RESTORING TRUST AFTER
Recent Accountability Failures

Governing the Corporation
Institute of Governing, Public Policy, and Social Research
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The Honorable David M. Walker
Comptroller General of the United States

September 21, 2004

High Profile Accountability Failures Around the World

- Enron
- WorldCom
- Tyco
- Global Crossing
- Quest
- Adelphia
- CitiGroup
- Tenet
- Parmalat
- National Irish Bank
- Delorean
- Royal Ahold, NV
- Lernout and Hauspie
- Superior Federal Savings Bank
- Micro Strategy
- Arthur Andersen, LLP
- ImClone
- Waste Management
- Xerox
- Health South
- CreditSuisse First Boston
- Fiat
- Yukos
- Dexia
- Elan
- Adecco SA
- Seibel Systems
- Lucent Technologies

Accountability Breakdowns

- The major accountability failures over the last several years were not isolated instances. Many were the result of significant structural weaknesses in institutional corporate governance and accountability models combined with a lack of personal ethics and integrity.

- These failures have shaken investor confidence in U.S. and global capital markets and in financial reporting and auditing matters. They have resulted in
  - loss of investor confidence
  - loss of tens of billions of dollars in investor capital
  - loss of livelihood/retirement for tens of thousands of employees
  - significant impact on national economies
  - significant impact on public trust in a variety of institutions and parties

Accountability Breakdowns

- Forces that led to the corporate scandals and audit failures include
  - ineffective governance systems
  - ineffective regulation and oversight of the accounting profession
  - inadequate accounting and auditing standards
  - inadequate attest and assurance procedures
  - financial managers, along with their legal and financial advisors, working to achieve certain reporting results
  - inappropriate and unreasonable executive compensation arrangements
  - confusion over who the auditors work for
  - auditors' services to clients that impaired independence
  - auditors and financial professionals doing what was minimally required and fighting tighter standards
  - individual and institutional greed

Ongoing Reforms in the U.S.

- The Sarbanes-Oxley Act of 2002 included reforms in corporate governance and the accounting profession that were intended to
  - improve corporate financial reporting and internal control
  - provide management certifications of financial reports and internal control assessments
  - strengthen audit committees
  - change the relationship between the auditor and client
  - improve auditor independence
  - provide additional auditor assurance over internal control
  - provide oversight and regulation for auditors of publicly traded companies through creation of the Public Company Accounting Oversight Board (PCAOB)

Ongoing Reforms in the U.S.

July 2004 marked the two-year anniversary of the passage of the Sarbanes-Oxley Act.

Benefits are being seen in the following areas:

- enhanced public trust and confidence in the capital markets
- transformation of many aspects of corporate governance
- needed changes in auditor relationships with clients
- more active and effective audit committees
- increased CEO and CFO attention to financial reporting
- internal control requirements providing beneficial results and adding value for many companies
- PCAOB inspections of audit firms identifying areas where significant future improvements can be made in audit quality
- entities not covered by the Act considering implementing similar practices

Ongoing Reforms in the U.S.

Companies are encountering the following challenges:

- many companies are finding the internal control requirements to be more difficult and costly to implement than expected
- implementation timeframes have presented difficulties for some companies
- roles and workloads for members of boards and audit committees are greatly expanded

Moving forward:

- although progress is being made, it will take some time before we realize the full benefits of the Act
- a comprehensive review of the effectiveness of the Act will be needed after at least one full implementation cycle
- other issues of modernizing financial reporting and auditing will need to be addressed by standards setters

Impact of U.S. Reforms in Other Countries

Non-U.S. auditing firms and corporations have identified the following challenges:

- potential conflicts between U.S. and home-country laws and regulations
- administrative burden of meeting requirements of both U.S. and home-country regulators
- inspections by U.S. regulators resulting in dual oversight
- implementation timeframes difficult for some firms
- delisting requirements make it difficult to withdraw from U.S. exchanges

Ongoing progress:

- PCAOB working cooperatively with non-U.S. regulators and placing reliance on those regulators
- constructive dialogue and discussions on auditing oversight with European Commission, European countries, Canada, Australia, Japan, and others
- recognition of home-country laws and regulations in tailoring requirements for non-U.S. corporations and auditors

Impact of U.S. Reforms in Other Countries

Ongoing progress (continued):

- accommodations for auditing firms: extended deadlines and registration flexibility
- accommodations for corporations, including
  - interim reporting on the basis of home-country rules
  - alternatives for satisfying audit committee requirements
  - extended compliance deadlines, e.g. internal control reporting
- movement toward harmonized international financial reporting standards
- landmark European Commission legislative proposal that contains requirements similar to Sarbanes-Oxley for corporate governance and auditing
- European Commission efforts to develop common oversight approach for European Union financial services market

Corporate Governance Challenges

- Corporate and other governing boards must take steps designed to
  - maximize value to shareholders over time
  - manage risks for stakeholders
  - hold management accountable for results both currently and over time
- Investors outside the company should have the information they need to clearly judge corporate performance and to compare one company's performance and practices against others.

