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CORPORATE Finance REVIEW

Strategic Segmentation

When You Have Made a Mistake...

An Accounting Checkup:

Accounting Analysis as a Tool for Better Governance

CORPORATE Finance REVIEW

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THE WAY FORWARD: THE GLOBAL AUDITING BIG SIX AND THEIR VISION OF FINANCIAL REPORTING

First it was the Big Eight US (and increasingly global) accounting and auditing giants. Then there were the mergers that produced the Big Five followed by the spectacular collapse of the Arthur Andersen partnership. Suddenly it was down to the Big Four: KPMG International, PricewaterhouseCoopers, Ernst & Young, and Deloitte Touche Tohmatsu. But if we add in BDO International and Grant Thornton for a new agglomeration of interests, we have a global "Big Six."

A shrink from eight to four firms surely has an impact on auditor competition. Given the size of smaller competitors, the next half dozen or more auditing firms would have to combine to create a Big Five in the United States. And what would happen if one of the remaining Big Four were to go out of business (perhaps due to a major class action lawsuit, a dramatic government investigation, or a stampede of partners away from the core operations)? Arthur Andersen's overseas partnerships quickly determined their own fate as the Enron financial collapse cast dark shadows over the global industry giant; literally overnight the Chicago-based, venerable old practice shut its doors.

It is difficult to predict the dire results of a Big Four failure. Suggestions are currently being offered from several parties on how to bulletproof today's auditing industry in the United States. Conrad Hewitt, chief accountant of the Securities and Exchange Commission (SEC), among other people, has advanced the idea that the US's Big Four should be shielded from legal liability if their corporate audit clients suffer financial scandals. Speaking early this year at a Northwestern University legal conference, Mr. Hewitt expressed clear concern about the potential of auditor liability's spinning out of control and causing the collapse of one (or more) of the Big Four. "It's a concern to us if something should happen to any of the four firms," he said. "Something can be done, and should be done, for the accounting profession" in order to limit exposure to lawsuits.[1] He apparently did not add for the audience of lawyers,"... in the litigation-prone environment that exists in the United States today."

In a later public speech Chief Accountant Hewitt called for input from the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), the American Institute of Certified Public Accountants (AICPA),and the executive professional organization, Financial Executives Institute (FEI). There already is input in circulation from the giants of the global public company auditing industry. The debate has begun.

The global Big Six look to the future

While there are the Big Four in the United States, there are six large global auditing firms with the following similar interests: the continued economic well-being of the auditing profession; the reliability of the auditing process; the evolvement of auditing standards that are relevant to market players; the need to change as operating conditions change (for example, as local economies become more globalized); and the protection of the auditing industry's reputation. Headline risk is ever present; recall the nasty headlines surrounding Andersen's collapse and the links to Enron et al.

Combining forces, the global Big Six in November 2006 issued sweeping recommendations in their collaborative report,

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"Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks." The publication was designed to put ideas on the table for a broad public dialogue and to position the auditing industry squarely in the center of the debate. The timing was perfect: Even as the auditors prescribed solutions and the way forward, the anti-Sarbanes-Oxley movement was being launched in the US.

There is one question posed in the report that hangs in the air over public discourse on the next steps in public company auditing: Have the recent changes in auditing delivered benefits outweighed by the costs?

The CEOs' report frames a public-policy debate on how the core needs of the capital markets can be fully met to benefit all stakeholders, in the short term and longer term. These core values include defining and addressing such issues and concerns as the following:

- Investors' need for timely, useful, and nontraditional information, along with new business reporting models capable of delivering this information;
- The roles of key players (including preparers, public policymakers, regulators, investors, and auditors);
- The vitality of the auditing profession and an environment with lower barriers for entry or growth in order to provide more choice;
- The potential for collusive financial fraud; and
- Business and financial information that is reported and audited according to globally consistent standards.

