In the spotlight: risk management
January 2015

The whole free market economy is built on the willingness of entrepreneurs to take risks and seize opportunities.
Welcome to the latest edition of Disclose! With risk management the main theme of this issue, you can look forward to some exciting reading.

Risk is part and parcel of life – and of modern business. The whole free market economy is built on the willingness of entrepreneurs to take risks in return for the prospect of earning a profit.

In response to the rapidly growing complexity and difficulty of dealing with risks and opportunities, this issue of Disclose takes a close look at the topic of risk management. With things changing so quickly on both the social and economic fronts, it’s hard to know whether you’re really able to recognise new threats and opportunities in time and weigh them up properly. Even if you succeed, you can’t always be sure of responding adequately and keeping the risks and opportunities under control.

Having taken a thorough look at these issues, we’ve developed a system that delivers answers to the burning questions: the PwC Assurance Framework.

Many organisations have developed special risk management tools to create greater clarity and certainty in the increasingly complex world in which they operate. They use internal control systems to build effective oversight mechanisms into their business processes. And they set up compliance functions to ensure the organisation keeps to the relevant rules and regulations. Given the lengths companies are going to to tackle these issues, it’s legitimate to ask whether too much is being done. We think not. Even so, it’s important for organisations to carefully coordinate their risk management instruments, demarcate them clearly from controls in the operational business, and have them scrutinised by their internal and external auditors. That’s the only way of making sure they continue to function effectively and efficiently. You can read more about this in Coordinated control: ‘the four lines of defence’ model and The role of compliance in risk management at banks.

Our auditors generally work for the same client over many years. This way they can gain a deeper insight into both the client and its competitive environment. This issue also contains a round table discussion where experienced PwC partners discuss the challenges and responses under the banner of Risk management: a comparison by

Alex Astolfi
Leader Assurance Switzerland
sector. Without giving too much away, I can reveal that there are commonalities as well as differences between industries.

Following publication of the first issue of Disclose as an interactive web magazine we asked you readers for your opinion. We were delighted with the number of people who took part in the survey, and with the pleasantly positive response. Many thanks! We’ve already followed up on your desire to be able to save or print out the current issue of Disclose: you’ll find the relevant icon at the top right of each page.

Another innovation is that Disclose will now also appear in English so that our English-speaking readers can enjoy the entire magazine without any linguistic barriers.

Now all that remains for me to do is wish you interesting and inspiring reading and a good start to 2015.

Alex Astolfi
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In the spotlight: risk management

Balance between managing the risks and seizing opportunities

More and more organisations have an interest in systematically managing their risks. The types of threats companies face, and how they deal with them in specific instances, varies by industry. Their appetite for risk also varies: while some organisations are geared to controls, others tend to pursue new business ideas more aggressively.

Risk management is very much in fashion. Leaders of large corporations all over the world are devoting increasing attention to a controlled approach to risk. There are many reasons for this. On the one hand the environment in which companies do business is becoming more complex, and with so many constantly shifting requirements to take account of, they’re permanently confronted with new uncertainties. At the same we’re seeing increasingly sophisticated business models giving rise to a growing number and variety of risks, making matters even more confusing.

In recent years risk management has also been gaining importance in the public sector. You only have to look at the websites of federal departments in Switzerland to see how the people responsible for safeguarding the public in the event of major risks such as earthquakes and floods are using state-of-the-art risk management tools to prepare for disaster scenarios.

Risk management is a reminder to managers and employees of the huge variety of risks that have to be considered. It’s a counterbalance to corporate management geared to quick development and rapid growth. The job of managing operational risks is an executive responsibility that extends to the job of every single employee within an organisation. A company’s internal controls comprise a set of risk management measures placed at the level above routine business tasks. Faced with the decision on what level of resources to invest in this function, in compliance, and in other areas of the organisation charged with monitoring risk, every board will decide differently. Some organisations err on the side of control, while others opt to pursue new market opportunities more aggressively. But ultimately they have to strike a reasonable balance between the two approaches.

Risk appetite within a specific industry or organisation depends on the expectations of investors, executives and other stakeholders. For
example, many companies in the pharmaceutical industry have dedicated themselves to combating serious diseases, and permanently invest large amounts in research and development for new cures. But the payoff of many of these investments will be minimal or non-existent – something that their stakeholders are all aware of. From time to time, however, a company will bring an especially effective drug to market and be able to capitalise on sustained commercial success over a span of years or even decades. It’s quite a different story for insurance companies and retail banks. In many areas of business they have to exercise a great deal of prudence, since any serious failure would affect a large number of small customers.

Responsibility for risk management strategy lies with the board of directors, and the audit committee working on its behalf. They decide on principles which then become the management’s responsibility to implement at the operational level. The board of directors and executive management jointly monitor whether the strategic targets and measures on the operational level are effective, and systematically assure the desired level of security. A good example of this system is way projects to implement new information technology are set up. Operations of this sort are generally very complex and protracted, last a long time, and entail an enormous number of risks. Experience has shown that IT projects occasionally get completely out of hand and end in spectacular failure. To prevent this from happening, alongside the actual project team you need an independent steering committee whose job is to ensure compliance with the rules and specifications of the project.

The most dangerous risk is the one you fail to see coming

The key question in risk management is how the board and management can recognise the relevant risks in good time. Without doubt the most dangerous risk is the one that management fails to recognise as a risk in the first place.

Most companies try to classify risks in terms of their origins. In the world of banking, for example, they distinguish between three main types of risk: financial risks, which in the worst case can entail life-threatening losses; reputational risks, which result in a loss of societal support; and regulatory risks. In the wake of the financial crisis, legislators and regulators have enacted a raft of regulations setting limits on the banks’ business activities.

Many organisations have an institutionalised risk management process in place with which they try and identify the ten most important risks
and evaluate their probability of occurrence and the seriousness of their impact. On this basis it’s possible to set priorities, define appropriate measures and decide on the resources to be invested in dealing with risks. If a company reiterates this process on an annual basis it will repeatedly identify new risks and judge former risks to be obsolete. But it has to be said that there’s no objectively reliable method for identifying risks. Working out what risks await you also requires a subjective component, in other words gut feeling.
Summary

Dealing with risk has always been part and parcel of managing a business. It used to be that you could implicitly build risk management into the entire range of management activities. But as the
operating environment becomes more complex and business models more differentiated, many companies are finding they need to set up an explicit risk management framework encompassing the entire range of measures for systematically identifying, analysing, assessing, monitoring and controlling risks. And with business changing all the time, they’re having to review their risk management strategies on a very regular basis. To help organisations navigate their way through all this, PwC has developed the Assurance Framework.
In the spotlight: risk management

Coordinated control: the ‘four lines of defence’ model

Risks are changing constantly in our rapidly moving times. Permanently adapting your risk management quickly and effectively without unnecessary increases in operating expense requires an agile framework integrated across the entire organisation. The four lines of defence model has established itself as a practical response to this challenge, coordinating the various players involved and their activities to enhance the efficiency of the risk management system as a whole.

The concept of four lines of defence has its origin in military strategy. The idea is to thwart attack by setting up a series of staggered lines of defence. If the enemy manages to breach the first line, they’ll only find more obstacles in their way to prevent them from getting any further. The subsequent lines of defence are all the more effective if each has its own means to fall back on. With the advent of heavy gunpowder artillery in the early modern era, the defences of cities and fortifications all over Europe were progressively enhanced with the addition of various lines of defence including moats, ramparts, covered wall walks, citadels and other structures designed to make the forward area deep enough to effectively defend against artillery attack.

Given the way new risks are constantly emerging, often evolving into massive threats at breathtaking speed, adopting this military analogy in the form of the four lines of defence concept (Figure 1) makes perfect sense in the context of risk management. Take internet crime, for example: what started out as fairly harmless isolated threats soon gave way to massive data theft with dramatic consequences. Then there’s the issue of aiding and abetting tax avoidance: after low-key political debate had rumbled on for years, suddenly we saw the whole business erupt in the US into drastic fines and a huge loss of reputation for Swiss banks. Another advantage of the four lines of defence concept is that it optimises collaboration between the different players involved in risk management and control processes (Figure 2). This is particularly important in an environment where risk management involves a growing number of tasks and controls, often spread across different departments and corporate functions simultaneously. The challenge for organisations is to carefully coordinate this complex range of activities and demarcate them clearly so that they can respond flexibly to new risks and handle and control them adequately.
Thanks to the simplicity of the four lines of defence model it can be used by any entity, regardless of its type, organisational structure or complexity. Essentially most organisations have been working with this model of risk control, to a varying extent, for a long time already. But its true impact only really unfolds once it’s embedded in an enterprise-wide risk management set-up. In concrete terms, this means that the management must first work with the board of directors to identify the relevant risks and locate them within the organisation’s risk landscape. Then the board defines the company’s risk appetite and strategy, which the management subsequently implements in the form of measures to assess, deal with, monitor and control risk. It’s only on this basis that the four lines of defence model can work properly (see the PwC Assurance Framework).

