Infrastructure

Developments

Introduction

The financial system and all of its various components (institutions, markets, and clearing and settlement systems) are supported by a set of arrangements, including government policies, that influence its structure and facilitate its operation. Taken together, these arrangements form the financial system's infrastructure. Experience has demonstrated that a key determinant of a robust financial system is the extent to which it is underpinned by a solid, well-developed infrastructure. This section of the Review *highlights work in this area, including that related to relevant policy developments.*

A key element of a well-functioning financial system is investor confidence in financial reporting and auditing standards.

Since 2001, a series of revelations regarding questionable corporate accounting practices have damaged investor confidence in financial statements, corporate governance, and auditing standards. Since then, there has been a world-wide effort to improve this situation. One example is the report of a task force established by the International Federation of Accountants. The task force was chaired by John Crow, former Governor of the Bank of Canada. In *Rebuilding Public Confidence in Financial Reporting: An International Perspective—Report on a Report,* John Crow outlines the key challenges that the task force faced and how these were approached. Mr. Crow also provides his views on the challenges associated with restoring investor confidence and on the progress currently being made at the international level.

Rebuilding Public Confidence in Financial Reporting: An International Perspective —Report on a Report

*John Crow**

In late 2002, the author agreed to chair an international task force sponsored by the International Federation of Accountants (IFAC). The objective was to examine the loss of credibility in corporate financial reporting and disclosure, and to make recommendations as to how the situation could best be improved.

This was a broad order, but with the help of the IFAC and its 159 member organizations, we were able to persuade a number of experienced individuals from around the world (Australia, Canada, France, Japan, the United Kingdom, and the United States) to participate. Besides our multinational provenance, the seven task force members were expected to contribute through a mix of professional backgrounds. These were in finance, law, economics, auditing, accounting, regulation, public policy, and corporate governance, among others, and the range proved invaluable.

What did this ex-central banker bring to the table? For one, the chair was a "non-expert," which meant that the Report minimized the use of specialized jargon. For another, the Report, while commissioned by the IFAC, was to be "independent" in its assessment.

Our work was to be at a "high level." That is to say, given the range of issues to be dealt with, we were bound to consider them more at the level of principle than in any particular degree of detail—either technical or national. Furthermore, taking a broader view was not only necessary but also the appropriate way to go. Most of the authoritative material that has appeared on these matters soon narrows in on particular, specialized issues. Besides being somewhat technical, it is largely national in focus, that is, addressing matters very much as a reflection of specific local regulatory structures and market traditions.

But the task force aimed to look behind local features to more central forces. At the same time, taking this global viewpoint did not mean that we would ignore the way different styles of market regulation and organization or legal approach might influence outcomes in particular jurisdictions. What we would need to do would be to evaluate the reasons for those differences, and their consequences, in reaching our broader conclusions and recommendations. This also meant focusing on mounting cross-border issues.

We also aimed to craft a document that, while authoritative, was as accessible as we could make it for non-specialists, such as politicians, journalists, and interested laypersons. For this reason among others, we needed to keep our narrative as short and to the point as a committee could. This helped to keep our group focused, as did the fact that one person, hired for the committee, held the drafting pen.

Our Report, bearing the same title as this article, was published in the summer of 2003. It can now be found on the IFAC's Web site at <www.ifac.org/credibility>.

Building Blocks

A loss of credibility?

How had the mighty fallen! Given the landscape in late 2002–early 2003 (Enron, WorldCom, Royal Ahold, HealthSouth, to name some of the more egregious instances), the task force had no difficulty agreeing that there must have been a loss of credibility in financial reporting.

Where the discussion became more interesting was over the question of whether that loss had

* Mr. Crow was Governor of the Bank of Canada from 1987 to 1994. The views expressed in this article are those of the author. No responsibility for them should be attributed to the Bank of Canada.

occurred everywhere. Certainly, the largest and most high-profile reporting scandals had occurred predominantly in the United States. But then again, the United States was also the largest, most high-profile economy—by a wide margin—so U.S. events, even if U.S. focused, also tended to cast a large shadow globally. At the same time, there were features of the American scene that seemed to exert particular pressure on good financial reporting, such as reliance on detailed rules in accounting/auditing decisions (encouraging more conformity to the letter than to the spirit of the exercise) and the mushrooming of executive compensation in the form of options (which, to the extent that they promised large short-term payoffs, increased the incentives for manipulating information so as to immediately enhance the share price).

