

Delivering  
**Trust**  
and  
**Quality**



*Isla Lipana & Co.*

A member firm of

PRICEWATERHOUSECOOPERS 



Cover photo: A drop of quality

We chose this cover image because it depicts a proof of quality in the tapping of latex from a rubber tree, a delicate and tedious process. A tree is tapped only upon maturity usually around seven years of age. The bark is periodically cut, taking extra care not to damage the tree, on a 25-30 degree angle from top left to bottom right to create channels where the latex will run to be collected in a cup. Each tapping yields about three-quarters of a cup of latex in a span of three hours.

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# Contents

## Foreword

Effective governance practices <i>by Jerry S. Isla</i>	2
Excellence <i>by Jerry S. Isla</i>	10
The new frontier: Tax risk management <i>by Tammy H. Lipana</i>	12
Diligence and hard work <i>by Tammy H. Lipana</i>	22
A call to action <i>by Judith V. Lopez</i>	24
Integrity <i>by Judith V. Lopez</i>	39
Advisory: An expanded capability <i>by Jose P. Lavares, Jr.</i>	41
Teamwork <i>by Jose P. Lavares, Jr.</i>	46
Reinventing the audit committee <i>by Wilfredo S. Madarang, Jr.</i>	48
Honesty <i>by Wilfredo S. Madarang, Jr.</i>	61

The facts of fraud <i>by Rossana S. Javier</i>	63
Positive thinking <i>by Rossana S. Javier</i>	76
What to expect in corporate workouts <i>by Charlie T. Francisco</i>	78
Consistency and balance <i>by Editha O. Tuason</i>	89
Of ethics and men <i>by Jose S. Tayag, Jr.</i>	91
Accountability <i>by Jose S. Tayag, Jr.</i>	97
Volunteerism <i>by Angelito M. Gabriel</i>	99
Leadership <i>by Jerry S. Isla</i>	106
Are you ready to make the change? <i>by Jerry S. Isla</i>	108
Isla Lipana & Co.	125
Management Committee	127
Partners and Principals	128
Photo credits	133

## Foreword

AS A PROFESSIONAL SERVICES firm, we live by a legacy of values inculcated in us by our predecessors and leaders from the time of our inception up to the present. We have always been guided by a mandate to serve clients in a high trust and quality environment.

We build trust with our integrity, commitment, and relationships. We deliver what we promise and strive to deliver beyond what is expected. We sustain trust with an openness to discuss even a most delicate subject in order to arrive at a fair and responsible conclusion. With trust as a precondition, we work together in harmony with all concerned to produce quality and value—for our clients, our firm and our people.

Trust and quality strengthen our belief that making the numbers will not compensate for taking the risk; for we can never risk the continuity of our business in exchange for short-term gains.

When we were conceptualizing this book, I was looking for the theme that would consolidate our thoughts and processes in a single phrase. We wanted a piece of work that would give our clients and friends an intimate look into our people and how we do things through more than 80 years of our firm's existence.

Rightly so, "Delivering Trust and Quality" was chosen as the title to present the sum total of that legacy that continues to be our guiding light today.

The technical articles in this book articulate the authors' knowledge and thought leadership and capture the essence of their expertise and experience. The subjects are current, have been discussed in other forums, and reflect what clients would need in light of new regulations or requirements in assurance, advisory and taxation. This book also contains short companion pieces lifted from editorials on values written by the partners more than a decade ago for *Staff News*, the now archived newsletter. This rich heritage of values has remained relevant in our work, in our actions and in our decisions.

We hope that as you read this book, you will have a deeper appreciation of who we are; how we do our work; how we report value; how we deal with clients and our publics—and more importantly, how we deliver Trust and Quality.



**Jerry S. Isla**

Chairman and Senior Partner

**Joaquin Cunanan**  
Senior Partner, 1956 to 1970

We dedicate this book in his loving memory.

To him who taught us that:

integrity is the foundation of a good reputation  
values make the house that you build strong  
leadership with a firm hand and a big heart is loved.



# Effective governance practices

for our firm and for our clients



Jerry S. Isla  
Chairman and Senior Partner

**EFFECTIVENESS** begins with good governance. For an accounting firm, it means managing our people, their competencies, the systems and processes in the work environment. It means ensuring that our professionals comply with the high standards set by our global firm and the applicable Philippine professional and governmental regulations.

These lead to good quality reports and information that the public can rely upon and use with confidence for their respective purposes.

Working for client's good governance is really assuring them their continued confidence in the quality of our audit work and in our steadfast commitment to independence and objectivity.

But with the recent corporate reverses that happened worldwide, is good governance still possible? Yes, and the key is restoring public confidence in the system and in the financial information used and relied upon by investors. How do we help restore public confidence? Market players, board of directors, regulators, professional accountants, standard setters and many other stakeholders agree: A stronger, open and effective client-auditor relationship is very important in restoring public confidence.

Our governance principles and practices provide a foundation for our relationship with our clients. They guide our engagement teams in conducting audits of financial statements. We consider as best practice our close coordination with the company's board of directors and its audit committee, and company management, including the internal audit. The relationship between the audit committee and our firm is vital, because we want the audit committee to

effectively represent the interests of the company's shareholders. The audit committee's support enhances our effectiveness.

Our best practices in client relationship include:

- Understanding the audit committee's needs and expectations.
- Clear and transparent communications with the audit committee on technical, professional and regulatory concerns.
- Impartial and objective approaches consistent with generally accepted accounting principles and auditing standards.
- Exercising professional judgment and ethical considerations to do the right things at the right time.
- Implementing and affirming our independence on real or perceived threats.
- Providing information about our quality control practices.
- Selecting appropriate audit personnel.

Integral to our corporate governance are best practices in risk management, categorized into managing the approval process and managing the engagement.

In managing the approval process, we have exhaustive guidelines based on stringent PricewaterhouseCoopers (PwC) global standards on our acceptance and continuance process, independence, conflict of interest, and professional risks.

In our acceptance and continuance process, we conduct careful and detailed inquiry about the prospective client, the owners, management, their governance practices, reliability of their records and documents, financial reporting practices, and independence. Yes, even existing clients are evaluated annually for purposes of the recurring audit engagements.

We have a global on-line network that lists all audit clients worldwide, for whom no other office in the world can be permitted to render prohibited services. The system automatically identifies investments in securities that might impair the auditor's independence, and notifies individuals when to dispose of any investment. Such divestment of stocks applies to all partners and staff, their spouses and dependents. When a major telco became our client, for instance, we had to divest the preferred shares under its subscriber investment plans.

More so, we are required to submit every year a written independence confirmation to ensure that we are, and can be seen to be, objective in all dealings with all audit and attest clients.

Our latest best practice in independence is adherence to the Global Independence Compliance Program (GICP), to which we commit to comply and to implement all independence processes and controls. Part of this commitment is investment in technology that is required to participate in the program and the imposition of sanctions to partners and staff for violations of the independence rules.

As a policy, we do not accept or continue an engagement if there is likely to be a conflict of interest between the firm and the client, or prospective client. We do not allow our partners and staff to accept any directorship, executive appointment, or position of influence, such as an *ex-officio* position, in any client company. Where our independence is impaired, or when there is conflict of interest, we have to decline the engagement, discontinue the client relationship, and therefore forego revenues.

We manage professional risks by ensuring that our client relationships will not assail our professional integrity, such as in the application of generally

accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), or the international financial reporting standards (IFRS). We review for compliance of these standards, full disclosure, transparency and accountability, all clients regardless of size or type of industry.

Another best practice that we have adopted even before corporate governance became a byword is in managing our client engagements. We begin with the organization of our audit engagement team composed of the engagement lead partner and staff with the necessary skills and experiences. For large and sensitive audit engagements, we also require the participation of a client relationship partner, concurring review partner, and the firm's risk management partner. The engagement team draws support from our industry experts and the technical services group.

Even prior to the Securities and Exchange Commission (SEC) ruling on the rotation of partners, we had been rotating our engagement partners every seven years. Now of course, with the new rule, we are rotating them every five years.

At the engagement level, the engagement partner has autonomy over the audit and binds the partnership on the audit report that he or she signs off in the name of the firm. However, if difficult and contentious

accounting or auditing issues that he cannot resolve are encountered, he elevates these to the technical panel, consisting of the engagement partner, the line of service partner, the risk management partner, and the senior partner. They deliberate and together adopt a firm position, which the engagement partner then takes as his own.

As added assurance that audit reports are appropriate and contain reliable information, our technical standards group conducts random pre-issuance reviews on the audit reports. Our global standards further require us to do periodic quality assurance reviews on selected clients, usually every three years. A review team assigned to the Philippines generally consists of PwC partners and senior managers from North America and Asia Pacific.

We regard with strictest confidence all client information, including data security and retention. To reinforce this, we require our partners and staff to submit annually a confidentiality confirmation in respect of client and non-client information.

Good corporate governance is an active process that does not stop with the audited financial statements. It goes far beyond numbers and spans managing people, their competencies, processes,

technology, brand and reputation.

With our corporate governance principles and practices we aspire to engender better understanding and cooperation between our clients and our audit teams—and nurture openness in the relationship. Even so, we know that one size does not fit all, so these principles and practices could accommodate differences that may arise in policies, practices, protocols, needs, and expectations of clients.

Our best practices have weathered the test of time, and have been enshrined in our professional standards. Having adopted these best practices, we are able to successfully serve our clients, and live up to the firm's more than 80 years of service in the Philippines. That these best practices are embodied in the public's clamor for good corporate governance through accountability, transparency, and integrity—that's probably just a bonus.



# Excellence

~ Jerry S. Isla, Chairman and Senior Partner

**IT IS OUR CLIENTELE** that defines the quality of our work and service. We must concentrate on what the clients want and provide the services they seek at the highest level of quality. We can improve our client orientation by:

- Making a conscious effort to take more time to listen to clients—not during 'crunch time' when a decision is due—but during our daily schedule.
- Going beyond listening to advising and acting. Exhibit a true hands-on attitude by doing something about what we learn.

- Communicating our ideas well. Explain in appropriate language what the issues are and how these may be dealt with.
- Leveraging on all our experiences, skills and capabilities. Improve the chances of providing powerful advice, strong results, and enhance our standing with the client.

The real issue in excelling lies in our concern for the delivery of distinguished quality service to our clients. When quality for the customer becomes the bottom line, other things including personal growth or success, will follow.



The new frontier:  
**Tax risk**  
management



Tammy H. Lipana  
Managing Partner, Tax

**RECENT** global developments have made businesses increasingly aware of the importance of risk management. So far, the focus has been mainly on financial reporting and internal control procedures. Some organizations, however, are giving a great deal of attention to tax risk management.

### What is tax risk?

Tax risk means different things to different people. This is not surprising as people have different aptitudes for risk, depending on their personality or their responsibilities within an organization.

Fundamentally, tax risk is the possibility of loss or hazard deriving from tax exposures. Before organizations can assess the type of tax risk they are prepared to assume, they need to understand what the risks are. Only then can an organization clearly establish the criteria against which to decide on the risks it is prepared to assume, the appropriate actions to take, and how the appropriate level of risk may best be managed.

In our view, there are seven broad categories of risks associated with taxes, four that are specific risk areas and three that are broader and more generic.

### Transactional risk

Transactional risk relates to the risks and exposures associated with the application of tax laws, regulations and decisions to specific transactions undertaken by a company.

