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FOREWORD

For over three decades, the United Nations has been engaged in promoting harmonized corporate reporting. In October 1982, the Economic and Social Council established the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) as a standing group of experts.

ISAR held its 22nd annual session from 21 to 23 November 2005 at the Palais des Nations in Geneva. The session took much of its cue from the September 2005 World Summit in New York, where world leaders underscored the importance of mobilizing resources for economic development. They affirmed their commitment to good governance at all levels and to enhancing the coherence and consistency of the international financial system. These outcomes are highly relevant for UNCTAD as the UN's focal point on trade, development and investment, including issues of enterprise accounting and reporting and corporate responsibility.

In 2005, an unprecedented number of enterprises around the world began preparing their financial statements in accordance with the International Financial Reporting Standards (IFRS). This transition to a global set of standards has major implications for resource mobilization and investment flows. Sound and high-quality corporate reporting is essential for attracting and protecting investors; managing risks and returns; reducing financial volatility; enhancing good governance, accountability and responsibility; and, ultimately, for the efficient mobilization, allocation and use of scarce economic resources that are urgently needed for achieving international development goals. Harmonized accounting and reporting practices also contribute to the stability and coherence of the international financial infrastructure.

Over the years, the growing globalization and interdependence of the world economy has increased pressure to harmonize financial information. Although there are still some serious implementation challenges to be met, the new standards enable the direct comparison of financial reports and economic transactions from around the world. Not only does this improve investors' and other stakeholders' confidence in the numbers, it also saves scarce resources by removing the need to prepare different sets of reports for users in different countries.

But today's investors and stakeholders are interested in far more than financial performance. Enabling a transparent investment climate requires disclosure of non-financial aspects as well. Stakeholders, particularly those who intend to maintain long-term investment positions in a given enterprise, want to know how it has performed in terms of corporate responsibility and corporate governance. They increasingly insist on corporate disclosure that is both comparable and relevant.

This volume of the proceedings of ISAR's 22nd session deals with the practical implementation issues of IFRS, corporate responsibility reporting and corporate governance disclosures. It also contains articles on current issues in the area of corporate reporting, such as revenue recognition and fair value measurements.

I am confident that a wide range of readers, including policy makers, standard setters, educators, corporate executives and board members, will find this volume a timely and useful resource.

Supachai Panitchpakdi
Secretary-General of UNCTAD
Geneva, December 2005

EXECUTIVE SUMMARY

This volume of the 2005 Review of International Accounting and Reporting Issues contains the proceedings of the 22nd session of the Intergovernmental Working Group of Experts on International Accounting and Reporting Standards (ISAR). During its 22nd session, the Group of Experts deliberated on two main agenda items: review of practical implementation issues of International Financial Reporting Standards (IFRS) and comparability and relevance of existing indicators on corporate responsibility.

The first chapter provides an overview of recent trends in the IFRS convergence process and highlights major practical issues that are arising in the implementation process. These include issues such as institutional framework, enforcement mechanisms and various technical challenges. The chapter was prepared with a view to facilitating discussions of the implications of adopting IFRS for developing countries and countries with economies in transition and assessing feasible implementation strategies that could enable them to meet international standards in enterprise accounting and reporting. The second chapter deals with corporate responsibility indicators in annual reports. It provides an overview of the principal stakeholders of an enterprise and their information needs; explains the criteria for the selection of core indicators of common interest to stakeholders; and details the key topics and related indicators selected. In chapter three, users of corporate responsibility reporting and their information needs are discussed.

The fourth chapter contains guidance on good practices in corporate governance disclosure. It covers financial and non-financial corporate governance disclosures, as well as disclosures regarding general meetings, and timing and means of disclosure. The chapter also contains a list of useful references on regional and international corporate governance disclosures. In 2005, the UNCTAD secretariat conducted a survey on the implementation status of corporate governance disclosures. The findings of the survey are presented in chapter five.

On 24 November 2005, the UNCTAD secretariat organized a technical workshop on the practical implementation of International Financial Reporting Standards (IFRS). The workshop addressed many technical issues such as first-time implementation of IFRS; measurement and recognition, including fair value measurement requirements; revenue recognition; and opportunities for cooperation and coordination in the implementation of IFRS. The event featured several leading experts in the area of IFRS. Articles contributed by panellists at the IFRS workshop are presented in the last chapter.

INTRODUCTION

The 22nd session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting brought together 217 experts from 72 countries. At its 22nd session, the Group of Experts addressed two main agenda items: review of practical implementation issues of International Financial Reporting Standards (IFRS) and comparability and relevance of existing indicators on corporate responsibility. During the "other business" segment of its agenda, the Group of Experts discussed corporate governance disclosure issues and also reviewed progress on follow-up work on issues that it deliberated on at previous sessions.

The deliberations of the Group of Experts on the first main agenda item were facilitated by an issues note prepared by the UNCTAD secretariat and by two panel discussions. In its discussions on the review of practical implementation issues of IFRS, the Group of Experts reiterated the importance of a common set of principles-based high-quality financial reporting standards for: the coherence and consistency of the international financial system; mobilizing and efficient allocation of financial resources; for facilitating investment needed for the economic development of member States. It also underscored a number of practical implementation challenges that need to be addressed to assist developing countries and countries with economies in transition to meet internationally recognized standards. In concluding its deliberations on this agenda item, the Group of Experts agreed to conduct further review of the practical implementation challenges of IFRS as well as ways to meet these challenges, including by preparing country case studies, with a view to developing guidance on good implementation practices. The Group of Experts further highlighted the importance of addressing the accounting needs of non-listed companies and small- and medium-sized (SMEs) enterprises as part of the implementation process of IFRS. It requested to discuss this subject as part of its deliberations on the implementation of IFRS.

During its deliberations on the second main agenda item, the Group of Experts discussed users and uses of corporate responsibility reports information, criteria for selecting topics to be reported on and selected indicators for reporting on corporate responsibility in annual reports. ISAR deliberations on this agenda item were facilitated by a report prepared by the UNCTAD secretariat. In concluding its deliberations on this agenda item, the Group of Experts agreed that the report prepared by the UNCTAD secretariat provided helpful voluntary guidance on improving relevance and comparability of corporate responsibility information as part of annual reports. The Group of Experts also agreed on certain refinements on the titles of some of the topics and on the need for additional information that could be provided in the report to enhance usefulness. Finally, the Group of Experts requested the UNCTAD secretariat to conduct a review of enterprise reporting practices based on selected indicators with a view to finalizing the report discussed at the 22nd session. The Group of Experts also suggested that follow-up work on measurement methodology for selected indicators could be conducted to ensure consistent reporting.

During the "other business" segment of the agenda, the Group of Experts discussed an UNCTAD secretariat document on *Guidance on good practices in corporate governance disclosure*. The report was prepared in accordance with the Group's request to the UNCTAD secretariat at its 21st session to update the report on corporate governance disclosures it discussed at its 19th session. Accordingly, the secretariat prepared an updated report by taking into account recent developments on corporate governance disclosure practices. In concluding its deliberations on this item, the Group of Experts recognized that the updated guidance document could be a useful voluntary tool for promoting increased transparency and improved corporate governance and requested the UNCTAD secretariat to prepare the document for publication and to disseminate it as widely as possible. Furthermore, the session discussed results of a survey on the implementation status of corporate governance disclosures.

The UNCTAD secretariat reported on follow-up work conducted on issues the Group of Experts addressed at its previous sessions. In the area of accounting by SMEs and environmental accounting, the secretariat reported on progress made in translation and dissemination of publications. The secretariat also reported on its cooperation with the International Federation of Accountants in general and the Education Committee in particular, pertaining to the implementation of the UNCTAD/ISAR Model Curriculum on accounting.

On the occasion of the 22nd session of ISAR, the UNCTAD secretariat organized a technical workshop on practical implementation issues of IFRS. The event was organized in cooperation with the International Accounting Standards Board (IASB). It took place on 24 November 2005 at the Palais des Nations in Geneva and about 90 participants attended the event. The workshop addressed: first-time implementation of IFRS; recognition and measurement issues, including fair value measurements; revenue recognition; and discussion on further steps in the IFRS implementation process and opportunities for facilitating the exchange of experiences around the world.

UNCTAD would like to express its appreciation to Mr. Aziz Dieye, Senior Partner, Cabinet Aziz Dieye, Chairperson of the 22nd session of ISAR, and Professor Valeriy Nikolaevitch Parhomenko, Chief of Division, Ministry of Finance of Ukraine and Vice-Chairperson-cum-Rapporteur of the 22nd session of ISAR for their excellent leadership of the session and for their contributions to the fruitful conclusion of the session. UNCTAD also acknowledges, with appreciation, the contributions of Richard Frederick and Nancy Kamp-Roelands as resource persons in the areas of corporate governance and corporate responsibility, respectively. The contributions of Paul Lee, Associate Director, Governance and Engagement, Hermes Investment Management Ltd, to the discussions on corporate governance disclosures are acknowledged with great appreciation.

UNCTAD expresses its gratitude to panel members who shared their views on the implementation of IFRS. These are: Philippe Danjou**,** International Organization of Securities Commissions, Member, Standards Advisory Council, International Accounting Standards Board, France; Gerald Edwards, Bank for International

Settlements, Switzerland; Liz Hickey**,** Technical Director**,** International Accounting Standards Board, United Kingdom; Wang Jun**,** Vice Minister, Ministry of Finance, China; John Kellas, Chairman, International Auditing and Assurance Standards Board, International Federation of Accountants, United States of America; Ulf Linder, Deputy Head of Unit, European Commission, Belgium; Abbas Ali Mirza**,** Partner, Deloitte and Touche, Middle East; Thirachai Phuvanatnaranubala, Secretary-General, Securities and Exchange Commission, Thailand; and Witold Skrok**,** Head of Controlling, BPH Bank, Poland.

UNCTAD expresses its gratitude to panel members who shared their perspectives on corporate governance disclosures on the occasion of the 22nd session of ISAR. They are: André Baladi, Member of the Advisory Board of the FTSE-ISS Corporate Governance Index, Switzerland; Karugor Gatamah, Center for Corporate Governance, CEO, Kenya; Saskia Slomp, Technical Director, The European Federation of Accountants (FEE), Belgium; Maged Shawky Sourial, Chairman, Cairo and Alexandria Stock Exchanges, Egypt; and Christian Strenger, Chairman, International Corporate Governance Network, Chairman, Germany.

UNCTAD expresses its appreciation to all members of the consultative group for their contributions in drafting the guidance on corporate responsibility indicators in annual reports. They are: Andre Baladi, Member of the Advisory Board of the FTSE-ISS Corporate Governance Index; Justine Bentham , KPMG; Helen Bloustein EPA, Victoria, Australia; Bernardo Calzadilla, International Organization for Standardization; Rob Gray, University of St. Andrews, Scotland; Paul Clements-Hunt, United Nations Environment Program Finance Initiative; Dwight Justice, International Confederation of Free Trade Unions; Nancy Kamp-Roelands, Ernst & Young; Alya Kayal, Calvert Group Ltd.; Michael Kelly, KPMG; Robert Langford; Independent Consultant; Debora Leipziger, Anders & Winst; Jianqiao Lu, Ministry of Finance, People's Republic of China; Cornis van der Lugt, United Nations Environment Program; Julie McDowell, Standard Life Investments; Mokhethi Moshoeshoe, African Institute of Corporate Citizenship; Anthony Perret, The Environment Council; Liz Umlas, KLD Research & Analytics, Inc.; Michael Urminsky, International Labour Organization; Ambreen Waheed, Responsible Business Initiative; Hazen Yassin, Capital Market Authority, Egypt; and Santiago Zorzopulos, Dubai Ethics Resource Center.

UNCTAD appreciates the contributions of the following experts in drafting the guidance on good practices in corporate governance disclosure. They are: Carlotta Amaduzzi, Institutional Shareholder Services (United States); André Baladi, Member of the Advisory Board of the FTSE-ISS Corporate Governance Index; Ian Ball, International Federation of Accountants; John Barrass, CFA Institute; Igor Belikov, Russian Institute of Directors; Robert Blanks, Institute of Chartered Secretaries and Administrators (United Kingdom); Geoffrey Bowes, The Boardroom Practice Ltd. (New Zealand); Jacqueline Cook, The Corporate Library (United States); David Devlin, President, European Federation of Accountants; Ndung'u Gathinji, International Federation of Accountants; Frederic Gielen, World Bank Group; Winston Griffin, Proctor & Gamble (Switzerland); Ashok Haldia, Institute of Chartered Accountants of India; Paul Lee, Hermes Investment Management Ltd. (United Kingdom); Paul Moxey, Association of Chartered Certified Accountants

(United Kingdom); Matthias Mueller, International Confederation of Free Trade Unions; Vijay Poonoosamy, Commonwealth Association of Corporate Governance; Gregor Pozniak, Federation of European Securities Exchanges; Paolo Santella, European Commission; and Saskia Slomp, European Federation of Accountants.

UNCTAD extends its special thanks to Robert Garnett, Board Member, International Accounting Standards Board and Chairman of the International Financial Reporting Interpretations Committee for his outstanding cooperation in organizing the technical workshop on the implementation of IFRS that took place on 24 November 2005 at the Palais des Nations in Geneva. UNCTAD is very grateful for the excellent contributions of panellists and panel chairpersons at the workshop. They are: Caroline Beer, Technical Volunteer on IFRS, Institute of Chartered Accountants in England and Wales; Norbert Breker, FEE Financial Reporting Policy Group; David Cairns, Visiting Professor, London School of Economics; Jérôme Chevy, International Assignment Coordinator, Conseil National de la Comptabilité, France; Peter Clark, Senior Project Manager, IASB, United Kingdom; Stig Envoldsen, Chairman, Technical Expert Group, European Financial Reporting Advisory Group; Mareike Kühne, Project Manager, German Accounting Standards Board; Richard Martin, Head of Financial Reporting, Association of Chartered Certified Accountants (ACCA), United Kingdom; John Njiraini, Chief Executive, Institute of Certified Public Accountants of Kenya; David Raggay, Pierre, Raggay & Co., Trinidad and Tobago; Martin Schmidt, Project Manager, German Accounting Standards Board; and Syed Asad Ali Shah, Senior Partner, Deloitte Touche Tohmatsu.

Finally, UNCTAD expresses its appreciation to the following team members of the UNCTAD secretariat for their dedication and contributions to the success of the consultations on corporate governance disclosures and corporate responsibility reporting; the 22nd session of ISAR, the technical workshop on the implementation challenges of IFRS and this publication. These are Yoseph Asmelash, Julie Henshaw, Catherine Katongola-Lindelof, Tatiana Krylova (team leader), Anthony Miller and Kairat Satkyn Uulu. The contributions of Richill Tamakloe and Bo Zhao to the 2005 survey on implementation status of corporate governance disclosures are acknowledged with appreciation.

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Chapter I

REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Summary of discussions

In introducing the agenda item to the session, a member of the UNCTAD secretariat drew the attention of participants to the issues note on the Review of practical implementation issues of International Financial Reporting Standards (TD/B/COM.2/ISAR/29) prepared by the UNCTAD secretariat to facilitate the deliberations of the Group of Experts on this agenda item. She gave an overview of the note and informed participants that in order to enrich the deliberations on the issue and take on board the views of a wide range of stakeholders, two panels would address the session.

The first panel featured highly distinguished experts who presented the perspectives of international financial institutions, international standard-setters and international and regional regulators. A panellist who presented the perspectives of international financial institutions underscored the importance of high-quality international financial reporting standards for the coherence, stability and efficient functioning of the international financial system. He noted that in the domain of international financial institutions, sound accounting and disclosure were essential for high-quality financial and supervisory reporting, accurate capital calculations and ratios, as well as for transparency, and for promoting stable financial systems.

Another panellist presented the perspectives of the International Accounting Standards Board (IASB) on the development and implementation of IFRS. The panellist highlighted the work programme of the IASB. She also noted that the aim of the IASB was to develop principles-based standards. However, she acknowledged that some of its standards were lengthy and seemed more rules-based. The panellist discussed the IASCF's education initiative. Finally, she highlighted the growing number of countries that either require or permit the use of IFRS by enterprises in their jurisdictions.

This was followed by a presentation on the implications of the implementation of IFRS for the work of auditors. With respect to the implementation of IFRS, the panellist stated that there was considerable shortage of expertise in the area of IFRS and the disparity in skills posed a significant risk that had to be managed. The panellist highlighted several International Standards of Auditing that were of particular relevance in the implementation of IFRS. These covered issues such as quality control, risk assessment and communicating with those charged with governance. He noted that endorsement processes on IFRS could result in endorsed

IFRSs that were different from those issued by the IASB. Such situations require auditors to make additional considerations in conducting their audit work and in preparing their reports. He stated that if countries that adopted only some IFRS required auditors to attest that financial statements prepared by entities in their jurisdictions were prepared in accordance with IFRS, as adopted in that particular country, the situation would create major confusion and negatively impact the benefits of financial reporting on the basis of a common set of high-quality standards.

The panel discussion continued with a presentation on the experiences in the European Union with implementing IFRS. In his presentation, the panellist provided an overview of the IAS Regulation (1606/2002/EC) and the implementation process of IFRS in the European Union, including the scope and the endorsement process. He noted the legal, political and administrative challenges and complexities that arise in the endorsement process and implementation efforts. The "carve outs" on IAS 39 that were made in the endorsement process created year-end issues in relation to audit statements. The task of translating IFRS into 20 languages was another challenge. The panellist added that a period of relative stability in the standard-setting area was desirable to allow entities to cope with IFRS implementation.

Another panellist discussed regulatory and enforcement aspects of IFRS implementation from an international and a regional perspective. The panellist stated that IFRS created a level playing field among issuers, easier comparability of financial statements, enhanced transparency, and deeper and safer financial markets. IFRS also provided better regulatory oversight tools. He underlined several challenges in the implementation and enforcement of IFRS that posed significant challenges, including: the limited number of interpretations, the influence of national accounting cultures, possible differences in the views of audit firms in jurisdictions where dual audit opinions were required, and the need for consistent enforcement and transparent decision-making on the side of regulators.

During the second panel discussion the presentations focused on different experiences and strategies that selected countries adopted towards convergence with IFRS. In sharing his country's experience, one of the panellists stated that as part of its plan to converge with IFRS, his country would issue in early 2006 a set of accounting standards based on IFRS. These would be adapted to the specific economic and legal realities in his country and would be applicable to large and medium-sized companies. The implementation strategy included a grace period of one year before the standards would come into effect. This time interval would allow for making adjustments to the standards in light of implementation issues that might arise. The panellist noted that fair value measurement requirements, identification of related parties in related-party transactions and certain impairment issues were subjects on which his country was engaged in further discussions with the IASB. He further noted the important role that multilateral institutions and forums like ISAR could play in the implementation of IFRS and called for further cooperation and coordination among such entities.

The next panellist also shared his country's experience with the implementation of IFRS. He noted that the accounting standards applicable in his country complied with IFRS to the extent of about 97 per cent. His country's plan was to move to full IFRS by 2006, when these standards would become a requirement for listed companies. The panellist stated that developing countries were under-represented in the international standard-setting process. He expressed the view that once international standards were set, they became applicable for all regardless of whether or not those required to implement them had a say in the standard-setting process. Thus, developing countries needed to be represented in all international standard-setting bodies and at all levels. The IFRS do not take into account the specific economic realities in developing countries. He elaborated on this point by citing several examples.

Another panellist discussed developments in standard-setting at the IASB from the perspective of developing countries. He stated that the sweeping changes in standards posed a significant challenge for the implementation process. For example, as part of the of the IASB’s Improvements Project, 13 International Accounting Standards were simultaneously amended, bringing about consequential amendments to other standards. Taken together, about 20 standards were impacted. Such frequent changes did not allow for real life examples of best practice to emerge. The IFRS’s mixed attribute measurement model and the trend towards more fair value based measurements did not allow for like things to be compared on the same basis. He cited a number of requirements in IFRS, particularly IAS 24 on Related Party Disclosures, which were difficult to interpret and implement.

The next panellist shared his company's experience in implementing IFRS in 2005. He stated that his company (a financial institution that belonged to a large group in Europe) embarked on the implementation process in early 2004. Prior to that, it prepared financial statements in accordance with national accounting standards for local regulators and IFRS based financial statements for its parent company. One of the first clarifications his entity sought was whether it qualified as a first-time adopter in accordance with IFRS 1. Since his company previously prepared IFRS based financial statements for its parent, it did not qualify as a first-time adopter and was not eligible for exemptions in IFRS 1. The panellist stated that his company interacted with its parent company, financial analysts, and its customers to determine the appropriate format and level of detail for its IFRS-based financial statements. Segment information was of particular importance in this respect. It also reviewed the reporting practices of another financial institution in the region that was considered to be a best practice example. He cited valuation of loan portfolio, goodwill, investment in subsidiaries and changes in the classification of financial instruments as main areas in which his company had to make major adjustments.

In the course of the deliberations on this agenda item, several delegates shared the experiences of their countries in implementing IFRS. A delegate stated that adoption of IFRS was an important consideration for his country in its quest for accession to the World Trade Organization and eventual membership in the European Union. An expert stated that blind application of IFRS, without the proper infrastructure in place, would create more problems. Another expert noted that when adopted in certain jurisdictions, IFRS formed part of national commercial law with consequential impacts on other national regulations. In such circumstances additional consideration and preparation would be required prior to entering the implementation phase.

During the exchange of views, it emerged that the question of the accounting needs of SMEs should be an integral part of the IFRS implementation strategy that member States adopt. Some expressed concern that too much focus on implementation of IFRS for large listed companies, particularly in the context of developing countries, failed to take into consideration the needs of unlisted SMEs, which constituted a vital part of their economies. Many delegates were keen to learn from the experiences of others on how to deal with the question of SMEs.

Many participants raised the issue of the shortage of educational and training materials on IFRS. Participants were informed that the IASC Foundation had made available such materials on the "shop" section of the IASB website. These included a guide on each IFRS/IAS intended for members of boards of directors and audit committees, a read-only compact disc on the conceptual framework, and a volume on financial instruments. They were also informed that the IASC Foundation had decided that such materials should be sold at a price to cover at least the Foundation's costs on its staff that were engaged in preparing such materials. An expert asked about the rationale for the changes in the wording of IFRS requirements from "should" to "shall". A member of the panel explained that the change was made to avoid any ambiguity about requirements, particularly from the perspective of enforcement.

Various experts raised the issue of fair value measurement requirements in the implementation of IFRS in the context of developing countries and countries with economies in transition. A member of the panel stated that this issue was frequently raised in the efforts of his country to converge with IFRS. He noted that his country adopted a flexible approach that took into account national economic and legal factors. An expert from a developing country where entities were required by law to provide defined post retirement benefit plans to their employees stated that actuarial valuations posed special challenges to preparers in his country. Given the shortage of actuarial experts in many developing countries, he called on the IASB to provide guidance material on this subject.

The 22nd session expressed its appreciation for the issues note prepared by the secretariat that clearly articulated the various practical challenges in implementing IFRS and also the high quality of the panel discussions on the issue. It recognized the positive role the ISAR forum played in facilitating the exchanging of views and experiences among member States. The Group of Experts agreed to further review the practical implementation of IFRS as well as ways and means to meet these challenges. It also requested a discussion on the issue of accounting by SMEs as part of its deliberations on the IFRS implementation process.

A. Introduction

Many developing countries and countries with economies in transition strive to mobilize financial resources from domestic and international sources to attain their economic and social development goals. The availability of relevant information on potential investment targets has a bearing on efforts to mobilize investment for financing economic and social development, as such information plays an important role in critical investment decisions and risk assessment. It also contributes to improved investor confidence and decreased cost of capital.

Recognizing the significant influence that corporate reporting has on investment decisions, developing countries and countries with economies in transition are attaching greater importance to corporate transparency and reporting and are making efforts to strengthen the various components of the accounting infrastructure so that financial resources can be mobilized and used more efficiently.

However, different countries use different national accounting standards, which makes it difficult and costly to compare opportunities and make informed financial and investment decisions. In addition, faster globalization, the growing interdependence of international financial markets and increased mobility of capital have increased the pressure and demand for the harmonization of reporting frameworks and related standards.

The need for a global set of high-quality financial reporting standards has long been apparent. The process of international convergence towards a global set of standards started in 1973 when 16 professional accountancy bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and the United States agreed to form the International Accounting Standards Committee (IASC), which in 2001 was reorganized into the International Accounting Standards Board (IASB). The IASB develops global standards and related interpretations that are collectively known as International Financial Reporting Standards (IFRS).[1]

The process gained speed when the International Organization of Securities Commissions (IOSCO) endorsed the IASC standards for international listings in May 2000. It was further facilitated by the Regulation approved by the European Commission in 2002 requiring the preparation of the consolidated (group) accounts of listed companies in the European Union in accordance with IFRS.[2] Recently, many more countries have announced their transition to IFRS, in some instances extending the scope of application beyond group accounts to legal entities and incorporating IFRS into their national regulatory framework.

However, some developing countries and countries with economies in transition lack the accounting infrastructure and professional institutions that are needed to meet the challenges posed by transition to a common set of global standards — standards that are formulated with developed markets in mind and are becoming increasingly sophisticated. Therefore, there is a need to address these issues and to identify ways of helping these countries build capacity to implement internationally recognized accounting practices.

A number of international organizations are involved in the process of harmonizing accounting requirements and practices. While the IASB formulates the IFRS, another global standard setter, the International Federation of Accountants (IFAC), formulates International Standards on Audit (ISA) and other professional requirements needed for harmonization of accounting practices, including in areas such as education and ethics. The World Bank and UNCTAD are also involved in the

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[1] See the IASB website for further information on IAS and IFRS and the history of the IASC and the IASB.

[2] Regulation (EC) 1606 of July 2002.

harmonization process, particularly in the context of economic development and how it could be enhanced through implementation of best accounting and reporting practices in developing countries and countries with economies in transition.

The United Nations has contributed for over three decades to global efforts to promote comparable and reliable corporate reports. In 1973, the UN Secretary-General convened a group of Eminent Persons that recommended the creation of an internationally comparable system of standardized accounting and reporting.[3] After a series of deliberations on these issues, the Economic and Social Council of the United Nations established the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) in October 1982 by resolution 1982/67.

Through ISAR, which is the only intergovernmental group at the international level that deals with corporate accounting and reporting, UNCTAD has contributed to an international debate on harmonization of accounting requirements with a view to facilitating understanding of the implementation challenges faced by developing countries and countries with economies in transition, and it has assisted these countries in implementing best international practices.

UNCTAD's efforts have been closely coordinated with the IASB and the IFAC through participation in events and standing committees. In November 2004, UNCTAD and IFAC signed a Memorandum of Understanding to work closer together to increase awareness of the importance of accountancy in economic development and to strengthen the accountancy profession in developing countries and economies in transition.

At UNCTAD's tenth quadrennial conference (in Bangkok, Thailand), member States requested that the organization "promote increased transparency and disclosure by encouraging the use of internationally recognized accounting, reporting and auditing standards and improved corporate governance" (para. 122 of the Bangkok Plan of Action). At the eleventh conference (in São Paulo, Brazil), member States reaffirmed the Bangkok Plan of Action and requested that UNCTAD "collect, analyse and disseminate data on best practices for stimulating enterprise development and identify ways and means for enterprises, especially developing countries' SMEs, to meet international standards, including accounting standards" (para. 55 of the São Paulo Consensus).

Given the scope of the challenge of the international transition to IFRS, ISAR, in concluding its twenty-first session in October 2004, proposed to include this issue in its agenda and to review issues involved in implementing IFRS at its 22nd session.[4]

[3] *The Impact of Multinational Corporations on Development and on International Relations*, Report of the Group of Eminent Persons, E/5500/Rev.1/ESA/6, 1974, United Nations, New York.

[4] International Financial Reporting Standards (IFRS) are the international accounting standards developed by the International Accounting Standards Board. Standards developed by its predecessor, the International Accounting Standards Committee, are referred to as International Accounting Standards (IAS). The whole set of IFRS and IAS, including related interpretations issued by the International Financial Reporting Interpretations Committee, are collectively known as IFRS.

This note has been prepared by the UNCTAD secretariat to facilitate discussions of this topic at ISAR's 22nd session. The note summarizes and highlights key issues of implementation of IFRS based on related literature and ongoing discussions in this area. It also aims to help developing countries and economies in transition assess the implications of adopting IFRS and develop feasible implementation strategies in order to meet international requirements in enterprise accounting and reporting.

B. Overview of recent trends in the IFRS convergence process

1. The rationale for convergence

A number of factors have contributed to the evolution of IFRS and the acceleration of the convergence towards IFRS since the mid-1990s.

Over the last three decades, the world economy and capital markets have become increasingly globalized and integrated. Evidence of the globalization of capital markets is widespread. For example, currently 459 non-US companies from 47 countries are listed on the New York Stock Exchange. They account for about 20 per cent of the listings and 33 per cent of the total market capitalization. On the NASDAQ, 338 companies from 35 countries are listed. Of those companies listed on the London Stock Exchange that account for over 60 per cent of its market capitalization, 17 per cent are foreign. The proportion of foreign companies in selected other markets is as follows: Euronext, 25 per cent; Germany, 21 per cent; New Zealand, 21 per cent; Singapore, 14 per cent; and Switzerland, 31 per cent.[5]

World capital markets have become so integrated and interdependent that the stability of one market affects others. The need for global financial reporting standards to support the stability of international financial markets has become so critical that the Financial Stability Forum has identified IFRS as one of the 12 global standards needed for the sound functioning of the global economy.[6]

Another argument for global standards is that they can help achieve greater mobility of capital and more efficient allocation of resources by reducing technical barriers created by national accounting differences. When listing their securities for trading in other jurisdictions, entities are required to present financial statements prepared on the basis of standards that are acceptable to the jurisdictions where they intend to offer their securities. The higher the number of markets in which an entity wishes to offer its securities, the more diverse the accounting standards it has to deal with.

In this respect, the benefits of having one set of high-quality globally recognized financial reporting standards are significant. Not only can they improve the mobility of capital flows and dialogue between different stakeholders, they can also reduce the costs of attracting capital. An entity that prepares its financial reports on the basis of such standards can avoid the additional issuance and transaction costs

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5 P. Pacter, "What Exactly Is Convergence? *International Journal of Accounting, Auditing and Performance Evaluation* 2 (1/2): 67–83.

6 Further information on the 12 standards is available at the site of Financial Stability Forum, www.fsforum.org.

that it would incur in providing financial statements that complied with a variety of accounting regimes. For example, according to some estimates, each of some 250 European companies listed on stock exchanges in the United States spends between $5 million[7] and $10 million a year to comply with requirements relating to reconciliation with US Generally Accepted Accounting Principles (GAAP).[8]

It is also argued that the use of IFRS would improve the quality of financial reporting and ensure a better presentation of enterprise performance. Various studies have documented the usefulness of global financial reporting standards. For example, a recent study by a team of researchers including a member of the IASB Board compared financial reports of entities that adopted IFRS with a matching sample of firms that did not. The study included a sample of IFRS-using firms from 23 countries and covered adoption years from 1994 to 2003. The researchers concluded that, after adopting IFRS, firms appeared to experience a decline in earnings management (the practice of using accounting tricks to mask true operating performance), recognized losses on a more timely basis and provided more value-relevant data. To a limited extent, the study also found a decrease in the cost of capital for IFRS-adopting entities.[9]

2. Overview of convergence trends

The convergence process has speeded up greatly in recent years. Today about 90 countries around the world reportedly either require or permit entities listed in their markets to use IFRS. Examples of IFRS requirements in some jurisdictions appear in tables I.1 and I.2.

Table I.1. Examples of countries and economies where use of IFRS by all domestic listed companies is currently required

Armenia	Dominican Rep.	Kyrgyzstan	Peru
Bahamas	Ecuador	Macedonia	Qatar
Bahrain	Egypt	Malawi	South Africa
Bangladesh	Georgia	Mauritius	Tajikistan
Barbados	Guatemala	Namibia	Tanzania
Bosnia and Herzegovina	Guyana	Nepal	Trinidad and Tobago
	Haiti	Nicaragua	
Bulgaria	Jamaica	Oman	Ukraine
Costa Rica	Jordan	Panama	Yugoslavia
Croatia	Kenya	Papua New Guinea	

Source: Deloitte Touche Tohmatsu, IAS Plus, 2005.[10]

Table I.2. Examples of countries and economies where use of IFRS by domestic listed companies is currently permitted

Bermuda	Dominica	Myanmar	Turkey
Bolivia	El Salvador	Sri Lanka	Uganda
Botswana	Lao PDR	Swaziland	Uruguay
Brunei Darussalam	Lesotho	Switzerland	Zambia
			Zimbabwe

Source: Deloitte Touche Tohmatsu, IAS Plus, 2005.[11]

[7] All references to "dollars" ($) are to US dollars.

[8] According to Charlie McCreevy, European Commissioner for Internal Market and Services, in a speech on the Commission's Financial Services Policy 2005–2010, Brussels, 18 July 2005.

[9] M. Barth, W. Landsman and M. Lang, *International Accounting Standards and Accounting Quality*, March 2005.

[10] Detailed information can be found at http://www.iasplus.com/country/useias.htm.

Countries vary in their requirements related to the application of IFRS. For example, in the European Union, IFRS must be applied to the consolidated financial statements of listed companies. Non-listed companies, which number over three million, are required by law to prepare and file financial statements in accordance with the GAAP applicable in their respective jurisdictions. However, EU member States are authorized to permit such companies to use IFRS in the preparation of their financial statements. Countries that do so include Austria, France, Ireland, Slovenia and the United Kingdom. In some other EU member States, non-listed entities are required to prepare IFRS-based financial statements; these countries include Cyprus, Malta and Slovakia. Certain EU member States require non-listed companies to use national GAAP and prohibit them from using IFRS. These include Latvia, Lithuania and Poland.[12]

There are also countries where only certain entities are permitted to use IFRS. These include, for example, China, Kazakhstan, Romania, and the Russian Federation. At the same time, a number of countries, including some of the world's largest economies, do not permit the use of IFRS for listing, at least without reconciliation. These include Argentina, Brazil, Canada, Chile, India, Japan and the United States. However, efforts are underway to bring domestic standards into line with IFRS. While they do not currently permit the use of IFRS for listing, several UN member States such as India, Malaysia, the Philippines and Singapore have brought their domestic GAAP into line with IFRS.

