
| Control and corresponding equity stake | 74 |
| Process for holding annual general meetings | 68 |
| Changes in shareholdings | 68 |
| Rules and procedures governing the acquisition of corporate control in capital markets. | 67 |
| Control rights | 63 |
| Anti-takeover measures | 10 |
| Corporate responsibility and compliance | |
| Policy and performance in connection with environmental and social responsibility | 86 |
| Mechanisms protecting the rights of other stakeholders in business | 81 |
| A code of ethics for all company employees | 74 |
| Impact of environmental and social responsibility policies on the firm's sustainability | 63 |
| The role of employees in corporate governance | 61 |
| A code of ethics for the board and waivers to the ethics code | 49 |
| Policy on "whistle blower" protection for all employees | 45 |
| Auditing | |
| Internal control systems | 86 |
| Process for interaction with internal auditors | 76 |
| Process for appointment of external auditors | 76 |
| Process for interaction with external auditors | 73 |
| Board confidence in independence and integrity of external auditors | 57 |
| Auditors' involvement in non-audit work and the fees paid to the auditors | 55 |
| Duration of current auditors | 45 |
| Process for appointment of internal auditors / Scope of work and responsibilities | 40 |
| Rotation of audit partners | 10 |

General Overview

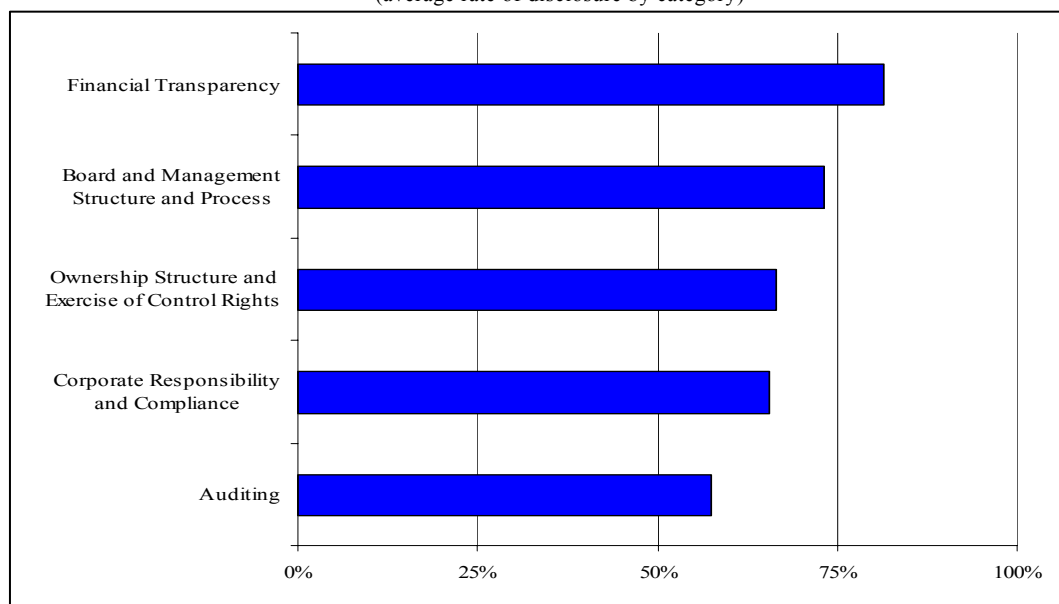
In total, table 3 above summarizes 5,300 individual data points (53 disclosure items multiplied by 100 emerging market enterprises). As depicted in figure 2 below, 70 per cent of the of individual disclosure items in the ISAR benchmark were reported by the sample group of 100 emerging market enterprises (i.e. 3,700 out of 5,300 possible disclosures). This suggests that, generally, the enterprises studied are providing a substantial amount of information regarding their corporate governance practices.

Figure 2. Disclosure of ISAR benchmark items for 100 emerging market enterprises
(total number of disclosure items = 5 300)



Examining disclosure practices by subject category, the main findings of the 2008 Review are largely consistent with earlier reviews conducted in 2006 and 2005. As shown in figure 3 below, the category of financial transparency is subject to the highest level of disclosure while the category of auditing is subject to the lowest.

Figure 3. Overview of disclosure practices by category
(average rate of disclosure by category)



The average disclosure rate for the 100 emerging market enterprises fell below 50 per cent for 8 of the 53 disclosure items, which can be seen in table 4 below. While these eight items were not concentrated in any one category (one item was in the category financial transparency, three were in auditing, two in corporate responsibility and compliance, and two in board and management structure and process) six of these eight were also among the 10 least prevalent disclosure items reported by low- and middle-income countries in the 2006 Review (see table 4, note (b)). And four of the eight were among the least required disclosure items for MSCI EM Index markets (see table 4, note (d)). The disclosure item with the lowest rate of disclosure in the entire study was “compensation policy for senior executives departing the firm as a result of merger and acquisition”. This item was disclosed by only three of the 100 emerging market enterprises studied.

Table 4. Most prevalent and least prevalent disclosure items

(number of enterprises disclosing this item)

| Top 10 most prevalent disclosure items reported by 100 emerging market enterprises | No. of enterprises reporting | Bottom 10 least prevalent disclosure items reported by 100 emerging market enterprises | No. of enterprises reporting |
|---|-------------------------------------|--|-------------------------------------|
| Financial and operating results ^{(a) (c)} | 100 | The decision-making process for approving transactions with related parties | 53 |
| Company objectives ^(a) | 100 | Existence of plan of succession | 51 |
| Composition of board of directors (executives and non-executives) ^{(a) (c)} | 99 | A code of ethics for the board and waivers to the ethics code ^(d) | 49 |
| Governance structures, such as committees and other mechanisms to prevent conflict of interest ^(c) | 96 | Duration of current auditors ^{(b) (d)} | 45 |
| Nature, type and elements of related-party transactions ^(a) | 94 | Policy on “whistle blower” protection for all employees ^{(b) (d)} | 45 |
| Role and functions of the board of directors ^(c) | 93 | Professional development and training activities ^(b) | 43 |
| Composition and function of governance committee structures | 92 | Process for appointment of internal auditors and scope of work and responsibilities | 40 |
| Critical accounting estimates | 88 | Anti-takeover measures ^(b) | 10 |
| Risk management objectives, system and activities ^(a) | 88 | Rotation of audit partners ^(b) | 10 |
| Ownership structure ^{(a) (c)} | 87 | Compensation policy for senior executives departing the firm as a result of a merger or acquisition ^{(b) (d)} | 3 |

^(a) Disclosure item also appears among the top 10 most prevalent disclosure items reported by enterprises from low- and middle-income countries in the 2006 Review.

^(b) Disclosure item also appears among the bottom 10 least prevalent disclosure items reported by enterprises from low- and middle-income countries in the 2006 Review.

^(c) Disclosure item also appears among the top 10 most prevalent disclosure items required among the 25 markets comprising the MSCI EM Index, as indicated in the 2007 Review.

^(d) Disclosure item also appears among the bottom 10 least prevalent disclosure items reported by enterprises from low- and middle-income countries in the 2006 Review.

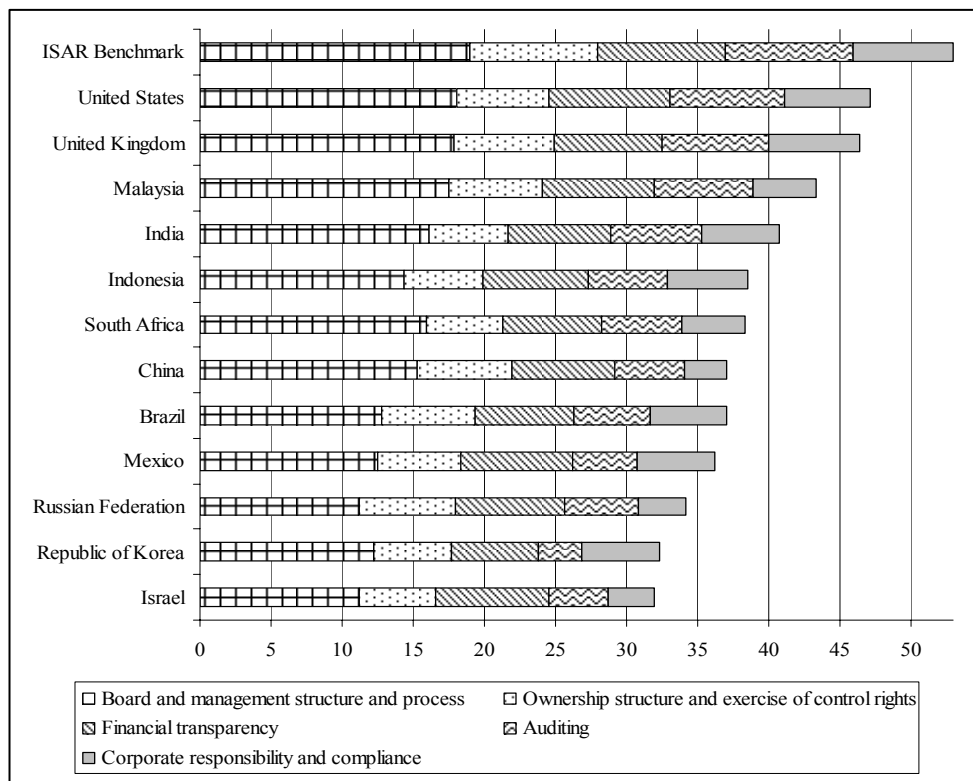
Of the 10 most prevalent disclosure items, five are in the category of board and management structure and process, four are in financial transparency, and one was in ownership structure and exercise of control rights. Six of these top 10 most prevalent disclosure items were also among the top 10 most prevalent items found among enterprises from low and middle income countries in the 2006 Review (see table 4, note (a)). It is also notable that five of the top 10 most commonly disclosed items were also among the most required disclosure items for MSCI EM Index markets (see table 4, note (c)). Indeed, there is an apparent correlation between market requirements and

disclosure rates: none of the most required items appear on the list of least disclosed, and vice versa. Six of the top 10 most commonly reported items are also among the most commonly required, and 4 of the bottom 10 least commonly reported items were also among the least commonly required. This relationship between disclosure requirements and actual disclosure practices is explored in more detail in section D below. Section C provides an overview of disclosure practices for enterprises by market.

C. Company disclosure practices by market

Figure 4 presents an overview of the average number of disclosure items reported by each of the selected top 10 enterprises with a breakdown by home market and category of disclosure. Despite the low per-country sample size of 10 enterprises, the position of these enterprises among the largest and most economically significant for each economy makes the analysis nevertheless useful for comparing relative practices between markets. Figure 4 can be seen as an indication of what leading large enterprises in different markets are disclosing about their corporate governance practices. For comparison purposes, figure 4 also includes data on the disclosure practices for top 10 enterprises in two of the largest developed country equity markets: the United Kingdom and the United States.

Figure 4. Average number of disclosure items per top 10 enterprise, by market and category

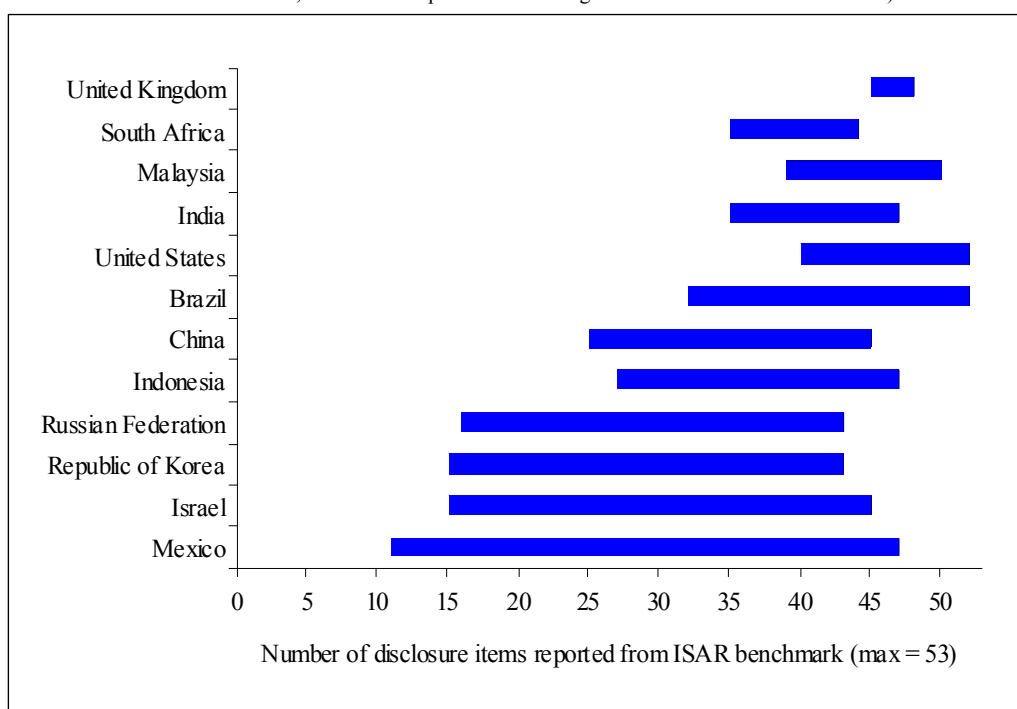


This overview of disclosure items suggests that there are relatively good disclosure practices among leading firms in the emerging markets studied. In each market, top 10 enterprises disclosed, on average, more than half the items in the ISAR benchmark. This analysis also provides a view of differences between reporting for particular subject categories. For example, Chinese and Brazilian top 10 enterprises display the same total level of reporting (an average of 37 items per company), yet show differences in per category reporting (the Brazilian top 10 enterprises tend to report more in the area of corporate responsibility and compliance, while the Chinese top 10 enterprises tend to report more in the area of board and management structure and process).

The averages displayed in figure 4 above, however, mask inconsistencies in reporting practices between different top 10 enterprises. Figure 5 below provides an overview of the range of total disclosure items in the ISAR benchmark that were reported by each top 10 enterprise within each market. This analysis suggests a significant degree of difference between the consistency of reports among top 10 enterprises in different markets. The top 10 enterprises from the United Kingdom, for example, display a high degree of consistency in reporting practices: 45 items were reported by the company with the least number of disclosed items from the ISAR benchmark, and 48 items were reported by the company with the most. Likewise, the reports of South African, Malaysian and Indian enterprises are relatively consistent in the amount of information presented. In contrast, enterprises from the Russian Federation, the Republic of Korea, Israel and Mexico demonstrate a relatively high degree of inconsistency between companies in their reporting practices. It is noteworthy, however, that none of the markets in the study show consistently low levels of disclosure; for all markets in the study, at least some enterprises have relatively high rates of disclosure. Higher consistency in reporting practices appears to coincide with higher rates of disclosure. This suggests that high levels of consistency in corporate reports might correspond with higher levels of compliance with national codes and regulations. This issue of compliance is examined in more detail in section D, below.

Figure 5. Consistency in reporting practices: spreading range analysis of disclosure practices for top 10 enterprises, by market

(Length of bar indicates difference between enterprise with the lowest number of disclosure items, and the enterprise with the highest number of disclosure items)



D. Compliance with disclosure requirements

This section addresses the issue of compliance with national codes and regulations on corporate governance disclosure by comparing actual reporting practices with the disclosure requirements found in national regulations and listing requirements. The data on national regulations and requirements are taken from the 2007 Review (TD/B/COM.2/ISAR/CRP.6). The main findings of the examination of compliance are presented below, with more detailed findings presented in annex II.

The section starts by comparing the disclosure of the required disclosure items versus the non-required disclosure items in the ISAR benchmark. Figure 6 below provides an overview of how disclosure practices differ between the required items and the non-required items. Of the 5,300 disclosure items examined (53 items in the ISAR benchmark multiplied by 100 emerging market enterprises) 3,990 are required by local

regulators or stock exchange officials. Figure 6 indicates that required items are subject to a significantly higher rate of disclosure compared to non-required items. This finding supports the generally accepted view that regulations and listing requirements play an important role in ensuring corporate transparency. The relatively high rate of disclosure among non-required items, at nearly 60 per cent, suggests that other influencing factors, including investors and voluntary codes, also play a significant role in promoting corporate governance disclosure.

Figure 6. Disclosure compliance for 100 emerging market enterprises: per cent

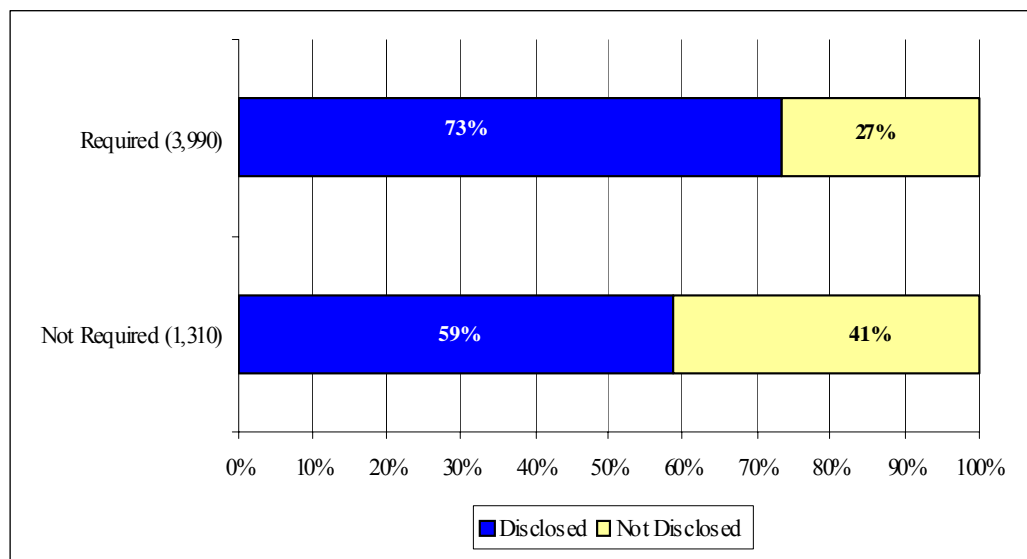
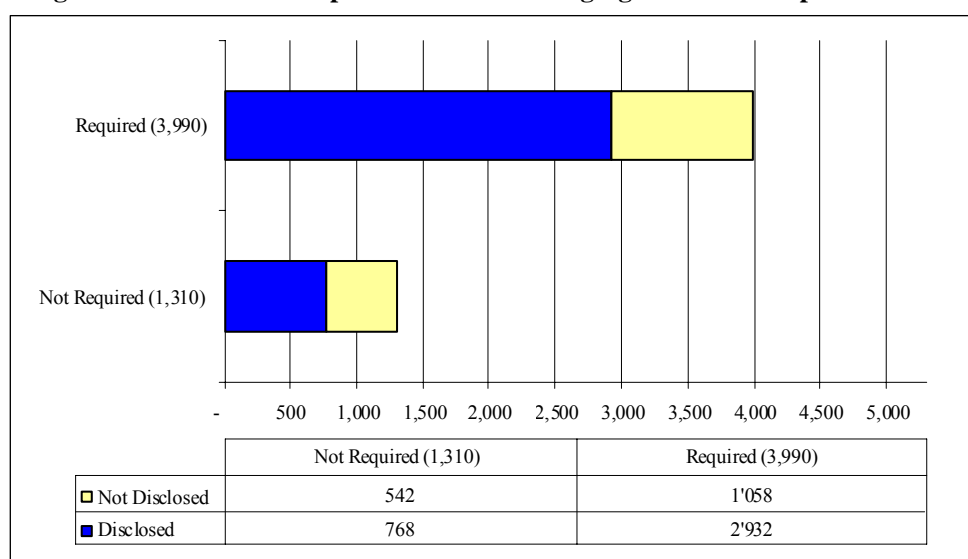


Figure 7 below presents the actual numbers, rather than per cent figures, for the data presented in figure 6 above. The actual figures provide an important sense of the relative number of disclosure items that are required by emerging markets: 75 per cent, or 3,990 of the 5,300 total disclosure items reviewed for emerging market companies were the subject of local requirements. Together, the data presented in these two figures support the conclusion that most corporate governance disclosure in emerging markets is the subject of local regulation, and that required disclosure items tend to be disclosed at a higher rate than non-required items. This conclusion implies that robust national policies on corporate disclosure can lead to improved corporate transparency.

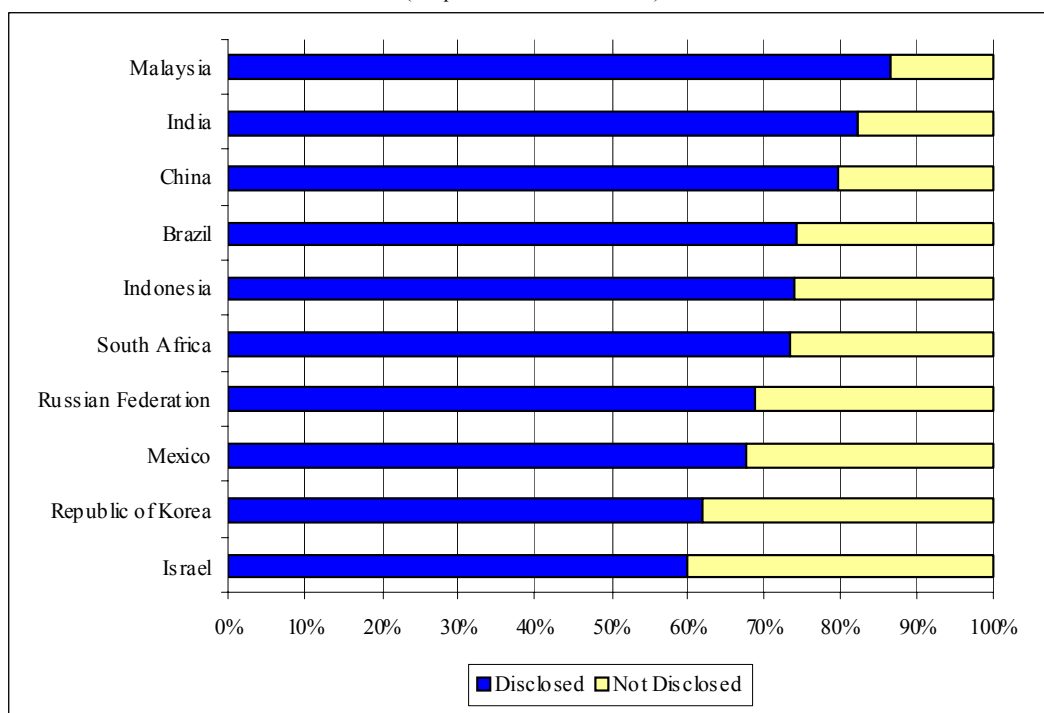
Figure 7. Disclosure compliance for 100 emerging market enterprises: actual



While the data has so far supported the conclusion that regulations are widely used and tend to promote stronger reporting, there are nevertheless lingering questions about compliance. Figure 8 below presents an examination of disclosure compliance for

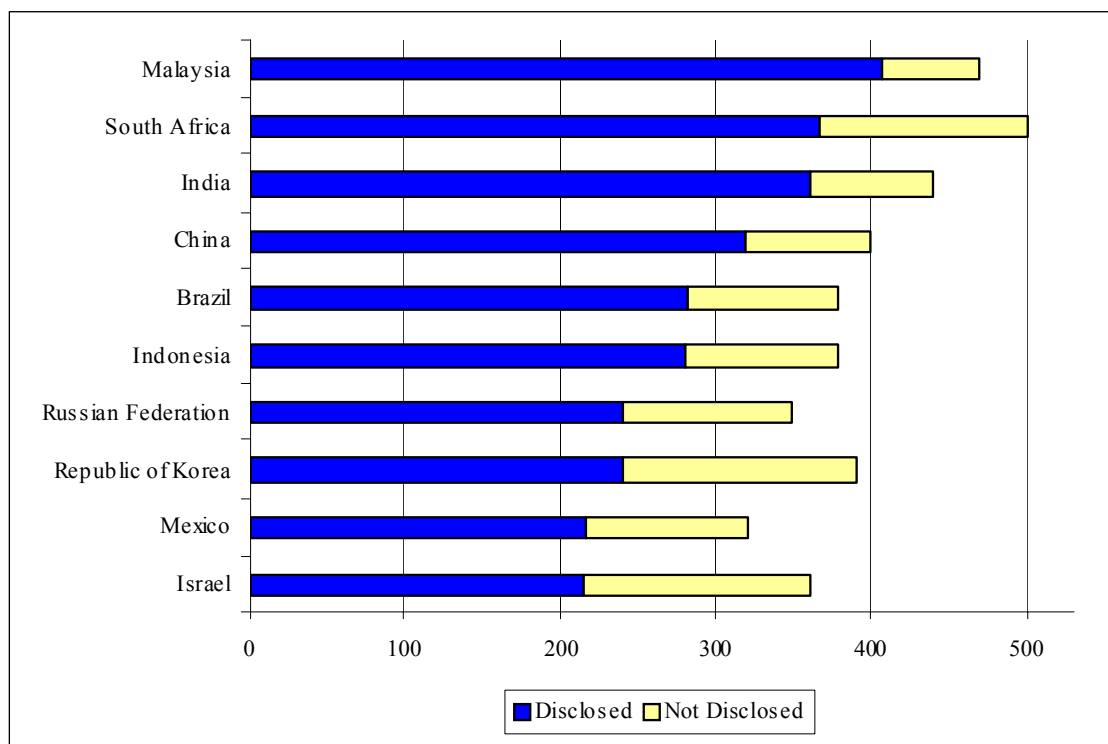
top 10 enterprises in each of the emerging markets studied. The markets are ordered by the size of the compliance gap, i.e. the percentage of required disclosure items that were not found among the public reports of the sample companies. A noticeable correlation exists between the compliance gaps in figure 8 below, and the consistency analysis presented in figure 5 above. The four markets with the largest compliance gaps also have the highest levels of inconsistency between the reporting practices of top 10 enterprises. On the other end of the spectrum, four of the five markets with the smallest compliance gaps also have the lowest levels of inconsistency among their top ten enterprises.