In our work we’ve observed a sharp increase in the number of internal controls in recent years. In many cases – particularly in larger organisations – this has increased costs and complexity, eroded...
entrepreneurial spirit, and resulted in a growing ‘checklist’ mentality. It’s therefore important for the board and management to lay great stress on the significance of their control activities and lead the way on a daily basis in terms of taking appropriate business risks. They also have to set the tone in terms of risk culture by ensuring a careful balance of market and control functions within the organisation’s governance structures, and making sure remuneration policy provides incentives geared to the long term. Companies have to clearly demarcate tasks between the various lines of defence, with staff assigned clear responsibilities and accountability. They also have to critically review controls within the four lines of defence on a regular basis, and deploy new methods and technology (for example big data evaluation) efficiently. This is the only way of avoiding gaps in security and the extra expense resulting from a lack of coordination.

The special role of the external auditors

The debate on the four lines of defence kicked off in January 2013 with the publication of a position paper by the Institute of Internal Auditors (IIA). While placing the external auditors outside the organisation’s structure, the authors of the paper point out that external auditors, regulators and other external bodies have an important role to play in the organisation’s overall governance and control structure. They can be considered as extra lines of defence that provide additional assurance to the organisation’s shareholders, including the governing body and senior management.

The external auditors play a particularly important role as a fourth line of defence in regulated industries. An example is the way a distinction is now made in the Swiss financial industry between the financial and regulatory audit. The financial auditors scrutinise the risks of financial reporting and assess the completeness and accuracy of the financial information contained in the company’s reports. The regulatory auditors evaluate the risks in terms not only of compliance and regulation, but also the market, credit and operational risks, to assess whether the relevant management processes take proper account of these risks. The external auditors work primarily with the third line of defence, the internal auditors.

«Any entity, regardless of its type, organisational structure or complexity, can use the four lines of defence model. Essentially most companies have been working with this model of risk control a long time already.»
Summary

The concept of the four lines of defence enables an organisation to take a holistic view of its entire risk management process. It facilitates coordination of the entire range of duties and responsibilities involved to ensure efficient and effective control. The model works on the assumption that all risks that crop up in the first line of defence will sooner or later turn into financial risks if not dealt with properly. A good example is the explosion on the Deepwater Horizon oil platform in the Gulf of Mexico in 2010, which happened because the equipment supposed to seal the borehole was defective. The failure to properly deal with an operational risk not only led to one of the worst human-made environmental catastrophes on record, but resulted in BP having to pay USD 7.8 billion in claims.

The first line of defence is designed to identify risks early on, analyse them properly, and apply appropriate measures to limit them. The second and third lines of defence are there to monitor risks in the first line of defence, advise operational management, and if required intervene where correction is necessary. The work of the third and fourth lines of defence builds on the first two lines, and consists in providing critical and supportive feedback. The big challenge is to adapt the model constantly to new risks without making coordination between the lines of defence less efficient.
In the spotlight: risk management

**When internal controls add value**

Too often, companies see internal controls as an impediment that slows down work processes. But if you get the focus of your internal controls right, they can actually help safeguard and develop your business. There’s no such thing as a ‘one-size-fits-all’ system of internal controls. You have to take account of the specific requirements of your organisation and the industry in which it operates. That’s the only way of creating an internal control system that adds real value and helps you manage your business pragmatically.

Internal controls have been around for a long time. Regardless of the degree to which controls are documented, they’re a crucial component of good management. Any business, whether it manufactures goods or delivers services, is exposed to certain risks. With an effective system of internal controls in place, you can adequately manage the risks relevant to your business.

But how do you decide what risks are relevant? Working on the basis of a classic risk checklist you have to think about the risks you are willing and able to bear yourself. Then you have to define appropriate measures to prevent the risks you’ve identified, and ways of remedying existing risks or reducing them to a reasonable level. At the same time you have to make sure your business remains stable and is able to pursue its objectives with as few obstacles in its way as possible. The right internal controls will not only free you up to concentrate on the essentials, but will stimulate the growth of your business by improving your operational efficiency. This type of control is good for both profitability and reputation. Take these factors into account, and your internal control system will provide management with truly useful tools for monitoring and controlling strategy and operational processes within your organisation.

In Switzerland the legislation contains only a rough outline of how an internal control system has to be set up in practice, with no guidelines as to the form or scope of concrete controls. The legislator’s expectations in this regard are essentially limited to risks in connection with financial reporting. The only thing specified in the Swiss Code of Obligations (CO) is that the external auditors of an entity required to undergo an ordinary audit have to confirm the existence of a system of internal controls.

But controls that only monitor risks related to financial reporting don’t
by any means cover the entire range of potential business risks. Such a limited set-up fails to take account of key factors including the industry or market in which your organisation operates. To be able to achieve its full impact, your internal control system has to go beyond the legal requirements and actively help your business in the achievement of its strategic and operational objectives. This means the board of directors has to set priorities for the internal control system and monitor the way management applies these controls. This approach is key if you want to deliver quality products and services.

**Balancing trust and control**

Companies that are unaware of their risks and risk appetite can respond in one of two ways. Either they assume that everything’s okay, trust their employees more or less blindly, and conduct few, if any, controls. Or they show little or no trust in their employees and impose costly, disproportionate controls, simply checking everything. The fact that the system identifies so many errors merely reinforces the belief that these controls are necessary. Thus begins a vicious circle. For this reason it’s vital to assess the risks.

One of the key principles of an internal control system is the idea of dual control: every important procedure has to be checked by a second, independent person. This generally recognised best practice is urgently recommended in an area such as bank payments. But incoming inventory usually only has to be checked by one person, as further controls are generally built into the procurement process. Controls should be viewed as part of the overall process rather than in isolation. Otherwise you’ll often have gaps in your control, or duplication of effort that undermines the efficiency of your operations.

If the people affected understand the control processes and the goals of the system in their overall context, they won’t feel so burdened by the responsibility. And they’ll be able to concentrate on the really important controls. They’ll also feel appreciated because they’re working in an environment built on trust.

**Key criteria in an efficient control system**

Internal controls are useful if they’re relevant. So it’s important for companies to be aware of how to improve their controls. There’s a whole series of criteria to indicate whether the system is working well, or whether it’s useless and merely getting in the way. An effective internal control system has to be geared to the specific processes and principles of the business. It has to be based on the needs of the organisation and
its customers. And it has to be made an integral part of value creation processes. If you locate your internal controls at the fringe of the value creation process, they’ll never make a full contribution in terms of helping you achieve your business objectives.

Here’s an example from e-banking. Clients sending their bank electronic instructions to transfer a significant amount of money are automatically sent a text message by the web-based system asking them to check and confirm the transaction. This way the bank makes sure the client really wants to make the transfer. The people responsible for internal controls now have to decide the limit for an additional control of this sort: CHF 2,000, or CHF 20,000? Clients will probably be insulted if they receive a text asking them to confirm any transfer over twenty francs. But they’ll take a very different view if a criminal illegally siphons off CHF 2000 from their account, and will probably start asking critical questions about the requirements the bank has put in place in terms of internal controls. This is an example of the gap that can exist between customer expectations and the bank’s assessment of the costs and benefits.

Internal controls can only work properly if they have the backing of management. If executives are convinced that controls add value, the system will fulfil its purpose. If, on the other hand, managers are complaining of too many useless controls, it’s a sure sign that the system is in need of an overhaul.

In larger organisations the board of directors and audit committee (if there is one) are crucial to the quality of internal controls. Leaders have to evaluate the effectiveness of the internal control system periodically and if necessary adjust it in line with the reality of the business. Management can regularly monitor the system and upgrade it to cover risks that might have been forgotten or ignored. Many risks may be fully covered by precise, documented controls. But others may have been completely forgotten when the system was set up. In many cases these risks can only be captured by means of special ad hoc mechanisms on top of existing controls, merely adding further levels of control. This makes the system more complex, often creating superfluous, uncoordinated controls that merely get in the way of doing business. In smaller organisations there’s no need for this process to be conducted on a formal basis. Even here, though, the directors and management of an SME must review the risk landscape and the controls that have been set up to make sure they’re up to date, as well as periodically assessing the organisation’s risk appetite – and intervene if necessary.
Summary

A system of internal controls will add value if it’s geared to the strategic and operational risks relevant to the business. Organisations should also ensure there’s a balance between trust in their employees and the necessary controls by the board of directors or audit committee. Asking the right questions and identifying the risks that can be covered by internal controls is an important step towards an efficient internal control system and the invaluable benefits it brings.
In the spotlight: risk management

**Economic crime increasingly affecting Swiss companies**

More than one in three organisations in Switzerland now report being the targets of economic crime, PwC’s recently published survey on Economic Crime in Switzerland has revealed. While this is in line with trends PwC has observed elsewhere in the world, some of the Swiss survey’s findings are characteristic to this country and the particular composition of its economy. We present the most important findings from the 2014 survey and compare these to the results of our survey in 2011.