As transactions become more complex, unusual or less routine, the level of risk generally increases. Similarly, if a company chooses to take a more

aggressive tax position, the risk of challenge from the tax authorities increases.

Probably the most significant transactional risk is tax planning that is not properly implemented. Many tax outcomes are sensitive to the underlying facts. A conclusion that holds for one set of facts may not hold if even a small variation occurs in the implementation.

The questions companies should ask are:

- How much risk is the company prepared to assume when planning a transaction?
- If the transaction is complex, how critical is it that the implementation be done right?
- Is the company complying with the transaction structure?

### Operational risk

Operational risk refers to the underlying risks of applying tax laws, regulations and administrative and judicial decisions to the routine everyday business operations of the company.

The key issue here is how involved the tax function is in the business operations. Operational risk will be reduced if tax is heavily involved in operations and there are formal sign off procedures in place. The question though is where would you like your company

to fall on the operational risk scale? Some companies might be quite comfortable if their tax function is seldom consulted on operations issues.

### Compliance risk

Compliance risk concerns how well an organization is meeting its tax compliance obligations. The risks here primarily relate to the preparation, completion and review of an organization's tax returns—for all tax types—and in how effective responses are to inquiries raised on returns by tax authorities.

Dealing with compliance risk involves a cost-risk trade-off. It should be possible to design control systems that achieve a zero-error goal for tax returns. However, if the cost of such controls would be prohibitive—and in most instances, this would be the case—a middle ground where some errors are expected but the associated risks are small and the cost savings significant might be a more effective balance.

In assessing compliance risk and how best to manage it, company management will also need to know what departments are involved in the compliance function. Responsibility for payroll taxes, for example, will often fall outside the tax team.

### Financial accounting risk

Financial accounting risk—the need to ensure effective "estimates" of deferred income taxes in the financial statement—has been brought into sharper focus by the Sarbanes-Oxley Act passed in the U.S. in 2002. Because the Act requires companies to document and test their internal controls over financial reporting, CFOs are becoming less tolerant of surprise adjustments to tax accounts.

The real risk here may be that the "no surprise" attitude may foster a risk averse attitude in tax directors, which may lead to structuring opportunities being rejected even though the overall level of risk would otherwise be within the level the company would be normally prepared to accept. The following questions may help to frame the tax risks embedded in the financial statements:

- How much uncertainty is there in the interpretation or application of the tax laws applied to compute the tax?
- What is the quality of the data received from or used in the transactional, operational and compliance areas?
- Are there issues or questions relating to the application of the tax law to the data?

- Are there complex or unusual financial reporting or disclosure issues?

### Portfolio risk

Portfolio risk refers to the overall aggregate level of risk inherent in transactional, operational and compliance activities as a whole. It examines the interaction between these three specific risk areas. Such as, how should a company proceed or manage a proposed transaction if it is below the company's risk threshold for transactional risk, but carries a higher degree of compliance and/or operational risk?

The cumulative risk profile might encourage the company to change the transaction, devote more resources to managing the transaction, or avoid it all together. In determining how to proceed, one useful question might be: If all of the areas of tax risk went wrong at the same time, what impact would that have on the organization?

### Management risk

Management risk exposure occurs when a company fails to systematically and effectively manage the risks. To assess the degree of management risk, a key question is: Does your organization have a documented tax risk management policy? With tax risk



management becoming increasingly important, the other critical question is: Do the people in your organization charged with managing tax risks have the skills, ability and resources to do so? A half-hearted approach to tax risk may still leave a company open to "surprises" or missed opportunities.

### Reputational risk

How happy would you be if your company's tax problems were headline news in tomorrow's newspaper? If a company engages in business practices that are perceived negatively by the public, even if entirely legitimate, the response of customers, suppliers and employees to adverse publicity may impact negatively on the company's overall business.

Companies that are seen—or perceived—to take more aggressive tax positions than their peers may find their reputations at risk. The transparency of a company's tax position may, therefore, be a material factor to consider in managing the company's reputational risk. How important is reputational risk to your company?

### Management of tax risks

These discussions suggest that addressing tax risks must be among the priorities of a company's

management, and no less than the board of directors or at the least, the audit committee of the board should take the lead role. Formulating and documenting the tax risk management policy for the company is the first step in effective tax risk management. No doubt, a documented tax risk management policy that is embraced by the board is crucial for good corporate governance.

Of the seven risks, perhaps the two key risks the board should focus on are portfolio risk and reputational risk. The board should have a general understanding of the company's risk profile as well as the impact that the company's tax position (or lack thereof) may have on its reputation. But how far the board should go is still an open question. Suffice it to say that in the new world of greater governance need, more involvement by the board than what has been normally practised does seem appropriate.

This does not mean, however, that the roles of the CEO and the CFO in tax risk management would be diminished. The CEO and the CFO are expected to provide high level input into the tax strategy design and should be using the same as a framework for participating in significant tax related decisions on both the transactional side and the operational side. They clearly have an interest in the figures in the accounts

and hence, in the financial accounting risk. They are also responsible for monitoring how tax risk is being managed and how the tax department is performing.

While the board will approve the strategy, in practice it is the head of tax that will set the tone on tax risk management for the rest of the company. It is therefore critical that the head of tax, the CEO and the CFO, and the board are in agreement on the company's tax risk management policy.

Equally important in tax risk management is the role of the finance department for it is almost always involved in the implementation of significant transactions and in the production of detailed information for the tax returns.

Not to be forgotten is the role of the operational people who are responsible for making decisions with potentially significant tax implications. Do they understand what risks they are taking; when they need to consult; when they can act without consulting; and what happens when something goes wrong? Will their performance be measured on a profit after tax so that they will not ignore the income tax implications of their decisions or actions?

The other key stakeholders in tax risk management are the external auditors and the tax advisors. They have to understand both the policy and

where the risks are being taken so they can plan their audit of the financial accounts.

One of the concerns in corporate governance is that some companies are not using the tax departments of their auditors for tax risk management as much as they do for tax planning. The auditors will already have a deep understanding of the company's business and therefore generally be in a better position to provide related tax services. Thus, the company's management of tax risk is improved by the involvement of its auditors in the provision of tax services as opposed to the provision of such services by others. And this can even lead to a better quality audit.

In any case, tax risk management needs to be a part of a company's overall risk management policy and has to fit within its overall tax strategy.

# Diligence and hard work

~ Tammy H. Lipana, Managing Partner, Tax


**THE NEED TO BEAT** the deadline is no reason to do a haphazard job. Diligence and hard work are traits that even the technically competent needs to perform a job well and ensure reliable results.

Here are some pointers, though not all-inclusive, that would sustain one's diligence and help ensure good performance:

- Be predisposed to start a hard day's work.
- Be productive and enjoy space and opportunity.
- Mind your business and respect the rights of others.
- Prioritize, organize, and carry out the tasks in the order of importance and urgency.
- Leave no room for mistakes or improvements by walking the extra mile; this will save precious time.
- Complete the task ahead of deadline to provide sufficient time for review, discussion, finalization and delivery.

Let me share this quotation: "Failure is more frequently from want of energy than want of capital."

# A call to **action**



Judith V. Lopez  
Managing Partner, Assurance

**RELIABLE** and transparent financial reporting is always fundamental to healthy capital markets. It cannot forecast the economy's strengths and weaknesses, but financial reporting can bring about informed decisions—and thus the continued efficient functioning of the capital markets. As players in the capital market, management, board of directors, auditors and audit committees must deal with the factors affecting financial reporting.

One such factor is the business environment. Difficult economic times slow down capital spending and investment. Cutbacks cause declines in earnings, borrowing capacity and stock market prices. While companies initiate restructuring, inventory liquidations, write-offs and layoffs, they also have to cope with both internal and external pressures. Internal pressures come from top management, whose own performance and compensation are tied to operating financial targets. External pressures come from the capital markets and shareholders, who demand return on investments. This earnings motivation induces an adverse tendency to strive for overly optimistic goals and go beyond acceptable practices.

As business structures become sophisticated and more complex, so do financial instruments and transactions. For instance, some companies transfer assets off-balance sheet, or arrange for units to be acquired by special purpose entities (SPEs), joint ventures, limited liability corporations, or partnerships. Some resort to expansion to support high price-to-earnings multiples. These are substantially risky transactions that could result in financial failure or liquidity crisis. An added challenge is compliance with the tremendous volume of international standards and regulations. All companies are mandated to fully



comply with international financial reporting standards (IFRS) by 2005. Therefore, every new standard or regulation, plus its interpretations, must be studied and understood.

### Key issues in financial reporting

With these environmental factors, management, audit committees and auditors must confront the issues that affect financial reporting:

- Liquidity and viability issues.
- Changes in internal control.
- Unusual transactions.
- Transactions with related parties.
- Transactions involving off-balance sheet arrangements, including special purpose entities.
- Materiality.
- Adequacy of disclosures.

### Liquidity and viability issues

Negative changes in economic conditions and negative publicity can rapidly lead to a liquidity crisis or to questions of an entity's going concern capability. Some examples are: recurring operating losses, working capital deficiencies, high level non-performing

loans, loan defaults, legal proceedings, destabilization of a trading partner, high financing cost, credit denial, and loss of principal customer or supplier.

These risk factors should be evaluated as to whether:

- Existing conditions and events can be mitigated by effective implementation.
- The management can control the implementation.
- The ability to continue as a going concern is realistic and not overly optimistic.
- Liquidity challenges have been appropriately satisfied and disclosed.

### Changes in internal control

Changes in business strategies, rapid expansion, or layoffs can affect internal control and make it less effective. Measures to be considered are:

- Attention to internal control is maintained.
- Key control procedures are still being performed properly.
- Layoffs have no negative effect on the integrity of information.

- Key functions being performed by new personnel produce good results.
- Layoffs or reductions do not create opportunity for fraudulent activities.

### Unusual transactions

Some companies resort to significant adjustments or unusual transactions at or near the quarter-end or year-end in order to reflect good results. Examples are: sales of assets not in the ordinary course of business, significant or unusual period-end revenues arising from sale of investments or disposal of a segment of a business. These transactions may not have been subject to normal checks and balances. Key points in evaluating the financial reporting risks include:

- The business purpose and the financial benefits or obligations.
- Whether the unusual transactions are subject to effective controls.
- The impact of these transactions on annual and quarterly results.
- Appropriate accounting and disclosure.
- Appropriate review and oversight.

### Transactions with related parties

Related party transactions call for scrutiny because they normally lack the independent negotiations present in transactions with unrelated parties. There is always a possibility that the economic substance of certain transactions may be other than their legal form. Key to these issues is whether:

- Management has a process to identify related parties and related party transactions.
- There is sufficient information to understand and evaluate the relationship of the parties to the transaction.
- The parties have the ability to carry out the transaction.
- Disclosures are complete as to the nature and extent of the transactions and relationship among the parties in conformity with existing accounting and SEC rules.

### Off-balance sheet arrangements including special purpose entities

Some business entities make use of off-balance sheet arrangements with non-independent entities, often referred to as special purpose entities. SPEs may be used to provide financing, market risk or credit

support, or other services that may impact financially on the other party. These transactions require special attention to ensure that generally accepted accounting principles (GAAP) and disclosure rules are followed, and the structures and arrangements are clear and understood.