Figure 8. Disclosure compliance for top 10 enterprises by market: per cent
(Required disclosure items)



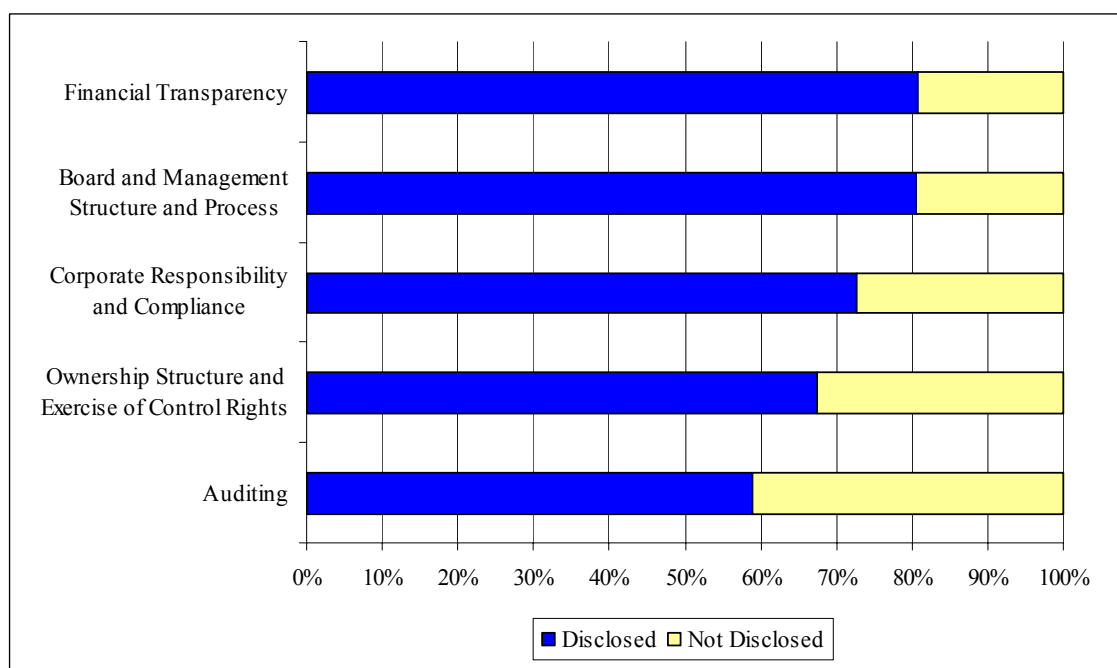
The one significant exception to this correlation between compliance and consistency is South Africa. The top 10 enterprises from South Africa have the highest level of consistency in reporting found among any of the emerging market enterprises studied. Yet in figure 8 above, the compliance gap for top South African firms appears comparatively higher than for firms in other markets. As figure 9 below indicates, the difference is caused by the high number of disclosure requirements in South Africa. While the top 10 South African enterprises disclose more information, on average, than most other companies in the study, the number of disclosure requirements in South Africa also exceeds the number of disclosure requirements found in other markets, as measured by the ISAR benchmark.

Figure 9. Disclosure compliance for top 10 enterprises by market: actual
(required disclosure items)



An analysis of disclosure compliance by subject is provided in figure 10 below. The strong correlation between figure 10 and figure 3 in section B above suggests that issues of compliance are playing a strong role in the types of information being reported. For example, the category of auditing is, as noted previously, subject to the lowest levels of reporting among the 100 emerging market enterprises in this study as well as for the enterprises from low- and middle-income countries studied in the 2005 and 2006 Reviews. Figure 10 below indicates that more than 40 per cent of the required disclosure items related to auditing issues were not found among the public reports of the enterprises studied. For investors, policymakers and other stakeholders that consider auditing disclosures critical to the overall credibility of corporate reports, this lack of compliance with auditing requirements may be a call to policy makers to consider stronger measures to promote the observance of corporate disclosure regulations.

Figure 10. Disclosure compliance for 100 emerging market enterprises, by subject
(required disclosure items)



IV. Conclusions

This report focuses on the disclosure practices of 100 leading emerging market enterprises. The sample of 100 enterprises is comprised of selected top 10 enterprises from the economies of the top 10 United Nations member States, by index weighting, found within the MSCI Emerging Markets Index. The leading enterprises of the MSCI EM Index were chosen as the sample for the study due to the economic significance of these enterprises within their economy and the influential role the MSCI EM Index plays in facilitating foreign portfolio investment towards developing economies and economies in transition.

The main findings of the 2008 Review show that on average, the selected top 10 enterprises from each market are reporting more than half the items in the ISAR benchmark of good practices in corporate governance disclosure. Further analysis indicates that some subject areas, such as issues related to auditing, are significantly less reported than other areas, such as financial transparency. This finding is consistent with UNCTAD’s earlier studies on corporate governance disclosure, which found that disclosure items in the category of auditing remain among the least reported, on average, among enterprises from emerging markets.

The 2008 Review also examined the compliance of enterprises with disclosure rules in their home markets. The findings indicate that while enterprises are, on average, more likely to disclose information if it is required by regulators, significant gaps in compliance still exist. Policymakers wishing to improve corporate disclosure practices should consider options for addressing these compliance gaps. Such options should include a mix of both penalties for non-compliance, as well as capacity building measures to raise awareness and provide training on how to produce good quality corporate governance disclosures.

While the 2007 Review recognized the relative good quality of disclosure requirements in emerging markets, this 2008 Review has called into question the efficacy of these same disclosure requirements. The apparent non-compliance among a significant number of enterprises for a significant number of disclosure items highlights the need to further align the actual corporate reporting practices of enterprises with the policy prescriptions of regulators and stock exchange officials.

Annex I. List of enterprises included in the study, by market

Brazil

- AMBEV PN
- BANCO BRADESCO PN
- BANCO ITAU HLDG FIN. PN
- CSN SIDERURGICA NAC'L ON
- GERDAU PN
- PETROBRAS PN
- TELE NORTE LESTE PART.PN
- UNIBANCO UNIT
- USIMINAS PNA
- VALE DO RIO DOCE PNA

China

- CHINA COMMUNIC CONSTRU-H
- CHINA CONSTRUCTION BK H
- CHINA LIFE INSURANCE H
- CHINA MOBILE
- CHINA PETRO & CHEM H
- CHINA SHENHUA ENERGY H
- CNOOC
- ICBC H
- PETROCHINA CO H
- PING AN INSURANCE H

India

- BHARAT HEAVY ELECTRICALS
- HDFC BANK
- HOUSING DEV FINANCE CORP
- ICICI BANK
- INFOSYS TECHNOLOGIES
- ITC
- LARSEN & TOUBRO
- OIL & NATURAL GAS CORP
- RELIANCE COMMUNICATION
- RELIANCE INDUSTRIES

Indonesia

- ASTRA INTERNATIONAL
- BANK CENTRAL ASIA
- BANK MANDIRI
- BANK RAKYAT INDONESIA
- BUMI RESOURCES
- INDOSAT
- INT'L NICKEL INDONESIA
- PERUSAHAAN GAS NEGARA
- TELEKOMUNIKASI INDONESIA
- UNITED TRACTORS

Israel

- BANK HAPOALIM
- BANK LEUMI LE-ISRAEL
- BEZEQ ISRAEL TELECOM.
- CHECK POINT SOFTW.
- ISRAEL CHEMICALS
- ISRAEL CORP
- MA MAKHTESHIM-AGAN IND
- NICE SYSTEMS
- PARTNER COMMUNICATIONS
- TEVA PHARMACEUTICAL IND

Republic of Korea

- HYUNDAI HEAVY INDUSTRIES
- HYUNDAI MOTOR CO
- KEPCO KOREA ELECT. POWER
- KOOKMIN BANK
- KT&G CORP(KOREA TOBACCO)
- LG ELECTRONICS
- POSCO
- SAMSUNG ELECTRONICS CO
- SHINHAN FINANCIAL GROUP
- SHINSEGAE CO

Malaysia

- BUMIPUTRA-COMMERCE HLDGS
- GENTING
- IOI CORP
- KUALA LUMPUR KEPONG
- MALAYAN BANKING
- MISC FGN
- PUBLIC BANK FGN
- SIME DARBY
- TELEKOM MALAYSIA
- TENAGA NASIONAL

Mexico

- AMERICA MOVIL L
- CEMEX CPO
- EMPRESAS ICA
- FEMSA UNIT UBD
- GRUPO FIN BANORTE O
- GRUPO MEXICO B
- GRUPO TELEVISA CPO
- INDUSTRIAS PENOLES CP
- TELEFONOS MEXICO L
- WALMART MEXICO V

Russian Federation

- GAZPROM
- LUKOIL HOLDING
- MOBILE TELESYS
- NORILSK NICKEL
- NOVATEK GDR
- SBERBANK RUSSIA
- SURGUTNEFTEGAZ
- TATNEFT COMMON
- UNIFIED ENERGY
- VIMPELCOM

South Africa

- ANGLO PLATINUM
- ANGLOGOLD ASHANTI
- FIRSTRAND
- GOLD FIELDS
- IMPALA PLATINUM HOLDINGS
- MTN GROUP
- NASPERS N
- REMGRO
- SASOL
- STANDARD BANK GROUP

United Kingdom

- ANGLO AMERICAN
- ASTRA ZENECA
- BARCLAYS
- BP
- GLAXOSMITHKLINE
- HSBC
- RIO TINTO
- ROYAL BANK OF SCOTLAND GROUP
- ROYAL DUTCH SHELL A
- VODAFONE GROUP

United States

- AT&T INC
- BANK OF AMERICA CORP
- CHEVRON CORP
- EXXON MOBIL CORP
- GENERAL ELECTRIC
- INTERNATIONAL BUSINESS MACHINES
- JOHNSON & JOHNSON
- JPMORGAN CHASE & CO
- MICROSOFT CORP
- PROCTER & GAMBLE

Annex II. Disclosure practices of 10 leading enterprises in each of 10 emerging markets

| Disclosure item | Brazil | China | India | Indonesia | Israel | Republic of Korea | Malaysia | Mexico | Russian Federation | South Africa |
|---|--|-------|-------|-----------|--------|-------------------|----------|--------|--------------------|--------------|
| | Number of enterprises disclosing this item (max.= 10) Shaded square indicates that the item is required in the company's home market* | | | | | | | | | |
| Ownership structure and exercise of control rights | | | | | | | | | | |
| Ownership structure | 9 | 8 | 10 | 9 | 8 | 7 | 10 | 8 | 8 | 10 |
| Process for holding annual general meetings | 6 | 8 | 6 | 6 | 6 | 8 | 9 | 6 | 10 | 3 |
| Changes in shareholdings | 7 | 7 | 8 | 9 | 5 | 7 | 7 | 5 | 6 | 7 |
| Control structure | 9 | 9 | 8 | 6 | 8 | 7 | 10 | 7 | 8 | 6 |
| Control and corresponding equity stake | 10 | 9 | 5 | 5 | 8 | 8 | 10 | 7 | 8 | 4 |
| Availability and accessibility of meeting agenda | 8 | 9 | 9 | 7 | 7 | 9 | 10 | 8 | 8 | 9 |
| Control rights | 7 | 8 | 6 | 4 | 6 | 4 | 5 | 7 | 10 | 6 |
| Rules and procedures governing the acquisition of corporate control in capital markets. | 9 | 8 | 4 | 8 | 5 | 4 | 3 | 8 | 9 | 9 |
| Anti-takeover measures | 1 | 1 | 0 | 1 | 1 | 1 | 2 | 2 | 1 | 0 |
| Financial transparency | | | | | | | | | | |
| Financial and operating results | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 |
| Critical accounting estimates | 8 | 9 | 9 | 10 | 10 | 7 | 10 | 8 | 9 | 8 |
| Nature, type and elements of related-party transactions | 9 | 9 | 10 | 9 | 9 | 9 | 10 | 10 | 9 | 10 |
| Company objectives | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 |
| Impact of alternative accounting decisions | 5 | 7 | 5 | 8 | 10 | 5 | 10 | 9 | 8 | 9 |
| Disclosure practices on related party transactions where control exists | 6 | 9 | 10 | 8 | 8 | 9 | 9 | 6 | 7 | 6 |
| The decision-making process for approving transactions with related parties | 7 | 4 | 3 | 4 | 9 | 1 | 6 | 9 | 7 | 3 |
| Rules and procedure governing extraordinary transactions | 4 | 5 | 6 | 5 | 7 | 6 | 4 | 8 | 9 | 5 |
| Board's responsibilities regarding financial communications | 10 | 9 | 9 | 10 | 7 | 4 | 10 | 9 | 8 | 9 |
| Auditing | | | | | | | | | | |
| Process for interaction with internal auditors | 9 | 7 | 10 | 8 | 7 | 1 | 10 | 6 | 8 | 10 |
| Process for interaction with external auditors | 7 | 7 | 9 | 9 | 3 | 3 | 10 | 8 | 8 | 9 |
| Process for appointment of external auditors | 8 | 8 | 10 | 7 | 6 | 6 | 9 | 6 | 9 | 7 |
| Process for appointment of internal auditors/scope of work and responsibilities | 4 | 2 | 6 | 2 | 7 | 2 | 4 | 1 | 6 | 6 |
| Board confidence in independence and integrity of external auditors | 8 | 3 | 2 | 7 | 5 | 3 | 8 | 5 | 6 | 10 |
| Internal control systems | 10 | 10 | 9 | 10 | 6 | 7 | 10 | 9 | 8 | 7 |
| Duration of current auditors | 3 | 5 | 9 | 8 | 1 | 4 | 9 | 2 | 3 | 1 |
| Rotation of audit partners | 2 | 0 | 0 | 1 | 1 | 1 | 0 | 3 | 0 | 2 |
| Auditors' involvement in non-audit work and the fees paid to the auditors | 3 | 7 | 9 | 4 | 5 | 4 | 9 | 6 | 4 | 4 |
| Corporate responsibility and compliance | | | | | | | | | | |
| Policy and performance in connection with environmental and social responsibility | 10 | 8 | 7 | 8 | 7 | 9 | 9 | 9 | 10 | 9 |
| Impact of environmental and social responsibility policies on the firm's sustainability | 7 | 5 | 7 | 8 | 4 | 8 | 8 | 5 | 5 | 6 |
| A code of ethics for the board and waivers to the ethics code | 4 | 2 | 10 | 7 | 4 | 6 | 4 | 8 | 2 | 2 |
| A code of ethics for all company employees | 9 | 4 | 7 | 8 | 6 | 9 | 7 | 9 | 5 | 10 |
| Policy on "whistle blower" protection for all employees | 6 | 2 | 8 | 5 | 4 | 4 | 2 | 7 | 1 | 6 |

*Chapter 8. 2008 Review of the implementation status of corporate governance disclosures:
an examination of reporting practices among large enterprises in 10 emerging markets*

| Disclosure item | Brazil | China | India | Indonesia | Israel | Republic of Korea | Malaysia | Mexico | Russian Federation | South Africa |
|---|--|-------|-------|-----------|--------|-------------------|----------|--------|--------------------|--------------|
| | Number of enterprises disclosing this item (max.= 10) Shaded square indicates that the item is required in the company's home market* | | | | | | | | | |
| Mechanisms protecting the rights of other stakeholders in business | 10 | 5 | 9 | 10 | 4 | 10 | 9 | 8 | 7 | 9 |
| The role of employees in corporate governance | 8 | 4 | 7 | 10 | 4 | 8 | 6 | 8 | 3 | 3 |
| Board and management structure and process | | | | | | | | | | |
| Governance structures, such as committees and other mechanisms to prevent conflict of interest | 10 | 9 | 10 | 10 | 9 | 10 | 10 | 9 | 9 | 10 |
| "Checks and balances" mechanisms | 10 | 9 | 8 | 10 | 6 | 4 | 10 | 6 | 6 | 9 |
| Composition of board of directors (executives and non-executives) | 10 | 10 | 10 | 10 | 9 | 10 | 10 | 10 | 10 | 10 |
| Composition and function of governance committee structures | 10 | 9 | 10 | 10 | 7 | 10 | 9 | 9 | 8 | 10 |
| Role and functions of the board of directors | 9 | 10 | 9 | 10 | 7 | 10 | 10 | 9 | 10 | 9 |
| Risk management objectives, system and activities | 10 | 10 | 9 | 10 | 10 | 5 | 10 | 6 | 8 | 10 |
| Qualifications and biographical information on board members | 8 | 10 | 10 | 10 | 9 | 6 | 10 | 8 | 7 | 8 |
| Types and duties of outside board and management positions | 9 | 10 | 10 | 7 | 9 | 6 | 10 | 8 | 6 | 9 |
| Material interests of members of the board and management | 3 | 8 | 10 | 7 | 3 | 6 | 10 | 7 | 5 | 10 |
| Existence of plan of succession | 4 | 7 | 6 | 6 | 1 | 6 | 9 | 2 | 1 | 9 |
| Duration of director's contracts | 10 | 10 | 10 | 10 | 6 | 8 | 10 | 7 | 9 | 7 |
| Compensation policy for senior executives departing the firm as a result of a merger or acquisition | 0 | 1 | 0 | 0 | 1 | 0 | 0 | 0 | 1 | 0 |
| Determination and composition of directors' remuneration | 3 | 10 | 10 | 10 | 7 | 6 | 10 | 3 | 7 | 10 |
| Independence of the board of directors | 7 | 10 | 10 | 4 | 6 | 10 | 10 | 9 | 6 | 10 |
| Number of outside board and management position directorships held by the directors | 9 | 10 | 10 | 6 | 9 | 7 | 10 | 8 | 6 | 10 |
| Existence of procedure(s) for addressing conflicts of interest among board members | 4 | 4 | 9 | 6 | 4 | 4 | 8 | 6 | 5 | 4 |
| Professional development and training activities | 3 | 2 | 6 | 6 | 2 | 1 | 10 | 2 | 4 | 7 |
| Availability and use of advisorship facility during reporting period | 6 | 5 | 5 | 5 | 4 | 7 | 10 | 8 | 2 | 7 |
| Performance evaluation process | 3 | 9 | 9 | 7 | 3 | 6 | 9 | 8 | 2 | 10 |

* Disclosure requirement information based on UNCTAD 2007 Review of the Implementation Status of Corporate Governance Disclosure (TD/B/COM.2/ISAR/CRP.6).

Chapter 9

2008 Review of the reporting status of corporate responsibility indicators

I. Introduction

Corporate responsibility (CR) reporting has been a focus of work for the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) for a number of years. Since the twentieth session of ISAR, the group of experts has recognized the demand among preparers and users of corporate reports for improved comparability and relevance in CR reporting. At its twenty-fourth session, the group agreed on a voluntary technical guidance on CR reporting within corporate annual reports (TD/B/COM.2/ISAR/42). This was published by UNCTAD in 2008 as the *Guidance on corporate responsibility indicators in annual reports*.

At its twenty-fourth session, the group of experts suggested that case studies on corporate responsibility reporting be conducted to provide practical feedback on the status of corporate responsibility reporting around the world. The present report presents a case study of the reporting practices of 100 large emerging market enterprises. The data and analysis presented in section III of this study were prepared in cooperation with the Ernst and Young CSR Knowledge Center and the CSR Management and CSR Auditing Programme at Erasmus University, Rotterdam.¹⁶⁴

The objectives of this study are to (a) provide a brief overview of recent developments in the area of corporate responsibility reporting; and (b) to present and analyse the results of the secretariat's study of corporate responsibility reporting among 100 large enterprises in emerging markets. The overview of recent developments is provided in section II, which examines significant developments in the area of corporate responsibility reporting. Section III presents the findings of the 2008 study of corporate responsibility reporting, along with detailed analysis.

The findings of this study show that half the indicators recommended in UNCTAD's *Guidance on Corporate Responsibility Indicators in Annual Reports* are reported by 25 per cent or more of the enterprises in the study. A further three out of five of the indicators recommend in UNCTAD's *Eco-efficiency* manual are also reported by 25 per cent or more of the emerging market enterprises in the study. Additional analysis indicates that 25 of the 100 enterprises studied report according to the guidelines of the Global Reporting Initiative (GRI), while five of the enterprises included a United Nations Global Compact "communication on progress" report. The study concludes that, while corporate responsibility reporting does appear in a significant number of emerging market enterprises, the practice is not yet widespread.

¹⁶⁴ Research conducted by Dr. Nancy Kamp-Roelands, Director of the Ernst and Young CSR Knowledge Centre and program director CSR Management and CSR Auditing at Erasmus University Rotterdam and Stefanie Smith with additional research support from Bas Pauwe, Robert Tjin, Leonie Veldhuis, and Ids Voerman of Erasmus University, Rotterdam.

II. Overview of recent developments in corporate responsibility reporting

A. Growth and development of CR reporting

CR reporting has grown more than 100-fold since 1992. That year (when the United Nations Conference on Environment and Development, or “Earth Summit”, in Rio de Janeiro helped popularize the term “sustainable development”, coined five years earlier by the United Nations-convened Brundtland Commission) saw the publication of 26 CR reports.¹⁶⁵ According to CorporateRegister.com, which compiles the world’s most comprehensive online database of CR reports, almost 2,700 CR reports were published in 2007 a decade-and-a-half later.¹⁶⁶

As of 4 July 2008, CorporateRegister.com databases were tracking a total of 17,410 CR reports by 4,449 companies. Of these reports, 2,748 refer to the GRI sustainability reporting guidelines and 320 index company progress on the 10 principles of the United Nations Global Compact. CorporateRegister.com Managing Director Paul Scott traces the development of CR reporting from its roots in Europe to regulatory developments across the Atlantic that spurred growth. According to Scott, “There have been sporadic initiatives [in the past] to produce non-financial corporate reports, such as the social reports produced in Germany during the 1970s.” He observes that “The current reporting movement emerged from reporting in the United States during the late 1980s, in response to the increasing volume of emissions data put into the public domain by the... ‘right to know’ legislation which established the Toxic Release Inventory [TRI].”¹⁶⁷

The Emergency Planning and Community Right-to-Know Act – enacted in 1986 by the United States Congress in response to the 1984 chemical explosion at a Union Carbide plant in Bhopal, India – requires the United States Environmental Protection Agency (EPA) to collect and publish facility-level toxic emissions throughout the United States through TRI.¹⁶⁸ According to the EPA, toxic releases decreased by more than 40 per cent (or 1.45 billion pounds) in TRI’s first decade, through 1997.¹⁶⁹

These data seem to support the theory underpinning TRI (and CR reporting more generally) that disclosure can assist in reducing adverse impacts.¹⁷⁰ This “TRI Effect” demonstrates a strong correlation between disclosure and improved management of environmental (and social) issues, though the relationship is neither automatic nor necessarily causal. There are many other factors besides corporate responsibility that can account for the reduction of problems, breaking a causality link. And there are plenty of examples where corporate reporting of environmental and social impacts does *not* lead to mitigation of adverse effects. The role of corporate transparency is, therefore, seen as a necessary but not sufficient condition, which allows for improved awareness and management of issues, as well as measurement of progress over time.

1. CR reporting awards

Two new CR reporting awards, both based on reader voting, were launched in the spring of 2008: one by CorporateRegister.com and one by GRI. The geographic

¹⁶⁵ CorporateRegister lists seven CR reports in 1991 and in 1990, three in 1989, and one in 1988. Brundtland Commission (1987). *Our Common Future: Report of the World Commission on Environment and Development*. 20 March. <http://www.worldinbalance.net/agreements/1987-brundtland.html>.

¹⁶⁶ *Global Report Output by Year*, CorporateRegister.com, 4 July 2008. <http://www.corporateregister.com/charts/byyear.htm>.

¹⁶⁷ Baue W (2004). *A brief history of sustainability reporting*. *SocialFunds.com*. 2 July. <http://www.socialfunds.com/news/article.cgi/1459.html>.

