



# REBUILDING PUBLIC CONFIDENCE IN FINANCIAL REPORTING

AN INTERNATIONAL PERSPECTIVE

This report was developed by the Task Force on Rebuilding Public Confidence in Financial Reporting, an independent group commissioned by the International Federation of Accountants to address, from an international perspective, the loss of credibility in financial reporting and approaches to resolving the problem.

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# REBUILDING PUBLIC CONFIDENCE IN FINANCIAL REPORTING

AN INTERNATIONAL PERSPECTIVE

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## INTRODUCTION

The Task Force on Rebuilding Public Confidence in Financial Reporting was commissioned by the International Federation of Accountants (IFAC) in October 2002 to look at ways of restoring the credibility of financial reporting and corporate disclosure from an international perspective. It is this international perspective that we believe distinguishes our report from the many national reviews on similar topics.

We were asked to:

- Identify and analyze the causes of the loss of credibility;
- Consider alternative courses of action which might restore credibility; and
- Consider recommendations as to best practice in the areas of financial and business reporting, corporate governance and auditor performance.

This report details our findings and recommendations in each of these areas.

The members of the Task Force have brought to our deliberations extensive experience from a wide range of professional backgrounds. They come from six countries: Australia, Canada, France, Japan, the United Kingdom, and the United States. Three members have experience as accounting professionals, although only one is currently an auditor; our other members have experience in central and commercial banking, international economics, academia, and law. Five of the Task Force members currently serve on the boards and audit committees of listed companies. Further background information is set out in Appendix 1.

Our initial discussions confirmed the assumption that low credibility of financial reporting is a serious and widespread issue. We also quickly concluded that the recent financial scandals were symptoms of deeper problems and not the prime cause of the loss of credibility. Our focus, therefore, has been on identifying the causes of the problems and recommending solutions.

This report concentrates on the impact of poor credibility on the financial reporting and corporate disclosure of listed companies. However, most of our recommendations would apply equally to other public-interest entities and some to all entities on which any form of public reporting may be required.

In developing this report, we have been greatly helped by those who have addressed this subject or elements of it before us. A list of the main reports we have reviewed is in Appendix 4. We have not attempted to duplicate this work. However, we have sought to augment it by obtaining input from individuals involved in or influenced by these issues and through extensive Task Force discussions. In developing this report, we were assisted and supported by a number of IFAC's member bodies, and by Ian Ball, IFAC Chief Executive, and Jan Munro, IFAC Technical Manager, who participated in some of our discussions, providing us with background information on developments within the international profession. We are grateful for this support. Our particular thanks go also to Brian Smith, who performed admirably as our tireless and resourceful secretary and scribe.

Finally, we must state that the views in this report are the personal views of the members of the Task Force and do not necessarily reflect the views of the organizations with which they are affiliated.



## TABLE OF CONTENTS

EXECUTIVE SUMMARY .....	1
THE BACKGROUND .....	5
The Loss of Credibility in Financial Reporting	
Business Failure and Reporting Failure	
The Origins of the Loss of Credibility	
The Global Nature of the Loss	
The Participants and Their Roles	
The Environmental Pressures	
The Key Weaknesses	
The Audit Function	
Recent Developments	
THE INTERNATIONAL DIMENSION .....	19
Credibility Is an International Question	
National Responses in Relation to International Needs	
Conflicts	
CONCLUSIONS AND RECOMMENDATIONS.....	23
Summary of Conclusions	
Corporate Management and Governance	
The Audit Function	
Other Private Sector Participants	
Regulation and Standard Setting	
APPENDICES	
1: Profiles of Task Force Members .....	46
2: Task Force Objectives .....	48
3: Recent Developments.....	49
4: Reference Sources.....	61
5: Glossary of Abbreviations .....	63



## EXECUTIVE SUMMARY

The Task Force on Rebuilding Public Confidence in Financial Reporting was commissioned in October 2002 by the International Federation of Accountants (IFAC) to provide an international perspective on the causes of the loss of credibility in financial reporting and corporate disclosure and to recommend courses of action to restore credibility.

### Scope and Focus of Work

The scope of our work involved identifying recent legislative actions and regulatory developments, reviewing reports issued by national and international bodies, and considering proposals that have been adopted or are being considered in a number of countries. We were able to give particular attention to developments in the six countries represented on the Task Force: Australia, Canada, France, Japan, the United Kingdom, and the United States. We also considered developments from international bodies such as the Financial Stability Forum, the International Organization of Securities Commissions (IOSCO), the European Commission, and the International Accounting Standards Board (IASB) as well as IFAC itself.

In our discussions, we assumed that public reporting is, by definition, a public interest activity and, therefore, places responsibilities on all the participants in the process. Recognizing the primacy of these responsibilities is a major first step in the change of attitudes necessary to raise the credibility of financial information. We believe that such recognition should lead to changed attitudes towards business ethics and a strengthened business culture, which, ultimately, would reinforce the effectiveness of our recommendations.

Our aim in this report is to provide details of best practice for worldwide application.

Our report sets out the background to the loss of credibility, describes the roles of the participants in this process of decline, identifies the international implications, and features our conclusions and recommendations.

### Principal Findings

Our principal recommendations are built on three basic assumptions:

- The credibility of financial reporting is both a national issue in each country and an international issue, with action required at both levels. Although the framework within which companies operate is still primarily the national one of their home base, international action is necessary if the changes made at the national level are to produce both improved and more consistent practices.

- Secondly, to improve the credibility of financial reporting, action will be necessary at all points along the information supply chain that delivers financial reporting to the market. Corporate managements and boards of directors, who have the prime responsibility for financial reporting, as well as auditors, standard setters, regulators and other participants in the reporting process such as lawyers, investment bankers, analysts, and credit-rating agencies, all have important roles to play and improvements in practices to make to restore the credibility of financial reporting.

- Thirdly, integrity, both individual and institutional, is essential if our recommendations are to be effective. Failure to recognize the primacy of integrity has been a major contributor to the financial scandals of recent years.

Our main findings are:

**1. Effective corporate ethics codes need to be in place and actively monitored.** We recommend that companies should set out their ethical policies in a code that should be widely distributed within the company and to shareholders; board-monitoring procedures should be put in place. We also recommend that training be given and that support be provided for individuals to better enable them to face difficult ethical questions.

**2. Corporate management must place greater emphasis on the effectiveness of financial management and controls.** We recommend that there should be formal reporting to shareholders setting out the responsibility for financial reporting and internal controls as well as regular assessment by the audit committee of the appropriateness of the resources being devoted to the adequacy and effectiveness of internal controls. We also recommend that knowledge of reporting and controls should be considered a core competence of the Chief Financial Officer (CFO) and that the key role of internal audit be emphasized by having it report to the Chief Executive Officer (CEO) and giving it unfettered access to the audit committee.

**3. Incentives to misstate financial information need to be reduced.** We recommend that companies refrain from providing the market with forecasts of profits that assume an unrealistic level of precision. We support the plans to introduce an accounting standard requiring the expensing of the costs and the clear disclosure of the terms of granting share options. We also recommend that the board or a board committee, independent of management, should be responsible for determining the terms and conditions of employment and the level and form of remuneration of senior management.

**4. Boards of directors need to improve their oversight of management.** We recommend that the board regularly evaluate the performance of the CEO, giving appropriate weight to each area in which the CEO should be providing leadership, including ethics, governance and financial reporting as well as the performance of the company. We also recommend that the board regularly evaluate its own performance and that of its individual members. In addition, we recommend that all public interest entities have an audit committee, or

*In our discussions, we assumed that public reporting is, by definition, a public interest activity and, therefore, places responsibilities on all the participants in the process.*

similar governance body or bodies, formed from directors independent of management with clearly defined responsibilities, including monitoring and reviewing the integrity of financial reporting, financial controls, the internal audit function, and relations with the independent auditors. All members of the committee should be financially literate and should receive relevant training. We also recommend that the committee hold regular private sessions with each of the independent auditors, the head of internal audit and the CFO.

**5. The threats to auditor independence need to receive greater attention in corporate governance processes and by auditors themselves.** We recommend that the auditor's primary relationship with the company should be with the board, through its audit committee, or similar governance body, and not with management. Additionally, we recom-



mend that: the IFAC Code of Ethics should be the basis for national codes on independence; there should be greater control over the auditor provision of non-audit services through, for example, the audit committee approving non-audit services provided by the auditor; non-audit fees should be disclosed; key personnel on the audit should be required to rotate off; employment by the company of key individuals on the audit should be approved by the audit committee and disclosed; and the audit relationship should be subject to a regular comprehensive review by the audit committee. We also recommend that audit firms review their profit distribution and other internal processes to ensure that they have a positive effect on audit quality.

*Our recommendations are set out as principles since we believe that it is complying with a set of high quality principles that is most likely to raise the credibility of financial reporting.*

**6. Audit effectiveness needs to be raised primarily through greater attention to audit quality control processes.** We recommend that attention be given to the “tone at the top” in the audit firms, to the quality of entrants into the auditing profession, and to the adequacy of post-qualification training. We also recommend the firms give additional attention to their client acceptance and retention processes, strengthen the independent partner review and internal consultation processes,

review their post-audit review processes to identify improvements, and disclose details of their quality control processes and financial information.

**7. Codes of conduct need to be put in place for other participants in the financial reporting process, and their compliance should be monitored.** We recommend that codes of conduct be developed covering the standards that should apply to the activities of financial analysts, to the provision of advice by lawyers to clients on matters relevant to financial reporting, and, similarly, covering the advice given to companies by investment banks. These codes should be made public and should be monitored both within the firms and externally. We also recommend that where lawyers take a position of advocacy, the advice should include a summary of the significant issues raised so that the board is in a position to evaluate the advice. Additionally, we recommend that credit-rating agencies should be required to disclose their criteria, their evaluation processes and the quality control mechanisms that they use.

**8. Audit standards and regulation need to be strengthened.** We support International Standards on Auditing (ISAs) becoming the worldwide standards. We recommend that the International Auditing and Assurance Standards Board (IAASB) complete its program of updating standards, including its standards covering the assessment of risk and fraud; discussions with external stakeholders should be completed so that International Standards on Auditing obtain the necessary legitimacy; convergence between international and national standards should be achieved as soon as possible; and the adequacy of IAASB resources should be evaluated. We also recommend that country external quality assurance reviews be brought into line with best practice, and that IFAC

complete its Statements of Membership Obligations and put in place a process for assessing its member bodies' compliance with them. In addition, we recommend that all public interest self-regulatory activities be reviewed to ensure that appropriate public interest monitoring or oversight is in place.

**9. Accounting and reporting practices need to be strengthened.** We support International Financial Reporting Standards becoming the worldwide standards for accounting. We recommend that the convergence process be given greater urgency. Standard setters and regulators should consider ways in which financial statements could provide additional information on operating and financial matters and could be made easier to understand and more timely.

**10. The standard of regulation of issuers needs to be raised.** We support early implementation of national regulations consistent with IOSCO Principles of Securities Regulation. We also recommend that regulators conduct post-issue reviews of financial statements for compliance with accounting standards.

### Actions Needed

Our recommendations are set out as principles since we believe that it is complying with a set of high quality principles that is most likely to raise the credibility of financial reporting. This approach also allows our recommendations to have the widest validity both among countries and among types and sizes of entities. At the same time, we accept that in most instances it will be appropriate to support the principles with guidance so as to assist preparers and auditors of financial information. It is important that any such guidance is seen as supportive and not as restricting the application of the overall standard.

Extensive action is required at both national and international levels to raise the credibility of financial reporting. It will require a change of attitude and a lengthy period of attention to reporting and governance issues by all the participants if credibility is to be returned to the level that users demand and have a right to expect. In a number of countries, provisions consistent with or similar to many of our recommendations are either in place or under consideration. Even in those countries, it is important that worldwide best practices are supported. With the continuing trend to globalization, it is important to all countries that reporting is of a consistent and high quality worldwide. We therefore urge all those with an interest in financial reporting to build on the positive developments that have occurred both nationally and internationally so that credible financial reporting can regain its central position in the functioning of the market economy.

The issuing of this report concludes the work of the Task Force on Rebuilding Public Confidence in Financial Reporting. Given the significance of the issue, IFAC, through its various boards and committees, will continue to address how credibility in financial reporting and the audit process can be enhanced. It will also continue to maintain a database of publications relating to financial reporting and governance issues on its website ([www.ifac.org/viewpoints](http://www.ifac.org/viewpoints)). Comments on this report may be submitted to [credibility@ifac.org](mailto:credibility@ifac.org). ■

## THE BACKGROUND

### The Loss of Credibility in Financial Reporting

Failures of businesses in which deficiencies of financial reporting and corporate disclosure have figured prominently are not new phenomena. However, high-profile cases of the recent past, such as Enron, WorldCom, Global Crossing, Adelphia Communications, HIH, Tyco, and Vivendi, and most recently, Royal Ahold and HealthSouth, together with a host of smaller-scale examples worldwide, have drawn far greater attention to this area. At the same time, there has been evidence of an increased frequency of restated financial statements. All of this has had a negative and cumulative impact on the way informed opinion views financial reporting.

In parallel with this, there has been great concern, in some cases approaching outrage, regarding the “fairness” of the operation of a market system where shareholders, employees in general, and pensioners have lost large sums, while those running companies, and seen as responsible for those losses, have enriched themselves as their businesses collapsed. The scale of this issue is evidenced in the U.S. by a calculation that executives of 25 companies whose stock price fell by 75% or more between January 1999 and May 2002, many of which had both business and reporting problems, “walked away” with \$23 billion. (*Fortune*, September 2, 2002, page 64.) Similar concerns about the level and terms of corporate compensation, even if involving smaller numbers, have arisen in other countries. These concerns have reduced the credibility of all those involved in the process of providing financial and other information, and increased the difficulty of restoring credibility.

This loss of credibility has been widespread across capital markets. Problems in one industry have been contagious, impacting other industries with similar characteristics. The increasingly global nature of the markets, and of businesses, has resulted in concerns crossing national boundaries.

A key factor in the scale of the problem was the unprecedented level of share prices in many markets. Maintaining these price levels was a top management objective, and when it became clear that the supposed level and trend of profitability justifying the levels had not existed, the fall in share price was accentuated by a major re-rating of the shares. This then impacted share prices in similar companies and more generally.

Financial statements have historically been one of the main ways in which information has been provided by a company to its shareholders and to investors considering whether to contribute capital. Reduced confidence in financial information and corporate disclosure produces an investor retreat and results in an increased cost of capital. This reduces the economy’s productivity.

### Business Failure and Reporting Failure

Almost all the high profile failures are the result of the combined effect of failures in business, failures in governance and failures in reporting. The business issue that should be communicated to users of the financial statements is not properly disclosed, governance structures fail to prevent or detect this, and a reporting failure results. As an entity moves closer to business failure, the incentive to distort reporting increases and, therefore, the chance of reporting failure increases.

A reporting failure will only rarely directly cause a business failure but can allow poor business practice to be extended and delay the confronting of difficult business decisions. However, there appears to be a close linkage between business and reporting failure such that many examples of misreporting, particularly when large sums are involved, appear to be part of the management policies that produced the business problem.

This report is concerned with the credibility of financial reporting and corporate disclosure and, therefore, focuses on failures in reporting. The close relationship between business and reporting failure means that we also must address governance issues generally. However, nothing in what we say should be taken to deny that business failure is an inherent, and even required, feature of a market economy. Alternatively put, strengthened governance and reporting practices, and the improved credibility of financial information that should result, will not eliminate business failure, although any improvement should reduce the chances of failure arising from deception or lack of transparency.

### The Origins of the Loss of Credibility

There has been a lengthy history of corporate failure linked to governance and reporting failure. The recent high profile corporate failures may have involved larger numbers, but many of the issues highlighted are similar to those raised by cases in past periods. The cumulative impact of high profile cases has led to a steady loss in the credibility of financial statements and of the participants involved with producing and reporting on them.

The 1980s and 1990s are littered with examples of reporting failure, generally associated with governance and business failure. In the U.K., these include names such as Maxwell, BCCI, Polly Peck and Barings; France has Credit Lyonnais; Germany adds Metalgesellschaft and Schneider; Australia

provides AWA, Bond, Spedley Securities, and Tricontinental; Canada adds Canadian Commercial Bank, Castor Holdings and Roman Corporation; Japan has Yamaichi; and the U.S. has the many examples from the savings and loan industry as well as cases such as Cendant, Sunbeam, Waste Management, Wedtech, and ZZZZ Best.

The East Asian financial crisis in the second half of 1997 also raised questions about the reliability of financial statements and about the role of the large international accounting firms in reporting on them. A report issued by the United Nations Conference on Trade and Development (UNCTAD) in March 1999 considered the corporate reporting implications of the crisis. The report stated that:

“The failure or near failure of many financial institutions and corporations in the East Asian region resulted from a highly leveraged corporate sector, growing private sector reliance on foreign currency borrowings and lack of transparency and accountability. . . . A crucial role was played by disclosure deficiencies. . . . And the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks.”

However, the concerns raised were seen, and in retrospect, rather narrowly, as matters for some Asian countries and not for the U.S., Western Europe, Japan, or elsewhere.

As noted earlier, in the period to 2001, the stock markets in many of the developed countries had a long period in which prices rose rapidly to historically high levels. In certain sectors, such as telecommunications and e-business, the surge was particularly dramatic. The pressures to deliver performance in line with the expectations of the market were correspondingly high and, in many cases, increasingly focused on maintaining share prices in the short-term.

The collapse of Enron and the related auditor issues are seen by many as the event that initiated the changed perception of the reliability of financial reporting. As the brief history set out here suggests, it might be better to consider Enron as the event that confirmed a trend and, by its sheer size, awoke many to issues that had been significant for some time. Enron gave the issues greater visibility.

The larger, but much simpler, reporting failure at WorldCom and issues raised at Global Crossing, Tyco, Adelphia, and Xerox added further examples, reinforcing the perception that financial reporting was not to be relied upon.

