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Diplomová práce

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DIPLOMOVÁ PRÁCE

WORLD AFTER ENRON:
Returning Trust to Corporate Reporting

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Akademický rok:	**2003/2004**

Prohlášení

Prohlašuji, že jsem diplomovou práci vypracoval samostatně a použil pouze uvedené prameny a literaturu

V Praze dne 19.7.2004

ABSTRAKT

Nedávný vývoj ve světové ekonomice jasně ukázal nutnost přehodnotit světový systém publikování korporátních informací ve jménu jejich vyšší transparentnosti, důvěryhodnosti a objektivní vypovídací schopnosti. Práce se tímto tématem zabývá v pěti základních kapitolách, věnujících se základním oblastem, které autor pokládá za klíčové z hlediska komplexního úspěchu reformy korporátního výkaznictví. Těmito klíčovými oblastmi jsou interní kontrolní mechanismy firem, jejich externí audit, problematika jednotných světových účetních standardů, úloha firemních manažerů a konečně otázka formátu publikovaných informací. Napříč uvedenými kapitolami je argumentováno ve jménu hypotézy, že transparentnost a objektivitu firemních (zejména finančních) informací nelze zajistit a udržet rigidním, trvale bobtnajícím pralesem regulativních opatření shora, ale otevřeným, rozumným a pružným přístupem regulátorů, firem, investorů i ostatních účastníků trhu. To vše na základě obecných, jasně patrných etických principů, jejich kontrolovatelnosti a vynutitelnosti.

ABSTRACT

Recent developments in the world business environment have clearly shown the necessity to critically review the worldwide system of corporate information disclosure in the name of increased transparency, credibility, objectivity and reliability. This paper addresses this topic in five basic chapters, which are dealing with the main areas, crucial in author's opinion to be considered for complex success of the reform of corporate reporting. These crucial areas are internal control of companies, their external auditing, the problem of the world's generally accepted accounting standards, the role of company executives, and the issue of the reporting format. Across the particular chapters, arguments are provided supporting the hypothesis that transparency and objectivity of the firms' (mainly financial) information disclosure cannot be secured through excessive, instantly growing regulatory instruments from above. Instead, success of the mission is seen in an open, rational and flexible attitude of regulators, companies, investors and other market participants in the name of apparent broader ethical principles, truly controllable and enforceable.

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INTRODUCTION

At the fall of 2001, an unprecedented corporate scandal filled cover pages of thousands of worldwide newspapers and gave the world a clear notice that a serious review of the worldwide used standards of corporate reporting and its regulation must be seriously considered. Enron, a giant U.S. company suddenly went bankrupt with no previous signals of such serious deficiencies. Arthur Andersen, Enron's principal auditor, survived only few more months after. All that due to just a single corporate reporting scandal. During the subsequent years 2001 to 2004, many other huge corporate scandals in the U.S. and elsewhere in the world emerged[1], showing that pre-Enron corporate reporting framework does not comply at all with the modern needs of investors and other market participants.

As a direct and immediate result of the above-mentioned developments, the trust of investors and the general public in the corporate transparency and accountability got seriously shaken and the huge economic and personal consequences of emerged corporate scandals have shown a clear fact: The urgent need for a serious review of the developed world's corporate reforming framework is not just an issue of displeasured ethical commissions or confused accountants. It is a necessary condition for the successful development of the worldwide business in the most general point of view.

Corporate scandals hardly ever emerged as a consequence of one single shortcoming of their corporate reporting systems. Mostly they happened due to various factors, which being alone would not be capable to cause a serious trouble. But combined together, these particular deficiencies created an institutional framework that gave space for serious corporate scandals to arise.