¹⁶⁸ United States Environmental Protection Agency. *What is the Toxics Release Inventory (TRI) Programme?* <http://www.epa.gov/tri/triprogram/whatis.htm> (visited 11 July 2008).

¹⁶⁹ United States Environmental Protection Agency. *Toxics Release Inventory Reporting and the 1997 Public Data Release*. 30 April 1999: 1. <http://www.epa.gov/tri/tridata/tri97/pdr/chap1.pdf>.

¹⁷⁰ Hamilton J (2005). *Regulation Through Revelation: The Origin, Politics, and Impacts of the Toxics Release Inventory Programme*. New York: Cambridge University Press. http://books.google.com/books?id=ovijnnKLw_0C.

concentration of winning companies differed significantly for each award: the CorporateRegister.com awards focused on developed country companies, while the GRI awards focused more on developing country companies. Studies surveying trends and best practices accompanied both awards schemes, advancing similar, as well as distinct, findings. Taken as a whole, these awards programmes and studies provide a useful picture of the current state of CR reporting around the world, as well as forecasting future trends.

CorporateRegister.com characterized the 461 users who registered 3,660 votes to determine its awards as “the largest (and most knowledgeable) reporting awards judging panel anywhere to date.”¹⁷¹ After inviting all 2,000 companies that currently register CR reports on its website, CorporateRegister.com closed the entrant list at 300, to keep the sample size manageable.

European companies made up 58 per cent of the entrants and 68 per cent of the winners in the CorporateRegister.com awards. Although 8 per cent of entrants came from Asia and 2 per cent from South America, no companies from either of these regions made it into the top three slots in any of the nine award categories. Awards in the “Best Report” category, for example, all went to European-based companies: United Kingdom-based Vodafone Group won, with Netherlands-based ABN Amro Holding and United Kingdom-based BP the runners-up.

For the GRI awards, GRI logged 5,650 votes cast by 1,725 people from 70 countries on at least two of the 780 CR reports submitted for the awards. This much larger group voted predominantly for developing country companies.¹⁷² This was despite the fact that almost half (46 per cent) of respondents came from Europe and North America. For example, Brazil-based Petrobras and Banco Real came in first and second in the “Best Report” category, while United Kingdom-based BP came in third.

Table 1. CorporateRegister.com and GRI CR Reporting award winners

| CorporateRegister.com Awards 2008 | Global Reporting Initiative Awards 2008 |
|---|--|
| <p><i>Best Report</i> Vodafone (United Kingdom) ABN Amro (Netherlands) BP (United Kingdom)</p> <p><i>Best First Time Report</i> Green Mountain Coffee Roasters (United States) PricewaterhouseCoopers (United Kingdom) De Beers (South Africa)</p> <p><i>Best Small and Medium-sized Enterprise Report</i> Green Mountain Coffee Roasters (United States) Australian Ethical Investment (Australia) Workspace Group (United Kingdom)</p> <p><i>Best Integrated Report</i> Novo Nordisk (Denmark) BHP Billiton (Australia) African Bank (South Africa)</p> | <p><i>Best Report, All Stakeholders</i> Petrobras (Brazil) Banco Real (Brazil) BP (United Kingdom)</p> <p><i>Best Report According to Civil Society</i> Petrobras (Brazil) Natura Cosméticos (Brazil) BP (United Kingdom)</p> <p><i>Best Report According to Media</i> Gas Natural (Spain) Italcementi (Italy) TGC-5 (Russian Federation)</p> <p><i>Best Report According to Financial Markets</i> ABN Amro India (India) Banco do Brasil (Brazil) Banco Real (Brazil)</p> |

¹⁷¹ *CR Reporting Awards 07 Official Report: Global Winners and Reporting Trends*. CorporateRegister.com, March 2008. <http://www.corporateregister.com/pdf/CRRA07.pdf>. CorporateRegister discounted a total of 1,262 votes: 674 for voting on their own companies' reports, and 588 resulting from “automated” voting by companies voting on their own report.

¹⁷² *GRI Readers' Choice Awards: Awards Ceremony 2008*. Global Reporting Initiative. http://www.globalreporting.org/NR/rdonlyres/E675567C-35B1-47FC-88A4-40F8038490B0/0/Awards_Brochure.pdf.

| CorporateRegister.com Awards 2008 | Global Reporting Initiative Awards 2008 |
|--|--|
| <p><i>Best Carbon Disclosure</i> BMW (Germany) Rio Tinto (United Kingdom) Energias de Portugal (Portugal)</p> <p><i>Creativity in Communications</i> Coca-Cola Enterprises (United States) Hewlett-Packard (United States) Nokia (Finland)</p> <p><i>Relevance and Materiality</i> BP (United Kingdom) ABN Amro (Netherlands) Akzo Nobel (Netherlands)</p> <p><i>Openness and Honesty</i> Bayer (Germany) Nike (United States) Corticeira Amorim (Portugal)</p> <p><i>Credibility through Assurance</i> BP (United Kingdom – Assurance Provider Ernst and Young) Royal Dutch Shell (United Kingdom – Independent Stakeholder Panel) ABN Amro (Netherlands – Ernst and Young)</p> | <p><i>Best Report According to Employees</i> ITC (India) Usinas Siderúrgicas de Minas Gerais (Brazil) ABN Amro India (India)</p> <p><i>Best Report by a Not-So-Big Business</i> Frigoglass (Greece) Findesa (Nicaragua) Euskatel (Spain)</p> <p><i>Best Report by a Non-OECD Company</i> TGC-5 (Russian Federation) Usinas Siderúrgicas de Minas Gerais (Brazil) ITC (India)</p> <p><i>Best Report by a Non-Business Organization</i> Fundación Empredimientos Rurales Los Grobo (Argentina) City of Melbourne (Australia) CILSA (Argentina)</p> |

2. The length of CR reports

The CorporateRegister.com study also documents the continuation of a trend reported in the previous edition of this UNCTAD report (*2006 Review of the Reporting Status of Corporate Responsibility Indicators*): the increasing length of reports, from an average of 30 pages in 1992 to 55 in 2007. The top three reports across the nine categories in the CorporateRegister.com awards averaged 95 pages, with a low of 18 and a high of 313.

The GRI study documents the same dynamic and analyzes the implications that “the volume of reports might overwhelm readers and impede trust as a result”.¹⁷³ Felipe de Lima Fagundes of a Brazilian non-governmental organization, one of the report readers interviewed for the GRI study, noted that “[s]ome of these reports are 200 pages. The first thought I have is that they might be trying to hide a few things in all that information”.¹⁷⁴

Companies have struggled with the “length dilemma” for years, weighing the relative importance of comprehensiveness (and hence length) versus the readability of brevity. An oft-used strategy for addressing this is to produce a shorter print report that tells the “story” in a narrative style, and to use Internet-based reporting for metrics and other data that require more space.

3. CR print reporting and Web reporting

The CorporateRegister.com study points out that while some experts had earlier projected, the eventual demise of the printed CR report as companies migrated disclosure to the Web, the study reveals this to be not the case.¹⁷⁵ The

¹⁷³ Bartels W, Iansen-Rogers J and Kuszewski J (2008). Count me in: the readers’ take on sustainability reporting. Global Reporting Initiative, KPMG, and SustainAbility. 22 May. <http://www.globalreporting.org/NR/rdonlyres/3F57ACC8-60D0-48F0-AF28-527F85A2A4B4/0/CountMeIn.pdf>.

¹⁷⁴ Ibid.

¹⁷⁵ *Op. cit.* fn 7.

CorporateRegister.com study observes that “The data shows that the printed report refuses to die: 81 per cent of 2007 reports were produced in hard copy (and almost all are also available electronically). The printed report is still necessary, both as a bona fide business document but also because it remains more readable and accessible to many stakeholders.”¹⁷⁶

Likewise, predictions of corporate reporting being conducted exclusively via company websites have not come to pass. According to the CorporateRegister.com study, “data for 2007 reveals that HTML reporting is less popular than many believe. Only 14 per cent of reports last year had an online, HTML format (and even these reports may also have been produced in other formats).”¹⁷⁷

B. CR reporting enhanced by user-generated content

In June 2008, apparel firm Timberland introduced a major innovation into CR reporting by fusing its sustainability reporting platform onto a social networking website. The company is shifting its print report (which shared the 2008 Ceres– Association of Chartered Certified Accountants (ACCA) North American Award for Best Sustainability Reporting) from annual to biennial.¹⁷⁸ More significantly, Timberland is filling in the gap with more real-time communications on at least a quarterly basis via a new dedicated webpage on JustMeans.com, a social networking site devoted to socially responsible business.¹⁷⁹

Robin Giampa of Timberland explained how this new approach invites direct input from readers, encouraging engagement between company and stakeholders to create an accountability feedback loop. “We follow our quarterly updates with a conference call for the public to weigh in with their feedback. Giving diverse stakeholders the opportunity to engage with us directly is a novel move in corporate sustainability, and we’re excited about its prospects.”¹⁸⁰

Similarly, Patagonia is using the web innovatively to enhance its CR reporting transparency. In March 2008, the company launched the *Footprint Chronicles* website that tracks “the good and the bad” in Patagonia’s supply chain, such as the distance products travel and locations where they are manufactured and processes, as well as CO₂ emissions and waste generated and energy consumed throughout the supply chain.¹⁸¹

Patagonia figures its customers and investors are savvy enough to know that problems exist in its manufacturing processes, according to Patagonia CEO and President Casey Sheahan. “Our customers are scientists, activists, professors, doctors and more – they have the collective experience and knowledge we’re looking for. We’re highlighting exactly what happens in the manufacturing process and asking customers for their suggestions and help in efforts to find solutions to our less sustainable practices.”¹⁸² So instead of glossing over the problems, Patagonia exposes them in hopes of partnering with its stakeholders to create solutions, just as Timberland is doing.

¹⁷⁶ Ibid.

¹⁷⁷ Ibid.

¹⁷⁸ Association of Chartered Certified Accountants (ACCA) and Ceres (2008). Ford and Timberland Win Ceres-ACCA North American Awards for Best Sustainability Reporting. 30 April. <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=889&srcid=421>.

¹⁷⁹ Baue B (2008). Organizations Learning How to Green Their Communications. *CSRwire.com Latest Corporate Social Responsibility News*. 1 July. <http://www.csrwire.com/News/12538.html>.

¹⁸⁰ Giampa R (2008). Timberland’s trendsetting use of social networking to advance corporate sustainability. *Corporate Watchdog Radio ViewPoint*. 9 July. <http://corporatewatchdogmedia.blogspot.com/2008/07/new-generations-in-sustainability.html> and <http://vcr.csrwire.com/node/9220>.

¹⁸¹ Baue B (2008). Patagonia takes next step in corporate transparency and accountability. *CSRwire.com Latest Corporate Social Responsibility News*. 25 March. <http://www.csrwire.com/News/11480.html>.

¹⁸² Patagonia (2008). Patagonia is first to track environmental and social impact of its products. *CSRwire.com*. 24 March. <http://www.csrwire.com/News/11493.html>.

Finally, CR reporting is beginning to apply eXtensible Business Reporting Language, or XBRL, a specific application of eXtensible Markup Language (XML) that creates taxonomies of “tags” for labelling specific pieces of information to enable their interconnection electronically. In March 2007, GRI released a beta draft taxonomy of XBRL tags mapped to the G3 Sustainability Reporting Guidelines.¹⁸³ This framework facilitates issue identification within CR reports, and direct comparability across reports. For example, a company can report its carbon dioxide emissions anywhere in its CR report, from the first page to the last. With XBRL tagging, this information gets reported under a discrete tag, allowing readers to locate the data easily in any given report.

C. Voluntary and mandatory CR reporting

A number of countries are mandating CR practices by companies, though CR reporting requirements vary. In May 2008, for example, the Nigerian Government’s Federal Executive Council (FEC) approved the development of a CR policy for the country. The Ministry of National Planning Commission said the Government would establish minimum environmental and social standards for all corporations focused on their core competencies to encourage “sensible” CR investment and guard against being “a financial drain on businesses”.¹⁸⁴

In August 2007, the Philippines Board of Investment (BoI) required CR programmes and reporting. Under the 2007 Investment Priorities Plan, companies granted six-year income tax holidays need to issue annual reports on implementation of their CR programmes during the last two years of the period.¹⁸⁵ “This is to ensure that the benefits granted to these companies in terms of the fiscal incentives trickle down to the community hosting them and uplift the people’s lives,” explained Trade and Industry Undersecretary Elmer Hernandez, who also heads the BoI.¹⁸⁶

This move was preceded by the July 2007 adoption of Article 74 by the Government of Indonesia requiring social and environmental responsibility programmes for companies dealing in natural resources.¹⁸⁷ According to CSR-Asia, a civil society group, some Indonesian industry organizations, including the Indonesian Chamber of Commerce, opposed the move, in part because of the unprecedented nature of regulating CSR.¹⁸⁸ “The question is, has Indonesia, as the first country to legislate, got it right? . . . [D]one correctly, it could open the door to new [socially responsible investing] funds.”¹⁸⁹ CSR-Asia pointed out that the scope of companies covered remained unclear at the time of the regulation’s introduction, with indications it may extend to all but financial institutions. CSR-Asia also expressed concern that the financial sector would be specifically excluded from any law on CSR. CSR-Asia experts suggested that the law was primarily focused on “mandating philanthropy” rather than addressing wider issues of sustainable business practices, noting that “The financial sector has a key role to play in CSR, to manage funds in a responsible manner and to loan new capital only to those companies who can demonstrate a commitment to environmental, social and governance issues.”¹⁹⁰

¹⁸³ Baue B (2007). If you tag it, it will be used: sustainability reporting in XBRL. *SocialFunds.com*. 16 April. <http://www.socialfunds.com/news/article.cgi/2272.html>.

¹⁸⁴ Nigeria Direct (2008). FEC okays n17.4b to settle fuel transporters’ bridging claims. 27 May. <http://www.nigeria.gov.ng/NR/exeres/69DF7B8E-F305-4AF9-AC86-162E59C37F93.htm?id=3242>; and Nigeria First (2008). Nigeria: FEC approves corporate social responsibility policy. 22 May. <http://allafrica.com/stories/200805221042.html>.

¹⁸⁵ Manila Bulletin (2007). CSR programmes now mandatory – BoI. 20 August. <http://www.mb.com.ph/issues/2007/08/20/BSNS20070820100791.html>.

¹⁸⁶ Ibid.

¹⁸⁷ Indonesia Business Links (2007). Corporate Social and Environmental Responsibility in the Limited Liability Law (UU PT), 11 September. <http://www.ibl.or.id/en/ibl/html/gateway.php?sid=newsandmode=readandid=77>.

¹⁸⁸ Lyon E (2007). CSR law in Indonesia. *CSR-Asia Weekly*. 25 July. <http://www.csr-asia.com/upload/csrsiaweeklyvol3week30.pdf>.

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

Bursa Malaysia, the Malaysian stock exchange, has long promoted strong corporate responsibility and governance. In 2004, the Malaysian Government came out in support of *voluntary* CR reporting, but during the 2007/08 intersession period, the Malaysian Prime Minister announced support for *mandatory* disclosure of CR activities in annual financial reports of publicly listed companies, in part to attract international investment.¹⁹¹ As the national stock exchange, Bursa Malaysia plays a key role in enforcing these government policies on CR disclosure and corporate governance.

In January 2008, the Chinese Government issued an advisory opinion on mandating CR reporting, according to the April 2008 report to the United Nations Human Rights Council by John Ruggie, Special Representative of the Secretary-General on human rights and business.¹⁹² According to a July 2007 report from China-based research firm SynTao, in 2006 there were 18 CR reports issued by Chinese companies, and 13 had been published by May 2007, exceeding the number in the same period the previous year.¹⁹³

In late November 2007, the Swedish Government mandated that as of March 2008 all 55 State-owned enterprises in that country must issue CR reports using GRI third-generation (or “G3”) sustainability reporting guidelines.¹⁹⁴ At the time of the announcement, 25 Swedish State-owned enterprises already issued CR reports using GRI guidelines.¹⁹⁵ GRI hailed Sweden as “the first Government in the world to introduce such sustainability reporting measures... It is expected that this development will further stimulate other Swedish companies to begin disclosing such information using the GRI framework for sustainability reporting.”¹⁹⁶

In September 2006, the Canadian Social Investment Organization submitted an official recommendation that the Canadian Government require “all publicly listed companies... to issue annual GRI reports”.¹⁹⁷ At that time, only 34 Canadian companies or organizations issued CR reports with reference to the GRI framework.¹⁹⁸

In November 2005, the United Kingdom Government repealed the Operating and Financial Review (OFR), an the annual environmental and social reporting regimen developed over three years of public consultation by the United Kingdom Department of Trade and Industry (DTI).¹⁹⁹ However, in November 2006, the United Kingdom

¹⁹¹ Domini Social Investments, *Malaysia (Bursa Malaysia)*, forthcoming, and Prime Minister Yab Dato’ Seri Abdullah Bin HJ. Ahmad Badawi, “The 2007 Budget Speech,” delivered 1 September 2006, Pages 22-23, paragraphs 88-90. <http://www.epu.jpm.my/bajet/engbajet2007.pdf>.

¹⁹² Ruggie J (2008). Protect, respect and remedy: a framework for business and human rights. Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, 7 April. <http://www.reports-and-materials.org/Ruggie-report-7-Apr-2008.pdf>.

See footnote 24 in the Ruggie report: “Instructing opinions about central State-owned enterprises fulfilling social responsibility,” issued by China’s State-owned Asset Supervision and Administration Commission of the State Council, 4 January 2008.

¹⁹³ Guo Peiyuan, Zhang Xubiao, Wei Ningdi (2007). *Study of Sustainability Reporting in China: A Journey to Discover Values*. SynTao, 13 July. <http://www.SustainabilityReport.cn>.

¹⁹⁴ Government of Sweden (2007): *Guidelines for external reporting by state-owned companies*. Ministry of Enterprise, Energy and Communications, 29 November. <http://www.sweden.gov.se/content/1/c6/09/41/25/56b7ebd4.pdf>.

¹⁹⁵ Global Reporting Initiative (2007). Sweden pioneers a global first in sustainability reporting. 20 December. <http://www.globalreporting.org/NewsEventsPress/LatestNews/2007/NewsDec07Sweden.htm>.

¹⁹⁶ Ibid. France was the first national Government to mandate CR reporting, with the passage of the *nouvelles réglementations économiques* in 2001. Baue “ (2002). New French law mandates corporate social and environmental reporting. *SocialFunds.com*, 14 March. <http://www.socialfunds.com/news/article.cgi/798.html>.

See the below section, *Stock Exchanges and Socially Responsible Investing Indexes Drive CR Reporting*, for discussion of how the Australian Government and the Johannesburg Securities Exchange in South Africa used the investment process to require corporate responsibility disclosure. Sweden distinguished itself as the first Government to require GRI reporting.

¹⁹⁷ Ellmen E (2006). *Written Submission to the National Roundtables on Corporate Social Responsibility and the Canadian Extractive Sector in Developing Countries*. Social Investment Organization, 13 September. http://geo.international.gc.ca/cip-pic/library/CSR_Toronto_Submission_%20Eugene_Ellman_0906.pdf.

¹⁹⁸ Ibid.

¹⁹⁹ *Speech by the Rt. Hon. Gordon Brown MP, Chancellor of the Exchequer, at the CBI Annual Conference in London*, HM Treasury, 28 November 2005. http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_99_05.cfm and William Baue, “United Kingdom Kills Operating and Financial Review of Environmental and Social Information,” *SocialFunds.com*, 8 December 2005. <http://www.socialfunds.com/news/article.cgi/1882.html>.

Government passed the revised Companies Act that requires a Business Review reporting “on environmental matters, the company’s employees and social/community issues”, according to the United Kingdom Department for Business Enterprise and Regulatory Reform.²⁰⁰ The United Kingdom Government replaced the OFR with the Business Review, removing what it considered onerous requirements while leaving in place what it considered essential elements of the OFR.²⁰¹ United Kingdom companies are also expected to comply with the European Union Accounts Modernization Directive, which requires an Enhanced Directors’ Reports analyzing environmental and social aspects of company impacts, including employee issues.²⁰²

During ISAR’s 2007/08 intersession period, the United Nations Global Compact, the largest corporate citizenship initiative in the world, has continued to strengthen its reporting requirement. Reporting on company efforts to support the Global Compact principles, known as a Communication on Progress (COP), is one of the primary responsibilities of Global Compact signatories. In June 2008, the Global Compact de-listed 630 companies for failing to publish COP reports.²⁰³ The move followed up on the de-listing of over 500 companies in late 2006 for the same lack of communication.²⁰⁴ While the Global Compact remains a voluntary initiative, signatories are expected to meet the commitments of joining it.

In September 2008, the International Organization for Standardization (ISO) Working Group on Social Responsibility convened in Santiago, Chile, and formally agreed to change the status of its working draft standard on Social Responsibility to a “Committee Draft”, the next step in the process of finalizing a new international standard. The proposed ISO standard (known as ISO 26000) identifies a number of key areas of social responsibility, including reporting. While the draft ISO 26000 standards does not provide detailed reporting guidelines, it does highlight the principle characteristics of reporting in this area, including that information should be understandable, truthful and accurate, balanced, material, timely and comparable. The ISO 26000 draft also notes that there are a number of initiatives – such as ISAR guidance or GRI guidelines – that exist on this subject. If the “Committee Draft” is adopted by national chapters of ISO, the new ISO 26000 would be a voluntary standard to provide guidance to organizations on the subject of social responsibility, and recommend that socially responsible organizations report on this subject.

D. Emerging markets CR reporting

In January 2008, the Social Investment Research Analyst Network (SIRAN), a working group of the Social Investment Forum (SIF), and KLD Research and Analytics performed an analysis of CR reporting amongst a select group of emerging markets companies.²⁰⁵ From the starting universe of the SandP/International Finance Corporation Index, the study covered the top four companies in three sectors (oil and gas, metals and mining, and telecommunications) from seven emerging markets: Brazil, China, India, the Russian Federation, South Africa, the Republic of Korea, and Taiwan Province of China.

The study finds 87 per cent of 75 surveyed companies make some sustainability disclosures, with just over half publishing stand-alone CR reports. A little over a quarter

²⁰⁰ United Kingdom Department for Business Enterprise and Regulatory Reform (2008). *Narrative Reporting: Business Review*. <http://www.berr.gov.uk/bbf/financial-reporting/business-reporting/page21339.html> (visited 13 July 2008.)

²⁰¹ United Kingdom Department for Business Enterprise and Regulatory Reform (2006). *Narrative Document: Consultation on Mandatory Business Reporting*. 24 March. <http://www.berr.gov.uk/bbf/financial-reporting/business-reporting/page27239.html>.

²⁰² Trucost (2005). OFR Environmental Reporting requirements set to continue under EU Accounts Modernization Directive. 28 November. <http://www.trucost.com/euaccmoddir.html>.

²⁰³ Global Compact (2008). 630 Companies Delisted as Part of Integrity Measures. 25 June. http://www.unglobalcompact.org/newsandevents/news_archives/2008_06_25.html.

²⁰⁴ Global Compact (2006). 203 Additional Companies to be Listed as “Inactive”. 28 December. http://www.unglobalcompact.org/newsandevents/news_archives/2006_12_28.html.

²⁰⁵ Social Investment Research Analyst Network (SIRAN), Social Investment Forum (SIF), KLD Research and Analytics (2008). Sustainability reporting in emerging markets: an analysis of the sustainability reporting in selected sectors of seven emerging market countries. January. http://www.siran.org/pdfs/SIRAN-KLD_Report_for_EM_Transparency_2007.pdf.

(27 per cent) of companies referenced GRI guidelines in their reports. The researchers attribute South Africa's leading role in CR reporting to Johannesburg Stock Exchange listing requirements that mandate the use of GRI. China, on the other hand, "has the greatest room for improvement".²⁰⁶

Chinese CR reporting in "developmental phase"

The July 2007 SynTao report referenced in the "Mandatory CR Reporting" section above notes that Chinese CR reporting is still in its "developmental phase".²⁰⁷ According to SynTao, the history of CR reporting in China dates back to 1999, when Shell China issued a CR report independent of its annual report, and reached only seven CR report preparers by the end of 2005 – more than half of which were foreign companies.²⁰⁸

Chinese CR reporting turned the corner in 2006, dubbed "the year of sustainability reporting in China", according to SynTao. That year, 12 first-time reporters brought the total number of CR reports in China to 18 – the same number as all previous years combined. Most of the reports followed GRI guidelines, and the majority of reporting companies were State-owned enterprises. Of all Chinese CR reporters since 1999, 17 are State-owned enterprises, 8 are foreign enterprises, and 1 is a Chinese private enterprise.²⁰⁹

SynTao attributes the rise in Chinese CR reporting to two factors – (a) rising awareness of CR reporting, fuelled by conferences and media accounts; and (b) momentum created by Government and state-owned enterprises. In 2004, the State-owned Assets Supervision and Administration Commission of the State Council and the Department of Construction Management at Tsinghua University set up a joint research team on CR reporting in China. In early 2006, the Ministry of Commerce's Transnational Corporation Research Center issued a draft of *Guidelines on Corporate Responsibility Reporting for Chinese Enterprises*.²¹⁰

SynTao adopted the CR reporting assessment methodology of SustainAbility, the United Kingdom-based research and consultancy firm and found Chinese CR reports doing relatively well in presentation of performance, governance and strategy. Chinese CR reports fall short on management indicators, as well as accessibility of information and assurance, according to the SynTao analysis.²¹¹

The SynTao report lists the "sustainability values of Chinese enterprises" such as PetroChina: "offering clean energy and creating harmony".²¹² These values contrast with CR related challenges facing Chinese enterprises, as well as other emerging transnational corporations (TNCs) from developing countries and economies in transition. As noted in UNCTAD's 2006 *World Investment Report*, developing country TNCs engaged in "South-South" investment, or direct investment between developing countries, can be subject to scrutiny over a number of CR issues, ranging from human rights and labour practices, to environmental controls and product safety issues.