Corporate Governance Challenges

- Corporate leadership must establish a climate of integrity and transparency at the top that reaches to every level of the organization.
- CEOs must remember that they are stewards, not owners, of the organization and are ultimately responsible for
  - hiring the right type of people with the right skills and values
  - creating/demanding accountability throughout the organization
  - ensuring that ethics and values are an integral part of the workplace, i.e., “tone at the top”
- Everyone at every level should understand the role and function of the organization, how decisions are made, how decisions should be executed, and where to go if they believe that illegal or inappropriate acts have occurred.

The Future Financial Reporting Model

In modernizing financial reporting, we need to

- review and revise the existing accounting and financial reporting model to reflect several dimensions:
  - meaningful financial reporting that is useful, timely, and relevant
  - generic provisions
  - industry information
  - entity-specific information (i.e., value and risk)
- recognize the difference between certain types of financial and other information:
  - historical cost
  - readily marketable assets
  - non-readily marketable assets
  - projection information
  - performance information

The Future Audit Model

In modernizing audit reporting we need to

- determine whether “generally accepted” is the appropriate framework versus “authoritative accounting principles” that could be used when the “generally accepted” framework may not provide a full and fair representation in the view of the auditor
- review and revise the existing audit reporting model to accomplish at least two objectives:
  - recognize that the opinion should address whether the financial statements are fairly presented in all material respects and prepared in accordance with authoritative accounting principles promulgated by FASB, FASAB, IFAC, and others, applied on a consistent basis
  - update the audit reporting model to link it with the new financial reporting model, and provide appropriate degrees of assurance for each type of information
- ultimately go global in connection with all major accounting and audit matters
- coordinate U.S. and domestic efforts in the interim

U.S. Auditing Standards Coordinating Forum

- Composed of PCAOB, GAO, ASB (AICPA)
- Seeks to
  - maximize complementary standards-setting agendas
  - minimize duplicative or competing efforts
  - identify any significant gaps not being addressed by the standards setters
  - assure consistency, where appropriate, in core auditing standards in the U.S.
  - develop strategies for overcoming challenges and avoid unintended barriers to movement between the sectors
  - modernize the accounting profession in the U.S.
  - explore opportunities for international harmonization

GAO's Work to Modernize the Accountability Profession

GAO is actively working to modernize and transform the accountability profession in government and the private sector—and to lead by example in this area.

- independence standards issued in 2002
- assistance to the Congress in evaluating accountability profession issues and needed reforms prior to the Sarbanes-Oxley Act
- monitoring implementation of the Sarbanes-Oxley Act
- 2003 revision of *Government Auditing Standards*
- continually modernizing Yellow Book standards
- enhancing federal financial management, reporting, and accountability
- expanding the definition of success in financial management: clean opinion, no major weaknesses in controls or compliance, and financial systems that produce timely, accurate, and useful information for management
- coordination with accountability organizations around the world (e.g., INTOSAI, IFAC, IAASB)
- promoting modernization of accounting/reporting and attest/assurance practices both domestically and globally
- creation of the U.S. Auditing Standards Coordinating Forum

Key Concepts in the Accountability Profession

- Public trust vs. personal interests
- Recognizing the difference between the floor (e.g., rules, regulations, laws, accounting standards) and the ceiling (e.g., principles, values)
- Doing what is right vs. what is acceptable
- Economic substance vs. legal form
- Being concerned with both fact and appearance (e.g., independence)
- Using judgment vs. completing checklists
- Recognizing that continuing improvement in today's rapidly changing world is essential
- Remember that trust is hard to earn, but easy to lose

Rebuilding Public Trust

For any system to work, it must address three fundamental issues.

- First, provide incentives for people to do the right thing.
- Second, provide transparency to help assure that people do the right thing.
- Finally, have effective accountability mechanisms if people don't do the right thing.

Restoring public trust will require that every participant in the corporate reporting supply chain embrace and live by the following core concepts*

6. A spirit of transparency—stop playing games with financial and performance data. Use full disclosure.
7. A culture of accountability—management, staff, boards, auditors, and stakeholders. High quality, unbiased information to support decision-making.
8. People of integrity—commitment to individual integrity.

*Excerpts from *Building Public Trust: The Future of Corporate Reporting,* Samuel DiPiazza, Jr. and Robert G. Eccles, 2002

Corporate Governance and Accountability on a Global Scale

….The globalization of business and communications, increasing technology and increasingly complex financial transactions, mean that a business failure anywhere touches people everywhere. A failure in London impacts the markets in Lagos. This is why a recent survey of business leaders by the Economist Intelligence Unit found that the attention being paid to corporate governance is increasing worldwide and will continue to do so into the future.