In the United States, since September 2002, the Financial Accounting Standards Board (FASB) and the IASB have been working to achieve better compatibility between their respective sets of standards in accordance with the Norwalk Agreement signed by the two entities.[13]

The IASB has undertaken several projects in response to this Agreement.[14] For example, it replaced IAS 35 with IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations, to converge with the FASB's Statement of Financial Accounting Standard 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The FASB has also undertaken activities to move towards convergence with IFRS in areas such as share-based payments, the treatment of idle capacity and spoilage costs in the cost of inventory, and asset exchanges. In mid-2005, the IASB and the FASB published their first joint proposals to improve the accounting and reporting of business combinations.[15]

An important issue relating to convergence efforts by the FASB and the IASB is whether the US Securities and Exchange Commission (SEC) will accept financial statements prepared by foreign registrants without reconciliation to US GAAP, and

[11] Detailed information can be found at http://www.iasplus.com/country/useias.htm.

[12] P. Pacter, "What Exactly Is Convergence?" *International Journal of Accounting, Auditing and Performance Evaluation* 2 (1/2): 67–83.

[13] Further details on the Norwalk Agreement are available at http://www.fasb.org/news/memorandum.pdf.

[14] Sir David Tweedie, Chairman, International Accounting Standards Board, and Thomas R. Seidenstein, Director of Operations, IASC Foundation, "Setting a Global Standard: The Case for Accounting Convergence", *Northwestern Journal of International Law & Business* 25 (3): 589–608.

[15] IASB Press Release, 30 June 2005.

when this could happen. In April 2005, the US SEC announced its "road map" highlighting the steps needed to eliminate the US GAAP reconciliation requirements for foreign private issuers that use IFRS. The road map indicates that the requirement for reconciliation to US GAAP could be eliminated by 2009 if not sooner.[16] Currently there is no indication of whether companies in the United States will be permitted or required to use IFRS instead of US GAAP for their financial reporting.

Japan's Accounting Standards Board, too, is currently working towards convergence with IFRS. In March 2005, the IASB and the Accounting Standards Board held initial discussions on a joint project for convergence. In the initial phase, the project was to consider topics such as Measurement of Inventories (IAS 2), Segment Reporting (IAS 14), Related-Party Disclosures (IAS 24), Unification of Accounting Policies Applied to Foreign Subsidiaries (IAS 27) and Investment Property (IAS 40).[17]

In March 2005, the Accounting Standards Board of Canada published its five-year draft strategic plan for comment. The strategic plan, on which comments were due by July 2005, proposed that, for public companies, the Board would direct its efforts towards participating in the movement towards the global convergence of accounting standards. The plan states that the best way to achieve a single set of globally accepted high-quality accounting standards is to bring Canadian GAAP into line with IFRS over a transition period expected to last five years (2006–2011). The proposal envisages that at the end of the transition period, Canadian GAAP will cease to exist as a separate, distinct basis for financial reporting by public companies.[18]

3. Equivalence to IFRS endorsed by the European Union

As of 1 January 2007, the European Union–wide rules on Prospectuses require foreign companies wishing to offer their securities to investors in the European Union to prepare their prospectus, including financial reports, in accordance with IFRS endorsed by the European Union, or IFRS equivalents. These requirements also apply, under the Transparency Directive,[19] to foreign registrants already listed in the European Union. Third-country GAAP would be considered equivalent to IAS/IFRS "when financial statements prepared under such third-country GAAP enable investors to take at least similar decisions in terms of whether to invest or divest, as if they were provided with financial statements prepared on the basis of IAS/IFRS".[20]

The European Commission has mandated that the Commission of European Securities Regulators (CESR) conduct assessments of third-country GAAP. The CESR's task also included describing the enforcement mechanisms in the three countries whose accounting standards were being reviewed for equivalence.

[16] For further details see US SEC press release 2005-62.
[17] See IASB Press Release, 11 March 2005, IASB and the Accounting Standards Board of Japan hold initial meeting on joint project for convergence, http://www.iasb.org.
[18] *Accounting Standards in Canada: Future Directions* can be found at http://www.acsbcanada.org/.
[19] Directive 2004/109/EC of the European Parliament and of the Council.
[20] The Committee of European Securities Regulators, Concept Paper on Equivalence of Certain Third Country GAAP and on Description of Certain Third Country Mechanisms of Enforcement of Financial Information, Consultation Paper, October 2004.

In April 2005, the CESR published a consultation paper on its review of Canadian, Japanese and US accounting standards to determine their equivalence to IFRS.[21] It completed its final technical advice for the European Commission on equivalence between Canadian, Japanese and US GAAP and IFRS in early July 2005. Based on its assessment, the CESR has concluded that, considering the needs of investors in EU financial markets, Canadian, Japanese and US GAAP, each taken as a whole, could be considered as equivalent to IFRS, subject to a number of remedies (additional disclosures).

On the basis of the CESR's conclusion, companies listed in EU financial markets that present their financial statements in accordance with any of the three countries' GAAP would not be required to present a complete reconciliation of their financial statements with IFRS. Instead, such companies would be expected to provide additional disclosure on a list of significant differences between the respective GAAP and IFRS that the CESR identified in its advice.[22]

C. Key issues relating to practical implementation of IFRS

1. The scope of application of IFRS

Initially the IAS were developed for consolidated accounts of listed companies. However, with increased globalization of economies and financial markets, the number of internationally active companies is growing, and use of IFRS for international financial communication is increasing. In countries that are building or improving their accounting infrastructure, IFRS-based corporate reports are considered by investors, particularly international ones, to be more reliable and understandable than statutory reports.

Therefore, in many countries, regulatory authorities try to improve their statutory accounting regulations, and in some instances adopt IFRS as their statutory requirement for legal entities. In such cases, one implementation issue for a country may be the need to reconcile the national legislative framework with the requirements of IFRS, which may include a number of legislative acts affected by such a transition.

Another significant group of issues on which debate continues is whether and how a transition to IFRS would affect small and medium-sized enterprises (SMEs), whether a separate set of standards for SMEs is needed, and what should be the underlying conceptual and methodological basis of such standards. Many argue that, given the complicated nature of IFRS, the costs to SMEs of applying them may overweigh the benefits. Still another issue is whether international harmonization should affect the smallest companies or should be addressed at the national level.

ISAR has been addressing the issue since 2000, when it first discussed the impact of the increasing volume and complexity of IFRS on SMEs and the need for simplified, understandable and user-friendly guidance for that sector. It also urged the IASB to address the needs of the sector. ISAR deliberated on this issue during three

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[21] Committee of European Securities Regulators, Draft Technical Advice on Equivalence of Certain Third County GAAP and on Description of Certain Third Countries' Mechanisms of Enforcement of Financial Information, Consultation Paper, April 2005, available at http://www.cesr-eu.org.
[22] Committee of European Securities Regulators, Press Release – Ref. 05-451, 5 July 2005.

consecutive sessions and in 2003 issued its guidance on accounting and financial reporting for two levels of SMEs — SMEGA Levels 2 and 3. The guidance is based on IFRS and is intended to help growing SMEs make smooth transitions from Level 3 to Level 2 and later to IFRS.[23]

In 2001, the IASB launched a project to address the needs of SMEs.[24] The IASB project is expected to issue a standard for SMEs by 2008. The recently established Developing Nations Permanent Task Force of the IFAC has also been looking into the issue of the suitability of IFRS for SMEs, particularly from the perspective of developing nations. The UNCTAD secretariat has been providing input on this issue to both initiatives.

2. Institutional issues

There seems to be growing emphasis at the international level on the challenges involved in implementing IFRS and on the related issues of due process of global standard setting and institutional mechanisms needed to achieve consistent application of the IFRS across borders. For example, in 2004, the IFAC commissioned a study on challenges and successes in the implementation of IFRS and ISA.[25] The study highlighted important issues that many stakeholders need to address in order to overcome the challenges in implementing these standards.

Since November 2001, the World Bank has been preparing Reports on the Observance of Standards and Codes (ROSC) on accounting and auditing standards and practices among its constituencies.[26] The objectives of the ROSC on accounting and auditing standards and practices are to assess the comparability of national accounting and auditing standards with IFRS and ISA and the degree to which corporate entities comply with established accounting and auditing standards in the country being assessed. The ROSC provide member States with useful insights on implementing IFRS and ISA successfully. Some of the main findings were summarized in 2004 in a report prepared by the World Bank.[27]

Another indication of growing emphasis on the issue is a revision of the International Accounting Standards Committee Foundation's Constitution. One of the changes in the Constitution issued in July 2005 calls for trustees to have an understanding of and be sensitive to the challenges associated with the adoption and application of IFRS.[28]

[23] The guidance documents developed by ISAR (SMEGA Levels 2 and 3) can be accessed at http://www.unctad.org/isar.

[24] Further information on the IASB project on SMEs is available at http://www.iasb.org/current/active_projects.asp.

[25] Peter Wong, *Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs*, International Federation of Accountants, September 2004.

[26] To view World Bank ROSC reports, visit http://www.worldbank.org/ifa/rosc_aa.html.

[27] "Implementation of International Accounting and Auditing Standards: Lessons Learned from the World Bank's Accounting and Auditing ROSC Program", *International Accounting and Reporting Issues, 2004 Review*, UNCTAD, 2005.

[28] The revised IASC Foundation Constitution can be found at http://www.iasb.org/uploaded_files/documents/8_887_RevisedConstitution1July2005.pdf.

The review of the Constitution has also called for steps to enhance the role of the Standards Advisory Council (SAC) of the IASB to make its operations more effective and improve links and dialogue between SAC members on the one hand and the Board and Trustees on the other, especially regarding strategic and implementation issues as they relate to the standard-setting process.

Another element essential for efficient implementation of the IFRS is that the debate be geographically diverse and inclusive. To address the issue of the new Constitution, the number of trustees has been increased from 19 to 22. The three additional trustees will come from countries outside of North America and Europe. This issue has also been taken into consideration in the SAC's new structure, with a new chairman coming from an emerging economy such as Brazil.[29] However, such mechanisms are still evolving, and further steps seem necessary to facilitate broader involvement of developing countries and countries with economies in transition in the global dialogue. One mechanism that has been debated at a number of events could be participation through regional representation.

Effective implementation also calls for a mechanism for ongoing interaction between the standard setter and national regulators. In February 2005, the IASB issued a draft Memorandum of Understanding on the role of Accounting Standard Setters and their relationship with the IASB that is an important step towards establishing such a mechanism. However, further steps might be required to ensure efficient continued interaction between national and global standard setters for the benefit of coherence between IFRS and national regulations and for the consistent application of IFRS.

The task of interpreting IFRS remains with the International Financial Reporting Interpretations Committee (IFRIC). The demand for implementation guidance and hence the volume of work for the IFRIC are expected to increase "dramatically" after 2005.[30] In the 2004 annual review of the European Financial Reporting Advisory Group (EFRAG), the Chairman of the Technical Expert Group of EFRAG called on the IFRIC to speed up its activities to meet the perceived demand.[31] The increase in demand is attributed to the increase in the number of enterprises applying IFRS and the heterogeneity of such enterprises in terms of jurisdiction, size, capital structure, ownership structure and degree of accounting sophistication. The task is complicated by the fact that IFRS are a moving target and a number of new changes are yet to come.

Therefore, one can ask whether additional mechanisms are needed to cope with demand of such scope and diversity. For example, in its four years of work, IFRIC has issued six interpretations, and one of those (IFRIC 3) has since been withdrawn. To address these challenges, in July 2005, EFRAG issued a discussion paper "Achieving Consistent Application of IFRS in the EU".[32] The objective of the paper is to obtain information about IFRS implementation issues that are arising in

[29] See IASB Press Release of 18 July 2005, "L. Nelson Carvalho appointed Chairman of the Standards Advisory Council".
[30] Katherine Schipper, "The Implementation of International Accounting Standards in Europe: Implications for International Convergence", *European Accounting Review* 14 (1): 101–126.
[31] The EFRAG 2004 annual review can be obtained at http://www.efrag.org.
[32] The discussion paper can be accessed at http://www.efrag.org.

Europe and assess the need for follow-up action. Some experts also argue that there might be a need for technical guidance at the national level to reflect particular economic contexts in which the judgement is being made as to how transactions should be recorded and reported.

Another issue related to the institutional challenges of IFRS implementation is a translation mechanism, which also requires ongoing interaction between national authorities and the IASB. IFRS are officially developed and published in English. Many member States require considerable amounts of time and other resources to translate IFRS pronouncements into their national languages. This process poses a significant challenge, particularly in countries where capacity for such highly technical translation is low.

In such cases there could be a need for consultations with the IASB regarding the proposed terminology, especially in cases where there is a conflict with existing national terminology or even legislation. While such mechanisms are especially needed at the beginning of the implementation process, they will have to be established as a standing part of a global standard-setting machinery, since the IFRS will change over time to reflect the needs of international financial infrastructure.

Variations in translation could also introduce inconsistency into the implementation of IFRS. Furthermore, time lags in the local "endorsement" process and in translating new IFRS into local languages and, in some jurisdictions, gazetting the translated standards before they become legally binding, may mean that at some point the set of IFRS available in a local language may not include some IFRS, owing to translation and gazetting delays. Such variations could lead to different sets of IFRS requirements applying in different countries and might result in financial reports that are not consistent with the original IFRS or lack comparability. Therefore there is a need for a coordinated mechanism and a reasonable time frame for translating IFRS into national languages. This could involve a database of issues raised and how they were resolved.

Another important element of a global mechanism for IFRS implementation is human resources and training materials that comply with IFRS. Today the availability of training materials and qualification programmes leading to certification in IFRS is very limited owing to a number of factors, including language and cost barriers. Many of the IFRS materials and programmes now available have not gone through an independent international assessment of their compliance with the IFRS, since a mechanism for this does not exist.

In addition to high-quality financial reporting standards, sound financial reporting infrastructure implies effective corporate governance practices, strong internal controls over the financial reporting process, high-quality auditing standards and practices, and effective enforcement or oversight mechanisms.[33] Therefore, the successful implementation of IFRS will depend partly on the robustness of the other elements of a global financial reporting infrastructure. Therefore, close coordination

[33] US Securities and Exchange Commission, SEC Concept Release on International Accounting Standards, 2000.

between all stakeholders at the global as well as the regional and national levels is important.

The accountancy profession, through IFAC, and international development organizations such as the World Bank, UNCTAD and others play an important role in strengthening the global financial reporting infrastructure. In addition to the International Accounting and Assurance Standards Board (IAASB), other standard-setting committees within IFAC, such as the Education and Ethics Committees, provide guidance that contributes to successful implementation of IFRS and other elements of the international financial reporting infrastructure.

A number of institutional challenges also exist at the national level. One such challenge is formulating an IFRS implementation strategy. On the one hand, any strategy has to be coherent with the IASB strategy and work plan and has to take into consideration the fact that IFRS are a "moving target". On the other hand, it should allow for consistent introduction and practical application of IFRS, which implies that necessary guidance is available on how IFRS could be applied in the national context, and that steps are taken to avoid possible conflicts with national regulations.

Another issue is whether an endorsement mechanism is needed as part of the implementation infrastructure. In the European Union, for example, after IFRS are issued by the IASB, they must go through an endorsement process before companies, listed in the European Union are required to apply them. An endorsement process can create endorsed IFRS that differ from those originally issued by the IASB, as has been the case with the IAS 39 carve-out in the European Union. Other member States, such as Australia and New Zealand, are adopting IFRS after making changes to address specific national needs.

Such an endorsement mechanism could pose yet another implementation problem, since its creation and efficient functioning require the existence of a critical mass of expertise and resources in order to exercise judgment related to IFRS endorsement which may not be readily available in countries with less developed financial markets.

Significant efforts are needed to educate all users of IFRS-based information since, depending on the jurisdiction, IFRS-based reports could be significantly different from reports prepared under the previous GAAP. Such target groups could include regulatory and tax authorities, investors, financial analysts and rating agencies, civil society, academia and others.

Another institutional issue at the national level is the need for coordination of legislative requirements related to or affected by IFRS, since implementation of IFRS can have implications for a number of legislative areas. The more complex the regulatory framework in a country, the more effort is required to achieve coherence among these requirements at the national level.

Therefore, it is important to clearly define the authority that IFRS have in relation to other regulatory reporting requirements that may exist in a jurisdiction. It is also essential to have a coordination mechanism at a national level to ensure that such issues are taken into account. For example, an assessment of the impact of the transition to IFRS has to consider possible tax, price control and statistics implications and possible adjustments or reconciliation arrangements that might have to be made as part of the transition if the desire is to maintain tax base and statistical records that existed prior to the implementation of IFRS. Other legislative areas such as company law or even higher-level legislative norms could also be affected. Certain sectors of the economy such as banking and insurance may be subject to additional regulation that may include special reporting requirements.

For example, when a business moves from domestic financial reporting standards to IFRS, its financial ratios, on which lenders provide their funding, could be significantly affected. Thus entities may need to review existing covenants that they have with lenders and assess the impact of transition on their ratios. This process may entail further negotiations with lenders with respect to the transition. If a lender and a borrower who moved to IFRS fail to reach agreement on the IFRS-based ratios, the borrower may be required to provide financial reports on the basis of previous GAAP. Such a situation may mean that the borrower has to maintain multiple sets of financial records, which lessens the utility of IFRS.

Corporate law, which is normally jurisdiction specific, or the incorporation agreements of a specific entity often limit the amount of funds that an entity can borrow. This limitation may be expressed in terms of legal capital, based on domestic GAAP. After switching to IFRS, an entity may find itself in breach of such requirements if legislative amendments are not made to reflect the impact of IFRS.

A related matter is the regulatory requirements that an entity needs to meet in order to be able to distribute dividends to its shareholders. In most cases, such requirements are expressed in terms of unappropriated retained earnings or the equivalent that the entity needs to have in order to be able to pay dividends. However, unless the necessary amendments are made, such requirements would remain based on national GAAP even after the entity moves to IFRS. Such a situation may create unintended confusion with respect to the ability of the entity to distribute dividends.

Significant efforts are needed to educate preparers of IFRS reports, especially in countries where accounting was not previously used as a tool for investment decision making. To ensure consistent application of the IFRS, such training should not be limited to accounting issues only but should also cover related areas such as finance and investment. Concerted training efforts are also needed for users of IFRS-based information. They could include regulatory and tax authorities, investors, financial analysts and rating agencies, civil society, academia and others.

3. Enforcement issues

Effective enforcement is essential for the successful implementation of IFRS. Actual enforcement of accounting and auditing standards, including securities and corporate laws, is something to be handled at the national level. Countries have different mechanisms, traditions and capacities for enforcing such standards and related laws.

An international mechanism for the coordination of enforcement mechanisms relating to IFRS is therefore essential for the successful interpretation and implementation of IFRS. Currently the International Organization of Securities Commissions (IOSCO) provides an important infrastructure for coordinating enforcement activities carried out at the national level with respect to publicly listed companies.

In May 2004, IOSCO announced that its Technical Committee had initiated a project on "regulatory interpretations of International Financial Reporting Standards". The objective of this project is to address communications among IOSCO members with a view to promoting consistent application and enforcement of IFRS. The main outputs of the project were expected to be a central database of regulatory decisions and a process for facilitating communication and cooperation among regulators and other enforcers relating to IFRS. IOSCO also announced that its Technical Committee would undertake an initiative on "review of enforcement of application of financial reporting standards".

In April 2005, IOSCO announced that it had distributed a consultation paper to its members outlining principles to be adopted and options available in its approaches to encouraging cooperation and consultation among members in the regulatory interpretation and enforcement of IFRS.[34] A final model from the initiative was expected during the second half of 2005, in time to be used in conjunction with reviews of the 2005 annual financial statements.

At the regional level, the European Union could be regarded as more cohesive in terms of enforcement of traditions and practices. There the importance of coordinating enforcement of standards on financial reporting was recognized early on. In particular, in its decision of 6 June 2001 (2001/1501/EC), the European Commission established the Committee of European Securities Regulators (CESR). The main objectives of the CESR are to improve coordination among securities regulators; act as an advisory group to assist the European Commission, in particular, in its preparation of draft implementing measures in the securities field; and ensure more consistent and timely day-to-day implementation of community legislation in the European Union. So far the CESR has issued two standards. These pertain to enforcement of financial information and coordination of enforcement activities respectively.[35]

4. Technical issues

IFRS implementation is also associated with a number of technical challenges. The highly and increasingly complex nature of the IFRS and their sheer volume make the task of practical implementation even more difficult, particularly in developing countries and countries with economies in transition that lack expertise, resources and infrastructure to accomplish such a comprehensive task.

An important feature of IFRS is that they are principles based. While this may be a useful feature in their applicability in a variety of jurisdictions and circumstances,

[34] International Organization of Securities Commissions, Final Communiqué of its thirtieth Annual Conference, 7 April 2005.
[35] Further information on CESR standards is available at http://www.cesr-eu.org/.

it may also contribute to unintended inconsistencies when those implementing IFRS differ in their mastery of the expertise required in order to apply the standards effectively and accurately. This challenge becomes more difficult when countries begin the transition to IFRS without a critical mass of adequately trained and sufficiently experienced accounting professionals who are familiar with the principles underlying the use of accounting information for investment decision making.

While IFRS are developed at a global level, most accounting professionals responsible for implementing them would normally have been trained to apply domestic accounting standards. It is likely that where there are options in implementing IFRS, preparers will tend to choose options that are closer to requirements in their national GAAP. For example, in an IFRS seminar that ING Group NV conducted to communicate the impact of moving to IFRS, the Chief Financial Officer said that, where the company had choices, it ended up as close as possible to what it did before (that is, on the basis of national GAAP).[36]

One of the major technical issues is fair-value measurement requirements, which have become an important feature of certain IFRS. Given the increasingly innovative financial instruments and growing liquidity of financial markets, there are grounds to argue that fair value is more relevant to users of financial information than historical costs. For example, in this context, Paul Volcker, Chairman of the IASC Board of Trustees, remarked that "the old rule book of historical value does not seem quite right for a world with layers and layers of volatile finance".[37] IFRS also require or permit fair-value measurements of many non-financial items, including property, plant and equipment; investment property; agricultural assets; assets acquired by government grant; and assets held for sale.

In UN member States, where the economy is well developed, capital markets could be expected to be liquid enough so that the information required for fair-value measurement can be easily obtained. The more liquid the markets are, the more likely they are to provide the measurement information needed to more accurately reflect the underlying value of the item being measured.

In reality, however, the liquidity of capital markets around the world varies. Trading activities in some markets and trading of some particular instruments could be so low that recent market information is not available. Such variations are likely to complicate the IFRS transition efforts of some member States. For example, the new members of the European Union were expected to face tougher challenges in their transition efforts mainly owing to the lower liquidity of their capital markets.[38]

In obtaining fair-value information, the alternative source for measurement information is simulating a hypothetical market or mathematical modelling. However, such alternatives are likely to be more consistently and accurately computed by

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[36] Cees Maas, CFO and Vice Chairman of the Executive Board, ING Group, "IFRSs Seminar" Conference Call, Fair Disclosure Wire, CCBN Inc. 11 March 2005.

[37] Remarks by Paul A. Volcker at the 150th Anniversary Conference of the Institute of Chartered Accountants of Scotland, Edinburgh, Scotland, 22 October 2004.

[38] "New EU Members Face Accounts Struggle", Accountancy, 1 April 2004.

professionals in developed economies than by those in developing ones, since the former have more experience of and regular exposure to such estimations.

On the other hand, to preparers and users who are used to easily verifiable historical cost-based valuation, recognizing estimated gains or losses based on market information while actual transactions are still pending might be a new and hard-to-grasp concept.

IFRS measurement requirements include important assessments or estimates that depend on other professional assessments and standards — for example, actuarial estimations with respect to pensions, investment property valuations, impairment testing, valuing share-based payments, and so on. The availability and proficiency of experts in the areas in which such estimates and assessments are needed vary from one UN member State to another. In some countries, the institutions that train such professionals are well established. In these cases, demographic and other essential data on which actuarial estimations can be based have been maintained for hundreds of years. Such institutions might not be well developed or even exist in other countries, and maintaining demographic and related data might be a relatively new practice. Variations in this respect are likely to introduce undesirable differences into valuations and other estimates, thereby lessening the comparability of financial statements prepared in accordance with IFRS around the globe.

D. Preliminary observations on the impact of IFRS on financial statements

For most entities that adopted IFRS as their reporting basis starting 1 January 2005, a full set of annual financial statements will only be due after December 31, 2005. As part of the requirements of IFRS, these entities need to prepare comparative figures for 2004. However, they are not required to release IFRS-based (restated) comparative annual financial statements for 2004 until the ones for 2005 are released.

At the time of this chapter's publication, many entities are tending not to provide disclosures on the impact of IFRS on their financial reports. For example, Standard and Poor's reported that, among the European industrial groups it rates, about half did not provide such information. Most of those that provided information were transnational corporations.[39] Those that disclosed information on the impact of IFRS provided either a full set of 2004 financial reports restated in IFRS or some general indication of the impact of IFRS on their financial reports. Most of the information available so far is unaudited and is intended to provide indicative rather than definitive figures. Nevertheless, a review of such reports and indications provides useful insights into what the general impact of IFRS may be on financial statements.

A survey of implementation of IFRS conducted by the accounting firm Mazars and involving 550 listed companies in 12 European countries, including Turkey, released in July 2005 shows that 87 per cent of the respondents consider themselves well prepared for the adoption of IFRS; 74 per cent have already prepared their opening balance sheets; and 66 per cent have assessed the impact of the restatements

[39] "European Corporates Effect a Smooth Transition to IFRSs – So Far", Standard & Poor’s, 11 May 2005.

on their 2004 financial statements.[40] With respect to the cost of conversion to IFRS, only 45 per cent of the respondents considered it high, while 55 per cent believed that the benefits of conversion justified the costs.

The magnitude of changes caused in the financial statements of reporting entities by the transition to IFRS differs from country to country, sector to sector, and entity to entity, depending on the extent of similarities between previous (usually national) GAAP and IFRS. The magnitude also depends on the accounting policy choices that the reporting entity made from among various options that existed under its prior reporting basis and later under IFRS. For example, an analysis of some of the information available at this point seems to indicate that in Europe the transition to IFRS will have a greater impact on the balance sheet of companies than their income statements. A study of 28 large European companies that reported on the impact of IFRS on their financial statements indicated that debt and other liabilities rose an average of 16 per cent while net income decreased by about 3 per cent among the sample of companies studied.[41]

Within the set of IFRS, certain requirements seem to be having greater impact than others. For example, a number of requirements in IFRS are prompting first-time adopters to recognize significant liabilities in their balance sheets. In moving to IFRS, entities may be likely to recognize larger amounts in pension obligations, deferred tax liabilities and provisions than under local GAAP. Under IFRS, first-time adopters may be bringing back to the balance sheet many financial arrangements that were moved off the balance sheet under prior GAAP. Some assets that either were not recognized at all or were valued at cost under prior GAAP, such as investments and derivatives, are now valued at fair values under IFRS.

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

One of the major changes that first-time adopters are experiencing is that, under the revised IFRS 3, Business Combinations, goodwill is not amortized but rather is tested for impairment annually, in accordance with IAS 36, Impairment of Assets.[42] This requirement is having a significant impact on the financial reports of some first-time adopters, particularly if they have recently made major acquisitions. A dramatic impact of this requirement can be seen in the restated 2004 financial reports of Vodafone, which transitioned from UK GAAP to IFRS in 2005. In the company's reconciliation of its UK GAAP–based financial reports with IFRS-based 2004 financial reports, its pre-tax loss of £2.18 billion under UK GAAP translated to pre-tax profit of £4.54 billion under IFRS. This result stemmed mainly from the fact that,

[40] IFRS 2005, European Survey, Mazars, http://www.mazars.com.
[41] *Financial Times*, 16 June 2005, citing a survey conducted by Dresdner Kleinwort Wasserstein.
[42] IFRS 3, Business Combinations, paragraphs 54–55.

when reporting on an IFRS basis, the company was no longer required to amortize goodwill in excess of £7 billion annually, as it used to do under UK GAAP.[43]

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

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

Moving to IFRS has important implications for entities that make share-based payments, either as compensation to their employees or for other transactions in the regular course of business. In accordance with IFRS 2, Share-Based Payments, preparers are required to expense such payments. Given the fact that share-based payments were not expensed under most national GAAP, the impact of this particular standard could be somewhat significant among first-time adopters that have regularly made use of share-based payments. For instance, applying this standard to the financial reports of Alcatel resulted in a decrease of 21 per cent in the company's 2004 earnings.[44]

E. Conclusion

This chapter has outlined a number of practical issues that are arising in the implementation of IFRS. It has also highlighted the possible implications of the adoption of IFRS to other related areas. The chapter was prepared in the early stages of the large-scale implementation of IFRS around the world in 2005; however, some important practical implementation issues and challenges of significance to UN member States can already be identified. These challenges require the concerted engagement of all parties in order to maximize the benefits of IFRS for the economies of countries around the world through consistent interpretation and application of IFRS. Many entities that are adopting IFRS and the relevant institutions in the respective countries are developing solutions to practical issues that are being encountered in the implementation of IFRS. Sharing of experiences among UN member States could make a positive contribution to this process.

During future sessions, ISAR may consider conducting further reviews of IFRS implementation issues in order to gain more insight into the challenges involved and to outline possible solutions. As entities that have already adopted IFRS complete a full reporting cycle and additional ones begin to implement IFRS, more comprehensive findings may be compiled in this area with a view to assessing

[43] See "Reconciliations of UK GAAP to International Financial Reporting Standards", Vodafone Group, Plc, http://www.vodafone.com.
[44] For further details see "Alcatel Transition to IFRS 2004" at http://www.alcatel.com.

progress in achieving comparability on a global basis and highlighting courses of action that countries might find useful for achieving more consistent implementation of IFRS.

ISAR may also wish to review other relevant issues with respect to the practical implementation of IFRS that pertain, for instance, to specific elements of the global financial reporting infrastructure such as global efforts towards consistent enforcement of IFRS with a view to facilitating the sharing of experiences and best practices among UN member States.

Chapter II

GUIDANCE ON CORPORATE RESPONSIBILITY INDICATORS IN ANNUAL REPORTS

Summary of discussions

The Chair introduced the agenda item before giving the floor to a resource person to present the topic in more detail. Background was provided on ISAR activities in the area of corporate responsibility (CR) reporting. The resource person also clarified and discussed distinctions between CR and corporate governance, and distinctions between shareholders and stakeholders, with reference to the conference room paper "User's of Corporate Responsibility Reporting and Their Information Needs" (TD/B/COM.2/ISAR/CRP.2). She also explained that the scope of this work does not include environmental issues as those were covered by ISAR in previous years and culminated UNCTAD-ISAR issuing guidance on accounting and financial reporting for environmental costs and liabilities as well as a users and preparers manual on eco-efficiency indicators.

The resource person gave an overview of the material presented in the background document "Guidance on Corporate Responsibility Indicators in Annual Reports" (TD/B/COM.2/ISAR/29), starting with topics addressed in the guidance and criteria by which indicators were selected. She explained the topics included contribution to economic development, human rights, labour practices, human capital development, health and safety, community support, value chain, and corruption. practices and health and safety. The criteria for selecting indicators had also been reviewed by previous ISAR sessions, and these included such aspects as: universality, comparability, relevance, and reflecting an incremental approach.

At the end of the first part of her presentation, the resource person opened the floor to comments on the topics and criteria for indicator selection. Some comments concerned the concept of stakeholders and how it was defined. While one delegate requested more information on the categorization of stakeholders, another delegate suggested some specific definitions for certain stakeholder groups. Another set of comments concerned the special circumstances of subsidiaries and enterprise size: one expert questioned whether guidance on this subject required a distinction between large and small companies, suggesting that such a distinction might be useful. A delegate raised the situation of TNCs having globally consolidated reports that obscure a view of a local subsidiary's operations; it was suggested that any guidance request subsidiaries to report individually, or at least nationally.

Acknowledging these comments, the resource person continued with the presentation, focusing on each group of indicators in turn. The first group of indicators related to the topic of "Contribution to Economic Development". After introducing and explaining each indicator in this category, the floor was opened to discussion. Some comments concerned the measurement and definition of indicators, some concerned presentation issues, and others suggested possible new indicators for consideration. One delegate also raised the issue of the repetition of certain information within annual reports. On measurement and definitions of indicators, one delegate questioned whether social security contributions should be included within taxes and government fees, or within employee compensation and pension schemes; the delegate observed that social security systems vary among countries and that in some countries there may be little or no difference between such systems and pension plans, while in other countries, social security contributions are more similar to a government tax. Concerning new indicators suggested: one delegate suggested an indicator for measuring the transfer of technology as well as an indicator measuring the re-investment of earnings. Another delegate suggested that some measure of "degree of integration" of a firm's economic activities could be used to supplement or replace the indicator on the value of imports versus exports. The delegate also suggested the use of a measurement on "value added" to replace the indicator on total sales.

The Chair and the resource person acknowledged the comments and addressed the points raised. It was suggested that the repetition of information in an annual report should not be considered a problem, since the annual report has several distinct sections which cater to different types of users or uses, and some of these sections already repeat some information. For example, turnover could be in the income statement as well as in the value added statement catering to the needs of different users. Concerning the suggested use of value added, it was recommended to avoid the use of figures that results from complex calculations and, as such information may cause confusion or undermine clarity.

The resource person continued with the presentation of the category of "Human Rights" and an explanation of the indicator on security arrangements. The resource person explained that in general the most frequent source of enterprise complicity in human rights abuses stems from security operations. While it was recognized that enterprises have a legitimate obligation to provide security for their personnel and assets, it was equally acknowledged that enterprises also have a responsibility to exercise proper management, training and oversight in the use of armed security.

Several delegates and experts discussed the role and obligations of enterprises in the area of human rights. It was observed by some delegates that protecting human rights is the responsibility of governments, not private enterprises. Several experts, however, argued that human rights considerations do fall within the responsibilities of the enterprise, therefore, they can present legal and financial liabilities for enterprises. Another expert observed that much of the activity of enterprises within the area of corporate responsibility revolves around the question of how enterprises can better avoid instances of complicity in human rights abuses.

The resource person responded to the comments and sought to provide some clarity on the issue. A distinction was made between the responsibility to protect human rights (which is the responsibility of governments) and the responsibility to avoid complicity in human rights abuses (which is the responsibility of all individuals and organizations, including enterprises).