E. Responsible investment

In 2008, a number of new environmental, social and governance (ESG) indexes were introduced. In January 2008, Standard and Poor's launched the SandP ESG India Index tracking the 50 Indian companies with the highest ESG scores out of the 500 largest companies listed on the National Stock Exchange of India. CRISIL and KLD Research and Analytics, India-based and United States-based social and environmental research firms (respectively), provide the ESG analysis, with support provided by the

²⁰⁶ Ibid.

²⁰⁷ Guo Peiyuan, Zhang Xubiao, Wei Ningdi (2007). Study of sustainability reporting in China: a journey to discover values. Syntao, 13 July. <http://www.SustainabilityReport.cn>.

²⁰⁸ Ibid.

²⁰⁹ Ibid.

²¹⁰ Ibid.

²¹¹ Ibid.

²¹² Ibid.

IFC.²¹³ This index served as the model for a similar set of indexes covering the Middle East and North Africa (MENA) region. In April 2008, SandP announced a partnership with Dubai-based Hawkamah, the Gulf region's leading institute for corporate governance, to develop the SandP-Hawkamah ESG MENA indices, initially covering 11 markets.²¹⁴ As with the India ESG index, constituents are weighted based on their ESG scores, linking index performance to companies' ESG performance instead of simply their market size. According to SandP's methodology, a significant portion of the score is derived from the existence of ESG indicators company reports.

The UN Principles for Responsible Investment (PRI), launched in April of 2006 by the United Nations Secretary-General and a coalition of institutional investors, continues to grow and attract new signatories. As of July 2008, the PRI had almost 400 signatories managing \$13 trillion in assets committed to six principles for analysing the ESG implications of their investments.²¹⁵ PRI Chair Donald MacDonald of the BT Pension Scheme indicated in June 2008 that PRI was considering exclusion of signatories who had failed to follow the sixth principle: to report on adherence to the five other principles. The move is similar to that taken by the United Nations Global Compact (noted above) and responds, at least in part, to calls by some investors and other stakeholders to strengthen the requirement of PRI signatories to report ESG assessments of their investments.²¹⁶

F. Climate reporting

1. Carbon Disclosure Project

At his address at the release of the Intergovernmental Panel on Climate Change (IPCC) Fourth Assessment Synthesis Report in November 2007, United Nations Secretary-General Ban Ki-Moon said that “[s]lowing – and reversing – these threats [posed by climate change] are the defining challenge of our age”.²¹⁷ The primary way companies can contribute to solutions is to reduce carbon dioxide and other greenhouse gas emissions in their own operations and supply chains. Consequently, corporate climate reporting on carbon emissions has become a major focus.

The genesis of the Carbon Disclosure Project (CDP) dates back to 2000, but 2003 was the first year that 35 institutional investors managing \$4.5 trillion sent questionnaires asking the world's 500 biggest companies (FT500) for information on their greenhouse gas (GHG) emissions – almost half of which responded. In 2008, the sixth year of this data request (or CDP6), the number of investors has grown to 385 and the assets managed have risen more than ten-fold to \$57 trillion, asking 3,000 companies about their carbon dioxide emissions.

CDP operates on the same principle as the “TRI Effect”: that disclosure prompts corporate responsibility – in this instance, GHG emissions reduction. However, the link between disclosure and sustainability performance is not necessarily causal, according to Matthew Kiernan, CEO of Innovest Strategic Value Advisors, a research firm that produces the annual CDP report. “Carbon disclosure is one thing, actual carbon performance is something else altogether”, Kiernan said.²¹⁸ To underscore this distinction, Innovest changed the name of the index it produces tracking the best CDP responders – from the “Climate Leaders Index” (CLI) until 2006 to the “Climate

²¹³ “SandP ESG India Index launched,” *Hindu Business Line*, 30 January 2008.

²¹⁴ <http://www.thehindubusinessline.com/2008/01/31/stories/2008013152251600.htm>.

²¹⁴ “Mena to get advanced indices,” *Gulf News*, 16 April 2008.
<http://www.gulfnews.com/business/Markets/10205906.html>.

²¹⁵ United Nations Principles of Responsible Investment. *Signatories to the Principles for Responsible Investment*, <http://www.unpri.org/signatories/>. Visited 14 July 2008.

²¹⁶ Molony J (2008). United Nations Principles for Responsible Investment prepares to expel fund managers over disclosure failures. *Thomson Investment Management News*. 27 June.
<http://www.thomsonimnews.com/story.asp?storycode=43285&encCode=5073548BC7194063JTBS737226611>.

²¹⁷ Ban Ki-Moon (2007). Secretary-General's address to the IPCC upon the release of the Fourth Assessment Synthesis Report. 17 November. <http://www.ipcc.ch/pdf/presentations/valencia-2007-11/pachauri-17-november-2007.pdf>.

²¹⁸ Baue B with Rheannon F (2007). Leave only footprints: measuring and managing corporate carbon emissions. *SocialFunds.com*. 4 September 2007. <http://www.socialfunds.com/news/article.cgi/2362.html>.

Disclosure Leadership Index” (CDLI) in 2007.²¹⁹ In other words, corporate leadership in climate disclosure does not necessarily translate into corporate leadership in climate action.

2. Corporate climate reporting studies

One proxy of the rising significance of corporate climate reporting is the wave of recent studies on the phenomenon, all examining the FT500 as their starting universe. GRI and KPMG Global Sustainability Services issued a study in July 2007, CorporateRegister.com did so in February 2008, and Ethical Corporation Institute added to the growing body of research in July 2008.

The CorporateRegister.com study examined the FT500 between September 2006 and December 2007, and found 67 per cent (335) issuing CR reports. Of these 335 CR reports, 87 per cent address climate change, with 78 per cent publishing quantitative GHG emissions data; 65 per cent include a specific climate change section; and 41 per cent address climate change in the CEO or Chairperson introduction. However, only 16 per cent assign management responsibility for addressing climate change.²²⁰

Almost two thirds (63 per cent) of reporters use the GHG Protocol, an emissions measurement platform developed by the World Resources Institute and the World Business Council on Sustainable Development.²²¹ Almost half (45 per cent) of reporters provide information on “downstream” emissions, for example from the use of their products (a level of reporting known as “Scope 3” in the GHG Protocol) while 46 per cent report as far as Scope 2 (“upstream” emissions, for example from purchased electricity) and only 9 per cent stop at Scope 1 (direct emissions from companies’ own operations).

The study distinguished between relative emissions data – or eco-efficiency indicators, (i.e. composite figures incorporating other key metrics such as turnover, product throughput or employee numbers) which were used by 7 per cent of reporters – and absolute data (used by 32 per cent), with 40 per cent using both absolute and relative emissions data (and 21 per cent reporting no emissions data).

A little over half (51 per cent) of reporters made commitments to reduce emissions, but CorporateRegister.com distinguished between those setting broad objectives (14 per cent) compared to those setting so-called “SMART” (specific, measurable, achievable, realistic, time-scaled) targets (37 per cent.) The study built on its distinction between relative (eco-efficiency) and absolute emissions data when it comes to target-setting, observing that “SMART targets for absolute emissions are the more challenging commitment: depending on the parameters used, a given company performance might meet a *relative* emissions target while breaching an *absolute* one.”

The Ethical Corporation Institute study reports similar findings that add different dimensions to the picture. This study finds 62 per cent of FT500 companies having set carbon emissions reduction targets, a slightly higher percentage than the CorporateRegister.com study. The Ethical Corporation Institute study focuses on CDP5 responses by FT500 companies instead of their CR reports, which may explain the difference. Interestingly, the study identifies 34 different public protocols or guidelines being used by the surveyed companies to report their emissions.²²²

The GRI-KPMG report examined a much smaller subset of the FT500, a tenth of the universe (50 companies), drawn from diverse sectors and regions.²²³ The study

²¹⁹ Interview with Matthew Kiernan, 31 August 2007. See also Climate Disclosure Leadership Index (CDLI) <http://www.cdproject.net/climateleaders.asp?menu=3andsubmenu=7>. Visited 22 August 2008.

²²⁰ Wayman M (2008). *The Corporate Climate Communications Report 2007: A study of climate change disclosures by the Global FT500*. CorporateRegister.com. February. http://www.corporateregister.com/pdf/CCCRReport_07.pdf.

²²¹ Ibid.

²²² Ethical Corporation Institute (2008). Only 62 per cent of the FT 500 companies reporting emissions have carbon reduction targets. *CSRwire.com*. 2 July. <http://www.csrwire.com/News/12547.html>.

²²³ Global Reporting Initiative and KPMG Global Sustainability Services (2007). *Reporting the Business Implications of Climate Change in Sustainability Reports*. 17 July. http://www.globalreporting.org/NR/rdonlyres/C451A32E-A046-493B-9C62-7020325F1E54/0/ClimateChange_GRI_KPMG07.pdf.

found all the surveyed companies addressing climate change in their 2005 CR reports, but focused more on upside opportunities (such as carbon trading) while largely ignoring financial risks such as threat of climate-related class-action law suits or business disruptions caused by climate-related extreme weather events, for example flooding, storms and droughts. “In general, companies did not quantify the financial implications of risks or opportunities, with the exceptions of some reporting on savings from reductions in energy use and emissions, and the purchase or sale of carbon credits,” the GRI-KPMG report stated.

G. CR reporting “sustainability context”

The GRI G3 Guidelines unveiled in 2006 included a new reporting principle, “sustainability context,” whereby a “report should present the organization’s performance in the wider context of sustainability”. In other words, companies cannot examine their corporate responsibility performance in isolation, but rather must analyse how their actions advance or hinder the broader societal achievement of sustainable development. “For example, this could mean that in addition to reporting on trends in eco-efficiency, an organization might also present its absolute pollution loading in relation to the capacity of the regional ecosystem to absorb the pollutant”, the guidelines state.²²⁴

The 2008 GRI/SustainAbility/KPMG *Count Me In* study reports that CR report readers “want to understand the reporter’s direct and indirect sustainability footprint”, but are not necessarily getting the sustainability context needed for understanding.²²⁵ “It is reasonable for readers to assume that any organization that takes the trouble to issue a sustainability report aims to demonstrate its performance in meeting the goal of sustainability, but this remains largely undefined”, the report states in the “Commitment to Sustainability” section of the “Report Content” chapter. “It can be challenging to extrapolate the specific sustainability impacts associated with a particular reporter’s activities through a report”, it adds in the “Sustainability Impact” section of the chapter.²²⁶ In this light, the future of CR reporting rests largely on its ability to contextualize its real contribution to the future of people and the planet, to the achievement of social, environmental and economic sustainability.

III. Status of implementation of corporate responsibility reporting

A. Background and methodology

1. Corporate Responsibility Indicators

The purpose of this study is to evaluate the level of reporting on the corporate responsibility indicators identified in the 2008 UNCTAD publication *Guidance on Corporate Responsibility Indicators in Annual Reports* (based on the ISAR document TD/B/COM.2/ISAR/41). The guidance selected 16 core indicators that enterprises could use in reporting on corporate responsibility issues in annual reports. A summary of these selected indicators can be found in table 2 below.

²²⁴ Global Reporting Initiative, G3 Sustainability Reporting Guidelines, Version 3.0, 17 August 2006 http://www.globalreporting.org/NR/rdonlyres/ED9E9B36-AB54-4DE1-BFF2-5F735235CA44/0/G3_GuidelinesENU.pdf.

²²⁵ Bartels W, Iansen-Rogers J, Kuszewski J (2008). *Count me in: The readers’ take on sustainability reporting*, Global Reporting Initiative, KPMG, and SustainAbility. 22 May. <http://www.globalreporting.org/NR/rdonlyres/3F57ACC8-60D0-48F0-AF28-527F85A2A4B4/0/CountMeIn.pdf>.

²²⁶ Ibid.

Table 2. Selected indicators on corporate responsibility

| Group | Indicator |
|---|---|
| Trade, investment and linkages | 1. Total revenues 2. Value of imports vs. exports 3. Total new investments 4. Local purchasing |
| Employment creation and labour practices | 5. Total workforce with breakdown by employment type, employment contract and gender 6. Employee wages and benefits with breakdown by employment type and gender 7. Total number and rate of employee turnover broken down by gender 8. Percentage of employees covered by collective agreements |
| Technology and human resource development | 9. Expenditure on research and development 10. Average hours of training per year per employee broken down by employee category 11. Expenditure on employee training per year per employee broken down by employee category |
| Health and safety | 12. Cost of employee health and safety 13. Work days lost due to occupational accidents, injuries and illness |
| Government and community contributions | 14. Payments to Government 15. Voluntary contributions to civil society |
| Corruption | 16. Number of convictions for violations of corruption related laws or regulations and amount of fines paid/payable |

Environmental issues are recognized as an important feature of corporate responsibility, so in addition to the aforementioned indicators, the study also included the indicators on eco-efficiency found in the 2004 UNCTAD manual *Eco-Efficiency Indicators* (UNCTAD/ITE/IPC/2003/7).²²⁷ The selected indicators can be found in table 3 below.

Table 3. Eco-efficiency indicators

| Indicators | |
|------------|--|
| 1. | Water consumption |
| 2. | Global warming contribution |
| 3. | Energy use |
| 4. | Dependency on ozone-depleting substances |
| 5. | Waste generated |
| 6. | Material efficiency |

2. Sample selection

In total, 22 indicators were tested against the actual reporting practices of 100 leading enterprises from 10 emerging markets. The sample used in this study is comprised of 10 of the top enterprises²²⁸ from each of the top 10 most heavily weighted United Nations member States found in the Emerging Markets Index produced by

²²⁷ The indicator “Material efficiency” was not derived from the manual *Eco-Efficiency Indicators*, but was added as an indicator of how enterprises contribute to the conservation of global resources, by means of recycling of materials and/or innovations in the area of scarce resource usage.

²²⁸ Note that in some countries, some of the top 10 enterprises by index weighting were related enterprises. This study sought to avoid reviewing the reporting practices of different entities within the same industrial conglomerate, and for this reason the “selected top 10” described in this paper may not correspond exactly with the top 10 by index weighting for each country; in some cases, the selected top 10 enterprises consist of 10 enterprises selected from among the top 15 largest enterprises by index weighting.

Morgan Stanley Capital International (MSCI EM Index).²²⁹ The current MSCI EM Index tracks more than 900 publicly listed enterprises, which account for roughly 85 per cent of the market capitalization of 25 emerging markets.²³⁰ Table 4 below provides a list of the economies included in the MSCI EM Index.

Table 4. The 25 economies included in the MSCI EM Index

| | |
|------------------------------|------------------------|
| 1. Argentina | 14. Republic of Korea |
| 2. Brazil | 15. Malaysia |
| 3. Chile | 16. Mexico |
| 4. China | 17. Morocco |
| 5. Taiwan, Province of China | 18. Pakistan |
| 6. Colombia | 19. Peru |
| 7. Czech Republic | 20. Philippines |
| 8. Egypt | 21. Poland |
| 9. Hungary | 22. Russian Federation |
| 10. India | 23. South Africa |
| 11. Indonesia | 24. Thailand |
| 12. Israel | 25. Turkey |
| 13. Jordan | |

The top 10 United Nations member States, by index weighting, within the MSCI EM Index are listed in table 5 below, along with their total index weighting. In addition, table 5 shows the weighting of the top 10 enterprises selected for this study. The top 10 enterprises from each country account for between 45 per cent and 84 per cent of their respective country's index weighting. These enterprises were selected on the basis of their economic significance within their home countries, and as samples of leading companies in each country. As a group, the 100 enterprises from emerging markets represent 46.5 per cent of the market capitalization of the entire MSCI EM Index. Thus, as a group, this sample represents a large portion of the investable universe of emerging market enterprises. A complete list of enterprises included in the study is found in the annex.

Table 5. Top 10 United Nations member States included in the MSCI EM Index, by index weighting²³¹

| Country | Index weighting of country (per cent) | Number of companies from this country in the index | Selected top 10 companies as a percentage of country weighting | Selected top 10 companies as a percentage of index total market capitalization |
|--------------------|---------------------------------------|--|--|--|
| Brazil | 14.9 | 72 | 50 | 7.5 |
| China | 14.2 | 112 | 56 | 8.0 |
| Republic of Korea | 13.2 | 114 | 45 | 6.0 |
| Russian Federation | 10.0 | 32 | 82 | 8.2 |
| India | 7.2 | 67 | 52 | 3.7 |
| South Africa | 6.7 | 50 | 63 | 4.2 |
| Mexico | 4.8 | 28 | 84 | 4.0 |
| Israel | 2.4 | 32 | 84 | 2.0 |
| Malaysia | 2.4 | 57 | 59 | 1.4 |
| Indonesia | 1.7 | 22 | 83 | 1.4 |
| Total | 77.4 | | | 46.5 |

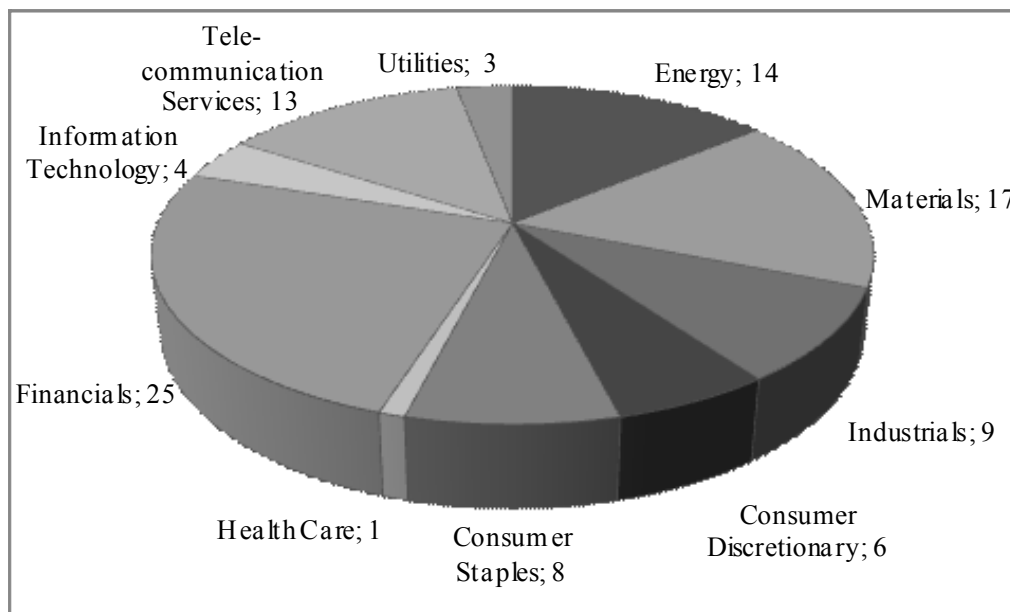
²²⁹ MSCI is a commercial provider of financial information, including equity indices tracking publicly listed enterprises around the world. The MSCI EM Index is considered by institutional investors to be the industry standard to gauge emerging markets performance, and is an important tool for facilitating foreign portfolio investment to developing countries and countries with economies in transition.

²³⁰ All MSCI EM Index data used in this study is based on the index as of 12 March 2008, unless otherwise indicated.

²³¹ This study focuses on the disclosure practices of United Nations member States; if all markets were included, then Taiwan Province of China, which makes up 11.3 per cent of the MSCI EM Index, would have been included.

The enterprises included in the study represent a wide range of industries. The distribution of the 100 enterprises by sector is displayed in figure 1 below.

Figure 1. Distribution of the 100 enterprises by sector²³²
(number of companies)



3. Sources of information

The purpose of the 2008 UNCTAD publication *Guidance on Corporate Responsibility Indicators in Annual Reports* is to assist preparers of enterprise reporting in producing concise and comparable corporate responsibility indicators within their annual reports. In that light, the review of corporate responsibility was based primarily on annual financial reports, the main focus of the guidance. If not all information on the selected indicators was disclosed in the annual financial reports, separate corporate responsibility reports and information provided on company websites were examined consecutively.

The guidance focuses on reporting on a nationally consolidated basis for the information to be useful to stakeholders within the context of a specific country. The study determined the level of reporting on the selected indicators by reviewing corporate reporting on a consolidated basis for 2007. When information for 2007 was not yet available, 2006 reporting was examined.

4. Research method

The various sources of corporate reporting were examined for the presence of quantitative information on the selected indicators, as described in the *Guidance on Corporate Responsibility Indicators in Annual Reports*. Qualitative or descriptive information was not considered, except as described below.

The study also examined the location of corporate responsibility information. A distinction was made between enterprises that report information in a specific section of the annual report (without a separate corporate responsibility report), enterprises that publish a separate report, and enterprises that disclose corporate responsibility information only on the company website. The nature of the information (quantitative or qualitative) was not taken into account in determining the various locations.

Finally, the corporate reporting of the sample was examined for references to the GRI and the United Nations Global Compact. The study distinguished between general references to the GRI or the Global Compact, and the use of more detailed tools such as a GRI index (a complete reference to GRI disclosures in a company report) and

²³² Based on Global Industry Classification Standard (GICS) as of 29 August 2008. Source: www.msicbarra.com.

a Global Compact progress report (a concise yet standardized means of reporting progress on each of the Global Compact's 10 principles).

B. Reporting practices of 100 emerging market enterprises

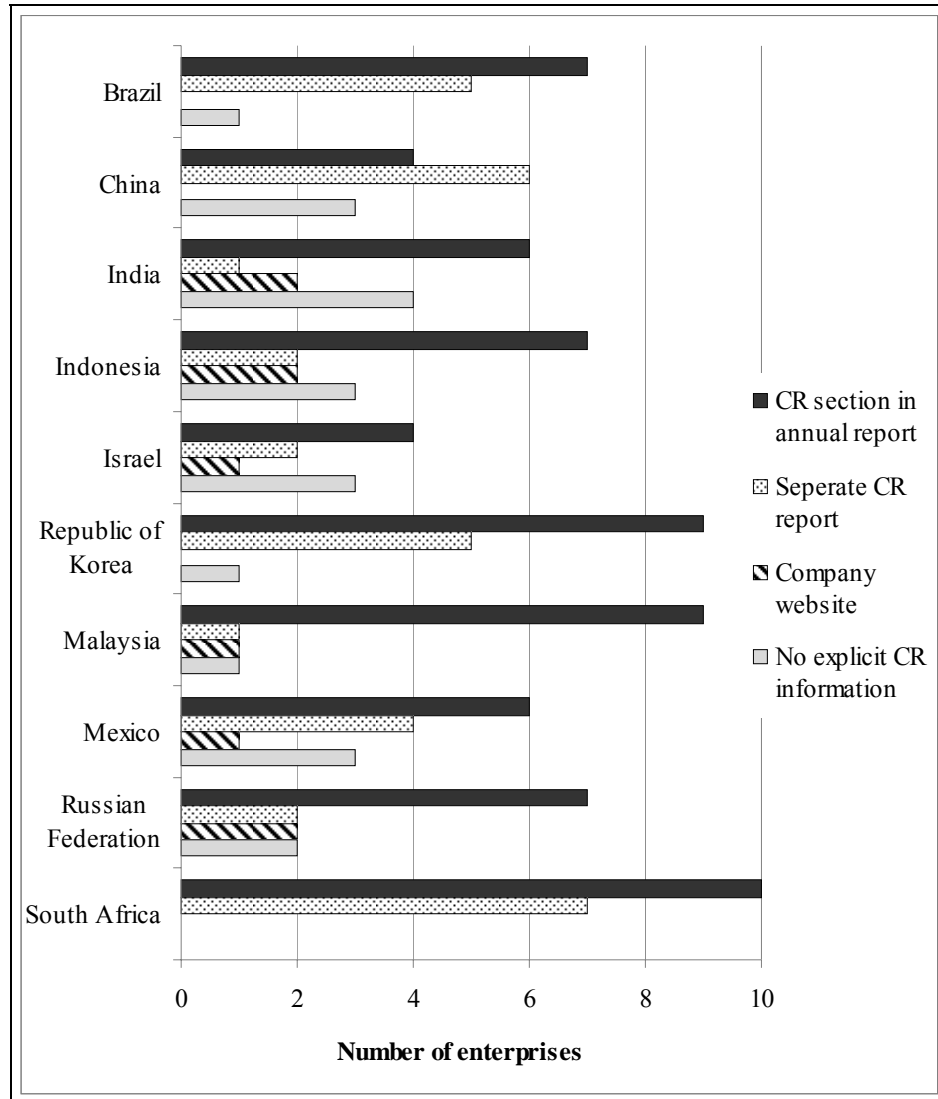
This section discusses the main findings of the study, and is divided into “Reporting context: location of corporate responsibility disclosures” and “Reporting practice: prevalence of corporate responsibility indicators”.

