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**CONFLICTS OF INTEREST
IN THE
ACCOUNTING AND AUDITING SYSTEMIC ENVIRONMENT
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South Eastern European Corporate Governance Roundtable
On Transparency and Disclosure
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Introduction

A free and fair market economy that encourages investment and competition will never exist unless there is a system in place with adequate checks and balances that provide reasonable assurance to the public that information is properly presented. Markets respond to actual or perceived risk and capital has a natural tendency to flow toward the least risk adverse investments either perceived or real.

As long as financial information which is disclosed appears opaque or subject to unfair manipulation of assets by a certain few, the market economy will be limited in its growth and movement. There will be movement but it will always be restricted and sluggish. This sluggishness will remain as long as the public perception exists that information is tainted and value is being manipulated by a select few.

The recent high profile global companies in the United States are witnesses to what can happen even if the rumour of opaque financial reporting exists. Company market capitalisation can quickly decline 50% in a single day and the overall economy is damaged because the existence of one tainted company increases the probability of there being more tainted companies. Every company and every investor pays a price as a participant of the market economy when the market shows that these risks and vulnerabilities exist.

As a result of this risk, it is in the interest of the public and the government to assure that a system is in place that attempts to minimise the probability of these events happening. It also requires the public to be vigilant to the dynamic changes that take place in an evolving market economy with the ability to respond and change in unison with the evolution of the economy in order to provide the best protection possible to the public and the market economy. Government is often seen as the organ responsible for this task as overseer. However, Government should be cautious to watch over and to respond as needed but should be discouraged in taking control of the system.

Systemic best practices

Best practices have always considered that independent auditors that were self-regulated audited the books and records of a company. These auditors were licensed often by the government (in some countries they were licensed by a professional association having received this authority from the government).

Auditors should have at least a university degree, with the necessary additional specialised accounting and audit education. Accountants and auditors should undergo an examination, adhere to a code of ethics and commit to a lifetime requirement of continuing education in order to stay abreast of the dynamic changes in the reporting and financial environment. Independence, integrity and objectivity are an absolute necessity to provide the necessary confidence to the capital markets that the public interest is being fairly served by the profession.

A company should be independent from the auditor and both the company and the auditor should assure that the company has its own internal checks and balances that provide systems in place to avoid unapproved benefits or preferential personal enrichment without the approval or knowledge of the investor owners of the company. Company boards are to serve in this capacity of fiduciary guardians of the company protecting the interests of the owners of the company.

Conflicts, collusion, and lack of independence

Management and Board- Management is tasked with handling the day to day operations and activities of the company following the strategic plan laid down before them by the board. The board provides guidance and oversight of management activities and conduct for the benefit of the owners of the company. Conflicts of interest result if the board is composed of strong executive management influence or is composed of former managers of the company. The board member too aligned with management may not challenge the information or the conduct of management as aggressively if the relationship of board and management is too close.

Auditor and management- While auditors will spend most of their time with management in reviewing the financial information of the company, the auditor must remember they have a professional duty to the investors (via the board which approves the auditor). Auditor reports and information is to provide results and feedback to the investors on the progress of the company. There is a risk of conflict if management of the company formerly worked for the auditor, which often is the case in developed economies.

Audit committee and management- the audit committee should have special responsibility related to financial activities of the company. They should have full access to financial information of the company and be subject only to the accountability of the board. They must have the right to question management and auditors related to any issues of financial importance. The audit committee must be or be willing to become knowledgeable about the financial activities of the company. Potential conflicts exist if audit committee members formerly were part of the company management team. Former working relationships may place undue pressure on the audit committee to avoid asking hard questions.

Audit committee and external auditor- the external auditor should be reporting to the audit committee on findings and issues. While the external auditor often will spend much of his time with the accounting department, company management, and company staff the matter of reporting findings, to discuss accounting policies and professional opinions should be with the audit committee. The audit committee bears ultimate responsibility to the company owners.

Controlling investor and management- At times an investor with substantial ownership will have access to management which other investors will not have. While from the standpoint of being able to manage a company in response to the interests of the owners would suggest a legitimate

reason why it would be appropriate to listen to the concerns of a large block of ownership, there is a risk that decisions could be taken which are in the interest of the controlling shareholder and to the detriment of the minority shareholders. The company is a legally created entity and management has a fiduciary duty to manage the company in the best interests of the company and the owners and should not manage in such a fashion to place the interests of the shareholders (including the minority shareholders) in jeopardy.

Professional Ethics/codes of conduct/ charters

The *independent auditor* should be bound by a code of ethics as a condition of licensing. Accounting associations in your region should require the auditor to sign a statement that will be maintained on record with the association. One association in your region had all successful examination candidates make an oath of commitment before the head of the Orthodox Church within the country.

Companies should have a section on codes of conducts included in their company manual. Policies and procedure manuals should include information on employee and management conduct and actions including the company policy for infractions.

Companies in developed economies are now using written charters that provide information on the duties and responsibilities of *audit committee members*. The SEC recently required that charters with audit committee member signatures be filed with the SEC along with the annual report.

How far do we take the concept of checks and balances?