The presentation of the indicators continued with an explanation of the three indicators within the category of "Labour Practices". Several comments were made by the participants: some suggesting new indicators and some raising questions of compilation or presentation. On the issue of equal opportunity, for example, a question was raised whether or not an indicator might be added on types of discrimination beyond gender, such as race, age, religion, or physical disability. Another suggestion for a new indicator was to record the ratio of the highest paid employee to the lowest paid employee (or a similar indicator, such as the ratio of the average or median manager's salary to the average or median worker's salary). Other comments from the Group focused more on questions of compilation or presentation of the labour practice indicators. For example, a question was raised as to why the number of female employees was not presented as a percentage of the total employees. Or for the number of employees generally, why this could not be presented in terms of percentage of permanent versus temporary employees.

The resource person reminded the Group of the selection criteria, which include universality; it was then observed that several issues of equal opportunity, such as race and religion, are highly specific to a region or country, and do not lend themselves to universal application and comparability. It was recognized though that indicators on age and physical disability would meet the selection criteria and could be added. Similarly, the suggestion for reporting the ratio of the highest to lowest paid employee was recognized as meeting the selection criteria, and could be useful indicator of pay equity. On the questions relating to compilation or presentation, it was acknowledged that many of these issues would have to be the subject of further clarification.

The presentation continued with an explanation of the two indicators for "Human Capital Development". A number of participants recommended deleting the word "internal" from both of these indicators, arguing that it was insufficiently clear. The resource person explained that term "internal" was used to make clear reference to training in relation to groups that are internal to the company, such as employees, as opposed to groups that are external to the company, such as suppliers, customers, or local community. The resource person agreed that better wording could be used. An expert also suggested that any presentation of an indicator on training expenditures should not be in an absolute figure, rather it should be done in the form of a ratio, such as expenditure or hours of training per employee. A general discussion emerged on the use of the term "human capital" as several participants felt uncomfortable with this expression and suggested alternatives, such as "human resource development".

The two indicators on "Health and Safety" were presented. Some questions were raised about identification issues, such as identifying exactly what would be considered an expenditure on safety: would, for example, spending on security qualify as expenditure on employee safety. The use of the word "expenditure" was also questioned, with suggestions for using the terms "cost" or "spending". The resource person recognized that further work would have to be done on identification and compilation issues, but also argued that the term "expenditure" had a place in existing financial accounting practices and was relevant in this situation. A general discussion among the delegates also took place concerning the distinction between healthcare spending on prevention versus spending on treatment.

The presentation continued with an explanation of the indicator on "Community Support". A number of delegates suggested that the word "donations" should be replaced with the word "contributions". It was also suggested that this indicator should be properly contextualized by, for instance, expressing it as a percentage of pre-tax profits or value added.

The resource person continued with a presentation of the indicator on the "Value Chain" of an enterprise. A question arose from a delegate about how this indicator might be reported; a number of other delegates suggested that this indicator would only report the absolute number of enterprises, and not give details of the name of the enterprise. For the sake of improved clarity, it was also suggested that the wording be changed to "Number of dependent enterprises in the value chain". It was also generally recognized that determining the definition for "dependent" would be need to be the subject of further work, and would probably rely on some percentage of sales or purchases between the reporting firm and the enterprise in the value chain.

The final indicator on "Corruption" was presented by the resource person. A number of delegates suggested adding an additional indicator to this category, simply noting whether or not an enterprise has some sort of code of conduct or other relevant internal policies. The resource person reminded delegates that while such information could usefully be reported by an enterprise as additional information, policy oriented indicators as such were not within the selection criteria of the indicators, rather the focus was on outcomes or impacts. One delegate raised an issue of compilation and reporting by asking whether or not materiality (e.g. the size of the fine) would apply to this issue. The resource person observed that the indicator reports both the number of incidents of corruption-related convictions as well as the amount of fines paid. In this sense, the incidence itself of a corruption-related conviction would be material, regardless of the amount of fine associated with it, since such a conviction would serve as some indication of the quality of internal control procedures and possibly also potential future liabilities (since the size of fines for any future conviction can, in some jurisdictions, be influenced by repeat offences).

The deliberations on the corporate responsibility indicators ended with a few general comments and suggestions from the participants. Recognizing ISAR's past work on Eco-Efficiency indicators, one expert suggested that the social indicators presented in the background paper ISAR/29 left a gap in the area of environmental reporting, which is widely understood to be an element of corporate responsibility. This expert suggested that an annex to ISAR/29 be added with the short list of the five eco-efficiency indicators, along with a reference to the publication "A Manual for the Preparers and Users of Eco-Efficiency Indicators" (UNCTAD/ITE/IPC/2003/7). A delegate suggested that it would be a good idea to begin testing the indicators based on existing corporate reporting practices, with a view towards developing guidance for preparing and reporting these indicators.

A. Introduction

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

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) of UNCTAD has identified reporting on corporate responsibility (CR) as one of the emerging issues in the area of corporate transparency. Within the framework of its mandate to promote harmonization of best practices in corporate reporting, ISAR agreed at its twentieth session to "begin examining existing indicators so that corporate social responsibility reports would be comparable and would not impose unreasonable burdens on enterprises in developing countries".[1]

The work of ISAR in the area of corporate responsibility reporting takes place within a broader international context of work by other international organizations on various aspects of this subject. Such work includes the OECD Guidelines for Multinational Enterprises, the ILO Tripartite Declaration, the United Nations Global Compact and the Millennium Development Goals, among others. The proliferation of global conventions and guidelines on CR has led to a growing general awareness of CR issues in developed and developing countries. As a result, there is increasing demand for guidance on reporting information in this area.

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

The report prepared by the secretariat for the twenty-first session, "Review of the comparability and relevance of existing indicators on corporate social responsibility" (TD/B/COM.2/ISAR24),[2] gives an overview of major existing initiatives and regulations on corporate responsibility reporting and outlines the main issues raised by the examination of the comparability and relevance of the related indicators. In particular, it discusses the question of whether the comparability and relevance of these indicators can be improved by focusing on a limited number of fundamental common indicators, or "core indicators". The report also discusses the scope of CR reporting and the potential users of such reports, as well as criteria that could be applied in selecting core indicators.

At its twenty-first session, ISAR agreed to continue working to develop guidance on voluntary disclosure to improve comparability in the area of CR reporting. In particular, it agreed that further deliberations were needed regarding the

[1] ISAR has changed the term "corporate social responsibility" that was used in document TB/B/COM.2/ISAR/24 to "corporate responsibility" to reflect the language of the São Paulo Consensus of UNCTAD XI. This paper refers to "corporate responsibility".

[2] Hereafter referred to as ISAR/24.

principal users of CR reporting, criteria for selecting topics and indicators, and the use of such information.[3] Accordingly, an ad hoc consultative group was formed consisting of experts from a range of countries and organizations (see annex II). This document reflects the past work of ISAR on CR reporting as well as the contributions of the ad hoc consultative group.

The focus of this guidance is on CR indicators as part of annual reporting.[4] The objective of an annual report is to provide information about the enterprise that is useful to a wide range of users in making economic decisions.[5] The ultimate goal of CR reporting, as of all corporate reporting, is to provide stakeholders with a greater understanding of an enterprise's aims, activities and performance, and sufficient information on which to base investment and economic decisions regarding that enterprise. Reporting of relevant and comparable indicators will enhance the transparency of enterprises, thus enabling shareholders and other stakeholders to properly evaluate enterprise performance in the broader context of sustainable development.

The purpose of this guidance is to contribute to voluntary disclosure on issues of CR, in order to improve the comparability and relevance of such reporting by organizations. The guidance addresses the principal users of CR reporting and their information needs, and it discusses the key issues and indicators relevant to an enterprise's social and economic performance, as well as the quality characteristics that should be taken into account when selecting indicators. The guidance may need to be further elaborated to discuss the extent to which it applies to small and medium-size enterprises (SMEs).

Including such information in annual reporting not only meets the information needs of a range of stakeholders but also offers the preparers a unique opportunity to showcase the conduct and contributions of the enterprise with regard to economic and social development. Transparency demonstrated in this respect can yield gains by increasing the public recognition of an enterprise's commitment, improving its reputation, enhancing its employees’ motivation and reducing the risk of conflict with third parties. CR reporting can also be a valuable communication tool that contributes to an enterprise’s culture and internal cohesion. Further, it may contribute to increased shareholder value and lower capital costs. In addition, in collecting relevant data, enterprises obtain information on their own organization and its operational context, which may lead to new market opportunities,[6] better risk management and better monitoring of performance.

To develop guidance on relevant and comparable CR indicators, the UNCTAD secretariat examined a total of some 350 existing indicators used in CR/sustainability

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[3] ISAR recognizes the work of the Global Reporting Initiative (GRI) as well as other organizations to develop specific social and environmental reporting indicators. ISAR’s efforts are meant to complement the work of organizations developing CR reporting by promoting the harmonization and comparability of CR indicators and the inclusion of such indicators in a company's annual report. ISAR recognizes the efforts of organizations and the work of individual enterprises in the production of more elaborate stand-alone sustainability reports.

[4] This paper refers to CR indicators as reporting on economic and social impacts in the context of corporate responsibility in the annual report.

[5] International Accounting Standards Board (2005). *Framework for the Preparation and Presentation of Financial Statements*. London, IASB.

[6] For example, by increasing its awareness of stakeholder needs and interests, an enterprise may discover unmet demand for new products and services, underserved consumers for existing products and services, or new production and/or sales process efficiencies derived from avoiding certain costs and liabilities.

reporting. The pool of indicators from which the preliminary selection was made included those used in national authorities' disclosure requirements, multi-stakeholder initiatives and corporate sustainability reports. The report (ISAR/24) prepared for the twenty-first session contained a preliminary list of suggested indicators within the existing reporting framework for corporate annual reports.[7] That list was drawn from surveys of stakeholder needs, with a view to identifying their common needs, and included indicators in nine areas: workforce profile, workforce turnover, training, employee representation, organization of working hours, health and safety, geographical spending, value chain and cases of non-compliance with regulations. At the twenty-first session, it was agreed that such information could also reflect corporate contributions to the economic, social and human capacity development of host countries.

During the twenty-first ISAR session, many participants expressed support for common topics in the field of CR. However, concerns were expressed about reporting on issues over which companies may have limited, indirect or even no control, and about the difficulties of reporting on complex subjects that may be hard to measure, especially in a comparable way.

It was agreed to adopt an incremental approach, focusing first on indicators that in principle could apply to all or most enterprises, regardless of sector, size or location, the intention being to maximize the comparability of the indicators. In addition, these core indicators would address issues the enterprise had control over and for which it already gathered information as part of its management systems. Once a satisfying reporting method for these issues was achieved, other issues could be added for which data gathering and interpretation were more complex and over which enterprises had no direct control, but which they might be able to influence.

ISAR acknowledges that, to achieve transparency towards an enterprise's stakeholders and to present a more complete assessment of an enterprise's performance, additional information may be necessary that is specific to the enterprise's industry and geographic context.[8] Quantitative data should be considered within the context of the social, political and economic conditions of the country in which the enterprise operates. Clearly the impact of corporations will vary from industry to industry, and therefore indicators can usefully be considered within their specific context. They can also be considered in relation to other enterprise performance factors by combining two or more indicators so as to highlight key relationships.[9]

In order to provide additional useful context, enterprises should disclose their policies and procedures as these relate to CR matters. A uniform descriptive format presented alongside the reporting of the indicators would be helpful to put the indicators into sufficient context. This format might include, among other things, a description of the enterprise's location and surrounding communities and stakeholders and its objectives regarding these stakeholders. The geographic context of an enterprise's operations would need to be reflected, as locations can affect the

[7] See annex II of ISAR/24 (available at www.unctad.org/ISAR).

[8] Such additional information, including environmental information, could be provided in an enterprise's separate reports and/or on its website.

[9] See for example, the Global Reporting Initiative's *Sustainability Reporting Guidelines 2002*, Part C – *Report Content*, Section 5 – *Performance Indicators* (www.globalreporting.org).

materiality of certain issues; this is particularly the case in considering the circumstances of developing countries and the differences between legal norms and legal infrastructure that exist among countries. It would be useful to include a comparison to prior years and plans and targets for future years.

Therefore, a limited set of core indicators, providing a common benchmark in the area of CR reporting, should in no way be understood as precluding additional reporting on these issues that provides useful industry-, enterprise- and location-specific information.

1. Principal stakeholders and their information needs in the context of corporate responsibility

The concept of corporate responsibility draws on the strategic management theory according to which managers can add value to an enterprise by taking into account the social and economic effects of an enterprise's operations when making decisions.[10] This theory claims that managers can best promote the long-term viability of an enterprise by balancing the needs of an enterprise's stakeholders with the financial requirements of sustaining and growing a business. Reporting on an enterprise’s performance in this area is therefore a means to provide shareholders and other stakeholders (as well as managers themselves) with an account of an enterprise's impact on society. This added transparency can make the enterprise more accountable to its principal stakeholders.

Enterprises should demonstrate how and to what extent they fulfil their responsibilities towards their stakeholders. These responsibilities are often, though not exhaustively, described and defined in existing regulations, codes, laws and international agreements. As organs of society, enterprises are increasingly being called on to demonstrate support for both international law and internationally agreed normative statements; this is most clearly reflected in the UN Global Compact. Failure to meet society's expectations in these areas may undermine an enterprise's license to operate.

Stakeholders are understood as groups of people who are affected by and/or can influence an enterprise, without necessarily holding an equity share of the enterprise. Their actions can affect an enterprise’s brand and reputation, its financial performance, and even its license to operate.

Communicating with stakeholders and ascertaining their views is therefore very important for enabling enterprises to provide relevant information. In doing so, enterprises ought to consider that the perception of usefulness and the use of such reporting are highly specific to the target group. To identify key issues, enterprises may engage in dialogue with stakeholders. This can be done in several ways — for example, through community panels, staff surveys, industrial relations, consumer surveys, opinion polls, workshops involving dialogue on specific issues, and meetings with external experts. Another method is to provide stakeholders with contact details and/or feedback forms in published reports or use company websites to encourage

[10] Freeman, R. E. (1984). *Strategic Management: A Stakeholder Approach*. New York, Pitman.

stakeholders to give input about the information they are interested in and about their opinions on the company's behaviour.[11]

Following is a discussion of key stakeholder groups and their information needs:

- Investors and financial institutions
- Business partners
- Consumers
- Employees
- Surrounding community
- Civil society organizations
- Governments and their institutions

This list comprises mainly groups already identified as users of financial reports — for example, by the International Accounting Standards Board.[12] It is expected that the inclusion of CR information in annual reports would not only give existing users additional useful information but also broaden the range of users to include additional stakeholder groups with a particular interest in the enterprise's impact on society.

Investors and financial institutions. The financial markets consist of various stakeholders, including shareholders, lenders, banks, rating agencies and analysts. While these entities have different information requirements, there is nevertheless a growing recognition within this stakeholder category of the importance of non-financial information, including CR information, in the evaluation of long-term enterprise performance. The different information requirements stem largely from the time frames focused on by the various groups: whereas short-term investors may not take much interest in CR reporting, long-term investors, such as pension funds, are increasingly interested in such reporting in order to better judge future opportunities, risks, legal liabilities and the general quality of management. Additionally, factors beyond time frame are driving demand for more reporting on these issues. For example, there are non-financial pressures on pension fund trustees to align the social values of pension fund beneficiaries with the social performance of the companies in which the fund invests.[13] Another example is the growth of "socially responsible investment" funds that base their investments on social and environmental information as well as financial information.[14]

Non-financial performance indicators are taken into account by financial institutions when valuing companies, in particular when assessing risk. In general, financial institutions seek information enabling them to assess both the current and future performance of an enterprise. Typically, these institutions are not primarily

[11] An example is the "Tell Shell" portion of the Shell Group's site www.shell.com.

[12] The International Accounting Standards Board identifies users of general-purpose financial statements in its framework. They include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. IASB (2005), *Framework for the Preparation and Presentation of Financial Statements* (www.iasb.org).

[13] UNEP-FI's Responsible Investment Initiative is an example of non-financial pressures' driving demand for social reporting. See www.unepfi.org.

[14] Further information on socially responsible investment (SRI) funds in the United States, for example, can be obtained from the Social Investment Forum, an SRI industry association (www.socialinvest.org).

concerned with improving CR per se but rather with the material impact that CR issues can have on a company's valuation.

CR information required by the financial sector includes the financial consequences of CR issues, the overall strategy of an enterprise, its risk and reputation management, compliance with laws and regulations, and the consequences of plant additions or closures and similar decisions. In benchmarking exercises (for example, when financial institutions choose enterprises for inclusion in social-ethical investment funds or indices), information needs to be presented in a way that allows comparisons.

Business partners. Business partners include potential or existing joint venture partners, suppliers, and customers. They will be particularly interested in the enterprise from a business relationship point of view. Enterprises that use CR reporting as part of due diligence on a future business partner or on the target of a future merger or acquisition need information that enables them to assess risks that might affect the enterprise’s operations. They want to know how the enterprise addresses CR issues, including labour practices, human rights, legal compliance and fair business practices (anti-corruption, anti-trust, respect for contracts, technology transfer, fair pricing, timely payment of invoices, etc.). This information should relate to both the enterprise and the key business partners making up the extended value chain of that enterprise. An important element of this information is disclosure on governance and management systems that are in place to address CR issues.

Consumers. Consumers are interested in information on product safety measures, the effect of products on health, product quality, product liability and warranty, new product development and the product manufacturing process. Regarding the latter, they want information about the circumstances in which products are produced (e.g. working conditions). This group is not limited to present and future customers; it also includes former customers, who are interested in product liability and product warranty issues arising from past purchases.

Employees. An enterprise’s present and future employees are interested in remuneration, the plans and intentions of the business, job prospects, working conditions, health and safety, industrial relations, risk management and personnel development opportunities. An enterprise’s former employees, to the extent that they receive pension and other retirement benefits from the enterprise, also have an interest in the enterprise’s present and future financial condition. Trade unions, as representatives of employees, already have access to employee-related information, at least for those enterprises with which they are affiliated. However, they may still find disclosure on employee issues useful when benchmarking against other enterprises, industries, or countries.

Surrounding community. Issues related to economic development are often the primary area of interest for an enterprise's surrounding community. These include questions about jobs, contributions to the tax base, and the secondary impact of an enterprise (through local business linkages and the multiplier effect of the local payroll). Also among a community's primary interests are issues related to the management of local health, safety and security risks and information on community complaints about corporate activities and how these are dealt with. With regard to security risks, communities have a natural interest in positive corporate contributions to the avoidance of human rights abuses; in particular, they need assurance that armed enterprise security employees are receiving proper training and supervision. In some contexts, the local community may also have concerns about the impact of an enterprise's operations on local culture; such impacts on culture can result from the introduction of new products or services, or from the generation of internal migration.

Civil society organizations. Civil society organizations, especially activist and relief-oriented non-governmental organizations (NGOs), use the information in CR reports as a basis for dialogue with the reporting enterprise. Civil society organizations are interested in a wide range of CR issues, including labour practices, human rights, anti-corruption efforts, economic development and environmental protection. They are particularly interested in information that enables benchmarking (comparison with other companies' performance) of an enterprise's record in this area. They also seek information on CR policy and its implementation.

Governments and their institutions. Governments are interested in the ways in which enterprises assume responsibilities toward society, in the voluntary initiatives of enterprises in this field, and in the impact of enterprises' social engagement. Governments need such information to help them formulate social and economic policies and identify gaps in regulation and enforcement. Some government offices also use such information when choosing suppliers.

B. Criteria for the selection of core indicators

1. Quality characteristics

As in the existing financial reporting framework, which provides principles underlying the usefulness of companies' reported information, the following quality criteria should be taken into account in selecting indicators that meet the needs of a wide range of users of corporate responsibility reporting:

- Comparability
- Relevance and materiality
- Understandability
- Reliability and verifiability

Comparability. Users should be able to compare the indicators over time and between enterprises so as to identify and analyse outcomes of changes in policy and management. For purposes of comparison over time, it is important to disclose corresponding information for preceding periods. If the methods used to measure, present or classify information are changed, comparative figures should be adjusted unless it is not practical to do so. The reason for a change should be explained via notes, and, where it is not practical to adjust comparatives, the reason for that should also be explained, as should the nature of the changes that would be required.

Relevance and materiality. To be useful, information should be relevant to meeting users' needs in forming an opinion or decision. Information is relevant when it influences the opinions or decision of users by helping them to evaluate past, present or future events, or by confirming or correcting their past evaluations.

The relevance of information is affected by its nature and *materiality*. In some cases, the nature of the information alone is sufficient to determine its relevance. In other cases, both the nature and the materiality, as expressed in the relative quantitative variables, are important. Relevance, moreover, often depends on the circumstances relating to topics and recent events. Therefore, it could be relevant to provide more details — for example, breaking down some indicators by specific categories.

Information is material if its omission or misstatement could influence the decisions of users. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point, rather than being a primary qualitative characteristic that information must have in order to be useful. Enterprises choosing to omit an indicator because of materiality considerations are encouraged to state the reasons for this decision.

Currently there is still much discussion going on as to how to develop further guidance on a consistent application of the concept of materiality as it relates to non-financial reporting.[15] The management of the enterprise is responsible for making adequate decisions with respect to the application of the materiality principle and its effects on the content of the enterprise's CR reporting. Decision-making by the enterprise's management in relation to materiality should preferably follow a structured and substantiated process that is consistently applied to determine what information the enterprise considers to be of material importance and therefore necessary to include in its reporting. This process could include internal consultations with responsible officers, supervisory boards and/or audit committees; identification of and consultations with important stakeholder groups; consideration of particular issues that play a role in politics and public debate associated with an enterprise's activities, products and locations; and specific industry reporting guidelines. The decision-making process with regard to reporting materiality should be sufficiently transparent and understandable for third parties and should preferably be disclosed in the enterprise's reporting.

Understandability. The information on corporate responsibility must be understandable to the reader. This means that the manner of presentation has to be in keeping with the knowledge and experience of users and should include a user-friendly design, systematic classification of topics and indicators, concise use of language, and an explanation of key terms in the text (or the inclusion of a glossary). Relevance takes priority over understandability, but the two concepts should not be seen as mutually exclusive. Information about complex matters that is relevant to users is not omitted merely on the grounds that it may be too difficult for some users to understand. In order to be properly interpreted, indicators must be reported in the appropriate context, such as information on related policies, management systems, and past performance. It is also helpful to use targets, both for measuring past performance relative to past targets and for forecasting future performance.

Reliability and verifiability. Information has the quality of reliability when it is free from material error and bias and gives a true, complete and balanced view of

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[15] See, for example, the deliberations of the UK Department of Trade and Industry in the publication *The Operating and Financial Review Working Group on Materiality: A Consultation Document* (www.dti.gov.uk).

the actual situation. The information should be faithful to and representative of the actual situation in the business; complete within the boundaries of what is relevant; balanced in its treatment of positive and negative events; presented in the right context; and free of material misstatement. It should be neutral (free from bias). CR reporting is not neutral if, by the selection or presentation of information, it influences the making of a decision or judgment in order to achieve a predetermined result or outcome.

The indicator selected should allow for internal or external *verification*. The indicator should enable comparison with underlying evidence.

2. Guiding principles

The twenty-first session of ISAR identified the following principles that could be used in selecting core indicators on CR reporting:

- Universality to maximize comparability
- Incremental approach
- Capable of being consistently measured
- Impact oriented rather than process oriented
- Link to sustainable development

Universality to maximize comparability. The indicators should in principle apply to all enterprises, regardless of sector, size or location, the intention being to maximize the comparability of reported information.

Incremental approach. The selected indicators should first address issues that the enterprise has control over and for which it already gathers, or has access to, relevant information.

Capable of being consistently measured. The selected indicators should be able to be recognized, measured, and presented in a consistent way. This enables comparison over time and across entities.

Impact oriented rather than process oriented. The selected indicators should help users of corporate reports identify areas of corporate responsibility needing attention and measure the performance of the organization in addressing these areas. The social impact of business operations cannot be assessed solely on the basis of the management processes and policies adopted by enterprises in the context of corporate responsibility.

Link to sustainable development. Indicators should help to analyse the enterprise's contribution to the economic and social development of the country in which it operates.

3. Constraints on the selection of indicators

The twenty-first session of ISAR recognized the following constraints in selecting core topics and indicators on CR reporting:

- Costs and benefits
- Confidentiality
- Timeliness

Costs and benefits. The measurement of indicators and the provision of additional information in relation to indicators should not impose an unreasonable burden on enterprises, particularly those in the developing countries and in the SME sector. The incremental approach helps to addresses this issue through a focus on indicators that can be derived from data that enterprises already gather or have access to in the course of doing business, without incurring significant additional costs.

Confidentiality. The confidentiality of commercial information is often a crucial practical consideration for the success of an enterprise. Therefore, the selection of indicators should respect the confidentiality of commercial data as well as the confidentiality of any enterprise data relating to the right to privacy of natural persons (e.g. employee data). However, if a particular indicator is deemed material to the needs of stakeholders, then materiality could take precedence over commercial confidentiality where this does not conflict with legal requirements to keep the information confidential.

Timeliness. If there is undue delay in the reporting of information, the latter may lose its relevance. Conversely, if the reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users, who have had to make decisions in the interim. For timely (and hence appropriately frequent) reporting, the enterprise has to find a balance between relevance and reliability. The overriding consideration in this respect is how the information needs of users can best be met.

C. Key topics and related indicators

Based on the criteria discussed in section B, the following topics and indicators were selected to cover significant areas of an enterprise's activities that have an economic and/or social impact and are of interest to the identified main users:

- Contribution to economic development
- Human rights
- Labour practices
- Human capital development
- Health and safety
- Community support
- Value chain
- Corruption

Contribution to economic development. An enterprise's contribution to the economy in which it operates consists of various aspects, including employment creation within the enterprise and throughout the value chain, tax payments and other fees, contributions to balance of payments, and transfer of skills and knowledge. Given the incremental approach adopted by ISAR, the focus of reporting in this category should be on direct economic contributions, rather than on the indirect economic impact.

One rather straightforward indicator is the total sales of an enterprise, which allows a calculation of the enterprise's contribution to GDP.[16] The value of an enterprise's exports in relation to its imports, as an indicator of its contribution to the balance of payments of the country in which it operates, could also give information about the enterprise's economic contribution to that country's economy; this issue is of particular relevance for developing countries which must manage their hard currency reserves.

One of the most significant positive economic contributions an enterprise can make to the community in which it operates is the creation of jobs and the payment of wages and other benefits to its employees. The total payroll of an enterprise, through the multiplier effect, supports the economic activity and economic development of the community in which the employees live.

Another significant economic contribution comes in the form of taxes and other fees paid to governments. This is particularly important for industries that do not have large payrolls or strong business linkages, and whose principal contribution to economic development is in the form of taxes.

Enterprises often contribute to increases in labour productivity. This is especially true for transnational corporations that transfer knowledge and technology and invest in human capital formation. An individual enterprise's labour productivity is an indicator of the enterprise's contribution to the overall economic efficiency and competitiveness of the country in which the enterprise operates.

Following are selected core indicators:

- Total sales (contribution to GDP)
- Value of imports versus exports (contribution to balance of payments)
- Number of employees (contribution to job creation)
- Total of all salaries and pension payments (contribution to local economic activity)
- Total of all taxes, fees, social security contributions, etc. (contribution to government finances)
- Labour productivity (contribution to economic efficiency)

It may also be useful to provide a value-added model. The value-added model shows the additional value created throughout the production process and services provided, and the distribution of the added value to the various stakeholders.

Human rights. One of the most basic human rights is the right to life, liberty and security of person.[17] The United Nations Global Compact emphasises that enterprises should avoid complicity in human rights abuses. In cases where such

[16] Gross domestic product (GDP) is the total market value of the goods and services produced by a nation's economy during a specific period of time. GDP is customarily reported on an annual basis. It is defined as including all final goods and services — that is, those that are produced by the economic resources located in a nation, regardless of their ownership, and are not resold in any form. GDP differs from gross national product (GNP), which includes all final goods and services produced by resources owned by that nation's residents, whether located in the nation or elsewhere.
[17] Article 3 of the Universal Declaration of Human Rights.

complicity has arisen, it has often been associated with an enterprise's security arrangements and human rights abuses committed against members of a local community. Enterprises have a legitimate need to provide security for their personnel and equipment. In many situations this includes a need for armed security. However, when armed security employees are not properly trained and supervised, they can become a human rights risk for an enterprise's surrounding community, as well as a reputation risk and legal liability for an enterprise. The first step in identifying such risks is the identification of the locations where armed security is deployed, along with an indication of what types of security arrangements have been made.

Selected core indicator:

- **Number of enterprise operations with armed security (with breakdown by type of security: company employees, contractor, government)**

Additional useful information that could be provided includes an indication of any legal requirements concerning security arrangements; for example, in some countries, for some industries, enterprises are required by law to hire government security personnel.

Labour practices. Issues related to an enterprise’s labour practices include equal opportunities, workforce turnover, and the right of workers to engage in collective bargaining.

The fundamental point when considering matters of equal opportunity with regard to, for example, gender, age or ethnicity is the human right not to be discriminated against, rather than any focus on diversity for diversity’s sake. An enterprise's contribution to eliminating discrimination is a central feature of corporate responsibility. The extent to which an enterprise reduces discrimination can also be considered a measure of the management team’s ability to recruit and retain people on the basis of merit. Given the guiding principles for selecting indicators, and in particular the universality principle, the related core indicator below focuses on the issue of gender discrimination. While instances of discrimination based on race or religion, among others, could be regarded as widespread, such forms of discrimination are almost always particular to a specific cultural context and do not lend themselves to international comparison.

Selected core indicator:

- **Number of female employees (with breakdown by function)**[18]

Workforce turnover rates reflect the job security of employees and the employment practices of an enterprise. Some companies use short-term employment contracts to deny these workers the benefits offered to full-time employees, or to be able to quickly remove employees without giving them the benefit of legal employment protections. These issues can be initially reflected in an enterprise's

[18] This refers to the type of employment (management, worker, etc.). A precise typology or uniform classification of employee functions would need to be developed for compiling this indicator, as well as other indicators in this document that refer to "function" or "employee function".

turnover statistics, which can be compared to industry averages and to best practice within the enterprise's industry or even other industries.
Selected core indicator:

- **Employee turnover rate (with breakdown by function)**

Additional useful information that may be provided includes the average employee tenure with the enterprise; a breakdown of employees' reasons for leaving the enterprise; and the number of seasonal workers employed by the enterprise. Seasonality is a special consideration, and enterprises engaged in seasonal industries should clearly provide this context to the above recommended indicators.

Employees have the internationally recognized rights to establish and join organizations of their own choosing and to have representative organizations for the purpose of collective bargaining. Whether or not employees exercise these rights in practice varies by location, industry and enterprise. For stakeholders trying to assess the relationship between management and workers, it is helpful to know how many employees are covered by collective bargaining agreements.

Selected core indicator:

- **Percentage of total employees covered by a collective bargaining agreement (with breakdown by employee function)**

Human resources. One of the ways in which companies can best contribute to local communities is by enabling employees to develop their skills. Training local employees leaves them in a stronger position to obtain new employment or start their own businesses. In economic terms, training of employees represents the management's conscious effort to invest in its human capital.

There are two dimensions to the issue of transfer of skills and knowledge. Internally, investment in training represents the building and maintenance of knowledge within the company as well as the creation of development opportunities for employees. Information on internal promotion related to training demonstrates the value an enterprise places on the development of its employees. To give insight into the financial consequences of training, figures on total expenditures (of money or time) on training could be analysed in conjunction with labour productivity improvement.

There is a more general linkage between training employees and building capacity in society. To describe this, a breakdown of investment in training into categories such as investment in supplier training, company training, and local community training, or simply into categories that are internal and external to the enterprise, would be useful. Linked to the issue of transfer of skills and knowledge is the question of whether an enterprise hires trained staff or trains its own staff (in-house training versus buying expertise via new employees). Therefore, a link between training hours and workforce turnover could be made in analysing the economic and social impact of an enterprise.

Selected core indicators:

- **Training hours for employee training with breakdown by employee function**
- **Expenditure on training with breakdown by employee function**

Additional useful information includes the total work hours per year compared to total training hours per year and a breakdown of investment in external training (for suppliers, distributors and members of the local community). Integrated indicators might also be useful, such as a comparison of the number of training hours with workforce turnover rates in order to provide insights into the effectiveness and efficiency of the personnel development measures of an enterprise. Another integrated indicator could be the relation of investment in training to labour productivity improvements.

Health and safety. Employee health and safety represents one of the most important corporate responsibility issues confronting organizations. This is particularly true for companies operating in an environment with weak regulatory infrastructure. Occupational accidents lower employee productivity, undermine human capital development, divert management attention, and could be symptomatic of poor management quality.

Enterprises should disclose the policies and procedures they have adopted to preserve and protect the health and safety of their employees in the workplace. A possible quantitative expression of an enterprise's efforts on occupational health and safety could be the amount spent on prevention and treatment.

Accidents, near-misses, injuries, illnesses, and fatalities are aspects of occupational health and safety that should be dealt with by means of quantitative indicators. Clear definitions are needed regarding what actually constitutes an accident or injury, since this is often shaped by industry specific-perceptions and country-specific regulations. In addition to year-to-year rates of work days lost because of accidents, injuries and illness, there could be an integrated indicator relating investments in health and safety at the workplace to improvements in other factors such as productivity and turnover. In affected regions, the inclusion of indicators regarding HIV and malaria is important.

The issue of health and safety extends beyond the boundaries of the enterprise. Surrounding communities can benefit, for example, from support provided by the enterprise for the families of employees, an enterprise-run hospital that also serves the local community, or training in occupational health and safety for suppliers. This benefit can be demonstrated by disclosing the amount of money invested in such programmes. Data on absences related to the illness of family members can serve as an indicator of local health and safety problems and provide a link to a need for the enterprise's community involvement.

Selected core indicators:

- **Expenditure on employee health and safety**
- **Work days lost due to accidents, injuries and illness**

Additional useful information includes the number of fatal accidents; expenditure on health and safety for non-employees (e.g. family members of employees); and employee absences owing to family-related illness as an indicator of local health and safety problems and as a link to the enterprise's community involvement.

