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Identifying Critical Functions in Effective Corporate Governance

Presentation by Gordon Thiessen
Chairman, Canadian Public Accountability Board
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So much has been said and written recently on issues of corporate governance that I wonder whether there is much new that I can add at this conference. The OECD has, this year, revised and reissued its Principles of Corporate Governance. It seems to me that these Principles provide an excellent guide to the broad legislative and regulatory framework required for effective corporate governance in any country.

This Panel rightly focuses, therefore, on identifying the critical functions in effective corporate governance. Identifying critical functions would, I believe, also be helpful to emerging market countries where it might be difficult to fully implement all at once all the principles of good corporate governance. The area that I want to focus on today, and which I believe is crucial in a market economy, is the issue of reliable financial information.

My point of view on what is critical reflects, I must admit to you, my present position as Chairman of Canada's auditor oversight agency and my former role as head of the Canadian central bank. I would suggest that once a country has in place the basic legal and regulatory requirements that establish the framework under which corporations operate, a crucial requirement is for disclosure and transparency of all material matters regarding a publicly traded corporation. This is Principle V of the OECD Principles of Corporate Governance.

Disclosure and transparency

Why is disclosure and transparency so important? For any market-based economy to function well requires effective arrangements for the transfer of savings to those who need financing. And, of course, what matters most for the long run performance of an economy is the financing of the capital required to increase productivity and expand production. That includes not only the financing of structures, machinery and equipment, but also new technology, improved processes and the training of employees. That transfer of savings will only work well if investors have access to adequate information on the companies in which they may potentially invest. And that is particularly true in countries that are dependent on international capital flows to finance domestic capital investment. International lenders and investors cannot be expected to rely on informal sources of local information that domestic participants may use.

It is only in the last number of years that we have come to fully appreciate the importance of some of the infrastructure that is required to make this transfer process work well. It was really only when former soviet bloc countries and a number of emerging economies turned to more market-based economic systems that we economists finally paid sufficient attention to the necessity of having what I call a good “plumbing system” to support financial markets. The “plumbing system” I am referring to includes property rights and a system of private contracts, and the judicial and enforcement systems to make them effective. It also includes, more specifically, company disclosure requirements and the accounting standards that make those disclosures comparable among companies. And finally, it includes the audit standards and the independent auditors to help ensure that company disclosures are as reliable as possible.

Having seen the importance of this basic plumbing in transition and emerging market countries, we in industrial countries did not immediately examine our own arrangements to ensure that they were continuing to work as required. As you know, there have been a number of high-profile corporate scandals in industrial countries that have led to a serious re-examination of our regulatory requirements and corporate governance practices. As a result, led by the Sarbanes-Oxley legislation in the United States, there have been widespread changes in corporate governance requirements. Indeed, there is now a debate about whether those requirements may have gone too far so that the costs of adherence and enforcement may outweigh the benefits.

Auditing public companies

In my view, however, the benefits for disclosure and transparency of company information from the governance changes that have been made in the area of auditing of public company statements have clearly outweighed the costs. There are four changes that I would like to highlight and to recommend as important requirements in a framework for good corporate governance.

The first is a requirement with respect to the composition of audit committees of corporate boards of directors. In North America, the audit committees of the boards of public companies are now required to be composed of directors who are financially literate and independent of the management of the corporation. This helps to ensure that the board of directors is capable of providing objective and informed oversight of the financial information produced by the corporation.

The second requirement is that the audit committee be responsible, on behalf of the board of directors, for the engagement and compensation of the external auditors. In the past, it was typically management who engaged the external auditor, and audit committees were not always very effective bodies. These circumstances did not provide strong support for external auditors in the function they are supposed to play in our market system. The job of the external auditor is to provide the shareholders, as well as other stakeholders, an assessment of the reliability and fairness of the financial information being publicly submitted by the management of a corporation. The board and audit committee act as agents on behalf of shareholders. If external auditors are reliant on management, rather than the board, for their continued engagement and compensation, it could be more difficult for auditors to resist management pressures on issues of aggressive accounting practices or inadequate controls.