A particularly noteworthy aspect of PwC’s Swiss survey is that more than a third of the respondents actually affected by some kind of fraud in the last two years were in the financial services industry, with cybercrime attacks on their companies’ data and networks now becoming increasingly widespread and sophisticated. Across all industries, the most common type of economic crime was asset misappropriation. Over the last two years, this had affected two thirds of fraud-affected respondents. Cybercrime came second, reported by a quarter of respondents who had been victims of economic crime. Given the ever-growing dependence on, and ubiquity of, technology, PwC believes cybercrime is here to stay.

The incidence of intellectual property infringements is also rising rapidly. Given the enormous commercial value of many companies’ work in researching and developing new products and services, and their increasing reliance on networking technologies to allow teams to work together efficiently on new projects, this is an area where many organisations are potentially vulnerable. Procurement fraud, a new category PwC has introduced for this survey, is now the fourth most common type of economic crime reported, affecting 16% of fraud-affected respondents.

Interestingly, 71% of all economic crime detected had come to light thanks to corporate controls and anti-fraud corporate-culture mechanisms – clear evidence that the significant efforts companies have made in recent years to make crime prevention an integral part of their day-to-day operations are now gaining traction. While this is good news, there is no room for complacency. Organisations will need to redouble their efforts to raise awareness of the ever-mounting risks to which their operations are exposed, both from external threats and those within their midst.
**Government enforcement-related crimes**

PwC classifies bribery, corruption, money laundering and anti-competitive behaviour in this category. These offences are coming under increasing scrutiny by regulators and other government authorities. When detected, they attract harsh penalties and remedial awards, as well as inflicting significant reputational damage on the firms concerned.

Interestingly, only 3% of Swiss fraud-affected respondents reported bribery and corruption (versus 12% of all Western European respondents and 27% of all global respondents). Similarly, while only 12% of Swiss respondents expected to experience this type of crime in the next 24 months, the figures for Western Europe and the whole world were higher (16% and 29%). Moreover, although nearly 75% of Swiss financial services companies either operate or plan to operate in territories with substantial corruption risk, no financial services respondents reported having been asked to pay a bribe or having lost business to competitors willing to do so.

Across all industries, 37% of Swiss respondents ranked bribery and corruption as the greatest risk arising from doing business worldwide, closely followed by money laundering (35%), with competition-law infringements in third place (23%). Swiss respondents were less concerned about bribery and corruption than their global counterparts, while seeing money laundering as a more prevalent threat.

As to the consequences of criminal activity of this type, respondents saw their organisation’s corporate reputation as being most at risk in the event of a crime occurring.

**Cybercrime – here to stay**

PwC expects attacks on Swiss networks to increase in future, given the concentration of financial services firms in Switzerland and their ever-increasing reliance on technology. Already, at 26%, cybercrime is the second most common type of crime reported. Swiss companies are increasingly aware that while cybercrime can be managed with appropriate measures, it can never be eliminated. Although general awareness of cyber risks has increased, Switzerland still lags other major industrialised nations in its efforts to address them. Notably, 23% of respondents could not quantify the cost of cybercrime to their organisation in the past 24 months. As awareness grows, PwC anticipates that organisations will be better able to gauge the financial impact of cybercrime.
Given current awareness levels, PwC believes that a significant proportion of respondents not reporting any cybercrime at all may well have been victims without even knowing it. Moreover, for certain types of cybercrime – particularly intellectual property theft – companies have compelling competitive reasons to keep quiet. It seems likely that a significant proportion of the damage inflicted on companies is currently not being reported – because it is not known, is difficult to quantify or is not shared outside the organisation.

In Switzerland, cybercrime threats are mainly seen as external, according to half of those surveyed, while one in three see internal and external threats as roughly equal. Interestingly, 12% of Swiss respondents see themselves as primarily exposed to internal cybersecurity threats, which puts Switzerland above the averages for Western Europe and the world as a whole. The media attention generated by internal data theft at Swiss financial institutions may explain this.

Financial services, where 43% of fraud-affected respondents reported cybercrime attacks, stands out. PwC believes this is due partly to the better safeguards in place in this regulated industry and partly to the large amounts of detailed customer and financial information stored in their systems, which attracts criminal interest.

Paradoxically, although PwC's 2014 Global CEO Survey shows that one in two CEOs say they are concerned about threats to their organisations' cyber security, they still distribute critical data to managers, employees, vendors and clients on multiple platforms – including high-risk cloud and mobile environments. Clearly, the economic and competitive advantages of these practices outweigh the sense of caution inspired by cybersecurity concerns. Switzerland’s continued strong economic performance will make it an increasingly attractive target to cyber criminals.

The thief in our midst

In line with earlier survey results, internal fraudsters are predominantly male (76% of perpetrators), and aged 41-50 (one in two). Roughly half have been with their organisations for more than 6 years. The largest category of miscreants, roughly one in two of all detected perpetrators, hold a high-school diploma or a lower qualification as their highest educational award.

External fraudster profiles have changed significantly since the 2011 survey, with agents/intermediaries now responsible for 31% of incidents (8% in 2011), while crimes by customers have fallen from half of all
cases in 2011 to less than one in ten in 2014. With companies now outsourcing so much more work to agents and intermediaries, it is clearly important that the due diligence checks carried out on these third parties be beefed up.

Just over half of all detected crimes are now reported as being committed by external actors in the ‘Other’ or ‘Don’t know’ categories, compared to only 30% in 2011. PwC believes this reflects the increased prevalence of cybercrime.

Swiss companies are more likely to dismiss fraudulent employees (in 82% of cases versus 60% globally) and to take civil proceedings (nearly two thirds for Switzerland versus less than a third globally). Conversely, where the criminal is external to the organisation, Swiss respondents are much less likely to take action than their global counterparts. Law enforcement authorities are informed in only about one third of Swiss cases, compared to more than half of all cases worldwide. Similar discrepancies exist with regard to notifying regulatory authorities, taking civil action or – where the perpetrator worked for a business partner – ceasing the business relationship.

Both corporate controls and corporate-cultural mechanisms are now equally effective in detecting crimes, the latter having become more effective since the 2011 survey. Data-driven fraud discovery and tip-offs now both yield significantly better results than they did back in 2011. Swiss firms have thus made considerable progress in improving their corporate controls and developing an anti-fraud corporate culture. Fostering a ‘no tolerance for fraud’ culture, heightening transparency within the organisation and setting an appropriate tone at the top have all contributed here.

**Outlook**

With over half of all respondents expressing the belief that they will not be victims of economic crime over the next two years, there is clearly considerable confidence among Switzerland’s business that the criminal threats facing their organisations are under relatively good control. As in 2011, cybercrime is clearly perceived as the most threatening menace, with 4 in 10 respondents expecting to experience some form of attack over the next 24 months (Figure 1). Though significantly harder to commit successfully, cybercrime is thus now regarded as a greater threat than simple asset misappropriation, the archetypal economic crime.

**About the Swiss and global surveys**
PwC’s 2014 Global Economic Crime Survey was completed by 5,128 respondents in 95 countries (3,877 in 78 countries in 2011). The survey covered the last 24 months. 83 Swiss organisations responded, of which 42% were listed companies. Over 50% of Swiss respondents were board members or senior executives.

Key findings for Switzerland:

- Economic crime is growing. 37% of respondents had suffered economic crime in the last 24 months, versus 18% in the last 12 months in 2011.
- 71% of incidents were detected by corporate controls and anti-fraud corporate-culture mechanisms.
- 26% of fraud-affected respondents had suffered cybercrime (the no. 2 crime, after asset misappropriation at 65%).
- Only 3% of fraud-affected respondents reported incidents of bribery and corruption, though 37% of all respondents saw this as the largest risk of doing business globally.
- The typical internal fraudster is male (in 76% of cases), aged 41-50 (47%) and has been with the organisation for at least 6 years (48%).
- Respondents are getting tougher on fraudulent staff, dismissing them in 82% of cases (60% in 2011) and taking civil action in 59% of cases (30% in 2011).
Figure 1: Perception of future likelihood of economic crime

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In the spotlight: risk management

The role of compliance in risk management at banks

The compliance function in the financial sector is changing radically as a raft of drastic new regulations are added to the rulebook. Originally designed primarily to assure minimum statutory requirements, compliance rules have become a key focus of the comprehensive risk management set-up at financial services companies.

The benchmark for banking compliance is a lot higher than it was five years ago. Many new rules have been introduced. The extensive new legal requirements that have to be met pose a particular challenge for financial services companies that operate internationally. For one thing, the regulations aren’t always coordinated from one country to the next. Not only that, but international banks work with clients who for their part also do business across borders, and likewise often have to deal with an uncoordinated array of rules and regulations. Another complicating factor is the way that reporting in the media and on internet platforms has dramatically increased transparency: infringements of the law and other official requirements come to light much more quickly than they used to, and reach a significantly broader and more international audience.

But it’s not just the breadth of the rules that’s making compliance more complex. The unprecedented depth and detail of regulation are also a growing challenge for financial services companies. In the course of adapting to new rules, banks are having to produce many more documents, conduct many more tests, and furnish much more proof than they did even only a few years ago. Various studies confirm the trend: most financial services companies anticipate a massive increase in the costs of compliance.

