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Financial Reporting: Evolving Accountabilities and Responsibilities

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Article abstract

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Financial Reporting : Evolving Accountabilities and Responsibilities[1]

by

Paul G. Cherry[2]

La détérioration rapide de la qualité de la présentation de l'information financière suscite de plus en plus d'inquiétude. Cette situation, qui a été le sujet de nombreuses études tant au Canada qu'à l'étranger, a, tout récemment, entraîné des efforts notables tels que le Rapport Estey *sur la faillite des banques ainsi que la* Commission Macdonald *au Canada et la* Commission Treadway *aux États-Unis. Malgré les divergences d'opinions sur certains points particuliers, tout porte à croire au bien-fondé de l'inquiétude générale, qui sera sans doute longue et difficile à écarter. Que les craintes soient justifiées ou non s'avère, au moment de l'analyse finale, d'importance secondaire. Il est essentiel qu'on ait confiance dans le système ; en plus d'être juste, la présentation de l'information financière doit être perçue comme telle et comme étant fiable par ceux qui font appel à cette information.*

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There is a growing concern that the quality of financial reporting has deteriorated seriously. The situation has been studied both in

[1] Speech given on February 6, 1989, at the Director Liability and Responsibility Conference, which was sponsored by the Institute for International Research, 60 Bloor Street West, Toronto, Ontario, M4W 3B8.

[2] Mr. Paul G. Cherry is a partner in the accounting firm of Coopers & Lybrand. The views expressed in this article are those of the author and do not necessarily reflect those of his firm.

Canada and abroad, including such notable recent efforts as the Estey Report on the bank failures and the Macdonald Commission in Canada and the Treadway Commission in the United States. Although differences of opinion exist on specific issues, there is ample evidence to indicate that the general concern is well-founded, and not likely to be dispelled easily or quickly. Whether the concerns are justified is, in the final analysis, of secondary importance. Confidence in the system is essential ; financial reporting must not only be fair but be perceived as fair and reliable by those who use the information.

The independent enquiries have concluded, wisely in my view, that immediate and significant remedial action is required to improve financial reporting. The purpose of this paper is to review the circumstances and to analyze some of the proposed solutions.

The Treadway Commission

In October 1987, the National Commission on Fraudulent Financial Reporting (often called the Treadway Commission) issued its findings, conclusions and recommendations in the United States. The Treadway report has attracted a great deal of attention in the business community, as well as in the SEC, Congress and elsewhere. Congressman Dingell, Chairman of the House Subcommittee on Oversight and Investigations, asked the members of the Treadway Commission to appear before his subcommittee and requested that the General Accounting Office monitor the implementation of the Commission's recommendations.

Treadway's major recommendations for changes in the financial reporting process fall under three main headings :

- *Recommendations directed to public companies :*
- independent audit committees ;
- disclosures about prior consultations with newly appointed auditors ;
- management report on their responsibility for financial statements and internal controls, including their assessment of the effectiveness of those controls ;

– annual reports of audit committees to shareholders.

• *Recommendations directed to independent public accountants :*

– greater responsibility for fraud ;

– pre-release review of quarterly financial data ;

– strengthened AICPA peer review program ;

– more involvement of partners in audits.

• *Recommendations directed to the SEC and others :*

– SEC authority to impose civil money penalties ;

– SEC authority to issue "cease and desist" orders ;

– SEC authority to bar/suspend any officers/directors involved in fraudulent financial reporting from future service ;

– higher priority by SEC on criminal prosecution of fraudulent financial reporting ;

– SEC acceptance of corporate indemnification for independent directors.

The Macdonald Commission

The report of the Commission to Study the Public's Expectations of Audits was tabled in June 1988 (commonly referred to as the Macdonald Report in honour of its Chairman, William Macdonald). Many of its recommendations are similar to those of Treadway.

Macdonald engaged Decima Research Limited to ascertain the public's expectations. The survey showed that only a minority of the population has any direct personal interest in financial reporting. Even within the financial community (e.g., preparers, users, auditors, regulators) there are discernible segments with quite different expectations.

A number of expectation "gaps" were identified where a significant percentage of the "knowledgeable public" (e.g., regulators) expressed dissatisfaction. The Commission concluded that such expectation gaps should be a matter of concern "even though the majority opinion may not yet perceive a problem."