Community support. Many enterprises support the communities in which they operate through donations of cash, goods and services. These direct contributions can result in significant positive contributions to, for example, the sustainable development of local infrastructure such as schools and hospitals, as well as the provision of emergency relief in times of natural disaster.

Selected core indicator:

- **Voluntary contributions to civil society (with breakdown by type [incidental charitable donations, long-term commitment to community projects, and sponsorship activities] and by nature [cash, goods, services])**

Additional useful information that could be provided includes the number of employee hours donated to community projects and the number of meetings with community groups to discuss community needs. In the case of non-cash donations, enterprises should disclose the method of calculating the value of the donated goods or services.

Value chain. Although reporting on value chain issues is difficult in many industries owing to rapid fluctuations in value chain composition and activities, the way an enterprise addresses the CR aspects of its value chain should not be excluded from reporting.

Fundamental to corporate responsibility issues in an enterprise's value chain management is the issue of dependence. In many value chains, certain suppliers or distributors become dependent for a substantial portion of their business on a single, often large enterprise; this large enterprise is referred to in economics literature as the "core firm" of the value chain.[19] A "dependent supplier" is a supplier whose substantial output is purchased by the reporting enterprise. A "dependent distributor" is a distributor whose substantial revenues are derived from sales of items purchased from the reporting enterprise.[20] In these situations, and as a result of this relationship of dependency, stakeholders assign responsibilities to the core firm because the core firm has the capability of influencing the performance of its dependent value chain. Therefore, a fundamental indicator is how many members of the value chain are dependent on the core firm. Another important factor is the geographic location of the dependent members of the value chain; dependent members of the value chain located in countries with weak legal infrastructure, or poor records on social and

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[19] Ruigrok, W., and R. V. Tulder (1995). *The Logic of International Restructuring*. London, Routledge.

[20] The term "substantial" indicates a level of business such that the supplier or distributor would suffer a major negative financial impact should the business relationship with the core enterprise cease to exist. An exact threshold in terms of the percentage of business involved may vary from enterprise to enterprise or industry to industry. For example, in the purchasing practices of a particular Fortune Global 500 enterprise, the threshold of 40% of output from suppliers is used. This may, however, not be the most appropriate threshold for all enterprises, and clearly there are degrees of dependency. A threshold or a range of dependency would need to be clarified for compiling this indicator.

environmental performance, may be of particular concern for an enterprise's stakeholders.

The promotion of equal opportunities, health and safety and human capital development are examples of issues that are often associated with a core firm's responsibilities towards its value chain. In addition, the economic health of suppliers and distributors in the value chain of a core firm is an important CR issue. An equally important economic issue is how value chain decisions can affect the broader economic health of the country in which an enterprise operates; this would include decisions related to the distribution of value added as well as decisions related to the national origin of products sourced.

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

Selected core indicator:

- **Number of dependent enterprises in the value chain (with breakdown by supplier, distributor and location)**.

Additional useful information that could be provided includes the number of employees in the dependent value chain (breakdown by suppliers, distributors, and location) and the amount of money invested in training and development activities for the dependent value chain (breakdown by suppliers, distributors and location).

Corruption. Corruption is internationally recognized as an obstacle to economic development and a hindrance to international trade and investment. Laws against corruption exist in virtually every country in the world. This anti-corruption position is also found in normative international guidance, such as the OECD Guidelines for Multinational Enterprises and the UN Global Compact; additionally, it can be found in the international conventions of the OECD and the United Nations. Corporations can make a positive contribution to respect for anti-corruption laws and international norms by ensuring that they are not involved in corruption. A basic measurable performance indicator in this regard is the number of legal infractions a company incurs as a result of corrupt practices. This indicator can provide useful information to stakeholders about legal liabilities and areas of the enterprise's internal control that require attention.

Selected core indicator:

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

Additional useful information includes a description of any punitive measures other than monetary fines imposed by a government for infractions related to corruption.

D. Conclusion

The 20th and 21st sessions of ISAR recognized the limited relevance and lack of comparability of existing CR indicators that enterprises were reporting on. During these sessions, ISAR also recognized the need for providing voluntary technical guidance on reporting on CR as part of information presented in corporate annual reports, with a view to contributing to improved comparability of such reporting without imposing undue additional burdens on reporting entities. In accordance with the agreed conclusions of the 21st session of ISAR, the UNCTAD secretariat is presenting this draft voluntary guidance on CR reporting for consideration by the 22nd session of ISAR.

Should the 22nd session of ISAR find the approach proposed in this draft voluntary guidance acceptable, the Group of Experts could consider the possibility of using it to review enterprise reporting practices with a view to facilitating comparability and identifying areas for further refinement of the document. One such area could be follow-up work on a measurement methodology for the selected indicators to ensure consistent reporting.

Annex I

Summary of selected core indicators

Group	Subgroup	Indicator
Contribution to economic development		1. Total sales (contribution to GDP) 2. Value of imports vs. exports (contribution to balance of payments) 3. Number of employees (contribution to job creation) 4. Total of all salaries and pension payments (contribution to local economic activity) 5. Total of all taxes, fees, social security contributions, etc. (contribution to government finances) 6. Labour productivity (contribution to economic efficiency)
Human rights	*Security*	7. Number of enterprise operations with armed security (with breakdown by type of security: company employees, contractor, government)
Labour practices	*Equal opportunity*	8. Number of female employees (with breakdown by function)
	Workforce turnover	9. Employee turnover rate (with breakdown by function)
	Collective bargaining	10. Percentage of total employees covered by a collective bargaining agreement (with breakdown by employee function)
Human resource development		11. Training hours for employee training (with breakdown by employee function) 12. Expenditure on employee training (with breakdown by employee function)
Health and safety		13. Expenditure on employee health and safety 14. Work days lost due to accidents, injuries and illness
Community support		15. Voluntary contributions to civil society (with breakdown by type and nature)
Value chain		16. Number of dependent enterprises in the value chain (with breakdown by supplier, distributor and location)
Corruption		17. Number of convictions for violations of corruption-related laws or regulations and amount of fines paid/payable

Annex II

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*The views contained in this document do not necessarily reflect those of the organizations with which the members of the ad hoc consultative group are affiliated.

Chapter III

USERS OF CORPORATE RESPONSIBILITY REPORTING AND THEIR INFORMATION NEEDS

Summary

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has identified reporting on corporate responsibility as one of the emerging issues in the area of corporate transparency and recognized a need to improve the comparability and relevance of such reporting. At its 21st session, ISAR requested further examination of the principal users of corporate responsibility reporting and the use of such information. Most of such information is presented in the main document prepared for the ISAR 22 session (TD/B/COM.2/ISAR/29) as it relates to providing corporate responsibility information in annual reports. The objective of this chapter is to provide additional reference on these issues based on a literature survey conducted by the UNCTAD secretariat. In particular, the chapter provides references to the debate on such issues as the definition of stakeholders, whether they are different from traditional users of corporate reports, how their information needs can be identified and what those needs are. It also refers to research regarding the actual use of information on corporate responsibility. It suggests that stakeholders and users have varying information needs but that a number of common issues are identifiable. The information in corporate responsibility reports is used primarily to conduct enterprise assessments in order to facilitate investment decisions, shareholder voting decisions, ratings and inclusion in social indexes. However, research also suggests that the extent of the use of such information at this stage remains relatively low. It is recognized, however, that as more and better quality information becomes available, interested parties may make more active use of such information.

A. Introduction

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has identified reporting on corporate responsibility (CR) as one of the emerging issues in the area of corporate transparency. Within the framework of its mandate on promoting harmonization of best practices on corporate reporting, ISAR agreed at its 20th session to “begin examining existing indicators so that corporate social responsibility reports would be comparable and would not impose unreasonable burdens on enterprises in developing countries”.[1] At its 21st session, ISAR agreed to continue its work in order to develop guidance on voluntary disclosure to improve comparability in the area of corporate

[1] ISAR has changed the term “corporate social responsibility” that was used in the document TB/B/COM.2/ISAR/24 to “corporate responsibility” to reflect the language of the São Paulo Consensus of UNCTAD XI.

responsibility (CR) reporting. In particular, it agreed that further deliberations would be needed regarding the principal users of CR reporting, criteria for selecting topics and indicators, and the use of such information.

The objective of this chapter is to provide additional reference on these issues based on a literature survey conducted by the UNCTAD secretariat. In particular, the report provides references to the debate on such issues as the definition of stakeholders, whether they are different from users of corporate reports, how their information needs can be identified. It also refers to research regarding the actual use of information on corporate responsibility.

B. Stakeholders as users of CR reporting

Stakeholders are widely regarded as the users of corporate responsibility information. In its broadest conception, *stakeholders* are understood as groups of persons that are affected by and/or can influence an enterprise, without necessarily holding an equity share of the enterprise (Freeman, 1984). Their actions can affect an enterprise's brand image, its financial performance, and even its licence to operate. There is a broad range of identifiable stakeholder groups (discussed in section C below).

The concept of corporate responsibility draws on stakeholder theory (Freeman, 1984) which argues that enterprises can best achieve long-term sustainability by taking into account the interests of all of their stakeholders when making decisions, and seeking to achieve a balance between different stakeholder interests. Part of considering the interests of stakeholders is providing relevant information which allows stakeholders to evaluate the activities of the enterprise; therefore the information needs of stakeholders should be considered when ascertaining which information should be included in corporate reporting. Disclosure on an enterprise's social performance is also a means to demonstrate how and to what extent enterprises fulfil their responsibilities towards stakeholders as identified in existing regulations, codes, laws, and international agreements (e.g. the ILO Tripartite Declaration and the OECD Guidelines for Multinational Enterprises).

Most of the literature studied does not distinguish between stakeholders and users of corporate reporting; in practice, the two terms are often used interchangeably. Some authors, however, do differentiate between stakeholders and users of corporate reports (e.g. ACCA 2003, Berthoin Antal *et al.* 2002; Dawkins and Lewis 2003). The Fédération des Experts Comptables Européens (FEE), for example, argues that 'stakeholders are not synonymous with users of sustainability reports: some stakeholders may not use the report; some users may not be stakeholders' (FEE, 2002:38). While noting these exceptions, it is recognized that most literature on the subject equates stakeholders with users and does not observe significant differences between the two. Currently the users of CR reporting comprise mainly groups already identified as users of annual reports, for example those identified by the International Accounting Standards Board.[2]

[2] The International Accounting Standards Board identifies in its framework users of financial statements. They include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

According to one of the recent surveys (Pleon, 2005), the users of the information on corporate responsibility consist of shareholders/investors (67 per cent), employees (52 per cent), consumers/clients (43 per cent), media (35 per cent) followed by NGOs, the regional community and next by business associates, suppliers and academia.

C. Categorization of stakeholders

There are important differences between types of stakeholders and this in turn can affect which information needs are to be addressed. A broad range of different stakeholder groups were identified on the basis of the literature review, with the most frequently identified stakeholder groups listed in table III.1.

Table III.1. Stakeholders most frequently mentioned in literature

1	Investors
2	Employees
3	Consumers/Customers
4	Government officials
5	Suppliers

In order to better conduct their relations with stakeholders, including better understanding the information needs of stakeholders, enterprises often seek to group stakeholders into categories. There are, however, several means of categorizing stakeholders, and there is no clear agreement on which of these methods is most useful. The most commonly used is a distinction between internal stakeholders (such as management and workers) and external stakeholders (such as government authorities, suppliers, customers, consumers, and communities) (Berthoin Antal *et al.* 2002; Warhurst, 2002). However, some authors observe that the boundaries between these categories are fluid (Berthoin Antal *et al.* 2002:24). Concerning investors, for example, it is debatable whether they should be seen as external or internal stakeholders. Some experts advise avoiding the use of the categories "internal" and "external" altogether, arguing that they obscure and diminish the importance of the issues and groups being considered (ISO, 2005). This view suggests avoidance of excessive or inappropriate use of the term "stakeholder" where other more specific terms such as "workers" "consumers" "customers" or "the environment" might provide more meaning.

Clarkson (1995) distinguishes between primary and secondary stakeholders. Primary stakeholders are defined as “those without whose continuing participation the enterprise cannot survive”. Secondary stakeholders are “those who influence or affect or are influenced or affected by, the organization, but … not engaged in transactions with the enterprise and are not essential for survival”.

The Institute of Chartered Accountants of New Zealand (2002) distinguishes between: (1) stakeholders with direct ownership, investment or consumption interest (such as present and future investors, consumers, employees, creditors, suppliers and insurers); and (2) stakeholders without direct interests (like government, NGO, other communities of interest).

Wheeler and Sillanpäa (1997) present a two-dimensional categorization based on the difference between primary and secondary stakeholders on the first dimension and the difference between social and non-social interests on the second dimension (see table III.2).

Table III.2. The Wheeler and Sillanpäa categorization (1997)

	Social interests (examples)	**Non-social interests (examples)**
Primary stakeholders	shareholders, partners, employers, employees, customers, suppliers, local community	future generations, non-human species
Secondary stakeholders	regulatory bodies, social pressure groups and competitors	environmental pressure groups and animal welfare generations

The question of stakeholder categorization is also being debated by the International Standards Organization's Working Group on Social Responsibility (WGSR). The WGSR explored the issue of categorizing stakeholders and considered it fundamental to any guidance on social responsibility (ISO, 2005). The WGSR recognized that the categorization of stakeholders was integral to the way in which an organization identifies stakeholders and communicates with them. While the WGSR has not yet produced guidance on this subject, it has noted that some methodologies for categorizing stakeholders already exist in ISO's 14000 series on environmental management standards. That series, for example, divides stakeholders into two groups "internal and external interested parties" (ISO 14063). This, however, is a very broad categorization, and there is no clarity on the process by which a company determines which stakeholder belongs in which category. It has therefore been suggested within the WGSR that organizations should disclose the process by which they categorize stakeholders, i.e. explain how they categorize stakeholders and how they determine which stakeholder fits into which category.

D. Information needs of stakeholders and the use of information

The choice of user needs as a starting point for selecting the social information on which enterprises should report is often considered a fundamental one. Research on the current status of the actual use of social reporting information (i.e. do users actually use the data?) sometimes suggests that the extent of such use remains relatively low. The debate continues on whether the reason for this is an insufficient quality of information or lack of understanding of users' needs, or other reasons.

However, it has also been suggested that the extent of use of such information is not indicative of the need for data: the existence of the information is the key to accountability, not the degree to which people use it. An issue related to this might be the notion of a "right to information". As Gray, (1997:330) for example, argues, "in the neo-pluralist accountability framework, the stakeholders are those with rights to the account and it is for them that the account is prepared. Whether or not they use it, and whether or not other parties see and/or use the account, are largely irrelevant".

The literature review revealed several studies on how to identify the information needs of stakeholders/users. Gehrmann (cited in Dierkes and Berthoin

Antal, 1985) conducted studies on the perceptions of employees regarding social reporting in Germany in 1979 and 1981. These works found that the perception of usefulness is highly specific to the target group; one example highlighted an apparent discrepancy between work council representatives and employees, wherein the two groups attached significantly different levels of importance to certain social issues (e.g. quality of life at the workplace is ranked higher by work council representatives than by employees).

The challenge of identifying stakeholder needs is further complicated by what Campbell *et al.* (2002) identify as the "frustrating effect of perception", i.e. that those who seek to understand stakeholder needs are themselves likely to have diverse perceptions and opinions. Thus, the management of an enterprise may have inaccurate perceptions of stakeholders that prevent the management from understanding stakeholder needs as users of corporate reporting. Likewise, stakeholders may have inaccurate perceptions of firms which lead to a poor understanding of what information is available for reporting. Additionally, interest groups within society differ in their preferences and values, hence the criteria they apply in assessing an enterprise differ as well, making it more complicated to identify their information needs (Woodward, Edwards and Birkin, 1996).

Woodward *et al*. (1996) point out that an important way of ascertaining stakeholder needs is to conduct stakeholder dialogues. In KPMG's 2005 survey of CR reporting, it is observed that 57 per cent of the reports in the study include information about their stakeholders, and nearly forty percent include information about structured stakeholder dialogue (KPMG, 2005). The KPMG report argues that "good stakeholder engagement should feed into risk assessment and business strategy, and ultimately into the reporting process". Stakeholder dialogue can be approached in several ways. As recognized by various international agreements (e.g. the ILO Tripartite Declaration), the principal means of stakeholder dialogue with employees is through industrial relations. In addition to this, and for other stakeholder groups, an earlier 2002 KPMG survey identifies various other tools for stakeholder dialogue, including: community panels, staff surveys, opinion polls, workshops with combined stakeholder dialogues on specific issues, and meetings with external experts (KPMG and Universiteit van Amsterdam, 2002). Another method is providing stakeholders with contact details and/or comment or feedback forms in published reports (McGuiness and Hays, 2004). Several enterprises also employ their websites to encourage stakeholders to give input about the information they are interested in and about their opinions on the enterprise's behaviour.[3] By definition, a dialogue involves two parties; consequently some authors argue that stakeholders have a responsibility to assist enterprises in identifying what information should be reported (e.g. ACCA, 2003).

Several papers explore the needs of stakeholders. For example, a recent global survey amongst stakeholders (Pleon, 2005) shows that the issues they expect to be addressed in relation to social reporting include (in order of relevance): human rights, health and safety, standards in developing countries, supply chain standards or guidelines, education and training, consumer protection, freedom of association and corporate citizenship.

[3] See, for example, the Tell Shell Forum at www.shell.com/tellshell.

Table III.3 below summarizes some of the most often identified issues relevant to stakeholder information needs, as indicated by the current literature survey. The issues were retrieved from studies that: (1) looked at what enterprises actually provide (e.g. KPMG and University of Amsterdam, 2005); (2) what enterprises should provide based on an analysis of several guidelines and studies (e.g. Loew *et al.*, 2005); and (3) what stakeholders, especially financial stakeholders, expect them to provide (e.g. Hamner, 2005; Pleon, 2005).

Table III.3. Issues relevant to stakeholder information needs as identified in the literature

1	Community welfare/involvement
2	Equal opportunity/workforce diversity
3	Customer information/protection/product quality
4	Human rights
5	Employee health and safety
6	Supplier relations
7	Education and training
8	Employee satisfaction

Research investigating the use of information on the social performance of enterprises has so far been mainly focused on the wider financial market and its participants. For example, the study mentioned above (Pleon, 2005) shows that 67 per cent of the financial community use information on CR very often in their professional work. This has been driven in part by the rapid growth of the socially responsible investment (SRI) community, which uses both financial information as well as social and environmental information to make investment and shareholder voting decisions. According to industry reports, SRI in the US, as well as in other countries such as the UK, has evolved into one of the fastest growing segments of professionally managed investment portfolios. More than one out of every nine dollars under professional management in the United States today is involved in socially responsible investing. The $2.16 trillion managed by major investing institutions (including pension funds, mutual funds, foundations, religious organizations, and community development financial institutions) accounts for 11.3 per cent of the total $19.2 trillion in investment assets under professional management in the United States (SIF, 2003). The rise of SRI has been accompanied by evolving new information services on corporate responsibility. Traditional investment information firms, FTSE and Dow Jones, for example, have both produced social indexes (respectively, the FTSE4GOOD and the Dow Jones Sustainability Index). A wide array of activities and new initiatives are taking place in this field, including the UNEP-FI's programme on *Principles for Responsible Investment*, which seeks to establish core principles in this area for institutional investors.[4]

Non-financial performance indicators are often used by financial institutions when valuing companies, in particular from the perspective of a risk assessment of the enterprise in question. In general, financial institutions seek information enabling them to assess both the current and future performance of an enterprise. Several authors (e.g. Roberts *et al.*, 1997) recognize that social information can be useful in making such assessments. Information with regard to social issues used by the

[4] See UNEP-FI's website for more information: http://www.unepfi.org.

financial sector includes financial results and financial consequences of social aspects, the overall strategy of an enterprise, its risk and reputation management, compliance with laws and regulations, the consequences of plant additions or closures and similar decisions. Financial institutions also use social information when selecting enterprises for inclusion in SRI indexes or mutual funds.

Hummels and Timmer (2004) describe three types of investors which use the information in CR reporting to inform investment decisions. These three types range from SRI institutions with a strictly ethical orientation, to more traditional investors having a strictly financial orientation. The first type is called the ‘principled investor’. This investor is strictly ethically oriented and when making an investment decision seeks to know whether an enterprise has violated one of the investor’s ethical principles. The second type of investor is in the middle of the range, and can be referred to as the "consequential investor". This investor uses information on how an enterprise manages its social responsibilities as a measure of quality of management and as an assurance that the enterprise is taking reasonable steps to avoid potential future social liabilities. For example, has the enterprise adopted internationally recognized business principles, and does it have any management systems in place to control compliance with those principles. The third type of investor is the "financially-oriented investor" whose primary use of CR reporting is to assess the extent to which an enterprise’s social, economic and environmental performance materially affects its current and near-future financial performance.

A set of studies on the use of non-financial performance indicators by the financial market conducted by Ernst & Young in 1997 and 2000 make a distinction between the sell-side and the buy-side. These studies show that non-financial performance indicators in general are used by analysts and investors when valuing companies. There was a positive correlation between the use of non-financial information and the accuracy of the earnings forecast. Sell-side analysts are mainly interested in customer-, products- and innovation-related factors. To some lesser extent sell-side analysts are interested in employee-related factors in relation to the strength of corporate culture such as social policy, employee turnover and quality of employee training. Buy-side analysts put more emphasis on measures of, for example, strategy execution, management credibility or market position, whereas employee issues or social policies do not appear to play an important role in their decisions. An important finding of this study is that the type of non-financial information investors rely on varies from industry to industry.

Johnson and Greening (1999) reveal significant differences between traders (short-term investors) and institutional investors (long-term investors) concerning the use of corporate responsibility information. They conclude that professional investors whose reward system is based on short-term profitability appear to make little use of information on an enterprise's social performance. In contrast, large, long term investors, such as pension funds, (who cannot quickly exit an enterprise by selling large blocks of stocks since this would cause a sharp drop in share price) are much more concerned with long term returns and are more likely to consider the benefits of good stakeholder relations to an enterprise’s long term sustainability.[5] These

[5] For example, Ernst & Young’s study *Measures that Matter* (1997) reports that the California Public Retirement System, the largest pension fund of the USA, intends to use workplace practices criteria to assess the value potential investments for its portfolio.

institutional investors make greater use of social information in their investment and shareholder voting decisions.

One of the important determining factors on who uses CR reports and how they are used is the availability of relevant information. New information allows for both new users and new uses. Therefore, it is expected that the inclusion of social information into annual reports, will not only provide existing users with additional information, but also that the scope of users will broaden and new stakeholder groups could become users of this information as new useful information becomes available.

E. Conclusion

The surveyed literature in most cases suggests that the stakeholders of enterprises and the users of social reporting are, with few exceptions, the same. However, there are different types or categories of stakeholders, and there is ongoing debate about how stakeholders should be classified to better understand their specific needs. Investment institutions, for example, were identified as both a key stakeholder group as well as one of the principal users of corporate responsibility reports. The information in these reports is used primarily within the "socially responsible investment" industry to conduct enterprise assessments in order to facilitate investment decisions, shareholder voting decisions, ratings and inclusion in social indexes. This in part stems from the investment community's position as, traditionally, an active user of corporate reporting more generally.

However, research also suggests that the extent of the use of such information at this stage remains relatively low. It is recognized, however, that as more, and better quality information becomes available, other stakeholders may make more active use of the information for assessing an enterprise's relationship with its stakeholders and its long-term financial, social and environmental sustainability.

The literature review suggests that despite the variety of user needs identified, there are nevertheless several common issues, including: community welfare; equal opportunity; customer protection; human rights; employee health and safety; supplier relations; education and training; and employee satisfaction. Such issues represent common user needs and could form the basis of selecting a common set of core indicators on corporate responsibility reporting.

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Chapter IV

GUIDANCE ON GOOD PRACTICES IN CORPORATE GOVERNANCE DISCLOSURE

Summary of discussions

The Chair introduced the agenda item and gave the floor to a resource person who presented the background document "Guidance on good practices in corporate governance disclosure" (TD/B/COM.2/ISAR/30). The resource person explained that this document was an update of the 2002 paper "Transparency and Disclosure Requirements for Corporate Governance" (TD/B/COM.2/ISAR/15) prepared for the 19th session of ISAR. It was noted that the original 2002 document was very up to date for its time; nevertheless, the intervening years were a time of significant developments in corporate governance disclosure. The resource person provided an overview of the main changes to the document that were made to reflect recent developments. These included, among others, updated disclosure requirements in the area of changes in control and transactions involving significant assets, as well as new disclosure items regarding the internal audit function. The resource person emphasized that the purpose of the guidance document was to assist enterprises in attracting investment. He commended the guidance for its quality and recommended its wide dissemination.

The Chair introduced a panel of experts to discuss corporate governance disclosure. The panellists raised several important issues and highlighted useful examples. These included: emphasis on the need for quality corporate governance disclosure to ensure compliance with new and existing corporate governance codes; an example of a country that includes most of its corporate governance code within stock market listing requirements rather than government regulations; an example of the problems associated with limited or differential voting rights; emphasis on the need to improve corporate governance in developing countries as a priority for economic development; and finally, examples of recent developments within EU legislation, along with a suggestion for future work on the issues of internal control and risk management.

Further discussions addressed existing or potential mechanisms, besides legislation, to implement stakeholder control in unlisted companies. Related to this question was a discussion of the potential gap in corporate governance practices that might emerge between listed and unlisted enterprises, if corporate governance requirements are primarily located within listing requirements. The Group also addressed a panellist's recommendation for more guidance on internal control and risk management; this subject was generally considered to be beyond the scope of the current guidance document (ISAR/30) but it was recognized by the Group as a potential subject of future work. A request also arose from the floor for more guidance on practical implementation of corporate governance disclosure: that is, not "what" to

disclose, but "how". Such practical implementation guidance should be suitable for both listed and unlisted enterprises, with a specific focus on helping enterprises in developing countries, and countries with economies in transition, to improve their disclosure practices. A final topic that received much discussion focused on the issue of minority shareholders and their rights. This discussion included a question about how one might evaluate not only directors' independence from management, but also the independence of directors from majority shareholders. Many of the participants commended the guidance document for its quality and usefulness.

A. Introduction

At its 10th quadrennial conference, which was held in Bangkok in February 2000, member States requested UNCTAD to promote increased transparency and improved corporate governance. In response to the above request, the 17th session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) decided to review existing corporate governance practices, codes and principles. Accordingly, a review was conducted and was presented at the 18th session of ISAR.

In concluding the 18th session and adopting the provisional agenda for the 19th session, the Group of Experts proposed to work on issues related to corporate governance. Discussions focused on how ISAR could contribute to the improvement of corporate governance practices in member States and on how it could assist developing countries and economies in transition in identifying and implementing best corporate governance practices to achieve better transparency and accountability.

The work for the 19th session culminated in the 2002 report "Transparency and disclosure requirements for corporate governance" (referred to as ISAR/15). The objective of the report was to help developing countries and countries with economies in transition apply good practices of corporate governance disclosure.

At the 21st session of ISAR in 2004, the Group of Experts proposed reviewing the ISAR/15 report with a view to considering further developments in the area of disclosures and updating it as needed. Accordingly, an ad hoc consultative group was formed, consisting of experts from a range of countries and organizations and which met in Geneva on 18 May 2005 (see annex II).

The objective of the ad hoc consultations was to review the recommendations on corporate governance disclosures that are outlined in the 2002 ISAR/15 report in light of developments since 2002 and to update the original report as needed. This document draws upon recommendations for disclosure relevant to corporate governance contained in such widely recognized documents as the revised OECD Principles of Corporate Governance (OECD Principles), the International Corporate Governance Network (ICGN) Corporate Governance Principles, past ISAR conclusions on this matter, the Commonwealth Association for Corporate Governance Guidelines (CACG Guidelines), the pronouncements of the European Association of Securities Dealers (EASD), the EU Transparency Directive, the King II Report on Corporate Governance for South Africa (King II), the Report of the Cadbury Committee on the Financial Aspects of Corporate Governance (Cadbury Report), the

Combined Code of the UK, the United States Sarbanes-Oxley Act, and many others (see annex I). References to codes in this chapter are provided by way of example only, and for every individual code highlighted, other codes may exist that address the same issue in a similar way.

Reference is made to the recommendations contained in the foregoing documents, since one objective of this guidance is to illustrate the convergence of opinion on the content of corporate governance disclosures. Another objective of this guidance is to encourage countries and/or companies to implement best international practices in a way tailored to their particular legal requirements and local traditions by giving various examples of existing best practices.

During the ad hoc consultations, it was re-emphasized that ISAR’s guidance on corporate governance disclosures would be a voluntary technical aid for, among others, regulators and companies in developing countries and transition economies. What and how organizations disclose will depend considerably on local laws and customs. In addition, particular industries may have some industry-specific disclosure requirements. In order to facilitate the general usefulness of this document, the focus is placed on widely applicable disclosure issues that should be relevant to most enterprises. The purpose of the work is to address the major concerns of investors and creditors, and to provide some reassurance, through disclosures on corporate governance. This work would be relevant to enterprises eager to attract investment regardless of their legal form or size. This guidance would also be useful for promoting awareness in countries and companies that are not adhering sufficiently to international good practices and are consequently failing to satisfy investors’ expectations regarding corporate governance disclosures.

The report revisits the content of major corporate governance codes and regulations since 2002, with a focus on: financial disclosures, a range of non-financial disclosures, disclosures in relation to general meetings, the timing and means of disclosures and the disclosure of the degree of compliance with local or other codes of corporate governance. The following sections present the main conclusions on these issues.

B. Financial disclosures

The ad hoc consultative group recognized as fundamentally important that ***enterprises should disclose their financial and operating results***.

One of the major responsibilities of the board of directors is to ensure that shareholders and other stakeholders are provided with high-quality disclosures on the financial and operating results of the entity that the board of directors had been entrusted to govern. Almost all corporate governance codes around the world, including the OECD and the ICGN Principles, the CACG Guidelines, the Cadbury Report, and the King II, specifically require the board of directors to provide shareholders and other stakeholders with information on the financial and operating results of a company to enable them to properly understand the nature of its business, its current state of affairs and how it is being developed for the future.

The quality of financial disclosure depends significantly on the robustness of the financial reporting standards on the basis of which the financial information is prepared and reported. In most circumstances, the financial reporting standards required for corporate reporting are contained in the generally accepted accounting principles recognized in the country where the entity is domiciled. Over the last few decades, there has been increasing convergence towards a set of non-jurisdiction-specific, widely recognized financial reporting standards. The ad hoc consultative group agreed that International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board provide a widely recognized benchmark in this respect.

Furthermore, the ad hoc consultative group was of the view that the board of directors could enrich the usefulness of the disclosures on the financial and operating results of a company by providing further explanation, for example in the Management's Discussion and Analysis section of the annual report, on critical accounting estimates[1] of the company in addition to the disclosure required by the applicable financial reporting standards.

The board could clearly identify inherent risks and estimates used in the preparation and reporting of the financial and operational results of the company in order to give investors a better understanding of the risks they are taking in relying on the judgement of management. For example, in some cases, financial reporting measurement requirements call for the valuation of certain assets on a fair value basis. However, while for certain assets deep markets might exist and fair value could be obtained with reasonable objectivity, that might not be the case for others. Situations of the latter kind may invite management to exercise great latitude and influence the direction of earnings in its favour by resorting to less objective estimates based on modelling hypothetical markets. In addition to the disclosure required by the applicable financial reporting standards, the board of directors may provide further comfort to shareholders and other stakeholders by disclosing that the board or its audit committee has reviewed fair value computations, if any, and that the computations were conducted in an objective manner.

The board's responsibilities regarding financial communications should be disclosed.

A description of the board's duties in overseeing the process of producing the financial statements should be provided. This is useful for supporting the notion that the board is responsible for creating an overall context of transparency. It is generally accepted that the board has responsibility for reporting on the financial and operating results of the corporation. Almost all corporate governance codes describe the basic responsibility of the board for reviewing financial statements, approving them, and then submitting them to shareholders. When the duties of the board in this area are

[1] An example of a definition of critical accounting can be found in the United States Securities and Exchange Commission Release number 33-8098, according to which an accounting estimate would be considered critical when it requires management to make significant judgement in making assumptions about matters that were highly uncertain at the time the estimate was made; and when alternative estimates that management could have reasonably used, or changes in the accounting estimate that are likely to occur from period to period have material impact on the financial and operating results of the company.

clearly disclosed, shareholders and other stakeholders could find it useful in providing an additional level of comfort with regard to the fact that the financial statements accurately represent the situation of the company.

The quality of financial disclosure could be undermined when consolidation requirements on financial reporting are not followed appropriately. In this respect, the board of directors could provide additional comfort to users of its financial reports. For example, the board of directors could state that it had ascertained that all subsidiaries and affiliated entities, including special purpose ones, which are subject to consolidation as per the financial reporting standards applicable to the entity, have been properly consolidated and presented.

The ad hoc consultative group was of the view that ***enterprises should fully disclose significant transactions with related parties***.

Many shareholders and stakeholders would be interested in information that would help them determine that management is running the enterprise with the best interest of all shareholders and stakeholders in mind and not to unduly benefit any related-parties (see also section C.5 below on conflict of interest). Most national financial reporting standards, and IFRS, require extensive disclosure on this matter. However, in circumstances where the financial reporting requirements are less stringent, as a minimum ***the board of directors should provide the following disclosures that are generally considered best practice: significant related-party transactions and any related-party relationships where control exists; disclosure of the nature, type and elements of the related-party transactions; and related-party relationships where control exists (irrespective of whether there have been transactions with parties under common control). The decision-making process for approving related-party transactions should also be disclosed. Members of the board and managers should disclose any material interests in transactions or other matters affecting the company***.

C. Non-financial disclosures

1. Company objectives

The ad hoc consultative group agreed that ***the objectives of the enterprise should be disclosed.*** There are two general categories of company objectives: the first is commercial objectives, such as increasing productivity or identifying a sector focus; the second is much more fundamental and relates to governance objectives: it seeks to answer the basic question, "why does the company exist?" This section refers to these governance objectives. The objectives of enterprises may vary according to the values of society. In many but by no means all countries, the primary corporate objective is to maximize the long-term return to shareholders (shareholder value). This objective appears in many codes throughout the world.

