

THE INTEGRITY OF FINANCIAL MARKETS ACCOUNTING SCANDALS AND CORPORATE GOVERNANCE

Summary: Investors' *trust* is one of the essential components of a well functioning financial market. It is built upon the quality and reliability of the information disseminated through the market. At the same time there can be no workable - and profitable - market without *risk*. In recent years, technological developments and innovative new financial products have allowed markets and operators to define sophisticated methodologies and instruments to measure, control and manage risk. Recently, the balance between trust and risk has been shaken by accounting scandals and the reappearance on the global scene of a further complicating factor: *uncertainty*. Can markets ensure stability against uncertainty? Are Europe's financial markets structures as fragile as the US' have shown to be? What is the best approach in order to reduce investors' mistrust through re-building the integrity of financial markets? The legislator and the regulators are looking for solutions and so does the financial industry.

Enron: the spark that lit the fuse

The series of accounting scandals that started with ENRON's collapse at the end of 2001, broke investors' confidence through two different types of violation. On the one hand, alleged accounting frauds and balance sheet manipulations undermined investors' faith in the reliability of information on the real economic situation companies. On the other hand, the perceived lack of independence of accountants, damaged trust in the audit system and put all the current market disciplines into question.

Weaknesses revealed by the ENRON case

The fall-out from the ENRON scandal pointed to a number of apparent weaknesses in the US system of oversight, based on *checks and balances*, which appear to have allowed certain types of abuses to the detriment of investors, creditors, employees. In general the market has proved itself to be vulnerable to fraud and unable to ensure an adequate level of security. Several weak points may be identified:

- **Accounting Rules:** the FASB rule n. 140 allowed Special Purpose Entities (SPEs)¹ not to be included within the consolidated balance sheet, subject to meeting mechanical conditions that do not necessarily reflect economic substance. ENRON's management made an extensive use of SPEs to hide losses from the company's accounts. Interestingly enough, it was the failure to meet these specific requirements (e.g., a 3% ownership by independent parties) which led to the unravelling of the abuses. The *marking to market* system normally applies to the evaluation of contracts of goods and financial instruments according to the *fair value* principle, e.g. the price that would be paid in the current market in transaction between willing parties. The management misapplied it also to the company's contracts of services and products, with an intentionally overly optimistic evaluation of (hypothetical) profits;

¹ The SPE is an entity created by an asset transferor or sponsor to carry out a specific purpose, activity or series of transactions directly related to its specific purpose. It is established as a limited partnership, limited liability company, trust, or corporation and, thus, may have a limited life.

- Abuse of Stock options Incentive System: a massive use of stock options (which under US accounting rules are not required to be accounted for on the balance sheets as ‘costs’) led the management to inflate the (hypothetical) profits supporting the value of their shares on the market;
- Statutory Audit and Corporate Governance: interests or inattention of ‘independent’ directors, internal auditing committees and managers appear to have converged in a way that undermined their respective control functions, to the detriment of the company’s shareholders and other stakeholders;
- Independence of External Auditors and Supervision of the Accounting Industry: external accountants, responsible for auditing the company, were acting under an apparent conflict of interest when providing the same audited company, much more profitable consultancy services that might jeopardise their independence. Moreover, US rules provided no rotation amongst accounting companies, given the practical difficulties and inefficiencies of rotating the auditors of large multinational operations. Supervision of the accounting sector also suffered from a lack of independence, with auditing companies being scrutinised on a peer review basis and the body in charge of supervision being an *ad hoc* board;
- Intermediaries, Financial Analysts, Rating Agencies: certain commercial banks and investment banks appear to have had their incentive to be vigilant upon credits, loans, or investments weakened by a desire to obtain more lucrative advisory fees from the same company (issues and placement of securities, trading, M&A, etc.). Financial analysts and rating agencies appeared not to have been immune to the myth of the success of the company, with their objectivity or research suffering as a result

The US counter-offensive

The feeling of mistrust and diffidence that investors expressed in the markets following the last months’ accounting scandals, prompted a strong intervention by US legislators: on the 30th of July 2002 the ‘*Public Company Accounting Reform and Investor Protection Act of 2002*’ (‘the Act’), promoted by Senators Sarbanes and Oxley and modifying, *inter alia*, the Securities Exchange Act of 1934, was adopted. The Act also applies to foreign issuers where no exemption is granted, the securities (whether equity or debt) of which are registered under Section 12 of the Securities Exchange Act of 1934, or that are required to file reports under Section 15 (d) thereof.

The new framework strengthens the disclosure requirements applicable to companies subject to control by the SEC and the civil and penal liability of directors and financial officers. It provides also for the compulsory setting up within all companies of an *internal Audit Committee*, the independence of which must be guaranteed (the Committee’s members must not be affiliated persons of the same company or of one of its controlled companies; no additional remuneration other than that for the position of member of the Committee must be allocated to the members; the members are not allowed to provide the company with non audit services).

The Act also specifies the services an external auditing company is not allowed to provide to the company it audits. The SEC is also empowered to regulate the activity of financial analysts in order to avoid pressure on or interferences (revision, evaluation, approval) on their research reports by persons dealing with investment banking.

The European reaction

European countries have remained relatively immune to the ENRON syndrome. Countries where the shareholding is typically public, like the United Kingdom, experienced no comparable crisis, nor did others where it is sometimes concentrated in the hands of a few – when not just one – majority stakeholders, like in many continental EU countries. A different approach to accounting and corporate governance issues has produced in Europe general accounting principles with a wider scope, tighter rules on consolidation, stricter oversight of accountants by regulators, and broader regular reporting obligations.