Nonetheless, we readily agreed that the records in our own countries indicated that complacency or “I told you so!” reactions were to be discouraged. For Canada, for example, Guylaine Saucier (the other Canadian member) and I were able to cite a goodly list of problem cases, even if nothing as seismic as in the United States. Instances from the Canadian litany that made it into the Report included the Canadian Commercial Bank, Castor Holdings, and Roman Corporation, and there were plenty of others to call on if they had been needed. More recent reporting headlines—e.g., Adecco, our own Atlas Cold Storage and Nortel, and Parmalat—would only confirm that it was wise to avoid complacency as to what could happen in your own backyard.

The costs

The damage from losing credibility is seen most clearly in the direct consequences for corporations where reporting problems are surfacing. Investors have now shown themselves exceedingly quick to dump positions at the first whiff of an issue of this kind. It has come to the point, at least in North America, where corporations strain every sinew to avoid having to restate earlier financial reports, given that a restatement itself, however inconsequential in reality, carries a bad odour to the marketplace.

More generally, the cost would show up as a hike in the cost of business capital and a loss of productivity and economic growth overall, as investors backed away from corporate finance. The present lofty levels for price-earnings ratios in many markets would suggest that investors still have considerable trust in the system. However, no one is likely to want to press the recent experiences in misleading reporting to the point where there would be such a broad retreat. That in itself explains the efforts made in virtually every jurisdiction to tighten rules and procedures in this area.

A broad view of responsibilities and participants

Our approach was based upon two premises. First, corporate reporting is public reporting and therefore very much a public-interest activity. Second, there is a range of different actors participating in that public process.

Those directly involved do not accept these premises as readily as one might hope. The reason seems to be twofold: a concern about incurring costly liability if things go wrong; and a worry that participants might all too often find themselves in a conflict position—over duty to a client or constituent on the one hand and the broader responsibility to the investing public on the other.

The task force was very aware of the challenges its view presented. One that engaged it for some time, for example, was how to reconcile the well-established duty of a director to a corporation with any responsibility that director might have to the public at large. In the end, however, we agreed that the reporting issues and abuses were sufficiently serious that the only credible position to take was indeed that “a duty to ensure that public reporting presents the information fairly should override all other duties of the individuals and firms concerned.”

As for the individuals and firms involved, we saw reporting as a process flow. It starts with management under the general direction of the board of directors, brings in the auditors for an independent opinion, and then the media, etc., who distribute the information, along with the analysts and credit-rating agencies, who evaluate it. Alongside this flow are the standard setters, who set the rules; the regulators, who enforce them; and those, such as investment bankers and lawyers, who provide ongoing advice to the other participants. The important point for us was that they all had an inescapable public responsibility for fairness in reporting.

Ethics standards and codes of conduct

Since fairness in presentation implies strong principles, it also leads quickly into a consideration of ethics and codes of conduct for the different actors on the reporting scene.

In this regard, it is often said that one "cannot legislate morality." The task force would probably agree with this, but it did not therefore believe that there was no point in emphasizing the importance of "the tone at the top" for a corporation's ethical outlook and the relevance of codes of conduct for all the participants, whether they were within or outside corporations. Frequent and careful reminders of the broader responsibilities for those involved in reporting, together with explicit guidance as to how to deal with challenging situations, can help improve underlying attitudes. No doubt, stronger after-the-event protection of "whistle-blowers" (something that has recently been provided through legislation and regulation in some countries) will also help by making it easier to follow through on difficult matters of principle.

Aligning expectations

What you expect to receive and what you get may be two different things. Gaps between what investors may expect a participant to supply in the reporting process and what is actually required professionally have been a persisting source of tension. Viewed from this angle, what the task force was aiming to do was to narrow those differences. We wanted both to clarify what the various actors in the process might be expected to be accountable for, and to explore ways in which the required standards of reporting and disclosure might be improved in light of the understandable, even if challenging, expectations of the marketplace.