The public's legitimate expectations, as identified by Macdonald, include :

- better warning in financial statements of risks, especially of imminent business failure ;
- more attention to the possibility of fraud ;
- in the case of financial institutions, a responsibility to the broad public interest as well as to shareholders ;
- an unbiased application of accounting standards.

Macdonald advocates a greatly expanded role for the audit committee in the financial reporting process, as well as a strengthening of accounting and auditing standards and a greater professionalism by auditors in exercising independent judgement. The proposed role of the audit committee will be examined in more detail later.

Some Reactions and Proposed Responses

Coopers & Lybrand has been monitoring actions taken in response to Treadway *[Report of the National Commission on Fraudulent Financial Reporting – One Year Later]* :

- The National Association of Securities Dealers mandated audit committees – with a majority of independent directors – by February 1989 for over-the-counter companies. The NYSE already requires domestic companies with common stock listings to have independent audit committees and the AMEX "recommends" it.
- The SEC adopted new disclosures regarding changes in auditors and potential "opinion shopping" situations.
- The SEC proposed an annual management report on internal controls.
- The SEC intends to issue a concept release on pre-release review of quarterly financial data by independent auditors.
- The Dingell Subcommittee prepared a discussion draft of possible legislation requiring for all public companies :

- an independent audit committee ;
- an annual audited management report on internal controls ;

- SEC notification by external auditors within 24 hours when audit appointment is terminated, stating the reasons.

• The American Institute of Certified Public Accountants issued revised auditing standards which, among other things :

- requires that any "reportable conditions" (i.e., significant internal control deficiencies) observed during an audit be reported to the audit committee [SAS 60] ;
- requires the auditor to be satisfied that the audit committee is aware of such audit-related issues as significant accounting policies, particularly sensitive accounting estimates, disagreements with management, consultation by management with other accountants and serious difficulties encountered in the audit [SAS 61] ;
- clarifies and expands the auditor's responsibility to search for material fraud [SAS 53].

The SEC-proposed management report on internal controls has four key components. First, a description of management's responsibilities for the financial statements and the estimates and judgements used therein. Second, a statement of management's responsibility for a system of internal control that provides reasonable assurance as to the integrity and reliability of financial reporting. Third, management's assessment of the effectiveness of their internal control system, with respect to material matters, as at year-end. Fourth, management's response to significant recommendations concerning internal controls made by the external auditors and internal auditors.

Large companies should have little difficulty reporting that their internal control systems are effective. Others may find that the cost and time for assessing their internal control systems – and developing related documentation – will be significant. Companies looking to the capital markets for the first time may find the cost of raising capital considerably higher.

The SEC proposal would have the management report "reviewed" by the external auditor. This does not mean that the management report would be audited. The precise implications of the SEC proposal in terms of the involvement of the external auditors has not yet been sorted out. The SEC's position appears to be that, under existing auditing standards in the United States, the independent auditor would be required to read the management report and point out any material misstatement of fact. This would not, however, require that the auditor do any detailed testing of internal controls other than those which the auditor might have performed in the normal course of the audit of the financial statements. Auditors often find it more efficient to perform other audit procedures directed at substantiating the financial statement accounts without relying extensively on internal controls. Rarely would they test and rely upon all of the major internal controls. Therefore, one cannot draw any valid conclusions about the effectiveness of internal controls from the fact that the auditors have expressed a clean opinion on the financial statements.

It is still very early days since Macdonald tabled his report. The indications are that prompt action will be forthcoming from CICA to beef up accounting standards and, to a lesser extent, auditing standards. A new Emerging Issues Committee has been created which will hopefully play a valuable and much-needed role in providing timely consensus views of senior practitioners on difficult problems for which existing standards provide no clear answer.

The International Organization of Securities Commissions, through a working party which I chair, is working with both the International Accounting Standards Committee and the International Auditing Practices Committee to pursue the international harmonization of standards. This forms part of a larger initiative designed to facilitate multinational offerings.

The IASC has just published *Exposure Draft 32, Comparability of Financial Statements.* It proposes to substantially reduce the number of free choices of alternative accounting treatments presently permitted in International Accounting Standards. Quite apart from the considerable enhancement in comparability that would be achieved, this initiative sends a clear signal to the various national standard-setting bodies, including the CICA, on the pressing need for greater comparability at the national level as well. Those who fail to take heed may find that their domestic role is diminished in future.

