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**Plenary 5**

**Corporate Governance**

*22. The Role of Financial Reporting and Auditing*

*in good Corporate Governance,*

*Speech by Michael Groom*

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*24 May 2002*

**CORPORATE GOVERNANCE – THE ROLE OF FINANCIAL REPORTING  
AND AUDITING IN GOOD CORPORATE GOVERNANCE – 24/5/02**

Thank you chairman,

This is a very welcome opportunity to restate very clearly my profession's desire to work in partnership with the global regulatory community.

We acknowledge our vital role in corporate governance and the value that accounting and audit contributes to the stability of the capital markets.

All the efforts that have been made in the last few years - globally by the International Federation of Accountants (IFAC), in Europe by the Fédération des Experts Comptables Européens (FEE) and in the UK itself by my Institute and other bodies - to ensure high quality in audit, to strengthen our accounting standards and codes of ethics, and to introduce credible independent oversight – strongly underpins our commitment to the public interest.

In tandem have been the moves to strengthen the International Accounting Standards Board (IASB) and, more recently, IFAC's International Audit and Assurance Standards Board (IAASB) in order to ensure increased transparency and global credibility in the process of developing and promoting acceptable and rigorous international accounting and auditing standards.

We have therefore wholeheartedly supported the European Commission on its Regulation on International Accounting Standards (IAS's), which we view as a landmark development for the single European capital market, as well as its efforts to raise the quality of audit throughout the EU.

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Indeed, in line with the importance of this, we have also supported FEE in its recommendation to the Commission that International Standards on Auditing (ISA's) should also be introduced along with IAS by 2005.

Yet clearly, the fallout from Enron and the perceived possibility of such an event happening elsewhere, has left us with the acknowledged task of restoring public confidence in corporate governance, restoring the credibility of financial statements in the international marketplace and the reputation of the accountancy profession globally.

We recognise that there is no room for complacency and that maintaining the status quo is not an option.

But, if regulatory reaction is needed, then it must be measured and the consequences well thought-out.

Many of the issues relating to Enron are not new.

They were painfully experienced in the UK in the late 80s/early 90s with the high profile collapses of Maxwell, BCCI, Polly Peck and others.

The lessons learned from those collapses caused a re-assessment in accounting and auditing standard-setting and in ethics for the accountancy profession.

Our response was to move away from a rules-based approach to one based on principles and rules that are necessary to show how those principles should be applied in important practical situations.

The formal requirement that financial statements should reflect the substance of transactions rather than their legal form was introduced into UK standards.

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In particular that off-balance sheet vehicles should be included in the consolidated financial statements whatever their formal status, in line with the requirement that financial statements need to present a 'true and fair view'.

The lessons learned also gave rise to the Cadbury Code on the financial aspects of Corporate Governance in 1992.

From Cadbury to the UK's Combined Code of 1998 and our recent Turnbull guidance on internal control, and work that my profession is currently doing on corporate governance such as on matters related to audit committees, a key theme has emerged over the last decade or so – that principles not prescriptive rules promote compliance with the intention and spirit of the requirements.

It is why we have supported the principles based approach taken in the development of IAS's and now with ISA's

One of the problems for the capital markets today, is of course, that whilst strengthening the nature of accounting and reporting on stewardship is right and proper, there is currently no truly complementary process that addresses market pressure for forward looking information.

We need a more disciplined and realistic information feed to investors in this area – a challenge of the assumptions underlying the forecasts and projections that companies announce.

As an example, and in no way the definitive solution, let me just mention briefly three developments on disclosure currently being discussed in the UK:

- First, an Operating and Financial Review
- Second, a framework on prospective financial information
- Third, a proposal on risk reporting

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First, the Operating and Financial Review (OFR) which has been a voluntary disclosure mechanism for about 10 years, and may well become mandatory under proposals in the UK Company Law Review.

It will contain a qualitative as well as a financial evaluation of performance, trends and intentions, prepared and signed off, by the directors.

Its purpose is to show, in the directors' own terms, what matters about the business as regards performance and direction.

Auditors will be required to review the specific processes used by the company by which the OFR has been drawn up to assess whether anything in the OFR is inconsistent with the results of their audit work on the financial statements themselves.

Let me stress, it will be a review of the process rather than the outcome

There is no intention that auditors should 'second guess' directors' judgements.