This expectation-gap issue has been particularly apparent with regard to the external audit function. Indeed, Canada's accounting profession was sufficiently concerned back in the 1980s to commission an independent and comprehensive public study on the matter. Our Report, building on this study and on other material worldwide, highlighted two features—accounting judgment and precision, and the detection of fraud. As regards the former, we were at pains to point out that corporate financial statements, while perhaps appearing at first blush to be very exact, are, in fact, a combination of estimates and judgments, and therefore have to be understood and analyzed in this light. As regards fraud, it must be recognized more clearly and more generally that an external audit cannot reasonably be expected to guarantee that internal fraud does not happen. At the same time, we also noted that auditors can probably do more to check for signs of fraud through their particular procedures without huge additional cost.

Main Messages

Corporate management and governance

Not surprisingly, the task force saw ample room for increased use of best practices with regard to corporate procedures. In particular, we saw the need for greater attention to controls in financial management, underlining the special role of the chief financial officer (CFO) and of the internal audit in this regard. Given the increased involvement of CFOs in such areas as strategic planning, information technology, financing, and investor relations, their direct responsibility for the quality of a corporation's financial numbers appears to have slipped in recent years. We wanted to stress that a good grasp of, and attention to, issues of financial control and reporting is still a core competency for a CFO.

In the same vein, we devoted appreciable time and space to the role of the internal audit—including to what extent an internal audit department might be necessary, and if it appeared not to be, how the important oversight function that internal audit supplies might still be provided. This last point is particularly important for Canada, which seems to have a relatively large number of small public companies, since these are likely to find the responsibilities of tight financial control relatively costly.

As regards the corporate board, our main focus was on the membership, role, and effective operation of the audit committee. And a key emphasis of our focus was on the shift in general understanding that needed to take place regarding where this body fits into the reporting and control process. That is to say, we had the clear impression that in the past, the audit committee had all too often been more a passive observer of the process than a central player. But the committee does have a uniquely important role

as the immediate (in the end, of course, reporting to the full board) representative of the shareholders' interests. It has a further, still broader, duty to see to it that reporting is fair for investors at large. So, instead of the process for reporting being largely bilateral, involving only the management and the external auditor, it needs to be more a threesome, with the audit committee also well involved. This means that many audit committees should be greatly increasing their direct contact with, and oversight of, the external auditors, as well as checking on management's progress and performance.

External audit

While the Report does underline the range of players involved, there is no doubt that external audit—with its anticipated seal of approval in relation to generally accepted accounting principles (GAAP) —provides an absolutely crucial element. After all, it is specifically charged with supplying a form of credibility.

In this regard, one question that preoccupied us was the matter of the auditor's so-called "independence." This question has two levels. The one that has garnered most attention recently has been how auditor independence might be affected by the size of fees for non-audit services. These could become so large that concern over losing them might distort an auditor's judgment in relation to the audit itself. The situation at Enron is widely thought of as a classic case where things went wrong in this regard (as well as in others). While this concern implies quantitative limits on non-audit work, the task force took the view, after quite some discussion, that limits on the amounts payable would be arbitrary. It did, however, emphasize the need for qualitative constraints (to be monitored by the corporation, as well as by the auditors) to ensure, for example, that auditors in their consulting mode are not creating systems that they themselves will need to verify.

Another, deeper and more structural, issue is also the fact that the corporation pays for its own audit. This "paymaster" situation puts the auditor in an undeniable conflict. Because of this, the task force spent some time exploring possible alternative sources of payment. However, those alternatives seemed too ingenious and/or bureaucratic to be credible now. For example, a "government agency" solution would, among other considerations, run counter to the generally accepted need for auditors to stay very conversant with ever-evolving business structures and practices.