To what extent should we worry about having checks and balances in place to stop any potential inappropriate or illegal manipulation of financial information. We can put checks and balances into a system to watch after the checks and balances. We can place internal controls that watch over the system of internal controls for a company. We can allocate more resources to administrative systems than the actual production of a company. It is nearly impossible to stop every potential problem from ever happening in every company. We reach the point of being ridiculous with our protections. However, as Enron, one single company has demonstrated, that a failure of one shakes the confidence of the entire capital markets costing all the participants of the market billions of dollars. The company employees and audit employees that participated in the collapse of Enron did a serious disservice to the entire capital markets and the participants yet they also provided a huge service to the markets by calling to the attention of the markets the risks and abuses that go on within the market behind the scenes where investors lose sight or fail to see. The system must change as the markets change. Financial vehicles and tolls exist within the market that never existed before and never to such a global extent. The system must respond also to this change.

Issues between developed and transitional free market economies

Transitional and emerging markets are in the advantageous position of being able to learn from the mistakes of developed markets that had to discover what works and what does not work over a long time period. While emerging and transition countries are currently going through significant financial and social difficulties in transitioning to a free market economy and to develop an economy that can compete with the developed countries, they have the advantage of being able to see and understand the real lessons learned from other economies.

Transitional countries are attempting to cope with pressure to privatise their markets when the system that supports a private free market system is underdeveloped and does not have the infrastructure in place to support adequately such a free market system. It is important for a free market to function that the free market infrastructure is in place. It is dangerous to accelerate privatisation and free market norms unless the free market support is established to see that it functions properly. Without the system, failures, corruption, and disenchantment with the free market will prevail. The society will view the old ways as being better than this new way.

Is it time to re-think self-regulation

There is a substantial amount of discussion currently taking place regarding the issue and legitimacy of an accounting and audit profession, which regulates itself. The discovery of auditors that compromised their professional integrity or just plain didn't have the courage to stand up to the client which pays millions of dollars and which bonuses and future advancement are tied to. In the global economy, global companies required global audit firms. As a result the control and influence of the professional and firms has narrowed down to five substantial firms that perform the majority of the audit work for the listed companies. This has resulted in a closely knitted and suspected arrangement where the necessary checks and balances if not in fact but in appearance have been compromised.

Public opinion is currently questioning the effective use of self-regulation and is now calling for greater intervention from something with greater independence and objectivity. This discussion ranges from complete governmental oversight to a newly formed independent body to simply a shake-up of the existing association oversight.

Historically government intervention has been discouraged and is considered to be not effective enough. In transitional countries, government intervention particularly with state owned companies has been the real issue and most significant reason for lack of economic competitiveness.

Financing and timing of an independent oversight body

Sources of possible financing- Discussions are currently underway on how to possible fund an independent oversight body within the United States. The SEC is having budgetary difficulties just carrying out the recently expanded company investigations. There is apprehension to require audit firms or companies to fund the independent body for risk of the oversight body becoming tainted. However, it seems that a shared funding proposal may become a reality. Those audit

firms and the companies they audit who have an interest in market integrity and who benefit from such a market should be the ones that pay.

How could such an independent oversight body exist in economically challenging regions where securities exchanges and professional associations are still struggling today? It seems that the establishment of an independent oversight body within such a region is not economically viable. However, the sharing of certain checks and balances established between the self-regulatory association and the government may be an efficient solution to the problem with a shared representative committee set up to provide for this oversight. Some markets are still yet small suggesting that a regional co-operative effort may be the most effective solution to the problem.

Finding the balance

Rules to minimise conflicts must always be balanced with the goal of minimising barriers to the efficient operation of a business. Too many rules, regulations, and reports attempting to assure compliance will stifle productivity of a company. Europe has criticised the United States for the weak regulatory framework regarding accountants and auditors, yet it is the United States markets everyone looks to for the quickest response to market development and growth and with the most efficient markets irrespective of the "Enron" issues. Europe is continually weaker when it comes to market growth and efficiency because of the increased social and governmental burdens placed on companies within the Eurozone. What this suggests is to attempt to avoid extreme swings of over-regulation on one side to neglecting the public interest on the other and seek to arrive at a balanced and fair approach between free markets and governmental oversight. The level of balance at which each region should settle at will depend upon the historical, cultural, political, and economic factors of that region with a view that it should not be rigid but should also avoid extreme swings.

Regional applications and recommendations

Effective implementation of systems that minimise conflicts of interest within the region may require modifications and alternatives from what might be considered "recommended practice" within the western countries. Resources are more limited and the capital markets are not fully matured. Corruption within the economies of transition are still a larger systemic problem than market player insider enrichment. Many of the companies within the region still retain either in form or substance control or at least influence with government or key government representatives who resist for various reasons to relinquish control of the company to the recommended corporate governance structures. This does not suggest that fault lies fully on government for relinquishment, systems may not yet be in place or fully developed within the market to support full independence.

Transparency and Disclosure with Judicial Remedies

Transparency and legal recourse are two absolutely critical components for a functioning market. Investors must have a consistent and responsive legal environment that will protect their interests before they will venture into the market. Information needs to be adequate and timely to make informed decisions and to make sure actions are transparent. Laws must be in place

with a system that will enforce these laws fairly and timely without a barrier of being cost prohibitive. The legal system needs to be stable. Frequent or material changes in the rules creates instability by creating unpredictability. Stability of an imperfect yet measurable legal system will often be more efficient than attempting to reach perfection yet is continuously changing. A company or investor is able to factor in the costs of a rule when making a decision to invest if they can make certain assumptions regarding the rule. If the rule is ever changing, it becomes impossible to factor in the costs of such a rule within the investment framework.

Summary

The effective control over risk require and effective management of the system checks and balances within the system. Conflicts of interest need to be managed and balanced with an attempt to minimise the conflicts of interest without being excessively burdensome to the business. The markets require this protection and balance in order to provide the necessary confidence that funds can be confidently placed within such a system.