The second development, a framework for prospective financial information (PFI), is being developed in the UK by my Institute in consultation with the Take Over Panel and the Listing Authority.

This framework is being developed on a common set of principles designed to ensure that PFI meets the needs of users and promotes consistency and transparency.

By avoiding detailed rules in this area, we believe that preparers of PFI and their advisers will be able to respond appropriately to complex situations and new developments in business practice.

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Management should, therefore, be able to provide information that faithfully reflects their strategy, plans and the risks they undertake and that will be comparable with subsequent historical information.

The third development is on risk reporting.

It is an area where disclosure must take a quantum leap – information that investor surveys consistently suggest is so important but critically lacking.

As an Institute, we are proposing that listed companies clearly identify the principal risks to which they are exposed and what they are doing about them.

Based on a premise of *No Surprises*, our proposal is one aimed at encouraging disclosure of business opportunities as well as threats.

Interestingly, our studies have suggested that companies are much readier to present useful risk information in prospectuses than they are in annual reports where the level of disclosure subsequently tails off.

It seems to me that if there are few barriers of commercial confidentiality to disclosure in prospectuses, there should be no reason why this could not also be translated into best practice in annual reports.

This is an area to which we are now giving further consideration.

Since greater transparency can be forced through accounting standards I suggest that we will need to look more closely at risk disclosure in the development of standards – especially in high risk areas such as derivatives.

So what of the role of audit within the corporate governance framework?

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As I have said, we acknowledge the vital role of audit in giving confidence to the capital markets and recognise that investors' confidence on the quality of financial statements is bound up in the reputation of audit firms.

It is why IFAC and others are currently engaged in an enormous renewed effort to ensure that that confidence is deserved.

Yet even the most conscientious auditor cannot be expected to unearth fraud driven by management collusion or prevent corporate collapse driven by bad business decisions.

Whatever the outcomes of reviews on auditor rotation, or the scope of audit and non audit services to clients, any change to the arrangements for appointing auditors will have little impact unless directors and management are open and transparent in their communication with their external auditors.

I believe there is a strong case for legislative backing to force them to be so, perhaps even criminal sanctions against those who deliberately withhold vital information from auditors that is material to the audit.

One of the core tenets of my profession has traditionally been our professional scepticism so vital to audit and our role in corporate governance.

This has been fostered by the principles based approach to professional ethics – as reflected in the ethical codes of IFAC and my own Institute.

We therefore welcomed the European Commission's Recommendation on Auditor Independence two weeks ago which takes this approach.

Be that as it may, we need a strong global culture of training and encouraging that scepticism among auditors the world over.

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The attempt to prescribe detailed rules for every eventuality could, I suggest, erode the ability of auditors to exercise professional judgement.

In conjunction with this, I suggest that any review of the role of non-executive directors should look to enhance their independence by encouraging them also to apply professional scepticism.

This would require training but must be hugely important if we want to enhance the quality and effectiveness of audit committees on which non-executives play a vital role.

We believe that the audit committee's increased importance means that annual reports should include disclosure by the committee of its activities during the year, especially in relation to matters concerned with financial reporting and its enquiries about the effectiveness of the systems of internal control and risk management.

Such a requirement would be underpinned if boards themselves were formally required to accept their responsibility for reviewing the effectiveness of internal control – even though operational responsibility might be delegated to management – and, importantly, to disclose how they as a board have done this.

Certainly, the Turnbull guidance on internal control, appended to the UK listing rules, requires this of UK boards and has focused their attention on these issues as never before.

There must be strong case for ensuring that this process becomes best practice on a global basis if only because a common factor in many corporate failures has been the lack of effective systems of internal control and risk management.

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In conclusion

I believe that what we need is:

- The evolution of the principles-based approach to become *the* de facto basis for all future standard-setting on a global basis as a key measure to ensure compliance, and
- The evolution of disclosure mechanisms to a more meaningful, transparent and disciplined dialogue with the capital markets to help ease the temptation for companies to employ inappropriate reporting practices to meet unrealistic expectations

On a final note, we know that global standards for global capital markets will be meaningless unless they are evenly enforced across the world.

This is an issue of concern to all of us.

My profession within Europe and indeed globally through IFAC will continue to participate and promote private sector contribution to dialogue across all financial institutions to do all we can to participate in finding the most expeditious ways forward.