However, serious questions have to be asked about whether European standards of disclosure and corporate governance - which have not yet converged fully and which may not be optimal in every way - would allow Enron type activities to be uncovered in Europe in the dramatic way they have been in the US. While there is little evidence of corporate malfeasance in Europe, many believe that Europe's Enrons are out there, in the sense that a number of major European companies may face accounting difficulties that shareholders are not fully aware of.

Nonetheless, European markets are far from being already harmonised and well functioning. There was probably no need of an 'ENRON case' for Europe to realise that some steps still need to be taken in order to achieve the Internal Market for Financial Services. On the other hand, the ENRON case offered EU institutions and financial operators the opportunity to ask themselves whether what had been done and what is still on the agenda is enough and responds efficiently to the need of rebuilding investors' confidence.

This is for a simple reason: the problems linked to the current financial crisis go well beyond a single country or group of countries and are present worldwide. As a consequence, the new legislative initiatives in the US and the harmonisation efforts conducted within Europe, which are starting to bear fruit satisfactorily, ought to lead to the definition of a consistent set of accounting standards on a worldwide basis. To this end concrete and cooperative steps between the US, Europe (and Japan) are of paramount importance.

The Commission's Statement in Oviedo

With this in mind, the Commission presented last April in Oviedo a list of policy actions complementary to the FSAP (Financial Services Action Plan), aimed at strengthening the defences against ENRON-like crises. Intervention is now focused on the following areas, in which some of the key-targets have already been achieved, others still being on the table of the DG Internal Market and the Committee of European Securities Regulators:

<u>Issues</u>	<u>Actions Achieved</u>	<u>Targets</u>
<u>Financial Reporting</u>	<ul style="list-style-type: none"> ◦ Regulation requiring the use of IAS by listed EU companies from 2005 (July 2002); ◦ Commission second consultative document on Regular Reporting, (closed in July 2002) focusing on periodicity of <u>financial reporting</u> (quarterly) and <u>on-going disclosure</u> obligations 	<p><i>The Commission's attention is focused on maintaining the international dialogue for a global – particularly with the US - convergence with truly international accounting standards, and on the implementation work thereof within the EU Member States.</i></p> <p><i>An US-EU agreement has recently been found upon the convergence between IASB and FASB standards.</i></p>

<u>Transparency</u>	<p>° CESR Consultation on Proposed Statement of Principles of enforcement of accounting standards in Europe (October 2002)</p>	<p><i>With the view of applying IAS also to unlisted companies, a modernisation of existing Accounting Directives is to undertake.</i></p>
<u>Statutory Audit</u>	<p>° Commission Recommendation on Auditor Independence (May 2002);</p>	<p><i>CESR will be invited to report on supervisory issues related to the increased complexity of derivatives and derivative trading and the implications for the regulation of EU financial markets, with particular emphasis on financial engineering techniques and hedge funds, taking into account the work of the Financial Stability Forum.</i></p> <p><i>The Commission foresees a review in 2003 on the national implementation of the 2000's Recommendation on minimum requirements for systems of external quality assurance for statutory audit in the EU.</i></p> <p><i>A new Communication on policy priorities in the field of statutory audit is also scheduled, touching at the extension of the IAS to all EU audits by 2005, the setting up of the public oversight on the auditing profession, accompanied by possible code of ethics, the future role of audit committees in EU listed companies.</i></p> <p><i>A modernisation of the 8th Company Law Directive on statutory audit will be also undertaken.</i></p>
<u>Corporate Governance</u>	<p>° Extension of the first mandate of the High Level Group of Company Law Experts to cover additional corporate governance issues, including the role of non-executive directors and supervisory boards; management remuneration; the responsibility of management for the preparation of financial information; analysis of the Commission's study on codes of corporate governance (April 2002).</p> <p>° Commission second consultation document on Regular Reporting including ongoing reporting requirements on voting rights and the <u>capital structure</u> of companies (closed July 2002);</p>	<p><i>Adoption of the Pension Funds Directive is now expected by in early 2003.</i></p> <p><i>The High Level Group of Company Law chaired by Prof. Winter is expected to deliver its report on corporate governance issues at the beginning of November 2002.</i></p>

Financial Analysts

*Adoption of the **Market Abuse Directive** including the changes on financial research, is expected before the end of 2002. After the public consultation on the review of the **Investment Services Directive**, the awaited modified proposal should touch at conflicts of interest potentially linked to financial analysis provided by investments firms and banks.*

Credit Rating Agencies

*The Commission is willing to analyse the role of credit rating agencies and the potential need to undertake regulatory intervention in this area. A **cross-sectoral policy assessment** might be adopted shortly.*

A lesson to draw

Financial markets are not new to cyclic crises and economic contraction and expansion (and nor are they to fraud). But what has made the present situation so critical is its dimension (no longer national but global), and the fear that more than one 'pillar' of the system has been showing the signs of age and calls now for an urgent update. If an agreement was reached by EU Member States at the last September ECOFIN Council on the necessity to draw up an Action Plan in order to tackle 'ENRON case' issues according to the forthcoming Winter Group's report, nothing has been said in that context about how to overcome the (usual) differences among national approaches and solutions. A European common ground would be a good starting point for a further overseas' dialogue and cooperation: the problem will be to find it.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

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