Professionalism and Judgement

Although more comprehensive accounting standards are helpful in some areas they are not, in my opinion, the cure. No set of standards, no matter how detailed and comprehensive, can or should replace professional judgement. The very sort of "technicalities of accounting rules" which Estey and Macdonald deplored as sometimes producing results that offered common sense could become even more likely if the standards begin to resemble statutes or cookbooks, which invite literal and narrow interpretations.

The problem is not that accountants and auditors have been unaware of what has been going on. Rather, the audit failure problem has been one of poor judgement, a lack of sound business sense and the lack of professional will.

What is the engine that will propel the drive for greater professionalism and better judgement ? It is not within the mandate of the standard setters. We could look to the provincial accountancy bodies who are responsible for the self-regulation of their members. It may be expecting too much, however, of even the best self-regulatory system.

The provincial institutes of chartered accountants have established a Committee to Harmonize Rules of Professional Conduct to reach a consensus on the preferred approach to change in the following areas of concern identified by the Macdonald Commission :

- country-wide uniformity in regulation ;
- bringing audit firms as well as individuals within the disciplinary process ;
- protecting the independence and objectivity of auditors ;
- the prevention of "opinion shopping".

The project will be managed through the Ontario Institute, which has made considerable progress on an already established program towards more harmonization between the codes of ethics.

Realistically, at least in the near term, the main incentive will have to come from elsewhere, which probably means the regulators.

The Quebec and Ontario Securities Commissions have collaborated on recent initiatives involving future-oriented financial information and management discussion and analysis. The MD&A proposals are intended as a uniform framework within which issuers will provide a meaningful discussion and analysis of the recent corporate history, results of operations and trends. It is a major step in the evolution of financial reporting in Canada, touching on such difficult matters as liquidity, capital resources, risks and uncertainties. The question is, why did this initiative not come from the accounting profession itself ?

The Office of the Chief Accountant of the Ontario Securities Commission recently published a report on its program from reviewing the annual financial statements of reporting issuers. It cites instances of poor disclosures and inappropriate accounting. I can assure you from my personal experience at the OSC that it has a serious concern about the uneven calibre of professional judgement being exercised by accountants and auditors in Canada today.

There can be no doubt that the regulators are ready and able to play the enforcer and the initiator of change if the profession is unwilling or unable to do the job itself. Unless the private sector responds, a significantly greater level of regulation of financial reporting seems inevitable with the equivalent of SEC Staff Accounting Bulletins and the like. The difficulty will be to strike a reasonable balance between a greater statutory responsibility, with effective monitoring by the regulators, on the one hand, and private sector flexibility to experiment, on the other.

The Legal Framework

Canada is almost unique in the extent to which accounting principles and auditing standards have been embedded in our securities and corporate laws which, in many cases, incorporate the *CICA Handbook by* reference. One cannot contemplate significant changes in the financial reporting process without taking into account the legal implications.

The requirements of public companies incorporated under the *Ontario Business Corporations Act* (OBCA) and the *Canada Business Corporation Act* (CBCA) are broadly similar :

- take adequate precautions against falsifying information ;
- make "accurate and intelligible" information available within a "reasonable time" ;

- maintain "adequate accounting records" ;
- maintain minutes of Board and Board committee meetings ;
- appoint an audit committee with a majority of outside directors ;
- issue annual financial statements prepared in accordance with GAAP and audited in accordance with GAAS and which have been reviewed by the audit committee and approved by the Board.

232 The directors and officers have a duty to notify the audit committee and the auditors of known errors or misstatements in the audited financial statements. Auditors have a similar duty. These obligations relate to significant errors except that the CBCA seems to require the directors and officers to report to *any* known error or misstatement, which seems rather extreme.

Auditors have the right and duty to attend, if so requested, at audit committee and annual shareholder meetings. Auditors may even call an audit committee meeting and are entitled to send material to shareholders when a change in auditors is being proposed. Statements or reports made under the *Act* by the auditor receive qualified privilege.