### The Global Nature of the Loss

Recent U.K. cases include Independent Insurance and Equitable Life. In respect of Ireland's Elan, a pharmaceutical company, questions were raised in relation to accounting, auditor independence and governance issues. The large French multi-national Vivendi added misleading reporting to business and governance issues. ABB, the Swiss-Swedish engineering group, added significant governance and accounting issues to its huge business problems.

Other recent continental European examples include Comroad, where 97% of revenue came from a nonexistent company, Babcock-Borsig, Kirch, Philipp Holzmann and EM.TV in Germany, and Lernout & Hauspie in Belgium. Australia had HIH Insurance, with its substantial accounting misstatement issues. Governance and accounting questions at Korea's large conglomerates continued, with allegations that the SK Group had inflated profits at one subsidiary by \$1.2 billion. Most recently, the Dutch retailer, Royal Ahold, has been tagged Europe's Enron, given the large numbers involved and the reports of aggressive earnings management, accounting irregularities, ineffective governance, and questions on auditor performance.

Each of the examples provides evidence of reporting failure. Many of the reports suggest the existence of fraud and all point to the failure of corporate governance mechanisms. Many question the effectiveness of the audit process.

As the summary indicates, the cases that initiated the recent heightened level of concern were U.S. events, but the levels of the stock markets and industry factors provided rapid linkages to other markets.

Governments and other bodies around the world have seen a need to take action, conduct reviews and commission reports. Some have claimed that "it could not happen here" even if history has shown otherwise.

Although the intensity of debate has not been as high elsewhere as in the U.S., there are sufficient examples of concern to say that the loss of credibility of financial reporting is widespread in countries with developed capital markets. The loss of credibility appears to be less in countries with less developed capital markets, but in a number of these, financial reporting has limited visibility and lacked credibility already.

### The Participants and Their Roles

In understanding more fully the reasons for the loss of credibility and identifying possible remedies, it is useful to review the many participants involved in the financial reporting process and the particular roles that they play.

Although the reporting of financial and other corporate information is an iterative process, involving discussion and contact between the participants at many points, it can also be useful to simplify the process and consider it as a process flow. It starts with corporate management which, under the general direction of the board of direc-

tors, prepares the financial information for eventual approval by the board and, in some countries, the general meeting of shareholders. The auditors interact with management and the board and provide independent opinions. The media and others distribute information, and analysts and credit-rating agencies evaluate it. The process ends with the investors and other stakeholders, who are the consumers. Sitting beside 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 advice to the other participants.

#### *Corporate Management*

The management of the company, led by the chief executive and, in this area, with major input from the chief financial officer, have direct responsibility for the preparation of financial statements and for the establishment of the processes and systems of control to ensure that the information necessary for supporting the statements is reliable and available on a timely basis.

Management is responsible for ensuring that the statements reflect economic reality and comply with the relevant accounting and reporting standards.

#### *The Board of Directors*

The board has oversight over the actions of management on behalf of shareholders, appoints the CEO, and often appoints or approves the appointment of other senior members of management. In many countries, the board also approves the financial statements. This governance role may be performed by the supervisory board in a two-tier structure or, in part, through committees, such as an audit committee, where there is a unitary board.

The board is responsible for ensuring that management has performed its role effectively and also, along with management, for ensuring that the

financial statements both reflect the activities of the company and are in conformity with accounting and reporting standards.

#### *The Independent Auditors*

The auditor's role is to give an independent opinion on the company's financial statements, assessing whether there is material misstatement in them or failure to conform to relevant accounting standards. In carrying out this responsibility, the auditor needs to follow appropriate auditing standards with competence and integrity and to give the independent opinion that is appropriate to the results of this work.

*Effective standards make the language of reporting comprehensible and responsive to users' needs, make comparisons possible, and restrict the actions of those who wish to mislead or disguise.*

Because it is objective and independent, the auditor's opinion should add credibility to the reported information, thereby facilitating its use by shareholders and others.

#### *The Standard Setters*

The standard setters for accounting and reporting and for auditing and professional ethics, establish the standards that companies use for reporting their results and that auditors use for obtaining and delivering their opinion on those results. In a large but declining number of countries, standard setting is the responsibility of the accounting professional body. In other countries standard setting is handled by government agencies or other independent bodies.

Effective standards make the language of reporting comprehensible and responsive to users' needs, make comparisons possible, and restrict the actions of those who wish to mislead or disguise.

*The Regulators*

Regulators impact the process in two main ways: through regulation of the capital markets and the financial statements used in those markets, and through regulation of auditors. Regulation may be directly by government or indirectly through delegation to stock exchanges and professional or other bodies. In some cases, the regulatory role is combined with that of standard setter. The regulator's role is to assess compliance with standards and handle any breaches of them.

An effective regulatory regime makes it more difficult to ignore the standards and easier to bring culprits to justice, resulting in increased trust among investors.

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*Credit-rating Agencies*

Credit-rating agencies evaluate the business and financial statements of companies so as to provide information to the market and assist banks and bond market lenders in providing financing to companies.

Good quality and timely evaluations that take account of the underlying business circumstances and risks facing a company provide an additional perspective that assists in the making of business decisions.

*Financial Analysts*

Analysts provide investors and potential investors with evaluations of individual companies, based on consideration of their financial statements, industrial and business strengths and comparison with other companies.

If these evaluations are unbiased, they provide additional information to facilitate decision-making in the market.

*Investment Banks*

Investment banks employ many of the financial analysts and are also providers of finance and facilitators of transactions. In performing these roles, the banks provide advice to companies and information supporting companies in major transactions.

Where these functions are performed with probity and with appropriate segregation of activities to avoid conflicts of interest, the banks can be useful facilitators in the market.

*Internal and External Lawyers*

Internal and external lawyers provide extensive advice on the appropriateness and structuring of individual business transactions, including, in some cases, the applicability of accounting standards.

Legal advice which takes account of best practice and gives priority to fair financial reporting and disclosure, and does not focus only on what is not illegal, can protect the interests of the company and assist the other participants in performing their roles.

*The Media*

The media provide an important communication channel for financial information, as well as providing analysis and comment on that financial information.

Balanced comment can provide shareholders with useful additional material to assist in their decision-making.

*Investors and Potential Investors*

This last group is the most important — it is the market. They are the group for which information is provided and in whose interest the market is regulated. They should be able to rely on the

information provided, but at the same time, they need to apply themselves to using the information that is available.

Active shareholders, particularly institutional shareholders who have the capacity to be both active and informed, are an important part of an effectively operating market.

### The Environmental Pressures

All the participants inevitably operate in an environment that places continuous pressure on them. Those pressures, which may be personal, financial or political, will be heightened if they combine or if the checks and balances that the system is supposed to provide fail to operate. A brief analysis of the more significant pressures may help in appreciating how they produce the weaknesses in the system.

Preparers of information have profit and performance expectations to meet. They have their jobs to protect. And in many cases, particularly where options have been granted, they have income to be made. These pressures primarily impact management, including any executive directors.

Standard setters face “political” pressures. For example, the pressures from industry explain the inadequacy of existing U.S. accounting standards on share options and the ineffectiveness of standards on special-purpose entities. The U.S. standard setter has been strongly criticized for the inadequacy of standards in these areas, but the irony is that the criticism has come from some of the same politicians whose lobbying on behalf of preparers prevented the production of effective standards in the first place. Standard setters around the world may also be pressured through inadequate funding. Regulators face similar problems.

Auditors face many pressures. They are required to give their paymaster an opinion that is by definition independent. They also face pressures with respect to the timing of completion of work, fees and retention of the audit assignment. These

pressures affect the audit firm as a whole as well as the career of the individual auditor. Individual auditors may also be under pressure to sell or retain both audit and non-audit services if they wish to further their own careers.

Credit-rating agencies, analysts and others who provide information and assessments to the marketplace face conflicts of interest either because those on whom they report pay them or because their organizations are dependent on the sale of other products or services to the firms they report on. Similar pressures affect key advisers such as lawyers and investment bankers.

There is one significant factor that has impacted many of the participants — their inability to respond effectively to market expectations. Each of the participants is assigned a role and each has expectations of a level of performance assigned to it by the other participants in the market. This performance level may or may not be achievable in a realistic time frame or at an economic cost. In some cases, it may be possible to move closer to expectations. In others, the impossible may be the expectation. As a result, an “expectation gap” exists.

This expectation gap, the gap between what investors and other stakeholders believe the participant does and what is professionally required, is particularly relevant in relation to the role of the independent auditor. The auditor’s role in the deterring and detection of fraud is a good example. The marketplace almost certainly has unrealistically high expectations, but auditors have for many years also been able to use this as a justification for performing at a level below that which it should have been possible to achieve without huge additional cost.

The audit expectation gap has been recognized for many years, but the profession’s attempts to eliminate it by informing stakeholders as to what



it is realistic to expect, and by raising auditor performance by improved practices, higher standards and strengthened regulation, do not appear to have reduced the gap significantly.

The general level of expectation regarding financial statements is also particularly relevant. This issue can be simply summarized by considering the often-asked question — are the statements accurate? This question assumes a degree of precision that is unrealistic and fails to reflect the combination of estimating and judgment that underlie all sets of financial statements. However many improvements there are in accounting standards, however

much managements improve their accounting systems, however effectively boards of directors oversee management, and however strong auditing standards and practices are, the financial statements will still involve many issues of judgment, where honest and competent individuals doing their jobs conscientiously will be able to reach different conclusions. It will never be possible to eliminate such differences, but it should be possible to narrow the range and to provide information which will allow users to understand the more significant estimates and judgments which have been made.

### CASE STUDY: ENRON

Enron provides a good example of the involvement of the many market participants and of many of the weaknesses that are now recognized as systemic. Underlying the collapse were a number of poor business decisions, some commercial misfortune and some personal fraudulent behavior, but many other factors combined to worsen the problem. The interests of the senior executives were supposed to be aligned with that of shareholders through share options. The use of “special purpose entities” shifted both losses and debts off the company’s financial statements. In theory, many safeguards were in place to prevent managers from boosting the share price through questionable accounting. The board and the audit committee appeared better qualified than most, but several members faced financial conflicts.

The accounting followed now looks unacceptable, but most of it was in line with accepted U.S. standards and practices. The auditors had extensive experience with the company, but may have been too close to management as a result of the large number of former audit firm employees at the client. The provision of non-audit services gave a perception of a lack of independence. The engagement team also appears to have overridden advice from the firm’s technical department.

Where were the regulators and the other market participants? The special purpose entities may not have been consolidated, but there was significant disclosure in the financial statements which might have raised questions as to the appropriateness of the accounting. However, the regulator was resource constrained and had not performed a recent review of the statements. The rating agencies did not probe deeply enough. Analysts at the investment banks appear to have been pressured by other parts of their organizations with the result that they were advising clients to buy Enron stock until the moment the firm collapsed. The investment banks profited handsomely over the years from serving Enron and the markets it created, including helping to establish the special purpose entities. Lawyers earned high fees from giving opinions that supported what is now seen as inappropriate accounting. The media were not critical until it was too late.

This one example demonstrates for all the participants how their roles impact the financial reporting process and many of the significant weaknesses that can undermine it. ■

### The Key Weaknesses

Given the number of participants, the relationships between the participants, and the range of pressures they face, it is not surprising that the market has significant structural weaknesses that need to be guarded against. Some have argued, at least pre-Enron, that these weaknesses, most of which have been recognized for many years, were being handled appropriately with the safeguards in place. In assessing the extent to which this view has validity, and how much further change, if any, is needed, we first need to look more closely at those weaknesses.

In setting out these weaknesses in this simplified fashion, we are not implying that they exist in all cases or that where they do exist adequate safeguards have not been put in place. Nevertheless, the issues are, we believe, of sufficient importance that they deserve general attention.

#### *The Incentives Provided to Management*

The incentives provided to management through direct remuneration and share options, and their relationship to a company's share price, can and have produced unacceptable behavior.

Managements are seen as having to protect their jobs by meeting the market's profitability expectations. Where their incomes are linked to the short-term or a point-in-time share price through bonus arrangements or the ability to exercise share options, pressures to manage the share price are intensified.

#### *Company Internal Controls*

Focus on growth and share prices has, in some cases, resulted in a neglect of basic internal discipline, including effective internal controls. Internal audit, which should be an important element both in assessing the effectiveness of controls and in improving them, may have been overlooked or neglected.

The focus of senior management, especially in this regard, the Chief Financial Officer, may be more on strategic issues than on the operations and controls in the financial functions supporting the preparation of the financial statements. Many CFOs now have responsibility for strategic planning, information technology, the devising of financial instruments, and the managing of investor relations. As a result, some have failed to give basic accounting and reporting principles and internal controls the attention they deserve.

*Focus on growth and share prices has, in some cases, resulted in a neglect of basic internal discipline, including effective internal controls.*

Where the CFO is not central to the reporting process, the roles of the board and the audit committee in relation to financial reporting are made more difficult. The pivotal position of the CFO is emphasized by the extensive access to the board that is necessary to perform the role, in addition to the responsibility to report within management to the CEO.

#### *Oversight of Management by Boards of Directors*

Some boards have failed to build a healthy governance structure or to see that management sets an appropriate "tone at the top," and gives adequate attention to reporting matters. A healthy governance culture requires a clear understanding of each party's role and must provide the opportunity to challenge management in a constructive and mature way that leaves both management and directors feeling comfortable. To fulfill their responsibilities, directors need independence, skills, resources, information, and adequate time.

Audit committees, which in many companies assume the key oversight role in relation to financial reporting, have devoted inadequate time, and have not always had the skills, resources or independence to handle their responsibilities.

#### *Auditor Independence*

Given that auditors are paid by the entity on which they report, they cannot be independent in all senses of the term. More frequent criticisms relate to the impact the provision of additional services has on independence, or the closeness of the auditor to management, and to the individual auditor's reliance on the audit relationship with management.

Auditors have traditionally had their primary relationship with management, and, in practice, are often appointed by them and have their fees determined by them. Both the firm and the individual auditor are dependent on that relationship for income, for the continuation of that income and, in the case of the individual auditor, for his or her future career. Individual auditors can also come under pressure to sell additional services. Pressures to keep fees down may impact the level of work or individual decisions on the audit. As a result, safeguards are needed.

#### *Auditors' Quality Control Mechanisms*

Ineffective consultation processes, weak independent partner reviews and superficial quality review programs are the most frequently mentioned issues. Failure to set an appropriate environment in which quality is the overriding objective is also a concern.

A firm's quality control system may be ineffective in picking up errors of judgment by individual auditors or in identifying systemic weaknesses in controls or procedures. The input of a firm's technical arm may be inadequate, or may be overridden for business reasons.

#### *Auditors' Work in Relation to Fraud*

Fraud is difficult to detect, particularly where it involves collusion among senior management or between senior management and third parties. Thus, auditors have long argued that they cannot be expected to detect it in all instances, even instances of material fraud. This is reflected in current auditing standards, but is not in line with the market's expectations.

*If self-regulation lacks effective monitoring, it may lack credibility, however worthy the activities undertaken.*

#### *Accounting Standards*

Besides questions of adequacy of standards in individual countries, there are significant variations among countries, leading to confusion and difficulty in comparing financial statements between countries. With investments across national boundaries now commonplace, this increases the difficulty of making informed investment decisions, as well as creating problems for preparers who have to handle more than one set of standards.

The difficulties at the national level may arise because individual standards are weak, poorly grounded in principles, fail to consider assets such as intangibles, or have inadequate emphasis on forward-looking information or on risks. Further factors contributing to these weaknesses may include standard setters being subject to political pressures, having inadequate resources, having sources of finance which raise questions about their independence, and being insufficiently timely in responding to market needs.

Few companies in developed capital markets use International Financial Reporting Standards (IFRSs) in presenting their financial statements.

National standards show a wide range of variations from international standards. This will reduce significantly in 2005, when listed companies in the European Union (which should by then include 25 countries) will be required to use international standards.

A recent study (GAAP Convergence 2002) surveyed the position in 59 countries, including the 30 largest countries (based on the market capitalization of their stock markets) and all the E.U. members and candidates. The study concluded that almost all the countries claimed to have a current intention to converge their national standards with international accounting standards. However, the report also states that there is often no clear plan to match the intention. The study identifies

a number of significant barriers to convergence, including the complex nature of certain significant international standards, the tax-driven nature of current national standards, disagreement with certain significant international standards, such as that on financial instruments, language problems, and an absence of guidance to support the first-time application of IFRSs. All this suggests that actual convergence will be less rapid than the stated intentions. As a result, unless further action is taken, the existence of a wide variation in reporting practices among countries is likely to remain a weakness, with an effect on credibility of financial reporting, for some time.

### CASE STUDY: ROYAL AHOLD

Royal Ahold is the world's third largest retailer. It is a long established Dutch company but one that had grown five-fold in the last ten years. Its problems in accounting for volume discounts and rebates at a major U.S. subsidiary, fraud questions related to its Argentine subsidiary, and consolidation issues for its 50% owned ventures in Sweden, Portugal and Argentina, show so many of the characteristics of the major U.S. cases that it has been described as "Europe's Enron."

When Ahold announced in February 2003 that its profits for 2001 and 2002 had been overstated by \$500 million (subsequently increased to \$880 million), its share price fell 63% in one day to some 11% of its level in late 2001. The CEO and the CFO departed at the same time.

Analysts had expressed concerns over Ahold's accounting practices for over a year. The publication of the 2001 annual report had highlighted the significant differences between Dutch and U.S. accounting, with differences in accounting for property sales, currency hedging, derivatives activities, and goodwill, eliminating most of the profit reported for Dutch purposes. Accounting problems associated with some of the almost 50 acquisitions made during the ten-year reign of the departed CEO, continued to be uncovered. The auditors uncovered the volume discount and rebate problem during the course of the 2002 audit, but it appears that the problem also occurred in 2001.

