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THE ROLE OF DISCLOSURE IN STRENGTHNING COPRORATE GOVERNANCE AND ACCOUNTABILITY
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DISCLOSURE: A CORPORATE GOVERNANCE TOOL THAT REALLY WORKS?

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Good morning ladies and gentlemen. The purpose of this Roundtable is to explore how disclosure can be used to strengthen corporate governance in the Russian Federation. I have been given approximately 15 minutes to start the discussion.

What is disclosure? And, what is the relationship between disclosure and good corporate governance? To me, this quote summarises it best: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman".

The quote is rather old. Louis Brandeis, Supreme Court Justice of the United States, said it in 1933. It was made in the context of the Great Depression and the turmoil in global financial markets of the 1920s.

It was also made in the context of President Roosevelt's great reform programmes that eventually lead to the passing of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the US Securities and Exchange Commission.

Even then, in 1933, financial transparency was the remedy of choice for the fraud and market manipulation that shook the financial markets of the US and contributed to the global crisis of the 1920s.

You are probably asking, couldn't you have found something a bit newer? Probably, but I doubt I could have found one that is so well known.

But there are other reasons for using this one. It is to illustrate that the stability of global financial markets is an old preoccupation and a global one at that.

And, it illustrates that the relevance of disclosure hasn't really changed since the 1930s. A more recent (but far less eloquent) quote by a US SEC commissioner referred to the common theme in securities market regulation as "disclosure, again disclosure and still more disclosure" (Richard B. Smith)

Why is disclosure such a strong recurring theme? The answer is that the disclosure is an effective tool for improving investor protection. Without good disclosure, it is easy to take advantage of minority investors. Of course, with any disclosure regime some of the responsibility for protecting the investor is shifted to the investor himself. However, informed self-interest has proven to be quite effective. With good information, the perception of risk in the markets is reduced, as is the cost of capital. Even very small changes in interest rates and the cost of capital can have a large impact on the economy as a whole. It also encourages better management of enterprises. Disclosure regimes do not appear to be designed for this purpose but better markets and better disclosure seem to make for better companies. The common wisdom is that "you manage what you measure". The corollary is, of course, "out of sight, out of mind". Better-run companies, in turn, contribute to greater economic efficiency and a greater capacity to generate wealth. This is important since it is not only the investor that benefits. The whole society has something to gain. In short, good information allows for more informed, more rigorous economic decision making.

Recently, Sir Peter Kemp of the Foundation for Accountancy and Financial Management reminded me that transparency is not just about economics but also the function of civil society. Enterprises do not exist in a vacuum (just as no man is an island). Company information is important to a variety of users ranging from shareholders to employees, to local communities, and government. Transparency is important in order to improve the public's understanding of enterprises and their interaction with society.

There are different approaches to securities market regulation. Regulators in the most developed markets tend to rely heavily on disclosure. In former centrally controlled economies, this reliance on transparency tends to be perceived as one of the most radical aspects of securities market regulation and one that is difficult to bring into the existing regulatory culture. I should add that this feeling is also shared by countries, in Europe, Asia and elsewhere.

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Disclosure based regulation sounds like an easy solution to a lot of problems. But it's not. For disclosure to work as a governance tool, quite a number of elements (or incentives) need to be working together.

The first is effective regulators: A regulator with teeth. Securities exchange commissions usually screen financial statements and some dedicate significant resources to this effect. I recently read that the US SEC has 120 accountants reviewing financial statements in just one of its divisions. In the event they discover a serious misstatement, they have a variety of disciplinary mechanisms at their disposal. Many countries have the proper regulation on the books. But most often problems come without proper enforcement. Enforcement must be effective, fair and unbiased --and not just targeted at people or companies we don't like.

Legal remedies: are also important. Shareholders need to be able to assert their rights when they are violated either through civil or criminal procedures. Private law remedies are very important. Investors need to be able to challenge auditors, and directors need to have some legal responsibility, as do auditors. Unless they are held accountable it won't work.

Foreign issuers probably tend to worry a great deal about US regulators and litigators. But, according to many analysts and institutional investors, they are much more troublesome than the government bureaucrats. What bothers many CEOs are the securities analysts. Within his own company a CEO is used to being treated with deference and respect. Not so at analysts meetings. Executives are asked difficult, sometimes even insulting questions. If regulators have teeth then I suppose, the analysts have fangs.

Analysts play another very important role. They are not only users of information. They are also important providers to management. Analysts inform CEOs of what the markets expect and can provide instant feedback to CEOs regarding their perceptions of the quality of management's decision making.

What drives the financial disclosure culture? Certainly, one key aspect is broad share ownership. In the US the majority of the population owns shares either directly or indirectly through collective investment schemes. Statistics are similar in other countries such as the UK. Share ownership is no longer something that is reserved for a wealthy elite.

As a result, the public has developed an enormous appetite for business news: News stories on companies have become a big business. Most of us have seen the hourly business updates on CNN and the news on 24 hour business channels such as Bloomberg's. There are even talk shows dedicated to the discussion of companies and markets.