1. Reporting context: location of corporate responsibility disclosures

In order to better understand the overall rate of corporate responsibility reporting as well as the location of that reporting, figure 2 below provides an overview per country of the location of corporate responsibility information, along with the number of top 10 enterprises disclosing information in those locations. In addition, the figure also displays per country the number of top 10 enterprises that do not explicitly disclose corporate responsibility information; “explicit” disclosure in this context means information that is distinctly presented as “corporate responsibility” or “sustainability” information in a recognized portion of the annual report, website or other company publication.

Figure 2 displays three possible locations for corporate responsibility information. The first is a specific section of the annual report dedicated to corporate responsibility. This section was defined as a distinct part of the annual report focusing explicitly on corporate responsibility-related topics, regardless of the number of pages in use. The reviewed enterprises used various headings for these sections, such as Environment, Health and Safety; Corporate Social Responsibility; and Green Management and Sustainable Development. The other two possible locations are a separate corporate responsibility report and the company website. The nature of the corporate responsibility information (quantitative or qualitative) was not taken into account in determining the various locations.

Of the 100 examined enterprises, 97 had an annual report available. Of these 97, 69 dedicated a specific section of the annual report to corporate responsibility issues. Separate reports were published by 35 enterprises, and 28 of those also included the information in the annual report. Finally, 9 enterprises disclosed their CR information solely on the company website. In summary, 85 of 100 enterprises disclosed some kind of corporate responsibility information. Simultaneously, 15 enterprises did not explicitly disclose their corporate responsibility information in a distinct location, but scattered CR-related information over a number of locations, including financial statements.

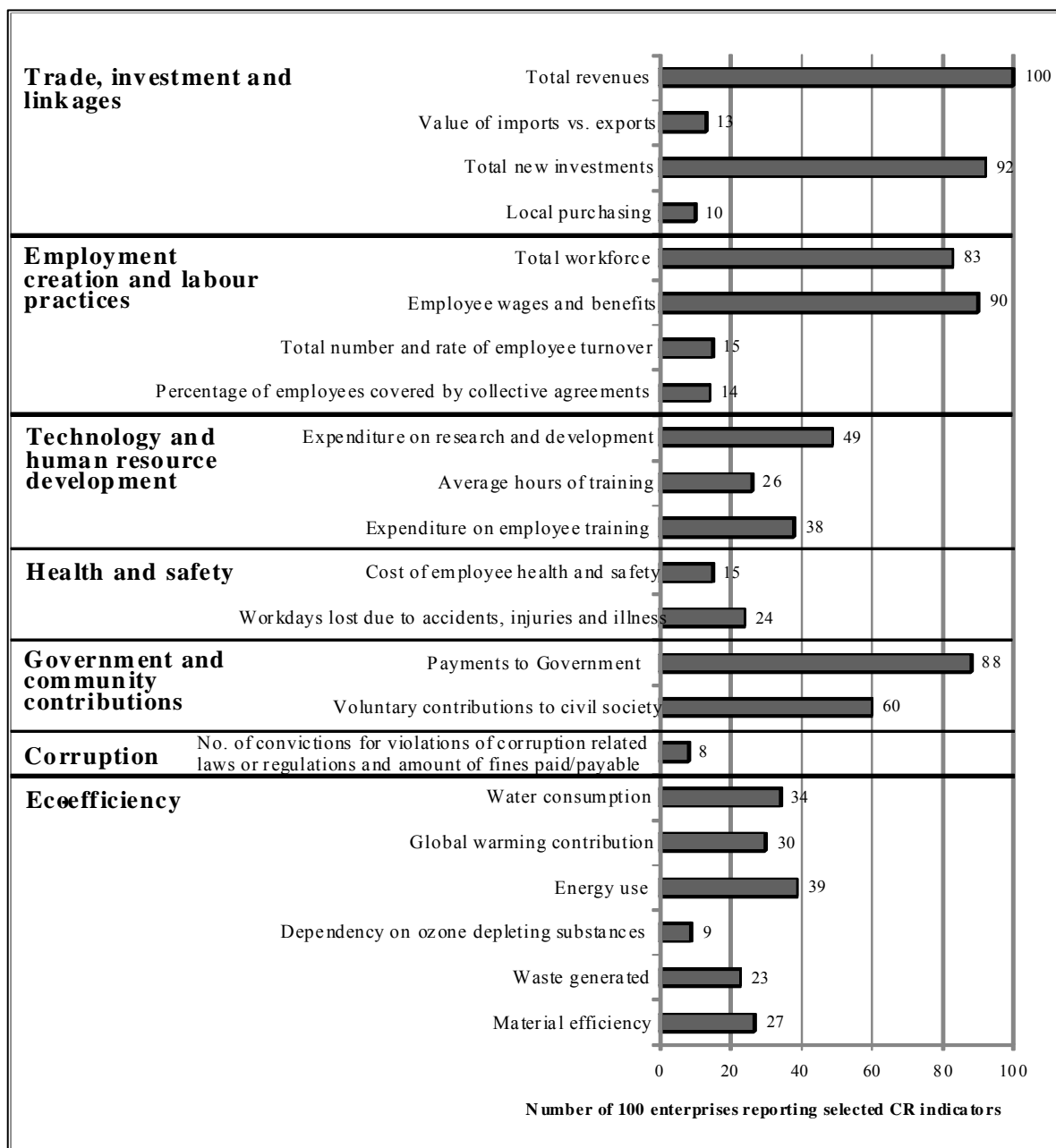
Figure 2. Number of top 10 enterprises reporting CR information and the location of that information

On a per-country level, the studied sample is relatively small, so any inferences should be made cautiously. However, since the sample includes 10 of the largest enterprises per country, and larger enterprises tend to be more advanced in corporate reporting than smaller enterprises, some generally useful observations could be made. For example, all 10 of the selected enterprises from South Africa are reporting on CR issues in their annual reports, with 7 enterprises also publishing a separate CR report. In comparison, only four of the 10 selected enterprises from Israel are providing information on corporate responsibility in their annual report.

2. Reporting practice: prevalence of corporate responsibility indicators

The main findings on the prevalence of the selected indicators are displayed in figure 3 below. Figure 3 provides an overview of the number of enterprises that disclose quantitative information on each of the 22 CR and eco-efficiency indicators described above (see tables 2 and 3).

Figure 3. Reporting of ISAR indicators among 100 emerging market enterprises



The most and least prevalent disclosures from figure 3 are summarized in table 6 below. “Total revenues” is subject to the highest level of disclosure, with all of the enterprises disclosing information. This outcome is not unexpected, given the nearly universal reporting of financial and operating results. The same is applicable for “Total new investments” and “Employee wages and benefits” (with respectively 92 and 90 enterprises disclosing quantitative information). With current income tax as part of the required disclosures, the indicator “Payments to Government” is disclosed by 88 enterprises. The indicator “Total workforce” completes the top five with a disclosure rate of 83.

Table 6. Most and least prevalent disclosure on indicators

| Top 5 most prevalent disclosure items among 100 emerging market enterprises | Disclosure rate | Bottom 5 least prevalent disclosure items among all 100 emerging market enterprises | Disclosure rate |
|---|-----------------|---|-----------------|
| Total revenues | 100 | Total number and rate of employee turnover/Cost of employee health and safety | 15 |
| Total new investments | 92 | Percentage of employees covered by collective agreements | 14 |
| Employee wages and benefits | 90 | Value of imports vs. exports | 13 |
| Payments to Government | 88 | Local purchasing | 10 |
| Total workforce | 83 | Corruption | 8 |

A large discrepancy exists between the disclosure rates of the five most and least prevalent disclosed indicators. “Total number and rate of employee turnover” is only reported by 15 out of 100 enterprises. Two of the four indicators from the group “Employment creation and labour practices” are part of the bottom five least prevalent disclosures, namely “Cost of employee health and safety” and “Percentage of employees covered by collective agreements” (with a disclosure rate of 15 and 14, respectively). This outcome is noteworthy, considering that another indicator from this group (“Total workforce”) is one of the most prevalent disclosure items. The two least disclosed indicators are “Local purchasing” and “Corruption”, with a disclosure rate of 10 and 8, respectively.

A comparison between the five most and least prevalent disclosures suggests that the most reported indicators are likely to already be disclosed in the conventional corporate reports, while the relatively new non-financial performance indicators clearly display a much lower disclosure rate.

C. Reporting practices by group

1. Trade, investment and linkages

Figure 4 indicates that all 100 enterprises disclosed quantitative information on “Total revenues”, and that 86 enterprises also included some form of segmental breakdown, as encouraged by the *Guidance on Corporate Responsibility Indicators in Annual Reports*. In addition, 25 enterprises provided a statement of added value, mostly as part of the financial statements (not shown in figure 4). Value added in enterprises is measured by the difference between the revenue from the goods and services produced and the cost of goods and services brought in. Brazil was the most prevalent in disclosure of value added, with 7 of the 10 largest enterprises of that country providing a statement.

The value of an enterprise’s exports in relation to its imports is an indicator of the contribution of an enterprise to the balance of payments of the country in which it operates. As displayed in figure 4, 13 enterprises disclosed quantitative information on both imports and exports. Five of these enterprises belonged to the 10 largest enterprises from India. Twelve enterprises reported only on export, and one enterprise reported solely on import. In total, 25 enterprises provided information on exports and 14 enterprises provided information on imports.

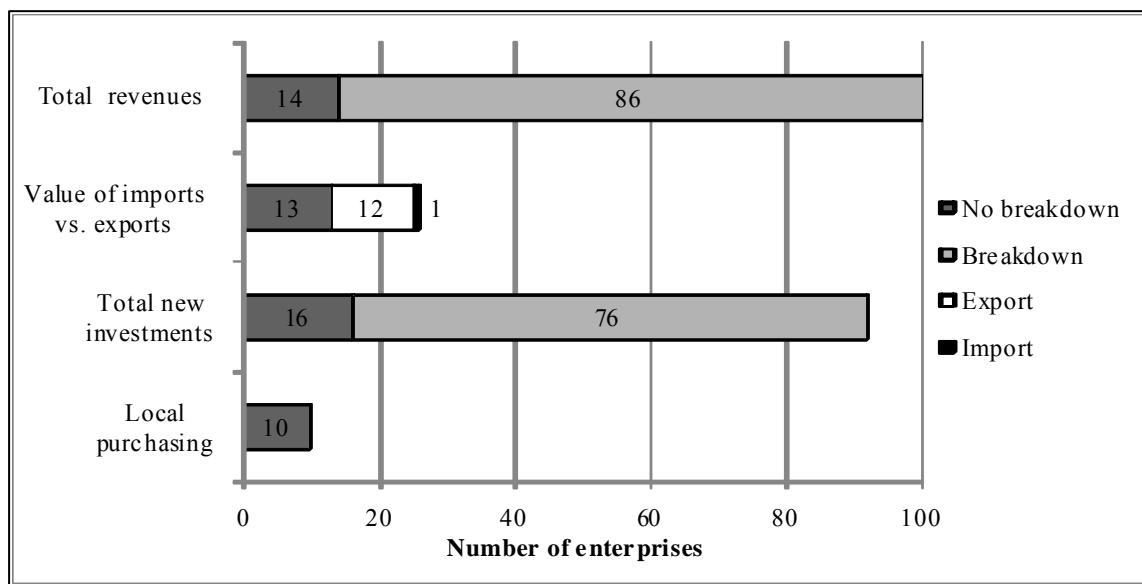
After “Total revenues”, the most reported indicator in the category “Trade, investment and linkages” was “Total new investments”. New investments by enterprises can have a positive economic and social impact, as these can lead to the development of productive capacity and the reduction of poverty in host developing countries. The indicator was reported by 92 of the enterprises in the study. South Africa was most prevalent in the disclosure of this indicator, with four of the 10 largest companies of

that country reporting quantitative information. In contrast, the reviewed enterprises from Israel, the Republic of Korea and Malaysia did not disclose any quantitative information on this subject.

The costs of local purchasing are a general indicator of the extent of an enterprise’s linkages with local economy, and this indicator was only disclosed by 10 enterprises. More enterprises provided descriptive information, often emphasizing the importance of a good relationship with (local) suppliers and of supplier education. Sixty per cent of the disclosed information was made by enterprises in the “Materials” industry (an industry sector containing chemicals and metal and mining companies, among others).

The level of reporting on the corporate responsibility indicators from the group “Trade, investment and linkages” appears to be ambiguous. Two of the four indicators in this group appear in the top five most prevalent disclosure items, while the other two are part of the five least prevalent disclosed indicators. The two indicators, “Total revenues” and “Total new investments”, are often disclosed in the traditional reports on financial and operating results, while the two indicators that reflect the enterprises contribution to the economic development of host countries – namely “Value of imports vs. exports” and “Local purchasing” – are clearly the subject of less disclosure.

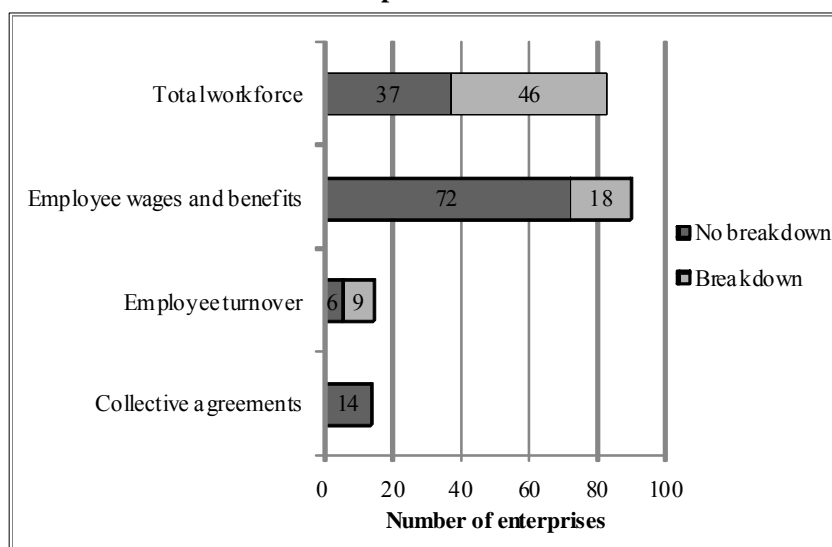
Figure 4. Number of enterprises reporting on trade, investment and linkages indicators²³³



²³³ The study did not include a breakdown for the indicator “Local purchasing”.

2. Employment creation and labour practices

Figure 5. Number of enterprises reporting on employment creation and labour practices indicators²³⁴



One of the most significant positive economic and social contributions an enterprise can make to the country in which it operates comes through the creation of jobs. As displayed in figure 5, 83 enterprises stated the total number of their employees; of these, more than half (46) provided some form of breakdown (e.g. gender, employment type, country).

“Employee wages and benefits” is one of the five most prevalent indicators. In total, 90 enterprises disclosed information on the amount of employee wages and/or other benefits. Of those enterprises, 18 reported some type of breakdown. Most enterprises reported at least information on expenditures on post-employment benefits (such as pensions) in their financial statements, explaining the high disclosure rate.

Workforce turnover rates can reflect the job security of employees and the employment practices of an enterprise, but the indicator was only disclosed by 15 of 100 enterprises. More than half of these enterprises (9 of 15) did state a type of breakdown, such as gender or reason of departure.

The indicator “Percentage of employees covered by collective agreements” refers to the collective bargaining agreements signed by the reporting enterprise or employer organizations of which it is a member. Collective bargaining is recognized as an effective private means for increasing the positive social impact of business activity. The indicator is disclosed by merely 14 enterprises, with 5 of these disclosures made by enterprises from the “Materials” industry sector.

The level of disclosure in the group “Employment creation and labour practices” varies widely between the two more traditional indicators (“Total workforce” and “Employee wages and benefits”) and the two relatively new indicators (“Employee turnover” and “Percentage of employees covered by collective agreements”). This conclusion is similar to the one stated earlier regarding the indicators from the group “Trade, investment and linkages”.

²³⁴ The study did not include a breakdown for the indicator “Percentage of employees covered by collective agreements”.

3. Technology and human resource development

Figure 6. Number of enterprises reporting on technology and human resource development²³⁵

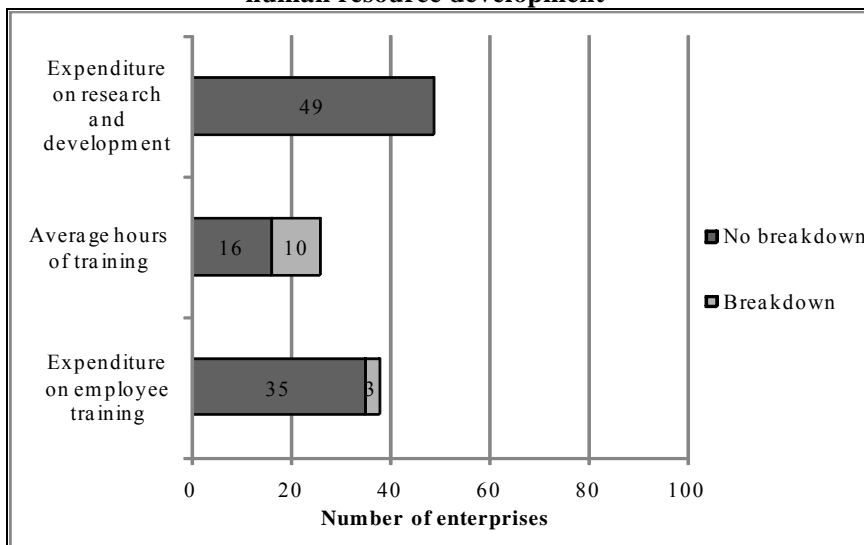


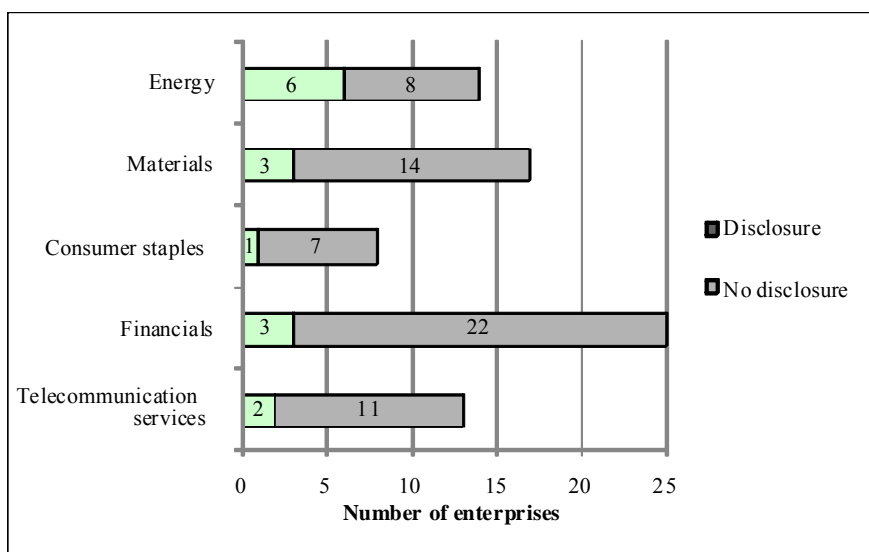
Figure 6 displays the number of enterprises that disclose information on each of the three indicators from the group “Technology and human resource development”. The figure indicates that 49 enterprises reported their total expenditure on research and/or development.

Enterprises can contribute to the capacity for innovation of local communities by enabling employees to develop their skills. The Guidance on Corporate Responsibility Indicators in Annual Reports distinguishes two different ways to measure employee training: by average hours of training per employee and by expenditure on training per employee.

In total, 26 enterprises stated the average hours of training per year, and 10 of these enterprises provided a breakdown by, for example, employment category. The expenditure on employee training is disclosed by more enterprises, namely 38. However, only 3 of these enterprises provide an additional breakdown of the costs. Out of 100 enterprises, 15 reported on both the average hours and the expenditure on employee training.

4. Health and safety

Figure 7. Disclosure on cost of employee health and safety by industry



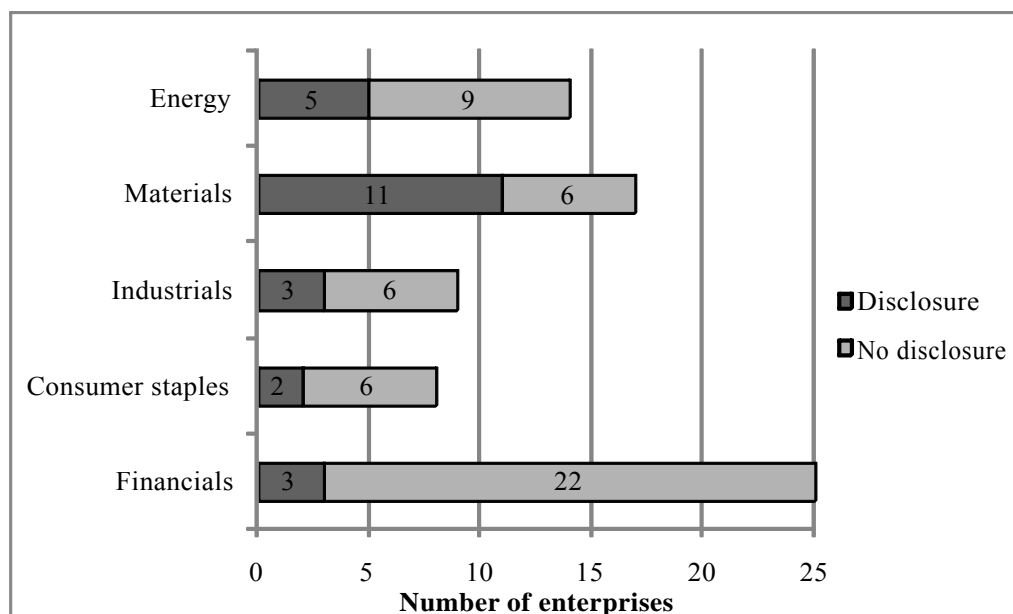
In total, 15 enterprises reported the company's cost of occupational safety and health-related insurance programmes (when such programmes existed). Figure 7 displays the division of these 15 enterprises among the various industry sectors. While caution should be applied before drawing any conclusions from this data due to small sample sizes, the data nevertheless can be seen as suggestive of practices among large enterprises in emerging markets.

In relative terms, the majority of the disclosures were made by enterprises from two typically hazardous sectors, namely "Energy" (a sector including enterprises involved in oil and gas drilling, exploration, refining and transportation) and "Materials" (a sector containing chemicals and metal and mining companies, among others). In total, nine enterprises from these sectors reported on health and safety issues. However, relative to the total number of enterprises from these sectors, a considerable portion of the sample of enterprises did not disclose any information, as shown in figure 7. The same is applicable for the disclosure rate of the other sectors.

The number of workdays lost due to occupational accidents, injuries and illness can reflect the degree to which enterprises contribute to creating a healthy, safe and productive environment. As depicted earlier in figure 3, the indicator is disclosed by 24 enterprises. Figure 8 below displays the division of these 24 enterprises among the various industry sectors. Again, caution should be applied when drawing conclusions from this small sample.

As seen in figure 8, enterprises in the "Materials" sector were responsible for the majority of the disclosures on work days lost, both in absolute and in relative terms. The sectors "Energy" and "Industrials" also had a relatively high disclosure rate. The "Industrials" sector includes, among others, enterprises engaged in construction and engineering and machinery, and could be, given the nature of the sector, more susceptible to occupational accidents. The same is applicable for enterprises in the "Energy" sector.