As national economies become more complex and global, and technological advances continue to affect capital flows and trade,"information" takes on more importance. Change is occurring rapidly; the continuing globalization of capital markets affects corporate financial reporting in several ways:

- The value of an enterprise is being determined in the marketplace by various intangible assets—such as employee loyalty, or relationships with suppliers—that are currently not consistently reported by corporations.
- Billions of people around the globe have the ability to access information simultaneously, while "owners" (investors in an enterprise) have to wait weeks and even months for corporations to publish their data (on a quarterly, semiannual, or even an annual basis).
- Dramatic advances in technology can enable financial reporting that is customized by the user (though most financial reporting remains one-size-fits-all).

These issues must be addressed in the future. The forces reshaping national economies and driving global standardization are also driving the need to transform the kind of information stakeholders want from issuers.

As the customization of financial data increases, long-standing "standard" financial statements may become less meaningful and even less relevant. The future relevance of auditing in the new environment, the Big Six note, will lie in the need to verify the process by which company-specific information is collected, sorted, and reported. Will it be reliable? Relevant to investor decision making? Disclosed in real time?

As companies operate more frequently in multiple countries and across the continents, and investors spread their capital across national borders, will tomorrow's reporting and auditing be compiled, classified, reported and audited in a consistent manner *across* countries?

The importance of public company auditing

Which brings us back to the important mission of public company auditing. Enlightened self-interest is a wonderful thing, according to Adam Smith. A cynic could say that the auditors are of course going to prescribe remedies and long-term solutions that fit their own needs and seek relief from the many reforms enacted since the start of the twenty-first century. In any game, it is the players who ultimately control the playing field and set the rules or bend the rules according to their needs. The accounting industry giants are indeed critical players in the effort to rebuild public and investor trust in the global capital

THE VALUE OF AN ENTERPRISE IS BEING DETERMINED IN THE MARKETPLACE BY VARIOUS INTANGIBLE ASSETS THAT ARE CURRENTLY NOT CONSISTENTLY REPORTED BY CORPORATIONS.

THE SARBANES-OXLEY REFORM ERA HAS CREATED NUMEROUS CHALLENGES FOR ALL CAPITAL MARKET PLAYERS, AND ITS INFLUENCE IS SPREADING QUICKLY TO OTHER CONTINENTS.

markets and so their collective will surely shape the global debates underway on accounting oversight.

The firms' leaders know that the mistakes and missteps of recent years cast a dark pall over the auditing profession. In light of this, auditing firms must be seen as leaders in facilitating positive change and addressing the needs of the stakeholders. The Big Six authors challenged their industry and others to address these barriers:

- Stakeholders need to address the expectations misalignment that now exists among companies, regulators, public policymakers, the media, and the auditing profession. The report discusses the "expectations gap" that exists concerning the ability of auditors to uncover material fraud at a reasonable cost. Just what are the reasonable expectations of an outside auditor's detecting deliberate corporate fraud?
- The auditing profession needs to develop new talent and a broader range of expertise in order to deliver consistent high-quality auditing services, which will entail significant investment in human resources and technology and the development of fair-value models and models for expanded disclosure.
- The legal and regulatory impediments that adversely affect public companies and audit professionals must be reviewed and dealt with. Regulatory regimes can make it more costly for companies to do business, and increased liability risk tends to inhibit issuers from reporting the kinds of nonfinancial (intangible) and forward-looking information stakeholders find valuable. Clearly, the Sarbanes-Oxley reform era has created numerous challenges for all capital market players, and its influence is spreading quickly to other continents.

Specific short-term steps. For the short-term, the global Big Six CEOs set forth a "convergence" process that would include first steps in a journey towards long-term success in achieving consistency in business reporting standards, audit standards, and enforcement of audit standards necessary in a global economy (and, at lower cost to issuers). These short-term steps include completing the ongoing effort by the International Accounting Standards Board (IASB) and the FASB to harmonize differences between international and American reporting standards.