As a Dutch company, Ahold had a two-tier board structure with a seven-person supervisory board. Questions have been raised as to its effectiveness, including whether the members spent sufficient time on board matters and whether a sufficient number of them were financially literate. The effectiveness of regulation is also in question. The Dutch regulator does not have the power to investigate the accounting questions, although as an SEC registrant, the company is being investigated by the SEC. ■

*Regulation*

The effectiveness of regulation of issuers varies among countries. Many countries allocate few resources to the task. The regulation of the profession also varies in effectiveness, with perceptions of weakness being high where the degree of independent monitoring of the regulation undertaken by professional bodies is low.

Regulators, whether professional bodies performing self-regulatory functions or government agencies, may lack skills or resources; their role may be narrowly defined; the rules they work with may be ineffective; and they may be subject to political pressures to do too little (or too much). If self-regulation lacks effective monitoring, it may lack credibility, however worthy the activities undertaken.

*Behavior of Investment Banks, Lawyers and other Advisers*

Investment banks have sold products which, upon inspection, have clearly been aimed at producing misleading financial statements. Loans have been structured to appear as sales, off-balance sheet finance has been structured to conceal the reality of the transaction, and special purpose entities have been set up to avoid disclosure of losses and borrowings.

Lawyers and others have given opinions relying on technicalities, without consideration for the need for fair presentation, that have supported approaches that are now seen as unacceptable.

*Ethical Behavior*

Many of the examples of reporting failure evidence a failure to act ethically by at least some of the participants. The list is lengthy: misleading auditors, auditors looking the other way, disguising transactions, withholding information, providing unbalanced advice, abuse of trust, and misusing insider information.

Participants have been seen as following self-interest without concern for the interests of the company or its shareholders. Where the participants are members of a professional body, they have been seen as ignoring the body's ethical guidance.

*The Audit Function*

Before considering a suggested framework for change, it may be useful to consider an important aspect of the overall way in which firms of auditors relate to their clients. By doing this, it may be possible to identify whether there are any inherent weaknesses which should receive attention, rather than lower-level operating issues which may require different, and simpler, solutions.

The largest firms of auditors have two high-level characteristics which are relevant to our charge. This part of our report considers the consequences of the firms being multi-disciplinary. The consequences of the firms being multi-national are discussed in the "International Dimension" section of this report, beginning on page 19.

The largest audit firms, at least in the larger economies, have come to provide a wide range of services including accounting services and advice, taxation services, insolvency and restructuring advice, advice and due diligence on acquisitions and disposals, forensic and investigatory studies and, in an increasing number of countries, legal services. Most of these services are provided to both audit and non-audit clients. The range of services has increased over recent years but many, particularly those that are tax, accounting and insolvency related, have been provided for much longer.

*Provision of Non-audit Services*

The provision of non-audit services to audit clients has frequently been alleged to threaten or even destroy the auditor's independence, based on the assumption that the audit firm's interest in performing the audit role is of secondary interest to obtain-

ing revenue from additional services. Attention has focused on the size of fees for non-audit services as compared with the level of audit fees, and on the supposed higher level of profitability of the non-audit services. The conflict of interest between the duty to shareholders in relation to the audit and the relationship with management necessary to obtain non-audit work has also been highlighted. These issues have been raised as major concerns as a result of many of the recent financial scandals.

Even those who strongly support allowing the auditor to provide non-audit services to audit clients recognize that there need to be some restrictions and that certain types of services pose particular threats. It is generally agreed that auditors should not perform work where it would result in them auditing their own work, without effective safeguards, or where it would result in them performing a role which was more properly that of management, or where they would be required to advocate the client's view rather than taking the objective view required of the auditor. Discussion in this area focuses on defining these terms and on whether any further restrictions are needed to avoid conflicts of interest and protect the public interest.

What are the arguments for allowing auditors to provide other services to audit clients? The first argument is the simplest — choice. A company should have the freedom to decide which supplier to use and, therefore, whether to use its auditor or not. Linked with choice is the question of efficiency. It may be more efficient for the auditor to perform some non-audit work because of his or her knowledge of the company. Restrictions on choice, which may lead to higher costs, should only be imposed where there is a clear public interest need.

*There needs to be a strong corporate governance process aimed at safeguarding the independence and objectivity of the auditor.*

The audit firms point out that the audit of most large corporations is a complex process requiring a mix of specialist skills. Not all are accounting skills. The range includes information technology and systems, business process controls, taxation, treasury, actuarial, legal in areas such as contracts, litigation, insolvency and money laundering, environmental and regulatory covering areas such as utilities, banking and financial services. The firms argue that these skills need to be available within their firms so that the knowledge can be readily brought to bear through the audit process and in

an environment in which the people with these skills can be recruited, motivated and retained. The firms then contend that this means that these specialists must be active in the marketplace as consultants if they are to maintain their

skill levels and be retained within the firm.

The audit firms then argue that it is important that these specialists provide consulting services to both audit and non-audit clients. The firms suggest that restricting the provision of non-audit services to audit clients would eliminate the common potential client base which is the key economic reason that keeps individuals with specialist skills within the firms. Without the common client base, the skills would move elsewhere and would not be available to support the audit; as a result, the quality of the audit would suffer. The firms then state that this argument is supported by the decision of three of the Big Four firms to split-off their information technology practices. This was done in anticipation of the firms being barred from providing such services to audit clients. As a result, the firms argue, the skills previously provided by the individuals providing those services will no longer be readily available to support the audit process.

We understand the firms' concerns that restricting the sale of non-audit services to audit clients would require a major change in the model under which their businesses have been run. We also accept that a wide range of skills is necessary to perform an audit. However, we have not found it necessary to decide whether the argument above is a compelling one which should have a major impact on our conclusions.

Audit firms put forward other arguments that restricting non-audit services may result in lower audit quality. Performing non-audit work may result in the auditor obtaining additional and important information about the client's business which may be helpful in the performance of the audit and which would not be obtained if others performed the work. For example, the more knowledge the auditor obtains about the client's business, the more the auditor will understand the client's procedures and controls and, therefore, the

business and financial risks that the client faces. This increased understanding can lead to more effective audits. Although it is possible that knowledge could be obtained from another supplier of services, there would be practical and possibly legal difficulties which would be likely to reduce the effectiveness of that transfer.

The firms also believe that restricting the range of services to audit clients could have a potentially damaging effect on the quality of personnel within the audit firms. In a number of countries, one of the main attractions in joining an audit firm is the wide range of alternative career options available within and outside the firm once the initial qualification and experience period is completed. The firms therefore contend that this is an important factor in allowing the firms in those countries to recruit a high proportion of the best qualified graduates.

### CASE STUDY: HEALTHSOUTH

In March 2003, the SEC accused U.S. hospital company HealthSouth and its chief executive of falsifying insurance claims in order to inflate its earnings by at least \$1.4 billion over four years. This figure has increased to over \$2.5 billion by adding two more years. As distinct from other recent U.S. cases, such as Enron, this alleged fraud did not commence in the late 90s when the pressure of the bull market increased the pressure on management to hit earnings targets. According to the SEC, it had begun soon after the company had been taken public in 1986.

The SEC alleges that senior company officials periodically approached the CEO to rein in the fraudulent practices, but that he indicated in 1997 that this should not be done until he had sold his shares. The CEO subsequently realized about \$200 million on share sales as well as receiving \$15 million in salary and bonuses between 1999 and 2001.

Questions arise about the overall effectiveness of the audit as well as about the auditor's involvement with quarterly reports as a result of the second-quarter 2002 numbers, including a cash overstatement of over \$300 million. The dominance of the CEO and the ineffectiveness and lack of independence of the board are other issues that impacted the situation.

The CEO signed off one quarter's financials under the new U.S. regime requiring CEO certification. Within two weeks, eight executives, although not the CEO, had pleaded guilty to securities offenses. ■

*The Alternative Approach*

What would the alternative be like? The auditor would only be able to provide a limited range of services outside the audit, basically those that are clearly associated with the audit role. This might include, for example, a limited amount of tax work, the performance of investigations relating to accounting and reporting issues and purchases and sales of companies, and any additional audit work such as that related to pension plans. This would reduce the total fees charged by the auditor to audit clients, in some cases by substantial amounts.

While this approach would avoid some of the pressures that flow from the provision of other services, it would also change significantly the business model under which the larger accounting firms have operated and would, arguably, lower the level of audit skills. Given this, we decided that we should consider the extent to which these potential conflicts and pressures might be effectively countered in other ways.

In considering this, we also had to bear in mind that however drastic the curtailing of non-audit services, such a step cannot eliminate independence concerns as they still exist in relation to the audit itself. The client can put the firm or the individual auditor under pressure both with respect to the level of fees and the continuation of the overall relationship. This problem cannot be eliminated without a complete change in the appointment and financing arrangements for audit services, perhaps to a government run operation. We reject a change of this kind on the grounds of both quality and efficiency.

*Our Conclusion*

Our recommendations, beginning on page 23, for strengthening the role of the audit committee in relation to non-audit work and for giving greater visibility to audit processes and quality control

should result in a substantive change in the relationship between a company and its auditor, and provide an adequate barrier with respect to the pressures and incentives that face the auditor.

Given this, and the valid arguments supporting choice in the provision of services, we have concluded that a total bar on the provision of non-audit-related services to audit clients would be inappropriate. However, we also conclude that there needs to be greater control over the provision of such services than has generally existed in the past. There also needs to be a strong corporate governance process aimed at safeguarding the independence and objectivity of the auditor. Without this strong process, and the other changes we recommend, the objectivity of the audit would be at significant risk. This would not be acceptable.

**Recent Developments**

Changes aimed at improving the credibility of financial reporting and corporate disclosure have been made over many years. A number of countries had reviews in progress prior to the collapse of Enron. Since then, intensive efforts have been made in a number of countries to review and address the significant issues and, at the international level to develop enhanced standards to guide the national processes of change.

Many of the changes are consistent with the recommendations in this report. Progress has not, however, been uniform and there are some areas that we believe require further action in all countries.

We have set out in Appendix 3 a summary of some of the more significant recent developments. The Appendix aims to provide some background without attempting a comprehensive survey. Many of the recent developments are proposals while others, although they have been put in place, are so new that it is too early to assess their impact. The focus is on the international standard setters and on developments at the national level. ■



## THE INTERNATIONAL DIMENSION

The interaction between national and international developments in financial reporting is critical. In this section of the report we consider whether the changes that are being made are consistent with the overall objective of raising the credibility of financial reporting on a worldwide basis.

### Credibility Is an International Question

Globalization of markets continues to be a major factor both for goods and services and for the provision of finance. Securities offerings are no longer limited to an entity's home country, but are frequently offered in multiple jurisdictions. Securities of many companies are now traded on exchanges in a number of countries. For example, during the 1990s, the number of non-U.S. companies listed on a U.S. stock exchange, and therefore subject to SEC reporting, increased threefold to over 1200. Similar increases occurred in foreign listings in other markets.

However, regulation is, and is likely to remain, a national matter and therefore the standards which determine how financial statements are presented are national standards. A company with securities listed in more than one country will continue to be subject both to the rules in its home country and those in the other countries in which it is listed. The presence in the market of sets of information that are different, but each of which purports to be a fair presentation, undermines the credibility of each set. This increases the inefficiency of the market as well as adding unnecessary costs.

The solution to this is not to have every country adopt one country's standards. While prior to Enron, some argued—and not just those based in the U.S.—that the solution was for all countries to adopt U.S. accounting principles and associated practices, adopting one country's standards was never likely to be acceptable politically even if it were possible to agree on which country's standards to adopt. The alternative is to agree on a “neutral” set of standards which can be accepted by every country and either adopted as the country's standards or incorporated into them. This was the conclusion of the Financial Stability Forum when it selected its 12 key standards (see Appendix 3).

A further matter that makes credibility an international question is the position of the large firms of auditors. These firms are multi-national, but organized differently from their large clients, the multi-national corporations. They are networks of independent firms with common processes and basic policies and standards, but without the corporation's common central ownership. Each independent firm is subject to national laws and professional regulations in the country in which it operates. They share certain central costs. When performing audit work for a multi-national corporation, the headquarters office will assign a team and issue instructions so that work can be performed in line with the requirements of the client's home country. As a result, a large firm's name is associated with financial reports presented using a wide variety of national standards; if these reports comply with the relevant national standards, they will all receive “clean” opinions. This will continue to be the case until one set of accounting standards is widely accepted.

### National Responses in Relation To International Needs

International needs are most likely to be met if national changes move national standards to the international benchmark standards. Generally, the international standards are principles-based rather than rules-based. In a country with a bias towards rules-based standards, it is possible to have a standard which is intended to be in line with the international standard, but with detailed rules which narrow the application of the principles and therefore end by not complying with the international standard.

Detailed rules are also a source of unimportant but aggravating differences which make it difficult for a company to comply with standards in more than one jurisdiction. The recent emphasis on having board members who are independent, but with different definitions of independence in different reporting jurisdictions, has produced such differences. Another popular change in regulation requires that an audit committee have financially literate members and that at least one member should have accounting or related financial expertise. The New York Stock Exchange is leaving the definition of financially literate to the board of each company; the Toronto Stock Exchange is also leaving the definition to the board, but will require disclosure of the assessment; NASDAQ has concluded that it is necessary to define financial literacy. Defining accounting or related financial expertise is being left to the board in Canada while the U.S. SEC final rule covers 56 pages.

These differences in corporate governance codes or regulations only matter to companies if they are listed in more than one country and are required to comply with each national set of rules. It would not be of concern if there were a process of mutual recognition in cases where the national rules, although different, complied with a benchmark standard. Sarbanes-Oxley does not recognize this approach as far as the U.S. is concerned.

The situation with accounting standards is of still more concern. A recent survey of knowledgeable investors (McKinsey Global Investor Opinion

*International needs are most likely to be met if national changes move national standards to the international benchmark standards.*

Survey on Corporate Governance 2002) showed 90% of investors supporting a single set of accounting standards, but with 78% of those in Western Europe concluding that the standards should be IFRSs while 76% of those in North America thought that the single set should be U.S. generally accepted accounting principles. If this difference of view prevails with the national standard setters, there will continue to be a major credibility issue, with at least two sets of standards being used to produce financial statements that present fairly.

Developments in the E.U. are intended to introduce IFRSs and ISAs, the international benchmarks for accounting and auditing standards, for at least listed companies in 2005. The success of this and therefore the extent to which this move will meet international needs is dependent upon how effectively and how quickly the associated

regulatory and compliance regimes can be put in place. This will be a major challenge, as there are currently important differences between countries and most have significant gaps as compared with the benchmark requirements. The European Commission is working with CESR, the Committee of European Securities Regulators, to develop a common approach for national regulation in the E.U., including on enforcement of accounting standards. In the E.U., statutory audit is required by law and only qualified professionals approved and registered by the competent national authorities may carry out these audits. Building on the bench-

*Many countries, particularly developing countries, have adopted International Standards on Auditing as their national standards, but in the absence of regulatory and compliance practices in line with the international benchmarks, this has not always made much of a difference.*

marks for public oversight of quality assurance systems, set out in its Recommendation of 2000 on Quality Assurance, the E.U. has recently announced its intention to require public oversight of the profession at the national level with an E.U. coordination mechanism.

Changes in accounting standards in countries other than the E.U. countries are moving in the direction of greater convergence with international standards. However, too few countries have clear timetables for the necessary changes or plans to put in place the compliance and regulatory regimes that are needed to ensure that changed standards result in changed practices.

Many countries, particularly developing countries, have adopted International Standards on Auditing as their national standards, but in the absence of regulatory and compliance practices in line with the international benchmarks, this has not always made much of a difference. The need for investment in education before attempting major changes in practice has been identified as an issue in many countries, including the transition economies of the former Soviet Union and Central and Eastern Europe.

The expansion of the European Union in 2004 will add 10 more countries that will be required to comply with E.U. regulatory and compliance requirements, including the adoption of IFRSs and ISAs for the consolidated financial statements of listed companies.

### Conflicts

It is inevitable when standards are established at the national level, even where those standards are purporting to implement an international standard, that differences will arise among countries. Translation into national languages is likely to be the first source of difference but it should be possible to minimize this impact through care and review. The European Commission recognizes the potential difficulties in this area and both IASB and IAASB have translation projects that should be helpful.

Differences in approach to standard setting between those countries that believe that detailed rules are required and those that believe that only the principles should be in the standard, present the potential for major conflict. Those that argue for rules want the certainty that they bring. Those that argue for principles claim that this approach avoids the focus on technical compliance and loop-

hole identification of the rules-based approach, and increases the chance that transactions will be accounted for in line with the objectives of the standard. A persisting divergence in approaches is likely to mean that a transaction could require different accounting, even though two countries had put in place standards consistent with the international benchmark.

These issues would be of less consequence if countries adopted international standards, rather than adapted their standards to comply with them. With the exception of the E.U., this does not appear to be the approach being adopted by most of the developed countries.

The main area of current or immediate conflict arises from the implementation of the U.S. Sarbanes-Oxley Act and, particularly, its extra-territorial impact. Issues arising from the need for a company to comply with the new U.S. governance regime, in addition to that in their home country, are a potential source of conflict; it is too early to know whether this will be serious or just aggravating and costly.

The situation regarding the registration and oversight of accounting firms by the U.S. Public Company Accounting Oversight Board (PCAOB) may be more serious. Each national practice of an accounting firm, that either audits a company which is an SEC registrant or audits a significant subsidiary of an SEC registrant, is subject to the PCAOB's authority, including its monitoring process. Discussions are in progress regarding the issues involved. The central issue for the firms is that they do not believe it appropriate or necessary that they should be subject to two monitoring regimes if the regime in their home country is one that complies with international benchmarks. This view is supported by the E.C., which has suggested that there be a moratorium to discuss

and resolve registration issues. The E.C. also agrees with the firms' view that the U.S. approach involves major conflicts of law relating to data protection and professional client confidentiality.