[1] One does not have to go too far for many examples of huge companies involved in corporate reporting scandals in recent years (i.e in the 2001 to 2004 period). We can mention e.g. DPL Inc., Parmalat, Vivendi Universal, Mutual Funds, Tenet Healthcare, Freddie Mac, HealthSouth, Grubman/Citigroup, Martha Stewart, ImClone, Tyco, Adelphia, WorldCom, Waste Management, Global Crossing, Enron, ING Barings, Merill Lynch, Xerox, Cendant, SunBeam, etc.
Similarly, one does not have to search for a long time for details about the particular scandals. To learn more, please visit e.g. www.thecorporatelibrary.com/governance-research/spotlight-topics/spotlight/scandals, which is providing a nice overviews and lots of supplemental information on the hugest corporate reporting scandals.

This paper tries to provide an up-to-date analysis of the main areas, crucial in author's opinion for the pre-Enron general framework's reform to be successful, regaining the lost trust of investors and the general public in the corporate reports. These crucial areas are internal control mechanisms of companies (chapter 2), their external auditing (chapter 3), the problem of the search for the world's generally accepted accounting standards (chapter 4), the role of company executives (chapter 5), and the issue of the reporting format (chapter 6).

Across the chapters, particular arguments are provided supporting the hypothesis that transparency and objectivity of the firms' (mainly financial) information disclosures cannot be secured and maintained through excessive, instantly growing regulatory instruments from above as the people will always be able to find the by-ways. Instead, the success of the mission is seen in an open, rational and flexible attitude of regulators, companies, investors and other market participants in the name of apparent broader ethical principles, truly controllable and enforceable. Principles-based approach of regulators, companies' understanding of the true benefits of information disclosure, and investors' rational attitude seem to be the right direction on the way towards the relevant post-Enron corporate reporting framework.

1. INTERNAL CONTROL AND DISCLOSURE

1.1. Investors' Concern

In the post-Enron era, we can say that the majority of registered companies got more-less used to facing the reality of instant regulatory changes and strengthening of applicable restrictions relating to the amount and scope of information disclosure. Based on the heritage of the negative experience of recent corporate scandals, investors have become more suspicious. In order to stay competitive in the battle for regaining their trust, companies must not only comply with the newly issued regulations, they have to do more. If the companies want investors to believe that they are doing as they state in their annual/quarterly reports, they should also try to prove it as firm as they can, regardless whether based on obligatory rules or on their own will.

Investors' trust used to be traditionally secured almost solely by the process of assurance of the reported numbers by the independent external audit companies (see chapter 2 of this paper). But the numbers that the independent auditor gets into his hands are always resulting from certain intra-company processes, whose full verification will always remain (at least partially) outside of the scope of a standard external audit engagement.

Also, not only the externally audited numbers are subject to post-Enron investor's interest. The investor wants to make an assessment of the level of risk exposure of the company.[2] He wants to feel comfortable that the externally audited numbers are not based on fraudulent intra-company processes, or that the performance of the company whose shares he bought is not extensively related e.g. to a sole profitable project with a high likelihood to fail. Investor owning shares of such a company can easily enjoy many years of happiness over the EPS and other nice figures published in the reports he reads, which however give him no option on how to assess the risk level of his investment and to adjust his investment exposure according to his preferences. One day, something can

[2] This relates particularly to financial institutions, as we will illustrate in part 1.8. of this paper.

go wrong and all his investment that brought a high profit for years can lose its entire value.

For a risk-taker investor with a diversified portfolio, such a situation would be accepted as a standard occurrence in a risk-return trade-off. For somebody else with less knowledge about safe investing it can mean a life-savings clearance. Regardless of the type of investor, there is no doubt that both the first and the latter would always prefer a company that convinces him about its risk exposure over a company that does not, as proved by significant amount of empirical research.

As a result, every company that wants to fight for investors' trust and for resulting funds, should open-up and forget the traditional attitude of hiding as much business-related information as possible from anybody. Instead, modern investors require to have access to as much primary information as possible. The scheme *"disclose as much as you can and give your investor the best room for assessing whether you do not lie*" seems to pay off in the modern business environment.