On the other hand, the benefits of compliance are also much greater than they used to be. The fines imposed by regulators these days are particularly stiff in the banking sector. This means that companies have to make substantial provisions for legal risks, which in turn increases the burden of responsibility on the compliance function. A bank that’s able to position itself well in terms of compliance and make this positioning visible to investors can positively influence the way the value of the business develops.
Danger of red tape

Financial services companies have gone to a lot of effort in recent years to ensure prompt compliance with the new regulatory requirements. In some cases they have been forced to do so. Many have responded by rapidly hiring new compliance staff and creating special departments to address areas such as financial crime, tax treaties (including FATCA, the Foreign Account Tax Compliance Act) and regulatory compliance. At the same time there’s been a huge increase in the volumes of data and the number of documents and reports involved. Banks have reached the point where it’s important to critically assess the set-up in its entirety. In many cases, departments have been created at short notice without being given a clear structure or priorities, often leading to overlaps and duplications of effort. Compliance has a beneficial effect. But if regulation continues down the same path, it could lead to bureaucratisation and get in the way of doing business.

To counter this threat, those responsible should take a step back and try to understand how the compliance function is embedded in the logic of so-called lines of defence. (See the article Coordinated control: the ‘four lines of defence’ model). There’s particular scope for leveraging improvement in the so-called second line functions. It’s worth analysing these functions thoroughly to see exactly how tasks should be demarcated and how issues within the second line of defence are to be handled.

Risk-based approach and risk culture

Rearranging the functions within the second line of defence requires a cross-disciplinary project. It has to be cross-disciplinary because the aim is to avoid seeing things in isolated terms. The idea is to lay down and coordinate areas of responsibility for the other second line functions while at the same time clearly demarcating the first and third line functions. It’s crucial to make sure these arrangements are embedded in an end-to-end risk culture and a clear understanding of who’s responsible for what risks. This is particularly important for issues that are ‘outsourced’ from the first line of defence to the compliance function, for example issues around knowing your customer.

Another important feature of the new set-up is that compliance processes also have to be risk-based. This means that while making sure that all the relevant requirements are met, you automate recurring, less risky issues as far as possible so that you can focus on areas that are really important, i.e. truly risky. Structuring the compliance function along risk-based lines and reporting accordingly gives management...
important new input enabling risks to be managed and controlled more effectively.

**New skills to tackle new issues**

This more challenging compliance environment also means that staff have to have new skills and competences. Compliance needs people with an eye for the risks and the economic context who really understand the banking business. They must also have a good understanding of how to harness information technology.

On the other hand there’s also a growing call for specialists. In the near future, for example, taxes, and sanctions stemming from increased regulation, will become even more important issues. Social networks will continue to require a great deal of attention as well. While the digital world certainly doesn’t make compliance management any easier, it’s also possible to use the internet to get to know and understand potential customers, suppliers and other interesting stakeholders better.

Alongside a wide variety of specialist knowledge, this especially requires people with the skills and experience to bring things together and present them in the form of consistent reporting. It’s particularly important for the compliance function to have people of high seniority who can talk to people in the business on equal terms and enjoy a degree of acceptance that enables them to ask questions about problem areas.

**Dr Peter Gassmann**

Dr Peter Gassmann studied physics, gaining his PhD from RWTH Aachen. He began his career in 1997 in investment banking at Dresdner Kleinwort in London, before moving to Booz & Company as principal in financial services in 2002. Following that he spent six years at Dresdner Bank and Commerzbank as divisional board member responsible for key areas of risk management. In 2010 he returned to Booz & Company as Global and European Practice Leader, Financial Services. Peter Gassmann’s role is to help banks and insurance companies develop and refine a holistic risk and capital management system, with a particular focus on the changing regulatory framework. Booz & Company merged with PwC at the end of March 2014, and since then has operated under the name of Strategy& as a strategy consultancy within the global PwC network.

We’re at your service!

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Summary

Banks seem to be finding it a great challenge at the moment to comply with the many new rules and regulations. This is mainly due to the sheer number of requirements and the fact that rules are often not coordinated across borders. Given the way the financial crisis has undermined trust in the banks, this is unlikely to change any time soon. Deep distrust in the financial services industry has led to calls for comprehensive controls and compulsory written documentation across the board.

But at the same time, tighter regulation is also an opportunity for banks to consolidate and create an adequate set-up, in the hope that risk-based compliance management and highly specialised and experienced staff will enable the contribution to value to be documented and thus help rebuild trust.

This process of consolidation, and getting the set-up right, only works if compliance is embedded in an overarching ‘lines of defence’ logic. Banks have to get a clear picture of how compliance, a second line function, interacts with the other functions, and how duplications can be avoided. If this process of optimisation doesn’t take place, compliance will end up expending a lot of time and effort for very little insight. This is a shame, because the whole reason compliance has become so important in the first place is because of a massive increase in the potential costs and implications of breaching the regulations.
In the spotlight: risk management

Risk management: a comparison by sector

Under the lead of Dr Daniel Suter, head of the Disclose editorial team, experienced PwC partners discuss the current issues and strategies in the context of risk management in various industries. Immy Pandor describes the situation in the insurance business, Bruno Rossi relates the position in the pharmaceutical industry, and Travis Randolph explains how commodity traders are dealing with the risks.

Your work as auditors and advisors gives you deep insights into risk management practices across a variety of sectors. What are your key observations?

Immy Pandor: The most progressive companies in the insurance industry have very sophisticated risk management frameworks in place. The reason for this is simple: actively assuming risk is at the very core of what insurance is about. Insurance companies’ business involves assessing a vast spectrum of risks, both financial and non-financial, packaging them, putting a price on them, and then assuming them on their balance sheets to take the uncertainty away from their clients. In this regard, unlike many other sectors, insurance firms actively seek risk. The risks assumed by insurers vary tremendously, and include events as diverse as traditional life insurance where the insured’s dependents of the insured receive a lump sum in the event of death, to earthquake, windstorm and other natural disaster cover for buildings, power stations and other physical assets. Even government agencies take out insurance so that they have funds available to pay compensation in the event of major damages resulting from, say, the cancellation of a major sporting event such as the Olympics. Insurers also assume significant financial market risks through their savings products and the investment strategies they select. It really is a very wide spectrum of risks.

Bruno Rossi: The pharmaceutical industry faces a whole bunch of risks. These include strategic, operational and financial risks, but also risks related to compliance and reputation. The biggest risk in the pharmaceutical sector is undoubtedly the uncertainty related to the enormous investments involved in developing new drugs. When companies make basic decisions on whether to go ahead, it’s always uncertain whether their research and development efforts will result in commercially successful products.

«Businesses need a certain degree of freedom to grow and develop. Risk shouldn’t get in the way of daily business, and the costs involved in risk management should be in proportion to the relative risk situation.»

Dr Daniel Suter
Partner, Assurance
Travis Randolph: The risks in commodity trading are diverse: business partners failing to comply with contractual agreements; payments that aren’t made correctly; operational risks associated with the transport of goods; or reputational risks. The core risks of commodity trading are market and price risks. Traders try to hedge these risks with all kinds of instruments. This isn’t always possible, and not always desirable, for example when traders are betting on long-term developments. Recently, new risks have come under discussion. With governments and non-governmental organisations calling for more transparency in terms of how traders conduct their business, commodity trading firms expect to be inundated with a wave of new regulation.

Daniel Suter: Reputational risks also pose a particular threat in the retail sector. For example revelations that products aren’t made with the declared ingredients unleash a storm of indignation. After incidents of this type it’s always a long time before customer trust is rebuilt and the brand has recovered from the damage. The main risks in the manufacturing industry are regulatory. Companies have to take great care to ensure they’re manufacturing their products in accordance with local regulations and behaving properly in terms of fair trade, for example. For their part, chemicals manufacturers invest huge amounts in development that may never by recouped through sales of marketable products.

Have the industries you work with developed specific methods and practices for dealing with risks?

Immy Pandor: Risk management is at the core of insurance companies’ daily business. And that applies at all levels, from the CEO, who has to ensure that the risks of the business as a whole are covered, to the underwriters, who have to correctly assess and price the risks to be assumed. As mentioned before, the most advanced insurers have very sophisticated tools to enable them to manage risk. This typically starts with clearly articulating risk appetite – in other words the maximum amount of capital they’re able to put at risk without overstretched the company’s financial resources. It also involves being very clear about what risks they feel they have the specialist skills and capabilities to price and manage. Their risk management framework comprises a comprehensive suite of tools, including instruments that help the company to quantify the amount of risk it’s taken on, manage the accumulation of risk, ensure that risk is optimally diversified, and make sure that day-to-day operational risk is managed effectively and cost efficiently.