Many players in the US would have to agree that changes are necessary in the FASB's and SEC's rule-making processes as well as in the rules-based philosophy underpinning American accounting and financial reporting. Future accounting standards should be principles-based (the FASB is a rules-based framework). Such an approach could include the development and acceptance of a global reporting model. Provisions of the newly applied International Financial Reporting Standards (IFRS) would have to be accepted as well by US policymakers, self-regulating organizations, and others. In December 2006, the members of the FASB agreed to forward staff comments to the IASB for review; this is part of the joint board effort to harmonize international rules with US rules beginning with integrating the balance sheet, income statement, and cash-flow statement with similar subsections in each. A process may be launched leading to a convergence of national audit standards, utilizing the International Standards on Auditing (ISA) developed with the oversight of the Public Interest Oversight Boards (PIOB) of the International Federation of Accountants (IFAC). This could lead to the development of a single set of global audit standards.

Longer-term measures. Looking toward the distant horizon, the Big Six agree that the current systems of business and financial reporting need to — and will—change, moving toward the public release of timely and customizable financial and nonfinancial data. The leaders of the global auditing industry committed themselves to the following:

- Work with corporate issuers, investors, regulators, and other capital markets participants to develop new models, including ways to disseminate a broad array of company information to users "in a manner more suited to the Internet age than the traditional quarterly and annual reports."[2]

- Attract and retain — through market-based incentives and improvements in the workplace environment—individuals with broad training in multiple disciplines (accounting, IT, finance, tax, general business) to deal with the complexities of the global business environment. This includes improving accounting degree curricula and investment in continuous training.
- Evaluate and address the legal restrictions on the scope of services that can be provided by audit networks while assuring auditor independence.

Closing the expectations gap on fraud detection. The global Big Six report explored the "expectations gap" regarding fraud detection: "Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud — or *intentional material misstatement* of financial information by public companies."[3] What can be done to close the gap? One of the report's ideas was that all parties engaged in business reporting establish policies and practices for preventing and detecting fraud. In addition, there needs to be a constructive dialogue among investors, company stakeholders, policymakers, and audit professionals on a global basis to address the expectations gap and to develop ways of working together to prevent fraud.

The report also set forth a few options addressing the expectations gap in fraud detection.

- All public companies could be subject to a forensic audit on a regular basis — an aggressive, costly, and intrusive way of rooting out fraud. It was suggested that such an audit could occur every three to five years.
- Alternatively, public companies could be subjected to forensic audits on a random basis, which would be less onerous and less costly.
- There could be "more choice" in the intensity of audits, perhaps by letting shareholders decide on the intensity of company audits (it is in their interests, after all, that audits are conducted). Or perhaps boards could decide on the level of fraud-detection intensity. Employees and executives may be less inclined to commit fraud if it is known that an intense audit could be ordered at any time, the argument goes.

Offering more options. While arguing in the report for a more auditor-friendly operating environment — such as by reducing or eliminating liability, creating and applying uniform regulations, liberalizing and harmonizing national accounting rules — the global Big Six concede that there are concerns today about auditor concentration, especially among leaders in the larger market capitalization corporate community.

But, the firms argue, there is "vigorous competition in our profession," and "much greater choice among auditors for companies in the middle-to-lower ranges of market capitalization in virtually all capital markets. . . ."* Looking to the future, "market-based actions" could foster more choice for small- and mid-cap firms. Carefully addressing the need for "more choice" and less concentration within the global auditing industry, the authors suggested the following:

- Audit firms should be encouraged to communicate their capabilities and target markets;
- Regulators should publicize the audit capabilities of other firms; and
- Corporate audit committees should be more attuned to other firms' capabilities.

The brave new world of corporate reporting

And what should the brave new world of corporate financial reporting be like in the future? What changes are in store for issuers? The report offers these projections:

- New and already established internationally accepted conventions should encourage the verification of quantitative (financial) and qualitative information issued by corporations in well-established formats on a regular basis. Verification should be possible across national boundaries.
- We could work towards enabling users of company data to customize the information they want in the way they want.