"*From an investor's standpoint, when you look at information coming out of an organization, do you get a good sense of what their risks are? Behind it, do you get a good sense of what their risk management activities are? That's the type of things investors need to understand in the environment today*" (REEVES, A., 2003, page 1)

In order to cope with the above-mentioned issues, control and audit of intra-company processes that influence the reported figures and disclosing the results has become a more and more frequently mentioned tool of regaining/supporting investor trust in corporate reports. Most of the companies that want to stay competitive in attracting investors have therefore taken a much closer look at this institution during the recent years. As we will illustrate below, certain post-Enron regulatory institutions even require internal audit in certain companies as mandatory[3].

[3] As we will see, the new requirements for the companies regarding the internal auditing are extensively set mainly in the Title IV (of the total of XI) – Enhanced Financial Disclosures of the Sarbanes-Oxley Act of 2002. Accordingly, the American Securities Exchange Commission changed their listing requirements so that the companies are now required to have an internal audit function.

1.2. Emphasis on Fraud Prevention

Historically, the objectives of the internal controlling were seen in slightly different light than they are today. Companies have not viewed fraud prevention as a primary objective of internal control activities. In contrast to this attitude, in today's business environment the fraud prevention became one of the primary drivers of the strengthened controlling initiatives – it became a heightened concern of all companies, public and private. Providing proofs to investors that the company fights against fraud attracts their trust. Moreover, according to empirical research, the fight against fraud, if correctly implemented, can mean a multiple effect: By reducing fraud, the company can cut costs and improve profitability[4].

In the past, fraud and misconduct were viewed as anomalies of corporate life and infrequent failures of internal controls. Only the huge costs (both direct and indirect) of recent corporate Enron-kind scandals have finally alarmed for paying more attention to fraud as an evil, but omnipresent and natural phenomenon in human lives[5]. Risk associated with fraud and misconduct have evolved into generally accepted kinds of risk closely linked to market and antifraud environment became much more characterized as *proactive prevention* than as compliance driven identification and prosecution of partial incidents.

As indicated above, the issue of deterring fraud is not anything new in the post-Enron era, however historically it only enjoyed much less attention than it enjoys now, when it was brought to light of public interest. Many independent professional bodies and experts, usually linked to the world's leading advisory and public accounting firms, specialized in this issue, build a high reputation and enjoy happy blossom of their business in recent years[6]. The accumulation of professional experience and reputation of

[4] A study conducted in insurance industry has shown that for every dollar invested in antifraud programmes, the return on investment was nearly $7. (Insurance Research and Publications, 1996).

[5] As indicated by the heritage of major fraud cases in recent years, a single fraud-related failure can result in a multibillion-dollar loss. In fact, a 2002 study of 663 fraud cases suggests that fraud can cost roughly 6 % of a company's gross annual revenues. This figure, when applied to U.S. 2002 gross domestic product, means a fraud-related loss around $600 billion for U.S.-based companies in 2002, which is about $4,500 per employee. (Association of Certified Fraud Examiners: "2002 Report to the Nation on Occupational Fraud and Abuse" at www.cfenet.com).

[6] The world's fraud fighting is supported by many worldwide organizations, such as Transparency International, or especially – the Association of Certified Fraud

these bodies allows them to seize the great business opportunity, meeting the market demand for independent expert advice, investigations or assessments on various business issues relating anyhow to fraud. These services (or forensic audits) usually relate to issues such as advices on creation of efficient antifraud programmes to businesses, governments and other various bodies, investigations of fraud's financial impact in various companies, proving bribery, providing expert assessments during the major business court disputes, etc.

1.2.1. Fraud…What Do We, in Fact, Mean?

When asking different people about what does the term – fraud – mean, every one of them would probably respond differently, according to each one's personal experience[7]. However, when using the word fraud throughout this paper, we are usually meaning one or more of the following corporate reporting-related categories:

- **Fraudulent financial reporting**
  Reporting in a way deliberately distorting the true picture – usually it involves earnings management, overstatement of assets or understatement of liabilitites (see chapter 3.2. of this paper)
- **Misapropriation of assets**
  Wide range of activities can fall within this category, such as pure theft, embezzlement, payroll fraud etc.