However, despite an increasing awareness throughout the world that shareholder requirements must be met in order to attract and retain long-term, low-cost capital, the emphasis on shareholder value maximization has not precluded a growing emphasis on other corporate objectives. Many codes now include social, environmental and economic objectives as part of the fundamental objectives of an enterprise. In particular, the codes emphasize the need for enterprises to address the interests of a range of stakeholders in order to promote the long-term sustainability of the enterprise. If an enterprise knowingly damages the interests of its stakeholders, it can risk negatively affecting its own ability to produce long-term shareholder value. This suggests that, rather than viewing shareholder value and stakeholder value as mutually exclusive objectives, there are indications that the opposite is true, and that the two objectives are probably interdependent in the long run. This emphasis on a broader set of objectives can be found in the Revised OECD Guidelines on Multinational Enterprises, the 2004 edition of the OECD Principles of Corporate Governance, proposed revisions of the UK Companies Act, and the King II Report.

2. Ownership and shareholder rights

The ad hoc group recognized that ***the beneficiary ownership structure should be fully disclosed to all interested parties.*** It was also recognized that ***changes in the shareholdings of substantial investors should be disclosed to the market as soon as a company becomes aware of them*.** The beneficiary ownership structure of an enterprise is of great importance in an investment decision, especially with regard to the equitable treatment of shareholders. In order to make an informed decision about the company, investors need access to information regarding its ownership structure.

It is recommended that this disclosure include the concentration of shareholdings, for example the holdings of the top 20 largest shareholders. This information is of particular interest to minority shareholders. In some countries (e.g. Germany), disclosure is required when certain thresholds of ownership are passed.

The group took the view that ***disclosure should be made of the control structure and of how shareholders or other members of the organization can exercise their control rights through voting or other means.*** It also discussed the fact that ***any arrangement under which some shareholders may have a degree of control disproportionate to their equity ownership, whether through differential voting rights, appointment of directors or other mechanisms, should be disclosed*.**

In certain cases, control is exercised indirectly via the ownership of one or several entities that in turn (collectively) control a corporation (i.e. a pyramid structure). In such cases, the disclosure of ultimate control is considered best practice. As noted in the OECD Principles, information about record ownership may need to be complemented with information about beneficial ownership in order to identify potential conflicts of interest, related party transactions and insider trading. In disclosing beneficial (or ultimate) ownership, information should also be provided about shareholder agreements, voting caps and cross-shareholdings, as well as the rights of different classes of shares that the company may have issued.

A company might have a single shareholder or group of shareholders with majority control of the company, either through holding the majority of the company's outstanding equity or through holding shares with superior voting rights. In this situation, without safeguards for minority shareholders, the latter group may be adversely affected. This issue is emphasized by a number of codes, including the OECD Principles.

A number of international statements advocate a “one share one vote” approach. Although the OECD Principles do not advocate any particular view on the "one share one vote" approach, they include examples of other international statements that do advocate a "one share one vote" approach. The International Corporate Governance Network, among others, is a strong supporter of this approach. Advocates of the "one share one vote" approach view any deviation from this approach as an undesirable distortion of the connection between investment risk and the decision making process. However, actual practice might be different. For example, in the European Union, many member States do allow shares with multiple or no voting rights. While this practice remains controversial, it is tolerated by investors as long as differentials in voting rights are disclosed. The European Association of Securities Dealers does not support such differentials but allows flexibility, noting that if they cannot be avoided they should at least be indicated by a different share class (EASD Principles, Recommendation II.2).

3. Changes in control and transactions involving significant assets

The group agreed that ***rules and procedures governing the acquisition of corporate control in the capital markets and extraordinary transactions such as mergers and sales of substantial portions of corporate assets should be disclosed.***

Best practice suggests a substantial amount of pre-control transaction disclosure, including the disclosure of the intention to acquire control and to take the company private and of associate squeeze-out/sell-out rights relevant for minority shareholders. Other typical disclosures include the identity of the bidder, past contacts, transactions and agreements between the merging entities (or acquirer and target, as the case may be), a discussion of the consequences of the control transaction for the shareholders of the companies involved, as well as disclosure of the financial situation of the bidder and its source of funds for the control transaction.

This disclosure should include any anti-takeover measures established by the enterprise. It should also cover the compensation policy for senior executives departing the firm as a result of a merger or acquisition.

Best practice disclosure for sales of substantial portions of corporate assets include a notice to all shareholders (usually at the annual general meeting), accompanied by an independent evaluation report. In the Republic of Korea, for example, the Corporations Code requires a special resolution for a transaction that may result in the sale of a substantial part of the enterprise. For such transactions involving listed companies, additional disclosure and substantive requirements are imposed. In South Africa, the Companies Act requires approval of the shareholder meeting for sales of the whole or the greater part of the company's assets, and for listed companies such approval is required for any transaction over 30 per cent of assets. In most governance systems, it is generally considered good practice to submit questions of extraordinary transactions (including mergers, acquisitions and takeovers) to a general meeting for shareholder approval.

In the interest of protecting minority shareholders, the principle of "equality of disclosure" should be practiced, such that all shareholders receive information equally. Any information disclosed to one shareholder should also be equally available to all shareholders (FEE, 2003a). This reflects the view that all shareholders should have a right to be equally informed, and complements the issue of simultaneous disclosure of information discussed in section D below. Major shareholders such as institutional investors should not have privileged access to information that is unavailable to minority shareholders.

4. Governance structures and policies

The structure, role and functions of the board

The group recognized that the term "board" has different meanings in unitary and two-tier systems. A unitary board is comprised of executive and non-executive directors. In a two-tier system the term “board” can refer to the management board, whose members have executive responsibilities, and the supervisory board, responsible for monitoring and supervising the company’s management. Variations exist among the two-tier systems, and the responsibilities of the supervisory board could in some countries include responsibilities for the strategic direction of the company. While the two-tier system is not as widely utilized as the one-tier system, it is nevertheless prevalent in several large economies such as Austria, Germany and the Netherlands. In this document, the term "board" is used to refer to the highest governing and monitoring body or bodies of an enterprise upon which executive and non-executive or supervisory board members sit. The recommendations contained herein typically apply to both one-tier and two-tier systems.

The group took the view that ***the composition of the board should be disclosed, in particular the balance of executive and non-executive directors and whether any of the non-executives have any affiliations (direct or indirect) with the company. Where there might be issues that stakeholders might perceive as challenging the independence of non-executive directors, companies should disclose why those issues are not significant and do not impinge on the governance role of the non-executive directors.***

One of the main issues in relation to the board structure and its disclosure is that, regardless of which structure exists in the company, independent leadership within the board is ensured. Some countries would give more emphasis to the need for a clear division of responsibilities between the chairman and the chief executive officer (CEO) (Cadbury Report, para. 4.9). Increasingly codes mention that while a combined CEO/Chair is tolerable (in a one-tier system), the separation of the two is desirable and considered best practice, as it helps to promote a balance of power within the leadership structure. There is also increasing debate on the need for an independent Chair of the board.

Acknowledgment of the benefits of the separation of the roles of the Chair and the CEO in a one-tier system is increasing. While combining these two roles is still common, it is becoming less so. Although the general practice in some of the world’s largest financial markets continues to be their combination, there are significant exceptions, such as the United Kingdom, where a combined role is increasingly rare. Even within economies where a combined role is still common, the accepted view is that measures are called for to balance the power at the head of the corporation such that no single individual has unfettered control of the company (FEE, 2003a).

If the roles of chairman and CEO are combined, the proportion of independent directors within the board structure assumes greater importance. For example, the Cadbury Report recommended that where the roles were combined, there should be a strong independent element on the board and that there should be a lead non-executive director to whom issues regarding the executive management could be addressed. This idea is followed by the Indian code and was also addressed in the 2002 Report of the Kumar Mangalam Birla Committee on Corporate Governance. The idea is also expressed in the Malaysian Code on Corporate Governance (2000). However, the definition of an independent director varies in different countries. Accordingly, a reference to a particular approach used in defining director independence might be useful in disclosing and discussing the board structure. FEE (2003a), for example, recommends that a principles-based approach used for assessing the independence of external auditors (see section 8 below) can also be usefully applied to the assessment of independence among non-executive (supervisory) directors. A crucial general principle in this respect is the principle on self-interest threat; a self-interest threat occurs when a director could benefit from a financial or other interest in the enterprise as a result of unethical behaviour or lack of independence (FEE, 2003b). FEE further recommends that the board should disclose its reasons for considering a non-executive (or supervisory) director to be independent.

It is recognized that not all non-executive directors can be considered independent directors. The Narayan Murty Committee Report in India, for instance, makes a clear distinction between non-executive and independent directors. For example, non-executive directors who are employees of banks and other financial institutions with which the enterprise has a business relationship cannot be considered independent. Similarly, for the boards of subsidiary companies, it is not uncommon for non-executive directors to be employees of the parent firm or some other subsidiary related to the parent firm. Any relationship of directors to the parent firm or its subsidiaries should therefore be disclosed. Such a relationship could be considered in assessing the ability of the non-executive director to fulfil his or her duties.

The group took the view that ***the board's role and functions must be fully disclosed***. Most guidelines and codes of best practice emphasize the stewardship and supervision functions of the board and distinguish its responsibilities from those of management. It is important that directors disclose what their functions and retained powers are, otherwise the directors may be considered accountable for all matters connected to the enterprise. In many Commonwealth countries, for example, the Companies Act makes the directors accountable for the 'management' of the company, but also allows the directors to delegate; hence the importance of recording and disclosing the retained powers of the directors, along with a clear statement about which powers are delegated to the CEO. However, there are differences in the specificity with which the board's role is explained. For example, the Dey Report (Canada), the Vienot Report (France), the Korean Stock Exchange Code, Malaysia's Report on Corporate Governance, Mexico's Code of Corporate Governance, and the King II Report (South Africa) specify board functions as strategic planning, risk identification and management selection, oversight and compensation of senior management, succession planning, communications with shareholders, integrity of financial controls and general legal compliance. In India, for example, a directors' responsibility statement outlining the board's responsibilities on compliance with standards, internal controls, risk management, fraud detection and other matters is a disclosure requirement under both the law and stock exchange rules. The degree of differences between codes may reflect the degree to which company law or listing standards specify board responsibilities.

Board committees

It has become common practice for boards to establish board committees to facilitate fulfilment of certain of the board's functions and address some potential conflicts of interest. The use of board committees is, among other things, intended to enhance independent judgment on matters in which there is potential for conflict of interest, and to bring special expertise in areas such as audit, risk management, election of board members and executive remuneration. While it may be advisable for the preparatory work of certain key board functions to be assigned to separate committees, there is an international consensus that the full board holds collective and final responsibility (FEE, 2003a). A number of codes address this issue, also outlining the need for clear terms of reference for such committees (e.g. Australia, India, Malaysia, South Africa).

The ad hoc consultative group suggested that ***governance structures should be disclosed. In particular, the group agreed that the board should disclose structures put in place to prevent conflicts between the interests of the directors and management on the one side, and those of shareholders and other stakeholders on the other.*** These structures may include committees or groups to which the board has assigned duties regarding the oversight of executive remuneration, audit matters, appointments to the board, and the evaluation of management performance.

It was also agreed that ***the composition and functions of any such groups or committees should be fully disclosed. Committee charters, terms of reference, or other company documents outlining the duties and powers of the committee or its members should also be disclosed, including whether or not the committee is empowered to make decisions which bind the board, or whether the committee can only make recommendations to the board. If any director has taken on a specific role for the board or within one of these structures, this should be disclosed.***

As a general rule, codes have recommended, and in some cases stock exchange regulations require, that some board committees be substantially or exclusively staffed by non-executive or outside directors, particularly independent directors, and especially with regard to the committee chairpersons. Disclosures that are becoming increasingly common include the disclosure of committee charters or terms of reference, committee chairs, reports on activities (in particular those of the audit committee), composition, nominations committee disclosure on whether use is made of external advisors/advertising to find new directors (as opposed to potentially conflicting informal connections), and the effectiveness of executive remuneration in providing incentives for executives

Ethics policy and support structure

The existence of an enterprise code of ethics and any governance structure put in place to support that code of ethics should be disclosed. Any waivers to the code of ethics or the rules governing ethics procedures should also be disclosed.

Ethics management is important to the promotion of good business practices, transparency and risk reduction. As ethics management becomes more common in enterprises, the existence of its key structural features is an important area of disclosure. It is noted that, with the exception of some countries such as the United States, no general or international best practice has yet been established in this area. Nevertheless, some possible features subject to disclosure might include: the existence of a senior ethics officer and that person's responsibilities; the existence of an ethics committee and its relationship to the board; policies for breaches of the ethics code, including reporting mechanisms and 'whistleblower' protection mechanisms; and policies on the dissemination and promotion of the ethics code.

5. Members of the board and key executives

Duties and qualifications

The group recommended that ***the number, type and duties of board positions held by an individual director should be disclosed. An enterprise should also disclose the actual board positions held, and whether or not the enterprise has a policy limiting the number of board positions that any one director can hold.***

The group discussed the issue of shareholders needing to be aware of the number, type and duties of outside board and management positions that any individual director holds. Information for outside board and management positions should be disclosed for key executives as well. The purpose of this information is to make a judgment on the ability of directors and key executives to meet all of their commitments; thus the number as well as the type and duties of the position (which gives some indication of the commitment involved) are the subject of disclosure.

Many codes and institutional investors have specified disclosure requirements (and/or actual limitations) on the number and type of positions held by directors. Among others, such disclosure requirements, can be found in the positions of the FEE and the Winter Group Report, the Dey Report, the Indian Code, the Malaysian Code, the King II Report, the National Association of Pension Funds in the United Kingdom. Some guidance, such as the report of FEE, also recommends disclosure of positions held in public or not-for-profit organizations.

The experts took the view that ***there should be sufficient disclosure of the qualifications and biographical information of all board members to assure shareholders and other stakeholders that the members can effectively fulfil their responsibilities. There should also be disclosure of the mechanisms which are in place to act as "checks and balances" on key individuals in the enterprise.***

Most governance guidelines and codes of best practice address topics related to directors' qualifications and board membership criteria. These may include experience, personal characteristics, core competencies, availability, diversity, age, specific skills (e.g. the understanding of particular technologies), international background, and so on. The CACG, for example, advocates that the director has to have integrity, common sense, business acumen and leadership. Some codes specifically require financial literacy (e.g. the National Association of Corporate

Directors in the United States) or knowledge of business and financial technology (e.g. the Brazilian Institute of Corporate Governance).

There should be disclosure of the types of development and training that directors undergo at induction, as well as the actual training directors received during the reporting period.

Recently, some countries have started to require specific training for directors. For example, in India, the Companies (Amendment) Bill 2003 makes director training mandatory. The Naresh Chandra Committee on Corporate Audit and Governance, also of India, recommends training for independent directors and disclosure thereof.

The group suggested that ***the board should disclose facilities which may exist to provide members with professional advice. The board should also disclose whether that facility has been used during the reporting period.***

The group realized that, on certain legal and financial matters, directors might discharge their duties more effectively if allowed access to independent external advisors, for example legal and financial experts. If used correctly, access to external expertise can enhance the ability of directors to fulfil their duties properly. In New Zealand, for example, it is considered vital for directors to have access to independent advice, and therefore this principle is stated in that country's Companies Act. The Merged Code in Belgium also points out the need for an agreed procedure for using external expertise, a point also mentioned in the Dey Report (Canada), Vienot (France), Mertanzis (Greece) and Olivencia (Spain) reports. Best practice suggests that, whatever approach is used, the approach should be disclosed.

Evaluation mechanism

The ad hoc group agreed that ***the board should disclose whether it has a performance evaluation process in place, either for the board as a whole or for individual members. Disclosure should be made of how the board has evaluated its performance and how the results of the appraisal are being used.*** Along with the duties and responsibilities of directors, shareholders will need to know how directors were evaluated, what criteria were used and how they were applied in practice, particularly with reference to remuneration.

CACG Guidelines stress that evaluations should be based on objective criteria. The IAIM Guidelines (Ireland) and Preda Code (Italy) leave to the remuneration committee the selection of appropriate criteria and the establishment of whether these criteria have been met.

An important aspect of performance is the attendance of directors at board and committee meetings. Specific requirements regarding the frequency and procedures of board meetings can be found, for example, in the Indian Code, the King II Report and the Combined Code of United Kingdom.

Directors' remuneration

The ad hoc consultative group took the view that ***directors should disclose the mechanism for setting directors' remuneration and its structure. A clear distinction should be made between remuneration mechanisms for executive directors and non-executive directors. Disclosure should be comprehensive to demonstrate to shareholders and other stakeholders whether remuneration is tied to the company's long-term performance as measured by recognized criteria. Information regarding compensation packages should include salary, bonuses, pensions, share payments and all other benefits, financial or otherwise, as well as reimbursed expenses. Where share options for directors are used as incentives but are not disclosed as disaggregated expenses in the accounts, their cost should be fully disclosed using a widely accepted pricing model.***

The current level of disclosure relating to directors' remuneration varies widely. However the trend appears to be towards greater levels of disclosure in this area, especially in Europe: France, Germany, Luxembourg, the Netherlands, Switzerland and the United Kingdom have all introduced laws to enforce the disclosure of directors' individual remuneration. In the United Kingdom, for example, the report of the company's remuneration committee must identify each director and specify his or her total compensation package, including share options. Recently added regulations also require companies to put their remuneration report to a shareholder vote at each annual general meeting. Other examples of this practice exist elsewhere in the world. The Indian Code, for instance, requires disclosure about remuneration in a section of the annual report on corporate governance, in addition to suitable disclosure on director's remuneration in the profit and loss statement.

The group discussed the fact that ***the length of directors' contracts, the termination of service notice requirements, as well as the nature of compensation payable to any director for cancellation of a service contract should be disclosed. Specific reference should be made to any special arrangement relating to severance payments to directors in the event of a takeover.***

Succession planning

The group took the view that ***the board should disclose whether it has established a succession plan for key executives and other board members to ensure that there is a strategy for continuity of operations.***

OECD Principle IV.D.2 stresses that overseeing succession planning is a key function of the board, while the Dey Report (Canada) considers it an important stewardship duty of the company, and the Vienot Report I (France) recommends that the selection committee be prepared to propose successors at short notice. While specific details regarding potential successors might be the subject of confidentiality, the existence of a procedure and a preparedness to appoint successors as necessary is not confidential, and should be the subject of disclosure.

Conflict of interest

The group suggested that ***conflicts of interests affecting members of the board should, if they are not avoidable, at least be disclosed. The board of directors should disclose whether it has a formal procedure for addressing such situations, as well as the hierarchy of obligations to which directors are subject.***

Conflicts of interest are required to be disclosed by law in many countries. The critical issue is that all conflicts of interest should be disclosed, along with what the board decided to do regarding the specific situation and the relevant director involved.

6. Material issues regarding stakeholders, environmental and social stewardship

The group recommended that ***the board should disclose whether there is a mechanism protecting the rights of other stakeholders in a business.***

OECD Principle IV concerns itself with ensuring that the rights of stakeholders protected by law are respected. Even where no legislation exists, it is considered good practice to make additional commitments, as corporate reputation and performance may require recognition of broader interests. For example, the CACG Guidelines require that a board identify the corporation's internal and external stakeholders and agree on a policy for how the corporation should relate to them.

The role of employees in corporate governance should be disclosed. Among member States of the European Union, for example, various practices exist where employees elect some of the supervisory directors, can be given a right to nominate one or more directors or can have an advisory voice on certain issues discussed by the board. This practice is considered by some to dilute the influence of shareholders, and to be a distortion of the connection between investment risk and the decision-making process. Others consider the strong interest of employees in the enterprise to warrant their special status in the governance process, and view employee involvement as having a beneficial effect on the overall sustainability of the firm. Regardless of one's views, any mechanisms for employee involvement in the governance of the enterprise should be clearly disclosed.

The group took the view that ***the board should disclose its policy and performance in connection with environmental and social responsibility and the impact of this policy and performance on the firm's sustainability.*** The environmental dimension of this issue was addressed by ISAR in its agreed conclusions on Accounting and Financial Reporting for Environmental Costs and Liabilities. ISAR noted that an enterprise's environmental performance could affect its financial health and hence its sustainability. At its twentieth session, ISAR concluded that the pressure for better reporting on social issues was increasing and that enterprises were producing more information on this topic. Among others, the King II Report (South Africa), the Association of British Insurers (UK) in its Disclosure Guidelines on Socially Responsible Investment, and the guidelines of the Global Reporting Initiative encourage disclosure of governance mechanisms in place to support improvement of social and environmental performance. Such governance disclosure is also relevant for creators of 'socially responsible investing' indexes, such as the Domini 400 Social Index produced by KLD Research & Analytics in the United States, the FTSE4GOOD produced by FTSE in the United Kingdom, or the

Dow Jones Sustainability World Indexes (DJSI) produced by the SAM Group of Switzerland in conjunction with Dow Jones Ltd and STOXX Ltd.

7. Material foreseeable risk factors

The group took the view that ***the board should give appropriate disclosures and assurance regarding its risk management objectives, systems and activities. In particular, it was agreed that the board should disclose existing provisions for identifying and managing the effects of risk-bearing activities. The board should report on internal control systems designed to mitigate risks. Such reporting should include risk identification mechanisms.***

In recent years, much attention has been paid to the role of the board in risk assessment or management and internal controls designed to mitigate risk. This issue is emphasized in most codes and principles, including the OECD Principles, the CACG Guidelines, King II and the United Kingdom's Combined Code.

Users of financial information and participants in the marketplace need information on foreseeable material risks, including risks specific to industries or geographical areas, dependence on certain commodities, financial market risk and derivative risks. The corporate governance structures in place to assess, manage and report on these types of risks should be the subject of corporate governance disclosure.

8. Independence of external auditors

The group agreed that ***the board should disclose that it has confidence that the external auditors are independent and their competency and integrity have not been compromised in any way. The process for the appointment of and interaction with external auditors should be disclosed.***

Independent external audits should provide an objective assurance that the financial statements present a true and fair view (or are presented fairly in all material respects) of the financial condition and performance of the audited entity. Accordingly, most governance codes and guidelines define procedures for enhancing the independence, objectivity and professionalism of the external audit. A number of approaches regarding the external audit, such as the need for auditor partner rotation and the avoidance of possible conflicts of interest involved in providing non-audit services, can be considered to ensure that external audits serve shareholder and other stakeholder interests in the intended manner.

Auditors' independence is a prerequisite for the reliability and credibility of the audit of financial statements. A principles-based approach to auditor independence (as set out in the EC's 2002 recommendation on auditor independence and in the IFAC Code of Ethics) is valued for its adaptability to new practices. The principles-based approach sets out the fundamental principles that must always be observed by the auditor and considers the threats and safeguards (including restrictions and prohibitions) to be in place to ensure the auditor's independence and objectivity. However, it could be useful for enterprises to disclose a substantial definition of those activities that would be regarded as non-audit-related, especially in those cases where audit and non-audit-related fees are not subject to mandatory disclosure.

Disclosures should cover the selection and approval process for the external auditor, any prescriptive requirements for audit partner rotation, the duration of the current auditor (e.g. whether the same auditor has been engaged for more than five years and whether there is a rotation of audit partners), who governs the relationship with the auditor, whether auditors do any non-audit work and what percentage of the total fees paid to the auditor involves non-audit work.

The audit committee should play a role in establishing a policy on purchasing non-audit services from the external auditor; this policy should be disclosed along with an explanation or assessment of how this policy sufficiently ensures the independence of the external auditor (FEE, 2003a).

9. Internal audit function

Enterprises should disclose the scope of work and responsibilities of the internal audit function, as well as the highest level within the leadership of the enterprise to which the internal audit function reports. Enterprises with no internal audit function should disclose the reasons for its absence.

The group recognized that an effective internal audit function plays a significant role within the corporate governance framework of a company. The scope of work and responsibilities of an internal audit function are often determined by the board (or management board in a two-tier system), typically in conjunction with the audit committee, and can vary significantly depending on the size, structure and complexity of the company and the resources allocated. Given the potential variation in the internal audit function among enterprises, it is recommended that relevant details of this function be disclosed.

D. General meetings

The group discussed the fact that ***disclosure should be made of the process for holding and voting at annual general meetings and extraordinary general meetings, as well as all other information necessary for shareholders to participate effectively in such meetings. Notification of the agenda and proposed resolutions should be made in a timely fashion, and be made available in the national language (or one of the official languages) of the enterprise as well as, if appropriate, an internationally used business language. The results of a general meeting should be communicated to all shareholders as soon as possible.***

The OECD Principles outline a general consensus as to the nature of shareholder meetings and the requirement to make shareholder participation as simple and effective as possible and ensure the equitable treatment of all shareholders. The Principles state that shareholders should be informed of the rules and be furnished with information regarding the date, location and agenda of the meeting, as well as the issues to be decided. Sufficient information should be provided so that shareholders can make fully informed decisions. Enterprises should do everything possible to facilitate the effective participation of all (including foreign) shareholders in general meetings.

In most governance systems, it is either required or considered good practice to put certain issues to shareholder approval at a general meeting. Best practice in this area entails that issues subject to shareholder approval be presented individually and unbundled, allowing shareholders to accurately exercise their voting rights. These rules can vary across different countries, and therefore disclosing information on the subject would be useful, especially for foreign investors.

The experts noted that in some countries, for some enterprises, new types of voting technology are being employed, for example Internet voting. The enterprise should, when issuing notice of the meeting, disclose the relevant details of voting technologies employed.

The enterprise should disclose all relevant information on the process by which shareholders can submit agenda items, and should disclose which shareholder proposals (if any) were excluded from the agenda and why. It is considered good practice in most governance systems to allow shareholders to include items on the agenda of a general meeting.

E. Timing and means of disclosure

The group agreed that ***all material issues relating to corporate governance of the enterprise should be disclosed in a timely fashion. The disclosure should be clear, concise, precise and governed by the "substance over form" principle.*** Some issues may require continuous disclosure. Relevant information should be available for users in a cost-effective way, preferably through the websites of the relevant government authority, the stock exchange on which the enterprise is listed (if applicable), and the enterprise itself.

The location of corporate governance disclosures within the annual report is not generally defined and can vary substantially in practice. Some degree of harmonization of the location of corporate governance disclosures would be desirable to make the relevant data more accessible. Two possible approaches include putting all corporate governance disclosures in a separate section of the annual report, or putting them in a stand-alone corporate governance report. Examples of the former approach are found in the recommendations of the Hong Kong Society of Accountants and the listing requirements in India and Switzerland, which provide for corporate governance disclosures to appear in a separate section of the annual report and in a prescribed format. Where corporate governance disclosures are not consolidated, there should be sufficient cross referencing to different disclosures to improve accessibility to the information.

Some information related to corporate governance may require immediate disclosure, and some codes and listing requirements address this issue. For example, in Malaysia listing requirements call for immediate disclosure of a change in the management, external auditor or board structure.

It is widely recognized that ***traditional channels of communication with stakeholders, such as annual reports, should be supported by other channels of communication taking into account the complexity and globalization of financial markets and the impact of technology.*** The OECD Principles state that the Internet and other information technologies provide the opportunity for improving information dissemination. In some countries (e.g. the United States), Internet disclosure is now accepted as legal disclosure and annual reports must indicate where company information can be found on the Internet. The King II Report also emphasizes the need for critical financial information to be made available to shareholders simultaneously and supports the idea that traditional channels of communication be complemented by new means, such as the Internet.

Whatever disclosures are made and whatever channels used, a clear distinction should be made between audited and unaudited financial information, and means of validation of other non-financial information should be provided.

F. Good practices for compliance

The ad hoc consultative group recognized that, ***where there is a local code on corporate governance, enterprises should follow a "comply or explain" rule wherein they disclose the extent to which they followed the local code's recommendations and explain any deviations. Where there is no local code on corporate governance, companies should follow recognized international good practices.***

The use of "comply or explain" mechanisms in many countries allows investors and other stakeholders greater access to information about the corporation and is to be encouraged. Related to this "comply or explain" rule, some countries now require companies with foreign listings to disclose the extent to which the local governance practices differ from the foreign listing standards.

The enterprise should disclose awards or accolades for its good corporate governance practices. It is recognized that there is an increase in the number of corporate governance accolades, awards, ratings, rankings and even corporate governance stock market indexes where constituents are selected on the basis of good practices in corporate governance. Especially where such awards or recognitions come from major rating agencies, stock exchanges, or other significant financial institutions, disclosure would prove useful, since it provides independent evidence of the state of a company's corporate governance.

G. Conclusions

This chapter has considered a range of areas in which disclosure may be advantageous to users of corporate information. It has discussed disclosure relating to various categories of financial and non-financial information. It has examined disclosure related to general meetings, the timing and means of disclosure, and disclosure on the adoption of best practices in compliance with corporate governance requirements.

In looking at areas where disclosure is necessary, the report has given examples from best practice codes from a number of countries. Although the review of such regional and national codes is by no means exhaustive, an attempt has been made to present a balanced review.

In accordance with the agreement reached at the 21st session of the Group of Experts, the UNCTAD secretariat is presenting this updated version of the 2002 report for consideration by the 22nd session of ISAR. If the 22nd session finds these revisions comprehensive and acceptable, it could recommend the finalization and dissemination of this chapter as voluntary guidance on good practices on corporate governance disclosure that could contribute towards further convergence of disclosures in this area to improve corporate transparency and facilitate investment.

Annex I

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* The views contained in this document do not necessarily reflect those of the organizations with which the members of the ad hoc consultative group are affiliated.

Chapter V

2005 REVIEW OF THE IMPLEMENTATION STATUS OF CORPORATE GOVERNANCE DISCLOSURES

Summary of discussions

The Chair called upon a resource person to present the findings of the "2005 Review of the Implementation Status of Corporate Governance Disclosures" (TD/B/COM.2/ISAR/CRP.1). The resource person began his presentation with an explanation of the enhanced methodology of the survey, including the increased sample size and the use of a broader range of sources of corporate governance information.

The resource person explained the findings of the 2005 survey in detail and highlighted several observations, including: the relatively low frequency of auditing related disclosures; the tendency of enterprises with an international listing to have better disclosure than enterprises with a local listing only; the tendency of enterprises based in higher income countries to have better disclosure than enterprises based in lower income countries; and finally, the tendency of state-owned enterprises to disclose less corporate governance information than their private sector counterparts. The resource person also provided a brief overview of recent developments in the area of corporate governance disclosure, highlighting the growth of increasingly influential governance monitoring services provided by members of the financial industry.

The Chair opened the floor for discussion. Many of the participants commended the 2005 survey and several suggestions were made on how it could be improved. There were also some specific suggestions for improving the survey. Several delegates supported avoiding the regional analysis due to insufficient sample size per country and the distorting effect that grouping multiple countries together can have on the impression of corporate governance disclosure in any one country. There was also a suggestion to conduct future surveys in such a way that year-to-year comparison could be done.

A. Introduction

The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has maintained a focus on issues of corporate governance since 1989 (E/C.10/AC.3/1989/6). At its 21st session, ISAR proposed reviewing the implementation status of corporate governance disclosures and the role of such disclosures in adding sustainable value (see TD/B/COM.2/ISAR/22). This resulted in a survey of disclosure practices based on the good practices in this area identified in the document TD/B/COM.2/ISAR/15 (hereafter referred to as ISAR/15). This survey was presented to the 21st session in 2004 in the report TD/B/COM.2/ISAR/25 (hereafter referred to as ISAR/25). That report was met with interest for further work in this area. ISAR felt that an annual study to assess the state of reporting on corporate governance would be useful. It suggested that this study should cover a larger sample of companies and a wider geographical area than the initial study found in ISAR/25.

Following this request, the UNCTAD secretariat conducted the second survey on corporate governance disclosure based on the good practices identified in ISAR/15 and the update to that paper, TD/B/COM.2/ISAR/30. The 2005 study employs an enhanced methodology and provides more in-depth information and analysis on the state of corporate governance disclosure. The secretariat revisited the original methodology with a view towards increasing the number of corporations in the survey, widening geographical coverage, strengthening the survey's reliance on objective criteria and enhancing the analysis of the results.

The objectives of this survey are to: (1) provide a brief overview of key developments in corporate governance since the 21st session of ISAR and; (2) to present and analyse the results of this year's survey of corporate governance disclosure practices. The overview of recent developments is provided in Section A, which also examines the emerging trend of corporate governance indexes, funds and information services for investors. Section B analyses the survey results based on type of companies' listing (local only or international) and the income level of the country in which the firm operates (OECD and other high income, or low and middle income). It also discusses disclosure practices of state-owned enterprises (SOEs).

B. Overview of recent developments in the area of corporate governance disclosure

During the ISAR intersession period of 2004/2005, the issue of corporate governance and transparency continued to receive high levels of attention. One of the more prominent trends during the 2004/2005 period has been the further rise of new activities focused on providing corporate governance information and analysis to investors and the monitoring of corporate governance in companies. These new activities have been built upon increased levels of corporate governance disclosure and among others include: proxy voting and compliance monitoring, enterprise governance ratings, outsourced shareholder activism, ratings of governance funds, establishing of governance investment funds and organizations to represent governance professionals.

One dimension of this trend has been the increase in the number, size and global spread of *governance related funds and indices* which select companies for inclusion in the fund or index based on good corporate governance. The success of funds such as Relational Investors in the US and Hermes Focus Funds in the UK have sparked marked interest in funds based on good corporate governance. New funds launched in late-2004 and 2005 include the Providence Recovery Partners fund launched by Providence Capital in the US, and the Corporate Governance Fund launched by the Pension Fund Association in Japan. This trend is also reflected in developing countries where investors increasingly see the benefits of good corporate governance: for example, the Good Corporate Governance Long Term Equity Fund was launched by ING in Thailand, and the Puma II fund was launched by Dynamo in Brazil.

The growth of such funds is facilitated by the emergence of *corporate governance indices*. While not the first in the field, one important new index was launched by FTSE, the index company. The global index provider, based in the UK, has teamed up with Institutional Shareholder Services (ISS) to create a corporate governance index, or family of indices. The design of the index series incorporates ISS corporate governance ratings into a financial index.[1] The first index produced through this collaboration focuses on enterprises in developed countries, but a second index is planned to cover enterprises in developing countries. These indices will serve as benchmarks for existing governance funds, and could serve as the basis for index tracking funds yet to be developed. New governance indices are planned to be developed for both the Shanghai and Shenzhen exchanges in China.