Good Corporate Governance
Ian Ball, IFAC Chief Executive
Presented before the Association of Accountancy Bodies in West Africa
April 26, 2004

How Do We Move Forward?

- Good governance and accountability are critical
  - in the private sector to promote efficiency and effectiveness in the capital and credit markets, and overall economic growth, both domestically and internationally
  - in the public sector for the effective and credible functioning of a health democracy, and in fulfilling the government's responsibility to citizens and taxpayers
  - in both sectors to support a healthy economy that provides economic opportunities and benefits to citizens
- Sorting out the needs and effective and appropriate governance and accountability mechanisms for different sectors and types of organizations and on an international scale will be critical.

Remembering Our Key Responsibilities

As business and governments face the increasingly complex and challenging issues of our modern and increasingly inter-dependent world, effective and appropriate governance structures and accountability systems are critical. As accountability professionals, we must always be mindful of our unique responsibility to do the right thing and to lead by example in order to maintain the public trust and show others the way forward.

Three Key Personal Attributes Needed for These Challenging and Changing Times

Leadership

Integrity

Innovation

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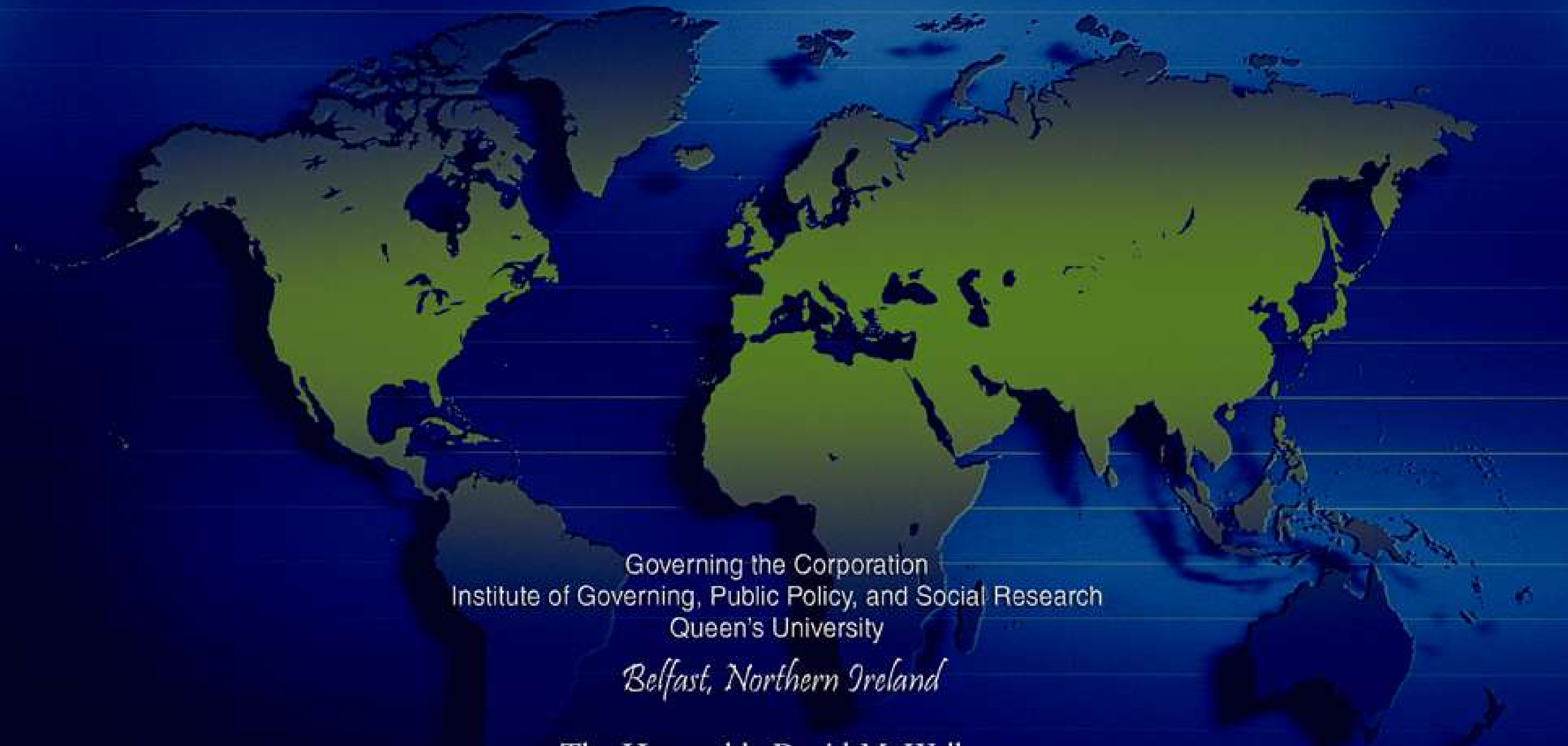

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