Examiners (ACFE) The ACFE is the world's premier provider of anti-fraud training and education. A leader in the global anti-fraud community, the ACFE has over 30,000 members, sponsors more than 100 chapters worldwide and provides anti-fraud educational materials to over 100 universities. Certified Fraud Examiners (CFEs) on six continents have investigated more than 1 million suspected cases of civil and criminal fraud. Together with our members the ACFE is reducing business fraud world-wide and inspiring public confidence in the integrity and objectivity within the profession. To learn more, please visit www.cfenet.com.

[7] Fraud, as defined by Black's Law Dictionary, is *"An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right; a false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury."*

- **Improper disposal of expenditures and liabilities**
  Any hidden influence of disposal with company resources is meant here – the most frequent example of this would be bribery with respect of company expenditures.
- **Illegitimately obtained revenues of assets, illegitimately avoided expenses**
  Here we mean any case of fraud commitment against employees or third parties. Tax fraud could be the typical case.

1.2.2. Example of a Company Antifraud Action Framework

In designing an efficient antifraud company framework, the stressed issues should be *prevention* and *fraud detection*. An example of a general framework for companies to be used in designing their internal audit role in antifraud efforts, developed by one of the major public accounting firms, is provided in its basic concept issues in the following box (PwC 2003B):

The framework defines 10 steps to be considered in the development of an effective internal audit antifraud action plan*:*

1-Anticipate Questions and Manage Expectations
From the management, external auditors or from the audit committee the internal audit should expect basic questions about the identification of the company's fraud and reputation risks, about the procedures to prevent and to mitigate them.

2-Assess Existing Antifraud Programmes and Controls
Almost every company already has some antifraud programmes, but their efficiency and ability to target the right issues should be examined.

3-Secure Management and Audit Committee Sponsorship
The antifraud audit department should ensure that the objectives and benefits to the company of the internal audits are well communicated to the management and to the board.

4-Assemble Fraud Expertise Within Internal Audit
The internal audit should ensure that a high level of experience and skills is maintained within the team to feel comfortable about the efficiency of their actions.

5-Organise a Fraud and Reputation Risk-Assessment
Instant revaluations and reassessments of the up-to-date risks are crucial for the internal audit to perform the right work.

6-Link Antifraud Activities
While stressing the most relevant issues to be addressed, the internal audit should as well ensure that no inadequate resources are dedicated to control activities relating to remote risks with a low likelihood to occur.

7-Evaluate and Test the Design and Operating Effectiveness of Controls
The design and operating effectiveness should instantly be challenged, taking in mind the possibility that the management might seek to circumvent or override controls intended to prevent or detect fraud.

8-Refine Audit Plan to Address Residual Risk and Incorporate Fraud Auditing
The internal audit should be designed to address the operating effectiveness and the possible override of those controls identified to mitigate the various fraud risks.

9-Establish a Standard Process for Responding to Allegations or Suspicions of Fraud Misconduct
Anyone who feels to have any fraud suspicion should be informed about the way how he can report his suspicion without the fear of receiving notice.

10-Remediate and Prevent Recurrence
Any incident should be appropriately punished, the resulting losses should be recovered and learning from the incident should improve further controls.

1.3. The Modern Definition of Internal Control

The definition of the term internal control, or internal audit, naturally means different things to different people running different businesses. The U.S. most broadly accepted framework for internal control, developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO[8]), defines the internal control as a process – effected by the board of directors, management and other personnel – that provides reasonable assurance regarding achievement of objectives in the following categories:

- Effective and efficient operations
  (operating performance, profitability, etc.)
- Reliable financial reporting
  (reliability of financial statements, information disclosure)
- Compliance with laws and regulations
  (relevant jurisdictions, company reputation, etc.)

Furthermore, the COSO identifies five components of internal control that combined together should serve for achieving the above objectives. These components are:

[8] To learn more about the COSO, please visit www.coso.org.