The E.C. considers that the E.U. regulatory approach to the protection of investors and other

*The main area of current or immediate conflict arises from the implementation of the U.S. Sarbanes-Oxley Act, and particularly its extra-territorial impact.*

stakeholders is equivalent to the U.S. rules and therefore should provide the basis for mutual recognition and European exemption from the U.S. rules. This approach has not been accepted by the U.S. and, as a result, the E.C. has indicated that the E.U. will have to consider parallel solutions involving the registration of U.S. audit firms in the E.U. Neither the U.S. approach nor the E.C. response will contribute to creating an efficient, cost-effective global capital market.

Whatever the outcome of the discussions on the international reach of the PCAOB, its existence provides support for those who argue that there needs to be a system of mutual recognition of regulatory regimes based on compliance with the agreed international benchmarks. This should provide the necessary level of confidence required internationally, without the burden of duplication of regulation and monitoring. ■

## CONCLUSIONS AND RECOMMENDATIONS

### Summary of Conclusions

Our recommendations are built on three basic assumptions:

- Improving the credibility of financial reporting and corporate disclosure is both a national issue in each country and an international issue, with action required at both levels.
- Action will be necessary at all points along the information chain that delivers financial reporting to the market. Corporate management and boards of directors, who have the prime responsibility for financial reporting, auditors, standard setters, regulators, and other participants in the reporting process, such as lawyers, investment bankers, analysts and credit-rating agencies, all have important roles to play and improvements in practices to make if the credibility of financial reporting is to be restored.
- Thirdly, a commitment to integrity, both individual and institutional, is essential if our recommendations are to be effective.

In crafting our recommendations, we have throughout borne in mind that public reporting is by definition a public-interest activity in which a company is required, usually by law, to publish financial statements that are a fair presentation. Management, the directors and the independent auditors usually already have duties in relation to this requirement. We conclude that these duties should be extended to cover all those who are involved in the process of public reporting, including advisors such as lawyers, bankers, brokers, analysts and public relations advisers, so that they as well as the management, the board of directors and the independent auditors have a duty to ensure that public reporting presents the information

fairly. In respect of public reporting, this duty should override all other duties of the individuals and firms concerned.

Our recommendations are set out as suggestions for change at the level of principles, not of detailed rules. We believe that the focus on principles is the appropriate approach. It allows consistent changes to be made across countries, while still reflecting their different business backgrounds and legal frameworks, and at the same time avoids the over-legalistic form-filling approach that can flow from very detailed rules.

In summary, our conclusions are:

- Effective corporate ethics codes need to be in place and actively monitored.
- Corporate management must place greater emphasis on the effectiveness of financial management and controls. In addition, incentives to misstate financial information need to be reduced.
- Boards of directors need to improve their oversight of management.
- The threats to auditor independence need to be given greater attention in corporate governance processes and by auditors themselves. This includes greater control over auditor provision of non-audit services.
- Audit effectiveness needs to be raised, primarily through increased attention to quality control processes.
- Codes of conduct need to be put in place and their compliance monitored for other participants in the financial reporting process, such as financial analysts, credit rating agencies, legal advisers, and investment banks.

- Audit standards and regulations, accounting and reporting practices need to be strengthened. The standard of regulation of issuers also needs to be raised.

Our detailed conclusions and recommendations expanding on this summary are set out in the remainder of our report.

#### • *Developed and Developing Markets*

The recommendations in this report are intended to apply to all countries. We recognize, however, that the benefit of actions to raise the credibility of financial information is likely to be greatest where the credibility problem is currently greatest — in the developed markets. At the same time, the potential for raising performance levels among developing countries is also great.

The efforts of the World Bank and the IMF in their Reports on Standards and Codes (ROSC) Studies are giving greater visibility to those areas in which individual developing countries are falling short of complying with the 12 Financial Stability Forum Key Standards, including those related to banking and securities regulation, corporate governance and accounting and audit.

IASB and IAASB should consider whether there are any areas in their standards that might not need to apply to developing countries. We believe that such a review is likely to identify very little. However, we also believe that it is likely that this work would identify a need for implementation guidance and training material. It would also be helpful if IFAC were able to put in place a process for providing greater assistance to its member bodies in developing countries, many of which lack the resources to implement major change without assistance.

#### • *Small and Large Entities*

As with any set of recommendations, it is necessary to weigh the costs of implementation against the broad benefits. Where there is no significant public interest, the benefits of any element of these proposals are likely to be less and the need for implementation correspondingly lower.

The recommendations in our report are focused on public-interest entities, although the thrust of some of the recommendations may apply in principle to all entities. For example, although effective governance is needed in all organizations, our detailed recommendations regarding governance apply only to listed companies and other entities, such as banks and other financial institutions, in which there is a significant public interest. On the other hand, our recommendations regarding accounting standards are likely to be of universal application.

### Corporate Management and Governance

#### • *Increase Emphasis on Controls and Financial Management*

The prime responsibility for the adequacy of a company's financial reporting rests with management, led by the chief executive. In turn, in most countries, the board of directors is responsible for approving the information before it is published. Recent examples of corporate failure suggest the need for greater emphasis on the responsibilities of management and the board for the information and the financial management and internal controls necessary to produce trustworthy information.

#### ■ **Approval of financial reporting**

We recommend that there be formal reporting to shareholders setting out the responsibility for financial reporting.

Reporting of this nature has been a requirement in some countries for a number of years. The new U.S. approach places this reporting responsi-

bility on the chief executive officer (CEO) and chief financial officer (CFO) rather than on the board. The initial reaction to this requirement has been positive, suggesting that this is one way in which greater attention may be given to the importance of appropriate financial reporting.

#### ■ **The chief financial officer**

In recent years, there has been an expansion in the role of many CFOs to include issues such as strategic planning, information technology, financing, and investor relations, giving lesser priority to financial controls and reporting issues. We acknowledge that there are benefits in having the CFO involved in the additional areas. However, we fear that this change in responsibilities has not been given the attention it deserves. We believe that whatever other roles the CFO performs, he or she must have reporting and controls as a core competence.

We recommend that knowledge of reporting and controls should be considered a core competence of a CFO and this competence should be assessed by the CEO and the audit committee before any CFO appointment is made.

#### ■ **Public reporting on internal controls**

The responsibility for the establishment and the maintenance of an effective system of internal control, such that published financial information is reliable, rests with management under the general oversight of the board. This management responsibility is not confined to those in the finance function, although their role is an important one, but extends to all members of management. We believe that highlighting this responsibility by requiring specific reporting to shareholders is likely to be beneficial.

We recommend regular management reporting to shareholders on internal controls and having the independent auditor report on management's evaluation. Annual reporting should be sufficient.

#### ■ **Role of internal audit**

The increased focus on internal controls provides an opportunity to reevaluate the role of many company internal audit functions. The traditional definition of internal auditing as an appraisal activity which includes examining, evaluating and monitoring the adequacy and effectiveness of accounting and internal control systems is completely consistent with our more general recommendations in this area. However, many internal audit departments have acquired other functions such as special project work on acquisitions and disposals, fraud investigations, cost/benefit analysis, process improvement, analysis of operational issues, and the provision of short-term accounting support to cover staff shortages in financial and other areas.

We believe that it is appropriate to refocus the role of internal audit to concentrate on internal controls. In many companies, this activity is likely to continue to be performed by a dedicated internal audit department. However, we do not consider that each public interest entity should be required to have an internal audit department, because in some cases, particularly with smaller entities, alternative approaches, such as outsourcing or use of personnel on a part-time basis, may be more appropriate.

We recommend regular assessment by the audit committee of the appropriateness of the resources being devoted to the adequacy and effectiveness of internal controls by the internal audit function or by other means.

Where a company has an internal audit function, it is important that the audit committee or an equivalent governance body has a significant involvement. The committee should approve the charter or terms of reference of the internal auditors and be satisfied that they have the resources and access to information to perform their role. The committee should be consulted on the appointment and approve the termination of the head of

internal audit and receive regular reports on the function's work, review management's responsiveness to audit findings, and assess the overall effectiveness of the function. The function should, as far as possible, be independent of the main activities and individuals that it will be assessing.

We recommend that the key role of the internal audit function be emphasized by having it report to the CEO and giving it unfettered access to the audit committee.

We also recommend that where a company does not have an internal audit function, the audit committee should directly interface with the outsourced or part-time resources and regularly review whether this continues to be appropriate, and whether the key activities that might be performed by such a function are being handled effectively in other ways. The results of this review should be reported to shareholders.

• *Reduce Incentives to Misstate Financials*

The recent corporate practice in some countries, whereby management provides shareholders, on a quarterly basis, with detailed guidance on likely future profit levels, has provided a significant incentive to manage earnings so as to meet the expectations created. In addition, particularly in the U.S., recent major corporate collapses suggest that management compensation arrangements, including short-term share options and other linkages to share prices, have provided management with significant incentives to misstate reporting. It is important to reduce such incentives.

■ **Provision of short-term forecasts**

We recommend that companies refrain from providing the market with forecasts of profits that assume an unrealistic level of precision. The audit committee should also consider whether such dis-

closure might create incentives to misstate earnings. Non-insiders, such as analysts would, of course, continue to be free to make any forecasts they chose.

■ **Accounting for share options**

We support the plans of the IASB and national standard setters to introduce an accounting standard requiring the expensing of the costs and clear disclosure of the terms of granting share options. The arguments presented by opponents of the proposed accounting standard center on the difficulty of calculating the cost. However, we believe that expensing of the cost involved, together with the

*We recognize, however, that the benefit of actions to raise the credibility of financial information is likely to be greatest where the credibility problem is currently greatest — in the developed markets.*

greater transparency provided by clear disclosure of the terms and effect of the options granted, by focusing all concerned on the economic cost to the company and its shareholders, is likely to enable the board to more effectively consider the establishment of appropriate performance hurdles as well as the size and the extent of options awarded.

■ **Approval of management compensation**

Management compensation levels and the linkage between those levels and a company's share price have been highlighted in a number of recent scandals. A company's governance body has an important role in reducing concerns in this area. The creation of a commonality of interest between the senior management and the shareholders through incentive plans linked to share prices has proved dangerous when the linkage has been short-term



and where grants of options have been made with minimal requirement for improved performance.

We recommend that the board, or a board committee of members independent of management and with the relevant competence, be responsible for determining the terms and conditions of employment and the level and form of remuneration of senior management. They should be provided with information both from within the company and externally. They should be able to obtain professional advice. In assessing incentive plans, the emphasis should be on the long-term. The conclusions of the review by the board or committee should be summarized in a report for the information of shareholders.

*The prime responsibility for the adequacy of a company's financial reporting rests with management led by the chief executive.*

- *Corporate Ethics Codes*

One of the most important roles of a board is ensuring that senior management creates an ethical environment that encourages openness and transparency. A widely distributed code of ethical conduct, tailored to the issues and circumstances arising in the company, is an essential element. The code should include policies on such matters as conflicts of interest, confidentiality, the protection of corporate assets, compliance with laws and regulations, including those relating to insider dealing, and should encourage reporting of illegal and unethical behavior. The code should apply to directors as well as to senior management and other employees.

A strong process for monitoring the code and for handling any departures from it is also required. The operation of the monitoring procedures could be handled by the internal audit function with the board or an appropriate independent board committee having a key role in evaluating compliance and in handling complaints and any breaches of the code.

We believe that an effectively monitored ethics code is an important ingredient in establishing the appropriate atmosphere in an organization — communicating the so-called “tone from the top.” A number of the recent corporate scandals provide examples of behavior by top executives that, by almost any standard, would be considered unacceptable. In these instances, the “tone at the top” supported widespread unethical behavior throughout the organization, to the detriment of the interests of shareholders, and established an environment in which major fraud could flourish. Top management behavior sends strong signals and both management and boards need to recognize this and react accordingly.

We recommend that companies should set out their ethical policies in a code that is widely distributed within the company and to shareholders. Board monitoring procedures should be put in place, with waivers or significant breaches of the code being reported to shareholders.

We also recommend that training be given on ethical matters and that support be provided, where appropriate, on a confidential basis for individuals to better enable them to face difficult ethical questions. This may be available through outside organizations, such as professional bodies.

• *Board Oversight of Management*

The area in which most changes are currently being introduced is in governance, with the aim of improving the effectiveness of the oversight role of boards of directors. This recognizes both the failures of boards and the central position they occupy.

Although we strongly support increasing the effectiveness of the oversight function of boards of directors, we would like to see this occur with a minimum of detailed prescription. It is necessary, in our view, to lay down a small number of principles, but we do not consider that it should be necessary to put in place a long list of detailed rules. The objective must be to achieve greater effectiveness rather than to simply encourage the completion of a long checklist.

The method of operation of boards of directors varies among countries. Our report is concerned with the board's oversight role. Where the board structure includes both a management and a supervisory board, oversight will be among the responsibilities of the supervisory board. Where there is a single board, oversight can be the responsibility of the board as a whole or it can be shared by the board and one or more committees, but with the final responsibility resting with the board.

Audit committees can have initial responsibility for certain of a board's or a supervisory board's oversight responsibilities, particularly in the area of financial reporting. As elsewhere in our report, we refer for convenience to the role of the audit committee. However, we recognize that alternative approaches, including leaving the total responsibility with the board or supervisory board, can achieve the same objective.

■ **Evaluating the CEO**

Among the many important responsibilities of the board, perhaps the most important is the appointment and evaluation of the CEO.

We recommend that the board regularly evaluate the performance of the CEO, giving appropriate weight to each area in which the CEO should be providing leadership, including ethics, governance and financial reporting, as well as the performance of the company.

■ **Evaluating the board**

A further important board responsibility is the assessment of its own effectiveness. A regular evaluation of the board's performance of its corporate governance responsibilities and the effectiveness of individual board members should enhance the overall performance of the board.

We recommend that the board regularly evaluate its own performance and that of its individual members.

■ **The relationship between the audit committee and the full board**

The audit committee is just that, a committee of the board; its operations and reporting need to reflect that position.

We recommend that the audit committee report regularly to the full board and that there be adequate time to discuss the committee's report. It is particularly important that the board discuss any concerns that the committee may have regarding the financial information, internal controls or audit arrangements.

Many of our comments that are set out below in relation to audit committees, such as the need to ensure that they are not dominated by management, that they allocate adequate time to their activities, and the need for them to demonstrate skepticism and the courage to challenge management's judgments and decisions, apply equally to boards of directors. Boards need to recognize their central oversight role in the governance of a company, which cannot be delegated to individual committees. All directors must share responsibility.

### ■ The powers and functioning of the audit committee

Audit committees have been in existence at many companies across many countries for some years. Given this, why have many been a failure? Put simply, we believe that too many of the committees have had poorly defined or poorly understood responsibilities, with agendas controlled by management, and have devoted inadequate time to their role. They have not accessed appropriate resources to supplement their direct knowledge and experience in areas of new or evolving financial techniques and business transactions. They have also often lacked skepticism and the courage to challenge management judgments and decisions. Changes need to be made so that audit committees can be an effective part of a strong governance structure.

An audit committee or similar governance body should be responsible for monitoring the integrity of the financial reporting of a company, for reviewing a company's internal financial control and risk management systems, for monitoring and reviewing a company's internal audit function and for recommending the appointment, remuneration and terms of engagement of the external auditors, as well as for monitoring and reviewing their independence, objectivity and effectiveness. These responsibilities should be agreed by the board and communicated to shareholders by providing them with a copy of the committee's charter or terms of reference. In larger companies, these responsibilities may be shared between an audit committee and other board committees, such as governance or risk committees. Our recommendations apply equally to such committees.

An audit committee must meet regularly and have sufficient time to perform its role effectively. Meeting just before the board meeting at which the

financial statements or interim financial information will be approved for distribution is not sufficient.

The committee must have access to advice and, where necessary, the power to obtain additional input to help its decision-making. Regular reports from management and/or the auditors covering areas of judgment or dispute, setting out the alternatives considered and the reasons for the conclusions, particularly in any matter where a departure from best practice is proposed, should be standard committee agenda items.

To operate effectively, the committee needs to have an open and constructive relationship with management and with the external auditors. The committee also needs to recognize that there may be occasions when it will need to take a different approach if its concerns suggest that the approach being taken by management is not appropriate. To be effective, the committee needs to strike a balance between its detached oversight role, as its normal method of operation, and becoming closely involved when developments appear contrary to its independent review and judgment.

To be effective, an audit committee needs to be objective. To be credible, such committees must be seen as separate from those they oversee; this means that they need to be independent as well as competent in financial matters.

We recommend that all public-interest entities have an audit committee or similar governance body or bodies formed from directors independent of management with clearly defined responsibilities including:

- Monitoring and reviewing the integrity of the financial reporting of the entity;
- Reviewing the entity's internal financial control and risk management systems;
- Monitoring and reviewing the internal audit function; and

- Recommending the appointment, remuneration and terms of engagement of the external auditors and monitoring and reviewing their independence, objectivity and effectiveness.

We also recommend that the committee or other governance body or bodies:

- Have clearly defined responsibilities that are agreed by the board and communicated to shareholders;
- Meet regularly and allocate sufficient time to its responsibilities;
- Receive regular reports from management and the auditors covering areas of judgment or dispute; and
- Have access to advice and the power to obtain additional input where necessary.

#### ■ **The effectiveness of the audit committee**

Our recommendations, and many of the changes that are being put in place across the world, increase the responsibilities of the audit committee and raise the level of expectation attached to its activities. The committee, like the board itself, is brought more clearly to the forefront as the representative of the shareholders, particularly in ensuring the objectivity of the audit process. This will require significantly more time. The committee will also need to interact directly and at times forcefully with both management and the auditors in areas that in the past have been largely handled outside the committee or the board.

The expanded role of the audit committee has focused attention on the qualifications and training of its members.

We recommend that each member of an audit committee should be financially literate, and at least one, and preferably a majority, of the committee's members should have substantial financial experience.