Accordingly, we focused considerable attention on the various safeguards that could be put in place to mitigate threats to auditor independence, given client payment, whether that threat came from outside the audit firm or from within. This is quite an involved, detailed area (even at the level of principle) that took up considerable space in our Report, and those arguments are not reproduced here. One aspect worth emphasizing, however, is that it was apparent to us all that, above and beyond the particular "threats and safeguards" considerations for auditor independence, having an involved and truly independent audit committee would be invaluable support for good audit assurance.

Other private sector participants

We spent less time and space on the other actors. They have a less central role and therefore there was not as much detail to deal with. As already indicated, however, we wanted to see to it that their responsibilities for appropriate public reporting were recognized and also to examine how those responsibilities might be incorporated into their work. In the main, our recommendations revolved around the desirability of codes of conduct (e.g., for investment analysts, lawyers, and investment bankers) that, in each case, would set out their responsibilities regarding fair public reporting and also what procedures would satisfy them. Such codes should be monitored both within the firms and externally.

We were aware, given the additional liability implied, that identifying broader responsibilities would be controversial. Controversy did not imply, however, that changes in procedures would not be very beneficial for fair disclosure.

Because they are paid by the client being evaluated, credit-rating agencies also suffer from independence issues similar to those facing auditors. One way to mitigate this kind of conflict would be to have agencies increase their disclosure as to how they go about their operations. This is something we also recommended, in some detail and in a broader context, for auditors.

Regulators

This section is relatively short, not because there is not a lot of detailed regulation in this area, but rather because the way forward is probably not so much through more regulation as through better recognition and enforcement of the principles behind it and through an improvement in the incentives facing market participants. The Parmalat case appears likely to reinforce this view of priorities.

The feature that particularly attracted our attention in the regulatory area was the question of self-regulation and how far it should go. The great and indispensable advantage of professional self-regulation is that it brings real understanding directly to bear on the matter at hand. An obvious disadvantage is that without effective external oversight, it can degenerate into an exercise of mutual insider forbearance. The task force considered that the risks of inadequate discipline in the area were sufficiently great and widespread, and the dangers to professional credibility sufficiently serious, that moves to enhance public-interest oversight in a mixed system were constructive, even if professionals might, understandably, be anxious to mitigate their more intrusive effects.

International Aspects and Concerns

Besides being able to bring a range of national experiences to our discussions, another important feature of the task force was that we were able to review more fully than most the difficult issues that are arising because corporate reporting rules are determinedly national, while business is increasingly international.

Those difficulties are particularly apparent at present, when so many countries (or groups of countries such as those in the European Union) are overhauling their domestic reporting requirements. It is only too evident that differing national or regional approaches to corporate-governance issues, accounting issues, auditing standards, or regulatory oversight, can lead to costly overlaps and divergences that businesses have to pay for—with no evident offsetting gain in overall fairness or market transparency.

As in instances beyond financial reporting, Canada is caught in the middle—between its general support of the use of international standards and, at the same time, its natural concern to maintain access to the all-important U.S. market, even when U.S. standards part company with professedly more international ones. Canada is also awkwardly caught by its inability to get its own act fully together, given the persisting differentiations in securities market regulations from one end of the country to the other. This adds domestic costs to those incurred across national borders.

The international divergence receiving the most focus at present has to do with accounting standards. International standards for accounting, promoted and guided by the quasi-public International Accounting Standards Board, clearly answer a need in a globalizing world. Furthermore, they have, at least in principle but not without controversy over some of the details, been adopted by the European Union for implementation in 2005. The challenge is to reconcile these emerging international standards with, in particular, the U.S. approach. I am happy to report that there seems to be authoritative good will on both sides. But this does not mean that getting an appropriate reconciliation will not still be a major challenge for all concerned—particularly if the issues take on a political cast, as they are all too prone to do.

Conclusions

In conclusion, let me emphasize that the above is just a brief overview of the task force Report and is by no means a substitute for the real thing—not even for its executive summary. It should also be added that in the months that have elapsed since the Report was completed, nothing has happened to suggest that the concerns it addresses have gone away.

References

Task Force on Rebuilding Public Confidence in Financial Reporting. 2003. *Rebuilding Public Confidence in Financial Reporting: An International Perspective*. New York: International Federation of Accountants. Available at <www.ifac.org/credibility>.