- Control environment
  (general nature and structure of controlling system)
- Risk assessment
  (identification and analysis of relevant risks and its management)
- Control activities
  (policies and procedures of controlling – how the control is carried out)
- Information and communication
  (information flows within the controlling process)
- Monitoring
  (oversight of the controlling process by management)

To provide one more angle of defining the internal controlling, we can mention the SEC definition of the purpose of the internal controlling as a providing a reasonable assurance, that: the company's transactions are properly authorized; that the company's assets are safeguard against unauthorized or improper use; and that the company transactions are properly recorded and reported.

1.4. Company-Specific Controlling

As apparent, the modern attempts to define the internal controlling process are very broad in sense. It nicely illustrates that no universal guidebook can be written for designing an efficient internal control system that would be cost-effective and met the necessary objectives.

1.4.1. Efficiency

The internal controlling system therefore has to be extremely carefully and wisely designed with respect to company-specific needs. Most probably, for a company that introduces an internal controlling system, it will hardly be possible to design the controlling system that would be 100-percent efficient and cost-effective from the first moment, so that it would not require any further adjustments and modifications. Instead, we could expect the controlling process to evolve through some of the phases outlined by COSO: "*Unreliable*" – "*Informal*" – "*Standardised*" – "*Monitored*" – "*Optimised*" or similar.

Professor Wallenstein from the Duke University (WALLENSTEIN, S., 2003) nicely outlines several attributes of an efficient internal control compliance program:

- Written standard and policies of corporate conduct are established;
- Responsibility for overseeing the compliance is well assigned;
- Standards and policies are effectively communicated to employees;
- A well understood system is designed to guarantee employees non-retaliation after reporting-violative conduct;
- Compliance is effectively enforced;
- Reasonable, sound steps are taken after detection of violations.

During the implementation of the newly introduced internal controlling policy, some new actions in order to meet the objectives of that policy are to be required from employees. Outlining, communication, disclosure and enforcement of a certain "code of conduct" certainly is a necessary step to achieve that. Up to certain degree, adoption of a specific code of conduct is even required by binding regulations[9]. I would like to stress the sensitivity of this issue in the light of the way, how it is in fact introduced, accepted and followed[10]. Designing a best-in-the-world policy, that would not be followed in fact, has no sense. Therefore nomination of very skilled managers with high level of practical management experience is essential for the designing and implementation of the correct internal controls policy, which would really work.

[9] The SEC's final rule entitled as "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" requires registrants to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the company has not adopted such a code of ethics, it must explain why. The NYSE and NASDAQ rules require the adoption and public disclosure of a code of a business conduct and ethics that applies to all directors, officers and employees and outlines specific topics that must be addressed. All these regulations even outline the basic topics that such standards must include.

[10] Mostly, the fact that every employee is familiar with his liabilities resulting from the code of conduct, is in practice usually secured in the following way: the code is transferred into the form of a questionnaire, where every employee has to confirm electronically or in a written form, that he has gone through it and that his actions for the confirmation period (a year) were in compliance with the code.

No matter how the new policy is in fact communicated to employees, its points must be realistic, understandable, and well, but shortly outlined, so that the reader in the reality of a working day can easily go through and remember. When reading it, or being instructed about it, there must be some internal incentives, so that the employee, although being informed about additional restrictions to his every-day life, can identify himself with the points and directly feel the benefits of the points to the company and to him personally.

Engaging the wrong people in the task of designing the policy and the way of its subsequent communication to employees can easily slide to wasting huge resources without any effect or with a contra-productive effect. Most of us sure have been subject to certain intra-company restrictive (administrative) procedures that took a large amount of time to comply with, although it was not in fact clear what was the sense of those procedures apart of taking the time. In effect, such attitude can easily lead to becoming a company informal culture to underestimate, or to completely ignore the rules that are generally accepted as useless waste of time, however important they might really be, just for the reason of improper communication.