### Materiality

The materiality concept plays a critical role in judging various factors in the financial reporting process. Although generally accepted accounting principles recognize the concept that accounting standards need not be applied to immaterial items, this recognition is more for matters of convenience than for the basic purpose of maintaining accurate books and records. Therefore, while management may consider materiality in selecting the accounting principles to use in the financial statements (including footnotes) and in preparing Management's Discussion and Analysis (MD&A), it is generally inappropriate to permit known errors to remain in the financial information based merely on their immateriality. Both quantitative and qualitative factors should be evaluated when assessing the materiality of misstatements. Key factors include whether misstatement:

- Is linked to increased compensation of top management and officers.
- Marks a change in earnings or trends.
- Hides a failure to meet analysts' expectations.
- Is in part compliance with FS related debt covenants.

### Adequacy of disclosures

Management and the auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements. Management should ensure that disclosure in MD&A is balanced and fully responsive. Prior to finalizing and filing annual reports, audit committees should review the selection, application, and disclosure of critical accounting policies. If companies, management, audit committees, or auditors are uncertain about the application of specific GAAP principles, they should consult with the SEC.

As an overall matter, clear and complete disclosure is key. In particular, complex transactions such as those with related parties, special purpose entities, off-balance sheet vehicles, or situations that involve contingent obligations, derivatives, financial guarantees, and liquidity, among others, heighten the importance of financial disclosures to present a complete picture of a

company and its risks. Therefore, it is important not only to assess whether the technical disclosure requirements of GAAP and MD&A have been met, but also to consider the depth and transparency of the disclosures with a focus on helping the reader more fully understand the substance of the company's risks and rewards.

### Specific financial statement risks

On top of business environment factors and financial reporting issues, there are new risks directed at specific financial statement areas that can arise. These are:

- Recorded assets that aren't assets.
  - Uncollectible trade receivables.
  - Impaired loans.
  - Surplus or obsolete inventory.
  - Capital assets, investments and intangible assets with impaired values.
  - Acquired assets with market value significantly below carrying value.
  - Deferred income tax assets with no future benefits.

Asset valuation issues clearly involve the exercise of professional judgment. However, there is a difference between genuinely judgmental uncertainty and deferring writedowns or write-offs until the reality of the diminished value is absolutely proven. When assets are impaired, adequate provision or write-off should be made.

- **Unrecognized liabilities/losses.** Liabilities can be even trickier because we have to envisage what might exist but hasn't been recognized by the entity. Some liability problems that may become more likely if a company is operating in a difficult environment include:
  - Contingencies—those arising from litigation or guarantees of the obligations of others, including related parties. For example, an entity may have guaranteed the performance of a related party under an agreement with which the related party is unable to comply, or the entity is itself having financial troubles and may be experiencing defaults from its loan covenants.
  - Violation of covenants under lending agreements for which the debtor-company (a) has not requested for a written waiver



from its lenders; (b) has requested but has not received, or is unlikely to receive, such written/legally enforceable waiver; (c) is not even aware that a violation of the pertinent loan covenants has been committed and that it is required to ask for a written, legally enforceable waiver from lenders. This situation may call for a reclassification of liabilities from long-term to current.

- Onerous commitments for the purchase of products at prices that, due to changes in prices or foreign exchange rates, are in excess of what can be recovered from customers.
  - Long-term lease commitments for real estate or equipment that has become surplus to the entity's requirements.
  - Restructuring provisions.
- **Income statement tricks.** Revenue recognition issues proliferate in difficult times when sales people are unable to meet their targets, which are otherwise easy to attain in normal, less difficult times. Among the problems that may be encountered are the following:

- Sales cut-off errors, or failure to record customer returns, thus overstating revenue amounts.
- Sales recorded where the company has significant future obligations such that the revenue earning process cannot be said to be complete. For example, customers of technology industry companies may not have any legal obligation until the hardware or software has been installed and subjected to rigorous acceptance testing.
- Treating operating leases as sales-type leases.
- Recording as sales, goods retained at seller's premises under "bill and hold" arrangement that create significant uncertainty over whether a sale has really occurred.
- Recording sales, goods shipped to customers but subject to undisclosed side agreement whereby the customers have extended payment terms and/or are free to return the products without any restocking or other charge. Some manufacturers of consumer goods have been known to "load" their distribution channels by shipping products and recording as sales inventory in excess of their customers' requirements.

- Inappropriate use of the percentage of completion (POC) method of revenue recognition on long-term contracts. For example, a company may not have sufficient experience to be able to estimate accurately the future costs upon which POC estimates are based.

The timing of cost recognition can also be used to manipulate earnings. If a company is seeking to maximize earnings in order to meet stakeholder expectations, it may resort to:

- Amortization of the costs of capital assets or intangible over an excessive period, thus reducing the annual charge to income. The present GAAP in the Philippines on amortization on intangibles is a maximum period of 20 years—however, this should not be used if there is evidence that the intangible assets may have been impaired.
- Inappropriate income smoothing by building excessive asset provisions or liability accruals in good times, then releasing the excess to income in difficult periods.

- Engage in transactions that generate material non-recurring gains without highlighting those gains in their income statement.
- Adopt less conservative accounting policies and inadequately disclose the beneficial effect on current year's income.
- Reclassify certain revenues/costs in an effort to minimize the applicable "minimum corporate income tax".

### A call to action

Management, auditors, and audit committees each have their separate roles and responsibilities. Still their goal must be the same, that is, making sure that a company's financial reporting is of the highest quality. Management has a role to play in promoting the highest quality financial reporting. Management should:

- Ensure that there is proper tone at the top, an expectation that only the highest-quality financial reporting is acceptable.
- Review all elements of the company's internal control—control environment, risk assessment, control activities, information and communication, and monitoring—in light of changes in the company's business

environment and with particular attention to significant financial statement areas.

- Ensure that appropriate levels of management involvement and review exist over key accounting policy and financial reporting decisions.
- Establish a framework for open, timely communication with the auditors and the audit committee on all significant matters.
- Strive for the highest quality, most transparent accounting and disclosure—not just what is required—in both financial statements and MD&A.
- Make sure estimates and judgments are supported by reliable information and the most reasonable assumptions in the circumstances, and that processes are in place to ensure consistent application from period to period.
- Record identified audit differences.
- Base business decisions on economic reality rather than accounting goals.
- Expand the depth and disclosure surrounding subjective measurements used in preparing the financial statements, including the likelihood and ramifications of subsequent changes.
- When faced with a "gray" area, consult with others, consider the need for SEC pre-clearance.

# Integrity

~ Judith V. Lopez, Managing Partner, Assurance

**WHEN WE SPEAK OF** integrity, we often identify it with uprightness, being able to keep our promises, maintaining congruency of our word with our actions, and keeping our commitments. These are values integral in any relationship.

Our corporate vision is like a tree whose fruits are the success of our clients and people. It is important to care for these fruits but it is equally necessary to nurture and enhance the roots. The roots, in this case, are our character, our principles and our values.

One of the fundamental attributes of our profession is integrity in our work. It empowers us to always maintain our independence and conduct our affairs (business and private), in a manner that would avoid allegations or impairment of our independence. It also empowers us to treat with strict confidentiality information relating to the affairs of our clients.

Our foundational values have guided our firm's actions in our relationship with clients and our people and have allowed us to consistently uphold our teamwork, excellence and leadership.



Jose P. Lavares, Jr.  
Managing Principal, Advisory

# Advisory: An expanded capability

**I**N light of the growing complexity in the business environment, we have found a niche in the advisory market by positioning ourselves to serve



client priorities across the business lifecycle. We have directed our efforts to train our people to become real business advisors equipped with industry knowledge and functional expertise.

Using our deep understanding of financial, analytical, and business processes, we identify business issues and package solutions that respond to company's needs depending on where it is in the business lifecycle, or where it is going. We have structured ourselves to deliver services that address key business priorities: transactions, performance improvement, and crisis management.

### Transactions

We relate the business lifecycle to transactions that occur anytime between the inception of a new business or when a new one legally exists—such as those resulting from mergers and acquisitions. Transactions basically cover corporate finance, transaction services (due diligence and post-deal integration), valuation and strategy. A typical response is to address a client's need for due diligence, post deal integration, cost savings analysis, or negotiation support assistance.

At whatever stage in the lifecycle the business is in, we focus on the longer term return of each deal at

each stage of the entire deal spectrum from strategy development and evaluation to post-acquisition integration. As an example, in project finance, we assist clients in developing the right commercial structure; the right mixes of financial instruments; and the negotiation strategy to help them get the best deal. We understand the potentials at every stage of the transaction and we can address them very quickly with qualified global professionals who can take a company to the marketplace.

### Performance improvement

As a business matures, it will need to improve the effectiveness and efficiencies of its processes. Performance improvement basically covers process improvement, finance, human capital and IT effectiveness reviews, governance, risk and compliance, and internal audit and control. We address process improvement with a practical framework where key business processes operate to predetermined standards and improved efficiencies in terms of timeliness, cost, quality and control.

We provide hands-on assistance to improve financial under-performance and cash flow management. We use multi-disciplined approaches to improve performance and behavior of employees and

management that are aligned with the goals of the business. We provide expertise and skills in enterprise and infrastructure security, data management, privacy, and access control and access management. We create frameworks to effectively manage key governance, risk and compliance activities. We measure the effectiveness of the internal audit processes and develop methodologies to enhance and support the internal audit function.

### Crisis management

Changes in the economy, society, or market conditions can decrease sales and profits. At anytime during its lifecycle, a business can go through a crisis and experience negative cash flows, insolvency problems, or disputes. Here, we have a full spectrum of business recovery services and disputes analysis and investigations. We help challenge clients turn their company around with a comprehensive approach to business recovery that will safeguard and maximize the interests of investors, lenders and management. We assist clients in assessing management and competitive barriers, buy-sell agreements, or tax strategy to sell or closeout a business.

In special cases, we provide financial, economic and statistical services to assist professionals with

diverse specialized knowledge, skills, experience and training in performing their respective fields of expertise.

### Expanded capability

While our current services and skills address most of our clients' needs, we recognize the evolving needs of companies as they go through the business lifecycle. Accordingly, we are able to develop new areas of services built on our existing competencies and on areas where we are strong. As each stage of the business lifecycle will have different problems, so will there be different solutions.

In today's complex environment, businesses need to effectively manage transactions, processes, crises and other unexpected events. Because we understand the dynamics of value and cost, we are able to maximize value knowing the differences between economic value, market value and strategic value. We make sure that clients can face up to the new challenges and benefit from the opportunities. We do this objectively with our expanded advisory services using comprehensive solutions designed to create stakeholder value, build trust, and communicate with the marketplace.

# Teamwork

~ Jose P. Lavares, Jr., Managing Principal, Advisory

**THE TWO MOST IMPORTANT** elements for a group to achieve its objective through teamwork are: a clear mission and leadership.