Figure 8. Disclosure on workdays lost by industry



5. Government and community contributions

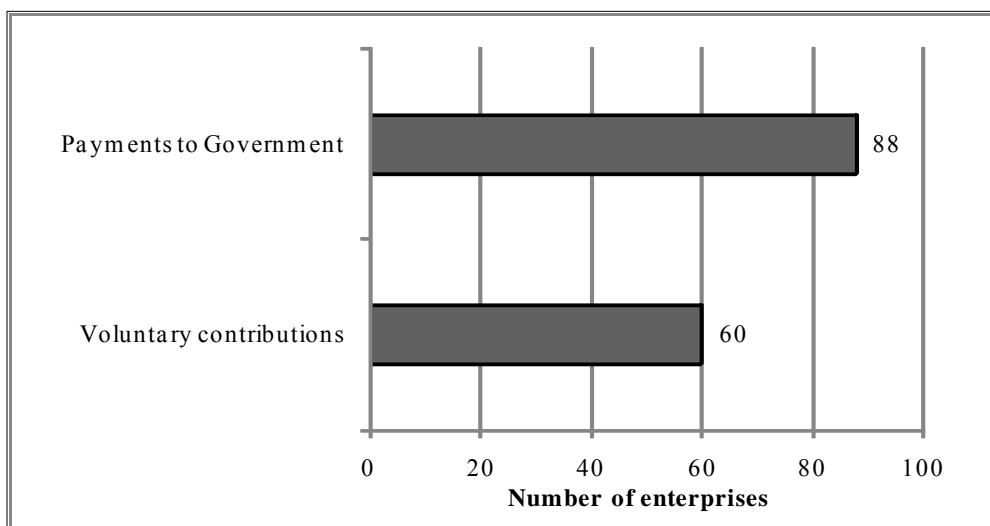
The indicator "Payments to Government" was reported by 88 out of 100 enterprises in the study, as presented in figure 9. Enterprises can contribute to government finances in the form of taxes, royalties, licence fees, and other payments to

²³⁵ The study did not include a breakdown for "Expenditure on research and development".

the Government. The study did not make a distinction between the different kinds of contributions, but most enterprises at least disclosed information on current tax.

Voluntary contributions are charitable donations and investments of funds in the broader community, where the target beneficiaries are external to the company. The total amount reported should account for the actual expenditures in the reporting period, not commitments. In total, 60 enterprises disclosed quantitative information on the indicator but even more enterprises presented descriptive information on various environmental and social programmes.

Figure 9. Number of enterprises reporting on government and community contributions

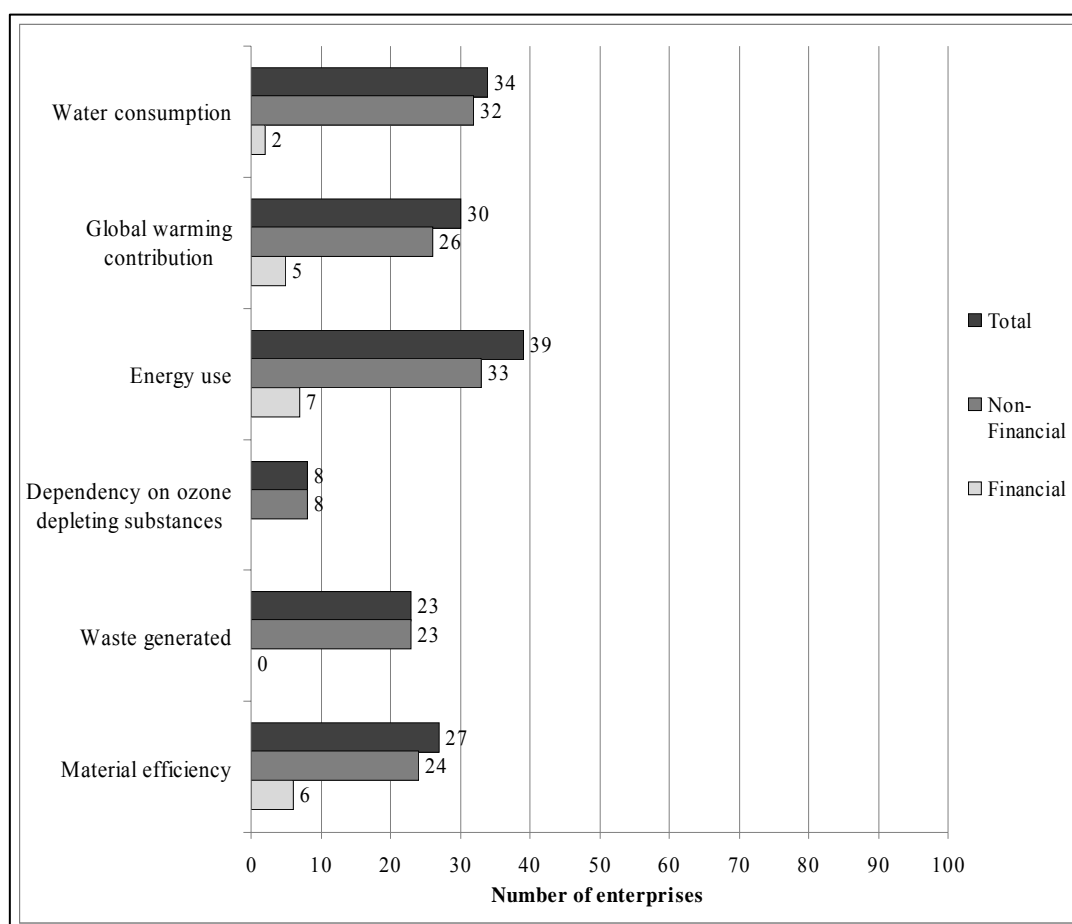


6. Corruption

Corruption is internationally recognized as an obstacle to economic development and a hindrance to international trade and investment. Enterprises can make a positive contribution to respect for anti-corruption laws and international norms by ensuring that they are not involved in corruption. A basic measurable performance indicator in this regard is the number of legal infractions a company incurs as a result of corrupt practices. As displayed in figure 3 and table 6, “Corruption” is the least prevalent indicator, with only eight enterprises disclosing quantitative information on this subject. In most of the cases, the reported information included the total number of cases with a description of the type of corruption and the resulting (legal) action. Descriptive information on corruption prevention was not taken into account.

7. Eco-efficiency

Figure 10. Number of enterprises reporting on eco-efficiency



The Guidance on Corporate Responsibility Indicators in Annual Reports does not focus on environmental issues, as ISAR previously conducted extensive work in this area, including the 2003 UNCTAD manual Eco-Efficiency Indicators. Since environmental issues are recognized as an important feature of corporate responsibility, six eco-efficiency indicators were included in the study (see table 3).

Figure 10 above displays the number of enterprises that disclose quantitative information on each of the selected eco-efficiency indicators. The study also distinguished between financial and non-financial disclosures. Financial information on eco-efficiency indicators was defined as information reported in monetary units, while non-financial information was defined as information in physical units (such as litres, kilojoules and cubic meters). Enterprises can disclose both financial and non-financial information on one single indicator, so the total number of enterprises in figure 10 is not necessarily the sum of the financial and non-financial disclosures.

“Energy use” is the most prevalent indicator, with 39 enterprises disclosing information on this subject. Most of the 39 enterprises reported non-financial information, but 7 enterprises also included financial information. Non-financial information on the consumption of water is disclosed by 32 enterprises, and financial information was disclosed by two enterprises.

The least disclosed indicator was “Dependency on ozone-depleting substances”. Ozone-depleting substances are chemicals/substances that are controlled under the Montreal Protocol. The dependency is defined as production plus purchases and stocks of those substances. This indicator is only disclosed by nine enterprises, with four from the “Energy” industry sector. For all eco-efficiency indicators, it was found that non-financial disclosures are more frequently used than financial disclosures.

The focus of environmental disclosures seems to have shifted towards global warming contributions. This indicator, reported by 30 of the 100 companies in the study, is momentarily a high profile global issue, and can be expected to receive much more attention in corporate responsibility reporting going forward.

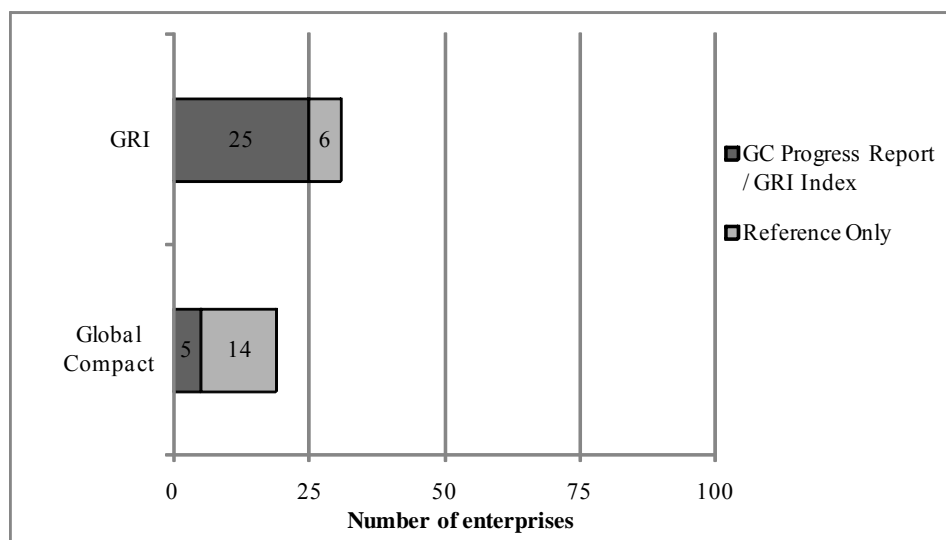
D. Reference to GRI and Global Compact in company reports

The Global Reporting Initiative has developed the world’s most widely used sustainability reporting framework; indeed, the GRI framework is cited in UNCTAD’s Guidance on Corporate Responsibility Indicators in Annual Reports as a source for 5 of the 16 indicators. The cornerstone of the GRI reporting framework is the Sustainability Reporting Guidelines. In 2006, the third and most recent version of the Guidelines (know as the “G3 Guidelines”) was published. To date, more than 1,500 companies, including many of the world’s leading brands, have declared their voluntary adoption of the GRI guidelines worldwide.²³⁶

The United Nations Global Compact is the largest corporate citizen initiative in the world. It is a voluntary initiative for businesses and other organizations that are committed to aligning their operations and strategies with 10 universally accepted principles in the areas of human rights, labour, environment and anti-corruption. By doing so, business can help ensure that markets, commerce, technology and finance advance in ways that benefit economies and societies everywhere. To date, the Global Compact has over 5,500 corporate participants and stakeholders from over 130 countries.²³⁷

Given the significance of these two initiatives to corporate responsibility reporting, this study also tracked the number of references to the Global Reporting Initiative and/or the Global Compact in reporting among the 100 enterprises in the study. As shown in figure 11 below, a total of 31 enterprises referred to GRI indicators and 25 of those enterprises used the GRI index. Regarding the Global Compact, 19 enterprises referred to support for the Global Compact, and 5 enterprises used a Global Compact communication on progress.

Figure 11. Reference to GRI and Global Compact among 100 emerging market enterprises



The Global Compact recognizes a CR report based on GRI indicators as meeting the requirements of a “Communication on Progress” (COP), but some companies choose to produce a COP in addition to a GRI based report, or in place of a GRI-based report. Four enterprises used both the GRI index and a Global Compact COP. Thirteen enterprises used the GRI index and made a reference to the Global Compact. This suggests that these companies used the GRI guidelines to meet the COP

²³⁶ Global Reporting Initiative, <http://www.globalreporting.org/>.

²³⁷ United Nations Global Compact, <http://www.unglobalcompact.org/>.

requirements from the Global Compact.²³⁸ Five enterprises had a reference to the Global Compact, but used neither a Global Compact progress report nor the GRI index. Two of the five enterprises also referred to the use of GRI indicators.

IV. Conclusions

This report is the second ISAR review of the reporting status of corporate responsibility indicators based on the indicators identified in the Guidance on Corporate Responsibility Indicators in Annual Reports (based on the ISAR document TD/B/COM.2/ISAR/41). The study has focused on the disclosure practices of 100 leading emerging market enterprises comprised of selected top 10 enterprises from the economies of the top 10 United Nations member States, by index weighting, found within the MSCI Emerging Markets Index. The leading enterprises of the MSCI EM Index were chosen as the sample for the study due to the economic significance of these enterprises within their economy and the influential role the MSCI EM Index plays in facilitating foreign portfolio investment towards developing economies and economies in transition.

The main findings of this study show that half the indicators recommended in UNCTAD's Guidance on Corporate Responsibility Indicators in Annual Reports are reported by 25 per cent or more of the enterprises in the study. A further three of five of the indicators recommended in UNCTAD's Eco-efficiency manual are also reported by 25 per cent or more of the emerging market enterprises in the study.

Additional analysis indicates that 25 per cent of the enterprises studied report according to the guidelines of the Global Reporting Initiative, while 5 per cent of the enterprises included a United Nations Global Compact COP report. In examining the location of CR reporting, the study found that 85 per cent of the enterprises studied had distinct reporting on CR information in their annual reports, in standalone CR reports, or on their company website. Of these three locations, a majority of companies in the study included a distinct section on CR information in their annual reports, while separate CR reports also remain quite common for enterprises reporting CR information.

The overall level of reporting on corporate responsibility appears to be ambiguous. A large discrepancy in disclosure rates exists between the most and least prevalent disclosures. Closer analysis reveals that the more prevalent indicators are typically those that are the same as traditionally found in financial reporting, while the indicators that display wider business impacts show a much lower disclosure rate of reporting. Furthermore, while distinct sections on CR information appear in the reports (annual or CR) of a majority of enterprises in this study, the use of specific reporting guidelines such as those of GRI or the United Nations Global Compact are used only by a minority of enterprises. This suggests that while awareness of corporate responsibility reporting appears common among leading emerging market enterprises, and some progress has been made in producing CR reports, there nevertheless remains room for improvement among enterprises in adopting international guidelines that might improve the comparability and relevance of reporting on this subject.

²³⁸ The Global Compact requires participating companies to produce, annually, a Communication on Progress (COP) in order to promote transparency and accountability, share corporate practices, and protect the integrity of the initiative (website *Global Compact*, http://www.unglobalcompact.org/COP/Review_Project.html).

Annex 1. List of enterprises in the study, by country

Brazil

- AMBEV PN
- BANCO BRADESCO PN
- BANCO ITAU HLDG FIN. PN
- CSN SIDERURGICA NAC'L ON
- GERDAU PN
- PETROBRAS PN
- TELE NORTE LESTE PART.PN
- UNIBANCO UNIT
- USIMINAS PNA
- VALE DO RIO DOCE PNA

China

- CHINA COMMUNIC CONSTRU-H
- CHINA CONSTRUCTION BK H
- CHINA LIFE INSURANCE H
- CHINA MOBILE
- CHINA PETRO and CHEM H
- CHINA SHENHUA ENERGY H
- CNOOC
- ICBC H
- PETROCHINA CO H
- PING AN INSURANCE H

India

- BHARAT HEAVY ELECTRICALS
- HDFC BANK
- HOUSING DEV FINANCE CORP
- ICICI BANK
- INFOSYS TECHNOLOGIES
- ITC
- LARSEN and TOUBRO
- OIL and NATURAL GAS CORP
- RELIANCE COMMUNICATION
- RELIANCE INDUSTRIES

Indonesia

- ASTRA INTERNATIONAL
- BANK CENTRAL ASIA
- BANK MANDIRI
- BANK RAKYAT INDONESIA
- BUMI RESOURCES
- INDOSAT
- INT'L NICKEL INDONESIA
- PERUSAHAAN GAS NEGARA
- TELEKOMUNIKASI INDONESIA
- UNITED TRACTORS

Israel

- BANK HAPOALIM
- BANK LEUMI LE-ISRAEL
- BEZEQ ISRAEL TELECOM.
- CHECK POINT SOFTW.
- ISRAEL CHEMICALS
- ISRAEL CORP
- MA MAKHTESHIM-AGAN IND
- NICE SYSTEMS
- PARTNER COMMUNICATIONS
- TEVA PHARMACEUTICAL IND

Republic of Korea

- HYUNDAI HEAVY INDUSTRIES
- HYUNDAI MOTOR CO
- KEPCO KOREA ELECT. POWER
- KOOKMIN BANK
- KTandG CORP(KOREA TOBACCO)
- LG ELECTRONICS
- POSCO
- SAMSUNG ELECTRONICS CO
- SHINHAN FINANCIAL GROUP
- SHINSEGAE CO

Malaysia

- BUMIPUTRA-COMMERCE HLDGS
- GENTING
- IOI CORP
- KUALA LUMPUR KEPONG
- MALAYAN BANKING
- MISC FGN
- PUBLIC BANK FGN
- SIME DARBY
- TELEKOM MALAYSIA
- TENAGA NASIONAL

Mexico

- AMERICA MOVIL L
- CEMEX CPO
- EMPRESAS ICA
- FEMSA UNIT UBD
- GRUPO FIN BANORTE O
- GRUPO MEXICO B
- GRUPO TELEVISA CPO
- INDUSTRIAS PENOLES CP
- TELEFONOS MEXICO L
- WALMART MEXICO V

Russian Federation

- GAZPROM
- LUKOIL HOLDING
- MOBILE TELESYS
- NORILSK NICKEL
- NOVATEK GDR
- SBERBANK RUSSIA
- SURGUTNEFTEGAZ
- TATNEFT COMMON
- UNIFIED ENERGY
- VIMPELCOM

South Africa

- ANGLO PLATINUM
- ANGLOGOLD ASHANTI
- FIRSTRAND
- GOLD FIELDS
- IMPALA PLATINUM HOLDINGS
- MTN GROUP
- NASPERS N
- REMGRO
- SASOL
- STANDARD BANK GROUP

Chapter 10

2008 Review of the corporate responsibility performance of large emerging market enterprises

I. Introduction

Corporate environmental, social and governance (ESG) disclosure has been a focus of work for the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) for a number of years. At its twenty-fourth session, in 2007, ISAR reiterated the importance of corporate responsibility reporting for meeting the increasing information demands of various stakeholders. It acknowledged that concise, comparable and performance-oriented reports in that area added value for shareholders and other stakeholders, and promoted sustainable economic development. The group of experts also noted the increasing integration of social and environmental issues into the broader corporate governance framework. ISAR further agreed at its twenty-fourth session that UNCTAD should continue to coordinate its work on this subject with a range of organizations active in the area of corporate responsibility reporting, together with private and public sector stakeholders. It suggested that case studies on corporate responsibility reporting be conducted to provide practical feedback on the status of corporate responsibility reporting around the world.

This report presents a review of corporate responsibility practices among a sample of large emerging market enterprises, based on the corporate reports and other publicly available information of those companies. It was conducted in cooperation with Ethical Investment Research Services (EIRIS), a London-based not-for-profit provider of independent research into the social, environmental, governance and ethical performance of companies.²³⁹ EIRIS is a provider of ESG research for such equity indices as the FTSE4Good, which tracks companies trading on the London stock exchange that demonstrate good corporate responsibility practices, and the Johannesburg Stock Exchange's Social Responsibility Index, which tracks leading South African companies based on their ESG performance.

Corporate responsibility, often seen as the preserve of major companies in developed economies, is gaining ground in emerging markets. Initiatives such as the United Nations Global Compact, the United Nations Principles for Responsible Investment (PRI) and the Carbon Disclosure Project (CDP) are increasingly focusing on emerging markets as investors turn towards these markets. This paper provides the results of a study of 40 companies to analyse the state of corporate responsibility in emerging markets, using a subset of EIRIS' assessment methodology. Publicly available documents of 40 leading companies in 10 emerging markets were examined and each company was assessed against key environmental, social, and governance indicators, including board practice, bribery, human rights, labour practices in the supply chain, health and safety, environment, climate change, and biodiversity. This analysis illustrates how some of the largest companies from emerging markets are addressing ESG issues.

The sample selected for this study is comprised of the top four companies by market capitalization from each of the ten largest United Nations member States within Morgan Stanley Capital International's Emerging Markets Index (MSCI EM Index). This analysis is based on the research methods used by EIRIS, and serves to illustrate

²³⁹ This chapter was prepared and edited by the UNCTAD secretariat based on EIRIS research compiled by Sonia Wildash and Shohko Iwami, with thanks to Stephen Hine and Stephanie Maier.

how ESG analysts view corporate ESG performance, and provides an ESG assessment of some of the largest companies based in emerging markets. Section II provides additional background on the growth of ESG analysis in emerging markets. Section III provides a general methodology of the study, and is followed by three sections (IV–VI) which provide key findings of the study grouped by general subject area (environment, social and governance). Potential users of this data include regulators and investors who will be able to better understand the current state of corporate responsibility among large companies in emerging markets, and better understand current practices in analysing ESG performance.

II. Background on the growth of ESG analysis in emerging markets

Forces associated with globalization are driving the growing need to address corporate responsibility issues in companies around the world. As noted in UNCTAD's 2006 *World Investment Report*, the regional and global challenges to meet good practices in ESG management are increasingly affecting transnational corporations (TNCs) based in emerging markets.²⁴⁰ TNCs from developing countries and economies in transition are increasingly seeking to address issues of corporate responsibility. Looking at the United Nations Global Compact, for example, a voluntary initiative that companies can sign up to, approximately 55 per cent of signatories come from emerging markets.

Investors are among the key drivers of this trend. Even though emerging market investments typically account for a smaller portion of institutional investment portfolios, investor exposure to emerging markets is much larger than is implied by notional allocations, given the increasing operational exposure of developed world TNCs to emerging markets. Combining these opportunities with responsible investment provides a unique set of risks and opportunities for investors as evaluated in EIRIS' 2006 paper, *Broadening horizons for responsible investment – an analysis of 50 major emerging market companies*.²⁴¹ Developments in corporate responsibility in emerging markets may also create market opportunities from which knowledgeable investors can benefit, although emerging market volatility may need to diminish before ESG issues noticeably add to or subtract from shareholder value. Indeed, one of the first pension fund mandates to seek global emerging market equity strategies containing elements of ESG within its remit was announced in October 2007, when PGGM, the €88 billion Dutch healthcare pension fund, began a search for high-performing emerging markets equities managers that had ESG at the core of their strategy.²⁴²

Investors based in developing countries also express a strong interest in ESG issues. In 2004, the Brazilian Pension Fund Association (ABRAPP) launched a set of guidelines on responsible investment covering issues such as improving environmental care, labour practices and corporate transparency on ESG issues. ABRAPP encourages pension funds to take these guidelines into account when considering investments. The São Paulo Stock Exchange (Bovespa) also has a local sustainability index which tracks the corporate ESG performance of companies as well as their economic and financial performance.

Additionally, high-profile funds from both South Africa and Brazil, such as the South African Government Employees Pension Fund, and PREVI (the employee pension fund of the federal Banco do Brasil) have signed onto the United Nations Principles for Responsible Investment (PRI), joining over 50 other signatories from emerging markets totalling \$250 billion in assets under management. Countries such as Indonesia and Malaysia are also developing initiatives to improve corporate responsibility reporting, with the Indonesian Institute of Management Accountants

²⁴⁰ UNCTAD (2006). *World Investment Report*. Chapter VI, section D, "Corporate Social Responsibility and TNCs from Developing and Transition Economies".

²⁴¹ "Broadening horizons for responsible investment - an analysis of 50 major emerging market companies". <http://www.eiris.org/files/research%20publications/emergingmarketseep06.pdf>.

²⁴² Press release 22 October 2007: <http://www.mercer.com/pressrelease/details.htm?idContent=1285435>.

holding national sustainability awards and the Malaysian Government legislating mandatory corporate responsibility reports for listed companies.^{243, 244}

Such investor interest is expected to increase over time. A 2008 joint report by the International Finance Corporation (IFC) and the Economist Intelligence Unit survey shows that about 80 per cent of asset owners who currently do not integrate ESG policies in their emerging market investments expect to do so over the next three years.²⁴⁵ The complete report, to be published towards the end of 2008, will detail investment in emerging markets that is based on ESG factors. Investors are already demanding increased information from emerging markets companies on their ESG practices. Linking into this is the ongoing Emerging Markets Disclosure Initiative. This is an initiative launched in 2008 by the United States Sustainable Investment Research Analyst Network and the asset management firm Calvert to improve sustainability disclosure in emerging markets. So far, the project has conducted a study of the state of sustainability reporting among companies in several emerging markets, and has a sign-on statement for investors encouraging emerging market companies to improve sustainability reporting.²⁴⁶ As of May 2008, the sign-on statement has been endorsed by 28 global institutional investor signatories (representing \$960 billion in assets under management) and 15 affiliated supporters (non-governmental organizations (NGOs) and research organizations). The final stage of the project focuses on targeted outreach and engagement in order to promote disclosure by companies operating in Brazil, China, India, the Republic of Korea, the Russian Federation, South Africa, and Taiwan Province of China. A number of other reports on sustainability trends in emerging markets are due to be published this year from the World Resources Institute, IFC and Mercers.

Global corporate responsibility initiatives, such as the Global Compact, and the increasing interest from investors, emphasize the increasing importance of ESG issues for emerging markets companies and for this reason, shares of companies which embrace sustainability may be more sought after, leading to higher valuations if investors use corporate responsibility measures as a proxy for management quality. Already, companies with good governance are more likely to be of interest to international investors. Many asset managers already consider corporate governance issues in their investment decisions, albeit not always systematically. These issues are seen as particularly important in the case of State-owned enterprises and family-owned enterprises, both of which are common ownership structures in many emerging markets.