Another factor that supports investor interest in governance-related funds and indices is better evidence that good corporate governance leads to an improvement in share price performance. A large number of reports, produced during the intersession period, highlight this connection. CLSA, a Hong Kong based broker, and the Asia Corporate Governance Association, in their report *CG Watch 2004: Spreading the Word*,[2] observe that over the past five years the stocks of companies ranked in the top quartile for corporate governance tended to outperform the stocks of companies ranked in the bottom quartile. The report notes that the connection between good CG and stock performance is also subject to the overall investment climate: when markets are rising and investors' appetite for risk increases, then even companies with poor CG may tend to outperform their benchmarks; conversely, when markets decline and investors become more sensitive to risk, companies with good CG tend to perform significantly better. Thus corporate governance disclosures and the rankings and indices based upon them, allow investors to adjust their investments according to their appetite for risk, with good corporate governance being taken as an indicator of lower risk.

Following a similar line of research, Governance Metrics International (GMI) in its latest global survey[3] found that the stock prices of the 26 enterprises, that it ranked highest in governance, outperformed their benchmark indices in one, three and five year periods. In addition, companies that ranked lower, had higher incidences of earnings restatements and fraud. This study also included a ranking of corporate governance practices by country; such research may influence future capital flows as investors assign a premium to enterprises based in countries with good corporate governance practices. Deutsche Bank, in its recent report *Beyond Numbers*, also finds a link between good corporate governance and share price performance, volatility and corporate profits. The report concludes that "corporate governance is a valid measure of equity risk" and thus reinforces the view that premiums may be attached to the share prices of those enterprises with good corporate governance practices.[4]

The Institute for Monetary Research in Hong Kong found further evidence of the link between governance and performance in their report entitled *Do Investors*

[1] More information on ISS ratings is available at: www.issproxy.com.
[2] CLSA and ACGA (2004). *CG Watch: Spreading the word, changing rules in Asia*, www.acga-asia.org and www.clsa.com.
[3] Governance Metrics International (2005) *Global Survey*, www.gmiratings.com.
[4] Deutsche Bank (2005) *Beyond Numbers: Corporate Governance - Implication for Investors*, www.db.com.

Really Care About Corporate Governance?[5] According to the authors, the more that companies move up on a scale of corporate governance, the better their equity valuations are. These findings are echoed in Brazil where the value of companies on the São Paulo stock exchange governance index were found to rise at over twice the rate of the broader index.

Further evidence on the benefits of good governance and the costs of weak governance comes from the Director and Officer (D&O) liability insurance market in the United States. Costs for D&O insurance have risen significantly since scandals and tightened regulation exposed boards to new risks. In light of this situation, National Union Fire Insurance (NUFI), a subsidiary of American International Group, recently entered into collaboration with Kalorama Partners, a corporate governance consulting firm run by ex-SEC chief Harvey Pitt. Under the terms of this arrangement, companies that receive high corporate governance ratings from Kalorama can receive discounts on D&O insurance of as much as 25 per cent.

Another dimension of the costs of weak governance is its impact on the likelihood of litigation. The Corporate Library, based in the US, released analysis demonstrating that poor governance results in a greater likelihood of class action lawsuits.[6] Since mid-2004, the Corporate Library has included a "Litigation and Regulatory Problems" component in their overall corporate ratings. In back-testing the forecasting value of this component, it was found that companies that performed worse on board effectiveness are far more likely to attract class actions and suffer the related costs.

Most of the reports and findings discussed above can be seen as supporting a longer term trend wherein corporate governance issues have begun to become as important to investor decisions as financial issues, especially for long term institutional investors. This trend is reflected in the 2005 CFA publication, *The Corporate Governance of Listed Companies: A Manual for Investors*, which provides guidance to investors on using corporate governance information as part of the analyses and valuation of enterprises.[7] In particular, the CFA guidance seeks to help investors better recognize, understand and analyse how corporate governance may affect the value of their investments, and thus help them in making informed investment decisions. As this trend deepens, interest in more and better corporate governance disclosure will continue to rise. The funds already developed to pursue this link between governance and share price performance will continue to refine and improve their methodologies. This trend will put more pressure on firms to properly disclose their governance practices, and at the same time, it will increasingly highlight the difference in performance between firms that are well governed firms and those that are not.

The governance of corporate pension funds received interest in a number of countries, where there was concern that fund managers could be influenced by

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[5] Hong Kong Institute for Monetary Research (2005) *Do investors really care about corporate governance?*, www.hkimr.org.

[6] The Corporate Library (2005) *Board Effectiveness & Securities Class Action Suits*, Research Highlights, April 12, www.thecorporatelibrary.com.

[7] CFA (2005) *The Corporate Governance of Listed Companies: A Manual for Investors*, CFA Centre for Financial Market Integrity, www.cfainstitute.org.

companies in their investment and voting decisions. The US Government Accounting Office published a study in 2004 that recommended the disclosure of pension fund voting similar to rules the US SEC had passed earlier on mutual funds.[8] The theme of the GOA recommendations is that plan fiduciaries must act solely in the interests of plan participants and beneficiaries and not companies. This theme is also found in recent developments in the UK, where employees and retirees can now name half of the trustees (up from one third) running corporate pension funds. The change is designed to enhance member involvement in boards and make pension funds more independent of their companies. However, critics of the measure wonder whether the change will discourage companies from establishing pension plans.

The level of activity in national and international code writing appears to be slowing. Most countries now have at least one governance code and many have several such codes. The trend is now towards increasingly specialized guidance, or sector-specific codes. One example is the *OECD Guidelines for the Governance of State-owned Enterprises* (SOE), which focus on SOE governance.[9]

The slowing in code writing does not, however, mean that compliance has reached a desired level. A survey from Paris-based advisor Proxinvest shows, for example, that there are significant gaps between practice and the Bouton code.[10] Similar gaps appear to exist in other countries. The next step after code writing may thus focus on implementing the numerous rules that already exist. For example, this year the OECD established a Business Sector Group to draft practical guidance for board members to bridge the gap between codes and practice. The group aims to provide concrete advice to board members on how to implement good governance in the absence of detailed regulation. The guide is being drafted by a high level panel of experts and is expected to be completed in early 2006.

The potential impact of technology, specifically the Internet, on governance is becoming apparent in the areas of disclosure, online proxy voting, attendance at annual general meetings and the disclosure of investment fund voting records. In the US, shareholder activism crossed a new frontier when video of a shareholder lawsuit against a major Delaware based company was streamed over the Internet. In India an innovative web-based service sponsored by the Federal Ministry of Company Affair allows investors to find out if company directors have been charged with insider trading. In Canada, the Institute of Corporate Directors introduced its Directors Register, an online database of board candidates. The New York Stock Exchange also launched an online service to help listed firms comply with governance listing rules by alerting them to filing deadlines, scanning director candidates against independence criteria and benchmarking companies against peers. In Columbia, Confecamaras, the Bogotá Chamber of Commerce Federation allows users to diagnose a company's governance through its online service, the Diagnóstico Gobierno Corporativo.

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[8] United States Government Accounting Office (2004) *Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting*, www.gao.gov.

[9] OECD (2005) *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, www.oecd.org.

[10] Proxinvest (2005) *Les Assemblées Générales 2004 des Sociétés Cotées*, February, www.proxinvest.com.

New interactive online tools also allow for analysis of networks of board directors. These include, for example, The Corporate Library's *Interlocks Tool*, which allows users to trace relationships among individual directors via their co-memberships on the boards of corporations, mutual funds, non-profits and think-tanks; this can highlighting instances of *interlocking* between boards, a situation wherein the management of one company sits on the board of another and vice versa. Since these interlocks can be the source of conflicts of interest, it useful to highlight their existence. These online tools also provide more details on all the board memberships held by a particular director, along with relevant performance indicators such as the level of shareholder support in director elections. This information allows the users of these tools to evaluate individual directors based on their performance across the complete range of enterprises and other organizations with which they are affiliated.[11]

On the regional level, the European Commission presented EU-wide corporate governance best practice standards under which listed companies are required to disclose details of top executive pay on an individual basis.[12] Remuneration programmes need to be submitted to shareowner approval and boards are to have a sufficient number of independent board members in order to prevent conflicts of interest. Over the past year, the Commission has also announced the creation of two new groups to provide inputs to its work on corporate governance: the first is the European Corporate Governance Forum whose purpose is to advise it on governance policies. The Forum consists of 15 senior experts from various professional backgrounds (issuers, investors, academics, regulators, auditors, etc.) whose experience and knowledge of corporate governance are widely recognized at the European level. The second new group is an expert advisory group to provide detailed technical advice on preparing corporate governance and company law measures. The expert advisory group is made up of 20 non-governmental experts from various professional backgrounds (issuers, investors, employees' representatives, academics, regulated professions, etc.) with particular experience and knowledge of the subject. The technical work of this group will be complementary to the more strategic role in the convergence of corporate governance in Europe carried out by the Forum.

In the UK, Britain's draft Company Law Reform Bill seeks to promote the wider participation of shareholders by ensuring that they are informed and involved in corporate governance. In addition, one of the objectives of the government is to increase the focus of decision making on long-term outcomes, rather than a focus on short-term profits. The bill includes regulatory impact assessments (RIAs) on the reforms as a whole and individual RIAs on auditor and directors' liability.

In Asia, the Japanese Financial Services Agency considered recommendations for disclosure regulations covering corporate internal controls and the Tokyo Stock Exchange announced rules requiring CEOs to certify financial statements. The China Securities and Regulatory Commission proposed rules aimed at increased transparency and transferring more power to minority shareholders. If adopted, related-party transactions would be subject to the approval of a majority of

[11] See www.thecorporatelibrary.com and www.directormap.com.

[12] European Commission (2004) *Commission Recommendation of 14 December 2004: fostering an appropriate regime for the remuneration of directors of listed companies*, Official Journal of the European Union, 29 December, (L 285/55).

independent directors. Further, only investors owning traded stock (not blockholders)[13] could vote on new stock issues or major strategic decisions. In addition, regulators are exploring the possibility of Internet voting. Prime Minister Wen Jiabao proclaimed 2005 a year for corporate governance reform with the objective of improving governance in both state-owned and publicly traded enterprises.

In the US, many listed companies have had difficulty complying with some sections of the Sarbanes-Oxley Act, in particular Section 404, which covers internal controls; a number of deadlines for meeting some of the act's requirements have been postponed. The postponement of these deadlines, however, does not appear to indicate backtracking by the US Securities and Exchange Commission regarding its efforts to improve corporate governance. Recently the SEC took action on a new governance issue by giving shareholders the right to vote on proposals that would require that US directors be elected by a majority of a shareholders (known as the 'majority vote rule'). Recent analysis by Governance Map[14] observes that whereas in 2004 only around 12 such proposals were voted on at annual meetings of shareholders of US public companies, in 2005 there appears to be between 50 and 60 such proposals. Institutional investors have taken a strong interest in this issue: in 2004 only two of the 29 fund families voting on shareholder resolutions addressing one of the 12 majority vote proposals supported the proposal; in 2005, 34 of the 41 fund families voting on this issue at one or more of their portfolio companies supported one or more of the 50 to 60 such proposals. At present, typical US procedure does not give shareholders the option of voting "no" in director elections; shareholders can only vote "yes" or withhold their vote, and one "yes" vote outweighs all those withheld. Thus recent developments in the 'majority vote rule' could potentially lead to a significant change in the way that directors in US listed companies are appointed.

In the Middle East and Northern Africa (MENA), SOEs, small and medium-sized enterprises (SMEs), local subsidiaries of multinational companies, and community-based enterprises (such as co-operatives) represent a greater portion of the productive sector than in other countries. As a result stock exchanges and stock exchange regulators, which have typically been the focal point for corporate governance reform in developed economies, have not played a similarly central role; it is also the reason why the emergence of governance activities built upon disclosure, as described in other parts of this chapter, is not as readily apparent as elsewhere.[15] As a consequence, a model for governance reform that depends on equity markets may not necessarily be applicable to circumstances in Africa. MENA countries, for example, look to other capital providers such as banks and the financial services sector to demand transparency and good corporate governance from business.[16] In sub-Saharan Africa, much of the emphasis seems to be on anti-corruption and in enhancing the credibility and stability of the banking and financial sector operations

[13] A *blockholder* is a long term strategic shareholder who will not be trading the stock and generally exercises a significant level of control in the enterprise.

[14] Governance Map (2005) *Funds Support Majority Vote on Director Elections*, www.governancemap.typepad.com

[15] Middle East Partnership Initiative (2005) *Corporate Governance Trends*, United States Department of State, www.mepi.state.gov/mepi/.

[16] Saidi, Nasser (2004) *Corporate Governance in MENA Countries: Improving Transparency and Disclosure*, The Second Middle East and North Africa Regional Corporate Governance Forum, Beirut.

and regulation. Despite some improvements in corporate governance in the region, the 2005 Progress Report of the Pan-African Consultative Forum on Corporate Governance concluded that the progress of further reform is constrained by limited enforcement capability and a lack of expertise, and must compete with other pressing socio-economic priorities.[17]

Overall, the trend this year shows the growth of increasingly influential governance monitoring services provided by members of the financial industry. The implication is that corporate governance codes are being reinforced by the markets themselves, as investors increasingly recognize the value of good corporate governance. These new and emerging services have been built upon the increased disclosure and rule making that followed in the wake of recent governance scandals. The overall result has been the establishment of a set of explicit standards by which companies can be measured and evaluated, and increased disclosure based regulation. Reforms in corporate governance continue on the institutional level, even if the interim period did not witness the same number of high profile legislative acts seen in prior years, such as the EU Transparency Directive or the Sarbanes Oxley Act. Rather, there appears to be a convergence within the reform process towards some elements of the new rules that have become increasingly accepted on an international level.

C. Status of implementation of good practices on corporate governance disclosure at the company level

1. Background and methodology

The purpose of the survey is to evaluate the level of implementation of good practices in corporate governance disclosure highlighted in ISAR/15 and ISAR/30. Those papers form a benchmark of fifty disclosure items on corporate governance. Compared to the 2004 survey, ten additional items were added to the benchmark for the 2005 survey. The addition includes four disclosure items discussed in the 2002 report (ISAR/15) but not included in the 2004 survey; these items are:

a. Disclosure practices on related party transactions where control exists
b. The decision-making process for approving transactions with related parties
c. Rules and procedures governing the acquisition of corporate control in capital markets
d. Rules and procedure governing extraordinary transactions.

The addition also includes six new disclosure items discussed in the updated guidance on good practices in corporate governance disclosure (ISAR/30); these items are:

a. CEO/CFO Certification of financial statements
b. A Code of Ethics for the Board and waivers to the ethics code
c. A Code of Ethics for all company employees
d. Identification of the "financial expert" in the audit committee

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[17] Pan-African Consultative Forum on Corporate Governance (2005) *Progress Report* www.corporategovernanceafrica.org.

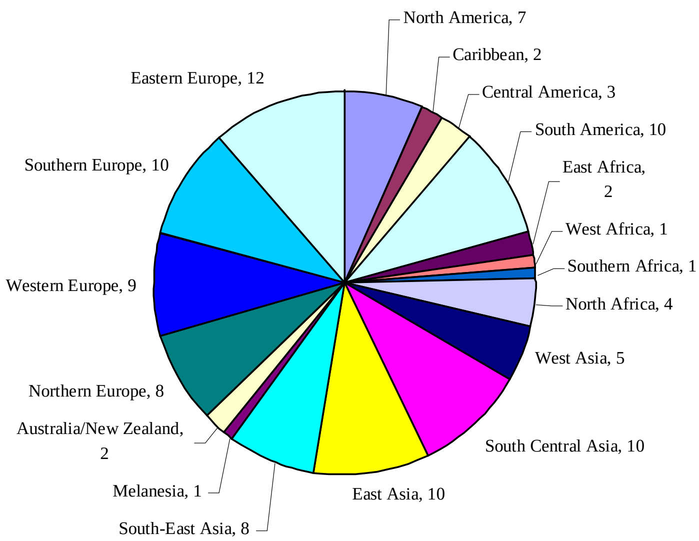
e. Anti-takeover measures
f. Policy on "whistleblower" protection for all employees.

These additional disclosure items are marked with a star (*) in table V.1, and discussed further in section 2. The complete set of disclosure items are grouped into five broad categories, or subject areas, of corporate governance disclosure, and are presented by category in section 2 below. These categories are:

a. Financial transparency and information disclosure
b. Ownership structure and exercise of control rights
c. Board and management structure and process
d. Corporate responsibility and compliance
e. Auditing.

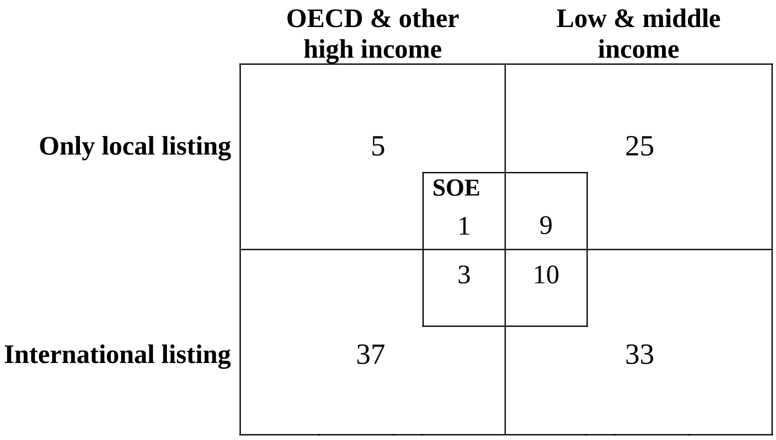
As in the prior year, the survey focused on leading enterprises making a significant contribution to the economy in which they are based. The 2005 survey of corporate governance disclosure examined 105 enterprises from 70 countries, with a broad regional distribution (see figure V.1 below). Enterprises selected for the survey were drawn from the top ten largest enterprises found within each region; the relative size of the enterprises was determined using sales and market capitalization data. The survey included publicly listed enterprises, privately held enterprises and SOEs. The enterprises included in the survey represent a wide range of industries including: mining, petroleum, communications, pharmaceuticals, manufacturing, and retail, among others. A range of corporate reports were reviewed for the survey, including: annual reports, corporate governance reports, exchange filings, and other information available from financial databases and enterprise websites. Where information on an enterprise was not available electronically, enterprises were contacted directly in an effort to obtain paper reports. As in last year's survey, this chapter does not intend to discuss the quality of disclosure of individual items.

Figure V.1. Distribution of the 105 enterprises by region
(Number indicates the number of enterprises surveyed)



The enterprises in the survey are based in both high income and middle and lower income countries, and represent both locally listed enterprises as well as internationally listed ones (see figure V.2 below). During the survey process it was found that a considerable number of enterprises had significant state ownership. The inner box of figure V.2 indicates how many companies in the larger box are state-owned enterprises. Therefore, these companies received additional analysis (see section 6). Five of the enterprises in the survey (all from low- or middle-income countries) were not listed and therefore do not appear in figure V.2; of these one was privately held, and four were non-listed SOEs.

Figure V.2. Distribution of the 100 listed enterprises by type of listing and country income



2. Main outcomes of the survey: overview of all disclosure items

Since not all disclosure items in the survey can be considered to be of equal importance to all users of corporate reports, table V.1 displays the results of the survey within each of the five broad categories discussed in section 1 above. This allows the readers of the report to draw their own conclusions based on the relative importance they assign to a particular category or subject area, and within that category, a particular disclosure item.

Table V.1. Main findings of survey on corporate governance disclosure
(Number of enterprises in parentheses)

Disclosure items by category	All *(105)*	Type of listing: International listing *(70)*	Type of listing: Only local listing *(30)*	Country income: OECD & other high income *(42)*	Country income: Low & middle income *(63)*	Special Focus: SOE *(27)*
Financial transparency and information disclosure (Per cent)						
Financial and operating results	**100**	100	100	100	100	100
Critical accounting estimates	**91**	93	93	95	89	89

Disclosure items by category	**All** *(105)*	**Type of listing**		**Country income**		**Special Focus**
		Inter-national listing *(70)*	**Only local listing** *(30)*	**OECD & other high income** *(42)*	**Low & middle income** *(63)*	**SOE** *(27)*
Nature, type and elements of related-party transactions	**86**	93	77	90	83	85
Company objectives	**79**	89	63	88	73	74
Disclosure practices on related party transactions where control exists*	**76**	84	67	81	73	78
Rules and procedure governing extraordinary transactions*	**70**	81	47	83	60	70
The decision making process for approving transactions with related parties*	**63**	76	43	71	57	59
CEO/CFO certification of financial statements*	**51**	66	27	69	40	44
Impact of alternative accounting decisions	**50**	56	43	69	37	26
Ownership structure and exercise of control rights (Per cent)						
Process for holding annual general meetings	**82**	90	73	88	78	74
Ownership structure	**78**	91	57	90	70	70
Changes in shareholdings	**76**	80	70	81	73	67
Availability and accessibility of meeting agenda	**75**	83	67	88	67	67
Control structure	**74**	86	57	81	70	67
Control rights	**70**	84	47	81	62	48
Rules and procedures governing the acquisition of corporate control in capital markets*	**60**	74	37	71	52	48
Control and corresponding equity stake	**57**	73	27	74	46	41
Anti-takeover measures*	**22**	27	13	31	16	15
Board and management structure and process (Per cent)						
Composition of board of directors (executives and non-executives)	**82**	93	67	98	71	74
Role and functions of the board of directors	**81**	91	67	98	70	70
Governance structures, such as committees and other mechanisms to prevent conflict of interest	**79**	91	63	95	68	63
Duties of the directors	**78**	87	67	95	67	70
Qualifications and biographical information on board members	**77**	86	67	88	70	74

Disclosure items by category	**All** *(105)*	**Type of listing**		**Country income**		**Special Focus**
		Inter-national listing *(70)*	**Only local listing** (*30*)	**OECD & other high income** (*42*)	**Low & middle income** (*63*)	**SOE** (*27*)
Composition and function of governance committee structures	**76**	89	60	90	67	59
Risk management objectives, system and activities	**75**	84	60	93	63	63
Material interests of members of the board and management	**69**	77	57	79	62	59
Performance evaluation process	**68**	79	53	88	54	56
Duration of director's contracts	**64**	80	37	81	52	41
Maintenance of independence of the board of directors	**64**	79	40	83	51	52
Compensation payable clauses in directors` contracts	**63**	80	33	79	52	41
Determination and composition of directors` remuneration	**59**	71	40	76	48	56
Professional development and training activities	**57**	63	50	79	43	48
Number of directorships held by the directors	**56**	67	37	71	46	41
“Checks and balances” mechanisms	**53**	64	37	71	41	30
Availability and use of advisorship facility during reporting period	**53**	64	33	71	41	48
Existence of procedure(s) for addressing conflicts of interest among board members	**50**	66	20	57	46	44
Plan of succession	**35**	46	17	50	25	19
Corporate Responsibility and Compliance (Per cent)						
Policy and performance in connection with environmental and social responsibility	**77**	79	73	88	70	67
A Code of Ethics for all company employees*	**68**	84	40	83	57	41
A Code of Ethics for the Board and waivers to the ethics code*	**65**	80	40	81	54	41
Mechanisms protecting the rights of stakeholders in business	**65**	76	50	71	60	59
Impact of environmental and social responsibility policies on the firm's sustainability	**63**	66	57	74	56	41
Policy on "whistleblower" protection for all employees*	**41**	51	23	57	30	22

Disclosure items by category	**All** *(105)*	**Type of listing** — **Inter-national listing** *(70)*	**Type of listing** — **Only local listing** *(30)*	**Country income** — **OECD & other high income** *(42)*	**Country income** — **Low & middle income** *(63)*	**Special Focus** — **SOE** *(27)*
Auditing (Per cent)						
Internal control systems and their effectiveness	**66**	80	43	88	51	52
Process for interaction with external auditors	**65**	79	43	88	49	48
Process for interaction with internal auditors	**63**	73	50	83	49	44
Process for appointment of external auditors	**61**	79	30	86	44	44
Board confidence in independence and integrity of auditors	**57**	69	40	79	43	33
Process for appointment of internal auditors	**53**	71	20	79	37	33
Identification of the "financial expert" in the audit committee*	**50**	67	20	67	40	33

* New disclosure items included in the 2005 survey.

General overview

As shown in table V.1, the strongest group of disclosure items is Financial Transparency, and the weakest group is Auditing. Generally, the disclosure of internationally listed enterprises is better than the disclosure of only locally listed enterprises, and the disclosure of enterprises from high income countries is better than that of lower income countries. The special focus on SOEs reveals a general weakness in disclosure compared to all the companies in the survey. These general observations are the subject of more detailed analysis in sections 3 to 6 below.

Table V.1 also shows that the average disclosure rate for all enterprises fell below 50 per cent for only three of the disclosure items. These three items (and their respective disclosure category) were: anti-takeover measures (in the ‘ownership structure’ category); policy on whistleblower protection (in the corporate responsibility and compliance category); and succession planning (in the board and management structure and process category). The disclosure item on anti-takeover measures — i.e. for all types of enterprises — was the least prevalent disclosure item in the entire survey. The disclosure item on whistleblower protection was the second least prevalent. Although the average rate of disclosure for this item rises to 57 per cent for both internationally listed enterprises and enterprises from high-income countries, it averages only 30 per cent for enterprises from low- and middle-income countries; this may suggest a practice that has become commonplace in more developed markets but which has not yet spread to all markets. The rate of disclosure for the item 'plan of succession' was also relatively low for all groups of enterprises surveyed, rising at its highest point to 50 per cent for high income countries. A short list of the most prevalent and least prevalent disclosure items is provided in table V.2.

Table V.2. Most prevalent and least prevalent disclosure items
(Per cent)

Top 5 most prevalent disclosure items among all 105 enterprises surveyed	**Disclosure Rate**	**Bottom 5 least prevalent disclosure items among all 105 enterprises surveyed**	**Disclosure Rate**
Financial and operating results	100	Identification of the "financial expert" in the audit committee	50
Critical accounting estimates	91	Impact of alternative accounting decisions	50
Nature, type and elements of related-party transactions	86	Policy on "whistleblower" protection for all employees*	41
Composition of board of directors (executives and non-executives)	82	Plan of succession	35
Process for holding annual general meetings	82	Anti-takeover measures*	22

* New disclosure items included in the 2005 survey.

Of the ten new disclosure items added to the 2005 survey, eight are disclosed by more than 50 per cent of enterprises surveyed. Only two of the additional disclosure items (anti-takeover measures; and policy on 'whistleblower' protection) are among the least prevalent disclosure items discussed above. And one of these least prevalent items (whistleblower protection) is disclosed by more than 50 per cent of the internationally listed enterprises or enterprises from high income countries examined in this survey. This indicates that most of the new disclosure items added to the 2005 survey's benchmark, as well as to the updated guidance document ISAR/30, represent relatively widespread existing good practices in corporate governance disclosure.

Another new disclosure item under Financial Transparency, was CEO/CFO certification of financial statements. The results for this item (with over 65 per cent of both high income and internationally listed firms making disclosure on this subject) are interesting given the relative novelty of this disclosure item in corporate governance reporting. Indeed this disclosure item is largely a product of the Sarbanes Oxely Act in the United States, yet it has clearly managed to influence a range of enterprises from around the world.

3. Comparison of disclosure items between internationally listed companies and only locally listed companies

Figure V.3 presents the average frequency of disclosure within each category and compares the disclosure practices of enterprises listed on international exchanges with those listed only on a local or national exchange. The figure displays an average for each category of disclosure items: to produce an overview of the rate of disclosure for that subject area, this category average is calculated by taking the average of each disclosure item within a category. Disclosure rates for individual disclosure items within a category can be found in table V.1 above, as well as in Annex I.

Figure V.3. Comparison between internationally listed companies and only locally listed companies

Average rate of disclosure by group

(Number in parentheses indicates sample size)

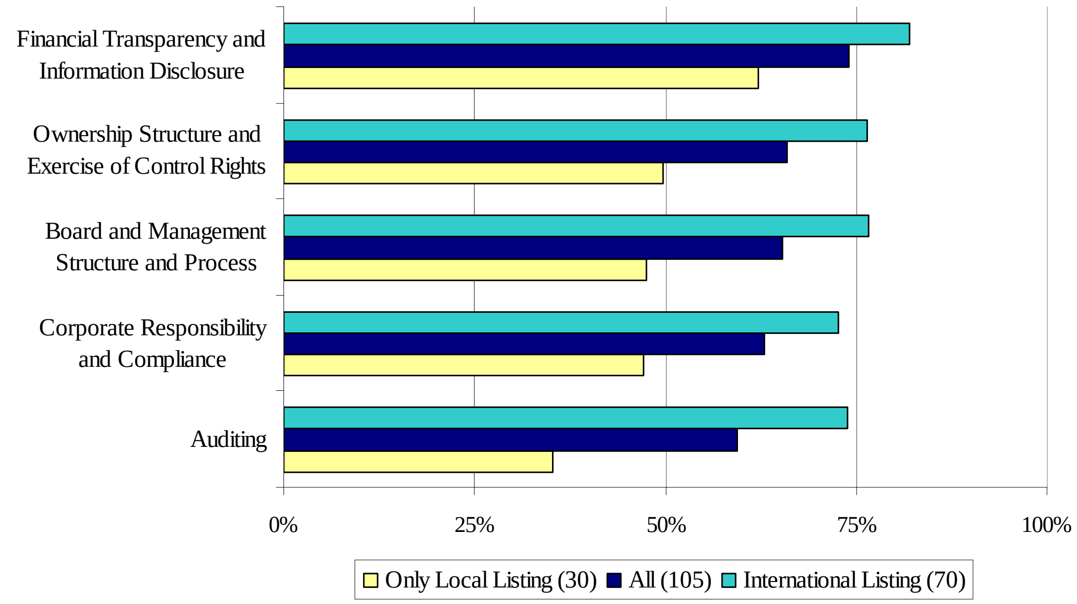


Figure V.3 also allows for a clear overview of the disclosure rates for the different categories, while at the same time providing a view of the disparity in disclosure rates between enterprises based on their type of listing. Figure V.3 supports the observation that companies that list internationally demonstrate a higher rate of corporate governance disclosure across all categories. This result is consistent with the comparison of these two categories in ISAR's 2004 survey (ISAR/25).

Indeed the three disclosure items with the greatest disparity between enterprises that are only locally listed and those that are internationally listed are all found in the category Auditing: the process for the appointment of external auditors; the process for the appointment of internal auditors; and the identification of the financial expert on the audit committee (see table V.3 below). The data in table V.3 indicates that the rate of disclosure for these items among only local listings lags the rate of disclosure among international listings by more than 40 per cent.

Table V.3. Top 5 greatest disparities in disclosure rates, by type of listing

(Number of enterprises in parentheses)

Disclosure item	**Disclosure rates** (Per cent)		
	International Listing (70)	**Only Local Listing (30)**	**Disparity**
Process for appointment of internal auditors	71	20	51
Process for appointment of external auditors	79	30	49
Identification of the "financial expert" in the audit committee	67	20	47
Compensation payable clauses in directors` contracts	80	33	47
Control and corresponding equity stake	73	27	46

4. Comparison of disclosure items between enterprises from high-income and low- and middle-income countries

Figure V.4 presents the average frequency of disclosure within each category and compares the disclosure practices of enterprises based in high income countries with those based in middle and lower income countries. The figure displays an average for each category of disclosure items: to produce an overview of the rate of disclosure for each subject area, this category average is calculated by taking the average of each disclosure item within a category. Disclosure rates for individual disclosure items within a category can be found in table V.1 above.

Figure V.4. Comparison between enterprises from high-income countries and low- and middle-income countries

Average rate of disclosure by group

(Number in parentheses indicates sample size)

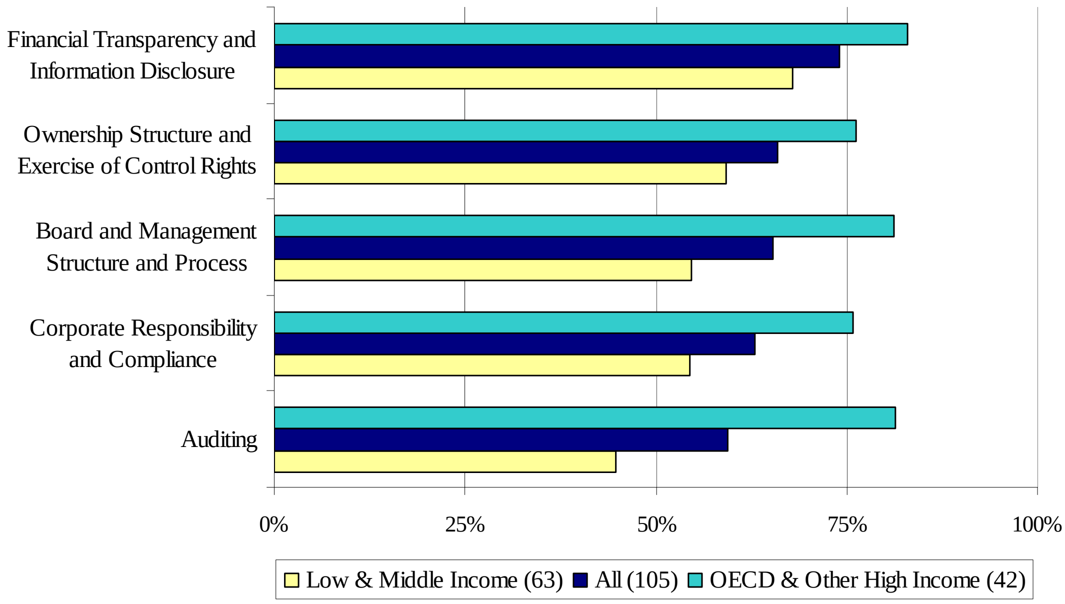


Figure V.4 supports the observation that enterprises based in high income countries in general demonstrate a higher rate of corporate governance disclosure across all categories than do enterprises based in middle and lower income countries. This analysis also reveals an exception to the general pattern previously noted of Financial Transparency being the most prevalent and Auditing being the least prevalent. While this pattern is clearly found among enterprises from low or middle income countries, enterprises from high income countries display a different pattern: for these enterprises, the categories of Financial Transparency, Board and Management Structure and Process, and Auditing are all subject to nearly equal and relatively high rates of disclosure, while the categories of Ownership Structure and Corporate Responsibility, lag somewhat. It is recognized however that even these lagging categories for the enterprises from high-income countries still exceed the average level of disclosure for the entire survey sample.