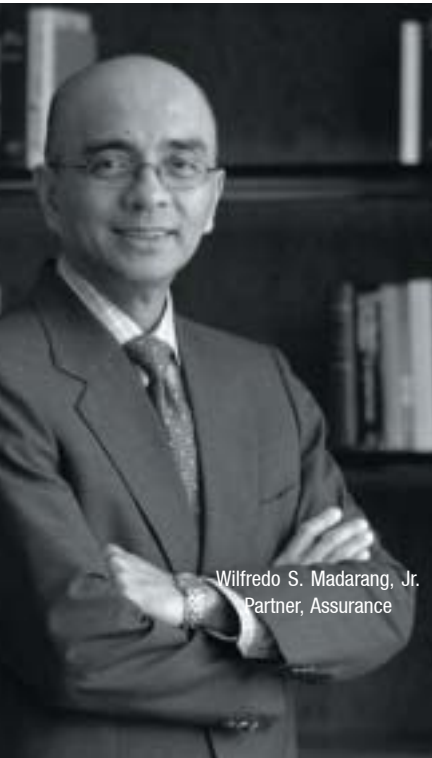
Every group or team should have a clear sense of purpose—nowadays interchangeably referred to in management as vision, mission, ambition, etc.

Not only should a mission be developed, but it should also be shared with each and every member of the group, or the firm, so that everyone begins to view the entity in a similar manner. Therefore, to achieve teamwork, adequate information about the purpose, or mission, and how the team members can contribute to its achievement, has to be communicated.

The flip side of mission is leadership: someone has to translate the goal into action; to motivate team members and drive implementation of the mission.

In a corporate setting, the prime task of the chief executive and all those who occupy leadership positions is to teach their managers what the goals and strategies are all about and then have them, in turn, teach their staff. The leader becomes a coach and facilitator, a builder and a cheerleader or enthusiast.

# Reinventing the audit committee



Wilfredo S. Madarang, Jr.  
Partner, Assurance

THE board of directors has a fiduciary role to provide effective oversight of management performance and to achieve accountability toward protecting shareholder interests and, increasingly, the interests of other corporate stakeholders. Such role spans around the functional areas of corporate reporting, which is categorized as

management oversight over audit, finance, governance, compensation and options, pension and strategic planning. It also includes oversight on investor decisions and the overall management of the company.

Considering these crucial oversight and management responsibilities, the board can turn to the audit committee for help. It is the audit committee's role to assist the board in fulfilling its oversight responsibilities for the external reporting process, assuring the integrity of information provided to outside stakeholders, including shareholders.

### Evolving audit committee scope

Traditionally, the audit committee is responsible for: annual reports, related processes, controls and tests of those controls, working relationships with the external and internal auditors, and oversight on interim financial reports and related information. Today, however, the audit committee's scope has evolved. It now takes into consideration the oversight of enterprise-wide risk management, the external information flows, and the reliability of financial and non-financial information and communications.

Its oversight responsibility is influenced by market demand, market expectations and regulations, the recent spate of corporate reverses, restatements of



financial reports by the world's largest corporations, and other failures. These drivers of change provide the impetus for increasing areas of focus in fulfilling the requirements of the oversight function. For instance, critical accounting policies, quality of management, related party transactions, and even tone at the top, are factors that help ensure the reliability of internal and external reporting processes and proper compliance and communications.

### Evolving role

The role of the audit committee has evolved with the expansion of its scope of work. Dramatic changes in the corporate landscape have triggered a greater scrutiny of the audit function. These changes include:

- Legislation and other emerging regulations.
- Emerging reporting models.
- Financial accounting standards, exchange requirements and other recommendations.
- Events such as September 11.
- Corporate failures such as Enron, Parmalat, etc.

The audit committee's responsibility becomes more demanding due to the need to comply with:

- Risk management principles.
- Laws, policies, code of conduct, ethics, social responsibility.

The committee must also be able to support decisions with an understanding of:

- Information systems.
- Non-financial information.
- Special investigations, perks, and the like.

### Best practices of audit committees

What are the procedures and processes that we consider best practices given the larger scope and role of the audit committee? The audit environment has become complicated and has made the audit committee's responsibilities quite extensive.

The audit committee must first answer practical questions like "What does it mean to oversee enterprise-wide risk management?" The answer will require a lot of audit committee work that will need some help from outside, such as that of audit practitioners. It means understanding how management identifies risk, how it assesses risk, and how it manages risk. It also means value

communication—that is, competent reporting supported by the ability to deal with ongoing change.

### External reporting process

One director-member of an audit committee is cited to have said: "If I could rule the world, I would require a retired auditor to be on the audit committee." This is as yet more of an ideal than reality; but to appreciate this comment, let us look at the external reporting process in the audit committee practice.

The audit committee needs answers to practical auditing questions, such as:

- What is the company's risk profile?
- What do the numbers mean, and are they consistent with the story behind the numbers?
- Is the story accurate and complete?
- Was there any disagreement among key parties regarding critical accounting policies and assumptions?

Knowledge of the auditing function is further underscored by the key information needs of the audit committee, which include:

- Accounting principles, which ones are used and why, the impact of changes, and regulatory perspective.
- Estimates, judgments, changes.
- Especially complex issues such as related party transactions, revenue recognition, derivatives, etc.
- Narrative reporting as regards full disclosure, consistency with financials.

### Risk management and internal control

There are some practical questions to ask:

- What is the scope of the internal control? Does it extend to financial or operational reporting, the information system environment, operational effectiveness and efficiency, safeguarding of assets, and compliance?
- How is risk identified, assessed, and managed?

To answer these questions, we must examine the key information needs, such as:

- Risk identification process.
- Risk assessment process.

- Understanding risks; and
- Risk management process.

Today, audit committees are taking their roles far more seriously. They meet more regularly and for longer periods, have greater structure, and have more dialogue with both internal and external auditors.

In our practical experience, we would hold meetings and discussions with the audit committee on best practice, at least twice a year. First, based on initial discussions, we would identify the issues and determine the implications of the planned responses to the issues identified. On the second meeting, we would go back and report on what has happened depending on the actions taken after the initial discussions.

### The audit process

To be effective in its role, the audit committee will depend much on both the internal and external auditors. Therefore it must understand and appreciate their work to help answer questions including:

- What are the audit objectives?
- What issues and geographical locations are emphasized in the plan, and why?
- To what extent are internal controls tested?

- How do the internal and external audit plans complement or overlap?
- How do we know that the auditors are qualified, unbiased, and appropriately experienced? What are their quality control processes?
- Are the external auditors independent, in fact and in appearance? Is there no conflict of interests?

To answer them, the audit committee needs to know key information such as:

- Global audit plans.
- Auditor qualifications, record, and risk and quality provisions.
- Auditor independence.
- Record of auditor disagreement with management.

### Compliance

On compliance with laws and regulations, it is important for the audit committee to know:

- What is the tone at the top?
- Is the code of conduct current,

comprehensive, and adequately communicated? Have any exceptions been permitted?

- Does the company have an effective compliance program?
- Is the impact of compliance covered in external reports?

It helps that the audit committee refer to key information such as:

- Reports on effectiveness of compliance with laws and regulations.
- Key issues, investigation, follow up, discipline.
- Information on trends, systemic issues, management plans.
- Reports of regulators and auditors.

### Effective practice and setting limits

In the final analysis, how is the effectiveness of the audit committee measured? Best practice should be able to positively fulfill these:

- Enough time to meet the oversight responsibilities.

- Access to the resources and information needed.
- An appropriate foundation of knowledge.

Likewise, the audit committee needs to know if its relationships, sharing, and communications are appropriately managed, and whether the audit committee charter clearly communicates and distinguishes its responsibilities to management, the board, and other parties.

In summary, the current scope of the audit committee's work impact on:

- **Corporate governance.** The expanding responsibilities pose significant challenge for directors. Boards and audit committees are finding that concerns about time commitments, liability, and reputation are making recruiting new members more difficult. They now look at being accepted as financial experts, questioning whether their "plates are full" and if they are capable as an oversight body.



- **SEC certification requirements.** Boards and audit committees are now probing their true compliance readiness, becoming proactive in understanding new processes such as the certification requirements of the Sarbanes-Oxley Act.
- **Evolving rules for auditors.** Independence rules are redefined, auditing standards are expanded in areas like fraud, disclosures in financial reports, and more time devoted in the selection and application of accounting and auditing principles.
- **Business reporting.** Audit committees are now asked to review financial reports, relevance of information, comparability, reliability and ability to understand key elements in rebuilding public trust.
- **International accounting developments.** The convergence of accounting, auditing, listing and regulatory standards and the narrowing of long standing differences between international and national standards, have made audit

committees recognize the effects and implications in their companies and discuss with management how these developments are being tracked and addressed.

- **Corporate and market developments.** Management, auditors, and audit committees are now taking added steps to ensure proper reporting, additional disclosures, reaudits, valuation of goodwill, intangible assets, special purpose entities, stock options, etc.

At the end of the day, the audit committee's success is measured by:

- Its knowledge of the external reporting process, risk management and internal controls.
- The extent of implementation of compliance requirements.
- Being able to manage relationships and clearly communicating with management, the board and other stakeholders.
- The audit process itself.

### Impact on Audit Committees

The expanding responsibilities of boards and audit committees pose significant challenge for directors. It is becoming more difficult to recruit new members because of concerns on time commitments, liability, and reputation. Audit committee members are asking themselves whether they have sufficient time and capability to do oversight work—as “financial experts”—and carry out the substance of what the rules expect.

Audit committees are expected to oversee the external auditor’s activities and study significant accounting, auditing, and financial reporting issues; auditor independence; and audit and nonaudit services. They also have to look more closely at the company’s financial management, the internal audit function, and their own independence. They will hold longer meetings, probe more deeply and continue to identify individuals deemed to be the financial experts. So far, they are doing their best to meet the challenges.

# Honesty

~ Wilfredo S. Madarang, Jr., Partner, Assurance

IN OUR DAY-TO-DAY ASSOCIATION with our clients, we require our people to be men and women of character: people who cannot be bought, who possess opinions and a will. We compel them to be honest in small things as in great things, to be totally truthful, ethical and right. We want to be known as an organization with the highest degree of integrity. It is a tall order, but it is worth taking to establish a good reputation.

When we live by our principles, remain honest about our strengths and weaknesses, we can be assured of enjoying the full trust and confidence of our clients and our people. When our integrity is beyond question, people will know that if it comes out of our mouth, it is the truth. That is a benefit of good reputation.

How may we practice honesty and integrity in our daily affairs? By keeping client matters confidential as needed, by not short-changing our clients with sloppy work, by treating others with respect and dignity, by fulfilling what we have promised to do for others, and matters as plain as putting the right information on the time sheet or expense reports.

With a conscious effort to exemplify these values in our everyday relationships, we will acquire the inner strength to steer the firm confidently into its destined course.

**WHEN** reviewing financial statements, the probability of fraud cannot be overemphasized. How does one detect fraud? Before we can answer that question, we must first know what is fraud.

Fraud is a broad legal concept. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. It may involve management, employees or third parties. It may involve one individual or a collusion of several persons.

Why commit fraud? Incentive or pressure can make management or other employees

# The facts of fraud



Rossana S. Javier  
Deputy Managing Partner,  
Advisory

commit fraud. When control is ineffective or absent, or when management has the ability to override controls, the circumstances are ripe for fraud. Sometimes the existing culture or environment enables management to rationalize committing fraud. The attitudes or values of those involved enable them to rationalize committing a dishonest act.

In a financial statement fraud, a company may deliberately misrepresent the financial condition of an enterprise through intentional misstatement or omission of amounts or disclosures to deceive users of financial statements. This is either through an overstatement of profits, assets and revenues or understatement of losses, expenses and liabilities.