We do not believe that it is necessary to define precisely how the financial experience might have been obtained, as this may differ among countries,

but we do believe that it would be beneficial if details of the background of committee members were provided to shareholders.

We also recommend that committee members should receive training both with respect to their general responsibilities and regarding the operations, business issues, financial reporting, control systems, and risk management processes of the company itself.

#### ■ **Private or executive sessions**

Although it has been rare for senior management to be members of audit committees, they have often been present and taken leading roles in the committee's activities. The committee itself should determine which members of management should be present.

We recommend that regular private or "executive" sessions be held with the independent auditors and with the head of internal audit, with no members of management present, so as to provide an opportunity to discuss any matters concerning management or the company which might be constrained by their presence. Besides providing useful input to the audit committee, these sessions should be helpful in reducing the effect of any pressure that management may be placing on the auditors concerning the raising of issues and concerns or discussing conclusions and judgments directly with the committee.

We also recommend that the committee hold private sessions with the CFO, and possibly with other senior financial officials, without other members of management being present.

#### ■ **Membership of the audit committee**

Members of audit committees and similar governance bodies should be independent of management. Academic studies in the U.S., the country which has had audit committees for the longest period of time, support the common-sense view

that audit committees that have members who are independent are more likely to be effective in overseeing management than those that do not. They are clearly likely to be perceived as more objective.

We recommend that members of audit committees and similar governance bodies should be independent of management.

#### ■ Defining independence

The changes in corporate governance rules or ethics codes that are being introduced post-Enron attempt to define independence. The U.S. SEC rules, extended by the proposed exchange listing standards, will be very specific in defining independence. Other countries, such as Australia, Canada, France, Japan, and the U.K., each have their own definition, with most being closer to a principle, rather than a set of detailed rules. The French definition, which states that “a director is independent when he or she has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to color his or her judgment,” is an example of a principle-based definition.

While strongly supporting the need for audit committee members to be independent, we do not believe it appropriate to have detailed international rules to define independence. We consider that a principles-based approach, combined with transparency through the disclosure of the qualifications, experience and background of the members of the committee, is more appropriate. The transparency would include disclosure of a director’s remuneration and shareholdings.

Without attempting to set a rule defining independence, we suggest that boards need to consider the potential threat to board member independence where any director has share options in the company, or any part of their remuneration is related to the profitability of the company, or

has a holding of shares in the company, where the amounts involved are material either to the company or to the director’s own total wealth.

#### The Audit Function

Most of the examples that have contributed to the decline in the credibility of financial reporting have produced criticism of the competence and independence of auditors. Many of the changes in processes and procedures that are being implemented are focused on these two areas.

##### • *Reduce Threats to Auditor Independence*

Restoring credibility to corporate financial reporting requires the restoration of credibility to the audit function. This requires that attention be given to the competence and the independence of the auditor. Independence has received more attention in the discussion and reviews following from the corporate scandals, and we therefore consider it first.

As discussed earlier in this report, we believe that strengthening the role of the audit committee and giving greater visibility to audit processes and quality control should result in a substantive change in the relationship between a company and its auditor, and provide an adequate barrier with respect to the pressures and incentives that face the auditor. As part of this strengthened process, there should be greater control over auditor provision of non-audit services and a strong corporate governance process aimed at safeguarding the independence and objectivity of the auditor should be in place. This corporate process needs to deal with perceived as well as actual threats to objectivity.

#### ■ The relationship of the auditor to management and the board

The process of appointment of auditors varies from country to country, but even in those countries where the formal appointment is made by the shareholders, the reality is that the auditors have very often been chosen by management. Traditionally,

the primary relationship between the company and its auditors is also with management. Until very recently, this had not been changed substantially by the establishment of audit committees.

We recommend that the auditor's primary relationship with the company should be with the board, through its audit committee or similar governance body, and not with management.

The audit committee's responsibilities should include recommending the appointment, re-appointment and removal of the auditors. It should include the approval of fees. It should involve the review of the annual audit plan, the findings from the auditor's work and the overall evaluation of the effectiveness of the auditors. It should also include other activities specifically aimed at protecting independence. We believe that this change in relationships should be a significant factor in protecting auditor independence.

With the already existing relationships between management and the audit committee and between management and the auditors, the relationships should become a well-balanced "troika."

#### ■ **The approach for determining which non-audit services are appropriate**

We believe that three elements are required to produce an effective approach to the question of auditor provision of non-audit services:

- A framework to determine what is or is not acceptable;
- An approval process; and
- Transparency.

The IFAC Code of Ethics relating to independence sets out a structure for assessing whether it is appropriate for an auditor to provide specific non-audit services to an audit client. The Code identifies a number of threats to independence and then considers whether there are safeguards that can be put in place to mitigate those threats. Where the safeguards are sufficient, the auditor can proceed,

subject to any process that the individual client may have in place. Where the safeguards do not mitigate the threat, the auditor should not accept the work.

The IFAC Code is primarily a framework or set of principles rather than a listing of detailed rules. Nevertheless, it does recognize that there are some services that by their nature pose significant threats to objectivity, and for which adequate safeguards are unlikely to be available. In such cases, the auditor should not perform the service. The Code states that the auditor should not perform a service where he or she would end up "auditing"

*We recommend that the IFAC Code of Ethics be the basis for national ethical codes relating to independence.*

the work performed without effective safeguards, or where he or she is put in a position equivalent to that of management, or where he or she acts as an advocate for the client. Specifically, the Code excludes providing such services as bookkeeping, asset valuation where it is for the purpose of including the valuation in the financial statements, and recruitment of management.

We recommend that the IFAC Code of Ethics be the basis for national ethical codes relating to independence. We believe that it provides a satisfactory framework of principles for determining whether an individual non-audit service can be appropriately provided by a company's auditors.

#### ■ **The audit committee's role in relation to non-audit services**

The IFAC Code places the responsibility for assessment on the auditor. We agree with those who have concluded that the responsibility should be shared with representatives of the company independent of management.

We recommend that the audit committee should approve non-audit services provided by the auditor. We doubt the necessity of approving all services in advance, but the committee should establish a procedure covering what they believe is appropriate and inappropriate and a policy for approval of significant assignments.

We do not propose the limitation of non-audit fees by relation to the level of audit fees. Any such restriction would be arbitrary. We believe it more appropriate to consider the nature of the service rather the level of fees received.

#### ■ **Disclosure of fees for audit and non-audit services**

The third key requirement in relation to non-audit fees is sunshine. Disclosure is already a requirement in some countries. We suggest that the total fees be broken down into categories and that major individual assignments be specified. The assessment of the audit committee as to how they evaluated the impact of fees for non-audit services on auditor independence might also be disclosed as part of the committee's reporting to shareholders.

We recommend that non-audit fees, as well as audit and audit-related fees, should be disclosed to shareholders.

#### ■ **Rotation of key audit personnel**

The IFAC Ethics Code recognizes that familiarity is one of the significant threats to auditor independence. The transfer of the responsibility for the prime relationship from management to the audit committee is aimed at reducing this threat, but it is unrealistic to conclude that this will be sufficient to mitigate the threat, given that senior management and the auditors will still have very extensive contact. Familiarity is helpful in the audit process as it should produce greater understanding and an improved ability to identify and evaluate risks and

resolve problems. However, excessive familiarity may result in complacency or hesitancy to challenge appropriately, and thereby reduce the level of skepticism necessary for an effective audit.

Two main solutions have been proposed to handle this issue: compulsory rotation of audit firms and compulsory rotation of audit personnel, but within the same firm. The evidence from the only country which has had compulsory rotation of auditors for long enough to be able to evaluate its effects provides no evidence that compulsory rotation of firms increases audit quality. We, therefore, do not suggest compulsory rotation of audit firms as the solution, but believe that rotation of personnel, together with our other recommendations to mitigate the familiarity threat, should be required.

A substantial element of the familiarity threat arises from the relationship between the individuals who hold senior positions in management and the key individuals on the audit. We, therefore, support the various proposals being put in place to limit the time an auditor may spend in any of the key audit roles, whether as the partner in overall charge of the audit, the partner handling the audit of a major division or subsidiary, or the partner performing the independent review of the financial statements. Countries have been adopting slightly different definitions and periods of either five or seven years. These differences are not in our view fundamental.

We recommend that key personnel on the audit, including the engagement partner and the independent review partner, should be required to rotate off the assignment after a period not exceeding seven years.

#### ■ **Hires from auditors into key roles**

Having former auditors in key roles at audit clients can give rise to a familiarity threat. There are many examples of audit engagement partners later becoming the client CFO, and the number two on

the audit then taking on overall audit responsibility. We think that this produces at least a perception problem regarding the relationship between the CFO and the audit partner.

We support the proposals that there should be a “cooling-off” period for an individual who has had a key role on an audit or in the chain of command within the audit firm before that person can take on a key role at that audit client. Company key roles would include CFO and other senior financial roles, chief internal auditor, CEO, and any other role with significant ability to impact the financial results. We also believe that a “cooling-off” period would be appropriate with respect to board positions. We also believe that the audit committee should satisfy itself that there is no significant impact on auditor independence of any hiring of key audit individuals or of audit personnel into key positions. Disclosure of the prior auditor affiliation would also be appropriate for director positions.

What “cooling-off” period is needed? The period has to be long enough to discourage transfers, but not so long as to produce practical difficulties severely restricting a company’s ability to recruit quality personnel. We conclude that two years combined with audit committee review and approval should be sufficient.

We recommend that there be a two-year “cooling-off” period for key individuals on the audit joining a company as a director or in a key management position. Appointments should be approved by the audit committee.

#### ■ Pressures on audit partners

Economic or career-related pressures may threaten the independence of auditors. An individual auditor may be put under client pressure to accept marginal accounting practices by suggestions that the audit might be lost if he or she does not agree and that this would likely damage his or her career. In addition to the help that the audit committee

may provide in such a case, the auditor’s firm needs to have in place a process for consultation which is robust enough to deal with such cases, ensuring that decisions are the firm’s decisions and not those of an individual partner acting alone.

The firm’s process of income distribution, and the firm’s related counseling process, must also ensure that quality-related decisions, which are appropriate firm decisions and which have a negative impact on the firm’s short-term revenue, are not affected by the partner’s concerns regarding the impact on his or her own income. The process must support the partner in communicating on problems and in making the right decisions.

We also believe that it is inappropriate for a firm to remunerate an audit partner on the basis of sales of non-audit services to audit clients introduced or sold by that partner to audit clients where he or she is involved in forming the audit opinion on those clients or in the chain of command. (This would not preclude such partners from receiving their share of the firm’s total profits, in the normal course of business.) This would reduce the incentive for the partner to sell such services, possibly ignoring threats to independence, reduce the appearance of commonality of interest between the auditor and company management and, by reducing the emphasis on non-audit services, keep the partner’s focus on the audit.

As in the other areas affecting independence, the audit committee will need to monitor how the audit firm handles the pressures facing its partners. As a result, the committee is likely to need to be aware of the firm’s policies on consultation, quality control and remuneration of partners.

We recommend that firms review their processes for consultation to ensure that they are robust enough to provide the support needed by partners.



We also recommend that firms review their profit distribution and counseling processes to ensure that they have a positive effect on audit quality. These policies should not remunerate an audit partner based on sales of non-audit services to audit clients where he or she can influence the audit opinion.

#### ■ **Reviewing the relationship with the auditors**

We recommend that, as part of its review of the effectiveness of the audit service, the audit committee or other appropriate governance body conduct a regular comprehensive formal review of the total audit relationship, including both quality and cost aspects.

We do not believe that it is necessary that a regular review should result in the audit being put out to tender and neither, if the decision is taken to re-tender the audit, do we believe that a change of auditor is required. These decisions should be left to the audit committee.

#### • *Strengthen Audit Quality Control Processes*

The financial scandals have highlighted questions regarding the competence of auditors as well their independence. Although the detail regarding most of the recent collapses is not available, sufficient information is in the public domain to reach a tentative conclusion that in many of the cases, auditors did not follow audit standards or their firm's own policies. What changes are needed to reduce the chances of similar failings in the future? We believe that each audit firm, and the profession as a whole, needs to continue to give greater attention to the effectiveness of its quality control processes.

#### ■ **The tone at the top**

We recommend attention to the “tone at the top” within the audit firms; the need is the same as with companies.

Attention means more than pious statements regarding the importance of quality. It requires top management to take action that reflects this in areas

such as income allocation, promotion of partners and other personnel, and the acceptance and retention of clients. It requires firms to reinforce the importance of the audit practice within the total firm. It requires firms to ensure that they continue to place high quality people in technical support and quality control roles. Quality must be first in action as well as speech.

#### ■ **The competence of auditors**

Although it is too early to make evaluations based on the most recent cases, past cases do appear to indicate some examples where the audit-related issues were not approached with the degree of

*We believe that each audit firm, and the profession as a whole, needs to continue to give greater attention to the effectiveness of their quality control processes.*

competence required. There is also evidence, in some countries, that the shrinkage of the available pool of qualified candidates may be reducing the quality of those seeking to qualify as public accountants. Some of this may be the result of the reduced attractiveness of auditing as compared with alternative careers, but a narrowing of the university backgrounds that the profession considers as suitable for those planning to enter it is also likely to have contributed to this decline.

We recommend that where it has not been performed recently, each country should assess the quality of entrants into auditing as compared with entrants into other professions. In those countries where the review indicates that there has been a decline in the quality of recruits into auditing, the

relevant professional bodies should investigate both why this has occurred and what action is necessary to reverse the decline.

We also recommend that additional attention be given to the post-qualification training of auditors both by professional bodies and by individual firms.

#### ■ **Client acceptance and retention policies**

Publicly available evidence indicates that most audit failure cases were identified as high or even very high risk clients. The firm involved then concluded, following whatever process it had in place, that the client should be retained. In some cases, but not all, additional procedures or quality control mechanisms were put in place. In all cases the firm concluded that it could audit away the high risk. The approach confirmed the general view that the client retention process lacked rigor and was based on the assumption that all current clients would be retained and most potential clients would be accepted.

We recommend that the audit firms' client acceptance and retention processes use greater skepticism and assume that some current clients will not be retained and some potential clients will not be accepted.

#### ■ **Independent partner review process**

For some years, it has been common practice, and in some countries a professional requirement, to have an independent partner review of the financial statements prior to the firm signing the audit report. We consider that this process, when performed with diligence and on a timely basis, should be an effective element in a firm's overall quality control system.

We believe, however, that the process should be improved by requiring involvement at interim dates, giving greater attention to the procedures that have been performed to respond to the identified risks, and considering in detail any areas where there have been disputes with company management or where accounting is not in line with best

practice. We also suggest that the "independence" of the assigned reviewing partner should be enhanced by excluding individuals who have performed significant work on the audit in prior years and by assigning individuals whose reporting line is different from that of the engagement partner. Finally, the procedures for handling disagreements between the engagement and reviewing partners need to be clear and involve individuals with "quality" responsibilities at an appropriately high level within the firm.

We recommend that the independent partner review process be strengthened by greater focus on risks, disputes with management, and any areas where accounting is not in line with best practice; the "independence" of the reviewer also needs to be strengthened and the procedures for handling disagreements clarified.

#### ■ **Firms' internal quality review programs**

The key elements of quality control must obviously take place before an auditor issues the report on the company's financial statements. The new ISA on engagement quality control should help bring greater consistency to these processes.

The four largest firms, and a number of the other international firms, also conduct post-audit reviews of compliance with their policies and procedures in basic policy areas such as recruiting, training and consultation, as well as the approach taken on individual audits. The firms conduct these reviews across the whole of their international network, aiming to cover the work of each partner every three years.

We recommend that the firms' post-audit review processes be reviewed to identify whether improvements in processes are necessary to comply with best practice and to give them higher visibility.

### ■ The internal consultation process

An audit involves the making of many judgments. To make these judgments, the audit team may require information of a factual nature or advice on interpretation of accounting standards or on the approach taken in similar circumstances on other assignments, from experts who are not part of the audit team. All the larger firms have technical experts assigned to provide information and advice and others to assist in the decision making and evaluation process for complex matters of judgment. The firms' policies require that audit teams make use of these resources so that appropriate levels of expertise and experience are brought to bear on complex issues and judgments, such as where there is doubt as to the approach which should be taken or where clients pressure the audit team to accept approaches which are not in line with best practice. Some of the recent audit failures indicate that technical advice is not always being followed and that consultation on matters of judgment is not always occurring.

We recommend that the results of consultation on matters of judgment and any technical advice given to an engagement team should be in writing, and that any disagreement between the results of the consultation or the technical advice and the conclusion eventually reached should also be documented.

Where the engagement team does not believe it appropriate to follow the technical advice, the matter should be referred to a higher level within the firm so that an agreed position can be reached and documented. This should be done at a sufficiently high level that client pressure concerns do not dominate the decision process.

We also recommend that where there is a disagreement between the engagement partner and those providing advice on judgmental and technical matters or the reviewing partner, and the firm's

high-level review process concludes that the engagement partner's view should be followed, this fact should be disclosed to the audit committee together with the rationale for accepting the engagement partner's view.

### ■ Disclosure of quality control processes and other information

We believe that increased transparency on the part of accounting firms could help significantly in raising the credibility of the firms and therefore contribute to raising the credibility of the financial information on which they report.

We are not convinced by the argument that as partnerships are not required to disclose financial and other information, the accounting firms, which are partnerships in many countries, should be treated similarly. We believe that publication would raise the credibility of the firms by eliminating a serious perception problem.

We consider that the most significant factor of a financial nature that should be disclosed is the degree of dependence that a firm has on individual clients. The relevant unit for disclosure purposes is probably the profit sharing unit for the partner who has responsibility for each major audit. This may be an office, a country or a group of countries. Where this analysis indicates a high degree of reliance on revenue from one or a small number of clients, it would be appropriate for the firm to indicate the special quality control mechanisms that have been put in place to deal with the threat to independence.

