The Global Challenge to Accounting

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CURRENT PERSPECTIVE

"*History teaches us that history teaches us nothing*" LORD ACTON

"*Don't make the same mistakes twice, there are plenty of new ones available*"

A CHANGING WORLD AND THE EFFECTS OF GLOBALISATION

Change

In our world today, change is an inevitable and increasing factor, increasing not only in quantum but also in acceleration. For everyone the real learning process from now on will be coping with that change. Success, in contrast to survival, will need both anticipation and adaptability in large measure.

The pace of change is accelerating:

TIME TAKEN TO REACH 50 MILLION USERS

Radio	38 years
PC	16 years
Television	13 years
Internet	4 years

In 1950, 20% employment required cerebral skills (ie 80% manual); now it is the other way round.

Change is inevitable but our reaction is not. In the past quite often the choice was to grasp opportunities or to defer them, such is the pace of life today that opportunities deferred may well be opportunities lost. (For further reading see David Hunt's professorial paper: *The challenge and management of change)*

In Alvin Toffler's book *The Third Wave* he found that there had been three major waves in our history:

— the agricultural wave 8000BC to c1750AD
— the industrial wave
— the information wave that started in the 1960s

Today there is 'information overload' and we have to learn to prioritise more quickly, concentrate on the essential and be ruthless in our time management. "*You have sent me so much information that I do not know what is going on*"

RICHARD CHAPLIN

In most countries there is an aging population as healthcare improves and there will be big changes in the next ten years. With fewer employed people and therefore less paying taxes and more taking out in the form of pensions many countries will have to change their fiscal structures.

Only 85 years ago, it took two days for the news of the death of the Russian Tsar to reach Moscow. Yet when Boris Yeltsin disappeared during an election 8 years ago (he was ill) many countries around the world knew about it before the Russian people (if they had known that he was ill they might not have voted for him). Today they would have known: it would have been on the Internet – unstoppable immediate communication. Whatever part of the profession we are in, we have been immediately affected by events over thousands of miles from our own country. The collapse of some major businesses in the so-called "tiger" economies of SE Asia and the later failures of Enron and World.Com hit us immediately, suddenly and almost without warning it seemed – at least to the external investors. Whether we were in business or practice our reputation fell. No one was immune. Some tried blaming the auditors, but actually they were at the end of the line. In my forty years professional experience there has never been an audit failure without there first being a management failure. We are all in it together.

All these changes affect our working methods and our profession.

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Globalisation

This is a huge subject and there is only time to refer to one or two aspects. However in some ways all aspects of this subject affect our businesses, our practices, our customers and clients and our profession.

The globalisation drivers are: the progressive removals of barriers to trade and foreign investment and technological advances. In 50 years the tariffs on manufacturing goods for major developed trading countries have dropped from an average of around 20% to just under 4%. Technological changes have been in the fields of: microprocessors and telecommunication (including the use of the Internet, leading to information overload for the individual and the need for enhancing skills in prioritisation) and transportation (containerisation and increased speed of air transport).

"*The key feature that underlies the concept of globalisation is the erosion and irrelevance of national boundaries in markets. For example, the securities markets of various countries are becoming integrated into a global system through cross-border transactions and listings and the increase in the number of multinational fund managers…The experience of the Asian currency crisis of 1997-98, when the problems of a few countries subsequently spread to many others, further signifies the global character of the financial markets.*

*Although national regulators have sovereignty over the movements of capital across their national boundaries, the rapid integration of financial markets renders such sovereignty ineffectual. The global mobility of production facilities limits the ability of governments to impose capital controls and recent attempts to do so through taxes and regulation have had negative impacts on capital markets (*FELDSTEIN 2000*). Further, the electronic movement of capital is creating a new form of market that exists in microprocessors and cyberspace and not necessarily in a geographical location. In addition, because of their multinational locations, the nationality of global firms may be difficult to ascertain, raising questions about regulatory jurisdiction".*

PERERA, RAHMAN & CAHAN; AUSTRALIAN ACCOUNTING REVIEW, 2003.

As a result of this no-one nation state will able to act in isolation, as there will emerge an interdependent global market with developing countries and smaller nations banding together to form regional economic units that can challenge even the largest nations that might be tempted to be independent and shrug off the burden of interdependence. Witness the recent stand off over steel imports into the USA by the EU, which the latter won. In this emerging global market one can already see global competitors: the oil firms have been there for years but are now being followed by the soft drinks market, that for airplanes and aero-engines and many others. Our local business (or client or customer) could soon become a part of the global production chain, if it has not already become so.