### Let us examine some perspectives on fraud

- **Fact No. 1.** Organizations suffer tremendous costs as a result of occupational fraud. A typical U.S. organization loses 6% of its annual revenues to fraud that translates into \$660 billion in total losses.
- **Fact No. 2.** Confidential reporting mechanism reduces fraud losses significantly. Median loss of a company with anonymous reporting was

\$56,500; for those that did not, the median loss was more than twice as much.

- **Fact No. 3.** Confidential reporting mechanisms should also extend to third parties like customers and vendors not just for employees. Cases detected through tips: 20% from customers, 16% from vendors, and 13% from anonymous sources or total of 49%.
- **Fact No. 4.** More effective internal controls are needed to detect fraud. Larger frauds may involve senior personnel overriding or circumventing traditional internal controls.
- **Fact No. 5.** Loss caused by occupational fraud is directly related to the position of the perpetrator. Frauds committed by owners and executives are six times higher than those caused by managers and fourteen times higher than those caused by employees. Companies were less likely to take legal action against these owners and executives.
- **Fact No. 6.** Most occupational fraudsters are first time offenders. Criminal background



checks are fine but they are not foolproof. Honest-looking employees commit most frauds.

### What to pay attention to in examining financial statements?

The balance sheet is the same as the statement of net assets, statement of assets, liabilities and owners' equity, and statement of position. It is a snapshot of a company's financial position. Scrutiny should be on:

- How safe is the shareholder's investment in the company?
- How solid is the company?
- How quickly can the company respond to a crisis or a change in the industry?
- Do the company's "ins" and "outs" meet your expectations?
- Is each balance sheet line reasonable in amount?

Income statement is the same as the profit and loss statement (P & L), and statement of earnings. It tells you how much income, or profit, the company generated for a specific time, such as a month or a year. The examination should determine:

- What sort of revenues the company generates?
- What is the proportion of revenues, expenses, non-operating expenses, and revenues to the same group accounts?

Cash flow statement is the same as the statement of cash flows. It tells you what happened to the entity's cash like your bank account statement. Queries should be made as follows:

- Does the company have heavy demands on their cash each period?
- Do the inflows equal or exceed the outflows?
- Are they increasing or decreasing their cash balances over time?
- Does it look like that they have to borrow or sell shares in the company to cover expenses?

Statement of retained earnings is the same as the statement of shareholders' equity. This tells you the changes in the company's retained earnings during the period reported, and also the amount that could potentially be distributed to the owners. It is useful to determine if the company retains or distributes its earnings. Did it retire or issue any shares?

Notes to financial statements are the same as footnote disclosures. It gives you information that could not fit in any of the four statements, and other information that might or might not be of interest to the readers. It is always a good idea to scan the notes for possible contingencies, lawsuits or extraordinary items. Footnotes offer a better understanding of the company operations.

In reality, financial statements will not tell you everything you need to know about the finances of the company. For you to judge the health of the company, you need to do more.

Once financial statement fraud has been committed, it is often necessary that it is perpetrated over time in order for it not to be uncovered easily. It is not normal for sales allowances to be directly proportional to increases and decreases in sales amounts. Suspect that someone is trying to manipulate period end sales and returning goods after period cut-off. Watch out for commission-based or revenue-based compensation schemes.

Can you rely on your auditors to detect fraud in your organizations? What is the difference between auditing and fraud examination? Auditing is recurring; general in scope; objective is to issue an opinion; non-adversarial; audit techniques are used; and it presumes

professional skepticism. On the other hand, fraud examination is non-recurring; specific in scope; can affix blame; adversarial; uses fraud examination techniques; and presumes proof.

The middle ground between audit and fraud examination is forensic accounting. It is the integration of accounting, auditing and investigative skills. Forensic accounting provides an accounting analysis that is suitable to the court that will form the basis for discussion, debate and ultimately dispute resolution. It encompasses both litigation support and investigative accounting.

### How to prevent fraud

The most cost effective way to deal with fraud is to prevent it. To do that, you need to watch out for the telltale signs. What does it take: assume anyone can commit fraud; think dirty; pay attention to details; check out hunches; look for patterns in an unusual transaction; know the business and its industry; keep an open mind.

The red flags that warn of internal fraud include:

- Inadequate or minimal managerial control, especially after downsizing.

- Payments made without supporting documentation.
- Payments made to unusual places or unlikely suppliers.
- Incomplete audit trail; key documents missing or accidentally destroyed.
- Backlogs creating disorder in record keeping; reconciliation not done immediately after a clean audit.
- Areas where key employees resent intrusions.
- Management insists there is no fraud because staff is trustworthy.
- No one, including management, understands all steps and links.
- Employees' lifestyles inconsistent with status and earnings.
- Purchasing decisions made by one person.
- Unusual number of bad debt write-offs.
- Employees disobey professional rules, especially audit, accounting, legal.
- No segregation of cash duties.
- Quality of items purchased is slipping.
- Annual spending increase greater than inflation rate.
- Invoicing is confusing, involving partial deliveries, substitutions, changes.

- Physical inventory does not match invoices.
- Split purchases to by-pass authorization limits.
- Inventory discrepancies.

To prevent fraud, internal controls must be put in place to promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations. A strong system of internal control supports the achievement of business objectives and therefore good internal control is a way of managing risk.

Internal control has five interrelated components derived from the way management runs a business and integrated with the management process.

- **Control environment.** This sets the tone of the organization, influencing the control consciousness of its people. It is the foundation for all components of internal control, providing discipline and structure. It includes integrity, ethical values and competence of the people, management's philosophy and operating style, the way management assigns authority and responsibility, and organizes and develops its

people, and the attention and direction provided by the board of directors.

- **Risk assessment.** Every entity faces a variety of risks from external and internal sources. A precondition to risk assessment is establishing objectives, linked at different levels and internally consistent. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the relevant risks.
- **Control activities.** These are the policies and procedures that help ensure management directives are carried out. These include approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
- **Information and communication.** Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication must

occur flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities are taken seriously. They must understand their respective roles and how they relate to the work of others.

- **Monitoring.** Internal control systems need to be monitored, a process that assesses the quality of the system's performance over time, through ongoing monitoring activities, separate evaluations or a combination of the two.

Everyone in the organization has responsibility for internal control, from management, to the board of directors, internal auditors and other personnel. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. All personnel should be responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions.

To help strengthen the internal control system, the following steps should be considered:



- Adopt a control framework.
- Create an honest environment.
- Improve detection reporting.
- Implement fraud policy "whistle blower program".
- Consider fraud hotline.
- Review hiring policy to weed out the undesirables.

### A word of caution

Internal control can help an organization get to where it wants to go and avoid pitfalls and surprises along the way. But internal control cannot change an inherently poor manager into a good one. Shifts in government policy or programs, competition, economic conditions can be beyond management control. No matter how well conceived and operated, the internal control system can provide only reasonable, not absolute, assurance regarding achievement of company objectives. Controls too can be circumvented by the collusion of two or more people, and management has the ability to override the system.

Internal auditors are not expected to be fraud specialists. Audit procedures, even if done with due professional care, do not guarantee fraud detection.

Detection of fraud is only a by-product of the audit function, not its main goal. Internal auditors involved in fraud examination risk giving cause for legal action by the employee-suspect against the auditor and the organization. So be careful!

# Positive thinking

~ Rossana S. Javier, Deputy Managing Partner, Advisory

I **USED TO KEEP** a book about “being happy” in my car and wherever I go. The book’s most important message is we need to keep positive thoughts so that we will attract positive events.

Why are some people just plain lucky? Why do people with lots of money get more money? Why do some people have easier time dealing with the most difficult people? Why are some people so relaxed when they should be harassed? Lady luck seems to be fond of them, right? The truth is, these people focus on what they want and are very positive about the outcome. They plan things ahead of time. In short, they work smarter, not harder.

Being in the consulting practice for many years now, I have come to realize and have advised my clients that “no task is too tough if you only put your heart into it”. This same adage caught their attention and became their own battle cry in their ongoing human transformation model.

# What to expect in corporate workouts

**WE** hear more and more executives trot out that old villain to explain why business is doing badly—the economic slump. Whatever the reason, the owner or manager or even a lender can overcome financial difficulties by understanding the typical process and the various financial, strategic, and operational issues involved in a debt restructuring exercise.



Charlie T. Francisco  
Principal, Advisory

### Call for help: A company in trouble

Your company is experiencing cash flow difficulties. Your relationships with lenders and suppliers are starting to get strained. You have been unable to keep most of your promises for repayment. Your efforts to raise new capital have fallen short, and some of your trade creditors are shipping only on COD terms while others are threatening to file suits.

Your bankers are running out of patience, and some are considering issuing demand letters. Your CFO can barely cope with the liquidity crunch. A number (if not most) of your bankers have demanded updates on your present financial position, not satisfied with the information you have provided. They demand more transparency and ask, as a condition of their continued patience, that you consent to having an independent party come in to assess and report on the company's current and prospective financial position and its "going concern" prospects or underlying viability in the near term.

Reluctantly, you agree to this request. You retain an independent financial adviser, who arranges for a meeting with all the creditors (predominantly lender banks) to inform them of the appointment and to suggest a way forward.

You are officially in a debt restructuring, also known as a "workout." For the next several weeks (or, potentially, even months or years), you will spend much of the time in efforts to save and revive the business.

### Moment of truth: Taking the "hot seat"

The main goal of the initial meeting with the creditors will be to convince them to "stand still" and not take any aggressive action against the company, pending findings and recommendations of the adviser's business review report.

If done fairly early in the process, financial creditors will normally agree with this request to stand still, either informally or in writing. They will instinctively know that if it has come to this—the all-hands creditors meeting—then the company's situation is serious. Rather than taking rash actions that could force fellow creditors to follow suit, it probably makes more sense for them to first obtain a better understanding of the company's present circumstances and any suggested solutions, and then decide what to do next.

In addition to getting much-needed breathing space from creditors, the initial meeting is very important for another reason. It is at this meeting that many of your lenders will form a view on you, management. You may not see a lot of familiar faces at

this meeting, as many of your lenders may have reassigned your account to a debt recovery specialist within their bank or institution. These hard-nosed bankers may be unfamiliar with you and your account, and will be watching carefully to assess your ability to come clean on the extent of your company's problems. They will look for your expressed level of cooperation and, perhaps most important, your sincerity.

Typically, your financial adviser will lead this important creditors meeting on your behalf, but you will be expected to provide thoughtful and candid answers to the tough questions that lenders will ask:

- Why is the company in this predicament?
- Where has all the money gone?
- Are the shareholders going to put in any new money? If not, why not?

These and other questions must be answered carefully for no matter what the business review report reveals and ultimately says, if your lenders do not have faith and trust in management, they will likely not support the company's restructuring efforts.



### The business review report: The good, the bad, and the ugly

The business review report is all-important, as it sets the stage for the rest of the restructuring. It is the aim of the business review report to provide answers to the following types of questions that lenders want answered:

- Is the company solvent?
- What are its assets? How much are they worth? To what extent are they pledged?
- What is the extent of the company's debt?
- Are the company's operations viable? If not, what is the best means to extract value from underlying assets?
- What resources does the company have to service and repay its debts?
- Are these resources sufficient to repay all existing indebtedness? If not, are they sufficient to service interest?
- What are the company's short- and long-term cash flow forecasts? Are they based on reasonable assumptions?
- What is the company's current cash position?
- Are there sufficient funds on hand to keep the company's operations afloat? If not, how much

money is required within the foreseeable future (short- and long-term)?

