

Business Reporting Beyond the  
Crisis: How to Make Sure That We  
Don't Tumble Into Another Black  
Hole



## Business Reporting Beyond the Crisis: How to Make Sure That We Don't Tumble Into Another Black Hole

“My general conclusion is that everyone is guilty,” says Jules Muis—former Ernst & Young partner, controller of the World Bank, and director-general audit of the European Commission—about the financial crisis. “The whole implosion is based on negligence by senior management of banks and other financial institutions, by investors, by auditors, as well as by regulators.”

The interview with Muis—alongside interviews with John Coombe, chairman of Hogg Robinson Group plc, non-executive director of HSBC, non-executive director of Home Retail Group plc, and former chief financial officer of GlaxoSmithKline plc; Jane Diplock, chairman of the Securities Commission of New Zealand, chairman of the Executive Committee of the International Organization of Securities Commissions (IOSCO), and member of the Financial Crisis Advisory Group; and Richard Petty, associate dean and professor at the Macquarie Graduate School of Management, Sydney, chairman of a Hong Kong-based investment company and president of CPA Australia—forms the second part of an interview series conducted by IFAC with 25 key leaders from around the globe on improving business reporting (see also “IFAC project on business reporting”).

### IFAC project on business reporting

In response to the report, [Financial Reporting Supply Chain: Current Perspectives and Directions](#) (March 2008), IFAC established a project group\* to study progress in the areas of governance, financial reporting, and auditing. [Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies](#) was issued in February 2009. This study indicated that, although progress had been made, several unresolved issues remain. In the final phase of this project, the project group has interviewed 25 key leaders from around the globe on what should be done to improve these areas.

Over the next months the interviews, including overviews of the recommendations, will be available on the [IFAC website](#), grouped in the following themes:

- Good governance and sustainability fundamental for improved business reporting (issued in June 2010)
- Business reporting beyond the crisis: how to make sure that we don't tumble into another black hole (issued in July 2010)
- Business reporting through the lens of the investor
- A global language for business reporting
- Towards a broader view of business reporting

Subsequently, the project group will develop an action plan, based on the recommendations of the interviewees and taking into account the reader response.

\* The project group consists of Charles Tilley (Chief Executive Officer of CIMA and Project Chair), Graham Ward (Senior Partner at PricewaterhouseCoopers and past IFAC President), Norman Lyle (retired Group Finance Director of Jardine Matheson Holdings Limited and Chair of IFAC's previous Financial Reporting Supply Chain Project), and Al Anderson (Managing Principal—Accounting and Assurance Services of Larson Allen and Chair of the Assurance Services Executive Committee of the AICPA). The steering group is assisted by Stathis Gould and Vincent Tophoff (both IFAC), and Amy Pawlicki (AICPA).

From their different perspectives in the business reporting supply chain (see also “The business reporting supply chain”), the four interviewees provide their insights into how the financial crisis developed and what should be done in the areas of governance, financial reporting, and auditing to prevent such a crisis from happening again.

### **The business reporting supply chain**

The business reporting supply chain refers to the people and processes involved in the preparation, approval, audit, analysis, and use of business reports. All links in the chain need to be of high quality and closely connected to supply high-quality business reporting.

## **What went wrong?**

The interviewees generally agree on the main issues that caused—or at least exacerbated—the financial crisis, including governance failures by all stakeholders in the financial reporting supply chain, such as a short-term focus and flawed risk management.

According to Jane Diplock, “Corporate governance is really at the core of the global financial crisis,” because the links between risk management, performance, and remuneration “all influence the behavior of company management.” John Coombe adds, “Too many people were gambling with other people's money and getting huge bonuses when it worked, but losing nothing when it went wrong.” On the other hand, as Jules Muis points out, investors are also part of the problem because “a lot of the pressures on management have come from ‘short-termism’ by investors, turning up the heat on management to seek short-term, ever more high-yielding, hence riskier business models, at the expense of long-term, sustainable performance.”

Risk management practices were also flawed, according to the interviewees. “You cannot imagine anything more inimical to the interest of the company than management and boards of directors engaging in such risky activities that could bring the company to ruin,” says Jane Diplock. “The fundamental error was in not pricing risk appropriately when the original investments were made,” says Richard Petty. “Far too few people had a proper understanding of derivatives and their inherent risk: no one on the board understood it, the CEO did not understand it, nor did other people in the organization.” The same was true for many auditors, Richard Petty continues: “I think that too few auditors currently specialize in the type of work that needs to be done to accurately assess risk for complex entities.” Jules Muis points out that this is not only a private-sector issue: “Regulators allowed themselves to be ideologically held captive by the in-vogue deregulation mode with no effective accountability constructs—not even for systemic risk.”

## **How to get it right?**

One valuable lesson with respect to risk is that black swans do exist, according to John Coombe: “We are all now much more alert to the fact that—even when the potential for risk is low—things can actually happen.” He recommends that directors increase their focus on risk, and engage more in a detailed understanding of the risks in their company's products and services. Richard Petty agrees, emphasizing the need for more education across the whole range of parties involved in this complex business.

“Especially on the buy side,” he says, “there should be much clearer guidance and advice given to people along the lines of: ‘You will lose money if you invest in things you don’t understand.’” He also sees the rise of a specialist class of auditors “who really can pull apart the various financial products and process the risk independently of the company,” so that their impact in terms of value and risk can be expertly assured.

In addition, Jules Muis would like to see securities regulators, the central banks, and the other financial regulators across the globe providing assurance statements on the existence (or nonexistence) of systemic risk. According to him, that would really help the private sector, because “you cannot expect banks and their auditors to identify and analyze systemic risk of the magnitude we have seen over the last couple of years.”

“The biggest risk going forward,” continues Jules Muis, “is a continuation of the disjointed international financial architecture.” He explains, “The various nations don’t want to sacrifice their autonomy. But they are out of sync with the reality that we have global fund flows but no global regulator. We need a ‘supra-national’ oversight body. A more solid international architecture of oversight bodies [would be] good for the total environment in the areas of governance, financial reporting, and auditing.”

Jane Diplock argues, however, that much of this financial crisis has to do with behaviors and cultures, which cannot be changed by regulation and oversight alone. She says, “What we need in corporate governance are more constraints on self-interest. The strongest form of defense comes from within the organization, its culture and its behaviors.” In addition, she continues, “Shareholders—and especially institutional investors—should more actively pursue their ownership responsibilities. For example, they should intervene if they believe that the remuneration framework is not aligned well enough with the performance of the organization.” John Coombe agrees: “Executive remuneration should be better aligned with the longer-term real performance—in terms of profitability, not sales volume—of the organization they lead: for example, deferred remuneration in the form of shares.”

In spite of recommendations regarding the initiatives the private sector should follow, the interviewees expect more regulation because of the crisis. As Richard Petty puts it, “There will be not only tighter corporate governance, but also more restrictions around what companies can do—for example, in accounting and in capital market regulation.”

The complete interviews with John Coombe, Jane Diplock, Jules Muis, and Richard Petty can be downloaded, free of charge, from the [IFAC website](http://www.ifac.org/frsc) at [www.ifac.org/frsc](http://www.ifac.org/frsc). Readers are encouraged to respond to the recommendations of the interviewees by completing a brief survey found at the conclusion of each interview transcript.

For information about IFAC’s business reporting project, please contact Vincent Tophoff at [VincentTophoff@IFAC.org](mailto:VincentTophoff@IFAC.org).