1.4.2. Cost-Effectiveness

Regarding the cost-effectiveness of the internal control system, I would like to stress one more time the necessity for the boards to be extremely careful in selection of the people/company to be entrusted with designing of the controlling system. Although it is evident that significant amount of company resources have to be sacrificed on successful designing and functioning of the system, every single measure has to be carefully reviewed from the cost point of view, as in the huge organizations the impact of a single inappropriate measure can mean hundreds of man-hours to be wasted and/or numerous interruptions and slow-downs of the company core operations.

Similarly, a smooth level of communication between the external auditors and internal company executives regarding the testing of particular internal company processes should absolutely be maintained in order to avoid duplicative testing in areas where it is not completely necessary. Of course, the external auditor can place only a limited reliability on the work of others, however in many cases the external auditor can worthlessly re-perform significant level of testing, which can be easily obtainable from the management.

Last but not the least, significant attention should be paid to the company structure during the designing of the efficient and cost-effective internal controlling system. Often, the managements design a system that well meets the above-mentioned criteria for the core company in the country where it is incorporated. However, significant part of company's core business is often performed through subsidiaries throughout the world, which have their national and other specifics, which makes the general internal controlling system impossible or hard to apply[11]. Wishing to have the internal control efficient and cost-effective even with respect to these subsidiary companies, appropriate local adjustments to the generally introduced system usually must be done in order to succeed.

As we pointed out above, having the objective internal control system and properly disclosing its results becomes to be more and more beneficial to the companies, however the wealth it brings to the company is not unlimited and should always be compared with its costs both in their widest complexity[12].

1.4.3. Data Quality

Together with the recent corporate world's closer look on internal auditing, the quality of the reported intra-company data, which are crucial for management's correct decisions and for the verity of corporate reports, became a subject of a closer look, too. As we mentioned above, one of the objectives of the internal audit function is to help organizations to manage risk – financial, operating, regulatory etc. Poor data quality directly impacts the quality of corporate reporting and management decisions, and increases the organization's risk position. Well defined roles and responsibilities around

[11] Ignoring this fact can easily make the internal controlling system not only inefficient and costly, but it also can make it contra-productive. An internal controller interviewing a subsidiary-company employees according to useless checklist he obtained from the mother company in the United States, will not only become subject to low respect and jokes from the side of interviewed employees, he can also present a significant obstructive factor to their performance.

[12] In 2003, the Financial Executives Institute performed a survey of the selected companies' estimates on audit fees increase due to additional requirement of attesting to and reporting on the company internal controlling. The results were

the critical enterprise data with appropriate business controls, ensures not only high level background for operations, risk management and for the financial reports, but also ensures a clearer general accountability of the company.

According to some managers' opinions, consulting the particular way of performing the company's operations with the reporting people is an unnecessary action, as the accounting people are something like *"those, who we pay for reporting as we need"*. However, the modern reality clearly shows, that short consulting with a skilled reporting expert before the finalization of the design of a particular production procedure or before drafting a vendor agreement can save really huge resources for the company. The same holds for purchasing and securing maintenance of the intra-company reporting systems – underestimating the importance of this issue usually lead to huge direct and indirect losses.

Specifically, poor quality of the company data presents the following kinds of risk:

- **Financial Risk**
  Improper reporting about certain actions has direct impact on the tax treatment of certain operations. Also, corporations can experience lost revenue due to overpayments and lost discounts due to lack of consistency on payment terms.
- **Regulatory compliance and legal risk**
  Potential fraudulent activity can arise when issues occur with segregation of duties and roles related to access to vendor and customer data.
- **Operational risk**
  Internal controls related to roles and responsibilities in the organization may compromise regulatory compliance requirements. Process inefficiencies may also result due to inaccurate and incomplete vendor and customer data including an increase in manual efforts for inquiry and reporting functions.
- **Inaccurate management reporting**

quite amazing – survey predicted an increase of about 30 to 50 percent. (ANONYMOUS, 2003, p. 69).

Lack of visibility to actual payment and sales information to a vendor or customer can have significant impact on negotiating vendor contracts of monitoring contracts compliance.