The answers to these questions are important, as they help portray the overall financial health of the company and its ability to repay its debt from existing resources. If the report indicates significant financial problems but a viable underlying business will be able to generate cash flows to service debt (something you as an owner want to believe but something your bankers will want to be confirmed by an independent, credible party), there will normally be a basis for a meaningful restructuring. However, if the underlying business is not deemed to be viable, a restructuring becomes much less likely; in this case, a financial restructuring becomes a spreadsheet hocus-pocus, or purely mental and financial calisthenics.

### Restructuring Options

Among the information that should form significant part of the business review report is the cash flow forecasts. Your company's projected cash flows from its new, restructured entities will form the basis for any restructuring proposals. If the projected cash flows appear to be sufficient to repay all outstanding indebtedness over time—from operating sources or

from asset sales/disposals—then your company's existing debts will most likely be rescheduled accordingly. This is called a "Self Rescue" (or normally referred to as simple rescheduling or extension of loan maturity), and where your company trades/manages itself out of its difficulties. Your lenders will normally be happy to accept such a scenario, as it sees them being repaid in full (though over a longer period than originally anticipated).

If your company's projected cash flows are insufficient to repay all existing indebtedness in full, then you will have little choice. You will have to consider presenting restructuring proposals that your lenders may not like: Proposals calling for deferment of principal repayment or to accept something less than full repayment (asking them to accept a "haircut"). While your bankers may not like such proposals, they will most probably recognize that such proposals are inevitable, as the underlying business simply cannot support the debt service requirements in full from existing assets, and the alternatives available to lenders—such as liquidation—will produce an even lower return.

Thus, what will become quite evident from the business review report will be the extent to which your company has the ability to repay its indebtedness from

its existing resources. If your creditors are convinced that the ability is simply not there from existing resources, the financial adviser's primary value is to assist in developing debt-restructuring proposals that may feature the following types of options:

- **Debt-for-equity swap.** This is a relatively simple way to relieve the company of its debt burden, often an element in a restructuring proposal of a listed company, particularly one whose projected cash flows are insufficient to repay all existing indebtedness. In essence, such a swap involves exchanging all or a portion of the company's debt for ownership in the company. This can often lead to the lenders taking a significant or even a majority stake in the business (as existing shareholders' stakes are diluted with the issuance of new shares). Lenders will normally prefer other options to debt-to-equity swaps, as they do not like to be in the "investment" business, but sometimes this is a necessary component of a multifaceted restructuring proposal.
- **Convertible notes.** Low or zero-coupon convertible notes are often used as a means to

keep debt on the balance sheet at a low carrying cost, leaving open the option of whether it is ultimately repaid or converted into equity. The convertible notes are given a strike price at which they can be later converted into company shares. If the company's share reaches or exceeds the strike price, then the holder normally converts his note into shares and exits via the stock market. If the strike price never reaches the market price, then the note can be sold (at a loss) or refinanced.

- **White (or sometimes black) knight.** A party comes to the rescue of a troubled company, generally by making large investments (ranging from cash or working capital to injecting healthy businesses or assets) which help to alleviate their cash flow problems and repay creditors. Generally, white knights "rescue" a company without compromising the claims of the company's existing creditors. In the eyes of lenders, white knights become black knights when they demand writedowns on their loans as a pre-condition to their investing in the company. Black knights are becoming increasingly more common than white knights in more sophisticated markets.

These are just three of the many types of options that are found in debt restructuring proposals. Your financial adviser should work closely with you to develop options that are, on one hand, reasonable and beneficial to the long-term future of your company and, on the other, acceptable to your lenders.

### Role of the Financial Adviser

During this difficult and trying period, the financial adviser must help you find a way out of your problems and deal with your lenders. Financial advisory services in relation to the restructuring process include:

- Leading the restructuring process and coordinating the work of all of the professionals involved.
- Advising on the appropriate form and structure of the company's restructuring plan with the aim of negotiating continued support from your lenders.
- Acting as an interface between you and your lenders.
- Finding and negotiating on your behalf with potential new investors and potential buyers of group assets/businesses.

- Raising new capital for you in the primary and secondary markets.
- Advising the board on any regulatory requirements of the Securities and Exchange Commission and, if the company is listed, the stock exchange authority.
- Advising on any announcements to be made in relation to the company's current and future financial position, including liaising with the stock exchange and the SEC on the company's behalf.

### Conclusion: Hopefully, a happy ending

Your restructuring plan has been accepted by all of your financial creditors. Your trade suppliers are now comfortable in resuming normal relations. Liquidation is no longer a threat. You now begin to focus much more on running the business. The debt restructuring has taken its toll, you have lost some good people, but you have survived.

Your people see the light at the end of the tunnel and morale is visibly improving. You have paid the financial adviser's fee—hopefully much deserved. You are free to move on and you do, learning much from your experience and vowing never to return.

# Consistency and balance

~ Editha O. Tuason, Partner, Technical Standards and Risk Management

**INTEGRITY, COMMITMENT AND DISCIPLINE** are essential to effective management. Integrity crystallizes one's principles and values, while commitment binds a person to a particular course of action. Discipline, on the other hand, focuses a person's attention towards the accomplishment of short term or long-term goals.



But if one fails despite the efforts exerted to reach his goal, he should assess the situation, relate the reason for his failure to his life's mission, and if necessary, correct the situation by shifting his paradigms.

All these factors can work together to enable someone to say "no" to situations not deemed important to his mission. Of course, it is also essential that one's life mission is congruent with the firm's mission.

Hence, it is almost difficult if not impossible to lead a well-balanced lifestyle.

However, if one is clear on his goals and his life exemplifies the principles stated in the Bible, then "a well-balanced lifestyle" is attainable. This can best be summarized in the scripture found in Matthew 6:33: "Seek ye first the Kingdom of God and His righteousness and all these things shall be added unto you."



# Of ethics and men

**THE** search for a company CEO is not easy. It goes beyond looking for the right qualifications, experience and personality of the candidate. It requires a closer scrutiny of the candidate's character, integrity and reputation.

Jose S. Tayag, Jr.  
Partner, Advisory



When interviewing the CEO-candidate, the board of directors should ask probing questions such as, "What is the standard you use in your role as an executive officer?" "Do you use the same standard in your personal life?" "If not, how does it differ and why?" It helps to know how the candidate would resolve a dilemma on matters of ethical conduct. Would he terminate an employee charged with unethical conduct? How would he treat a whistle-blower?

These are just some of the instances where the CEO must exercise his judgment, and where he cannot let his sense of right and wrong get in the way. He may choose to do things in the name of the corporation, but would rather not if they are in conflict with his personal beliefs. If he feels it is the wrong thing to do, he should first find out whether the proposed action is legal—legal compliance being the baseline standard.

If an action is not in accordance with the letter and spirit of the law, the action should not be taken regardless of its effect on shareholder value. Medical ethics, for example, do not compel a physician to do something that violates personal ethics, in the same manner that corporate law does not require directors to check what is right or wrong when outside the boardroom.

Corporate officers and directors make decisions only after proper deliberations and discussions and how those decisions affect shareholder value. While decisions are made in the best interest of the corporation, it does not mean maximizing shareholder value without regard for employee morale, customer satisfaction, supplier goodwill, welfare of the communities where the company operates or the environment.

For good public image, top executives should observe propriety and appear to be proper at all times. Their fat bonuses and perks should not lead others to think that they are worth far more than the average employee. This would breed resentment in the workplace and cause damage to internal as well as external relationships. If left unchecked, this could lead to business decline, and when it happens, everyone even those who try to do their best would be affected.

A healthy workplace is preserved if authorities and responsibilities are properly defined. The rules apply to everyone, and management is expected to lead the way as role models. One of the reasons why the roles of the CEO and the chairman of the board are separated is because everyone has to be accountable to a higher authority. When matters of conflict arise, such as competence or succession issues, an

independent director is appointed to act as officer-in-charge. This appointment is important to assure shareholders and employees that the board of directors function effectively as a check and balance to management.

Should any of the burdens of ethical and social corporate behavior rest on shareholders? The answer is that it is not practical to rely on the shareholders. For one, they have little or no access to information. They are not privy to details of company decisions or involvement in many of their corporate programs. The cost of ferreting out information for shareholders to make informed judgment on whether the company is acting ethically or is socially responsible is not economical. Even within the organization, middle managers have no control over the investments the company makes. However, accountability in the decision-making should not be held separate from the consequences of an economic decision.

If not the shareholders, should it be the directors? The directors cannot and should not be overseeing the day-to-day affairs of the corporation. But the board can do its best to empower every employee to be ethical. The board must encourage everyone to come forward without fear of retaliation if they believe that something is not right.

Legal and ethical training for employees is important and should be applied consistently with company policies. If the executives get away with cheating on their expense reports or using company resources for personal gains, employees then become cynical and begin to doubt the sincerity of management.

Can ethical decision-making be taught? It is not enough to exhort managers and directors to be ethical. Companies need to define what it means to be ethical. People within and outside the corporation would normally consider certain values that would represent an ethical company. This could include providing or maintaining high-quality goods to customers, meaningful and well-compensated work for employees, a high return to shareholders, or a program for a sustainable environment. For a company to be considered ethical, every value should be evaluated and balanced with all others.

Once there is a consensus on which values are important, future business leaders need to be taught how to engage in moral reasoning. Some skeptics argue, though, that ethics cannot be taught because by the time a person is an adult, his or her values would have been formed.

But no one said that value is in the eye of the beholder. We either learned it from our parents or we don't have it at all. Consider how business schools teach students that providing value to the customer is key to commercial success. Professors use theory and case studies to teach future business leaders the importance of value, the why, where, and how organizations can foster value creation.

Similarly, we need to teach future and present business leaders why ethics is important, how to figure out what is ethical, and what conditions tend to push people in the organization to be more or less ethical. We need to teach future business leaders how to use moral reasoning to determine what is ethical and how to create an organization that reduces the temptation to do the unethical.

As a minimum, we should know where the legal lines are drawn, and why compliance with the law is critical for a business to be considered ethical. This is basic to promoting a culture for value creation and building a reservoir for making good management decisions. This by the way is not just the responsibility of the CEO or any single officer or director but of everyone in the company. However, top management must show the way!

# Accountability

~ Jose S. Tayag, Jr., Partner, Advisory

**ACCOUNTABILITY IS MORE THAN** just providing information. It is accompanied by an obligation and commitment to account or explain information or action.



Because there is an act of giving, there is a giver or the source of the information who takes upon himself the responsibility to seek the truth of what he reports.

Accountability implies a legal or moral obligation for which one must answer to someone sitting in judgment. It implies being able to distinguish between right and wrong and to think and act rationally. It means being able to conduct oneself ethically through words and deeds. It means readiness to accept duties and sanctions.

In our work, we embrace and live in a culture of accountability, transparency and integrity—a collective environment where we share the same values, respect each other, and connect our thoughts and action. Inherent in this culture is our continuing effort to ensure high quality and trustworthy work. We have a complaints and allegations policy to address complaints or concerns that our people have failed to comply with professional, regulatory, and legal requirements, or our system of quality controls. We have a written PwC Code of Conduct that governs all our actions.