Bruno Rossi: Many drug manufacturers take a highly systematic approach to their complex risk situation. This begins with compiling a
comprehensive risk inventory, followed by an assessment and evaluation of the impact and likelihood of specific risks, leading to a structured and detailed programme to address these risks. All drug companies pay particular attention to the legal requirements applying to the processes used to manufacture their products. This industry has some of the most stringent – if not the most stringent – rules governing manufacturing processes. If a pharmaceutical company violates the rules it can lose its manufacturing licence, and if violations go public its reputation will be damaged. This is why manufacturing licences are so highly regulated. Added to this is the risk that consumers will claim damages resulting from the use of a product. Another notable risk for the pharmaceutical industry is the animal experiments conducted in the context of research and development, which are not accepted by large sections of the population, including the industry’s own stakeholders.

Travis Randolph: Every trader has to be a risk manager and use a variety of tools and processes for managing risk, depending on the maturity of the organisation. The more experienced the trader, the better they’ll be able to handle the risks and master the relevant hedging instruments. Commodity traders are also seeing the emergence of new challenges. Larger commodity trading companies in particular are now extending their activities to cover the entire value chain involved in raw material extraction and processing. Oil traders, for example, are acquiring refineries or operating filling stations. Trading companies may not be ready for such new management challenges and the associated risks. This makes risk management for trading firms expanding into new business areas much more difficult overall.

Daniel Suter: So it seems that while the relevant risks are similar in all sectors, the approach to risk management varies from company to company. Here PwC’s Assurance Framework can help by categorising risks, listing different ways of managing them, and drawing up a systematic plan containing adequate measures arranged in four lines of defence (originally the concept only contained three lines of defence). The first line of defence takes the form of the business, line management and internal controls; the second line consists of risk management, compliance and other such functions; the third line is internal audit; and the fourth line comprises external functions such as the auditors. Any company can use PwC’s framework to define its own relevant risks, determine the most appropriate methods, and develop an adequate assurance system.

What kind of resources are companies in your fields investing in risk management? In other words, how many employees deal specifically with risk management?
Immy Pandor: The typical second line, in other words the functions within an insurance company whose sole responsibility is to oversee and monitor the firm’s risk-taking activities, comprises the risk management and compliance functions, often assisted by the third line of defence, the internal audit team. These, together with the business, the first line of defence, all play a very active role in managing risk. The more complex the business model, and the wider its product suite and geographical coverage, the greater the level of resources the company will invest in formal risk management, i.e. the second and third lines of defence. Added to these functional resources are risks that are managed by way of the insurance company’s governance structure. The board of directors, the executive and the audit committee are increasingly requiring oversight. The board will delegate specific risk management responsibilities to a risk and compliance committee, an operational risk management committee, and maybe even an asset and liability or capital management committee. So all in all, a very significant proportion of an insurance company’s resources are typically dedicated to risk management.

Bruno Rossi: Risk management in the pharmaceutical industry has top priority at board and senior management level. Boards often have their own risk committee focusing on the key challenges. Whereas risks related to financial reporting will to a large extent be evenly distributed over the group as a whole, there are other risks specific to individual business units or geographic regions. Given that the pharmaceutical industry’s customers are often governmental institutions, there is often the risk of bribery and corruption in dealings with them. One of the keys here is the market access model adopted by the company and the economic incentives it gives to sales representatives in the various countries. In emerging markets such as Africa there’s also the risk that products might not be reaching patients owing to inadequate distribution channels. The launch of a new product in a specific country hinges on your ability to get a marketing licence in time, make the product available at the right place, and have an effective strategy in place to gain market share. These risks are different than for products at the end of the life cycle that are facing pricing pressure and generic competition.

Travis Randolph: Every commodity trading company has its own individual risk management concept. The larger global firms usually have a separate risk management department, while small firms and niche traders may combine the risk management function with other roles within the organisation. In response to growing reputational risks and fears of regulation, many traders are creating management functions that are relatively new to the industry. Until a few years ago, for example, commodity trading companies had no specific compliance,
Daniel Suter: Besides the resources deployed for risk management, you also have to take the numerous monitoring and control activities into account. Added to this, the external and internal auditors, and internal controls, also play a part in risk management because of their role in reviewing processes and decisionmaking.

**How would you quantify the risk appetite of the industries you work with closely?**

Immy Pandor: It’s a fact that mature insurance companies apply quantitative methods on a systematic basis. They first define how much and what type of risk they’re willing to take. Then they assign the most ‘desirable’ risks to specific geographic units, business areas and perhaps even customer groups. The amount of risk that management is willing to take will depend not least on how well the company is capitalised.

Bruno Rossi: The pharmaceutical industry is basically risk-averse. The main question is always when and how much to invest in a specific compound or molecule so that you have a successful product several years down the line. Since this in itself is a very risky process, in general management aims to actively mitigate any risks related to production and reputation in the hope of avoiding them as far as possible.

Travis Randolph: In day-to-day business most traders rely on straightforward calculations of value and risk to decide what transactions to take on. Depending on the complexity of the issue and the judgement of the people involved, additional tools such as scenario analyses and stress tests may also be used.

Daniel Suter: Another example is a company in the electricity industry that systematically quantifies risks before deciding whether to take them. But quantitative methods of this type aren’t widespread.

**Are Swiss companies well or badly equipped to meet future risks?**

Immy Pandor: Insurance companies are well aware of their responsibilities. They meticulously prepare themselves to meet the expectations of shareholders, rating agencies and customers. The biggest challenge for the insurance industry will be to handle the rapid and extensive changes taking place on the regulatory front. And European insurance companies will have to cope with a high level of strategic risk in the future. They operate in mature markets, where growth is limited and competition high. To deliver growth, European
insurers will have to innovate and expand into emerging markets. This will entail considerable strategic risk, and even where they opt for the right strategy, implementing it will still involve risks.

**Bruno Rossi:** The pharmaceutical industry is well positioned to face the current risks. The question remains whether relatively new risks such as information governance and data security and cybercrime, which affect many other industries as well as pharma, are adequately mitigated and managed. You also have to remember that global pharmaceutical companies operate in regulated, often country-specific environments that evolve quickly. Therein lies one of the greatest risks: management has to respond to regional developments in good time and rapidly implement the necessary measures.

**Travis Randolph:** Commodity traders who stick to their core trading business are well positioned in terms of risk management. They have highly focused (often informal) internal controls and monitoring functions in place. But integrated trading companies that are expanding into new business models by extending their value chain may need to reassess their approach to risk management.

**Daniel Suter:** All the industries discussed – in fact probably all industries – have a substantial interest in managing risk. A company’s risk appetite is a function of its strategy, its ability to bear risk (especially in a financial sense), the know-how within its industry, the company’s business model, and the system it uses to manage and oversee risk on a routine basis. At the same time businesses need a certain degree of freedom to grow and develop. Risk shouldn’t get in the way of daily business, and the costs involved in risk management should be in proportion to the relative risk situation.

In today’s rapidly changing world, companies have to keep asking the same question: how do we go about managing the risks of change?
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Update

New regulations for notes to the financial statements

The new Accounting Law specifies new and more stringent requirements for the notes to the financial statements. Below, we outline the key aspects of the new reporting provisions.

The new Accounting Law has been in force since 1 January 2013. It applies to financial statements for financial years beginning 1 January 2015, at the latest, and to consolidated financial statements for financial years beginning 1 January 2016, at the latest. The following paragraph gives an overview of the main features of the new law. For the preparers of financial statements, the new provisions raise questions concerning valuation and presentation. These include, for example, the valuation of investments and real estate at both group level and individual entity level, the disclosure of an undertaking’s own shares and the treatment of leasing contracts. In addition, there are important changes affecting the notes to the financial statements. In the following, we describe some of the key points in more detail.

The main features of the new Accounting Law

- Financial reporting now depends on the size of the company – not its legal form.
- Financial statements can be presented in Swiss francs or in the functional currency of the company.
- Financial statements shall be prepared according to detailed minimum structure requirements.
- Tax assessments are still based on annual financial statements compiled in accordance with the Swiss Code of Obligations.
- Hidden reserves are still permissible.
- Large companies must also prepare a cash flow statement and a management report, with additional information in the notes to the financial statements.
- The protection of minority shareholdings has been extended: significant minorities are now entitled to request additional financial information (e.g. financial statements prepared according to a recognised standard).
- Consolidated financial statements are now subject to the principle of ‘control’, not the principle of ‘management’.
- Consolidated financial statements based on book values are still
The new reporting provisions at a glance

The previous regulations for the notes to financial statements according to the Company Law were limited primarily to the disclosure of quantitative information. However, the new Accounting Law, in article 959c CO (Figure 1), not only calls for more extensive quantitative reporting but also for additional qualitative information and explanations of the figures and matters of judgement in the financial statements. This should support the real purpose of financial reporting, according to article 958 CO, which is to present the economic position of an undertaking in the financial statements in such a manner that third parties can make a reliable assessment of them.

With regard to financial reporting, article 959c CO sets out in four paragraphs the minimum information to be provided in the notes to the financial statements of a commercial undertaking. The key amendments for most companies are in the first two paragraphs.