The *Ontario Securities Act* (OSA) also requires GAAP financial statements and annual GAAS audits. There are no provisions relating to the books and records to be maintained by reporting issuers unless they are also a registrant (e.g., a publicly-traded securities dealer). The OSA imposes a continuous disclosure obligation. Two important components of continuous disclosure are material change reports and interim financial statements.

Interim financial statements are required for each of the first, second and third quarters. They need not be audited.

The Board is required to approve annual financial statements but not interim statements. The only requirement with respect to audit committees is that, where the company has or is required by another jurisdiction to have such a committee it must review any financial statements included *in a prospectus* before being approved by the Board.

Improving Upon the Present Framework

There are obvious gaps in the OSA requirements. Proper books and records, for example, are every bit as important to investor protection as the continuous disclosure requirements. One might argue, I suppose, that it is implicit in the continuous disclosure obligations, it is hard to imagine how proper and timely reporting could otherwise be accomplished. But that seems a bit oblique and it would be preferable to make the requirement explicit. Another example is the lack of an audit committee requirement. The OSA requirements should stand on their own.

None of the statutes deals explicitely with internal controls. Does a company that keeps its records in a shambles, to be sorted out once a year in the annual audit, satisfy the present statutory requirements ? It is commonplace to have significant year-end adjustments which are really the correction of prior interim reports. The usefulness of interim reports is impaired if the accounting system does not produce reliable numbers throughout the year. The concept of internal controls is sufficiently well developed that it should be part of the statutory requirements. (A definition is provided in Appendix I).

Risk assessment is a topic that has received much attention in recent years. Auditing standards and practice increasingly recognize that exposure to risks must be assessed in order to audit effectively. Perhaps management should be required to make similar periodic risk assessments to satisfy themselves that adequate controls and safeguards are in place. This would ensure that both the company and its auditors are pursuing similar objectives and would preserve the auditor's traditional role of attesting to what management itself has done.

A single standard for all public companies is no longer appropriate. The statutory requirements should be responsive to differences in risks. Risks differ from business to business. For example, financial institutions and other entities performing fiduciary duties or having access to customer assets or that are required to comply with regulatory capital requirements might be required to have systems capable of reliable monthly (or even weekly) reporting. Effective control systems are particularly important to these entities. Perhaps a management report along the lines of the SEC proposal would also be appropriate for them.

The timing of the required procedures should be rationalized. Audit committee review of financial statements included in a prospectus comes too late, possibly several years after the original statements were released. In a similar vein, the Board approves the annual financial statements which should, one would hope, be a progression based on the first, second and third quarter financial statements. It would seem more effective to involve the Board and audit committee before the original statements are released. Once the statements have been released there may be a natural reluctance by management to make any changes at all simply to avoid embarrassment.

The SEC is currently considering a proposal to require auditor involvement in quarterly reporting. This has a lot of appeal but also has serious cost/benefit implications. A review is far less than an audit and significant year-end audit adjustments could still be expected. In addition, one would have to be careful not to delay the issuance of quarterly reports in order to permit auditors to become involved at a time when pressures are growing to accelerate quarterly reporting. A reasonable compromise would be to mandate audit committee review. Auditor involvement, if any, might be better directed at the system of internal controls.

The present statutory requirements have proved workable even though they are couched in rather broad and vague terms such as "independence" and "review" without much indication of what was meant ; of course, now that we have more experience we could provide some further guidance. This suggests to me that the Macdonald Commission formula erred too far on the side of caution. You will not get enough experimentation without the engine of a general statutory requirement. Obviously, the requirements should be expressed in as specific terms as seems appropriate, but they will of necessity always be broadly stated. What we should attempt to establish is the minimum basic functions that are to be performed and, in that regard, the Macdonald Commission recommendations fall short of the mark.

The Role of the Audit Committee

It would not be appropriate for the Board or its committees to manage the company's affairs. Their role is an oversight one. This is a difficult distinction to make in practice and therefore the roles should be defined as clearly as possible. This would also achieve a degree of consistency from one company to another.

Five basic specific objectives for an audit committee are :

- to help directors meet their responsibilities, especially for accountability ;
- to provide a better communication between directors and external auditors ;
- to enhance the external auditor's independence ;
- to increase the credibility and objectivity of financial reports ;
- to strengthen the role of the outside directors by facilitating in-depth discussions between directors on the committee and management and external auditors.

