HIGH-QUALITY FINANCIAL REPORTING

The Six-Legged Stool

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For capital markets to function efficiently and effectively, participants (including investors and creditors) must have confidence in the financial reporting process. Financial statement fraud, as we've all seen recently, is a serious threat to this confidence.

Quality financial reports, including reliable financial statements free of material misstatements due to errors and fraud, can be achieved when there is a well-balanced, functioning system of corporate governance. Corporate governance is a mechanism of managing, directing, and monitoring a corporation with the goal of creating shareholder value while protecting the interests of other stakeholders (such as creditors, employees, and customers).

For good corporate governance, companies should develop a "six-legged stool" model that supports responsible and reliable financial reports. Each participant in the process is a leg of the stool, supporting the one top goal of producing high-quality reports. The model is based on the active participation of all parties and fosters continuous improvements.

It consists of six groups:

- Board of Directors
- Audit Committee
- Top Management Team
- Internal Auditors
- External Auditors
- Governing Bodies

Management accountants play an important role in helping corporate governance participants fulfill their responsibilities. The 1999 report of the Blue Ribbon Committee on "Improving the Effectiveness of Corporate Audit Committees" suggested a "three-legged stool" involving the chief financial officer, independent auditor, and audit committee. Now, however, more emphasis is being placed on the entire corporate governance responsibility.

BOARD OF DIRECTORS

Aligning the interests of managers and shareholders requires vigilant, independent, effective boards. A board of directors doesn't get involved in day-to-day management, yet it has the unique role of overseeing, monitoring, and controlling management activities. It should monitor management plans, decisions, and activities and act independently. The tone set by the board usually influences the behavior of others within the company.

Ineffective boards make financial statement fraud possible. A board can be rendered ineffective when management overrides the board's monitoring responsibility, influences the selection of outside directors, controls meetings and agendas, and delivers inside information to certain members.

The two biggest corporate failures of recent times, Enron and WorldCom, raised concerns about the lack of vigilant oversight. Enron's board allowed the creation and operation of special-purpose entities designed to overstate earnings and assets and understate liabilities.

Congress enacted the Sarbanes-Oxley Act of 2002 to improve corporate governance, and the Securities & Exchange Commission (SEC) imposed new rules as well. Sarbanes-Oxley requires the board to either form an audit committee or take on its responsibilities. It also prohibits directors and officers from fraudulently influencing, coercing, manipulating, or misleading auditors. They're also barred from purchasing, selling, or transforming any equity security during a pension fund blackout.

AUDIT COMMITTEES

The audit committee (composed of nonexecutive and independent board members) oversees corporate governance, financial reporting, internal control, and audit functions. The more vigilant the audit committee, the lower the probability of financial statement fraud.

Members must be financially literate, professionally qualified, operationally knowledgeable, and functionally independent. They're directly responsible for the appointment, compensation, and oversight of external auditors, and they must preapprove all audit and any permissible nonaudit services external auditors provide. They should establish procedures for whistleblowers to submit their concerns without fear of retribution, and at least one committee member should be a financial expert.

The success of audit committees depends on their working relationships with other corporate participants. When audit committees receive information about possible fraud, they should investigate thoroughly and report to the board.

Enron's audit committee was criticized for its lack of vigilant oversight. Its infrequent meetings were brief and limited in scope, and the committee failed to question management decisions about the special-purpose entities.

TOP MANAGEMENT

Management, specifically the CFO, is responsible for the fair presentation of financial statements. Management should produce high-quality, transparent financial reports and present objective, consistent, transparent, and comparable financial results and conditions. Enron's management failed to fulfill its responsibilities by engaging in transactions with special-purpose entities and by preparing and disseminating misleading statements.

Top executives must now certify the accuracy and completeness of financial reports, and they're responsible for establishing and maintaining effective internal controls. They shouldn't influence, coerce, manipulate, or mislead auditors, and they should reconcile pro forma statements with financial statements. They should also prepare Management's Discussion and Analysis (MD&A) sections that discuss and fully disclose critical accounting estimates and accounting policies.

They must refrain from taking loans from their company, disclose insider stock trades, and return benefits received in the 12 months prior to an earnings restatement. Penalties for willfully certifying a misleading or fraudulent report include fines of up to $5 million and 20 years in prison. Those judged "unfit" by the SEC can't serve on boards or as top executives of any public company.

EXTERNAL AUDITORS

Users of audited financial statements typically expect external auditors to detect fraud and irregularities. But external auditors don't certify a clean bill of health for the audited company. They provide reasonable assurance that audited financial statements are free of material misstatements, reducing the risk that they are misleading, false, or fraudulent.

Ideally, auditors lend credibility to audited financial statements. Risk reduction makes capital markets more efficient and creates more trust and confidence. But when auditors participate in or fail to discover fraud, market participants ask, "Where were the auditors?" (Witness the situation of Arthur Andersen, which audited Enron and WorldCom. It was criticized, scrutinized, and indicted for its failure to discover material misstatements.)

Sarbanes-Oxley also creates an independent Public Company Accounting Oversight Board (PCAOB). Made up of two accountants and three outsiders, it will register accounting firms, conduct yearly evaluations, conduct investigations, hold disciplinary proceedings, and impose sanctions.