**Paragraph 1: General guidelines**

Article 959c para. 1 CO stipulates that the notes to the financial statements must now disclose the accounting principles applied where these are not specified by law. Information, breakdowns and explanations relating to items on the balance sheet and the income statement must also be disclosed. The law does not prescribe how detailed these should be. In light of the aforementioned purpose of financial reporting, however, it is appropriate to provide quantitative details for significant financial statement items, such as tangible assets or reserves, in the form of tables or schedules. This information can be supplemented with qualitative explanations of specific aspects of the financial statements in question. This should help create more transparency in financial reporting in accordance with the Swiss Code of Obligations – despite the fact that the admissibility of hidden reserves remains unchanged.

According to article 959c para. 1.3 CO, changes to hidden reserves must be disclosed if net, they result in a material release resulting in an improvement to the net result for the period. This provision was already part of the existing Company Law, but it now applies to all undertakings subject to the Accounting Law.

Article 959c para. 1.4 stipulates the disclosure of additional information required by law. Figure 2 shows some examples.
Paragraph 2: Detailed disclosure requirements

Among the new provisions of the fourteen numbered items of article 959c, para. 2 CO concerning specific information to be disclosed in the notes, the items 1 to 3 as well as 10 to 13 are worth mentioning.

Figure 1: Article 959c CO

C. Notes to the financial statements

1. The notes to the financial statements complement and clarify other components of the financial statements. They contain:
   1. details of the principles applied in the financial statements where these are not specified by law;
   2. information, breakdowns and explanations relating to items on the balance sheet and income statement;
   3. the total amount of replacement reserves used together with changes in hidden reserves where net, if there is a material release of reserves resulting in an improvement to the net result for the period;
   4. further information required by law.

2. The notes to the financial statements must also contain the following information, unless it is already apparent from the balance sheet or the income statement:
   1. business name or name of the undertaking, legal form and registered office;
      This provision concerns new information needed to identify the financial statements and the applicable accounting principles.
   2. declaration as to whether the average number of full-time employees per year exceeds 10, 50 or 250;
   3. business name, legal form and registered office of companies in which there are direct or significant indirect shareholdings, indicating the share of the capital and votes held;
      Disclosure is now required of all direct shareholdings and all substantial indirect shareholdings.
   4. number of own shares held by the company itself and by the companies in which it has shareholdings;
   5. acquisitions and sales of own shares and the terms on which they were acquired or sold;
   6. residual amount of liabilities from sale-like leasing transactions and other leasing obligations, unless these expire or may be terminated within twelve months of the balance sheet date;
   7. liabilities due to pension funds;
   8. the total amount of collateral for third-party liabilities;
   9. the total amount each of assets used to secure own liabilities and of assets subject to a retention of title clause;
10. legal or actual liabilities where a cash outflow either appears unlikely or cannot be reliably estimated (contingent liability);

Contingent liabilities must be disclosed, too. For the users of the financial statements to make a reliable assessment of contingent liabilities requires information on the background of the legal or actual obligations and the underlying reasons why a cash outflow either appears unlikely or cannot be reliably estimated, and why it was not necessary or possible to create a provision. To aid understanding, this information is broken down by the type of contingent liability, for example, ‘warranty risks’, ‘other litigation’, ‘transactions with affiliated companies’ or ‘potential contract penalties’.

11. number and value of shares or options on shares held by management or administrative bodies and by employees;

Disclosure is required of the number and value of shares or options on shares held by management or administrative bodies and by employees, that were allocated during the reporting year. The law does not specify how to determine the value of the shares. A useful basis for such valuations may be the share price, tax authority guidelines or actuarial calculations.

12. explanations of exceptional, non-recurring or prior-period items in the income statement;

The new Accounting Law requires that exceptional, non-recurring or prior-period expense or income (‘extraordinary items’) are disclosed separately in the income statement and explained in the notes. There is no overall definition of what constitutes an ‘extraordinary item’. Hence, the preparer of the financial statements first has to define what is included under this term and then provide clear explanations of these items in the notes.

13. significant events occurring after balance sheet date;

Lastly, another new disclosure requirement concerns significant events occurring after the balance sheet date. The law does not detail what must be disclosed under this term. Accounting practice differentiates two kinds of event:

- Accountable events: originating prior to the balance sheet date.
- Disclosable events: originating after the balance sheet date.

The preparer of the financial statements must consider which disclosable events are ‘significant’ (positive or negative); what are the financial implications; and what has to be included in the notes to the financial statements. We recommend stating in the notes the date on which the financial statements were officially approved to give a clear indication of the period during which events occurring after the balance sheet date were considered.

14. in the event of the premature withdrawal of the auditor: the reasons for this.

3 Sole proprietorships and partnerships may dispense with notes to the financial statements if they are not required to file financial statements in accordance with the provisions for larger companies. In the absence of notes to the financial statements, any additional information according to the minimum structure requirements for the balance sheet and income statement must be disclosed directly in the balance sheet or in the income statement.
4 Companies with outstanding bonds must provide details of their amounts, interest rates, maturities and other conditions.

**Figure 2: Examples of further information required by law**

- Deviations from the going-concern assumption (article 958a para. 3 CO)
- Conversion rates used for accounting in foreign currencies (article 958d para. 3 CO)
- Other balance sheet items, if this is essential for the assessment of the asset or financing situation or it is customary as a result of the company’s activity (article 959a para. 3 CO)
- Receivables from and payables to related parties (article 959a para. 4 CO)
- Personnel expenses, depreciation and amortisation in the income statement (article 959b para. 4 CO)
- Other income statement items (article 959b para. 5 CO)
- Information on bonds or warrants (article 959c para. 4 CO)
- Notes on the valuation of the share price or the observable market price (article 960b para. 1 CO) and disclosure of the total value of the corresponding securities and other assets
- Amount of the fluctuation reserve for the valuation of the share price or the observable market price (article 960b para. 2 CO)
- Significant shareholdings and the conversion and option rights held by members of the company’s governing bodies (article 663c CO)
- Information on revaluation items and amounts (article 670 and 671b CO)
- Disclosures pursuant to special laws (e.g. Mergers Act)

Source: Swiss Audit Manual, Volume: Accounting and financial reporting, p. 279

**Summary**

You, as a preparer of the financial statements, must disclose additional information in accordance with the new Accounting Law. This includes not only purely quantitative data, but also more qualitative information on the financial statements, such as explanations of ‘extraordinary items’ or matters of judgement. This additional transparency should enable the readers of the financial statements to make a reliable assessment of the economic situation of the company. We recommend you familiarise yourself with the new disclosure requirements in good time to ensure you provide the required information for meaningful notes to the financial statements.
COSO for non-financial reporting: more transparency, more trust

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) publishes the internationally recognised standard for internal control systems over financial reporting. The COSO Framework can also make a lasting improvement to the trust of users in non-financial reporting.

The COSO Framework

COSO’s principal objective is to improve the quality of financial reporting by promoting good corporate governance, ethical conduct and effective internal controls. Since its publication by COSO in 1992, the ‘Internal Control – Integrated Framework’ has become the de facto global standard. Now, following a revision in 2013, it can be applied to areas beyond the traditional scope of financial reporting.

Such non-financial reporting includes operational aspects, such as corporate responsibility. Increasingly, companies are being evaluated (and they measure themselves) in terms of how successfully they pursue the goals of sustainable development. To this end, they prepare information on their social, economic, tax and environmental impact, which they make available to interested stakeholders.

The COSO Framework provides a comprehensive basis for a company to develop and implement an internal control system relating to non-financial reporting. They can also use the COSO Framework to extend and improve existing operational controls. In this way, companies can meet internal and external stakeholders’ demands for better quality non-financial reporting.
Applying COSO to non-financial reporting

The COSO Framework comprises seventeen principles divided into five main groups:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring activities

The application of these principles in non-financial reporting can be a major challenge in practice. We illustrate this in the following by taking the example of corporate responsibility reporting.

Control environment
The control environment forms the basis of a comprehensive internal control system. Among other things, it establishes the ‘tone at the top’, influencing awareness of the controls and, thus, intrinsic factors such as
ethical values, integrity or the competences of employees involved in reporting. How the board of directors and the executive management design the internal control system has a significant impact on the definition and implementation of the system.

In our experience, the board and senior management don’t support non-financial reporting sufficiently – if at all. Accordingly, the existing framework for the reporting of corporate responsibility indicators is inadequate; the organisation, processes and controls aren’t as mature as those for financial reporting. Frequently, employees lack incentives, meaning that the quality of the reported information suffers.

**Risk assessment**
According to COSO, a company should set up a systematic and continuous process to identify, analyse and evaluate its key risks relating to non-financial reporting, just as it does for its financial reporting.

In practice, however, risk assessment and risk management in the area of corporate responsibility usually isn’t part of the company-wide processes. Consequently, it is either very informal or it doesn’t exist at all. In addition, experience shows that the employees responsible have little or no direct involvement in risk assessment and risk management. Furthermore, they have only limited awareness of the risks associated with corporate responsibility reporting. Such risks are usually difficult to identify and assess. Their direct financial impact is limited because often it’s a question of reputational risks.