# Volunteerism

~ Angelito M. Gabriel, Partner, Assurance

I READ A RECENT newspaper article about Benjamin Abadiano, a recipient of the Ramon Magsaysay Award for emergent leadership for his steadfast commitment to improve the lives of indigenous Filipinos. The article quoted Mr. Abadiano as taking part in other people's dreams.

In the public lecture he delivered at the Ramon Magsaysay Center, he encouraged Filipinos—especially the youth—to be empowered by the "spirit of volunteerism" to make a difference in the lives of Filipinos in indigenous communities and outcasts of the drawn-out conflict in Mindanao. He was quoted as telling his audience, "Rather than dream of things to gain and self-recognition to achieve, we have to let ourselves take part in the dreams of others. We ought to welcome the simplicity of being active participants in the building up of lives that are not our own."



More recently, another publication featured an article entitled, "It Takes a Village and a Consultant", about Ayub Tahir, a partner of accounting and consulting giant, PricewaterhouseCoopers (PwC), volunteering to help the village leaders in the Namibian outback address their community's growing AIDS

crisis. Faced with language barriers, cultural differences, and scant access to electricity, Ayub and his two colleagues had to scrap their PowerPoint presentations in favor of a more low-tech approach: face-to-face discussion. The village chiefs learned that they needed to garner community support for programs to combat the disease, and Ayub learned an important lesson as well: technology isn't always the answer. "You better put your beliefs and biases to one side and figure out new ways to look at things," he said.

Ayub is one of the participants in PwC's Ulysses Program, a corporate social responsibility program, which sends top mid-career talent to the developing world for eight-week service projects. The program aims to test the talents and expand the worldview of the firm's future leaders. For these next generation of partners, overcoming barriers and forging a connection with clients the world over will be a crucial part of their jobs.

It's those skills that PwC hopes to foster in partners who take part in the Ulysses Program. Since PwC started the program four years ago, it has attracted the attention of Johnson & Johnson, Cisco Systems, and other big companies considering their own corporate social responsibility programs.

These are indeed inspiring stories of people and organizations who are making a difference in the lives of people through volunteer work. But where do these volunteers get their energy to accomplish such inspiring and ennobling work? What is it about the spirit of volunteerism that allows people to do what is good for others and enjoy doing it?

I believe that the power of these volunteers come from their motivation to serve and help other people and make a contribution to the betterment of the world we all live in. I also know that love must be the motive of these volunteers who enjoy doing what is worth doing for others. The following quote made by an American statesman, Brian Hinckley, aptly describes the feats of these volunteers:

"Service is a virtue that distinguishes the great of all times. It places a mark of nobility upon its disciples. It is the dividing line, which separates the two great groups of the world: those who help and those who hinder; those who lift and those who lean; those who contribute and those who only consume. How much better it is to give than to receive? Service in any form is comely and beautiful, to give encouragement, to

impart sympathy, to show interest, to banish fear, to build self-confidence and awaken hopes in the hearts of others. In short, to love them and to show it is to render the most precious service."

I am inspired and encouraged by people such as Messrs. Abadiano and Ayub Tahir and many others who volunteer their talents to make a difference in the lives of other people. These people unselfishly offered their talents and helped build up the lives of others.

I agree with Mr. Abadiano when he encouraged the Filipinos, especially the youth, that the "spirit of volunteerism" should empower them to make a difference in the lives of others. The same spirit of volunteerism is needed today to help our country that is now reeling from the effects of a fiscal crisis.

More than the congressmen's volunteering to cut their pork barrel, we need more people who voluntarily pay the right taxes, do their best to perform their jobs diligently, and strive to do the right thing and not only what is expedient. As we find ways to help our countrymen and our country, our efforts may eventually benefit the whole world that is becoming borderless and turning into one global village.

Volunteers or the spirit of volunteerism must be the paradigm of everyone who wants to make a difference in what they do. Even in business, we must treat our customers as volunteers, for they will volunteer their resources to patronize our products/services that add value to their business. To ensure that we add value to the products/services we provide, we also need to treat our own employees as volunteers for they will volunteer their best minds and hearts if they are being treated as if they are our best customers.

Volunteerism, through our firm's existing policy on corporate social responsibility, is alive in the hearts of our people. Fulfilling corporate social responsibility has been an innate practice in our firm throughout the years. For the most part, such practice has been in the form of involvement in various activities—ranging from being part of a team assigned to NGO clients for services done *pro bono* or with partial billings to participation in civic and professional associations rendering community outreach work as well. Such "involvement" has largely been considered as "part of the job", thus, little recognition of such effort, if at all, was conferred to the employee by the firm.

I am encouraged to note that more organizations are becoming catalysts for volunteer work through their corporate social responsibility programs. Interestingly,

these companies are consistently being cited as one of the most admired companies. These companies are developing responsible citizens who possess the heart to serve others. These people see service as a true virtue and demonstrate them by volunteering their talents to help, lift and to contribute to the betterment of their community. These are the emerging leaders of the 21st century. They are our hope for a better world!



# Leadership

~ Jerry S. Isla, Chairman and Senior Partner

**LEADERSHIP IS PUTTING INTO** action the realization that the incumbent is compelled to do his best in order to pass on something that is better than what he received. It is providing continuity for the business to go on smoothly even in a different environment, in a difficult economic situation, or when changes in key positions take place.

Leadership is attaining financial success when profits are acquired because integrity, transparency and accountability of the people and processes are the rules; when the client relationship will not expose the firm to risk; and when professional satisfaction of the people are evident of high global standards of excellence.

Leadership is stewardship where the responsibility entails preparing future stewards to take on your role. It is also authority because it propels you to do things that are larger and bigger than life itself. But that authority must be used only in the right way, at the right time.

Leadership is being empowered to do great things, with great responsibility.

# Are you ready to make the change?



Jerry S. Isla  
Chairman and Senior Partner

What is IFRS? And why should corporate directors be wary about it?

The International Accounting Standards Board (IASB) mandates that financial statements as of December 31, 2005 should apply international financial reporting standards (IFRS). As of December 2004, thirty-seven (37) IFRS have been released, consisting of 32 international accounting

standards (IAS) and five IFRS. There is a tremendous amount of work needed to convert GAAP-based accounts into IFRS. Corporate directors must appreciate the magnitude of the work.

### Where to begin?

It is important to note the dates in the conversion process:

- 1 Jan 2003 is the date of transition for SEC registrants and any other company requiring three years of income statements.
- 1 Jan 2004 is the date of transition for most companies, to recognize and measure all items using IFRS.
- 1 Jan 2005 is the date of adoption of IFRS 1, which includes the application of all standards in force at this date.
- 31 Dec 2005 is the first IFRS reporting date for the first IFRS financial statements.

### Why IFRS?

Corporate directors must understand why IFRS. Accounting as we know it is very straightforward and very rules-oriented. Under generally accepted accounting principles (GAAP): pre-operating expenses

are deferred and amortized over a period of time; property, plant and equipment are generally depreciated over their estimated useful life; investments may be carried at cost. The question arises: does this method help reflect fair values? When property, plant and equipment are sold, the fair market value is used in the negotiation, not the depreciated value. The same is true with investments. The fair market value is needed to determine selling price. In the case of pre-operating expenses, better judgment calls that a direct charge be made rather than amortize them. Under these rules, the financial statements are effectively rendered inaccurate and unreliable, because they do not reflect the true results and financial position of the business. Thus, the use of IFRS.

### Economic benefits

IFRS can produce economic benefits. An asset is defined as a resource controlled by the entity that holds future economic benefits. The economic benefit linked to the asset corresponds to the potential that the asset has in contributing, directly or indirectly, to positive cash flows. Analysis must be made on what are the assets, the indicators to assess their benefits, how these benefits will be measured, and what information must be disclosed.

### Cash-generating units (CGUs)

A CGU is the smallest group of assets that generates independent cash flows, and must be tested for impairment annually. CGUs identified when IFRS is first adopted will form the basis for impairment testing on an on-going basis.

### Cash flow projections

Impairment of nonfinancial assets is tested using "value in use" driven by expected cash flows or net selling price. Both require management to make judgments about the future. Expected cash flows should be consistent with the company's strategy, and updated if changes are made. Mandatory disclosures about cash flows and assumptions make it easier for analysts and users to challenge management's assumptions or to re-perform calculations using alternative inputs, such as discount rates, growth rates and market share.

### Calculation of residual values

Residual value is the amount an entity expects to obtain for an asset at the end of its useful life. The assumptions made in arriving at values should reflect the company's strategy and the expected future cash

flows. Management will need to involve valuation specialists more frequently than in the past.

Some IFRS effects include: special purpose entities that were previously off-balance sheet will be consolidated; subsidiaries previously excluded from consolidation because of their non-homogeneous nature will need to be consolidated; derivatives will be brought on-balance sheet; many more assets will be stated at fair value or cost, less impairment; most preferred shares will be transformed from equity to debt.

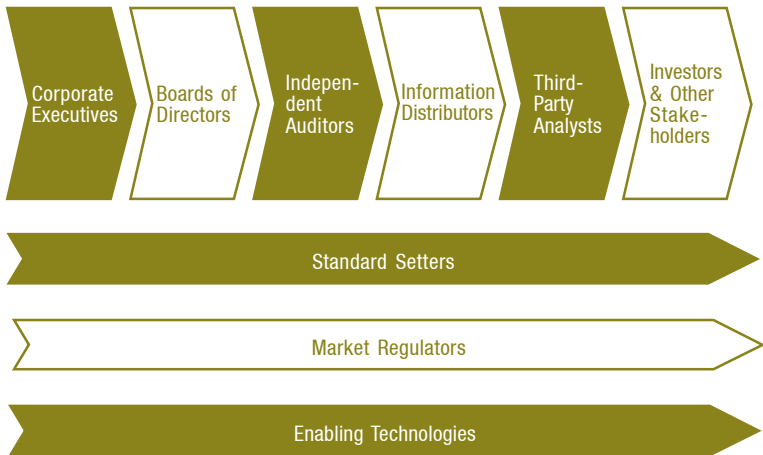
### IFRS and the corporate reporting supply chain

IFRS will show the way to convert historical costs into fair values so that financial statements become a true representation of business value. It will promote uniform and comparable reporting, transparency, and proper accountability.

Participants in the corporate reporting supply chain—company executives, boards of directors, independent auditors, standard setters, regulators, third-party analysts, information distributors, and enabling technologies—can now have a common understanding of financial reports. IFRS will help restore public trust because every participant in the corporate reporting supply chain is expected to embrace and live

by the spirit of transparency, the culture of accountability, and integrity, and hold himself accountable for his actions and decisions.

The corporate reporting supply chain



Source: Samuel A. DiPiazza, Jr., CEO, PricewaterhouseCoopers  
Dr. Robert G. Eccles, Senior Fellow, PricewaterhouseCoopers  
*Building Public Trust* (New York: John Wiley & Sons, Inc., 2002)

Companies can now more easily access the world's capital markets with less cost using IFRS-compliant financial reports. They can compare their own performance with that of industry peers and make use of other company-specific information, such as strategy, plans, risk management practices,



compensation policies, corporate governance and performance measures unique to the company.