Environmental issues such as climate change are also becoming increasingly material to investors, especially if Governments increase regulation in this area. As government policies increasingly move toward constraining greenhouse gas emissions and introducing a price for carbon dioxide emissions, investors are increasingly looking to take emissions into account in their investment strategies while seeking to maintain the financial performance of their portfolios. It is possible that over the longer term, decreased country risk stemming from good corporate reporting and performance on environmental, social and governance factors could lead to lower market volatility as uncertainty is reduced and investors have more clarity on the longer-term outlook. In this way, strengthening corporate ESG practices, particularly in the area of corporate reporting, could be used as a point of differentiation and could lead to a competitive investment advantage.

III. Methodology

This study has assessed companies primarily by looking at information published by the company, including annual reports, sustainability or corporate social

²⁴³ CSR awards launched to reward transparency for stakeholders. www.thejakartapost.com/news/2008/06/27/csr-awards-launched-encourage-transparency-stakeholders.html.

²⁴⁴ <http://www.csrwire.com/News/7423.html>.

²⁴⁵ Press release 28 April 2008: <http://www.mercer.com/pressrelease/details.htm?idContent=1305005>.

²⁴⁶ Emerging Markets Disclosure Initiative July 2008 update: www.eurosif.org/content/download/1093/6024/version/1/file/Emerging+Markets+Disclosure+Initiative_July+2008.pdf.

responsibility (CSR) reports, company documents and company websites. The data examined relates to 40 companies in total, comprised of the largest four enterprises from the top 10 largest United Nations member States by index weighting found within the MSCI EM Index (see appendices II and III for the list of countries, industries, sectors, and companies). The study assesses this sample of 40 companies on a range of ESG issues. The research was largely conducted by EIRIS, with companies from Brazil, Israel, the Republic of Korea and Mexico researched by EIRIS research partners. EcoDes²⁴⁷ was responsible for researching Brazilian and Mexican companies, Greeneye²⁴⁸ for Israeli companies and KOCSR²⁴⁹ for Republic of Korea companies. All figures are based on information extracted from the EIRIS databases as of August 2008.

It is important to note that only publicly available policies and systems were assessed. Some of the companies may indeed have undisclosed internal policies and procedures relating to the issues covered. The present report focuses on the corporate responsibility and governance issues identified by United Nations bodies, including ISAR and the Global Compact, utilizing a subset of EIRIS criteria described in table 1 below.

Table 1. EIRIS criteria

| | |
|--------------------|--|
| Environment | Environmental issues Climate change Biodiversity |
| Social | Human rights Supply chain Health and safety |
| Governance | Board practice Bribery |

Observations are reported by industry sector. Companies have been grouped into industries based on their Industry Classification Benchmark (ICB) classifications.²⁵⁰ The ICB system allocates companies to subsectors based on a definition which most closely describes the nature of its business. The nature of a company's business is determined by its source of revenue. Subsectors are then amalgamated into sector groups which are then fed into broad industry classifications. See annex II for a sector summary.

It is important to take company impact or level of risk that a company may face into account when analysing a company's corporate responsibility activities. This study uses a range of sources to determine levels of risk corresponding to each area researched. High-risk exposure in a particular area signifies greater materiality than low-risk exposure. For this paper, risk exposure has been determined by examining the nature and location of companies' operations for the following subject areas: environmental issues, climate change, biodiversity, human rights, supply chain, and bribery. In these areas, companies are assigned a risk or impact indicator based on their exposure to the issues. Further details are available for each issue in the relevant sections. Since not all companies in the study are subject to the same types of risks, sample sizes can vary from on subject area to another (see table 2).

²⁴⁷ A long-standing Spanish NGO in the field of environment and development, EcoDes, began ethical investment research in 1997. The research function was originally established to supply data to an environmental fund set up by EcoDes, but has now expanded to provide data on Spanish, Portuguese and Latin American companies to EIRIS. www.ecodes.org.

²⁴⁸ Greeneye is the environmental advisor to the Maala CSR Tel Aviv Stock Exchange Index, and is EIRIS' research partner in Israel. www.greeneye.co.il.

²⁴⁹ KOCSR is a provider of corporate responsibility research on Republic of Korea companies and is partially owned by CCSR. www.kocsr.com.

²⁵⁰ http://www.icbenchmark.com/docs/English_Structure_Defs.pdf.

Table 2. Sample of companies examined

| | Number of enterprises (Max = 40) | | |
|----------------------|----------------------------------|----------------------|-----------------|
| Risk exposure | Very high/ high/ large | Medium/ small | Low |
| Environmental issues | 18 | 14 | 8 |
| Climate change | 17 | 1 | 22 ^a |
| Biodiversity | 11 | 4 | 25 ^a |
| Human rights | 18 | 10 | 12 ^a |
| Supply chain | 4 | 2 | 34 ^a |
| Bribery | 21 | 16 | 3 |

^a Policy, systems, and reporting are not assessed for these companies. For the corresponding graphs where not all companies are assessed, n = the number of companies assessed.

For each of the areas, this study has used a standardized grading system which indicates the level of company response. The grades are summarized in table 3 below.

Table 3. Grading system

| | Grade | Explanation |
|----------------|--------------|--|
| <i>Lowest</i> | No evidence | No evidence of the selected indicators |
| ↓ | Limited | There is some evidence that the company is aware of this issue and has taken steps to address it |
| | Intermediate | The company is some way towards managing the issue |
| | Good | The company is managing the issue well |
| <i>Highest</i> | Advanced | This category is intended to identify leading companies that may be gaining a competitive advantage (with stakeholders or society in general) by addressing the issues |

IV. Environment

A. Environmental issues

Issues such as climate change, water shortages and local pollution are driving the environmental agenda in many emerging markets. This study classifies companies as “high”, “medium”, or “low impact”, based on the direct impacts of their business activities on the following key issues: energy use, air pollution, water pollution, waste and water consumption. The sample of emerging market companies was then evaluated on their responses to environmental issues under the following categories according to the EIRIS methodology: policy, management systems and reporting. Based on their performance in each of these categories, the companies were assigned one of five assessment grades: “no evidence”, “limited”, “intermediate”, “good” and “advanced”. Examples of indicators which are used in this study to assess companies’ environmental policies and practices include setting objectives and targets in key areas, quantitative data on all key impacts, and ISO 14001 environmental management system coverage. In order to be assessed as having a “good” environmental policy, a company would have to have a combination of the following: a demonstration of a commitment to all

key environmental issues impacted by their business, board level responsibility for environmental issues, environmental objectives and targets, operating standards beyond compliance, a commitment to environmental reporting, a commitment to environmental auditing and/or monitoring, stakeholder involvement, and product stewardship where applicable. In order to be assessed as having a “good” environmental management system, a company would need to demonstrate that objectives and targets have been set in all key areas and that the company has a means to achieve them, evidence of an audit plan and of internal reporting for management review purposes. The depth of its environmental management systems and the extent or percentage of the company which is covered is also considered which includes looking at both externally-certified and internally-developed systems. A “good” environmental reporting grade would include such elements having a good quality publicly available environmental report. The report must contain meaningful performance data and show the company’s performance against targets in the key areas. The report also has to be independently verified.

Key findings

More than two thirds of the companies in the study were in “high” or “medium” impact sectors (figure 1). The companies assessed scored much better for environmental areas than for social or governance areas. As noted in figure 2, many companies achieved good or advanced scores, grades more typically seen amongst developed country environmental leaders. As expected, companies in high impact sectors, such as those in the resource sector, tended to have better environmental policies, systems and reports. However, some low or medium impact financial companies also scored well.

The assessments for environmental areas were highest for the four South African companies studied. One reason for this is that the Johannesburg Stock Exchange requests listed companies to report annually on the nature and extent of their environmental management policies and practices, among other corporate responsibility indicators. The four Brazilian companies studied also stand out in terms of their excellent assessments. The two Republic of Korea companies that received advanced grades for environmental systems have significant international operations and over 95 per cent of their operations are ISO 14001 certified. Many Republic of Korea companies have recognized that ISO 14001 certification is an important strategy for industrial competition and for improving company and product recognition.

Figure 1. Environmental impact
(number of companies)

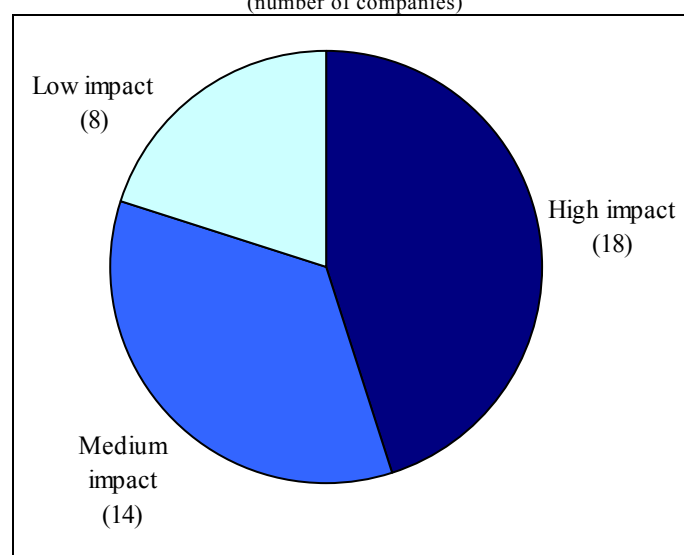
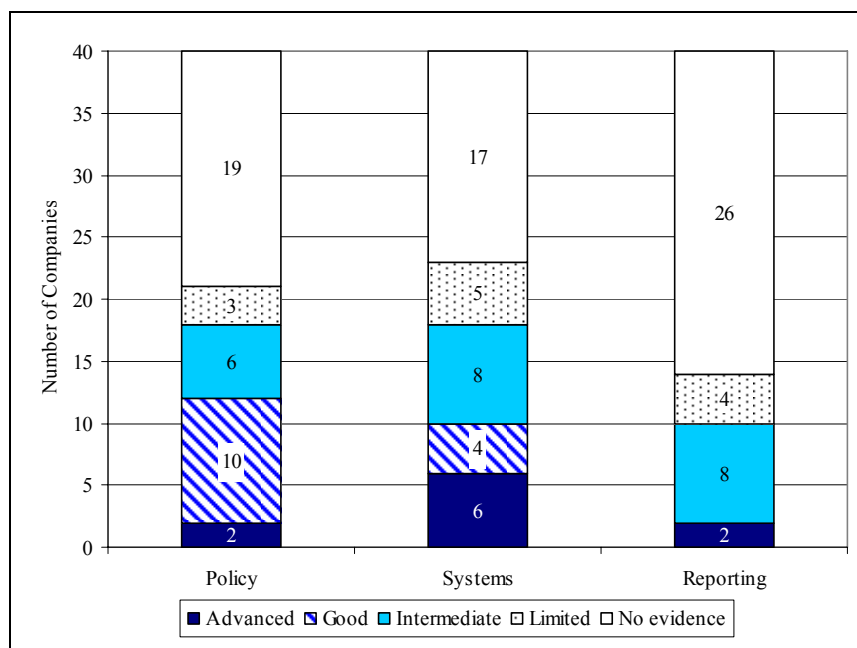


Figure 2. Environmental management
(companies assessed for environmental management = 40)



B. Climate change

Climate change has the potential to impact shareholder value, especially as increasingly strict regulation is introduced and emissions trading schemes are developed. There is more focus on the issue in emerging market companies now that the Climate Disclosure Project has 5 of its 14 partners located in emerging markets, including Brazil, China, India, the Republic of Korea and South Africa. Four of the five emerging market partners have been added since 2007. This study examined companies' risk exposure and management response to the issue including disclosure of data, policy and governance, strategy and performance. In terms of climate change impact based on their operations, companies are categorized as "very high", "high", "medium", or "low risk". This is based on the direct, indirect and product emissions over which companies have control. Classifications also take into account the projected growth of emissions in the sector, the overall impact of the sector (e.g. benefits of public transport), the allocated share of upstream and downstream emissions, and the strategic importance in contributing to solutions to climate change.

Companies are then assessed on their management response and disclosure of company performance. Indicators include evidence of target setting and disclosure of emissions, including disclosure of performance against targets. Based on their performance in each of these categories, the companies were assigned one of five assessment grades: "no evidence", "limited", "intermediate", "good" and "advanced". In order to be assessed as having a "good" management response to climate change, the company would need to show evidence of the following indicators: senior responsibility for climate change related issues, climate change commitment, product-related climate change commitment (where relevant), long-term strategic climate change goals or short-term management targets linked to greenhouse gas emissions reductions. In order to reach a "good" grade for disclosure, companies are required to provide data on its absolute and normalized emissions, the scope of those emissions, trend emissions data, as well as product or service related emissions (where relevant). They also would need to demonstrate minimum operations emissions reductions of 2.5 per cent or other efficiency gains as well as product emissions reductions if relevant. Companies whose impacts were categorized as "low risk", such as those in the financials and technology industries, were not assessed.

Key findings

A total of 18 companies in the study were seen as having a medium to very high risk for climate change impacts (figure 3). The management response to climate change was strongest amongst the resource companies, as might have been expected given the energy intensive nature of the sector. However, it is interesting to note that 6 out of 12 resource companies had no evidence of climate change disclosure while five of the remaining six companies attained an intermediate grade (figure 4). Given the high impact that many of these companies have on climate change, this is an area in which both regulators and investors will likely be interested.

Figure 3. Climate change risk
(number of companies)

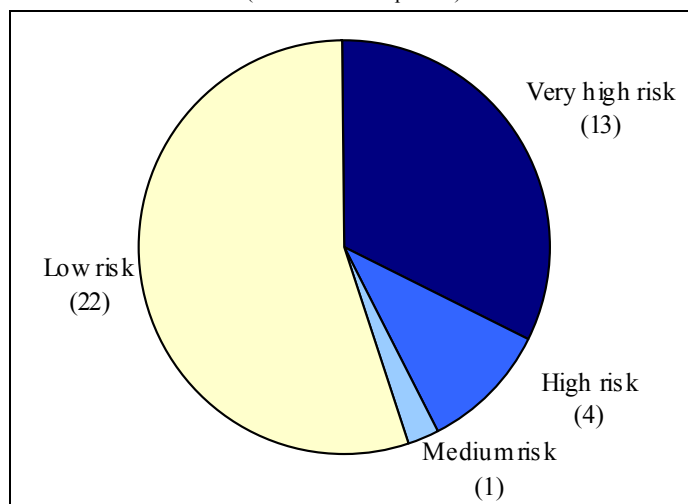
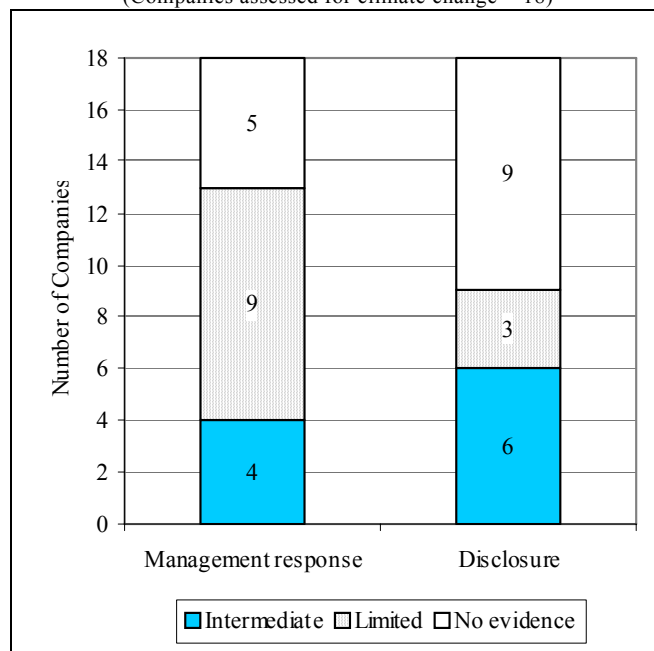


Figure 4. Climate Change

(Companies assessed for climate change = 18)



C. Biodiversity

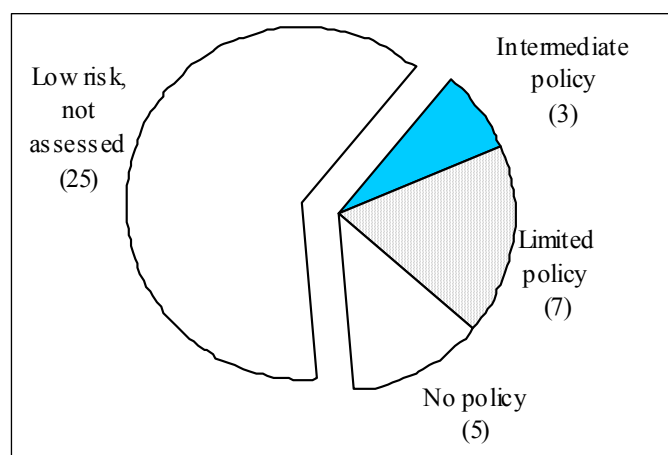
The biggest threat to biodiversity is from changes in land use leading to habitat destruction, fragmentation or simplification. Biodiversity has practical implications for enterprise. Many industries – for example, forestry, fishing and agriculture – depend directly on biological resources, and destruction of biodiversity is therefore a risk to their resource base. Others may depend on the quality of the local environment or

require ecosystem “services” – for example, the purification of sewage discharges by river systems. For the purposes of this paper, biodiversity policies were assessed for the 15 companies that were categorized as “medium” or “high risk” for this issue. Those companies’ biodiversity policies were graded as “no evidence”, “limited”, “intermediate” or “good”. Examples of indicators which are used by ESG analysts to assess companies’ biodiversity policies and practices include evidence of a biodiversity action plan, assessment of potential for enhancement and disclosure of biodiversity improvements.

Key findings

Out of the 40 companies evaluated, 25 were in sectors for which biodiversity was not a significant issue, and therefore not assessed (see figure 5). Five of the remaining 15 companies did not have a biodiversity policy; 7 had a basic or “limited” policy while three were assessed as having a moderate or “intermediate” policy. No companies had a “good” biodiversity policy, the highest grade available. In order to achieve a “good” grading under the EIRIS methodology, a company must demonstrate the majority of the following criteria: a group-wide policy or biodiversity action plan, involvement of conservation organizations in developing specific biological action plans at a strategic level, an assessment of the potential for enhancement, and – where relevant – a policy to source natural resources from suppliers operating an appropriate certification scheme. Resource and industrial companies had more comprehensive biodiversity policies than those in the consumer or health industries. Companies in the financial or technology industries do not have biodiversity as a significant issue and so were not assessed.

Figure 5. Biodiversity policy
(number of companies)



V. Social

A. Human rights

Due to increased concerns about the role of business and human rights, and new and novel forms of foreign direct liability for corporate complicity in human rights abuses, investors increasingly see human rights issues as both a moral responsibility as well as a material concern affecting their investments. The issues and standards used in this study to provide benchmarks for human rights research are based on internationally endorsed conventions, notably the United Nations Universal Declaration of Human Rights and the core Conventions of the International Labour Organization (ILO), which cover child labour, forced labour, freedom of association and collective bargaining, and non-discrimination.

Whilst noting that human rights violations can occur in all countries, ESG investment analysts typically focus their research on particular countries where human

rights are perceived as being most at risk (based on a risk assessment using information from a range of sources, including the Freedom House Annual Survey, World Bank Political Stability and Absence of Violence Governance Indicator, Amnesty International and Human Rights Watch). The size of a company's operations identified in a country of concern was also taken into consideration and categorized as "large", "small-medium" or "low". EIRIS, for example, categorizes a company as having a "large" presence in a country if it has been identified as having more than £100 million of annual turnover or assets or over 1,000 employees in its operations in the country. A company is categorized as having a "small" presence if its operations in a country fall under the above mentioned thresholds.

The sample companies' overall performance on human rights was assessed according to EIRIS methodology by looking at the quality of their human rights policy, management systems, and reporting mechanisms. Based on their performance in each of these categories, the companies studied were assigned one of five assessment grades: "no evidence", "limited", "intermediate", "good" and "advanced". Indicators which were used in this study to assess companies' human rights policies and practices include evidence of board level responsibility, details of policy communication, and staff training. In order to achieve a "good" human rights policy under the EIRIS approach, a company would need a public policy which included all five core ILO labour areas, an explicit statement of support for the Universal Declaration of Human Rights, board level responsibility, evidence of policy communication to all employees, and where relevant, an armed guards policy, based on United Nations guidelines as well as a policy on indigenous rights. A "good" human rights system under the EIRIS approach would include such areas as an identification of major human rights challenges, training of all employees, consulting independent local stakeholders, monitoring and procedures to remedy non-compliance, and an integration of its systems into risk assessment procedures. For human rights reporting, a "good" grade would include the public communication of details of many of the aspects of human rights systems such as details of risk and impact assessments and details of engagement with local governments or NGOs. It would also need to include at least one detailed example of human rights performance in the developing world, a statement on compliance with human rights policies and whether there were any breaches, in addition to other criteria.

Key findings

As indicated in figure 6, there were 12 companies with low exposure to human rights risk; these 12 were not assessed, leaving 28 companies in the "small-medium" and "large" exposure categories for assessment. In figure 7, it is seen that slightly more than half of these 28 companies had policies on human rights. A much smaller proportion of the companies studied, however, report on the details of their systems and performance. The data shows that there may be a greater tendency for resource companies to recognize human rights as an issue than companies involved in the financial sector which may reflect the type of work being done in each field. Ten out of 11 resource companies have some sort of human rights policy in place, compared with none of the 7 financial companies. The results for human rights systems and reporting show the same tendencies: companies where the risk is greatest appear to be reporting on the issue more fully. However, only 2 out of the 30 companies assessed had better than a limited policy and no companies achieved above a limited grade for systems or reporting, showing that further emphasis is needed in this area.

Figure 6. Exposure to human rights risk
(number of companies)

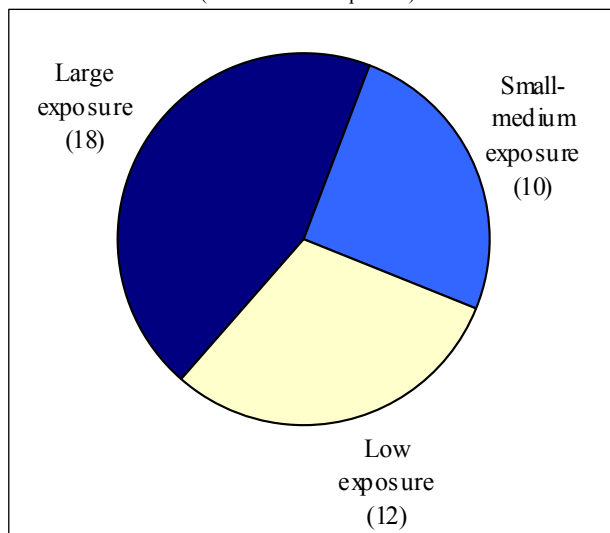
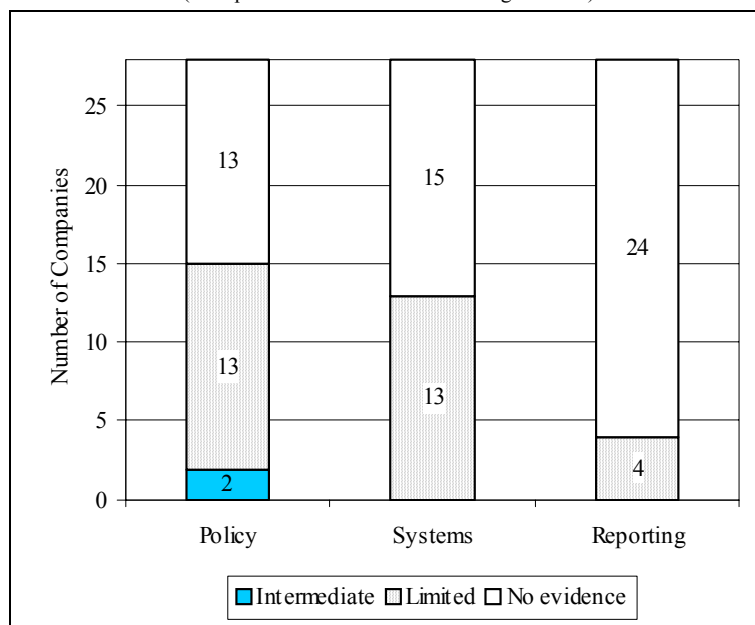


Figure 7. Human rights
(Companies assessed for human rights = 28)



B. Labour practices in the supply chain

Due to the increasingly international nature of production and trade, an ever-growing number of products are being assembled or processed in many different countries all over the world and greater attention is beginning to be paid to the working conditions in the countries of origin. EIRIS categorizes the companies according to their exposure to supply chain labour risk based on their sector, the countries from where their products are sourced, and the size of their operations. Companies determined as having high or medium exposure to supply chain labour risk were then assessed on their supply chain policy, management systems, and public reporting. Based on their performance in each of these categories, the companies were assigned one of five assessment grades: “no evidence”, “limited”, “intermediate”, “good” and “advanced”. Indicators which were used to assess companies’ supply chain labour standards policies and practices include integration of policies into procurement procedures, monitoring and auditing, and procedures for addressing non-compliance.