The third requirement that I want to emphasize is to have high quality accounting and auditing standards in place. Increasingly, accounting and auditing standards are being debated and agreed to internationally. This strikes me as a very valuable development. It is often difficult in individual countries to avoid political pressures of various sorts that can downgrade standards. Moreover, it is a huge investment for an individual country to develop and keep up to date its own unique accounting and auditing standards. High quality standards are needed for auditors to do their job well. And investors, whether investing in corporate stocks or bonds, want to be reassured that the same standards are being applied to the audited financial statements issued by all domestic corporations. An important development has been the new professional standards dealing with audit quality and auditor independence that have been developed under the auspices of the International Federation of Accountants. Hopefully, these will be the basis for new standards of quality and independence in an increasing number of countries. They are the basis for new standards in Canada.

The fourth requirement, which I would advocate, is an auditor oversight body to ensure that accounting and auditing standards are being enforced. Just giving auditors new and explicit standards to deal with the quality and independence problems that marred the work and undermined the credibility of auditors, at least in some countries in the past, is likely not enough. Traditionally, we relied on accountants' professional codes of conduct and their self-regulatory associations to ensure standards would be rigorously applied. In most cases during benign times, that might be sufficient. But what the recent corporate scandals in industrial countries have taught us is that we need to set up our corporate governance infrastructure so that it is effective not only in good times but also in difficult times. I am thinking of the difficult times when “irrational exuberance” takes hold—to use Alan Greenspan’s memorable turn of phrase. We need arrangements to help auditors face up to chief financial officers who may become desperate during such exuberant times to have their financial results meet analysts’ expectations and justify continued high and rising market valuations of their stock.

This is a more difficult problem than you might expect. The pressures can become enormous and the incentives facing auditors are not always helpful. In most countries that I know of, accounting firms that do audits are private, profit-seeking entities. In other words, they need their audit clients to provide them, one way or another, with a regular, reliable and adequate stream of revenue if they are going to be able to continue to survive in the audit business. But there are times when they need to discard otherwise profitable clients who start to engage in unacceptable financial practices. As well, audit firms that are going to do high quality audits need to ensure that their audit partners remain well trained and informed in a rapidly changing financial world. This is an expensive process. Auditors also have to be prepared at times to devote more resources than planned to a difficult audit, even when it may cost more than the fees they have agreed to with the client. These requirements do not sit comfortably, at least in the short run, with profit maximization.

Where I am going with this argument is that audit firms need the support and also the risk of potential disciplinary measures from an oversight body to ensure that they carry out their crucial public role in verifying financial statements of corporations to a high level of quality and objectivity. This is not to denigrate the self-regulation work done by professional accounting bodies around the world, but in market conditions where greed overwhelms fear, something more is needed.

I would argue that auditing has some elements of a public good, and the private sector, on its own, may not devote sufficient resources to the audit process without some intervention from an outside agency with a broad mission to protect the public interest.

Finally, I would contend that an independent audit oversight agency need not be expensive. In many countries, including my own, the very large accounting firms have most of the audit business. Thus in Canada, the oversight activities of the Canadian Public Accountability Board are heavily focused on the Big Four accounting firms. We will also inspect the next rank of medium-sized audit firms and any small firms that audit internationally-listed companies. We are going to rely on the professional, self-regulatory, accounting bodies to inspect the other small audit firms, subject to using our methodology and subject to our oversight. But this does not require a huge staff and a large budget. The Canadian Public Accountability Board operates with approximately 25 staff and has a budget of about 6 million Canadian dollars. This is financed by imposing a fee on audit firms equal to 1.6 per cent of their audit revenues.

Conclusion

Let me summarize. Disclosure and transparency by publicly traded companies is a crucial requirement if financial markets are going to do an effective job of transferring savings to companies that require external financing. It is even more important where a country is dependent on international flows of funds to finance domestic capital investment. International lenders and investors cannot be expected to have all the local knowledge available to domestic participants. As a result, these international lenders and investors will be even more reliant on the information provided by domestic corporate borrowers and are likely to want to be reassured about the quality and reliability of that information.

In the area of financial system regulation, a good deal of international time and attention has been devoted in particular to banking regulation, but also to the regulation of other financial institutions and financial markets. Less time and attention, until recently, has been devoted to issues of accounting and auditing standards and to the quality of auditors and the auditing process. That is now changing, and I would add that some international attention is also needed on the issue of auditor oversight. It is increasingly clear to me that an oversight agency should be part of an effective system of corporate governance arrangements. Such oversight is even more important in a world where capital movements are becoming more international but where the fallout from corporate scandals may mean that the attraction of recipient countries to international investors can be significantly affected by the reliability and credibility of its arrangements for company financial disclosure.