Arnold Schilder: Corporate governance, accounting and auditing post-Enron issues

Address held by Professor Arnold Schilder, Executive Director of the Netherlands Bank and Chairman of the Basel Committee's Accounting Task Force, on the occasion of the opening of the new premises of the Bank of the Netherlands Antilles, Curacao, 8 May 2002.

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Ladies and gentlemen,

Let me start by congratulating the Bank of the Netherlands Antilles with the opening of their new premises. Governor Tromp, on behalf of the Dutch central bank, I bring you the best wishes of Governor Wellink and my other fellow Directors. Also, in my capacity as Board member of the Dutch Pensions and Insurance Supervisory Board (PVK), I bring you their best wishes as well! So a positive start, and one would expect this week's program to be orchestrated in the same way.

However, Governor Tromp invited me to speak about more troublesome issues such as accounting and auditing after Enron. I hesitated for a while, suggesting that we keep it a bit more general. But when preparing this speech, I realised he was right. We can no longer speak about accounting and auditing without mentioning Enron.

I address this issue from the perspectives ensuing from my mixed background. For 26 years I was involved in public accounting at one of the Big Four firms. (You will agree that we can no longer speak about the Big Five, sadly enough). In 1994 I finished my PhD on the subject of auditor independence. In 1995 I visited Curacao as the President of the Dutch Institute of Public Accountants Royal NIVRA. And then, in 1998 I was invited to join the Dutch central bank as the Executive Director of Supervision, succeeding Tom de Swaan. As a consequence I became a member of the Basel Committee of Banking Supervision, and in 1999 I was asked to chair the Basel Committee's Accounting Task Force. You will notice this mix of accounting, auditing, regulation and supervision in my address.

Enron has seriously shaken our confidence. This is a grave matter, because it means confidence has weakened in rules and regulations, in supervisory authorities and in the functioning of the financial system in general. Therefore, I will first discuss key issues regarding Enron. From there we will proceed to confidence and trust, accounting and ethics. I will then review some challenges to the auditing profession. Finally, I will draw some conclusions. My one-line conclusion will be that the ethos of public service needs to be restored and that this is a matter which concerns people from many more walks of life than just auditors.

Enron has shocked our confidence. That conclusion is obvious from so many comments, articles, and even worse, the spate of sceptical jokes about auditors. Such as: if you want to win an Olympic medal, just put some auditors on the jury. But it is actually about much more than auditors. The biggest shock is that no warnings were issued – and yet it happened. So the reputation of directors is at stake. The Enron executives are subject to public enquiries – but many other directors outside Enron suddenly face greater scepticism about their assurances. The slightest unclarity about financial statements may cause considerable confusion. Because it is no longer taken for granted that they can be trusted. Then the auditors, already mentioned. Are they still to be relied upon? In whose interests are they working: their paying clients? Their own interest in large fees? Is their integrity still intact? But the doubts do not stop here. Rating agencies: why did they not warn in time? How good are they? Can we still believe in their quality? And then analysts: important messengers to investors. Are they just telling stories to please the firm's important clients? Are they focused on their bonuses only? And the investment bankers, what is the value of their advice? Do they apply professional judgement or are they simply out to conclude the next deal?

And so on. Confidence is shocked – in virtually every participant in the financial reporting cycle.

Nevertheless, one keeps wondering about the pervasiveness, the magnitude of this event. Inquiries are going on, also on the more technical issues. However, these as such were not new. Special purpose vehicles, derivative instruments, consolidation principles: they are examples of technically complex issues. But also in this field there is a pervasive accounting literature, and each accounting firm, rating agency or bank has specialists at hand. Of course, there is much to learn and to develop.

Was it just the magnitude of the fraud then? Secret documents, side-contracts, lying to the auditors maybe? But think of large scandals like Maxwell, BCCI, Barings. Did they bring similar shocks or consequences?

To me it seems that the most unique element in Enron was the shredding of documents by Arthur Andersen and, subsequently, the handling of the resulting publicity. The gradual confession of that professional and ethical crime really caused the earthquake. Because it was a blow to the very heart of the ethics that underlie our financial reporting system. So a public sense of great urgency resulted. For example, the Financial Stability Forum, which comprises finance ministers, central bank governors and regulators, discussed the Enron-case at length at its March meeting in Hong Kong.

Let me briefly explain the ethics of the financial reporting model that are at stake. In business we have shareholders on the one hand, and firms led by directors on the other. Shareholders are dependent on the accounts given to them by the directors. But the latter know more about their business than the shareholders. This is called information asymmetry. To bridge this gap, directors use accounting as an intermediating language between them and the shareholders. But this language is difficult to understand and can be manipulated. So the shareholders called for independent interpreters. The shareholders require these interpreters to check the language used, and then to convey to them the real messages they need to know. The shareholders are entitled to ask this, as they are the principals of the directors who are using their money. Now multiply these shareholders into many kinds of stakeholders, including employees, taxpayers, bondholders, agencies. One can easily see that you need a lot of interpreters. By interpreting correctly, they help to establish fiduciary relationships between all these principals and their many agents. That is, building trust in the economic relationships that are the basis for our conduct of business.