To illustrate how these changes can have a devastating effect on the lives of an individual, I will refer to a friend of mine. Life in the London Stock Market when he started was easy enough: reading the financial papers, a few local deals in the morning, long liquid lunches and some more local deals in the afternoon and off to the squash courts or the golf club – a truly 9 to 5 job. At the end of his career: he would arrive at the office at about 07.30, do some deals before the end of the Tokyo market; then he would come across the world doing deals in Hong Kong,

Zurich, Frankfurt, Paris and his own London market. Before his working day was up, he would do some deals on the now open New York market before getting the 21.00 train home. It affected me too – we could only play squash at the weekend!

Whilst globalisation has brought benefits to well-positioned businesses, it has also brought many unwanted changes to which we must adapt (unless you want to try to stop the steam-roller): loss of jobs in industries under the threat of foreign competition; exploitation of cheaper labour and natural resources (with sometimes extensive damage to the local environment) before moving on to even cheaper countries.

21st CENTURY ASSURANCE – SOME LIKELY CHANGES

(In my research for this section, I used a number of sources but if you want to read more you should read the writings of Robert K. Elliott, a partner in KPMG New York and a past president of AICPA; the quotes below are from one of his articles and some of the rest is paraphrased from the same source)

"Every aspect of the accounting profession is being pervasively affected by advances in IT. IT shifts

power from producers (such as accountants and auditors) to consumers (such as investors, creditors and other information users). Present and potential users of accounting and auditing services have increasing needs for relevant, reliable and timely information. It provides the means to them, but responding to these needs will require changes in virtually every aspect of auditing – where it is applied and how it is produced and distributed, for example, as well as the profession's relations with assurance users".

Business reporting (? using XBRL: Extensible Business Reporting Language) will move from the periodic to the continuous. Some firms can report in near real time (eg Cisco Systems can close its books in a few hours). Assurance services may have to follow with future users being "*decision-makers not just investors and creditors*" – and they will define their own (different?) needs, not just the accountancy standard setters.

"Because IT permits relatively reliable (ie error free) preparation of reports, detecting fraud may receive greater attention in proportion to that given to detecting errors".

Continuous reporting is nearly here and therefore continuous assurance is only a matter of time. The buyer or receiver of a flow of information always has an interest in knowing whether the information supplied is reliable. (Real time reporting should reduce if not eliminate quarterly earnings surprises).

Assurance is a broader concept than audit. Currently the historical audit makes opinion on a presentation as a whole; users depend on the reliability of the presentation as a whole. Users who apply their own analysis to data they select from continuous reporting on web sites will need assurance on the specific data they incorporate into their own reports (perhaps even using their own accounting assumptions).

CRISIS OF CONFIDENCE

Enron changed nothing. It changed nothing but was (until very recently) the most spectacular example of what is wrong in our profession. None of us can escape blame. You and I belong to major institutes – we do have a responsibility.

Younger members? If you do not like the profession today then, I accept, it is my generation's fault. If you do not like it in 20 years' time it will be your fault.

Enron was not alone

Parmalat seems to be fraud but even Enron is not yet proven fraud, although it seems to have adopted (with auditor sanction) some highly questionable accounting practices. Add World.Com, Polly Peck, Maxwell, Equitable Life, Atlantic Computers, Barings and BCCI and it is no wonder that onlookers (world agencies, governments, investors etc.) look upon us with disbelief if not downright distrust.

'Going concern' and economic downturns

It was the SE Asia "tiger economy" corporate collapses that set off the World Bank, the SEC and many others. "You did not warn us" was the cry. It was self-evident to us that heavily debt-laden corporations run into trouble in economic downturns or when interest rates rise. It was not a question of inappropriate accounting policies but of business policies that were unsustainable except in favourable economic trading conditions.

Did we think that when framing (or auditing) the 'going concern' accounting policies that these corporations were only going concerns if there was no economic downturn? That is not to suggest that accountants should be economic predictors but that we should spell out the effects of our assumptions. The ordinary punter has no chance. On the other hand, the sophisticated investor and investment analyst, living more in hope than reality, might have ignored the signals - if they had seen them.