The tasks of audit committees vary not only in accordance with the size and make-up of the Board but also according to the type of business and its organizational structure. Appendix II provides a specimen terms of reference. The list is lengthy and could easily be expanded.

It is only by reading the full Macdonald report that one gains an appreciation of the sort of role that the Commission has in mind :

> "To achieve this improvement we advocate building on the community of interest and shared exposure to legal liability among those responsible for financial reports, especially the directors, auditors and, where applicable, regulators. *Directors and auditors bear a special responsibility for fair financial reporting.*" [Emphasis added].

Macdonald envisages a proactive role, with the audit committee getting involved in resolving accounting disputes between management and the auditors, including "opinion shopping" situations where other accounting firms may have been consulted. The committee "should develop its own financial disclosure philosophy. It should vigourously present this philosophy to both the auditor and management to ensure the best disclosure is made... should be more involved in assessing key management estimates and judgements that can be material to reported figures."

In the words of Macdonald "a good audit is not a standardized commodity to be purchased off-the-shelf." The audit committee would be charged with ensuring that a properly-tailored audit is planned and executed. This would include a review of any problems encountered by the auditors, and restrictions on their work, the cooperation received from management and the audit findings with particular emphasis on items relating to internal control and management's response.

The Macdonald Commission felt it was necessary to provide companies with flexibility to tailor the role of the audit committee to best suit their individual circumstances. There was also a fear that experimentation would be discouraged if the statutory responsibilities of the Board and the audit committee were more specific. The Macdonald formula is simple – each Board should be free to establish its audit committee's responsibilities ; shareholders are to be informed of the mandate given the audit committee and the committee is to report on how it has discharged its duties. The only other new requirements are that the Committee be composed entirely of outside directors and that interim financial statements also be reviewed.

In my view, a bolder step is appropriate. The minimum functions of the audit committee should be expanded. The "Level One" functions, including the sub-items within each numbered item, as set out in Appendix II, would be a good starting point. In addition, it should review the annual report (Level 2, item 8) and the reports of internal auditors (Level 2, item 12). This could be coupled with SAS-60 style amendments to Canadian auditing standards which would *close the loop* by imposing on auditors a responsibility to satisfy themselves that the committee is aware of key audit-related issues (significant accounting policies and estimates, disagreements with management, consultations by management with other accountants, etc).

Finally, National Policy No. 31 "Change of Auditor of a Reporting Issuer," issued by the Canadian Securities Administrators, should be reexamined. It requires that shareholders be advised of "reportable disagreements" between auditors and management. The definition of "reportable disagreements" is too narrow, such that a comment is triggered only in those extremely rare situations when the auditors have been unable to accept management's position and the item in dispute is significant enough to cause the auditor to qualify his report and both sides have made their decision. The matters in dispute are usually not straightforward and the discussion process leading up to the "decision" is often lengthy. The proof is in the pudding. The communications being issued pursuant to National Policy No. 31 seldom contain useful disclosures.

The auditor has ample leverage under most corporation statutes to make his case before the Board and the shareholders when he is being replaced. In my experience these powers are seldom used, perhaps out of a sense that management, and not the shareholders, effectively control the audit appointment, and that the best business decision is for the auditor to bow out gracefully.

The real benefit of National Policy No. 31 is the attendant publicity. Disclosure of reportable disagreements should be abandoned in favour of something broader. The recent SEC revisioned (FRR No. 31) requires disclosure of accounting consultations with the newly engaged auditor and the company that occurred prior to their appointment as auditors and disclosure of areas of disagreements with the former auditor.

Conclusion

As far back as 1933, the U. S. Congress recognized that corporate directors were in the best position to prevent misstatements of financial reports. At the same time, Congress recognized the importance of an independent audit. "Independence" has traditionally focussed on the financial and business relationships between the auditor and his client. In addition, auditing standards have required that auditors approach their task with an objective and inquisitive frame of mind.

We are entering a new era of accountability and a significant shift in philosophy is required of management, directors and auditors. Many of the expectation gaps identified by the Macdonald Commission are appropriately directed at accountants, including senior financial management and the directors, as well as auditors. "Independence" is more important than ever, but it is independence in the sense of objectivity and skepticism. And it is expected of the Board as well as the auditors. We are seeing a move towards a greater congruence of the public's expectations of preparers and auditors of financial information. Fair reporting is required whether it is audited or unaudited.