Key findings

As noted in figure 8 below, only six companies from the sample analysed were considered to face a “high” or “medium” supply chain risk exposure; therefore, caution should be used in drawing firm conclusions from this small sample size. Only two companies had a supply chain policy for labour standards and they only met the weakest grade of EIRIS assessment, “limited” (see table 4). One company had a limited system for assessing compliance with its policy and none of the companies reported on supply chain labour practices. A “good” grade in these areas, according to the EIRIS approach, would include a public commitment to the four core ILO convention areas as well as at least two of the other key ILO convention areas selected by EIRIS. The company would also need to show evidence of policy communication to its suppliers, a demonstration of procedures to remedy non-compliance on sourcing standards and have senior level responsibility to champion the company’s policy on this issue. It would also need to report substantively on labour conditions in its supply chain, including providing details of remedies for non-compliance and would either have its reports independently verified or provide some notable details.

In general, there appears to be a lack of attention being paid by the companies in this study to this issue at the moment. This is in stark contrast to many developed market multinational companies which often have exacting standards of labour practices in their supply chain which tend to be based in emerging markets.

Figure 8. Exposure to supply chain risk
(number of companies)

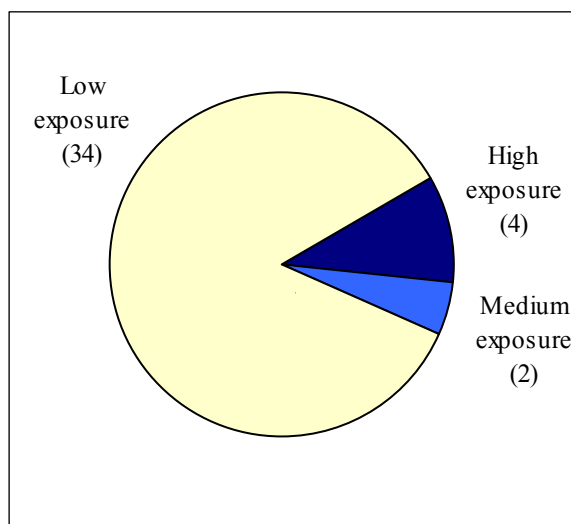


Table 4. Labour practices in supply chain
(number of companies)

| Assessment | Policy | Systems | Reporting |
|--------------|----------|----------|-----------|
| No evidence | 4 | 5 | 6 |
| Limited | 2 | 1 | 0 |
| Intermediate | 0 | 0 | 0 |
| Total | 6 | 6 | 6 |

C. Health and safety

Investors see health and safety issues as symptomatic of material issues related to quality of management, liability, productivity and risk of work disruptions. ESG analysts typically assess all companies on health and safety systems. EIRIS for

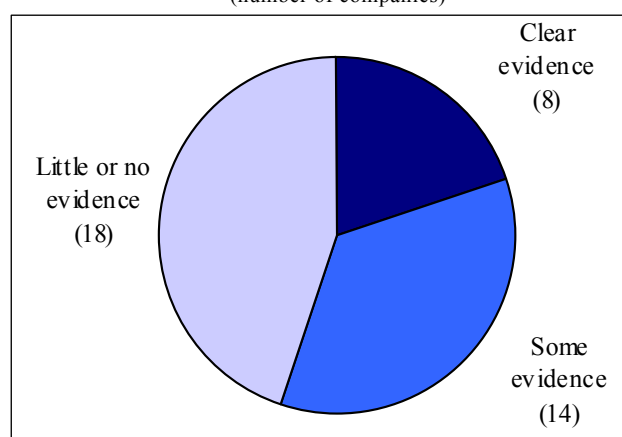
example, grades companies as “little or no evidence”, “some evidence” or “clear evidence”. Indicators used to assess companies’ health and safety practices include evidence of senior responsibility, quantitative data on its health and safety record, and details of staff training. “Clear” evidence of health and safety systems could include details of senior responsibility, details of training, significant awards won, and detailed quantitative data illustrating changes to performance and/or sectoral comparisons.

Key findings

Almost half of the companies in the sample studied showed “little or no evidence” of managing health and safety in their operations (figure 9). However, industrial companies and all but two companies in the resource industry had either “some” or “clear” evidence of health and safety systems, compared with only 4 out of 15 financial companies. This shows that for industries where health and safety represent significant operating risks, the companies in the study are addressing this issue.

Figure 9. Health and safety systems

(number of companies)



VI. Governance

A. Board practice

The way in which boards are structured should facilitate good corporate performance by ensuring that a company is managed in the best interests of its owners. Although improved governance practices and procedures cannot provide a foolproof safeguard against deliberate fraud or financial collapse, many investors see their existence as evidence of sound management practice within a company.

This study focuses on four key indicators to determine the strength of board practices: the separation of the roles of chair and chief executive, proportion of independent directors, independence of the audit committee, and disclosure of director remuneration. According to the EIRIS methodology, a non-executive is not considered independent if they have served the same company for a long period (over 10 years), have close family relationships with executive directors of the company, represent a major shareholder/supplier/customer of the company, have a close consultancy or advisory relationship or contract with the company, or were otherwise employed by the company or one of its subsidiaries within the previous three years.

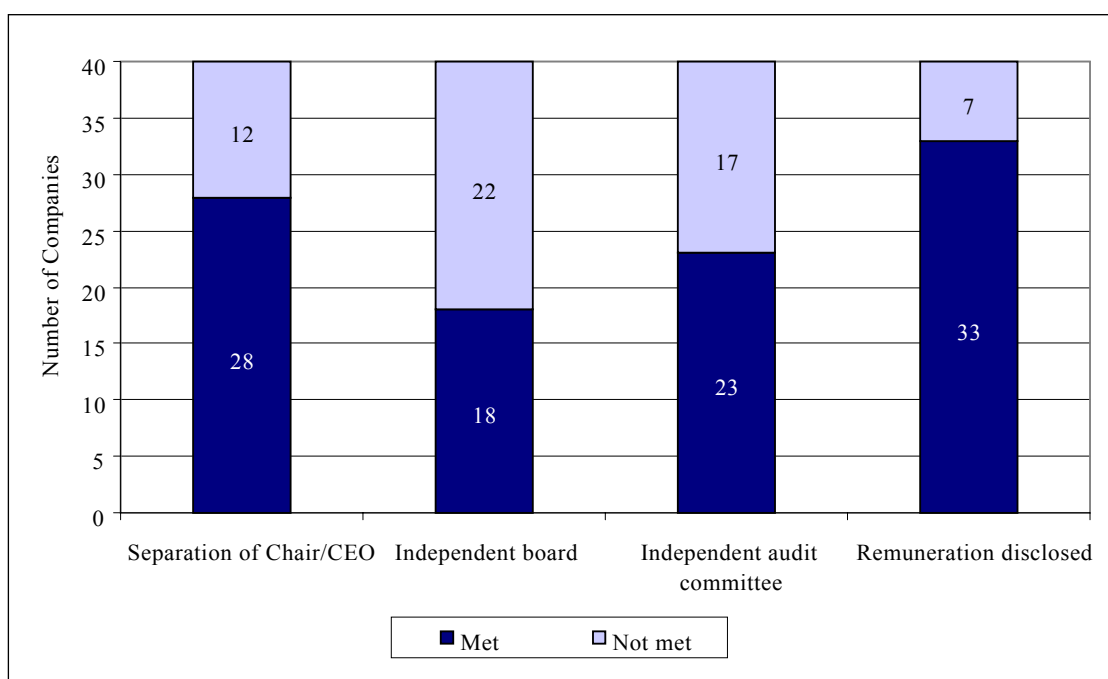
Key findings

All but one of the companies in our sample had at least one core element of corporate governance and 36 out of 40 had at least two of the core elements of good board practice. As indicated in figure 10 below, public disclosure of director remuneration (33 out of 40 companies) and the separation of the roles of chair and CEO (28 out of 40 companies) seemed to be much more prevalent among companies than

having a board made up of at least 33 per cent independent directors (18 out of 40 companies). Out of the 40 companies researched, 23 companies had audit committees made up of at least 33 per cent independent directors. The country divisions below seem to reflect the influence of national codes in place in some countries. Enforcement of governance, especially if those codes have only recently been adopted, may also differ by country. For example, in the Russian Federation, the level of voluntary compliance to the domestic corporate governance code differs significantly from one company to another although some larger companies who plan to enter foreign financial markets have taken steps to comply with corporate governance best practices such as actively appointing independent directors. The South African Corporate Governance recommendations, outlined in the King II code, not only address core corporate governance issues, such as director independence and splitting CEO from Chair positions, but also provide guidelines for disclosing social and environmental performance.

Figure 10. Board practice

(Companies assessed for board practice = 40)



B. Bribery

Corporate bribery and corruption can have serious consequences for investors and enterprises alike. Corruption can have financial, legal and reputational repercussions that can damage the growth and development of an enterprise. Companies involved risk lawsuits and material financial penalties. It can also undermine the effectiveness of government policies and market mechanisms. In many countries, regulators and prosecutors are becoming ever more vigilant and convictions and fines for business corruption are rapidly increasing.

The EIRIS approach to ESG analysis identifies companies' risk exposure to bribery and corruption ("low", "medium", or "high risk") and provides a comprehensive analysis of a company's anti-bribery policy, its systems and reporting in the public domain. Based on performance in each of these categories, the companies were assigned one of five assessment grades: "no evidence", "limited", "intermediate", "good" and "advanced". Indicators which are used by this study to assess companies' anti-corruption policies and practices include evidence of board commitment, whistle-blowing procedures and staff training. In order to receive a "good" assessment from EIRIS for an anti-corruption policy, a company would need to publicly demonstrate that it prohibits bribes, obeys laws, restricts so-called "facilitation payments" and improper

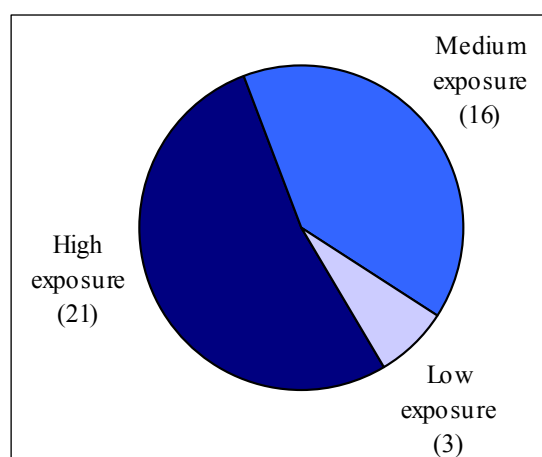
gifts,²⁵¹ has board level commitment on the issue, transparency of political donations and that the policy is applicable to contractors, suppliers, and agents. “Good” systems would include the following: communication of the policy to employees and business partners as well as training, evidence of compliance mechanism, whistle-blowing procedures, a sanctions process, an assessment of risks, and appropriate systems for the appointment and remuneration of agents. “Good” reporting would include details of policy communication, training, monitoring, auditing, compliance mechanisms, systems for the appointment and remuneration of agents, as well as other elements such as details of performance, non-compliance, or independent verification, among others.

Key findings

For all but three companies in the sample, bribery was assessed as being a “medium” or “high” risk issue based on their sector, countries of operation and involvement in traditionally high risk activities such as government contracts and licensing (see figure 11). Most companies have a public bribery policy of some description but no companies attained a “good” or “advanced” grading (see figure 12). Key factors which were examined included whether active and passive as well as direct and indirect aspects of bribery were considered in the policy and how far the company communicated its policy – both externally to its suppliers, contractors and agents, and internally to employees and its subsidiaries.

Fewer companies had clear systems in place to implement their policies and companies either showed no evidence of reporting on their initiatives to counter bribery or only disclosed limited details of their management systems and performance. All four Brazilian companies studied appear to be the most transparent in terms of their overall initiatives to counter bribery as all had an “intermediate” policy, all had either “limited” or “intermediate” systems and all had at least some level of disclosure in reporting. The four Republic of Korea companies studied also stood out as having good overall practices to counter bribery. This may be the result of a range government policies in the Republic of Korea that have specifically sought to improve good governance at all levels.

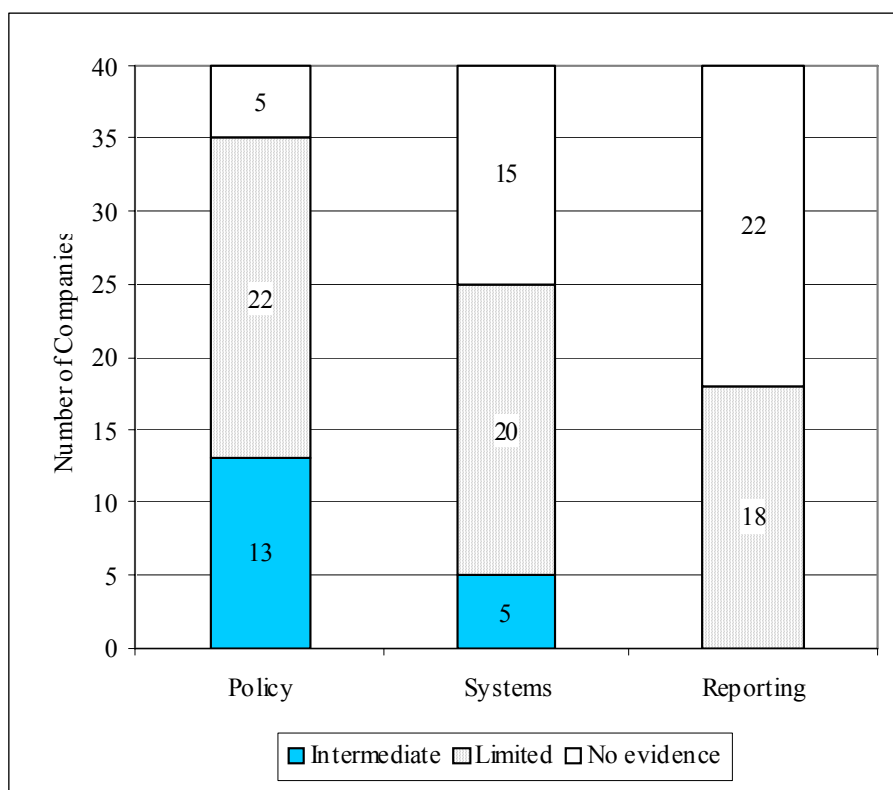
Figure 11. Exposure to bribery risks
(number of companies)



²⁵¹ Terms such as “facilitation payments” and issues such as the propriety of gifts are defined and clarified in the Organization for Economic Cooperation and Development Convention on Combating Bribery of Foreign Public Officials.

Figure 12. Countering bribery

(Companies assessed for anti-bribery practices = 40)



VII. Conclusions

This study's findings indicate that the majority of the 40 companies in the study have shown evidence of addressing at least some ESG issues in their public disclosures. The study's relatively small sample size and focus on the disclosure of large capitalization companies means that caution should be used when extrapolating the findings. Nevertheless, the study has facilitated a number of useful observations:

- (a) The South African and Brazilian companies studied stood out overall as consistently having the highest assessments among the companies sampled. These countries also developed some of the first responsible investment indices in emerging markets, indicating the positive role that investors can play;
- (b) Companies scored much better in environmental areas than in social or governance areas, with some reaching grades in environmental performance and systems on a par with developed country environmental leaders;
- (c) Higher impact companies, including those in the resources sectors, performed better on issues such as health and safety and environment, where the risk is greater;
- (d) Public disclosure of director remuneration (33 out of 40 companies) and the separation of the roles of chair and CEO (28 out of 40 companies) were high.

The majority of companies in the study have shown evidence of addressing at least some ESG issues in their public disclosures. However, the analysis presented in this study indicates that the eight large South African and Brazilian companies sampled performed better on ESG issues than their peers in the other emerging market countries studied. This may be a function of national policy initiatives to improve corporate responsibility, responsible investing, and ESG disclosure. It is noted that all four of the

South African firms in this study are also constituents of the Johannesburg Stock Exchange's responsible investment index, and three of the four Brazilian firms are members of Bovespa's sustainability index.

South African firms appear to be ahead of most other emerging market enterprises in disclosing corporate responsibility activities. This may reflect a number of policy choices and initiatives in that country, including the development of the King Reports²⁵² and the Johannesburg Stock Exchange's responsible investment index.²⁵³ The most recent King Report recommends the annual use of the Global Reporting Initiative guidelines for disclosing social and environmental performance for companies listed on the Johannesburg Stock Exchange as well as addressing core corporate governance issues. There is also evidence of domestic investor demand for responsible investment products. In 2007, South Africa had approximately \$33 billion of assets managed with some sort of responsible investment strategy.²⁵⁴ The four Brazilian companies in this study also scored highly against the criteria employed and, similarly, there seems to be a strong background of domestic interest among investors in ESG issues, and strong support from institutions such as Bovespa.

Although the findings of this study suggest that corporate responsibility activities are well established in South Africa and Brazil, it is possible that in other countries actual corporate responsibility-orientated activities may be greater than their public disclosure. It is difficult to assess whether the lack of ESG disclosure reflects formal corporate policies toward disclosure or simply a lack of awareness among managers that these issues are of interest to investors. Some companies may be reluctant to disclose details of their corporate responsibility initiatives until a cohesive program is in place.

Another significant observation of this study is that the companies scored much better in environmental areas than in social or governance areas, with some reaching grades in environmental performance and systems typically seen amongst developed country environmental leaders. As companies' environmental policies and systems were superior to their reporting disclosure across the board, this may indicate an ongoing evolution of company responses to the issues. Although it is encouraging that environmental issues are catching the attention of company management, it is important that the many material issues in the social and governance domains are also considered. Effective anti-corruption programmes not only mitigate legal risk but can also enhance commercial opportunity by strengthening reputation and credibility. Links have been made between corporate governance practices and share performance which indicate that good corporate governance is positively viewed by investors. Investors and policymakers should continue their efforts to strengthen the capabilities of enterprises to strengthen ESG structures, including disclosure.

There are 13 companies in our sample for which a climate change policy response or disclosure is a significant result, as most of them do not have the benefit of institutions such as carbon trading markets which would create transparent price incentives for action. Instead, action appears to be driven by other pressures, such as customers, competitors, investors or outside regulators. In Asia, for example, the influence of developed country TNCs on companies in their supply chain is often very pronounced and, as a result, many of these companies are rapidly improving their environmental and labour practices.²⁵⁵

Domestic regulation is likely to increase as a driver for improved performance in the future. China, for example, has introduced new laws on water pollution which are directed at company executives²⁵⁶ and new labour laws which give additional

²⁵² Institute of Directors – South Africa. King Report on Corporate Governance for South Africa – 2002 (King II Report) <http://www.iodsa.co.za/king.asp>.

²⁵³ The JSE SRI index is compiled based on data provided by EIRIS.

²⁵⁴ The State of Responsible Investment in South Africa.

http://www.unisa.ac.za/contents/colleges/col_econ_man_science/ccc/docs/State%20of%20responsible%20Investment%20in%20South%20Africa.pdf

²⁵⁵ The development of CSR in Asia, 1 September 2008. <http://www.asria.org/news/press/1220240367>.

²⁵⁶ Tougher law to curb water pollution. 1 March 2008. http://www.syntao.com/E_Page_Show.asp?Page_ID=6858.

protections to workers.²⁵⁷ China's State Environmental Protection Association (SEPA) is also tightening the rules on the listing of companies involved in high-polluting industries on the Shanghai share index. The new rules will see SEPA working with the China Securities Regulatory Commission to decide if a company with a poor environmental record should be allowed to list on the exchange.²⁵⁸

Failure to apply corporate responsibility practices poses tangible risks and missed opportunities for emerging markets in terms of attracting investment. This study shows that some of the top companies in emerging markets risk failing to meet the ESG tests of international investors. On the other hand, those emerging market companies that devote resources to ESG activities may well gain potential financial benefits from being seen as leaders among their peers. Applying ESG analysis to emerging market investments provides analysts with a new set of challenges regarding debate over complex ESG issues in rapidly evolving developing countries and economies in transition. But it can also provide investors with greater opportunities for engagement and improvement of ESG performance within companies. For emerging market enterprises, improvements in ESG performance can enhance the ability to attract investment.

One way to improve ESG practices in emerging markets involves investors engaging with companies in a constructive way. This entails transparent, regular contact with companies and regular follow-up on their ESG actions. Such an engagement approach should lead companies towards more sustainable practices, and will also favour the development of additional financial and ESG research. Investors may want to consider being more vocal in requiring minimum ESG disclosure standards from emerging market legislators and exchanges. Actions such as the United Nations Global Compact's, which removed 394 of its over 4,000 corporate participants from its online database in January 2008 show that serious initiatives are underway to convince companies of the merits of corporate responsibility. Most of the de-listed companies were based in emerging markets, and were removed for failing to report on corporate responsibility issues.²⁵⁹

As corporate responsibility seems to work best when instigated domestically, as in the cases of South Africa and Brazil, emerging market regulators, policymakers and stock exchanges can also work to reduce some of the ESG risks that serve as barriers to certain investors in their countries. Emerging market Governments can put their own stamp on the issue, and affect the levels of corporate take-up when they have specific issues they want to promote (such as black economic empowerment in South Africa) or when they see corporate responsibility as a source of comparative competitive advantage. This can be accomplished by setting up initiatives to further increase understanding among domestic companies about corporate responsibility and responsible investment and encourage sustainability reporting, using guidelines such as those developed by ISAR or the Global Reporting Initiative

²⁵⁷ Fair Labor Association. 15 January 2008. <http://flaglobalaction.blogspot.com/2008/01/assessing-impact-of-new-china-labor.html>.

²⁵⁸ China to smoke out worst polluters. 23 August 2007. <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/08/23/cnchina123.xml>.

²⁵⁹ Press Release 28 January 2008. http://www.unglobalcompact.org/newsandevents/news_archives/2008_01_28.html.

Annex I. List of companies in the study

| Company | Industry | Country |
|-----------------------------|------------|--------------------|
| PETROBRAS | Resources | Brazil |
| VALE DO RIO DOCE | Resources | Brazil |
| BANCO BRADESCO | Financials | Brazil |
| BANCO ITAU HLDG FIN. | Financials | Brazil |
| CHINA MOBILE | Technology | China |
| ICBC | Financials | China |
| CHINA LIFE INSURANCE | Financials | China |
| PETROCHINA CO | Resources | China |
| RELIANCE INDUSTRIES | Resources | India |
| ICICI BANK | Financials | India |
| INFOSYS TECHNOLOGIES | Technology | India |
| HOUSING DEV FINANCE CORP | Financials | India |
| BUMI RESOURCES | Resources | Indonesia |
| TELEKOMUNIKASI INDONESIA | Technology | Indonesia |
| ASTRA INTERNATIONAL | Consumer | Indonesia |
| BANK CENTRAL ASIA | Financials | Indonesia |
| TEVA PHARMACEUTICAL | Healthcare | Israel |
| ISRAEL CHEMICALS | Resources | Israel |
| BANK HAPOALIM | Financials | Israel |
| BANK LEUMI | Financials | Israel |
| SAMSUNG ELECTRONICS | Technology | Republic of Korea |
| POSCO | Resources | Republic of Korea |
| KOOKMIN BANK | Financials | Republic of Korea |
| SHINHAN FINANCIAL GROUP | Financials | Republic of Korea |
| BUMIPUTRA COMMERCE HOLDINGS | Financials | Malaysia |
| IOI CORP | Consumer | Malaysia |
| SIME DARBY | Industrial | Malaysia |
| MALAYAN BANKING | Financial | Malaysia |
| AMERICA MOVIL | Technology | Mexico |
| CEMEX | Industrial | Mexico |
| TELEFONOS DE MEXICO | Technology | Mexico |
| WALMART DE MEXICO | Consumer | Mexico |
| GAZPROM | Resources | Russian Federation |
| LUKOIL HOLDING | Resources | Russian Federation |
| SBERBANK | Financials | Russian Federation |
| NORILSK NICKEL | Resources | Russian Federation |
| SASOL | Resources | South Africa |
| MTN GROUP | Technology | South Africa |
| IMPALA PLATINUM | Resources | South Africa |
| STANDARD BANK GROUP | Financials | South Africa |

Annex II. Sector summary

The following table summarizes the sectors which made up the industrial groupings. These are based on the ICB classifications but only those sectors which had analysed companies were included in the industry groupings.

| Industry | Sectors |
|-----------------|--|
| Consumer | Automobiles and parts, food producers, food and drug retailers |
| Financials | Banks, life insurance, general financial |
| Health | Pharmaceuticals and biotechnology |
| Industrial | General industrials, construction and materials |
| Resources | Oil and gas producers, industrial metals, chemicals |
| Technology | Mobile telecommunications, software and computer services, fixed-line telecommunications |