It is a corporation's finance/management accountants who frame the accounting policies, which the auditors approve as appropriate. The general management are also responsible but courts on the whole tend to blame those with proven experience and expertise. But an audit failure must have been preceded by a management failure. We are all in this together.

If any one corporation had acted alone and made full explanation of its assumptions on going concern ("should there be an economic downturn, this corporation in common with other heavily indebted businesses would experience operational difficulties"), the share price would have fallen and the shareholders would have sued. All corporations and their auditors would have had to act together to achieve the result that the World Bank expected.

However, conditions were not right. The then Big 5 Firms felt strong enough not to need the accountancy institutes, who in turn were not strong enough (many are still not) to tackle the big firms. On the whole, the management

accountants did not have any means of coordination and stayed out of it. The lessons are there to be learned. Have we? Would we act any differently today? Would we have even seen the problem? We do not have many chances left to maintain our profession's credibility.

Nation states are under threat. Bewildered governments will be looking for scapegoats. We are the obvious choice.

"Accounts are business facts in money terms"

Whether we are the chairman, CEO, CFO or auditor that must be our underlying philosophy – the framework for our accounting decisions. That was clearly not the case at Enron, irrespective of whether fraud is proven or not. If we abandon our principles and professional values and descend to a grubby circumvention of the rules, we will not deserve a future.

We are all in this together

We cannot sit cosily or smugly in our armchairs and blame everybody else. If we were not either management or auditors of these collapsed corporations, we were still members of institutes that did not act. Every individual member has a professional responsibility.

Our profession always gets the blame even if unjustified

- Enron and World.Com Chief Financial Officers were not qualified accountants…but their auditors were!
- Instant communication brings instant trouble. The Houston office wrong doings led to instant worldwide loss of confidence in Arthur Andersen & Co. and to the destruction of a good firm.
- Early blame and late exoneration: in the UK, one case took nine years until the auditors were resolved of guilt by the courts and the Institute. However, at that time, it was hardly reported: out-of-date and good news does not sell newspapers.
- Management has greater responsibilities than the auditors. It is the management who lay down the underlying principles of corporate governance and behaviour.

Expediency does not help

- Courts/insurers collude that whatever the underlying proportion of responsibility, the auditors bear the liability often totally because they have the insurance cover. Insurers' expediency in not pursing accountable directors (because of insufficient assets compared to the costs of pursuit) must have contributed to reckless corporate behaviour to the detriment of our societies and especially of the auditors.
- On occasions, Courts have deferred institute disciplinary proceedings to prevent risk of seriously prejudicing potential litigation (eg BCCI, but not a precedent for all cases). That may be convenient for the firm and their insurers, but not for the long-term good of the profession. Justice is often slow because of drawn out legal arguments (and the complexities of the cases). Out-of-court settlements may satisfy the parties involved but nobody else, as the profession is yet again perceived as exclusive, privileged and far from transparent. When institutes are subsequently allowed to act by the courts, the media conveniently forget the reasons for delay and point to the profession's slowness.
- Loss of moral compass: corporate management

  Sherron Watkins (ex Vice President of Enron, who alerted CEO Kenneth Lay in August 2001 to accounting irregularities) said: some chief executives were like *"dictators of resource rich African countries, treating their company assets as their own"* (one ex-tycoon spent US$6000 company money on a shower curtain). In 1970 US directors were paid 26x the average worker remuneration, by 2000 that had risen to 531x…. and there must be many accountants in that number. She went on to say: *"once you start getting it, you just want more and more. When CEO's are making that much,* ***they lose their moral compass****"*.

  At the Enron 2000 Corporate Conference, Chief Operating Officer Jeff Skilling (widely regarded as the most brilliant corporate leader in the country) took to the stage for his annual stock price prediction. *"In years past he had been on the money – Enron had gone from $40 to $60 a share in 1998 and had soared to $60 in 1999. Now he stood before his faithful and bowed his head. When he*

looked up at the crowd again, he was beaming. Enron stock, he told them, would hit $126 a share in 2001. There was stunned silence before the crowd burst into applause". Wanting *"to boost morale a little higher, Enron (he said) had found the one successful business model that could be applied to any market".* He then introduced Tom

Peters, management guru and author of the best selling book "In search of excellence. *"Peters strode to the stage, abandoned his prepared speech and started pacing back and forth. 'That's the scariest thing I have ever heard. What exactly had Enron done that was so novel? What accounted for such self-? congratulation? The company had taken a model and replicated it in other fields…but everyone knew that now. Other businesses were already copying Enron and the novelty would soon wear off. And then where would Enron be? An excess of self-confidence kills companies".*

"Within months Enron's finances were in a shambles. Instead of being praised as the world's leading company Enron would be vilified as one of the world's most callous and corrupt". Within a year financial revelations and an announcement of questionable write-offs led to the collapse of the share price – in a further six weeks the company had gone (2 December 2001).