The Forum of Firms, in which most of the international networks are represented, should be able to devise a common approach for the financial and other reporting we believe appropriate.

We recommend that the firms disclose details of their quality control processes and of their procedures for ensuring that those processes are effective.

This could also include the results of their firm's internal inspection program and of any external reviews conducted around the world.

We also recommend that firms publish financial information and that the networks disclose the relationships between the network members and with any coordinating entity.

### Other Private Sector Participants

In assessing what is needed to handle issues related to credit-rating agencies and financial analysts, both of which provide information and assessments to the marketplace, it is necessary to focus on the conflicts of interest that exist either because they are paid by those on whom they report or because their organizations are dependent on the sale of other products or services to the firms they report on. While the legal advisers and investment banking advisers may also have conflicts of interest from these sources, they also face potential conflicts between their role as advisers to management and what they should see as their duty to the company.

#### • *Financial Analysts*

The almost \$1.4 billion settlement between the U.S. regulators and 11 investment banks, in relation to the issuing of research reports containing exaggerated claims that were not based on facts, illustrates the extent of the misinformation that the analysts provided to the U.S. market. We consider that procedures should be put in place with the objective of avoiding similar situations in the future.

We recommend that, as a minimum, a code of conduct be put in place covering the operations of financial analysts. The code should be made public and should be monitored both within the firms and externally.

We recommend that the code of conduct include a provision barring the payment of money to analysts based on sales of stocks or other products by other parts of the organization.

#### • *Credit-rating Agencies*

We believe that greater transparency should apply in the operation of credit-rating agencies.

We recommend that credit-rating agencies be required to disclose their criteria, their evaluation processes and the quality control mechanisms that they use.

#### • *Legal Advisers*

We recommend that a code of conduct be developed covering the standards that should apply when lawyers provide advice to clients on matters relevant to financial reporting; the code should be made public and should be monitored both within the firms and externally.

The code should reflect the fact that lawyers must recognize that the company, and not management, is their client and that their advice should reflect a public interest standard. Where the advice does not reflect best practice, they should summarize best practice and set out their reasons for departing from it. Fees paid in relation to matters relevant to financial reporting, including details of the basis on which they are paid, should also be disclosed to the audit committee and the board.

We also recommend that where a position of advocacy is taken, the advice should include a summary of the alternative or best practice options and the significant issues raised so that the board is in a position to evaluate the advice.

#### • *Investment Banks*

We recommend that a code of conduct on matters relevant to financial reporting be developed covering the advice given to companies by investment banks; the code should be made public and should be monitored both within the firms and externally.

As with lawyers, the code needs to recognize that the company, and not management, is their client and that their advice should reflect a public interest standard. Where the advice does not reflect best practice, they should summarize best practice and set out their reasons for recommending departing from it. Their report should also set out the total fees and the basis of the fees that they will earn directly from the advice and indirectly if any transaction follows from the acceptance of the advice. This information should assist the audit committee and the board in evaluating the advice.

• *Investors*

The market works most effectively when each of the participants assumes its full role. This applies as much to the investor as to others. Institutional investors are in the best position to be informed participants. Such investors should take an active interest in the operation of the corporate governance systems of the companies in which they have investments, including voting at general meetings of shareholders.

We recommend that institutional investors take an active role in relation to the companies in which they have investments; they should publish their criteria for voting at general meetings and should also make available details of their voting records.

### Regulation and Standard Setting

• *Improve Audit Standards*

Although we conclude that compliance with standards is a bigger issue than the detail of the standards themselves, we also consider that there would be benefit to both users of audit reports and audit practitioners from focusing on strengthening individual auditing standards and from moving to a common high level of standards around the world.

### ■ **International audit standards**

The medium-term objective should be to have International Standards on Auditing (ISAs) as the worldwide standards. In the meantime, ISAs can be used as the basis for national requirements so that changes at the national level produce a structure of standards that, with appropriate monitoring and compliance processes, can help raise the credibility of financial reporting.

We support International Standards on Auditing becoming the worldwide standards.

### ■ **The convergence process to move to one standard**

Given that standard setting is still seen as a national activity in most countries, a program should be set up by IAASB, in cooperation with the standard setters in key countries, to achieve convergence between international and national standards as soon as possible. This is likely to be achieved by a combination of national implementation of current international standards and new international standards that are developed jointly with national standard setters and result in changes to both international and national standards.

We recommend that IAASB establish a program to achieve convergence between international and national standards as soon as possible; this should be done in cooperation with the standard setters in the key countries.

### ■ **The international standards**

IAASB has embarked on a program to upgrade International Standards on Auditing. This is being done in cooperation with a number of national standard setters.

We recommend that IAASB complete its program of upgrading ISAs as soon as possible, particularly so that it is in time for ISAs to be used for 2005 audits of E.U. listed companies.

### ■ Regulator and other stakeholder involvement

We urge an early completion of the discussions between IFAC and the representatives of the regulators and other international bodies regarding the membership, financing and public interest oversight or involvement in its activities so that ISAs can become the agreed “neutral” benchmark for auditing standards. The same need exists in the area of international standards for independence and ethics. The aim of this process is to provide the international standards with the legitimacy necessary for them to be acceptable on a worldwide basis.

We recommend that IFAC complete its discussions with external stakeholders as soon as possible so that ISAs and IFAC standards on independence and ethics can obtain the necessary level of legitimacy to be acceptable in all countries.

### ■ IAASB resources

The increased importance of IAASB as its standards become more widely accepted places increased pressure on the committee to develop its standards in a timely way. This is likely to mean an increase in human resources and, therefore, in the budget for the committee.

We recommend that IFAC evaluate the additional resources necessary to respond on a timely basis to the needs of users of its standards and ensure that they are put in place as soon as possible.

### ■ The audit standard regarding fraud

One of the major elements in the existence of the expectation gap between what auditors do and what users expect them to do relates to the area of fraud. Auditors claim that they perform the work required by professional standards while users of financial information see cases of fraud and quickly assume that, as the auditors did not prevent or find the fraud, the audit was a failure and that professional standards must be inappropriate. This area has been recognized as one of considerable difficulty for many years.

The U.S. Auditing Standards Board issued a new standard covering the fraud-related concerns in an audit in September 2002. For the first time, the auditor is required to perform specified procedures aimed at identifying factors which may be indicative of the existence of fraud even when an initial evaluation by the auditor does not identify the company as having a high risk of fraud. IAASB is in the process of developing a revised standard with similar requirements. These standards should be helpful in directing greater audit attention to this key area.

We recommend that IAASB issue a revised standard on fraud as soon as possible; the firms should adopt the additional requirements promptly.

*We support International Standards on Auditing becoming the worldwide standards.*

### ■ The standard on internal controls

While we do not believe that inadequate audit standards in the area of internal controls were a major factor in the recent cases of alleged audit failure, there does appear to be a gap between what is specified in the standards and the expectations of users. The introduction of the requirement for auditors to report on management’s assertions as to the adequacy of internal control, as now required for U.S. listed companies, will focus attention on this area. It is also likely to remove some of the bias against performing extensive audit work in relation to controls that has arisen primarily for economic reasons.

We recommend that IAASB, in close cooperation with national standard setters, issue its revised standards covering the assessment of risk, the audit procedures that should follow from that assessment and the evidence that should be recorded, as soon as possible.

- *Improve Audit Regulation*

In many countries, until recently, the regulation of auditing and auditors has been in the hands of national professional bodies with little involvement of government or government-related bodies. Most regulation has been self-regulation. The trend now appears to be towards direct regulation as a response to the failures of self-regulation. We do not believe that direct regulation will automatically prove more effective in protecting the public interest as it risks introducing a bureaucratic regime divorced from knowledge of the issues and with less ability to react to changes in circumstances. The alternative is a mixed approach with self-regulating bodies being closely monitored in the public interest.

- **Independent external quality assurance review of auditors**

The IOSCO Statement on Principles for Auditor Oversight issued in October 2002 specifies, in very general terms, the matters to be considered in independent external quality assurance reviews of auditors' work. IFAC's planned Statement of Membership Obligations on Quality Assurance should provide further and largely consistent guidance on the main features of an external review process. The Forum of Firms has developed detailed guidance on the mechanics of the process. Together, these provide the basis for an effective system of independent external quality assurance.

We recommend that each country should review, if it has not already done so, the structure and operation of its process for external quality assurance review to ensure that it is in line with best practice as set out in the IOSCO, IFAC and Forum of Firms guidance. If the conclusion is that the process should be performed by a self-regulatory body, attention will need to be given to assuring that appropriate public interest oversight is in place.

- **Monitoring of public interest self-regulatory activities**

Our conclusion is that self-regulation without public interest oversight or monitoring is unlikely to be effective. However, we strongly believe that those who are to be regulated should be involved in the process of regulation. IOSCO has indicated that it considers self-regulatory bodies to have an important role as they are able to respond more quickly and flexibly to market conditions than governments and that there are general benefits in involving those with depth of knowledge.

Most of the accounting professional bodies perform self-regulatory functions. In some cases, they are the audit and accounting standard setters for a country, as well as those responsible for the key roles of examination, qualification, registration, quality control monitoring, investigation, and discipline. Even in countries where some of these responsibilities have been transferred to other bodies, the remaining self-regulatory role of professional accountancy bodies is still significant.

We recommend that each professional body review its public-interest self-regulatory activities to assess whether they are being performed in accordance with best practice including, where appropriate, public-interest involvement or monitoring.

- **Standards for all public-interest activities including external quality assurance**

All public-interest activities relevant to the accountancy profession, whether carried out by professional bodies or regulators, need to be supported by clear and comprehensive standards to provide guidance to the parties that perform the roles. Clear and comprehensive standards also allow others to assess whether the regulators are performing their roles in line with best practice.

We recommend that IFAC issue Statements of Membership Obligations, covering the main areas in which a professional body may perform a self-regulatory role, so as to provide the required best practice framework for the professional bodies.

#### ■ **Monitoring the effectiveness of IFAC member bodies**

When professional bodies join IFAC, they commit their best endeavors to comply with IFAC's constitution and guidance. This includes, where they are the national standard setter, incorporating ISAs into national standards, and adopting IFAC's Code of Ethics and its guidance on education, quality control, investigation and discipline.

Recently, IFAC has focused on assessing whether its member bodies are complying with its guidance. An initial self-assessment identified a significant level of non-compliance. Extensive discussions have followed regarding how best to provide assistance to member bodies so as to raise the level of compliance.

We recommend that IFAC, as a matter of urgency, complete its discussions regarding how best to raise the level of member body compliance with IFAC guidance. IFAC should then allocate appropriate resources to the continuing assessment of member body compliance, particularly in relation to the effectiveness of their self-regulatory role with respect to public-interest entities.

#### • *Raise Accounting and Reporting Practices*

The recent scandals have highlighted certain areas where accounting standards fall short of what informed users of financial information expect, most notably in relation to recognition of revenue, accounting for share options, and off-balance sheet financing.

The highlighting of accounting issues has also resulted in additional attention being given to the variation in standards between countries. Although not a significant factor in the recent scandals, we

believe that these differences expose management, boards of directors and auditors to criticism and contribute to the low level of credibility of financial information. With international standards and most national standards claiming to produce financial information that is a fair presentation, it makes no sense that there should be so many versions of fairness.

#### ■ **International standards**

International Financial Reporting Standards (IFRSs) produced by IASB have been agreed in principle as the benchmark accounting standards.

We support IFRSs becoming the worldwide standards for accounting. We believe that, as soon as possible, international standards should replace national standards.

We support the general approach of IASB in setting principles-based standards, rather than establishing lengthy lists of detailed rules. A rules-based approach encourages a legalistic approach and the finding of loopholes, rather than attention being given to the objectives and principles of the standard. The principles-based approach requires the use of more judgment by management and by the auditor.

We believe that the improvements in governance and in the regulation of auditors that are being implemented in some countries, and which we support, will be helpful in strengthening the environment in which a principles-based approach will operate effectively.

Effective in 2005, IFRSs will be the required accounting standards for the consolidated financial statements of listed companies in the E.U.; individual governments will also have the option of extending this requirement to all companies. This is a major step towards the acceptance of international standards. This will require substantial implementation discipline, as well as the establishment of national review regimes to test compliance, if 15 (or 25) slightly different versions of IFRSs are not to result.



### ■ The convergence process

Although we would like to see one set of accounting standards across the world, we recognize that this is a medium-term possibility. The move to a common approach, at least in most of the non-E.U. developed countries, will initially occur by changing national standards to conform to international standards, rather than by the direct adoption of IFRS. It is therefore important that countries develop, if they have not already done so, a plan to converge their national standards with international standards. The changes that will be needed will occur partly by adjusting current standards to conform to IFRS and partly by implementing new standards that are being developed currently, often in cooperation between IASB and national standard setters. The aim in the convergence process must be to minimize the period during which users of financial statements are faced with multiple sets of standards.

We recommend that the convergence process for international accounting standards be given a greater sense of urgency; this will require extensive cooperation between IASB and national standard setters.

We also recommend that, without encouraging the continuation of differences, IASB should consider whether there are simple ways in which users might be provided with information that would help them to understand the differences between national and international standards.

### ■ Making financial information understandable

In recent years and in most countries, the quantity and complexity of financial information provided to shareholders and the market has increased significantly. Although much of this has occurred as a result of pressures to remedy specific deficiencies in reporting, it has not in all instances achieved the desired result. It has become increasingly diffi-

cult for even the informed reader to understand the information provided. As a result, one of the primary objectives of reporting — providing information relevant to the making of decisions — is not being achieved as the reader is unable to distinguish what is important from what is not. Financial information cannot be credible if it cannot be understood.

We recommend that accounting standard setters and regulators consider ways in which financial reports could be made more understandable so that the key messages are not lost in the midst of lengthy but less important material. One possible solution would be the provision of a shorter and simpler form of reporting for general use in addition to the longer report, which would be available for reference.

### ■ Additional interpretive information

As part of providing relevant information to users of financial reports, we suggest that companies consider providing a review of operating and financial matters, including a discussion of the main risks facing the business. The review would provide readers with an historical and prospective analysis of the company, including discussion and interpretation of the performance of the business and the structure of its financing, in the context of known or reasonably expected changes in the environment in which it operates. Such a review might also be accompanied by a summary of the implications of any critical accounting policies that the company has adopted. It is important that such information is presented in language that is easily understood by a nonspecialist reader.

We recommend that additional information be provided to shareholders on operating and financial matters and on the implications of critical accounting policies.

### ■ **Timely financial reporting**

Users of financial information need to have it available on a timely basis as well as in an understandable form. Although there has been improvement in this area in a number of countries in recent years, further changes are needed, particularly with respect to disclosures outside the normal schedule for annual and interim financial reports.

We recommend that regulators consider whether additional regulation is needed so that companies give a sufficiently high priority to the timely reporting of information to shareholders.

#### • *Raise Standard of Regulation of Issuers*

Having devoted a considerable part of this report to the regulation of auditors and closely related matters, we need to reemphasize the fact that the responsibility for a company's financial information rests primarily with the company's management and board and that, as a result, the direct regulation of issuers also needs to receive attention.

### ■ **Post-issue reviews of financial statements**

Although, as the Enron case indicates, even an extensive post-issue review process for financial statements for compliance with accounting standards will not catch all problem cases, a structured risk-based sampling should be helpful in raising the level of compliance with accounting standards. Appropriate resources both in quantity and quality need to be made available and assigned by the regulator. Few countries currently have any process in this area.

We recommend that regular and timely post-issue reviews of financial statements for compliance with accounting standards be conducted by regulators.

### ■ **The benchmark for national regulation**

IOSCO issued a revised version of its "Objectives and Principles of Securities Regulation" in February 2002. This provides comprehensive

guidance as to the key characteristics of effective regulation of the securities markets, including the regulation of issuers of securities.

We recommend early implementation of regulations consistent with the IOSCO principles of securities regulation. This is likely to require significant change in some countries. This would be beneficial as part of the overall strengthening of the regulatory environment.

### **International Issues**

In most of our report, we have been focusing on changes that need to be made at the national level to deal with what are primarily questions of national professional practices, national standards and national laws and regulation. In the main, we believe that the same solutions, at least at the level of principles, should apply to each country individually. At the same time, however, the increasing internationalization of markets, where investors based in one country may have investments in many others, means that access to credible financial information has become an international question, with a need for action across boundaries on a consistent basis.

Although progress towards the provision of more credible financial information is being made in many countries, changes are not taking place fast enough or consistently enough to be responsive to international needs. We believe that more work is needed to ensure that the international standards are as robust as possible. At the national level, implementation of benchmark standards for accounting and auditing must be matched with similar moves in corporate governance practices and in regulation. Implementation of these changes, which in some countries will be a major task, will require substantial effort in education and in professional and other infrastructures.

This part of our report summarizes some of the issues with particular impact at the international level.

• *The Importance of International Standards*

We have already concluded that IFRSs and ISAs should become the standards in the accounting and auditing areas and that the IFAC Code of Ethics should be the standard for auditor independence matters. IFRSs and ISAs have international support in principle through inclusion in the Financial Stability Forum's 12 key standards. As indicated elsewhere in our report, this high-level support needs to be converted into substantive support, by regulators requiring the use of the international standards or by incorporating them in national standards.

*...changes are not taking place fast enough or consistently enough to be responsive to international needs.*

• *The Effectiveness of IAASB*

The international structure of standard setting requires an international audit standard setter. IAASB currently performs this role. If it is to continue to do so, it needs to establish credibility for both its processes and its standards with the international bodies representing regulators and others.

Among the issues that need to be resolved are the composition and selection of members, the sources of funding, the effectiveness of the IAASB Consultative Advisory Group as a means of obtaining broad input, including that of stakeholders, and the possible need for the further involvement of regulators and others in an oversight or monitoring role to provide legitimacy to its processes and output. IFAC should also consider whether adequate resources are being provided, whether sufficient

effort is being devoted to obtaining convergence and whether there is adequate communication aimed at improving the uniformity of auditing practices.