Some have argued that if boards of directors are becoming more alert, more vigorous and more independent, then the new culture in the board room also reflects the increase in attention they receive, and heightened sensitivity to the extraordinarily high volume of criticism. The controversies stirred up by the media cause directors to ask: how can we do our jobs more effectively? Are we doing the right things?

Today, one ignores the power of the media spotlight at one's peril. Boards are not exempt as they once used to be. They too are being held to account.

Standards: To illustrate the importance of accounting standards, take the case of General Motors. In 1992 the FASB, the US standard setter, required the recording of future pension and health benefits of employees as liabilities. Previously they were not. As a result, a new liability of 36 billion dollars appeared on the balance sheet of GM reducing its equity from 42 billion dollars to 6 billion. Now that's quite a difference.

But it's not just accounting standards that are important. There are also standards for non-financial disclosure, standards for how to conduct an audit. There are even standards for environmental, social and ethical disclosure. Whatever you disclose, the quality of the information you provide cannot be better than the quality of the standard under which it is prepared.

Thus, the importance of accounting standard setters: Accounting standard setters usually receive their authority from a public sector body, though they often work in very close partnership with, and draw heavily upon, the expertise of the private sector. Beyond technical competence, the independence of the standard setting body is of the highest importance (much in the same way that the independence of a board is important) in order to protect the interest of users and the public.

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Last, but certainly not least, is the accounting and audit profession: It seems safe to say that the accounting profession has not captured the public's imagination. It is remarkable in light of what accountants really do. Financial data is reliable only because auditors check it first. They are the first line of defence for shareholders and serve one of the most valuable functions in a market economy. They provide assurances regarding the information on which almost all our economic decisions are based. If the information is wrong, then the economic decisions we make will also be wrong. Can one imagine a larger responsibility?

In contrast to other professions the auditing profession bears a special burden of being objective and independent. The public's expectation of objectivity and independence is very important. If the profession loses or does not have a reputation for independence, its role as protector of the "truth" and its role in protecting the credibility of financial markets will be diminished.

I have listed some of the important features of a system in which disclosure is an effective tool for monitoring management and holding management accountable. I am sure one could list more.

I do not mean to imply that once you have these various bits in place that the disclosure framework will work. The field of disclosure is in a constant state of evolution. There are multitudes of challenges that remain.

One of the challenges results from the shift from a predominantly manufacturing based economy to a knowledge based economy. Take Microsoft. Like many high tech firms it has almost no fixed assets on its balance sheet. 25 years ago Microsoft (360) didn't even exist, today it has a market capitalisation exceeding those of giants such as IBM (163), General Motors (29), Daimler/Chrysler (46), Boeing (56), and Motorola (48) combined. Today, investors are financing ideas not machinery. How does one provide them with the information they need to make informed decisions?

Earnings manipulation: is not new and it will never go away. The reason is that accounting--unlike bookkeeping--is inherently imprecise. Accounting requires judgement. Should a building be depreciated over 20 years or 40 years? If its market value rises, should it be depreciated at all? Should training of human resources be written off immediately as an expense or capitalised as a long term investment? Judgement allows for manipulation and there are plenty of examples of companies bending the rules to the breaking point.

There are lots of ways to paint a picture, and the auditor has the important role of reigning in the tendency of companies to paint an overly rosy one. The importance of auditor independence was already mentioned. Raising the quality of the audit and improving the independence of the auditor will remain important challenges in the years to come.

The recent Asian crisis also raised the issue of the gap between public expectations, and the assurances provided by the audit profession. Criticism shook some of the large firms. They were criticised for putting their signatures to accounts prepared and audited according to weak national standards and for bestowing a level of credibility on these national standards through the use of their brand names, brand names that are recognised world-wide.

Standard setter independence: I mentioned that standard setters also need to be independent. Discussion is healthy but, standard setters are sometimes subject to heavy lobbying to reduce disclosure. Recently, heavy lobbying prevented FASB from accounting for stock option grants at fair market value, the way that you account for other employee benefits. Taking into account the real cost of stock options would have meant that many companies in the US would have posted significant losses rather than gains.

More challenges. Developing a response to international standards: Financial reports from different countries are hard to compare. The text book case of the differences that can result from different national standards is the 1993 listing of Daimler Benz in the US. Under German accounting standards Daimler reported a profit of 170 million DM. Under US reporting, they had a loss of almost 1 b DM.

If you only invest in one country you would, at least, be comparing apples to apples. But, the world is seeing increasing flows of capital across borders and investors generally need to go to considerable expense to make sure they do not compare apples to oranges, or they take a greater risk and charge you a risk premium for it. The utility of a high quality international standard that allowed for international comparison has long been recognised but hard to achieve.

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As a consequence, one of the most significant events of the 90's was the endorsement by IOSCO of International Accounting Standards and the re-organisation of IASC as a more effective and accountable international standard setting body. International Audit Standards have now become a global reference point. International accounting and audit standards are now part of the core 12 standards identified by the Financial Stability Forum that are to make up the new global financial architecture.