- Loss of moral compass: the auditors

Undoubtedly Enron management was to blame for the excessive amoral (if not immoral) aggressive and unquestioned corporate culture but the auditors went along with the consequences. Substantial off-the-balance sheet debt means that the financial statements could not pretend to be "business facts in money terms" Although the book is dedicated to the memory of Arthur Andersen, Sherron Watkins is angry about the firm: *"I joined Andersen in 1982 and it really was the holy grail of good accounting and auditing…. That's the Andersen I knew and if you talk to any old-time Andersen people they all have some local office story of how they all stood by their accounting principles and turned away a client and dropped a client. I was proud to work there".*

I felt like that in 1970, but for some reason they had a failing of keeping high profile questionable clients. In those days it was Bernie Cornfield's IOS. At their subsequent trial, it emerged that in February 2001 (only 10 months before the collapse – surely they must have known the reality) Andersen's had a meeting and considered Enron its riskiest client worldwide. But it was a $52 million client and could grow hugely, so they decided not to drop the client but put more people on the audit.

(Quotations and extracts from: *Power failure: the rise and fall of Enron"* by Mimi Swartz and Sherron Watkins)

There lessons to be learned, but will we?

Before we turn to anger and blame, how would we have done? When a client's accounting moves from trifling errors and omissions to the creative, aggressive and the fraudulent, it is like a steam-roller - difficult to stop. As Sherron Watkins put it: *"each step doesn't look too much different from the one you have just taken. But all of a sudden you've stepped off".*

If similar circumstances arose, would we collectively have learned the lessons and acted differently. Would the Forum of Firms (of transnational audit firms) take a moral stand? Would our institutes through IFAC have done the same? Would we, individual members, have got off our backsides and encouraged them? We all have responsibilities as we choose to remain.

SO WHAT CAN WE DO NOW?

It is not all bad news.

Chris Joy, a senior ICAEW professional standards manager, said: *"well before the crisis of con-*

fidence, as a profession globally, we had been making considerable efforts to ensure a high quality audit, to strengthen our accounting standards and codes of ethics (and global standard setting process) as well as introducing a credible degree of independent oversight in the public interest. We were pouring considerable resources into global standard setters – IFAC and IASB. (As an aside, did we encourage our institutes to increase our subscriptions so this could happen? Or did we keep our heads down – not our problem – and leave it to others?) *All this was ultimately acknowledged by regulators as necessary but not sufficient. Now…we are undertaking further moves to strengthen our global processes".*

Institutional and regulatory response

All of the following can help the process of reform and restoration of the credibility of our profession:

- Encourage rather than accepting public oversight boards to replace self-regulation, in order to help restore public confidence;
- For public interest companies (including major charities) encourage true auditor independence by forbidding auditors to do other work for such clients;
- Regain the high moral ground by encouraging our members to review their personal responsibilities to act always in the highest professional standards;
- Actively support the harmonisation and strengthening of international financial reporting standards and those for audit and assurance. In this way, we will remove significant barriers to international trade through improved investor understanding and acceptance. It is unforgivable that under differing national accounting standards, one corporation's net income could differ by nearly 20% in one regulatory regime and 145% in another!
- Work with other players in the financial markets, who also have responsibilities (but little accountability) in formation of acceptable market cultures: investment analysts and bankers, board members of public interest companies, financial journalists, stock exchanges, national and international funding agencies, corporate finance intermediaries (including lawyers) and investors;
- Encourage openness, transparency and integrity in financial reporting so that accounts really do represent "business facts in money terms";
- Support stronger audit committees and non-executive directors at the expense of short-term inconvenience, even embarrassment, for the long-term good;
- Look to the long-term good of corporations and auditors over the short-term inconvenience;
- Work with indemnity insurers to achieve a level playing field between management and auditors, so that liability follows responsibility;
- Lobby governments to introduce proportional liability as a principle and not weaken the principle through the expedient acceptance of liability caps;
- Provide support (help lines etc) to members faced with ethical dilemmas;
- Actively support and apply IFAC's programme for rebuilding public confidence in financial reporting (In many cases it will mean finding out about it);
- Audit firms should be extremely cautious in taking on an audit where the previous auditor has resigned on matters of principle or because of doubtful ethical behaviour. It is better some companies find themselves unauditable than the accountancy profession is seen as expedient, short-term and unprincipled. In the extreme in countries of universal corruption, no company could be auditable or at least not by non-local firms – thus giving a powerful signal to potential investors. In these cases, a united professional approach (auditors and institutes) is absolutely essential;
- Encourage the establishment of and support regional groupings of, especially, small and developing nations facing erosion of their powers and thereby undermining of their standards;
- Have an open-minded approach to regulation proposals. As Jenny Daly, of the Irish Institute of Chartered Accountants, put it: "*it's not all bad news, increased regulation is good for public confidence and public confidence is good for business"*;
- Refrain from unrealistic or excessively optimistic statements and acknowledge criti-