• *The Role of IFAC*

IFAC's stated aim is to be the international self-regulatory body for the worldwide accounting profession. Is this a needed role given that each of its member bodies is subject to regulation in its home country? We think it is, but considerable changes must be made if IFAC is to perform the role effectively. The characteristics of an effective self-regulatory organization as set out by IOSCO, including the need for disciplinary powers and public interest involvement, will need to be incorporated in a revised structure of monitored self-regulation.

• *International Conflicts*

With the current degree of variation in standards and in regulation, it is inevitable that some degree of conflict will exist when an entity is subject to more than one jurisdiction. The potential for conflict is heightened when one of the countries implements international standards using a principles-based approach and the other uses a rules-based approach. The solution is for each country to adopt international standards rather than to adapt their standards to comply with them. However, with the exception of the E.U., this does not appear to be the approach that is likely to be adopted by most developed countries.

The conflict of laws arising from the extra-territorial jurisdiction of the U.S. Sarbanes-Oxley Act is a current issue. Short of a process of mutual recognition of regulatory regimes, where those regimes comply with international benchmarks, this type of issue is likely to recur as international business activity continues to increase. ■

## PROFILES OF TASK FORCE MEMBERS

### John Crow – Chairman

John Crow is a former Governor of the Bank of Canada, Chairman of the Central Bank Governors of the Group of Ten countries, and a one-time head of the North American Division of the International Monetary Fund (IMF). He is a director or advisor to a number of companies and also the Vice Chairman of the Toronto Centre for Financial Sector Supervision. In 1999, he chaired a committee of international experts that was commissioned by the Executive Board of the International Monetary Fund to evaluate IMF bilateral, regional, and multilateral surveillance activities, and in 2002 he took part in a high-level international mission to advise on monetary problems in Argentina.

### Christian Aubin

Christian Aubin is a former Inspector General of Finance in France and has held senior-level financial positions within a number of multi-national industrial groups. In 1988, he was appointed Senior Executive Vice President of Corporate Finance for Banque Nationale de Paris and more recently has served as Secretary of the Board of Directors and Head of Ethics and Compliance for BNP Paribas Group. He is a member of France's National Accounting Council, Accounting Regulatory Committee and a member of its Auditors' Ethics and Independence Committee.

### Olivia Kirtley

Olivia Kirtley is a former Chair of the American Institute of Certified Public Accountants (AICPA) and current Chairperson of the AICPA Board of Examiners, which is responsible for content and structure of the Uniform U.S. CPA Examination. During her career, she has served as Chief Financial Officer of Vermont American Corporation and as a senior manager at Ernst & Young. She is a member of the board of directors and audit committee chairperson for three companies traded on U.S. stock exchanges.

### Kosuke Nakahira

Kosuke Nakahira is Vice Chairman of the Institute for International Economic Studies and, since 1999, has been a member of the Joint Committee on Remuneration of IMF/World Bank Executive Directors. He is a former Vice Minister of Finance for International Affairs and has held other senior positions within Japan's Ministry of Finance, including the Banking and Securities Bureaus. He has also served as Controller of the Tokyo Stock Exchange.

### Ian Ramsay

Professor Ian Ramsay is Dean of the University of Melbourne Law School and Director of the University's Centre for Corporate Law and Securities Regulation. He is the author of the recent report to the Australian Government on the independence of company auditors, which has been adopted by the government as the basis for a new framework for ensuring the independence of auditors.

**Guylaine Saucier**

Guylaine Saucier is a corporate director and has experience both as a Chief Executive Officer and as a non-executive chairman. She recently chaired a Canadian committee on corporate governance and she has also served as chair of CBC/Radio Canada. She currently serves on the boards of several major Canadian corporations. Ms. Saucier is a current member of IFAC's Board and a former Chair of the Canadian Institute of Chartered Accountants.

**Graham Ward**

Graham Ward is a Senior Partner in PricewaterhouseCoopers and a Board member of IFAC. He is also a member and former Deputy Chairman of the Financial Reporting Council in the United Kingdom and Vice Chairman of the U.K.'s Auditing Practices Board. He is a former President of the Institute of Chartered Accountants in England & Wales and a former member of the United Kingdom's City Panel on Takeovers and Mergers. ■

## TASK FORCE OBJECTIVES

The Task Force was commissioned by the International Federation of Accountants in October 2002 to address the issue of the loss of credibility of the published financial statements of companies. This loss of credibility had occurred prior to the Enron collapse, though this event called further into question the credibility of financial statements. The effect of this and other corporate failures has, at a national level, resulted in many proposals for reform.

The Task Force was asked to provide an international perspective on the problem of loss of credibility involving:

- An assessment of the extent and seriousness of the problem;
- An analysis of the fundamental causes of the loss of credibility;
- Identification of alternative courses of action to restore credibility; and
- Recommendations on the courses of action that need to be taken to restore the credibility of financial statements, including recommendations on principles of best practice in the areas of financial and business reporting, corporate governance and auditor performance.

The Task Force, in carrying out its mandate, was asked to consider the responsibilities of audit committees including the implications of remuneration and communication matters, such as short-term periodic reporting on remuneration policies for senior management and aggressive financial reporting. Additionally, in the course of its work, the Task Force identified other areas it considered both germane and critical to the credibility of financial statements.

The Task Force focused on the impact of these elements on publicly listed companies, but was also encouraged to consider their impact on other corporate entities which have broad public interest.

In carrying out its work, the Task Force was asked to give attention to:

- The considerable volume of work already undertaken by member bodies and others at a national level in addressing the loss of credibility;
- Cross-national variation in the extent of the loss of credibility and its causes; and
- The emerging patterns of convergence in such areas as financial reporting and corporate governance.

Finally, the Task Force was urged to take a forward-looking approach and operate at a relatively high level in proposing approaches to resolving the problem, in order for the recommendations to have wide validity. ■



## RECENT DEVELOPMENTS

Changes aimed at improving the credibility of financial reporting did not start after the collapse of Enron. They have been continuing for many years. Intensive efforts have been made in a number of the developed countries to review and address issues such as corporate governance, accounting standards and auditor performance, and at the international level to develop enhanced standards to guide the national processes of change.

This summary, which focuses on the international standard setters and on developments at the national level, particularly in those countries represented on the Task Force, sets out some of the more significant developments in recent years; it aims to provide some background without attempting a comprehensive survey. Many of the more recent developments noted are still at the proposal stage while others, although they have been put in place, are so new that it is too early to assess their impact.

### The Financial Stability Forum

The Financial Stability Forum (FSF) was established by the G7 Finance ministers in 1999 in an effort to improve the international financial architecture. It was asked to focus on ways in which crises such as the East Asian financial crisis could be avoided or, if they did occur, the consequences could be minimized. The Forum comprises representatives of national finance ministries, central banks and other regulatory and government agencies and international institutions. It concluded very quickly that matters would be improved if all countries had strong market foundations with regulatory systems in areas such as banking, insurance and securities that were in line with best practices. They moved on to identify best practices and from a list of over 60 standards or sets of rules, concluded that there were 12 standards that were the most important.

Included in the 12 standards are: International Financial Reporting Standards, issued by IASB; International Standards on Auditing, issued by IAASB; the OECD Principles of Corporate Governance; the Core Principles for Effective Banking Supervision, issued by the Basel Committee on Banking Supervision; the Objectives and Principles of Securities Regulation, issued by IOSCO; the Insurance Core Principles, issued by the International Association of Insurance Supervisors; and principles on insolvency which are being developed by the World Bank. The remaining key standards are of less direct relevance to financial reporting and cover transparency in monetary and fiscal policies, fiscal transparency, data dissemination, securities settlement systems, and money laundering.

The World Bank and the IMF were given the job of assessing whether individual countries are complying with these standards. The World Bank, in its ROSC (Reports on Standards and Codes) process, has focused on accounting, auditing and corporate governance. Its reviews, primarily in developing countries, have identified many gaps between actual practice and the standards. The reviews have also attempted to identify the causes of noncompliance. From this, the World Bank has facilitated meetings of stakeholders, in both the public and the private sectors, to develop plans to upgrade both standards and practices.

In its twice yearly meetings and through regional meetings, the Financial Stability Forum has continued to look at ways in which the international organizations can increase the pace of change, either through encouragement and support or through external pressure.

### The Organization for Economic Cooperation and Development

The OECD Principles of Corporate Governance, one of the Financial Stability Forum's 12 key standards, were issued in 1999 and cover five areas: the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the responsibilities of the board.

OECD has started preliminary work toward a 2004 assessment as to whether changes in the Principles are needed. Although suggestions have been made for expanding the Principles to include detailed "rules" on such matters as the criteria for consolidation of subsidiaries and off-balance sheet finance, the consensus appears to be that the Principles are appropriately named and should not be converted into a detailed set of rules. The FSF has suggested that the Principles should be strengthened to reflect recent improvements in national practices and that more guidance should be provided on implementation and enforcement, major issues in this area as in others.

### The International Organization Of Securities Commissions

IOSCO, the International Organization of Securities Commissions, issued a revised set of objectives and principles for securities regulation, another of the FSF's 12 key standards, in February 2002. Among the 30 principles are those related to full, timely and accurate disclosure of financial results (by issuers), the need for high quality and internationally acceptable accounting and auditing standards, and the need for the regulator to have comprehensive inspection, investigation, surveillance and enforcement powers.

The guidance to regulators was expanded when it issued two statements relating to auditing in October 2002. The first statement, on auditor independence, supports the "threats and safeguards" approach underlying IFAC's Code of

Ethics, but then indicates that a framework is not sufficient to protect investors without the clarity that comes with specific provisions on activities and relationships considered unacceptable regardless of any safeguards that might be applied. This statement also concludes that there should be requirements for audit firms to maintain internal systems and processes for monitoring, identifying and addressing threats to independence and for ensuring compliance with the standards. This statement also includes the requirement that a governance body, independent of management, should oversee the selection, appointment and remuneration of the auditor and the conduct of the audit.

The second statement sets out principles for auditor oversight, including the need for the audit firm's processes and systems to be assessed and evaluated by an external oversight body that is seen to act in the public interest. The body would oversee the process for the licensing of auditors, auditor independence and the implementation of auditing standards. It should also establish a process for regular reviews of audit procedures and practices of firms that audit listed companies. All these functions could be performed by a professional body, as they are today in many countries, but where this is so, an independent public interest oversight body should also be in place.

### The European Union

Among the more significant developments crossing national boundaries have been those within the European Union. Although the E.U. focused, from an early stage, on the importance of financial reporting as a key element in producing a common internal market, the impact of the 4th, 7th and 8th Company Law Directives in providing a high-quality common approach to reporting was very limited as countries implemented the Directives



with minimum changes from their previous very different practices. Recent developments should produce both improvement and convergence in financial reporting.

The decision to require the use of IFRSs for the consolidated financial statements of listed companies and to allow individual countries to decide whether this requirement should be extended to other companies should improve the financial statements of many companies across the E.U. At the same time, it will put pressure on IASB to deliver on its program of strengthening its standards. The E.U. is putting in place a structure to give input to IASB during the development of standards and to formally approve them. IASB will want to have this approval and the E.U. will want to provide it; this will provide constructive tension in the process, which should be beneficial to all potential users.

In parallel with the decision-making on accounting standards, the European Commission has been focusing on issues related to the quality of auditing and to compliance with standards through its Committee on Auditing. This committee has representatives from each member state government and from the accounting profession. The deliberations in the committee have allowed the E.C. to issue recommendations on external audit quality control and auditor independence.

In May 2003, the European Commission issued proposals for extensive and positive changes in corporate governance and auditing. The corporate governance proposals include requiring an annual corporate governance statement, establishing minimum standards for the composition and role of nomination, remuneration and audit committees, and providing greater transparency and shareholder influence in relation to directors' remuneration. The audit-related proposals include the adop-

tion of ISAs, the strengthening of public oversight of the audit profession and reinforcement of the regulatory infrastructure. The E.C. will also analyze the economic impact of auditor liability regimes.

### The International Federation of Accountants

Standards and regulations are today primarily national matters. The E.U. decision to use international standards in accounting and auditing instead of national standards is intended to change this. At the same time, this decision raises questions of how structures can, practically speaking, be developed or adjusted to support a multi-lateral approach.

In 2000, IFAC embarked on a four-point plan to strengthen its position as the international standard setter in the audit field and potentially as the international self-regulatory body for the profession.

- The first area to be addressed was audit standard setting. Additional resources have been provided to IAASB, its membership has been widened and its processes have been made more transparent. Discussions continue with representatives of regulators and others as to whether additional changes are needed so that ISAs can receive the necessary acceptance from the regulatory community.
- IFAC has also focused for the first time on whether its member bodies are complying with IFAC's guidance as to best practice in running a professional body. An initial assessment of the issues has been made and the requirements of member bodies are being codified and clarified by issuing Statements of Membership Obligations.
- The large networks of accounting firms, which perform most of the international audits and most of the audits that have been subject to recent criticism, have been linked more closely to IFAC through the establishment of the Forum of Firms. The Forum is not part

of IFAC, but its operational committee, the Transnational Auditors Committee, provides the link through being a committee of both IFAC and the Forum.

- The fourth element in the plan for strengthening IFAC was to have been the establishment of a public oversight body with characteristics similar to the then existing U.S. Public Oversight Board. With the strong criticism of the U.S. Public Oversight Board post-Enron, this solution for providing public interest input was no longer considered credible, and discussions continue with stakeholders to determine whether there is an alternative approach to obtaining public-interest involvement which would be both beneficial and acceptable.

During this period of restructuring, IFAC has continued to develop new or improved standards in its public interest activities. The Code of Ethics on Auditor Independence, which provided major input to the European Commission's Recommendation on Auditor Independence, and the completion of a substantial body of International Public Sector Accounting Standards, are two of the main examples. The IFAC Ethics Committee is now focusing on the remainder of the Code, including that part of it related to accountants in industry. The IFAC Board has also underlined its commitment to the public interest by requiring that each board member confirm this in an oath of office.

### The International Accounting Standards Board

The International Accounting Standards Committee (IASC) was founded over 25 years ago by the same accounting professional bodies that founded IFAC. This close association with the profession began to be questioned as IOSCO conducted its review of its standards to determine whether it was appropriate to endorse them. A Task Force with representatives of various stakeholders, including

regulators, IFAC and IASC, concluded that IASC should become independent of the profession and that it should have substantially greater resources including a mainly full-time Board. The International Accounting Standards Board (IASB) was the result.

IASB is responsible for the development of IFRSs, one of the 12 key FSF standards. IFRSs and ISAs are different from the other standards in that they are the only two of the 12 which are developed by private sector bodies. This creates special issues in gaining acceptance by government bodies such as regulators. It means that in addition to accepting the appropriateness of the standards themselves, the regulators need to be satisfied as to the process by which the standards have been pro-

*A governance body, independent of management, should oversee the selection, appointment and remuneration of the auditor and the conduct of the audit.*

duced. This covers areas such as selection of board members, transparency of operation, input of stakeholders, finance, and public interest oversight. The restructuring of IASC, to form IASB, appears to have established a basis for acceptance in the area of international accounting standards.

IASB is in the midst of upgrading standards in response to concerns of IOSCO, which has endorsed IFRSs subject to resolution of certain issues, and the needs of the European Union, which will require the use of IFRSs for the consolidated financial statements of listed companies from 2005. IASB has also committed to reviewing IFRSs from the viewpoint of the smaller entity. Members of

IASB have been given responsibility for liaison with the accounting standard setters in a number of countries to encourage both cooperation in the use of resources and convergence of standards.

### National Developments

The national developments that have received the greatest visibility at the international level have been those in the U.S., where the Sarbanes-Oxley Act, which was passed in 2002, introduced additional requirements for management of listed companies, stronger corporate governance rules and major changes in the regulation of auditors. SEC regulations will implement the provisions during 2003.

However, there have also been significant developments in other countries, many of which pre-date Sarbanes-Oxley. In the U.K. a series of reviews, starting in 1992, the most recent of which reported in January 2003, has produced extensive changes in corporate governance requirements and in the regulatory structure impacting auditors. France reviewed various aspects of corporate governance in the Bouton Report published in September 2002. Developments in Australia, Canada and Japan are also summarized to illustrate the extent of changes being put in place.

### Requirements of Management

Sarbanes-Oxley introduces in the U.S. a number of restrictions relating to management that some other countries had had for a number of years. For example, in the interests of protecting auditor independence, the CEO, CFO, Controller, and Chief Accounting Officer cannot have been employed by the company's audit firm during the one-year period preceding the audit. In the future, it will also be unlawful to make loans to directors and officers. Directors and officers are also required to disclose their share transactions by the end of the second business day, much more quickly than ever before. Sales of company securities by directors and

officers are now prohibited when company pension fund members generally are barred from doing so during so-called black-out periods.

The CEO and CFO are now required to prepare a statement to be filed with the quarterly and annual financial statements certifying the "appropriateness of the financial statements and disclosures contained in the report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition" of the company.

Annual and quarterly reports are now required to disclose all material off-balance sheet transactions and other relationships with unconsolidated entities. The SEC is also required to conduct a study of the appropriateness of accounting followed in this area.

Management is now required to make and report an assessment of internal controls. The auditor will be required to report on the assessment.

Each company is required to disclose whether it has adopted a code of ethics for its senior financial officers and to disclose its contents.

The Act also introduces new provisions making it an offense to "fraudulently influence, coerce, manipulate, or mislead" an auditor. The SEC may also bar an individual from being a director or officer of an SEC registrant.

Finally, the CEO and the CFO are now required to repay any bonuses or other incentive or equity based payments and any profits made on the sale of securities where the financial statements are found to be materially noncompliant in the following 12 months.

In 2001, the U.K. Auditing Practices Board issued a paper highlighting issues related to aggressive earnings management.

Ireland proposes to introduce in 2003 a requirement for the directors to publish a statement that the company has complied with company, tax and other laws. This statement will need to be reviewed by the auditor.