Appointed and overseen by the SEC and funded through mandatory fees, it will issue or adopt American Institute of Certified Public Accountants (AICPA) standards. It can inspect registered accounting firms' operations and investigate potential violations of securities laws, standards, competency, and conduct.

The law also forces firms to rotate their lead auditor or coordinating partner and the reviewing partner off the audit every five years. External auditors must report all critical accounting policies and practices to the audit committee and report on management's assessment of the effectiveness of internal controls. They must also keep work papers and audit evidence for at least seven years.

INTERNAL AUDITORS

The internal audit function, the first line of defense against fraud, now focuses on a broad range of activities and is becoming integral to corporate governance. Internal auditors should continuously look for red flags. Indicators such as excessive related-parties transactions must be reviewed to detect opportunistic behavior.

New SEC rules require CEOs and CFOs to establish and maintain a system of disclosure controls and procedures and to evaluate the system's adequacy and effectiveness. Internal auditors can help management establish, maintain, and monitor this.

Years ago, the Treadway Commission suggested that the SEC require public companies to maintain an independent internal audit function. The chief internal auditor should be appointed by the audit committee and report to it and the CEO or a superior financial officer not directly involved in preparing financial statements.

To prevent potential conflicts of interest, Sarbanes-Oxley prohibits external auditors from performing internal audit outsourcing for public companies contemporaneously with the financial audit.

GOVERNING BODIES

Stock exchanges, the SEC, the Financial Accounting Standards Board (FASB), the AICPA, the Institute of Internal Auditors (IIA), and state regulators may influence corporate governance, the financial reporting process, and audit functions.

The SEC has imposed new rules on senior executives, audit committees, auditors' independence, and disclosure guidelines for off-balance-sheet, over-the-counter derivative contracts, and related-party transactions. New rules also require certification of financial reports by senior executives and expedited filing of annual and quarterly reports.

Both the New York Stock Exchange and NASDAQ have issued guiding principles requiring that the majority of board members be independent. These principles mandate that audit committees have the sole authority to hire, fire, and retain independent auditors.

The AICPA's recently issued Statement on Auditing Standards (SAS) No. 99, "Consideration of Fraud in a Financial Statement Audit," requires auditors to approach every audit with skepticism and not presume management is honest. Auditors should brainstorm about how fraud could occur and identify the risk as well as management's incentives, opportunities, and ability to rationalize it. They should design tests responsive to the risks of fraud, conduct procedures that would be unpredictable and unexpected, and test for management override of audit controls.

The AICPA also released a draft of proposed standards designed to improve the effectiveness of audits by requiring auditors to use the audit risk model, which focuses on the organization's risk assessment process and the testing of disclosures.

Since 1973, the FASB has been the designated private organization for establishing accounting standards (generally accepted accounting principles, or GAAP). Sarbanes-Oxley lets the FASB continue establishing accounting standards, provides public funding for it to effectively fulfill this role, and encourages it to move toward a principles-based approach. It issued a proposal on a principles-based approach in October 2002.

It is also trying to reduce or eliminate differences between U.S. accounting standards and those issued by the International Accounting Standards Board (IASB). The goal is to have a set of uniform globally accepted accounting standards by 2005.

The IIA since 1941 has dedicated itself to the promotion and development of internal auditing worldwide. It has encouraged internal auditors, especially the chief audit executive, to take a proactive role in corporate governance, among other duties. The IIA encourages organizations to establish and maintain an independent, adequately resourced, and competently staffed internal audit function.

California, the first state to regulate accountants, prohibits them from taking jobs at companies they have audited within the last year. Accountants must keep records and work papers for seven years, and the majority of the California State Board of Accountancy must not be accountants.

THE MANAGEMENT ACCOUNTANT'S ROLE

As members of the strategic planning team, management accountants can improve the quality, reliability, and transparency of financial reports.

Establish ongoing communication with corporate governance participants. They should have greater exposure to audit committees, internal auditors, and external auditors, and they should provide strategic information. Their knowledge of how business and financial information needs to be tailored for different purposes can be very useful.

Help management prepare certification requirements. New rules require CEOs and CFOs to certify that they reviewed annual and quarterly reports. Management accountants should help them effectively discharge these responsibilities.

Help management establish and maintain adequate and effective disclosure controls and procedures. Sarbanes-Oxley requires a yearly report stating management's responsibility for establishing and maintaining an adequate internal control structure and setting procedures for financial reporting. SEC rules also require that fraud involving management or key employees, as well as significant deficiencies or material weaknesses in the design or operations of internal controls, must be disclosed to external auditors and the audit committee. Management accountants can help fulfill these requirements.

Get involved with strategic issues. Management accountants must get more involved with significant corporate governance, strategic risk management, and business risks. They should develop core competencies to help manage risk in their organization's core business, fast-moving transactions, and products.

Help management establish an appropriate "tone at the top." Management accountants should help the board and top executives fulfill their stewardship responsibilities. The corporate code of conduct should protect whistleblowers who lawfully disclose information pertaining to fraud.

Finally, the six-legged stool model is based on the proactive participation and cooperation of the board, audit committee, top management, internal auditors, external auditors, and governing bodies. It fosters continuous improvements in the quality of financial reporting. The increasing interest in, and the demand for, vigilant corporate governance and high-quality financial information have created a unique and timely opportunity for management accountants to align their strategic vision with the emerging demands for more effective systems of corporate governance. ■

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