Finding a coherent strategy with respect to international accounting standards will be a challenge for all countries in the years to come. All countries, including the most advanced, will have to formulate a strategy for how to react.

Fair disclosure: how things are disclosed makes a difference. Selective disclosure is when analysts receive material information that is not simultaneously made public. Selective disclosure can be considered a breach of fiduciary duty or loyalty to the company and its shareholders.

Technology: emergence of internet as a powerful governance force Web casting of analysts meetings (US SEC monitoring of chat rooms)

Historical data: financial statements report on past events. What the markets are looking for is future performance. Does this negate their value. No, indicator of what is reasonably achievable. But also monitoring function.

There are even more challenges but I will leave it at that. Suffice it to say that there will be work for accountants, auditors and public sector officials for generations to come.

As is usually the case that some of the toughest challenges are reserved for transition economies, economies that are just trying to put their economic frameworks in place.

I will not go into a detailed discussion since I anticipate that these issues will be looked at in far greater detail during the meeting. I will briefly mention a few.

Many place their faith in the large institutional investors to demand better governance and disclosure. Unfortunately, there is a limited impact of institutional investors: Small number of traded companies (cannot count on institutional investors) I spoke with an institutional investor looking to invest in Asia. Wanted to be able to buy in within a 3 week period without affecting the share price. He also wanted to ensure a relatively quick exit or the ability to sell without dampening the share price. Only 44 companies in all of Asia. Much talk about the importance of foreign investors. Most investment still comes from domestic investors. Expectations for domestic investors need to be raised. If we cannot protect our own investors, how can we protect others? Better disclosure for domestic investors could convince people to remove money from the mattress or wherever else it is that they are currently keeping it.

Accounting for smaller enterprises: Good governance is still relevant for others

Small companies are overlooked: The bulk of companies are smaller (some sort of differential reporting is required.)

Young institutions: Limited powers of SECs. May be difficult to shift responsibility to private sector as they catch only the most egregious cases of malfeasance. One or two cases can take up a huge amount of resources and time. Also bureaucrats are paid very little. When investigating in a company, temptation may be too difficult to resist.

Emerging profession: Audit is defined completely differently. Current examination of auditor independence in US. US SEC has threatened with pulling apart the audit and business advisory services of the big firms. Audit in Russia is a business advisory service, 91 associations. Need to get house in order, how can users take their work seriously.

Attitudes towards transparency: The central message is that if management is not ready to have transparent reporting on the financial and other relevant aspects of the entity, the accountant and the auditor will face a much harder task. So, changing the culture may be necessary, if the profession is going to deliver the goods.

Official capture: interest groups can influence drafting and also influence biased enforcement. Not just large firms, but regional, sectoral or whatever regulation it might be.

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Training needs: Where are the armies of well-trained accountants and auditors that are supposed to bring our financial statements up to world standards?

One of the biggest problems to address is the link between accounting and taxation: If you change the way you account, you can affect earnings and other figures and the level of tax receipts. It is logical that authorities are cautious when it comes to revising the system.

Does all this make disclosure or should we be focusing our attention elsewhere?

Disclosure can be a tremendously powerful tool for monitoring enterprises: It is a market based alternative to substantive regulation. Transparency, accounting and audit are of the greatest importance to the functioning of the economy and should, as a consequence, be of greater interest to policy makers. Without accounting there is no accountability.

If anyone doubts this I will cite two examples. In 1980 when the US congress deregulated the US Savings and Loan industry, the industry had a positive net worth of 36.2 billion. But most of its assets were in bad loans. Had the assets been marked to market, the net worth of the industry would have been between negative 78 and negative 118 billion-- in 1980 dollars. Who knows what that figure represents today. Who knows whether the US congress might have decided not to deregulate with this information. It certainly would have had a better chance of avoiding this costly crisis. The restoration of a credible banking sector is clearly a high priority concern in Russia today.

The situation finds eerie parallels in the recent Asian crisis where, financial disclosure was almost certainly not the root cause. Better financial transparency would have given better opportunity for policy makers to react. Decision making without good information is like driving a car at night without the headlights on. The results are all too predictable.

Effective disclosure based regulation depends upon a multitude of factors: and there appear to be some important pre-requisites (an incentives framework) before we can expect disclosure based regulation to function. Disclosure is not a panacea, it cannot function without the rule of law, interested and engaged investors and a variety of other factors.

Transparency is a moving target: Accounting standards are always in a state of flux, audit standards change less but also change, requirements for non-financial disclosure are also changing. It can be difficult for the public sector to keep up. Partnerships between regulators and self-regulatory institutions need to be forged in order to find the skills and resources to get the job done. Despite all of these challenges we are seeing a move to greater transparency. A move that reflects not only great recognition of its effectiveness as a tool to monitor and hold accountable but also a greater recognition of shareholder interests. Despite the almost counterintuitive nature of disclosure, and difficulty in understanding it, many countries are moving towards greater disclosure based regulation as they find that merit based systems are costly to manage and less effective in delivering the intended results.

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