Investors can also more easily and accurately compare the performance of any company, in any industry, in any country, thus broaden their investment choices. Market regulators could also agree to allow any company using IFRS to list on exchanges within their jurisdictions.

### How to go about converting to IFRS

IFRS 1 entitled First-time Adoption of International Financial Reporting Standards will guide companies in the preparation of their first IFRS financial statements for the year ending December 2005.

This means that the beginning balances, which are the accounts in 2004 should already be IFRS-compliant. An additional reporting requirement for the financial statements in 2003 will be required for listed companies because of the three-year comparative financial statement presentation.

IFRS 1 applies to the first IFRS financial statements. The first-time user will need to identify the date of transition, select accounting policies that comply with IFRS, prepare an opening IFRS balance sheet, and prepare the first IFRS financial statements.

It requires retrospective adoption of most IFRSs, but allows 10 optional exemptions and four mandatory exceptions. The exemptions, however, may not apply to situations, so that greater work detail is needed to resolve certain issues requiring expert help. Additionally, disclosure requirements are very extensive.

The optional exemptions cover:

- Business combinations.
- Property, plant and equipment/investment properties, intangibles.
- Employee benefits.
- Cumulative translation adjustment.
- Transition date for subsidiaries, associates and joint ventures.
- Compound instruments.
- Comparatives for financial instruments.
- Designation of financial assets and financial liabilities.
- Share-based payments.
- Insurance contracts.

The mandatory exceptions cover:

- Estimates.
- Derecognition of financial assets and liabilities.

- Hedge accounting.
- Assets held for sale.

### Practical challenges

There are many challenges in adopting IFRS. The more notable ones are:

- **Systems overload.** One of the biggest shocks is the sheer number of disclosures and how different they are from the national GAAP. The systems are just not collecting the needed data. So the options are either to put in new systems or employ an army of people to do the work manually. Most would prefer to put in new systems, which can be expensive, but it can be done quicker given the right people and budget.
- **Exposure.** The most feared effect of conversion to IFRS is the way that the emerging fair value will expose results to the marketplace. This is true with financial institutions, which argue that the changes to fair value will tend to distort results and make it difficult for stakeholders to judge how well management is running the business.

- **The effects on the application of IAS 39 on Financial Instruments.** For financial institutions, new disclosures and presentation affect something like 90% of the asset side of the balance sheet. It is not just the accounting for derivatives and hedging that change, but accounting for investment securities, loan losses and securitization as well. It is this standard, more than any other, that drives the need for systems change.
- **Performance.** IAS 30 on Disclosures in the Financial Statements of Banks and Similar Financial Institutions can significantly change key ratios, such as return on capital and cost/income ratios are calculated. So banks reporting under IFRS have found that the key performance measures that they have been communicating to analysts and investors all these years will suddenly look very different.
- **Return on Investment.** When shareholders want to know what kind of returns they are getting on their investments, they often look at the return on equity measure. How will IFRS

affect this? Return on equity will drop. Why? For two reasons. First, many financial institutions have traditionally provided for "rainy day" money or unallocated provisions sitting on the balance sheet. This is unacceptable under IAS and the provisions are added back to equity.

At the same time, under IAS 22 on Business Combinations, goodwill that was previously written off to equity appears on the balance sheet to be amortized over a number of years. This increases equity still further because goodwill is no longer deducted from equity, but it depresses profits as the amortization stream is charged in the income statement.

- **Timing.** For companies used to reporting sometime in April for a December yearend, they will find themselves under pressure to report earlier. If the report is done in February or March, the analysts and investors will expect to get all the IFRS results at roughly the same time. So these companies must either have a system that can produce the numbers

fast, or again, have an army of people prepared to work round the clock to manually crunch the numbers.

- **Staffing.** Finding enough staff that are knowledgeable about IFRS is already difficult. There are not yet enough people who understand IFRS. Companies therefore have to think about intensive training of existing staff and/or extensive use of consultants, which can be very expensive.
- **Cost of conversion.** The cost of conversion is another matter to worry about. The cost is going to depend on what each individual conversion project involves. If new systems are needed, it is obviously going to cost more. Almost all companies will have to pay to find qualified people, train existing staff, or get good advice on the application and the change process itself from outside experts.

At PwC, our systems and people are geared up for IFRS work. Training has been extensive, so rapid in fact, that while we are yet getting familiar with new

revisions, recent changes already render obsolete what we know as new.

Worth mentioning is our global experience on conversion issues for telcos. Companies in the telecoms industry sometimes apply different accounting methods to similar accounting issues. The introduction of a common set of accounting standards will improve the comparability and transparency of financial reporting, but similar transactions can vary between markets and operators, depending on the specific facts and circumstances of a transaction, the customer demands of that market, and the regulatory environment. This will not mean that telcos will have a single set of accounting policies. In fact, a big challenge is the quality of disclosures made about critical accounting policies. Some discussion on accounting policies follows:

### Revenue recognition

There are two factors in revenue recognition—multiple-element arrangements, and principal versus agent model of reporting.

Under multiple-element arrangements, the telecoms sector increasingly offers complex bundled arrangements for the sale of equipment, connectivity, maintenance services, and various sales incentives in a single transaction, such as free future upgrade and

installation. It may be difficult to identify discrete components that should be accounted for separately, and determine the fair value of these components.

Are free e-mails, SMS, downloads, installation and gifts separable components for accounting purposes? What is the fair value of a mobile handset or subscription? Specifically, IFRS requires transactions to be accounted for based on substance, meaning what the customer has purchased, and what the operator's obligations are.

Principal versus agent. Convergence has been a trend for some time, such as in "one-stop shop." To facilitate this, operators enter into alliances or network sharing and revenue-sharing arrangements with third parties for content and other services. The question arises as to who is the principal and therefore would record revenue at gross, and who is the agent, in which case revenue would be recorded as the net commission earned. Operators must establish the specific framework to ensure that the appropriate accounting treatment is adopted. Otherwise, the revenue recognition would be distorted.

### Internal costs

Another concern is capitalization of internal costs. The costs of constructing a telecoms network range



from the cost of purchasing network equipment and fees paid to third-party engineers, to the internal costs of planning and financing the construction process. Internal costs directly attributable to bringing the asset to the location and condition necessary for it to operate can be capitalized. The cost of employees deployed in the rollout of the network tends to be the most significant internal cost.

### Impairment

This entails the definition of the cash-generating unit and the treatment of capital expenditure. Cash-generating units are defined as the smallest group of assets that includes the asset under review, that generates cash inflows from continuing use, which are largely independent of those cash flows from other assets or groups of assets. The independence of cash flows will often be indicated by the way management monitors the operator's activities. Operators need to consider if the 2G business is independent of the 3G business; if the local loop (the access part of the network) should be treated as separate from the core network; and if fixed and mobile/wireless businesses can be a single cash-generating unit.

### Treatment of capital expenditure

The recoverable value of the network infrastructure and licenses is usually calculated by reference to their value in use to the business. IFRS requires future cash flows to be estimated for the asset in its current condition. Estimates of future cash flows should not include amounts expected to arise from improving the asset's performance.

Most operators have significant capital expenditure programs in place. Determining whether items of capital expenditure complete, maintain or enhance the network asset is often complex, and the results of the analysis can lead to material differences in the impairment decision.

### The case of Volkswagen

Our global experience with Volkswagen demonstrates the fact that changes can be very dramatic in the conversion to IFRS. The Volkswagen Group converted their 2001 accounts and results of operations in accordance with IFRS. This was an 18-month project launched in March 2000 to convert their accounts from the German Commercial Code (their equivalent GAAP) to IFRS.

Part of the work was to examine the 1999 group figures to determine the 2000 IFRS opening balances.

One of the significant highlights of this conversion was the reconciliation of the capital and reserves. The opening group capital and reserves at January 1, 2000 under IFRS became double that of the German GAAP. From EuroDollar 9.8 billion under the German GAAP, it became EuroDollar 20.9 billion under IFRS.

As you can see from the Volkswagen experience, the application of IFRS in fact improved the company's financial position. In most cases, however, it is likely to be on the downside, as many of adjustments will be a charge to equity.

Our experience shows that converting to IFRS is a complex matter and requires extensive planning and implementation. If companies are yet to start this process properly, we recommend that they do so immediately because time has run out. Delay is not an option. So make the change now.

## Isla Lipana & Co.

**ON OUR 84<sup>TH</sup> YEAR** of service, we begin the fiscal year with a new name: Isla Lipana & Co., a member firm of PricewaterhouseCoopers.

We decided to adopt Isla Lipana & Co. as our trade name to make it consistent with the partnership name that has been used since 2001. It carries the surnames of two of the more senior partners: Jerry S. Isla, Chairman and Senior Partner, and Tammy H. Lipana, Tax Managing Partner.

Volatile markets, stricter regulations, and new methodologies impact the practice environment today. We respond to the changes by expanding our knowledge, by sharing our best practices, and by working harder and smarter. We look at every challenge as an opportunity to deliver what our clients deserve: Our integrity and quality service.

Our name may change, but we stay committed to the public we serve. Our passion for excellence remains vigorous, and our commitment to deliver value, trust and quality, more than ever, prevails.

Our firm is undergoing a name change for the fourth time since our predecessor, White, Page and Company, was established in 1922. In 1948 we were

known as Stewart, Dacanay, Cunanan & Co.; in 1951 as Stewart, Cunanan & Co.; and in 1964 as Joaquin Cunanan & Co. During this period, we were under the stewardship of three Senior Partners: Joaquin Cunanan (the first Filipino to hold the position, 1956 - 1970), Jose C. Florento (1970 - 1981), and Corazon S. de la Paz (1981 - 2001). To this day, they are our source of pride and inspiration.

Our affiliation with PricewaterhouseCoopers goes a long way. We became a correspondent firm of Price Waterhouse in 1958, and a member firm of the Price Waterhouse International in 1973. In July 1998, legacy Price Waterhouse merged with legacy Coopers & Lybrand to form what is today, PricewaterhouseCoopers, the premier global professional services organization that is helping shape the future of business around the world.



*Tammy H. Lipana, Managing Partner, Tax. Jerry S. Isla, Chairman and Senior Partner.  
Jose P. Lavares, Jr., Managing Director and Chief Operating Officer.*

*Wilfredo S. Madarang, Jr., Business Development Partner. Judith V. Lopez, Managing Partner,  
Assurance. Rossana S. Javier, Deputy Managing Partner, Advisory. Jose S. Tayag, Jr., Ethics  
Partner.*

management committee



Judith V. Lopez



Rodelio C. Acosta



Geraldine H. Apostol



Jenny L. Arciga



Roderick M. Danao



Angelito M. Gabriel



Cherrylin M. Javier



assurance



John Patrick V. Lim



Victor O. Machacon



Wilfredo S. Madarang, Jr.



Ador C. Mejia



Blesilda A. Pestaño



Melissa L. Ramos



Ireena R. Vallesteros





Tammy H. Lipana



Alexander B. Cabrera

Myrna M. Fernando



George T.J. Lavadia



Mary Assumption S.  
Bautista-Villareal

tax



Jose P. Lavares, Jr.



Rossana S. Javier



Jose S. Tayag, Jr.



Charlie T. Francisco



advisory



Editha O. Tuason  
*Technical Standards &  
Risk Management*



Rosario B. Nañagas  
*Human Resources*



Akinori Kusuno  
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