THERE NEEDS TO BE A CONSTRUCTIVE DIALOGUE AMONG INVESTORS, COMPANY STAKEHOLDERS, POLICYMAKERS, AND AUDIT PROFESSIONALS ON A GLOBAL BASIS TO DEVELOP WAYS OF WORKING TOGETHER TO PREVENT FRAUD.

ONCE REAL-TIME ACCESS IS UNIVERSAL AND QUARTERLY REPORTS AND OTHER PERIODIC FILINGS HAVE LESS IMPORTANCE, INVESTORS CAN BEGIN TO LOOK OVER LONGER TIME HORIZONS.

- "Timely disclosure" would take on a new meaning if investors were able to decide when to view financial information rather than wait for traditional company filings.
- The global extensible Business Reporting Language (XBRL) movement and possibly other technologies may revolutionize issuer disclosure and the ultimate uses of what is disclosed (or uncovered). Note that the SEC recently committed to a $50+ million investment to create Electronic Data-Gathering, Analysis, and Retrieval (EDGAR) filings in XBRL formats.
- The current discrepancy between "book" and "market" values of many public companies will change and in the process underscore the limited usefulness of today's statements of assets and liabilities.
- A wide range of intangible data that now drive company performance will take on greater importance for capital market players.

The new models that emerge should be driven by what investors and users of company information want, according to the global Big Six, and should reflect both intangible and traditional measurements of management performance. Corporate management will have powerful incentives then to manage enterprises in ways that benefit shareholders, employees, customers, and the wider economies in which they conduct business.

Conclusion

What are the benefits to society of new reporting models, as prescribed or envisioned by this report? Beginning with the acknowledgment that "we will be the first to admit how difficult it is to forecast," history shows us that every major innovation — electricity, the automobile, personal computer, etc.—produced changes that would have been difficult or impossible to predict at the outset. "We expect the same thing to happen with the coming revolution in business reporting."[5] These changes can be glimpsed even now:

- It's a given that more efficient markets can emerge with better information about public companies; information that is disclosed more frequently and in user-friendly formats will improve the ability of investors to assess the value of a company, which will encourage investment and better direct capital flows.
- Markets will become more efficient both within and across national boundaries by rewarding those companies and shareholders that deliver great value (capital and talent allocation) as investors allocate capital.
- Increased financial stability is possible through better and timelier disclosure, which enhances transparency, creates trust, and creates greater market stability.
- More investors will shift their focus to the long term. This may seem counterintuitive, the Big Six CEOs observe, but more information that is more frequently disclosed may reverse short-termism. Think of it this way: Once real-time access is universal and quarterly reports and other periodic filings have less importance, investors can begin to look over longer time horizons; the disclosure of nonfinancial and forward-looking information should enhance and speed up this trend. Finally, the contentious debates over CEO compensation may disappear when boards are encouraged to form compensation packages in ways that reward long-term performance.

"In short, good information matters — a lot. The critical question is what kinds of non-financial data should public companies be reporting. Investors and other stakeholders need to get engaged and weigh-in or change will be marginal at best."[6]

The report issued by the auditing industry leaders is intended to stimulate a broad debate on the future of auditing, the auditing profession, financial reporting, and the needs of the market players both short- and long-term. "It is time for business and the methods for assuring investors of the quality and reliability of business information to change as well."[7] As the

Big Six leaders sign off: "The world is rapidly changing. Let us begin the conversation. It promises to be lively."[8] •

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"Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks," issued by the CEOs of PricewaterhouseCoopers International Limited, KPMG International, Grant Thornton International, BDO International, Deloitte, and Ernst & Young at the Global Policy Symposium held November 7 and 8, 2006 in Paris, France. The report can be viewed at www.GlobalPublicPolicySymposium.com.

NOTES

1. Dow Jones Newswires: Mr. Hewitt's speech was delivered on January 25, 2007 at a Northwestern University legal conference in San Diego.
2. "Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks" (November 2006): 3.
3. Ibid., page 12.
4. Ibid., page 15.
5. Ibid., page 19.
6. Ibid., page 6.
7. Ibid., page 4.
8. Ibid., page 20.