**Control activities**
According to COSO, a company has to define and implement processes and internal controls, perform them consistently and document them. In this way, it can ensure it achieves the operational objectives of its controls and manage the key risks identified by the risk assessment.

Experience shows, however, that processes and controls aren’t executed consistently. This is because the board and senior management don’t issue mandatory requirements and there is no systematic identification of the risks relating to corporate responsibility reporting. For example, a manufacturing company’s technicians may be unaware of the need to report local water consumption data correctly and completely. Failure to do so can directly affect the accuracy of non-financial reporting. Moreover, reliance on people rather than system-based processes and controls means that the quality of the recorded data varies depending on the individual employee.

**Information and communication**

«Your company needs to pay just as much attention to non-financial reporting as to financial reporting. The COSO Framework provides you with a practical tool to help you do so.»
Non-financial reporting enables a company to support its business decisions and provide internal and external stakeholders with important information. But this assumes the relevant information is complete, accurate and communicated in a timely manner to the people responsible.

In our experience, the informal processes in the area of corporate responsibility often can’t assure adequate communication and the employees involved don’t grasp completely the extent of their work. The technicians mentioned above, for instance, are usually unaware of their key role within the internal control system. They may consider collecting data as just an extra burden, which might have a negative effect on the quality of the data they provide.

**Monitoring activities**
A company should regularly monitor its internal control system to ensure that all processes and controls are operating effectively. The line organisation, internal audit or an external auditor could manage this assurance activity.

Unlike financial reporting, non-financial reporting – such as in the area of corporate responsibility – is often neglected. The managers responsible often fail adequately to address the control activities and internal audit usually treats the subject selectively. Furthermore, in the absence of legal and regulatory requirements, a company is not obligated to perform regular reviews of the effectiveness of its non-financial reporting.

**Using non-financial information as an advantage**

Non-financial reporting is growing ever more important. Stakeholders no longer make investment decisions solely based on financial information. Increasingly, their decisions also take into account a company’s commitment to sustainable development. Accordingly, your company needs to pay just as much attention to non-financial reporting as to financial reporting. The COSO Framework is an internationally recognised standard that provides you with a practical tool to help you do so.
The new standard for recognising revenue might change the way revenue is accounted for. IFRS preparers should assess their transactions with customers to identify the extent to which they are impacted by the new standard.

Earlier this year IFRS 15 Revenue from Contracts with Customers, the new standard for revenue recognition, was published. The guidance has now converged with US GAAP, for which an identical standard was issued simultaneously. IFRS 15 replaces the previous revenue standards IAS 18 Revenue and IAS 11 Construction Contracts, as well as the related IFRIC interpretations. The application date of 1 January 2017 might seem a long way away, but the standard could have implications that go far beyond accounting. We observe that preparers have started actively assessing the impact of the new standard, with a view to having their assessment completed by the end of this year.

Five-step approach: the idea behind it

Revenue is a very important metric in financial statements; many users seem to focus more on revenue than on any other item in the financial statements. Any changes to the revenue line may therefore be crucial. The basic approach taken by IFRS 15 is in fact quite simple: an entity earns revenue from providing a good or service to the customer. The basis for revenue recognition is a contract with a customer in which the entity and the customer agree to the exchange of goods or services for payment. Revenue is recognised once the entity has transferred control of the promised goods or services to the customer. This is different from the current guidance in IAS 18, which looks at the transfer of risks and rewards. This shift might lead to different timing for revenue recognition; for example revenue for certain licences might now be recognised over time rather than at a point in time.

The standard describes a five-step approach to recognising revenue.
Step 1: Identify the contract with the customer
This first step might look straightforward. However, contracts come in different forms, and they do not necessarily need to be in writing. There are also situations where several contracts need to be combined for the purpose of applying the revenue recognition model. Step 1 is the entry point into the new revenue model. ‘Revenue’ can only be recognised for contracts which meet the criteria set out in the standard. One important criterion is that it needs to be probable that the seller will be able to collect the consideration to which it is entitled.

Step 2: Identify the performance obligations in the contract
Performance obligations are really the building blocks of the new revenue model. Each distinct good or service that an entity promises to transfer to its customer is a performance obligation. When there are multiple promises in a contract, an entity needs to determine which goods or services are distinct and thus separate performance obligations. These can include promises that are implicit in a contract or those arising from customary business practices.

Step 3: Determine the transaction price
In many cases determining the transaction price will be a simple exercise. However, complexities can arise when a contract includes variable consideration or a significant financing component.

Step 4: Allocate the transaction price to the performance obligations
When a contract is for the delivery of more than one distinct good or service, the transaction price needs to be allocated to each separate performance obligation to recognise the right amount of revenue at the right time. The allocation is based on relative standalone selling prices. If these are not directly observable, an estimate will be required.

Step 5: Recognise revenue when/as the entity satisfies a performance obligation
Revenue is recognised when the customer obtains control of a good or service.

Figure 1: The five-step approach

1. Identify the contract
   Revenue may only be recognised from contracts which meet the specific criteria in IFRS 15.

2. Identify performance obligations
   Goods or services promised to the customer are separate performance obligations if they are distinct.

3. Determine transaction price
   IFRS 15 introduces a new model for recognising variable consideration.

4. Allocate transaction price
   The transaction price is allocated to the performance obligations based on relative stand-alone selling prices.

5. Recognise revenue
   Revenue is recognised when (or as) a performance obligation is satisfied.
service. The standard describes two models for the transfer of control – over time or at a point in time – which result in recognition of revenue over time (as is presently the case for services and PoC [percentage of completion] type contracts) and at a point in time (as is presently the case for sale of goods).

What changes do we expect?

The impact of IFRS 15 will vary significantly for different preparers. Companies with large numbers of diverse customer contracts, those offering bundled products and services, providing rebates, or companies which have contracts with variable consideration, are more likely to see changes to their revenue recognition. One of the industries most heavily affected is telecommunications, as contracts with customers frequently cover a bundle of goods and services such as the sale of a mobile phone together with a network subscription for a certain period. More revenue will likely be recognised up front for such contracts under the new standard than is the case at present.

Percentage of completion method
An area where we are likely to see changes compared to the current guidance is accounting for PoC type contracts. IFRS 15 allows for revenue to be recognised over time only if control over the goods or services is transferred to the customer over time. The standard lists three specific criteria (IFRS 15.35) against which performance over time is assessed.

This requirement is not automatically met for every arrangement to which PoC accounting is applied today. Under IAS 11, the current standard for construction contracts, it was sufficient to meet the fairly loose definition of a ‘construction contract’ to be in a position to apply the PoC method and achieve revenue recognition over time. Preparers will have to carefully consider the facts to work out whether revenue recognition over time is still appropriate under the new standard. If none of the above criteria is met, revenue needs to be recognised at a point in time.

Variable consideration
IFRS 15 contains a new concept for recognising revenue when the amount of consideration is variable. Variable consideration is common in many industries; it encompasses price concessions, volume discount, rebates, refunds, credits, incentives, performance bonuses and penalties. The transaction price includes the effect of variable consideration, but only to the extent that it is highly probable that there will not be a significant reversal of revenue once the uncertainty associated with the variable consideration is subsequently resolved.
Judgement will have to be exercised to determine this amount. Estimates of variable consideration are subject to change over time. Management needs to revise its estimates of variable consideration at each reporting date throughout the contract period. This requirement is likely to impact the asset management industry.

**Contract cost**
Another area of change is how costs incurred to obtain a contract are treated. Telecoms, for example, often incur incremental cost when obtaining a contract, such as commissions paid on signing the contract. Such cost must now be capitalised and amortised over the life of the contract (including expected renewals), where previously this would have been recognised in profit or loss immediately.

**Disclosures**
The new standard will also have an impact on disclosures. The previous standards only contained limited disclosure requirements in relation to revenue. Given that revenue is one of the most important line items in a set of financial statements, it should not come as a surprise that the level of disclosures has been increased. Preparers should assess whether they can collect all data required for the disclosures in their existing systems.

**Wider implications**
To determine the level of impact on their business, IFRS preparers will need to consider the changes beyond accounting well in advance of the deadline for adopting the new standard.

**Systems, controls and processes**
A number of important questions will have to be answered when entities are looking at implementing the new standard. Often systems draw revenue numbers directly from the billing system. Due to a shift in allocation of the transaction price to separate performance obligations, revenue recognised might no longer be in line with amounts billed or cash collected. Is the system set up to handle such situations?

Is the system able to track progress in satisfying the promise to the customer at the level of the individual performance obligation?

What processes are in place to ensure compliance with the new guidance on recognising revenue from contracts with variable consideration? Preparers will have to reassess the amount of revenue to be recognised until the uncertainty is resolved.
Will the new standard lead to situations where previously automated processes now require manual intervention?

Contracts
One way of minimising the impact of the new standard would be to rethink how contracts with the customer are structured. Changes to payment terms could, for example, be required in order to fulfil one of the criteria for recognising revenue over time. But companies should bear in mind that the standard looks at the economic substance of contracts – so simply splitting a contract in two might not be good enough to achieve the desired outcome.