The largest disparity between countries based on income can be found in the Auditing category, which is also the only category where less than 50 per cent of enterprises from low and middle income countries, on average, disclose the selected items. Indeed all of the top five greatest disparities in disclosure rates fall within Auditing (see table V.4).

Table V.4. Top 5 greatest disparities in disclosure rates, by country income
(Number of enterprises in parentheses)

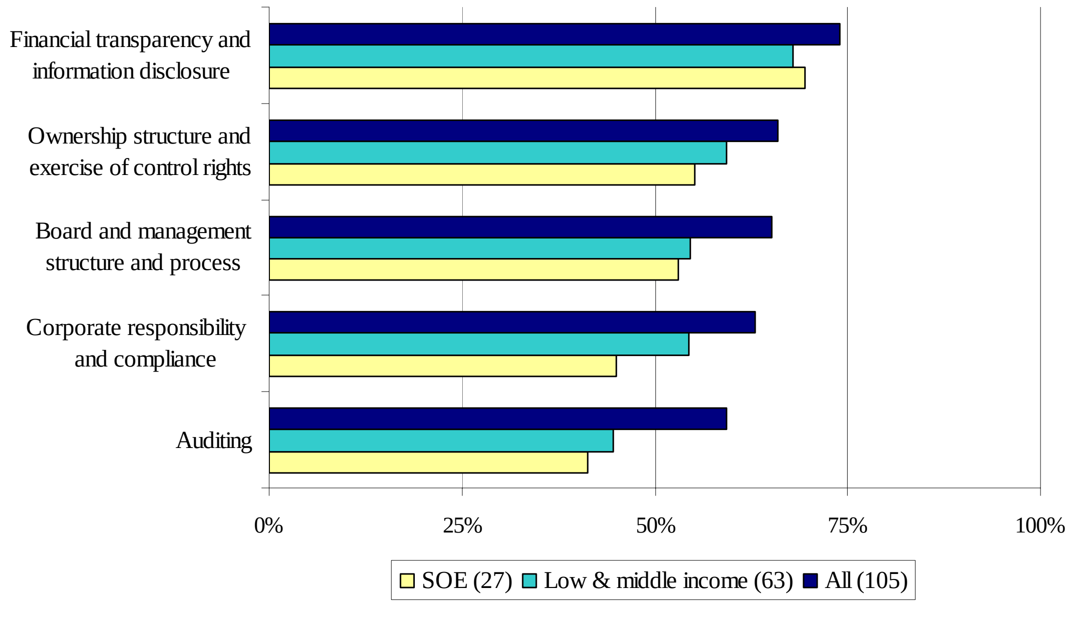
Disclosure Item	**Disclosure Rates** (Per cent)		
	OECD & Other High Income (42)	**Low & Middle Income (63)**	**Disparity**
Process for appointment of internal auditors	79	37	42
Process for appointment of external auditors	86	44	41
Process for interaction with external auditors	88	49	39
Internal control systems and their effectiveness	88	51	37
Board confidence in independence and integrity of auditors	79	43	36

5. Special focus: state-owned enterprises (SOEs)

Nearly one third of the enterprises in the survey were SOEs. This has allowed a special focus on this type of enterprise. As indicated in figure V.2 above, almost all of the SOEs in the survey were from low or middle income countries (23 out of 27). The SOE model is frequently a feature of the industrial strategy of developing countries, and as this survey has found, SOEs are often among the largest enterprises found in developing countries. Given this significance of SOEs, it seems worthwhile to take a closer look at their corporate governance disclosure practices.

Figure V.5 below, provides an overview of SOE disclosure rates by category. When viewed as a group, SOEs in the survey tend to under perform the average rate of disclosure for enterprises from low and middle income countries and significantly under perform the average rate of disclosure for all the enterprises surveyed.

Figure V.5. Comparison of disclosure between SOEs and enterprises from low- and middle-income countries
(Number in parentheses indicates sample size)



Despite the relatively low performance of SOEs as a group, it is important to recognize a significant difference between SOEs: internationally listed SOEs perform much better than non-listed or only locally listed SOEs (see table V.5 below). The disclosure rate of SOEs that are listed internationally is significantly higher than both the rate of all other SOEs, as well as the rate for low- and middle-income countries generally. The disclosure rate of internationally listed SOEs is close to the disclosure rate of all internationally listed enterprises surveyed.

Table V.5. Detailed analysis of SOE disclosure rates
(Number in parentheses indicates sample size)

SOE from Low & Middle Income Countries (23)	Avg Rate of Disclosure (Per cent)	"Score" out of 50			
		Min	Max	Avg	Median
International Listing (70)	77				
SOE with International Listing (10)	**70**	**13**	**46**	**35**	**39**
Low & Middle Income (63)	56				
Other SOE (13)	**38**	**2**	**35**	**19**	**19**

D. Conclusions

This chapter is the second annual survey of corporate governance disclosure prepared by the UNCTAD secretariat for ISAR. It is based on an enhanced methodology, increased sample size, and has sought to provide more in-depth analysis of the resulting data. The report has examined the data using different filters: country income and type of listing. The report also provides a special focus on SOEs.

Section A of this chapter provides an overview of recent developments in corporate governance disclosure, and highlights a number of areas of innovation and activity in the field of corporate governance disclosure. One of the most significant trends is the increasing use of corporate governance disclosure information by investors to construct new indices and funds. This follows from the growing body of research which demonstrates a strong correlation between good governance and good investment performance.

The presentation and analysis of survey data found in section B provides an indication of the implementation status of good practices in corporate governance disclosure. The data is the result of comparison of corporate disclosures with a benchmark of disclosure items based on the guidance documents ISAR/15 and ISAR/30. Due to changes in the methodology and an expansion of the sample size in the 2005 survey compared to the 2004 survey (ISAR/25), only limited comparisons between the two sets of data can be made at this stage. Therefore, while it is not possible to conclude with any certainty whether or not corporate governance disclosure is better in 2005 than in 2004 based on this survey, there are nevertheless some important observations that can be made.

For example, the analysis in Section II of the 2005 survey supports several of the findings of the first survey prepared for the 21st session of ISAR (ISAR/25). Among the findings that were supported: the relatively lower performance of enterprises in low- and middle-income countries when compared to rates of disclosure for enterprises in high-income countries; and the lower level of disclosure among enterprises with only a local listing, versus those that are also listed internationally.

Beyond comparisons between the two surveys, the 2005 survey also provides useful insights into current disclosure practices. For example, one of the more consistent patterns throughout the analysis in Section II was the relatively lower level of corporate governance disclosure regarding auditing functions. This may be an area requiring further attention among ISAR member states.

Despite the general patterns, this year's survey also noted that within country income groups that as a whole have lower disclosure rates, there are often individual enterprises that display relatively good practices and could be used as examples to promote better disclosure. The analysis in Section II also shed some light on the corporate governance practices of SOEs. The analysis shows that while some SOEs tend to fall below international practices, there is a new class of internationally listed SOEs that display world standards of disclosure.

Annex I. Figures

Figure V.A. Financial transparency and information disclosure
(Percentage of enterprises disclosing this item; survey sample size in parenthesis)

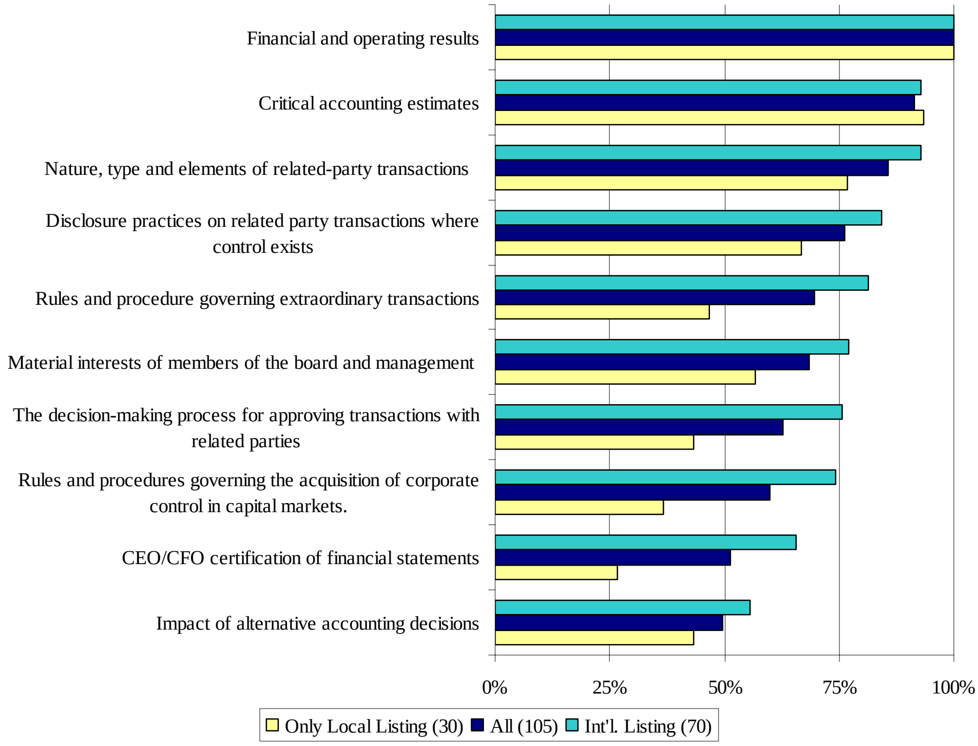


Figure V.B. Ownership structure and exercise of control rights
(Percentage of enterprises disclosing this item; survey sample size in parenthesis)

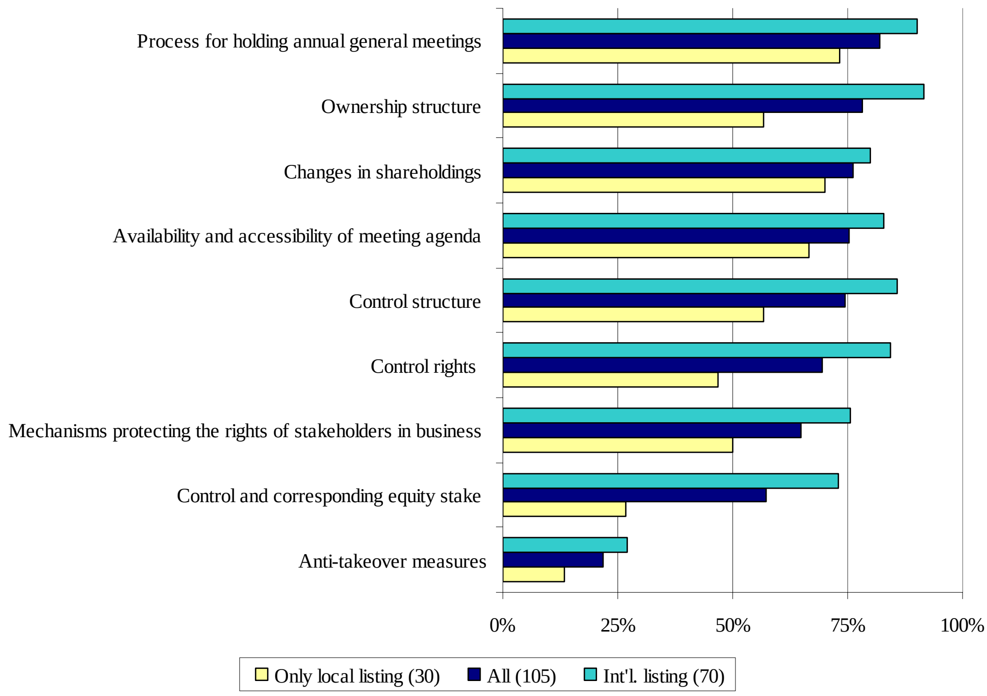


Figure V.C. Board and management structure and process
(Percentage of enterprises disclosing this item; survey sample size in parenthesis)

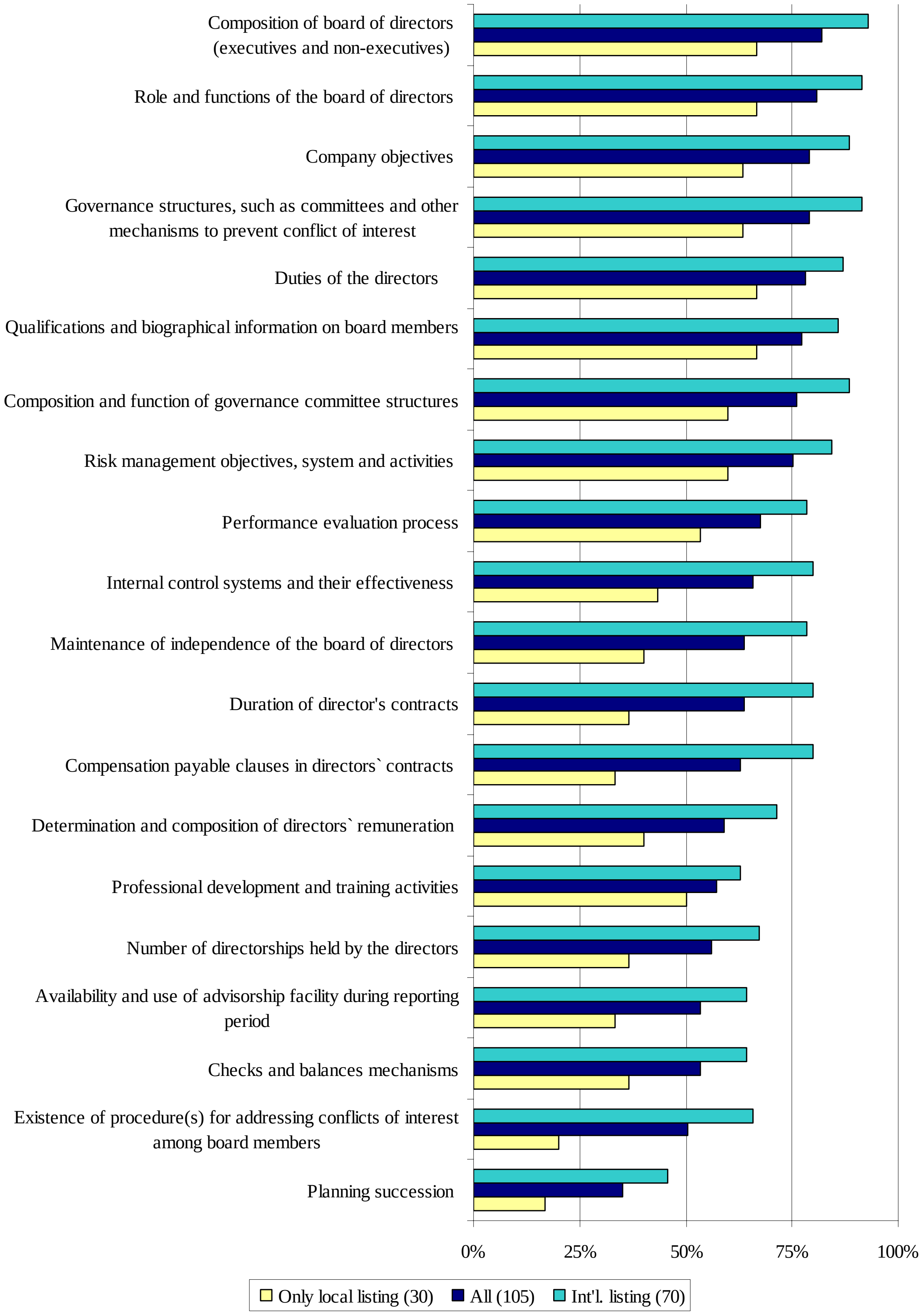


Figure V.D. Corporate responsibility and compliance

(Percentage of enterprises disclosing this item; survey sample size in parenthesis)

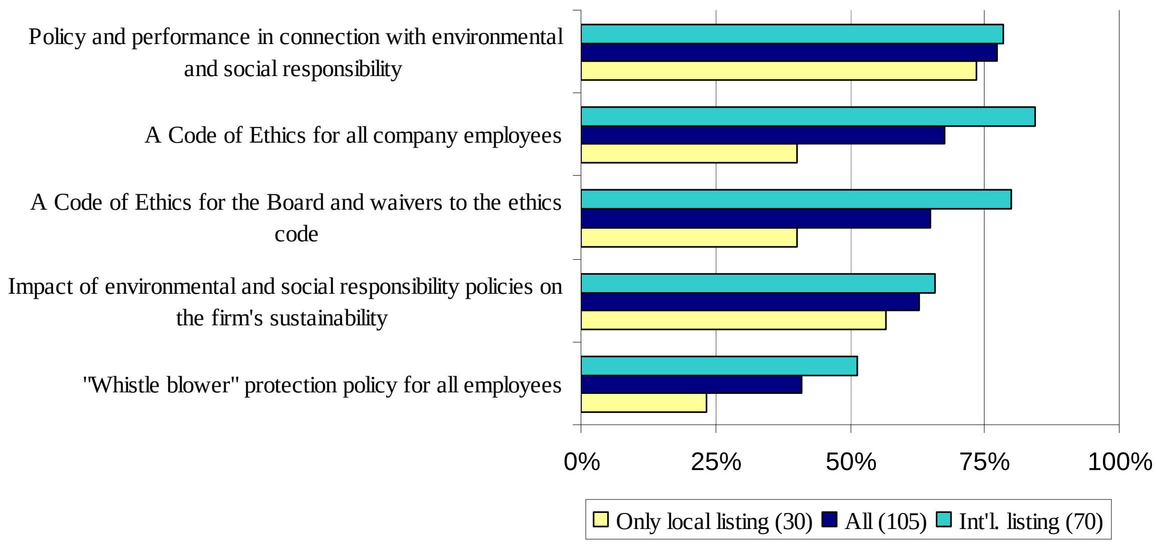
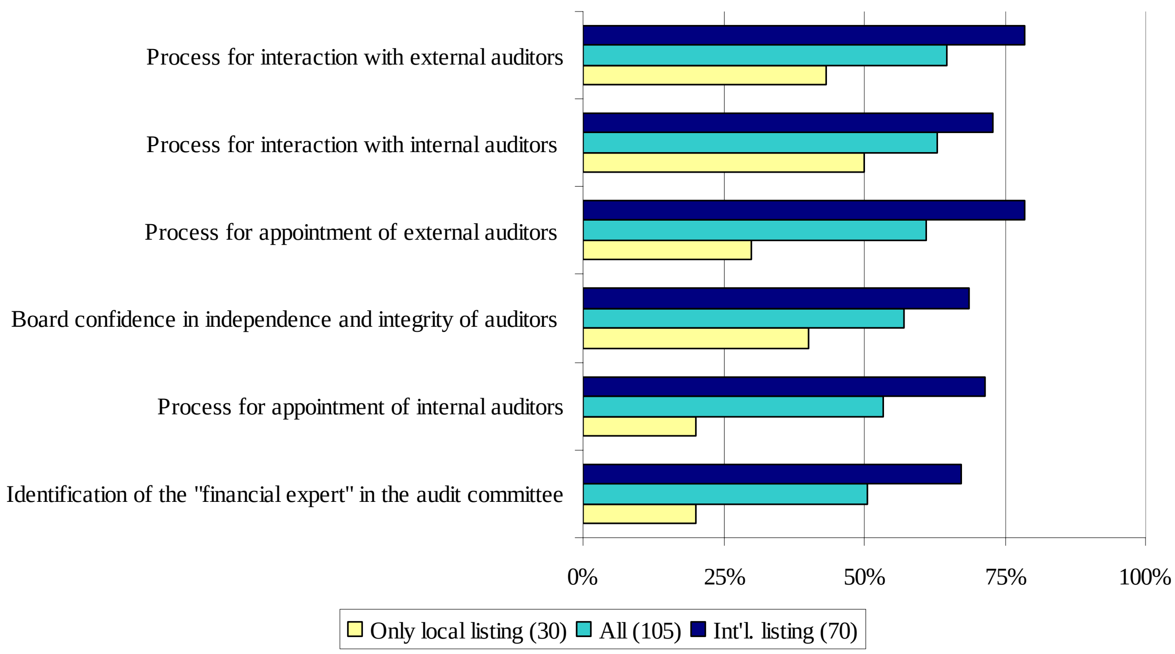


Figure V.E. Auditing

(Percentage of enterprises disclosing this item; survey sample size in parenthesis)



Chapter VI

CORPORATE REPORTING: SELECTED ISSUES

This chapter contains two articles on corporate transparency contributed by panellists who addressed participants at the technical workshop on International Financial Reporting Standards. The first article discusses revenue recognition issues in the context of International Financial Reporting Standards (IFRS). The second deals with fair value accounting issues in IFRS.

A. Revenue recognition: content and application of IAS 18 – *Revenue* and IAS 11 – *Construction Contracts* [1]

1. Introduction

The question of how to recognize revenue is very challenging from both practical and conceptual perspectives. Current International Financial Reporting Standards (IFRS) addressing this question include:

- IAS 18 - Revenue;
- IAS 11 - Construction Contracts;
- IAS 17 - Leases;
- IAS 39 - Financial Instruments: Recognition and Measurement;
- IAS 41 - Agriculture.

The term ‘revenue’ should not be confused with the term ‘gain’. Conceptually, revenue and gains both fall under the definition of income included in the framework:

Income [Framework.70(a)]
“Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.”

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What distinguishes **revenues** from gains is that revenues arise in the course of the **ordinary activities** of an entity and are **reported gross**. Revenue is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent (Framework.74).

Gains on the other hand are often **reported net** and generally do not relate to the ordinary business of an entity. For example, gains arise on the disposal of non-current assets. It is important to notice that the definition of income also includes unrealized gains. Those can, for example, arise from the revaluation of marketable securities or increases in the carrying amount of long-term assets.

2. Revenue recognition according to IAS 18

IAS 18, which only covers recognition of revenue, defines revenue as follows:

Revenue (IAS 18.7)

"The **gross inflow** of economic benefits **during the period** arising in the course of the **ordinary activities** of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."

Revenue excludes amounts collected on behalf of third parties and shall be recognized when the following conditions are met:

Revenue recognition principle (framework)

Revenue shall be recognized

- when it is **probable** that future economic benefits will flow to the entity, and
- these benefits can be **measured reliably**.

IAS 18 specifies this general principle by addressing recognition of revenue for certain types of transactions in greater detail. Those types of transactions are:

- sale of goods;
- rendering of services; and
- use by others of entity assets yielding interest, royalties and dividends.

Revenue shall be **measured** at the **fair value of the consideration received or receivable.** Usually, it is the amount agreed on by the counterparties. In determining the amount of revenue to be recognized, amounts of any trade discounts and volume rebates allowed by the entity shall be taken into account (IAS 18.10).

a. Recognition of revenue for sale of goods[2]

According to IAS 18 revenue arising from the sale of goods shall only be recognized when all the following conditions have been met:

[2] The term "goods" includes goods produced by the entity for the purpose of sale and goods purchased for resale.

Recognition of revenue on sale of goods (IAS 18.14)

- the entity has transferred to the buyer the **significant risks and rewards of ownership** of the goods;
- the entity retains **neither continuing managerial involvement** to the degree usually associated with ownership **nor effective control** over the goods sold;
- the amount of **revenue** can be **measured reliably**;
- it is **probable** that the economic benefits associated with the transaction will flow to the entity; and
- **costs** incurred or to be incurred in respect of the transaction can be **measured reliably**.

According to the general criteria of revenue recognition, revenue can only be recognized if it is probable that economic resources will flow to the entity and that those inflows can be measured reliably. IAS 18 specifies these general criteria by establishing a critical events test: revenue can only be recognized if risks and rewards have been transferred. Only then is the inflow of economic benefits considered to be probable. The critical event of transfer of risks and rewards shall ensure that the revenue number reported is reliable. By doing so the risk of having to reverse revenue which has already been shown in the income statement is significantly decreased.

A company that applies IAS 18 will most likely have the following questions:

- What are the significant risks and rewards of ownership that can be transferred?
- What does significant' mean in that context?
- When can one consider risks and rewards as being transferred?

The assessment of when an entity has **transferred the significant risks and rewards** of ownership to the buyer requires an examination of the circumstances of the transaction.[3] IAS 18.15 goes on stating that, in most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. However, there are cases for which this general guidance is not sufficient and more detail is needed for solving accounting problems which arise in practice.

This leaves **room for interpretation** and implies the risk of treating identical transactions differently. The appendix to IAS 18 reflects that the IASB was aware of this risk at the time the standard was published. The appendix contains a number of examples serving as application guidance for certain transactions such as bill and hold sales, goods shipped subject to conditions or subscription to publications and similar items.

IAS 18.16 gives examples of situations in which an entity may retain significant risks and rewards of ownership:

[3] See IAS 18.15.

Significant risks and rewards of ownership are retained:[4]

- when the entity retains an **obligation for unsatisfactory performance** not covered by normal warranty provisions;
- when the receipt of the revenue from a particular sale is **contingent on the derivation of revenue by the buyer** from its sale of the goods;
- when the goods are **shipped subject to installation** and the installation is a **significant** part of the contract which has not yet been completed by the entity; and
- when the buyer has the right to **rescind the purchase** for a reason specified in the sales contract and the entity is **uncertain about the probability** of return.

However, if, for example, the entity retains the legal title to the goods solely to protect the collectibility of the amount due, revenue shall be recognized. In this case, retaining the legal title for that reason is considered keeping only insignificant risks and rewards. IAS 18.17 gives another example of a case in which the entity only retains an insignificant risk of ownership: An entity might enter into a retail sale and offer a refund if the customer is not satisfied. The general rule in this case is that revenue shall be recognized at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors.[5] In practice this leads to the question what percentage of return cannot be considered insignificant risk so that the reporting entity would be precluded from recognizing revenue.

b. Recognition of revenue for rendering of services

In contrast to the sale of goods, rendering of services typically involves the performance by the entity of a contractually agreed task over an agreed period of time. Examples include a cleaning service offered by an entity which is performed on every Monday over the next twelve months. In those cases clearly no transfer of title or significant risks and rewards takes place which could determine the timing of revenue recognition.

Therefore, IAS 18 establishes special principles for recognition of revenue from service transactions:

Recognition of Revenue on Rendering Services (IAS 18.20)

Revenue associated with a transaction involving the rendering of services shall be recognized when the **outcome** of that transaction **can be estimated reliably**.

The outcome of a transaction can be **estimated reliably** when all the following conditions are satisfied:

- the amount of **revenue** can be **measured reliably**;
- it is **probable** that the economic benefits associated with the transaction will flow to the entity;

[4] See IAS 18.16.
[5] See IAS 18.17.

- the **stage of completion** of the transaction at the balance sheet date can be measured reliably; and
- the **costs** incurred for the transaction and the costs to complete the transaction can be **measured reliably**.

If the criteria are satisfied, revenue shall be recognized by reference to the **stage of completion** of the transaction at the balance sheet date. Another name for the recognition of revenue by reference to the stage of completion is the **percentage of completion method**. Under this method, revenue is recognized in the accounting periods in which the services are rendered. Recognition of revenue on this basis reflects the extent of service activity during an accounting period and provides useful information on the performance of the reporting entity. Further guidance on how to apply the percentage of completion method is given in IAS 11, which is covered in this article in section C.

A company which applies the criteria given for the recognition of revenue according to the stage of completion will most likely have the following questions:

- How can the stage of completion be measured reliably?
- How can the costs incurred be measured reliably?

In order to be able to apply the percentage of completion method a company needs an effective internal financial budgeting and reporting system. An entity is required to review and, when necessary, revise the estimates of revenue as the service is performed. According to IAS 18.23, the need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

IAS 18.24 shows a variety of **methods for determining the stage of completion** of a transaction. An entity shall use a method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

- surveys of **work performed**;
- services performed to date as a **percentage of total services** to be performed; or
- the **proportion that costs** incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction. Progress payments and advances received from customers often do not reflect the services performed.

According to IAS 18.25, for practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognized on a straight-line basis over the specified period. This is valid unless there is evidence that another method better represents the stage of completion. Sometimes it might be the case that one specific act is much more significant than any other acts. If this is true, revenue recognition is postponed. Revenue shall only be recognized once that significant act is executed.

According to IAS 18.27, during the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. It may nevertheless be probable that the entity will recover the transaction costs incurred. Therefore, revenue is recognized only to the extent of costs incurred that are expected to be recoverable. In cases where the outcome of the transaction cannot be estimated reliably, no profit is recognized.

In cases where the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognized and the costs incurred are recognized as an expense.[6] Once the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognized according to the stage of completion.

c. Unsolved issues: multiple element arrangements

One of the main problems arising in conjunction with the application of IAS 18 is the question of how and when to recognize revenue if an entity provides multiple interrelated goods and/or services to a customer. These transactions are called multiple element arrangements are common in everyday business life.

Case study of a multiple element arrangement

On 20 December Mr. Schmidt decides to buy a hi-fi system. The system is available with speakers which are also sold separately. The price of the set is lower than the combined price of the separate goods. As he buys the system and the speakers he is entitled to a 30 per cent discount on a DVD player of the same design which he then decides to buy as well. For the whole package (hi-fi system, speakers, DVD player) he is given an additional discount of 3 per cent. Unfortunately the speakers and the DVD player are not in stock anymore, but is told that it would be delivered within the next three weeks. Mr. Schmidt decides to buy the whole package anyway but asks for a right to return the whole package if the speakers and the DVD player are not delivered within three weeks. He is granted that right to return.

The question is how to account for such a transaction. IAS 18.13 only states that "in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction." However, IAS 18 is silent on the issue of how to disaggregate such a contract into separately identifiable components.

Because of the lack of guidance under IFRS, companies currently apply US GAAP in order to account for multiple element arrangements. This recourse to US GAAP is in line with IAS 8.12 which allows management to "consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices". However, this can only happen as long as these sources do not conflict with existing IFRS and the framework.

[6] See IAS 18.28.

Pronouncements applied on this base include, for example, Emerging Issues Task Force's *Accounting for Revenue Arrangements with Multiple Deliverables* (EITF 00-21) which was approved by the EITF in November 2002. This is an unsatisfactory situation. The absence of guidance under IFRS is therefore one of the reasons for the current IASB project on revenue recognition which is addressed in section IV of this paper.

3. Construction contracts (IAS 11)

Construction contracts are specifically negotiated contracts for the construction of an asset or a combination of assets that are closely interrelated or interdependent.[7] In many cases it takes longer than one accounting period to fulfil such a contractual obligation. If revenue was only recognized once the contract is completed there would be accounting periods in which an entity could not show its performance although the activity might take place, for example, on a straight line basis. Therefore, the principles for recognition of revenue on construction contracts follow the principles introduced by IAS 18 on recognition of revenue for providing services. If certain criteria are fulfilled revenue shall be recognized according to the stage of completion (IAS 11.22). This ensures that useful information is provided on the performance of the reporting entity.

Regarding the criteria of revenue recognition IAS 11 distinguishes between fixed price contracts and cost plus contracts:

The percentage of completion method shall be applied, when the following criteria are met:

Fixed price contract (IAS 11.23)
- Total contract revenue can be measured reliably;
- Economic benefits associated will probably flow to the entity;
- Both the contract costs to complete and the stage of completion can be measured reliably; and
- Contract costs attributable can be clearly identified and measured reliably.

Cost plus contract (IAS 11.24)
- Economic benefits associated will probably flow to the entity; and
- Contract costs attributable can be clearly identified and measured reliably

An expected loss on the contract shall be recognized immediately irrespective of the recognition criteria given above.

In applying the percentage of completion method the stage of completion has to be identified. Methods to measure the stage of completion (IAS 11.30) include:

- proportion of contract costs incurred to the estimated total contract costs

[7] See IAS 11.3.

- surveys of work performed
- completion of a physical proportion of the contract work.[8]

In some cases the outcome of the construction contract cannot be measured reliably.

When the **outcome of a construction contract cannot be estimated reliably**:

- revenue shall be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and
- contract costs shall be recognized as an expense in the period in which they are incurred.[9]

4. Conceptual problems and current discussion

The IASB has identified a list of conceptual and practical problems arising from the existing IAS 18 and IAS 11. Those problems include:

From a **conceptual perspective:**

- Recourse to the **realization principle** in IAS 18 is said to contradict the definition of revenues in the **framework** (changes of assets and liabilities);
- Application of IAS 18 can lead to recognition of **deferred assets and deferred liabilities** (which do not meet the definition of assets and liabilities).

From a **practical perspective:**

- Application of the **realization principle** is often unclear (as evidenced by the need for extensive additional explanations in the appendix of IAS 18);
- IAS 18 leaves (too much?) room for **interpretation;**
- No sufficient guidance on how to account for **multiple element arrangements** exists.

In the light of these above-mentioned conceptual inconsistencies and the absence of guidance on how to account for multiple element arrangements, IASB decided to undertake a project on revenue recognition. The project is carried out jointly with the US Financial Accounting Standards Board (FASB) and is aimed at reaching convergence in the area of revenue recognition.

From the point of view of the IASB the goal is to rethink current principles of revenue recognition and to develop a new standard which will eventually supersede IAS 18. Furthermore, the project is supposed to lead to changes of the existing framework. The project is of highest importance to the IASB.

[8] See IAS 11.30.
[9] See IAS 11.32.

Under US GAAP plenty of different pronouncements on the issue of revenue recognition already exist. These are published by about half a dozen of authorities. However, US GAAP are lacking one uniform Standard which addresses the general principles of revenue recognition. The goal of the FASB is to develop such a uniform Standard.

The approach currently discussed defines revenue as measurable changes in net assets.

In an earlier phase of the project the IASB discussed the possibility of recognizing selling revenue when signing of a binding contract takes place. It furthermore discussed fair value as a measurement base for performance obligations. This decision has been revised mainly because of practical problems expected to arise from fair value measurement of performance obligations. Currently, the IASB discusses measurement of performance obligations at the amount of the customer consideration which generally is the amount agreed upon by the contracting parties.

A discussion paper is scheduled to be published in 2006.

5. Summary

According to the framework revenue shall be recognized when it is probable that economic benefits will flow to the entity and those inflows can be measured reliably. IAS 18 and IAS 11 specify this general principle for certain types of transactions such as sale of goods, rendering of services and construction contracts. For example, revenues for the sale of goods shall only be recognized if — besides other criteria being fulfilled — the significant risks and rewards of ownership are transferred to the buyer.