A greater role for independent directors may also reflect the reality that having auditors nominally report to the shareholders does not provide much support in dealing with management who control their nomination and often have *de facto* control of the audit appointment.

Given the highly subjective nature of financial reporting, it often is impossible to demonstrate conclusively that a particular presentation is right or wrong when a set of statements is being prepared. Unfortunately, when hindsight makes it abundantly clear that what was done was inappropriate, the directors may be hard pressed to demonstrate that the original presentation was reasonable at the time. Perhaps the best defense is that it was reviewed and approved by competent persons with an objective state of mind.

The directors must be in a position to visibly demonstrate that they are discharging their responsibilities by taking positive steps to ensure that the appropriate matters have been brought to their attention, the issues identified and that the proposed solutions are appropriate. Obviously they cannot be expected to become experts in every field and may require outside assistance in such areas as control risk management. We are already seeing products, such as the Coopers & Lybrand Control Self-Assessment and Representation program, which are designed to help companies in this regard.

The key to discharging the directors' legal liability is, I believe, to have a well-defined and properly executed plan. Using internal controls as an example, the plan should ensure that :

1. An appropriate system of internal controls is designed, implemented and adjusted periodically as risks change.
2. Management periodically reports on the continued effective operation of those controls.
3. The directors seek direct confirmation from the external and internal auditors on matters relating to internal controls.
4. The directors of companies experiencing financial or operating difficulties take special measures which are seen as being an appropriate response to the additional risks.

Appendix I

Internal Controls

Internal controls within a business operate at different levels of detail and can broadly be classified as :

- *The control environment.* This encompasses such matters as the overall organisation of the business, the degree of delegation of authority and responsibility, and management's consciousness of the need for effective control.
- *Management controls.* These include such matters as the quality and use of management accounts, budgetary information and reviews of exception reports.
- *Detailed controls.* These are all the checks and procedures carried out to ensure the accuracy and completeness of information and to safeguard the company's assets.

The primary focus of the audit committee should be on the control environment. It will not usually be realistic for an audit committee to review the effectiveness of management controls and detailed controls except through its review of the activities of internal and external audit. The audit committee might also look to the external auditors for assurance that such controls match up to good management practice in other businesses.

Appendix II(3)

Specimen Terms of Reference

The following specimen terms of reference are illustrative only. In practice, the terms of reference will need to reflect the type and organisation of the business. The duties are arranged in increasing order of distance from external financial reporting. Many audit committees may confine themselves to those duties most closely related to the financial statements (Level I).

The audit committee is a committee of the Board and shall report to the Board in writing at least once a year. Its duties shall be :

(3) *Audit Committees : The Next Steps,* Coopers & Lybrand (UK), June 1988.

LEVEL 1

1. To review the draft annual accounts prior to their approval by the Board, focusing in particular on :
   - significant changes in accounting policies and practices ;
   - major judgemental areas ;
   - significant audit adjustments ;
   - departures from accounting standards.
2. To monitor compliance with statutory and Stock Exchange requirements for financial reporting.

3. To discuss the scope of the audit with the external auditors.
4. To discuss matters arising from the audit with the external auditors.
5. To review the effectiveness of the internal audit function.
6. To review interim financial statements prior to publication.
7. To review preliminary announcements of results prior to publication.

LEVEL 2

8. To review the annual report taken as a whole.
9. To ensure that the Board receives reliable and timely management information.
10. To review the effectiveness of the control environment established by management.
11. To review significant transactions outside the company's normal business.
12. To review the reports of internal auditors.
13. To make recommendations on the appointment and remuneration of external auditors.

LEVEL 3

14. To review the adequacy of management information systems.

15. To monitor compliance with important regulations relevant to the company's activities including local regulations for overseas subsidiaries.

16. To monitor the ethical behaviour of the company and its senior management.

17. To review prior to publication press announcements including advertisements relating to financial matters.

18. To review circulars issued in connection with a proposed merger or takeover or other major transactions of a non-routine nature.

19. To initiate special projects or investigations on any matter within its terms of reference.