Compensation and bonus plans
In many cases, payments of bonuses or commissions are linked to revenue targets. Entities will need to consider how changes in the timing of revenue recognition affect these and other internal arrangements.

Taxes
Any change in the pattern of revenue recognition will also have an impact on taxes. Where the same treatment is applied for statutory accounts, cash tax will be affected. An impact on deferred tax will result in situations where IFRS and statutory revenue numbers start to be different.

Investor relations
Stakeholders will want to know how revenue recognition will change and how the new standard will affect the company’s financial picture. Companies should aim to be in a position to address this early in the lead-up to the new standard.

Transition and next steps
IFRS 15 will be applicable for annual periods beginning on or after 1 January 2017. The standard allows entities to choose from two basic approaches for transition.
The first option is to apply the standard retrospectively. In this scenario, the new standard is already applied to the 2016 comparative period. Entities that choose option 1 can make use of some practical expedients to make transition easier.

The second option is to apply the standard prospectively from 2017. Under this option, the 2016 comparative information will still be prepared under IAS 11/IAS 18, with a cumulative catch-up effect in equity on 1 January 2017. While this option might seem attractive at first sight, entities should be aware that this approach requires disclosure of revenues for 2017, as they would have resulted under the previous standards. In situations where revenue is accelerated under the new standard, this effect on 2016 revenues will never be shown in the income statement. Further, full comparative information will only be available to users of the accounts in the 2018 financial report.

Summary

Entities are advised to start looking closely into the effect of the new revenue standard: it brings changes in a number of areas, sometimes not in the principle of recognition but in the way the principle is applied. The actual impact on each individual preparer can ultimately only be assessed at the level of contracts with customers. Finding the right accounting solution will often be the easiest task. Where there is a need to change systems, controls and processes, this could take considerably more time and effort.
Update

*Swiss GAAP FER firmly in fashion*

Few organisations are actually required to apply recognised accounting standards under the new financial reporting legislation. But even without a legal obligation, the use of Swiss GAAP FER is growing and for many undertakings is an option worth considering.

**The new financial reporting law**

Under the new regulations, large cooperatives and foundations must now apply recognised accounting standards. Furthermore, qualified minorities may require that the entity in which they hold shares produce financial statements in accordance with an accepted accounting standard.

**Large cooperatives and foundations**

The new legislation specifies that cooperatives with at least 2,000 members and foundations that are required by law to do an ordinary audit must prepare their financial statements or consolidated financial statements according to a recognised standard. The Federal Council has issued an ordinance specifying the International Financial Reporting Standards (IFRS as issued by the IASB), IFRS for SMEs, Swiss GAAP FER, US GAAP and IPSAS as the accepted standards. Additionally, banks and securities dealers can apply the ‘Accounting guidelines for banks, securities dealers, financial groups and conglomerates (AGB)’ issued by the Swiss Financial Market Supervisory Authority (FINMA).

The law also extends the obligation to prepare consolidated financial statements to foundations and cooperatives. This means, for example, that corporate foundations have to report on a consolidated basis in accordance with one of the specified standards if they exceed certain size criteria.

Many of the cooperatives and foundations affected by the new requirement are domestic. So it’s not surprising that most of them will be applying Swiss GAAP FER. Not only this, but a large number of non-profit organisations are already using Swiss GAAP FER voluntarily, not least because Swiss GAAP FER 21 provides specific accounting and reporting recommendations for charitable non-profit organisations. It’s also worth noting that charities seeking approval from certification body ZEWO have to produce financial statements in accordance with FER 21.
There are also specific accounting and reporting recommendations in place for other industries (Figure 1). For example, all Swiss pension schemes already have to comply with FER 26 by ordinance, which means they won’t have to do anything differently under the new financial reporting law.

**Figure 1: Industry-specific accounting and reporting recommendations**

<table>
<thead>
<tr>
<th>FER 14</th>
<th>Consolidated financial statements of insurance companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>FER 21</td>
<td>Accounting for charitable, social non-profit organisations</td>
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<td>FER 26</td>
<td>Accounting of pension plans</td>
</tr>
<tr>
<td>FER 41</td>
<td>Accounting for real estate insurers and for health insurers</td>
</tr>
</tbody>
</table>

**A qualified minority can demand recognised accounting standards**

While other organisations still aren’t required to prepare financial statements giving a true and fair view as a matter of course, they may be required to do so by a qualified minority. To invoke this right, the qualified minority must represent at least 20 per cent of the basic capital, 10 per cent of all cooperative members or 20 per cent of all members of an association. The same right is also accorded to any company members or members subject to personal liability or a duty to pay in further capital.

In practice it’s unlikely that many minorities will exercise this right. But given that it can be invoked irrespective of the size of the undertaking, it’s something that in theory could affect the majority of the 400,000 or so organisations subject to the new financial reporting law. This means that even smaller firms could be faced with having to decide which of the accepted accounting standards they should apply. The advantages of Swiss GAAP FER for smaller organisations are obvious. Thanks to its modular structure (Figure 2), small firms only have to apply the framework and six other central recommendations (core FER). This way meaningful accounts can be prepared using a smaller number of highly principles-based recommendations.
Swiss GAAP FER increasingly attractive for listed companies

Given the stock exchange regulations already in place, companies with equities listed on a stock exchange won’t have to take any significant action under the new financial reporting law. Entities listed on the SIX Swiss Exchange are required to use IFRS, US GAAP or Swiss GAAP FER, although Swiss GAAP FER is permitted only for those listed under the Domestic Standard or the Standard for Real Estate Companies.

Companies listed on the SIX Swiss Exchange thus have a choice of different accounting standards. This is in contrast to the European Union, where under EU law all authorised issuers on an EU-regulated stock exchange must apply IFRS. Since 2008, about 40 listed Swiss companies have switched from IFRS to Swiss GAAP FER.

What makes Swiss GAAP FER so attractive? With the IFRS rulebook steadily expanding, the Swiss GAAP FER rules are becoming increasingly attractive in terms of costs and benefits. Using the compact (around 200 pages), principles-based recommendations of Swiss GAAP FER, companies can achieve the same main objective as with over 3,000 pages of detailed IFRS rules: financial statements presenting a true and fair view of their financial position that are accepted both in
Switzerland and (at least by lenders) internationally. There are cases where the rules diverge, in particular when it comes to the recognition of goodwill and pension liabilities. And it’s in these very areas that many companies that have made the switch believe Swiss GAAP FER allows a more realistic presentation of their financial position.

The advantages of voluntary adoption

Even in the future, Swiss GAAP FER will be applied largely on a voluntary basis. A recent survey by the Swiss GAAP FER Commission shows that around 40 per cent of companies subject to consolidation under the new financial reporting law already prepare their consolidated financial statements in accordance with Swiss GAAP FER. This figure demonstrates both the need for true and fair accounting and the attractiveness of Swiss GAAP FER thanks to its focus on small and medium-sized enterprises of national standing.

Before a company chooses its accounting standards it should assess the costs and benefits on an individual basis. With the introduction of the new accounting legislation, most undertakings will need to fulfil slightly stricter requirements under the Code of Obligations. For example, entities will basically have to apply the individual valuation principle, and the disclosure requirements will be extended. Larger organisations will also need to prepare a cash flow statement. But there will be few benefits in return for all this extra effort. The fact that the creation of hidden reserves is still permitted means that financial reports prepared according to the Code of Obligations will continue to have only limited indicative value.

This makes the voluntary adoption of Swiss GAAP FER all the more attractive. Leveraged firms in particular should find it worth considering. But the positive effects of Swiss GAAP FER don’t just apply when it comes to borrowing capital. It can also simplify benchmarking against competitors and facilitate management, control and decision-making within the organisation itself.
Previous issue of Disclose (in German)

Disclose – Juni 2014
Im Fokus: Audit Committees
Update: Hedge Accounting unter IFRS 9; Konzept der Wesentlichkeit; COSO-Update; Revisionsbericht; Umsetzung Minder-Initiative

Disclose – Dezember 2013
Im Fokus: Informationssicherheit
Update: neues Rechnungslegungsrecht; Kosten der Compliance; neuer Leasingstandard; Minder-Initiative

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Update: Wird der Wirtschaftsprüfer zum Whistleblower?; ergänzende Fachempfehlung für kotierte Unternehmen; Schweizer Prüfungsstandards; Integrated Reporting

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Im Fokus: Rechnungslegung
Update: eingeschränkte Revision; Comment Letters; projektbegleitende Prüfung von Grossprojekten

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Im Fokus: Integrated Reporting
Update: Regulierung des Prüfungsmarktes; freiwillige ordentliche Revision; neuer Standard zu Umsatzrealisierung; Datenanalysen

Disclose – Dezember 2011
Im Fokus: Mehrwert der Revision
Update: Management von Fremdwährungsrisiken; neue IFRS zu Konsolidierung und Joint Ventures; Vorsorgepläne nach IAS 19; Strukturreform bei Pensionskassen
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