### Corporate Governance

The strengthening of corporate governance has been a key focus in many countries, including all the countries represented on the Task Force.

The U.K. has devoted considerable attention to the strengthening of corporate governance starting with the Cadbury Report in 1992. The resulting Code of Best Practice has been expanded and remains voluntary. However, the Financial Services Authority, in its role as the U.K. regulatory authority, requires that companies that do not comply should explain that fact. The Code covers such matters as the composition of the board, the responsibilities of directors and audit committees and the relationship with auditors. Following from the Turnbull Report in 1999, listed companies have also needed to report that they have processes for identifying, evaluating and managing significant risk.

Ireland proposes to make major changes in its corporate law in 2003, including strengthening the role of the audit committee with a wide scope, including larger non-listed companies.

In May 2001, a French law introduced a new legal framework enabling companies to separate, for the first time and on a voluntary basis, the functions of the chairman and the chief executive. The law also contains provisions on shareholder rights, the responsibilities of the board, prevention of conflicts of interest, and allotment and disclosure of share options.

The Canadian Joint Committee on Corporate Governance, the Saucier Committee, which reported in November 2001, presented a comprehensive set of proposals covering what they identified as the five core functions of a board: choosing the CEO, setting the broad parameters within which management operates, “coaching” the CEO, monitoring and assessing the performance of the CEO, and providing assurance to the shareholders

and stakeholders about the integrity of the company’s financial performance. Included in the detailed description of these core functions is approving a communications policy that includes a framework for investor relations and a public disclosure policy. The report also emphasizes the importance of having the right directors, as well as directors who are independent, and introduces the idea of an independent board leader where the chairman is not independent.

The committee confirmed the importance of audit committee members being outsiders and unrelated as well as being financially literate, but concluded that it was not necessary to set detailed definitional rules along the lines subsequently introduced in the U.S.

The committee also concluded that the external auditors should be accountable to the board and to the audit committee and not to management. Additionally, the committee concluded that where there was no internal audit function, this situation should be reviewed regularly by the audit committee.

Germany introduced its first comprehensive corporate governance code in February 2002. As in some other countries, the code is non-statutory but if a company chooses not to comply, it must disclose that fact. The detail of the code reflects Germany’s dual board system of supervisory and management boards. The supervisory board, which has either one-third or one-half employee representatives depending on the size of the company, may not have more than two members who are former members of the management board. The supervisory board is required to establish an audit committee, whose chairman should not be the chairman of the supervisory board or a former member of the management board. The audit committee has a similar role to committees in other countries.

Sarbanes-Oxley introduces an independence requirement for audit committee members. Committee members may not receive compensation from the company except as a director and may not be affiliated with the company. The company will now be required to disclose whether at least one member of the committee is a financial expert, make a declaration that the audit committee members are independent, disclose the committee's charter and produce an annual audit committee report.

The committee now becomes responsible for the appointment, compensation and oversight of any accounting firm employed by the company and has the authority to engage outside advisers.

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The New York Stock Exchange issued new rules in August 2002 incorporating the Sarbanes-Oxley requirements and making a number of them more precise.

The High Level Group of Company Law Experts presented their final report, the Winter Report, to the European Commission in November 2002. A key recommendation was that corporate governance issues are best dealt with in national codes, rather than in legislation and that companies should be required to comply with a specified national code or explain non-compliance. This report recommended a major role for the audit committee with a number of differences from the U.S. approach, including, for example, monitoring

the provision of non-audit services rather than pre-approving them, and only requiring a majority of the committee to be independent. On the other hand, it suggested that audit committees meet at least once a quarter with the external auditors.

The Higgs and Smith Reports in the U.K. on the role of non-executive directors and on audit committees issued in January 2003 make a number of recommendations for change, but still conclude that a voluntary Code, supported by disclosure which requires the company to indicate whether it is in compliance with the Code or to explain why it is not, is preferable to rules set by law. The recommendations are likely to be put in place in late 2003.

The Higgs Report confirms the desirability of separating the roles of Chairman and CEO. A draft provision of the Code states that a CEO should not go on to become Chairman of the same company. The report also confirms the provision of the current Code that there should be a senior independent director in addition to the Chairman.

The Higgs Report also suggests that the balance of the board should be such that at least half the Board, excluding the Chairman, are independent of the company. The classification of a director as independent or otherwise is a matter for the board to determine, but among the criteria that would provide a definition of independence to assist the board are that the director: may not have been an employee in the previous five years; cannot have had a material business relationship in the previous three years; may receive no remuneration beyond a fixed fee; can have no family ties with directors, senior employees or advisers; can have no cross-directorships with other directors; cannot be a representative of a significant shareholder; and finally, cannot have served on the board for more than 10 years.

The Smith Report defines the role of the audit committee as monitoring the integrity of the company's financial statements, reviewing its financial

control system and the effectiveness of internal audit, recommending the appointment and remuneration of the external auditors, and reviewing their independence. The members of the committee should be independent, as defined above, and should include at least one with significant, recent, relevant financial experience.

The Toronto Stock Exchange introduced new rules for operation of audit committees in April 2002. The new rules implement many of the recommendations of the Joint Committee on Corporate Governance. All committee members are required to be unrelated and financially literate, with at least one member of the committee being required to have accounting or related financial expertise. The committee is required to have a charter and its functions are similar to those in other jurisdictions, but emphasis is put on discussions with the auditors regarding the quality as well as the acceptability of accounting policies.

Canada also introduced specific corporate governance guidance for federally regulated financial institutions in January 2003. In addition to considering the role of the audit committee, the guidance places substantial emphasis on the role of the board in relation to risk management and internal controls.

The Bouton Report, issued in France in September 2002, proposes a lengthy list of changes to increase the effectiveness of boards of directors. The report considers the composition of the board, including proposing an updated definition of independence, the need for the board to have an evaluation process, the operation of the audit, compensation and nominating committees, and various matters related to stock options. The definition of independence is similar to the Higgs definition. The report also devotes considerable attention to the relations between the board and the auditors.

A government proposal currently in the parliamentary process will merge two French regulatory bodies into a new independent Financial Markets Authority with responsibility for protecting investor rights and improving investor and saver protection.

Proposals issued in September 2002, and effective for 2003, make it compulsory for the first time for the 500 largest Australian listed companies to have audit committees. Members will be required to be independent and, as in Canada, be financially literate. Additionally, at least one should have accounting or related financial expertise. The proposals require the committees to have charters covering similar ground to the U.K. in such areas as auditor effectiveness and independence and review of company financial statements, but in the light of some of Australia's recent corporate scandals they add a requirement to review and monitor related party transactions and their propriety.

Japan has strengthened its corporate governance system through amendments to its Commercial Code. The board of statutory auditor system has been enhanced by increasing the number of independent members required. Effective April 2003, listed companies have two options for their corporate structures: they may have, as before, a board of statutory auditors or have a board of directors with audit, nomination and compensation committees. If a company chooses to retain its board of statutory auditors, at least half of its members will need to be outsiders with no director or employee relationship with the company. If the board and committee structure is chosen, a majority of the members of each committee will need to be independent.

### Accounting Standards

Country reviews in the area of accounting standards have, in general, confirmed the national structures for developing standards and have supported the role of IASB and the principle of convergence.

Sarbanes-Oxley will require changes at the U.S. accounting standard setter, the FASB, specifically in relation to governance and funding, but the standard setter will remain a private sector body. The FASB will need to be more focused on keeping standards current and to consider the extent to which international convergence of standards is necessary or appropriate.

The U.K. review leaves the accounting standard setting process unchanged and confirms the preference for standards based on principles rather than the detailed rules-based approach of the U.S.

The French review suggests that the annual report should summarize the company's procedures for identifying off-balance sheet commitments and assessing material risks as well as providing more specific disclosure of the information itself. While supporting the move to convergence of national and international accounting standards, the report is critical of the approach being taken by IASB "in seeking to impose fair value accounting" in relation to derivatives and more generally as to the lack of transparency in its standard-setting process.

As part of its program to converge with international standards, Japan has introduced a requirement for fair value accounting of financial instruments.

### Auditors and Auditing

Concerns regarding the competence and independence of auditors have arisen regularly in recent years and have been the subject of a number of committee reports. Although the conclusions in most of these earlier reports have either been superseded by events or repeated in later reports, one recent report that has not been fully implemented is worth a brief mention.

The U.S. Panel on Audit Effectiveness, which reported in August 2000, was established by the now defunct Public Oversight Board. The panel

performed a comprehensive and independent review of the way in which audit work is performed. It considered audit procedures and methodology, and firm and external quality control. Among its many recommendations, it concluded that there needed to be extensive changes in the then existing U.S. peer review system, as well as many detailed changes in audit procedures, including a greater focus on fraud. Among its other recommendations, which are still relevant, it suggested that the firms put greater emphasis on the performance of high quality work and that IFAC establish an international self-regulatory system for the auditing profession. The disbandment of the Public Oversight Board and the delays in activating its successor has meant that many of the panel's recommendations have not been implemented.

Sarbanes-Oxley establishes a U.S. Public Company Accounting Oversight Board (PCAOB), appointed by and responsible to the SEC, with much wider powers than the Public Oversight Board. The PCAOB's powers cover the registration of accounting firms, the establishment of auditing, quality control, ethics and independence standards, the inspection of accounting firms and investigations and disciplinary proceedings against accounting firms. The Act sets out detailed requirements that the Board must impose on firms, including the requirement to retain records to support audit reports for a period of at least seven years and a requirement to perform second partner reviews and adopt quality control standards. Annual quality reviews will be required of all firms auditing more than 100 SEC registrants; other firms will need to be reviewed every three years.

The list of services that an auditor may not provide to an audit client has been extended by the

inclusion of financial information systems design and implementation and internal audit outsourcing, and now covers:

- Bookkeeping or other services related to the accounting records or financial statements of the client;
- Financial information systems design and implementation;
- Appraisal or valuation services;
- Actuarial services;
- Internal audit outsourcing services;
- Broker or dealer, investment adviser or investment banking services; and
- Legal services.

The lead partner and the reviewing partner must rotate off the audit every five years. There will also be a study of the potential effects of requiring mandatory rotation of audit firms.

The auditor will also be required to hold more extensive and structured discussion with the audit committee, reporting all “critical accounting policies and practices to be used...all treatments of financial information within accepted accounting practice that have been discussed with management...ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the firm.”

The Act, as expanded by the proposals from the New York Stock Exchange and NASDAQ, requires the audit committee to be responsible for the appointment, compensation, and oversight of the work of the external auditor, including the resolution of disagreements between management and the auditor regarding financial reporting. The auditor is required to report directly to the audit committee. The audit committee must pre-approve any non-audit services that are provided by the auditor. The audit committee’s role is significantly extended to include reviewing:

- Major issues regarding accounting principles and financial statement presentation;
- Analyses prepared by management or internal audit setting forth significant reporting issues and judgments made in the financial statements;
- The effect of regulatory and accounting initiatives and off-balance sheet structures;
- Earnings press releases and financial information and earnings guidance provided to analysts and rating agencies; and
- Any audit problems encountered during the course of the auditor’s work including management’s response.

The Ramsay Report issued in Australia in 2001 considers the independence of auditors in great detail. It recommended changes in a number of areas including:

- Updating existing legislative requirements concerning the independence of auditors;
- Mandatory disclosure of fees paid to auditors for non-audit services, together with an assessment by the audit committee that the services do not impair the auditor’s independence;
- Mandatory audit committees for listed companies;
- Requiring the professional accounting bodies to update their ethical codes relating to audit independence;
- A two-year cooling-off period for retired partners of accounting firms who have had audit involvement with a client before they could become a director of that company;
- Mandatory rotation of audit partners every seven years; and
- The establishment of a new monitoring body, the Auditor Independence Supervisory Board, independent of the accounting professional bodies, to oversee the audit profession.



In September 2002, as part of a wider program of corporate law reform, the Australian government proposed changes in the law relating to auditor independence. These proposals are based largely on the conclusions of the Ramsay Report and are intended to be in place by the end of 2003.

The U.K. proposals reorder the regulatory and standard-setting bodies under a restructured Financial Reporting Council, which will be given statutory authority and whose chair and deputy chair will be appointed by the government. The Council will have responsibility for:

- The previously independent Accounting Standards Board, which will otherwise remain unchanged;
- The Auditing Practices Board, which will add auditor ethics and independence to its role;
- The Financial Reporting Review Panel, which will, in the future, take a more proactive role in searching for cases of failure to comply with accounting standards;
- An Investigations and Discipline Board, which will consider serious public interest cases of alleged failure by auditors; and
- A Professional Oversight Board, which will take over from the professional bodies responsibility for the quality inspection process of firms auditing public interest entities.

The U.K. review rejected firm rotation but supported the profession's decision to follow the U.S. by reducing the rotation period for the lead partner, but not for other partners, to five years. The review confirmed the E.U. recommendation on restrictions on non-audit services, including the "threats and safeguards" approach. The review also proposes greatly enhanced transparency on the part of audit firms, including the publication by all firms with listed audit clients, of an annual report providing information on the firm's policies and

procedures, especially those related to audit quality and the management of threats to independence, and management and financial information.

The U.K. has also given attention to the relationship between auditors and the board and the audit committee with the Auditing Practices Board, issuing an Auditing Standard (SAS 610), *Communication of Audit Matters to Those Charged with Governance*, in 2001.

France has given significant attention to this area over a number of years, starting with the Le Portz Reports in 1992 and 1999. The Bouton Report, issued in September 2002, highlights the French view that its system of joint audits greatly reinforces auditor independence as it should result in all the key issues being reviewed twice. Having a fixed appointment of six years is a further reinforcement. The report rejects compulsory firm rotation, whilst supporting partner rotation, and concludes that the audit committee should oversee a tendering process at the end of the six years. The report takes a strong line on the provision of non-audit services in concluding that, with the exception of ancillary work, the auditor should carry out no other work for the client.

France is proposing compulsory rotation of audit partners after each six-year fixed term. The soon-to-be established Financial Markets Authority will be required to set up a new audit oversight body, the Council of Statutory Auditors. The new Council will, among other matters, be required to ensure that there is a strict separation of the provision of audit and non-audit services to audit clients.

New legislation has recently been passed in the Japanese Diet based on a December 2002 report from a subcommittee of the Financial System Council. Auditor oversight is to be enhanced by having the professional body's (JICPA) system of quality control review monitored by an independent third-party board, the CPA and Auditing

Oversight Board (CPAAOB), to be established within the Financial Services Agency (FSA). The FSA will also have a general right to inspect audit firms and require firms and the JICPA to make improvements.

The new law focuses on auditor independence. Rules similar to those in place in other countries have been introduced relating to prohibition of certain non-audit services, rotation of engagement and review partners, restriction of employment of former engagement partners and disclosure of audit and non-audit fees.

A further area of change in Japan relates to increasing the number of CPAs. The objective is to provide the capacity to permit an increased volume and quality of auditing.

In parallel with the various national reviews and reports, the accounting firms have also taken action. Three of the four largest firms have now disengaged from performing information systems installation and design work by selling or spinning off that element of their practices.

### Analysts

Sarbanes-Oxley requires the relevant self-regulatory organizations to adopt conflict-of-interest rules for research analysts that recommend equity investments, but otherwise the Act is silent. The most recent U.K. reviews have not considered the role of analysts, although the securities regulator, the Financial Services Authority, has issued a discussion paper on the conflicts arising in relation to investment research.

The French regulator issued new provisions in April 2002 aimed at strengthening the independence of analysts by managing conflicts of interest and disclosures and by establishing procedures for disseminating research.

Effective April 2003, enhanced self-regulatory rules covering the activities of securities analysts were implemented in Japan. Analysts are required to be institutionally independent from investment banking operations, their compensation should not be linked to the performance of investment business, and the analysts and their firms are required to disclose any conflicts of interest relating to the companies they report on. Firms are required to establish review processes which ensure the objectivity and integrity of research reports. Those reports must not be disclosed to companies before publication.

The German Society of Investment Analysts and Asset Management adopted a new Code of Professional Conduct in February 2003. The Code focuses on independence and integrity and requires the disclosure of conflicts of interest.

Canada has also introduced new standards to deal with the potential conflicts of interest impacting investment analysts.

The Australian Securities and Investments Commission is currently investigating the practices of analysts to determine whether changes in regulations are required.

IOSCO is also currently considering the principles that should be applied to investment analysts and credit-rating agencies.

### Other Changes

Sarbanes-Oxley requires the SEC to set minimum standards for professional conduct for lawyers practicing before it. The SEC is also to conduct a study of those professionals — accountants, investment bankers, investment advisers, brokers, dealers and lawyers — who may have aided and abetted the violation of securities laws including the filing of materially misleading financial statements.

Reviews in other countries do not appear to have considered the role of these other participants. ■



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## GLOSSARY OF ABBREVIATIONS

AFEP	Association Française des Entreprises Privées (Association of French Private Sector Companies)
AGREF	Association des Grandes Entreprises Françaises (Association of Major French Corporations)
CESR	Committee of European Securities Regulators
CPA	Certified Public Accountant
CPAAOB	CPA and Auditing Oversight Board (Japan)
EC	European Commission
E.U.	European Union
FASB	Financial Accounting Standards Board (U.S.)
FSF	Financial Stability Forum
GAAP	Generally Accepted Accounting Principles (U.S.)
IAASB	International Auditing and Assurance Standards Board
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standard on Auditing
JICPA	Japanese Institute of Certified Public Accountants
MEDEF	Mouvement des Entreprises de France (French Business Confederation)
NASDAQ	National Association of Securities Dealers Exchange (U.S.)
OECD	Organization for Economic Cooperation and Development
PCAOB	Public Company Accounting Oversight Board (U.S.)
ROSC	Reports on Standards and Codes (World Bank)
SEC	Securities and Exchange Commission (U.S.)
UNCTAD	United Nations Conference on Trade and Development