Although IAS 18 and IAS 11 give specific guidance for certain kinds of transactions issues occur in practice which are not covered by these standards. For example, the problem of how to recognize revenue from multiple element arrangements has not been addressed sufficiently.

The issue of revenue recognition is of highest importance to the IASB. Existing conceptual inconsistencies and reservations have led the Board to undertake a project on revenue recognition. This project is directed towards developing a new approach to recognition of revenue which is based on the definition of income given in the framework. According to this approach, revenue would be recognized when measurable changes in net assets occur. The goal of the IASB is to develop an approach which is not limited by notions of the earnings process.

The project is undertaken jointly with the FASB. Both Boards are working towards convergence of standards on revenue recognition. A discussion paper on the approach is scheduled for 2006.

B. Fair value measurement issues [10]

1. Introduction

Fair value accounting is currently the subject of intense discussions, even through it is not a new concept in accounting theory. It was highly popular in Germany in the 19th century,[11] as late as the 1920s,[12] and briefly re-emerged in US literature in the 1960s.[13] The related economic concept of income was also intensively discussed in Scandinavian literature.[14] Today, fair value accounting is experiencing an astonishing renaissance. This is mainly driven by the accounting for financial instruments, but comprises a lot of other balance sheet items.

The purpose of this article is to give an overview on:

- international accounting standards currently making use of fair values (section II);
- related methods to determine a fair value, sometimes referred to as "fair value hierarchies" (section III);
- recent developments related to fair value measurement (section IV); and
- problems associated with fair value accounting (section V).

2. Current use of fair values under International Financial Reporting Standards (IFRS)

a. Measurement bases

There are many differences between the different accounting concepts. They can be roughly distinguished between concepts based on *past* outflows (of cash or other resources) to acquire an asset (or *past* inflows to acquire a liability), or *future* cash flows (inflows associated with assets and outflows associated with liabilities). Traditionally, the measurement basis on *initial recognition* would be the cost, defined as the consideration given to acquire an asset or received to acquire a liability,

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[10] This article was prepared by Dr. Martin Schmidt. He is a project manager at the Deutsches Rechnungslegungs Standards Committee e.V. (DRSC)/Accounting Standards Committee of Germany (the German Standard Setter). The views expressed in this paper are the views of the author.

[11] Article 31 par. 1 of the Allgemeines Deutsches Handelsgesetzbuch (ADHGB) – General German Commercial Code from 1861 required every asset to be measured at fair value. See Blaufus, Fair Value Accounting, Wiesbaden 2005, par. 102 et seq. for a discussion.

[12] See Schmidt, Die Organische Tageswertbilanz, Wiesbaden 1929, p. 124 who proposed that all items be carried at fair value, defined as the amount at which the item could be purchased at the balance sheet date and taken as a market-based estimation of the value in use.

[13] See for example Edwards/Bell (1961). *The Theory and Measurement of Business Income*, Los Angeles and Chambers (1961). *Accounting, Evaluation and Economic Behaviour*. Englewood Cliffs.

[14] See for example Myrdal (1927). *Prisbildningsproblemet och föränderligheten*. Stockholm/Uppsala, who discussed (probably as one of the first) the difference between income/expenses and gains/losses (see p. 44). In the 1960s, these issues were discussed, among others, by Johansson, Skatt – Investering – Värdering, Stockholm 1961 and Honko, Yrityksen Vuositulos (1961). *The Annual Income of an Enterprise and its Determination.* Helsinki.

including transaction costs. This amount is also sometimes defined as a fair value.[15] However, it should be noted that subtle differences may exist between a transaction amount and fair value.

On *subsequent measurement* dates, items would be either carried at cost (unlimited useful life) or amortized cost (limited useful life). The amortized costs would include a depreciation to reflect the pattern in which the future economic benefits associated with the item are consumed over time. Therefore, this cost concept is based on *past outflows*. An additional impairment test would ensure that the carrying amount was not higher (lower) than the current value of the asset (the liability). In that case an impairment loss would be recognized. This concept is therefore called *lower of cost or market*. Gains or income would only be recognized according to a *revenue recognition* or *realization principle*.[16]

Alternatively, balance sheet items might also be reported at amounts representing *future inflows* (assets) or *outflows* (liabilities), determined independent of past outflows (inflows), i.e. the cost. In this context, the fair value concept is but one alternative. Under the fair value concept, the *markets' perspective* of the present value of the future cash flows is used. Another alternative could be to use the *entities' own perspective* of the future cash flows. The measurement base under this approach would be the value in use and not the fair value. Overall, the term 'fair value accounting' usually refers to the usage of the fair value as the measurement basis in *subsequent measurement*.

b. What is fair value?

As shown above, fair value is one measurement basis used in accounting. The International Financial Reporting Standards (IFRS) define the fair value[17] as the "amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." Based on this definition, fair value is the price of a *real* or *hypothetical* transaction in an active market. However, the notion of an active market is not included in the definition itself.

There are a number of advantages commonly associated with fair values. Most of them are derived from theories of finance. Among these advantages is that the market participants' exchange transactions work to resolve the different expectations and risk preferences into a single price. This market mechanism is implicitly based on a hypothesis that the market price incorporates all publicly available information (information efficiency).[18] The fair value would then be based on the risk-adjusted present value of the cash flows associated with the item. Therefore, reporting the fair values would result in presenting the assets and liabilities with their respective *future* inflows or outflows (and providing information about them).

[15] See IAS 39.AG64: "The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph AG76)."
[16] See Kühne's paper in this volume for an example.
[17] See IAS 39.9 for an example.
[18] See the two 'classics' on this issue: Fama: Efficient capital markets: A review of theory and empirical work, *Journal of Finance* 1970, p. 383-417 and Fama: Efficient Capital Markets II, *Journal of Finance* 1991, p. 1575-1617.

By definition, in these markets there can only be one price at any given point in time and fair value accounting would also achieve comparability. Any entity would report the same amount — the market price — at the same balance sheet date for the same item. In comparison, under the cost concept, different amounts might be reported for the same item. If two entities acquired two *identical* items of investment property at different dates (in different years), they will naturally report differing amounts under a cost-based measurement concept: One entity might very well report 500,000 Kenyan shillings it paid thirty years ago, the other 100 million Kenyan shillings for an identical item acquired half a year ago.

c. The Move towards Fair Value Accounting

It could be said that the (new) move towards fair value accounting began in the 1980s when the former International Accountings Standards Committee (IASC) started working on accounting regulations for financial instruments.

Developments in capital markets motivated increasing usage of financial derivatives by a growing number of entities, regardless of size and business. However, presentation of these derivatives was deemed inadequate under the cost concept. Because most derivatives (such as financial futures or swaps) apart from financial options have no cost[19], derivative financial instruments are literally "invisible" under cost-based accounting. After a considerable number of exposure drafts, the IASC finally published the first version of IAS 39 *Financial Instruments: Recognition and Measurement* in 1998. This version of IAS 39 retained cost accounting for some instruments and fair value accounting for others, both through profit or loss and directly to equity for others. It is therefore sometimes referred to as a "mixed model". The years 2000 and 2001 saw the light of the two first 'true' fair value standards. IAS 40 covers investment property and IAS 41 *Agriculture* covers biological assets and agricultural produce. In 2004, IFRS 2 was published, the standard requiring share-based payments to be measured at fair value.

Presently, the International Accounting Standards Board (IASB) is working on refining IAS 39. The current version of the standard uses a rather complex "mixed model" approach with different categories for financial instruments, each with its own measurement concept and additional rules on hedge accounting. Some say the only possible way to make this standard simpler would be to switch to a full fair value concept.[20] Other projects that are likely to make more use of fair values are Phase II of the insurance contracts project and the project on business combinations, meaning the approach under the current IFRS 3 and the exposure draft of changes to IFRS 3 as a result of Phase II of the project.[21]

Taken together, all recently issued standards show an apparent move towards more fair values in subsequent measurement (see figure VI.1).

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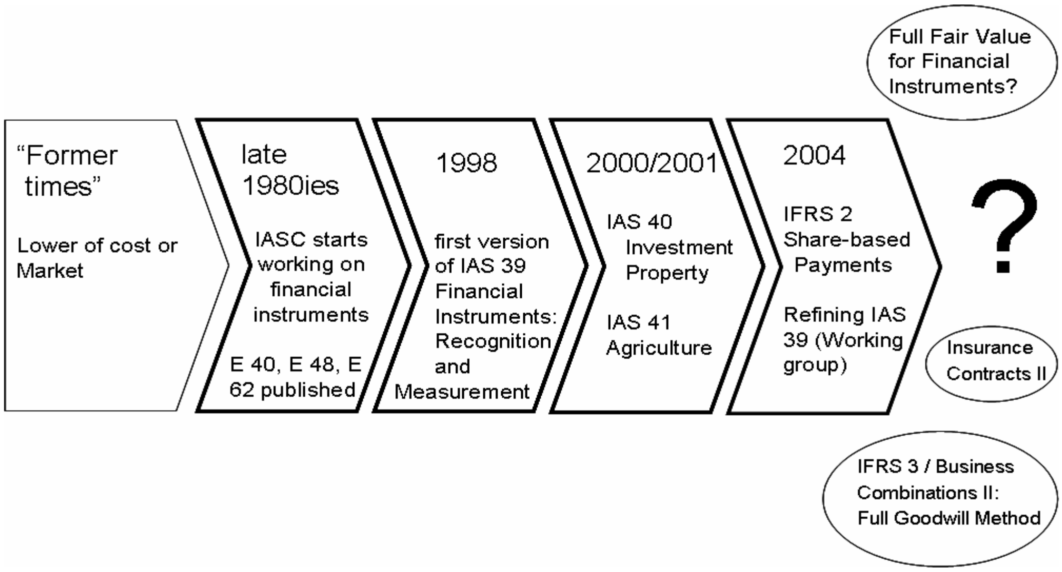
[19] This is due to the fact that there are usually no payments when an entity enters into a derivative contract.

[20] A full fair value concept was also proposed by the joint working group of standard-setters in its draft standard, published in 2000.

[21] More information is available on the IASB website: www.iasb.org.

Figure VI.1. The move towards fair value



d. Items to be carried at fair value on subsequent measurement under existing IFRSs

The ongoing discussions in favour or against fair value measurement sometimes wrongly give the impression that nearly all balance sheet items are to be carried at fair value. It is important to understand that this is not the case, although there are certainly a number of items reported at fair value on subsequent measurement dates.

The relevant items may be categorized by two criteria: Is fair value measurement compulsory or optional? Are changes in fair value reported in profit or loss, or directly in equity?

Table VI.1. Items to be carried at fair value under current IFRSs

Items in question	**Through profit or loss**	**Directly in equity**
Compulsory	• Certain financial instruments (derivatives, instruments held for trading) [IAS 39][22] • Agricultural produce/ biological assets [IAS 41][23]	• Certain financial instruments (available-for-sale instruments) [IAS 39][24]
Optional	• Investment property [IAS 40][25] • All other financial instruments [IAS 39][26]	• Intangible assets [IAS 38][27] • Property, plant & equipment [IAS 16][28]

22 See IAS 39.46 read in conjunction with IAS 39.55(a).
23 See IAS 41.12-13.
24 See IAS 39.46 read in conjunction with IAS 39.55(b).
25 The entity may choose the 'fair value model', according to IAS 40.33 et seq. or the 'cost model' according to IAS 40.56 which in turn refers to IAS 16's cost concept. If the entity chooses the 'fair value model', the changes in fair value are included in profit or loss, see IAS 40.35.
26 The so-called "Fair Value Option" was published in June 2005 as an amendment to IAS 39.
27 See IAS 38.75 *et seq*.
28 See IAS 16.31 *et seq*.

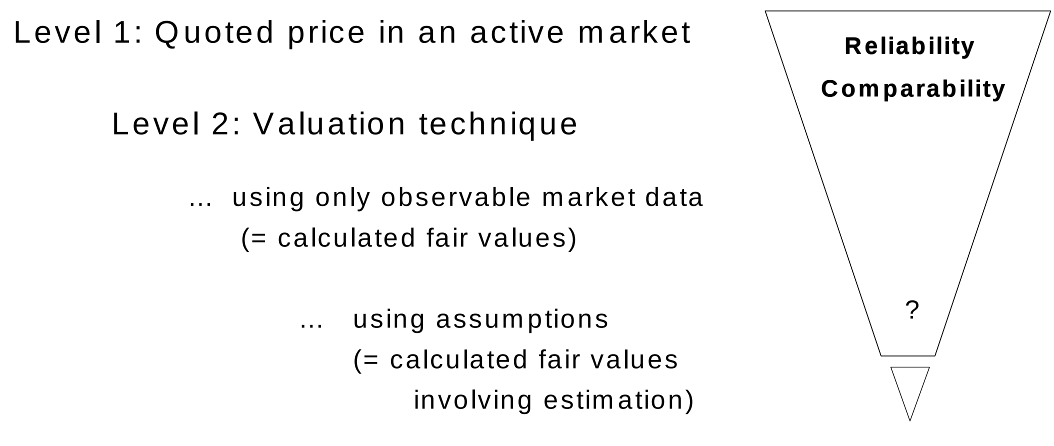
It has to be noted that if the alternative 'cost model' is chosen for investment properties under IAS 40, the fair values have to be disclosed in the notes. Therefore, although not carried at fair value and changes not being reported in profit or loss, a fair value needs to be determined in any case.[29] It should also be added that the optional "revaluation model" under IAS 38 for intangibles and for property, plant & equipment under IAS 16 are of limited importance in practice.

3. Methods to determine a fair value

The simplest way to determine a fair value is to observe the price for the item in question in an active market. However, if there is no active market for this item or the market is not sufficiently active, other methods to determine a fair value have to be applied. The methods and the order in which the different methods may be applied are sometimes referred to as a "fair value hierarchy". In the current IFRS, these hierarchies are standard-specific and therefore item-specific. This might seem odd, as the definition of a fair value applies to the measurement basis and to all items carried at this measurement basis. On the other hand, it may be argued that items as different as a gooseberry shrub in Sweden, a *Camellia assamica* in India, an investment property in Cairo and a financial future on Arabica Coffee traded at the Brazilian Mercantile & Futures Exchange might call for different methods to determine a fair value.

For example, IAS 39 *Financial Instruments: Recognition and Measurement* basically relies on two approaches to determine a fair value (see figure VI.2).[30]

Figure VI.2. IAS 39 Fair Value Measurement Guidance



Level 1 is the observed transaction price in an active market for the item to be measured. On level 2, the standard refers to accepted valuation techniques, and covers a wide range of different valuation techniques. For example, a transaction price

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29 See IAS 40.79(e).

30 See IAS 39's Application Guidance. According to paragraph 71, the published price quotation in an active market is the best evidence of fair value. Paragraph 74 *et seq*. mention possible valuation techniques. According to paragraph 74, an adjusted price for a similar instrument is also a valuation technique, with the quoted price for the similar instrument being an input parameter for the valuation technique.

observed in an active market might be adjusted for small differences because the item to be measured is quite similar, but not identical to the item traded in the active market.

Another approach would be to discount the contractual cash flows associated with a particular financial instrument using a risk-adjusted interest rate. This discounted cash flow method also draws the attention to a very important aspect: Apart from the validity of the valuation technique, which may be assured by periodical back-testing[31] and the correct usage of the technique itself, the input parameters used with the technique are of the utmost importance.[32] These input parameters might be:

(1) market data, that is, data observed in an active market; or
(2) assumptions the entity made because the relevant information may not be observed in the active market but the assumption tries to reflect market information as much as possible.
(3) This type of assumption is sometimes referred to as “assumptions that market participants would use”. The parameters might also be entity-specific assumptions.

Of course, also assumptions mentioned under (2) are entity-specific in the sense that the entity will *produce* the assumptions. The term "entity-specific" in this context should be thought of as *relying*, for example, on entity-specific expectations that cannot be justified to reliably represent market expectations. However, both types of assumptions will involve estimation.

The higher the degree of estimation and the more significantly the assumptions will influence the fair value to be determined, the more reliability and comparability will be reduced. As assumptions may never be “true” but only “neutral” and “understandable”[33] to a higher or lesser degree, there will always be a range of possible fair values. However, since the reported amount is only a point estimate from that range, the fair value will not be as reliable as other measurement bases (e.g. cost) and probably not as reliable as it is perceived to be. As different entities might use different assumptions, they are likely to report different fair values for similar items. However, this lack of comparability might be compensated by additional disclosures. On the contrary, if only market data are used with the valuation technique, there should be no problems with respect to reliability or comparability, provided a valid valuation technique is used correctly, as the determination of the fair value will be a calculation.

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[31] To check the validity of the valuation technique by way of back-testing, the technique is used on a financial instrument traded on an active market using market input data to enable a comparison between model prices and market prices. IAS 39.AG76 also mentions back-testing.

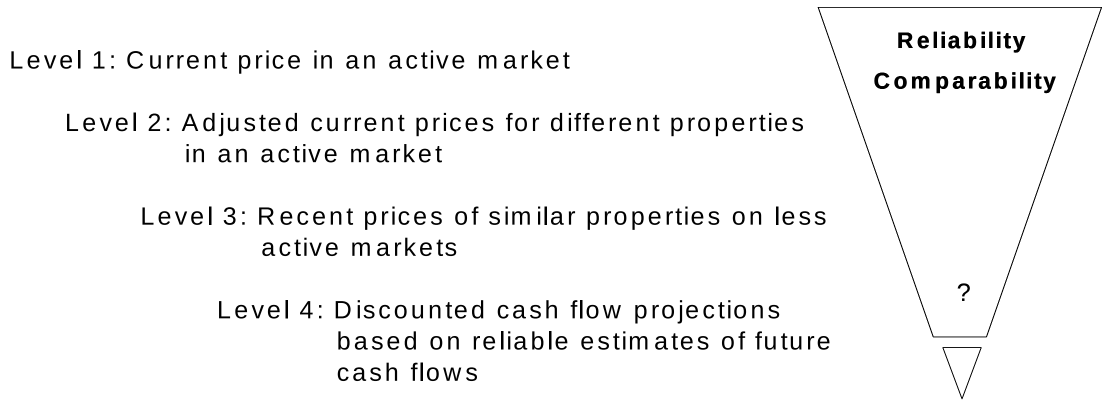
[32] See IAS 39.AG82, dealing exclusively with the input parameters. However, paragraph AG74 *et seq*. also mention input parameters.

[33] See, for example par. 40 of the International Standard on Auditing 545 *Auditing Fair Value Measurements and Disclosures* (ISA 545). Note also the difference between the criteria to assess assumptions involving, by definition, estimation (relevant, reliable, neutral, understandable complete) and the criteria relating to data. Data is observed at the market and, by definition, not estimated. Consequently, the criteria in paragraph 51 of ISA 545 (accurate, complete, relevant) do not contain reliability or neutrality. Observed data may only be either accurate or not.

Level 1-fair values may be characterized as *observed* fair values, level 2-fair values determined solely by market data as *calculated* fair values. Level 2-fair values based on either type of assumption may be characterized as *estimated* fair values.

IAS 40 contains a slightly different fair value measurement hierarchy (see figure VI.3).[34] A level 1-fair value will probably be rather rare, as it is highly unlikely that two identical items of investment property will exist. Note that both level 2 and level 3 fair values involve adjustments: Level 2 because the properties are different and level 3 for the time-lag between the day the price was observed and the measurement date. Level 4 involves a good deal of estimation with respect to the cash flows and risk-adjusted interest rates. These estimations might impede reliability and comparability. On the other hand, a comprehensive discussion should also look at alternatives. Coming back to the example in Section I.2 and the two items of investment property, we note that both amounts are reliable, but certainly not comparable. The illustration is of course a very simple one. However, it should be noted that questions related to comparability are raised very rarely in connection to a cost-based measurement concept, but they *should* be raised.

Figure VI.3. IAS 40 Fair Value Measurement Guidance

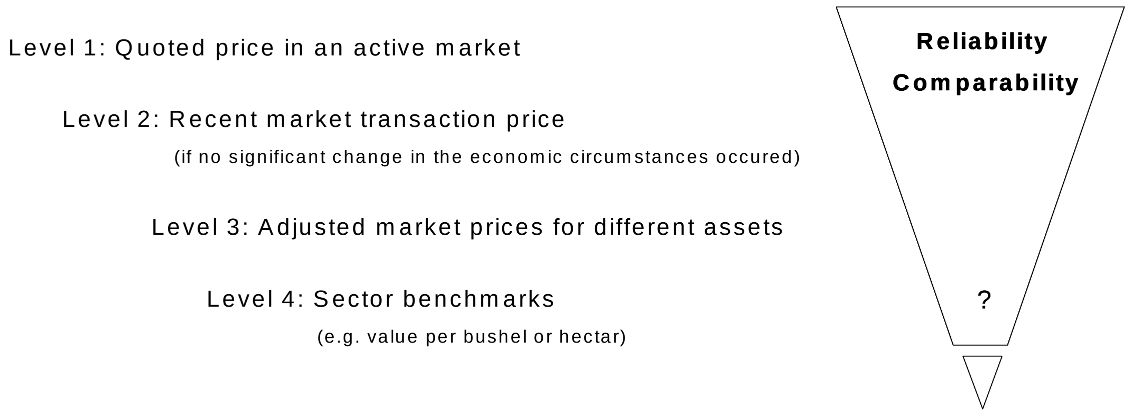


An interesting aspect of the IAS 41 fair value measurement hierarchy[35] is the difference between levels 1 and 2: As already mentioned above, there might be a difference between a price observed in an active market and a transaction price. A single transaction does not constitute a market, albeit an active one. This is also the reason for a transaction price (the consideration given to acquire an asset) used in a cost-based measurement concept *not necessarily* being a fair value.

[34] See IAS 40.45 (current price in an active market as fair value) and IAS 40.46 (other sources, level 2-4 in figure VI.3).

[35] See IAS 41.17 (the quoted price in an active market as fair value) and IAS 41.18 (other sources, level 2-4 in figure VI.4).

Figure VI.4. IAS 41 Fair Value Measurement Guidance



One of the major problems connected with fair value measurement might be a misconception of what a fair value actually *is*. The fair value does not "claim" to be the only true and real amount at which any given item may be realized (liquidated) at any given point in time. This would only be the case with a fair value determined by observation of a transaction price in an active market. If the fair value is determined by a valuation technique, the amount might not be realized at any given point in time as there is no active market. If there was an active market, there would be no need for a valuation technique. In this situation the fair value is a hypothetical amount – the transaction price two parties *would* agree on. This could almost be called an "expectation gap" as there is the danger that users of financial statements might mistake the fair value determined by a valuation technique for a market price.

4. Recent developments related to fair value measurement

Some recently published papers are closely related to fair value measurement.

- In November 2005, the IASB published a discussion paper "*Measurement Bases for Financial Accounting — Measurement on Initial Recognition*",[36] prepared by the Canadian Accounting Standards Board. The paper contains an in-depth analysis of the fair value as the measurement basis on initial recognition. It contains some details which will most likely be quite controversial. For example, the discussion paper clearly states that a transaction price is not necessarily a fair value.[37] It also contains an a priori expectation reasoned from the market value measurement objective that there can be only one market (fair) value for an asset or liability on any measurement date.[38] Consequently, there would be no need to differentiate between an entry or an exit price. In addition, if fair value would be used as the measurement basis on initial recognition, transaction costs (such as cost for transporting the item to the entity or bringing it to a condition necessary for it to be capable of operating in the manner intended by management) would *not* be

[36] The paper can be downloaded from the IASB's website. The paper exists in two versions: a longer version and a 'condensed' version. The paragraphs cited in this article refer to the comprehensive version.
[37] See paragraph 243 *et seq.* of the discussion paper.
[38] See paragraph 135 *et seq.* of the discussion paper.

included in the asset's initial carrying amount but *expensed* as they are, by definition, not part of the fair value.[39]

Apart from controversial details, the discussion paper clearly aims at opening up an in-depth discussion about the usefulness of (more) fair values. This is a discussion needed and repeatedly asked for by a number of parties taking an interest in accounting standard-setting. The discussion paper is therefore certainly an enjoyable development as it helps focusing on some very important issues.

- In 2004 the US-Financial Accounting Standards Board (FASB) published an exposure draft on "Fair Value Measurement". This draft does not address the question *when* to measure an item at fair value. Therefore, the usage of the fair value concept would remain unaffected. The draft only deals with a "*how to*". It contains definitions, e.g. what an "active reference market" actually is, guidance related to valuation techniques (e.g. discounted cash flow-methods) and introduces a "fair value hierarchy" with five levels which would be applicable to *all* standards requiring an item to be measured at fair value.[40] Contrary to the discussion paper mentioned above, the working draft takes up an *exit price* notion for the definition of fair value, i.e. the fair value is defined as the price an asset could be *sold* at.

The FASB plans to publish the standard in late 2005 and the IASB intends to issue the FASB's final standard on fair value measurements as an IASB Exposure Draft with an invitation to comment.[41] It should be noted though that if the IASB will adopt the FASB standard into the IFRS, consequential amendments to a vast number of IFRSs and IASs all referring to fair value would probably be necessary.

In general, both papers will improve the transparency about the *kind* of fair value that is used for a particular item in a financial statement, because by stating that the amount is a fair value from a lower level of the fair value measurement hierarchy, the reporting entity will inform the user that this fair value is not a price from an active market, not even a transaction price at all, but an amount based on a valuation technique involving estimations. The user will be informed that a range of possible fair values exists and ideally about how small or large the range is. In short, the user would be informed about the measurement uncertainty contained in the point estimate within that range that is reported as a fair value. That does not make the fair value more reliable, but it will provide information on how reliable it actually is. A (false) perception of reliability (an expectation gap) would be avoided.

5. Fair value measurement — methods and problems

A number of issues related to fair value measurement clearly are worth discussing. This article will focus on just two of them.

1. What to do in the absence of an active market?

[39] See paragraph 198 *et seq*. of the discussion paper.
[40] The working draft of the FASB standard was discussed by the IASB during the November Board meeting and can be downloaded (together with the other agenda papers on this topic) from http://www.iasb.org/meetings/nov2005.asp.
[41] See IASB Update September 2005, p. 3.

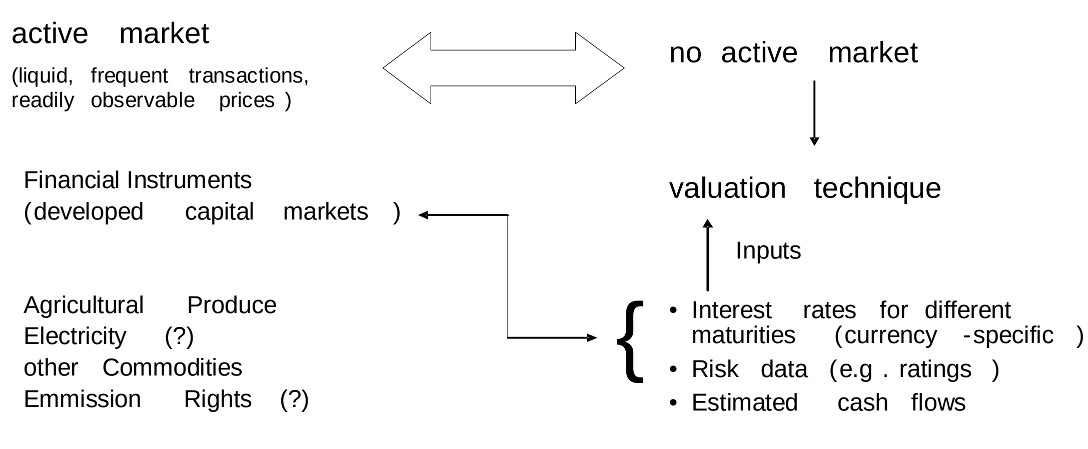
To answer this question, it is necessary to analyse which items could have active markets. This evaluation depends of course, on the definition of an active market, or using the terminology of the FASB draft an “active reference market”. With respect to current IFRSs, IAS 38 contains a definition and according to this definition, an active market needs three conditions to be present:

(1) homogenous items;
(2) buyers and sellers can normally be found at any time; and
(3) prices available to the public.

The second condition that market participants may be found at any given point in time is actually a liquidity condition. Together with the homogeneity of the items, the existence of active markets is *de facto* almost reduced to securities or commodities exchanges. Consequently, items with an active market might include financial instruments in countries with developed capital markets, some agricultural produce, electricity, other commodities, emission rights under an environment protection scheme when publicly traded. The other side of this story is that an active market does not exist for a lot of items.

This will lead back to the question of the fair value measurement hierarchy. Apart from differences in detail, some kind of valuation technique would be used to determine a fair value. This valuation technique will most likely be based on some kind of cash flow projection. Therefore, spot interest rates are needed (probably for longer maturities) and risk-related data. If this information is supposed to be only marked-based data, this would require *sufficiently developed capital markets* (see figure VI.5). To put it another way: Without at least sufficiently developed capital markets, fair value measurement is associated with some major problems, as even the data needed for the valuation technique may not be observed in the capital market.

Figure VI.5. What to do in the Absence of an Active Market?



2. Does fair value measurement introduce volatility?

Unlike a cost amount based on *past* cash flows, a fair value will vary through time. As the underlying information (or synonym, changes in the input parameters such as *future* cash flows, interest rates, risk premiums, prices for other items, e.g. commodities) will vary continuously, so will a fair value based on these parameters. This volatility is independent of the approach used to determine the fair value, i.e.

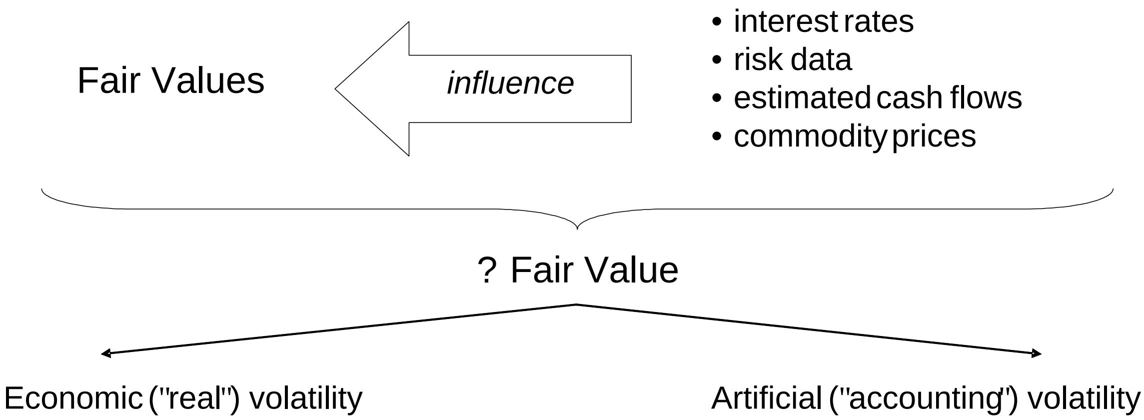
whether the fair value is determined by using the market participants' estimation of the present value (market price) or by calculating it.

Consequently, if an entity chooses to invest in items whose fair values are volatile and if the accounting standards require the item to be measured at fair value and if changes in fair value are reported in profit or loss, the reporting entities' net income will become more volatile over time when compared to entities using the cost-based measurement. However, it should be noted that although this volatility quite adequately reflects volatility in the economic environment of the entity. If the entity is a banking institution which deals with financial instruments in an economic environment primarily dominated by volatile capital markets, the financial statements may very well reflect this volatility.

However, there might be significant problems if not all balance sheet items whose fair values depend on certain parameters are measured at fair value. More precisely, the problem arises when *some* items are measured at fair value and *some* are measured at (amortized) cost, but still all the items' fair values depend on the same parameter(s). Since changes in fair values cannot compensate each other, such a mixed measurement concept may results in distorted income figures.

This is due to an artificial accounting-induced volatility introduced to the profit or loss figures (see figure VI.6).

Figure VI.6. Economic and accounting volatility



For illustration, consider a very simple example: the reporting entity invests in a straight bond, which is financed by a matching liability (fixed interest rates, matching notional amounts, matching maturities). If the bond (the reporting entities' asset) is measured at fair value and the liability is measured at cost, every change in the interest rates will result in a change in the fair value attributable to the asset reported in profit or loss. As interest rates tend to be volatile, so will be the net income over time. The economic position of the entity with respect to interest rate risk is not reported faithfully, as there is no interest rate risk exposure. If the liability is also measured at fair value, the changes in its fair value would offset the changes attributable to the asset and both changes would compensate each other in profit or loss. If the liability is not measured at fair value, however, this mixed measurement concept will produce an artificial accounting-induced volatility, which could be misleading to the users of the financial statement. The key question that needs to be discussed is therefore whether *all* items whose fair value depends on certain parameters are measured at fair value. There are a number of empirical studies which point out this problem.[42]

6. Some concluding remarks

Fair value is probably the only meaningful measurement basis for certain items. For example, as many derivatives have no cost, they would be "invisible" if measured at amortized cost on subsequent measurement dates. According to the problem discussed in the previous section, this would require measuring all financial instruments at fair value, since all financial instruments' fair values depend on certain parameters such as interest rates or other prices.

Apart from financial instruments, there might be other items for which fair value is a suitable measurement base because fair value information will be useful. For example, it might be practically impossible to measure at cost agricultural assets that grow in size and value over a longer period of time, as there will be no or almost no cost. In general, there is a clear need for an in-depth discussion about a more comprehensive use of fair values and this discussion should include questions as:

- What items can be reliably measured at fair value?
- What items should be measured at fair value?
- What items cannot be measured at fair value for practical reasons or with respect to reliability?
- Which disclosures are useful to users to compensate for measurement uncertainty, keeping in mind the already large size and complexity of the notes to the statements.

Fair value measurement depends on active markets or sufficiently developed capital markets if a valuation technique is used. There is a need for more guidance with respect to different valuation techniques used for measuring different kinds of items. A special focus should be kept on countries in transition as they are most likely not to have sufficiently developed markets. In addition, fair value measurement founded on finance theory and based on information-efficient or even perfect markets is thrilling and convincing from a theoretical point of view. However, real world markets sometime fail the theoretical model. This should not lead us to abandoning the theoretical model, but to discuss consequences for practical application.

[42] See Beatty/Chamberlain/Magliolo (1996), An empirical analysis of the economic implications of fair value accounting for investment securities. *Journal of Accounting and Economics,* 1996, p. 43-77.