cism where it is valid. Do not indulge in PR statements that promote complacency rather than a sense of reality;

- Support a framework approach as opposed to a rules approach when setting our codes of behaviour.

Individual and collective response

It is no longer enough to do a good job and ignore the wider world – it has come to us. Already accounting packages are rendering some of our traditional work redundant and that trend will continue. We may not have that job. We and, even more so, our successors will have to be flexible. Do or will our qualification processes encourage that flexibility? What will differentiate our qualifications will be our standards and professional behaviour but if they are set in the past without regards for the future then they will be ignored by the business world. The compliance regimes will go elsewhere and we will be replaced.

For our part as individuals, we should:

- Undertake a personal crusade for a return to professionalism (as opposed to the prevalent commercialism) and to healthy professional scepticism;
- Promote and live the seven (Nolan) principles for public life: selfishness, integrity, objectivity, accountability, honesty and leadership;
- Support institutional responses for the long-term good and do not undermine them by immaterial short-term disagreements;
- Volunteer to accept higher subscriptions to support reform.

CONCLUSION

In their book '*Built to last*', Collins and Porrass examine why some companies have stayed the course over 50 years and in some cases for over 150 years. "*When operating at their best (which they don't always do), enduring companies do not abandon their core values and high performance standards when doing business in different cultures. As the CEO of a more than 100 year old, privately held multibillion dollar visionary company explained: 'it may take us longer to get established in a new culture, especially as we have difficulty finding people who fit with our value system. ...So, we move more slowly and grow only as fast as we can find people who will uphold our standards. And we're willing to forgo business opportunities that would force us to abandon our principles. We're still here after 100 years, doubling in size every six or seven years, when most of our competitors from 50 years ago don't even exist anymore. Why? Because of the discipline to not compromise our standards for the sake of expediency. In everything that we do, we take the long view. Always.*"

The defining characteristics of a profession are:

- Technical knowledge and specialised skills
- Professional values, attitudes and ethics

"A distinguishing mark of a profession is acceptance of its responsibility to the public. The public interest is defined as the collective well-being of the community of people and institutions the professional accountant serves".

IFAC CODE OF ETHICS

(The accountancy profession's public includes: clients, creditors, governments, employers, employees, investors, the business and financial community and others who rely on our objectivity and integrity)

It is not a question of regulation or a return to personal honesty. It is not a choice. Without the latter we will not deserve the former. In addition the individual's commitment to the profession is needed more than ever and more than ever we need to work together within our institutes, between our institutes and through IFAC.

Your institute has the vision: *Vision for the 21st. century.* Have you read it? Are you personally committed to it?

As a profession, we are in the 'Last Chance Saloon'. We do not deserve anymore. However, I am an optimist. Always look on the bright side. It is healthier: it takes, so they day, 265 muscles to frown and only 20 to smile.

Mark Twain once wrote: "*I am an old man and I have known a great many troubles: but most of them never happened*".

We can degenerate into a group of isolated, complaining individuals with no chance, or we can take personal responsibility and work together. Having worked and lived in over 40 countries and despite all that has happened, I believe that we are a profession of technically skilled, but downright honest but bewildered persons. But that is not enough. We have got to get our act together to convince an increasingly sceptical and extremely litigious public. Together we can do it but it needs you and me to make our personal commitment really count through our actions. ■