- **Impact on customer service and customer satisfaction**
  Many corporations have records that do not allow the staff to act according to complete picture of the customer's business profile. Many direct and indirect costs can be incurred in duplicate/improper mailings to customers, slow responding to problems, etc.

1.5. The Sarbanes-Oxley Guidance

The soundest post-Enron regulatory legislative tool – the U.S. Sarbanes-Oxley Act of 2002 (see its summary and excerpts in Appendix to this paper) – has posed many new restrictions targeted on supporting the increase in the amount and scope of information disclosure about internal controls. Between others, it has established a requirement that the CEOs and CFOs explicitly evaluate and report on the effectiveness of specified internal controls over corporate reporting.

Indeed, the Act largely extends the obligations (and the personal responsibilities) of CEOs and CFOs with respect to published company quarterly and annual reports[13]. Based on the Title III, par.302 of the Act, and on Title IV, par.404 of the Act, the SEC has issued a management certification rule[14], which defines their particular obligations as follows:

- To certify that they have reviewed the report;
- To confirm that based on their knowledge, the report contains no untrue or misleading information;

[13] In this respect, Europe goes similar direction as the Sarbanes-Oxley driven United States. At the time of writing this paper, an EU Transparency Directive was due to be voted on in the European Parliament. The increased responsibility for the corporate reports is laid rather on boards, not on the top managements, similarly as the Sarbanes-Oxley does, requiring the boards to include in each report a "responsibility statement".

[14] "Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports", which became effective on August 29, 2002.

- To confirm that based on their knowledge, the report provides a fair view on the company financial position, results of operations and its cash flows;
- To confirm their personal responsibility over designing, establishing and maintaining disclosure controls and procedures, and that the report includes conclusions about the effectiveness of disclosure controls and procedures based on their evaluation;
- To confirm that they have disclosed to the audit committee and to the external auditors any significant deficiencies and material weaknesses in internal controls as well as any cases of fraud they could have discovered concerning any of the people engaged in the internal controls;
- To confirm that they have disclosed in the report whether, after their most recent evaluation, significant changes occurred that affected internal controls for financial reporting, and whether any actions were taken with respect to significant deficiencies or material weaknesses.
- To confirm that the external auditor has attested to, and reported on, management's evaluation[15].

In accordance with the general nature of the U.S. means of listed companies financial regulations, the exact wordings of the above-mentioned certifications were defined and are strictly enforced to be followed. On the other hand, no exact content of management's internal control report was defined. The SEC here respects the specific needs of any single company and rather stresses the principal fact that the report must be well targeted and processed in a manner that allows review by others. It states that the management should tailor the report to the company's circumstances.

1.5.1. Enforcement Issues

As apparent, the latest regulations put huge responsibilities with respect to internal controls to managements through the above provisions. Above we stated that between

[15] These provisions under Section 404 of the Act became first effective for annual reports for fiscal years ending on of after September 15, 2003, with the date for compliance additionally postponed to June 15, 2004. According to many surveys, companies' compliance with Section 404 is regarded as the most costly to comply with. For more reference on the costs of compliance with the Sarbanes-Oxley Act, please see (KATZ, M.D., 2003).
For more details on the wording of the Section 404, please see Appendix to this paper.

others, the regulations require corporate managements to evaluate and test the design of operating effectiveness of internal antifraud controls. This requirement represents a sea change: Compliance alone is insufficient, public registrants must now take affirmative, timely action to prevent and detect fraud and misconduct. In today's business environment, the organization that engages in misconduct may find itself liable on two bases – once for the commission of the offence and again for failing to have controls in place to prevent and detect its occurrence in a timely manner.

In the U.S., the Congress immediately approved tough civil and criminal penalties for those who would willingly certify a report with material misstatements of information or any significant omissions[16], being followed by many other national legislations worldwide. This is a very admirable point – while the misbehavior of company executives remains under the thread of strict civil and criminal law punishment, one more leverage for fraud prosecutors was added – through strict definition of responsibility for the corporate reports and introducing another punishment for breaking the principles for its contents.