Now what kind of ethics would one require from these interpreters? Well, the least that one expects from the interpreters is that they are unbiased, impartial translators of what they hear. If they make a mistake now and then, are tired or simply miss something, OK. But it would not be acceptable if they made up their own stories, or are deliberately involved in playing games with their audience. They would be thrown out immediately.

These key ethics are well known in the auditing profession. Let me read you several quotes from a magnificent book about the history of 75 years Arthur Andersen, called “A Vision of Grandeur” (1988). The young Arthur Andersen and his partners believed strongly in key statements like: “Think straight/talk straight.” And: “Rigid standards of honesty and integrity.” And: “Accounting principles can and should only be accepted if they present most fairly and most honestly the financial facts.” For the experts among you: a clear-cut example of principle-based accounting, including a true and fair override principle!

These are the ethics that made Arthur Andersen such a strong global firm. So, what the firm shredded were not documents – it was their basic ethics. Arthur Andersen destroyed the trust it had earned in 90 years’ time. What can society do in response other than withdrawing the license to operate?

This is what happened to Arthur Andersen. But what does it tell the auditing profession in general? What challenges does it pose?

First, the profession has to fully understand what caused the shock. So far I am not sure whether that is already the case. The other Big Four have been keen to pick up the victims from the global AA firm. But what is the response to the broad concerns in society as a whole? Or, how can one stop the scepticism? As Bryan Carsberg and John Kay wrote (Financial Times, April 2, 2002): “It is to restore the ethos of public service and public obligation that has been eroded as accounting has moved from liberal profession to competitive business.” That, I believe, is the action program. In March 2002, the International Federation of Accountants (IFAC) announced a comprehensive “project on restoring the credibility of financial statements in the global marketplace”. IFAC said: “The project will address worldwide problems, issues, and best practices in the areas of financial and business reporting, corporate governance, and auditor. It will be developed by a task force comprised of members representing IFAC, audit committees, boards of directors, the investment community, and financial management.” Well, it is to be hoped that IFAC will be able to do more than just ‘address’ this – the project needs clear deliverables that help to restore confidence and trust.

In this context, the profession should prepare to have a more effective crisis management plan than Arthur Andersen was able to demonstrate. Much can be learned for example from the food and health industries. They have learned their lessons. If a problem occurs, the reaction is no longer to minimize the issue and to hide behind vague excuses or to accuse other parties involved. Instead, full transparency is given about the issue and the risks involved for the public. At the same time, a comprehensive action plan is announced to fully take away the risks or their consequences, to compensate for damages and to explain how in the future such an event will not occur again.

Another important issue is public regulation and oversight. It is all right to make maximum use of sound self-regulation. But the auditing profession should realize that self-regulation alone does not suffice. Like for example financial services, accounting and auditing services are of great importance to society. It is all right that such services are offered on a commercial basis in competition. But as a counterbalance, strong independent oversight has to be established. Various initiatives are discussed in this context. It is important not to compromise but to make such oversight independent and powerful. Licensing, examining audit practices and disciplinary measures are some of the crucial elements to be incorporated here.

Let me mention several other important issues that may help to restore confidence and trust. In the accounting area, we have to remember what I quoted from young Arthur Andersen: accounting principles and their implementation in daily practice have to aim at presenting a true and fair view of what was and is. This general principle has to override detailed rules and interpretations if necessary. It is not easy, it can be subjective and judgemental, it may lack comparability in the details – but in the end it is the only thing that matters. This of course is not something that is relevant to auditors only. It matters to all people involved in the reporting cycle. So it is a matter of education, of awareness and of discipline.

Regarding auditing, let me highlight a few important issues. Partner rotation should be made mandatory. At least for so-termed public interest companies, e.g. listed ones, or financial sector firms. Personally, I believe it should be applied more widely as it is a healthy discipline.

Peer reviews have to be strong and powerful. As a consequence of public oversight, independent reviewers need to be involved. And adverse results should have adequate response and, where necessary, disciplinary measures transparent to the public.

Strong audit committees can be very helpful to monitor both a company's executive management and its internal and external auditors. They need to comprise independent non-executive directors only and to report to the full board. They are also the appropriate body to monitor the extent to which the audit firm performs consultancy engagements for the audit client, and to set principles and limits for such practice.

Finally audit firms have to be much more transparent. At least they should be as transparent and accountable as financial sector firms. I refer to what will be known as Pillar III in the new Basel Capital Accord, that will require substantial transparency from banks. I cannot see why global audit firms should be allowed to be any less accountable than listed companies in the United States or Europe. This includes openness about partners' income.

Ladies and gentlemen, let me conclude.

In 1994, I concluded my PhD on auditor independence by stating that, at the end of the day, it all comes down to the ability to withstand pressure. That this is what matters most for the auditor's reputation of integrity, and that without integrity auditors cannot exist. We have learnt a hard lesson from Enron in that not only auditors (or auditing firms) can be threatened in their existence. We are all on call. There is a need to restore the ethos of public service, whether we are auditors, bankers, analysts, regulators or executives. In fact it matters to all players in the broad area of corporate governance. We all have a license from society to operate, as long as we adhere to essential ethics of public responsibility.

Thank you.