Adding leverages for easy enforcement of law regarding the company executives misconduct is definitely a crucial thing. However, if we generally speak about finding new way for the corporate reporting in the name of securing transparency and accountability, such enforcement of complying with the principles of fair attitude to information disclosure is only one part of the solution.

It seems to me, that much more emphasis should be laid on more liberal, market-based solution – through promoting incentives for the managements to disclose information *voluntarily, based on their own will.* Many studies were already conducted, showing that a company, which discloses information about itself, generally gains from that disclosure, although it might not be evident from the first sight. In fact, even some

[16] The tough criminal penalties were approved also for auditors willingly act fraudulently with respect to their audit of corporate reports: one of the earliest post-Enron examples was the charge of Ernst&Young partner and his two colleagues of falsifying records and obstruction of a federal investigation, for amending and destroying critical audit records about the company NextCard.

of the companies with bad information to disclose, ended-up better-off after the disclosure of that information[17].

1.6. The Role of the Leading Public Accounting Firms

Above we explained, that the great personal responsibility was imposed on top managements regarding the effectiveness of internal controls and the overall quality of the resulting corporate reports. We explained that the management had to confirm, that according to its knowledge, that its reports contain no material misstatements. But how can the top managements get the proper knowledge of the efficiency of internal controls, when their businesses are so complex that the process cannot be in fact checked by one or few persons? To tackle with this issue, managements need to hire independent experts, which have the experience and skills to provide an independent check for him.

In a simple model, outlined in part 2.1. of this paper we illustrate the basic relationships between companies, investors and auditors. Although the model was designed mainly for approximation of relationships relating to external auditing, it can as well be applied to internal auditing and relating relationships between companies and auditors. The results of the model are in accordance with the current common real-life practice, whereas it explains companies' choices in selection of namely the world's biggest public accounting firms'[18] services for checking of the efficiency of internal company controls.

[17] It is not possible exactly to compare, but a there is a nice example in the book by R.H. Frank, which can support the rationality of such conduct: The case of frogs is provided there: The bigger the frog is, the lower the tone of its voice. One would say that being invisible in the evening darkness by the pond, small frogs would not make any sound - not to show that they are small. However, they do, to show that they are not even smaller … (FRANK, R.H., 1995).

[18] The soundest and the very biggest world's public accounting and audit companies are obviously the so-called "big four" companies (in alphabetical order): Deloitte&Touche Tohmatsu, Ernst&Young, KMPG and PricewaterhouseCoopers.
(After some initial waves of merging of the world's leading public accounting firms, for many years before the Enron scandal, the widely used synonym for the world's leading public accounting firms was the "big five", as the above-mentioned group of four included also Arthur Andersen. One of the immediate consequences of the Enron collapse was the end of Arthur Andersen's, Enron's auditor's, worldwide operations. A lot of Andersen's people, and/or its entire local departments became parts of its former "big five" competitors and the "big five" became a "big four".)

It became a standard for the biggest national and international companies in whichever business, for the sake of their reputation, to hire the “big four” firms for providing audit, accounting, tax, consulting and similar services, although their fees are usually much exceeding the fees of firms with the same or higher professional qualities but insufficient reputation[19]. “*They are being audited or advised by any of the “big four” companies – than there should everything be all right.”* Even after the scandal of Arthur Andersen & Enron and other corporate scandals, the previous phrase above remains a generally widespread notion between investors and general public. As long as these companies (regardless how) maintain their leading-edge position regarding their professional reputation, companies competing for investors’ trust will have a rational reason for engaging the “big four” companies for audits and other services – and to disclose that they do so.

1.7. External Auditor’s Attestation

We will devote a significant amount of attention to various principal issues related to the post-Enron review of external auditing principles in chapter 2 of this paper. Before that, in this subchapter we will take a brief look at selected issues relating to internal audit.

1.7.1. Two Problems of the pre-Enron Attitude & the Expectation Gap

[19] It is worth to note the fact that in recent years, the worlds leading public accounting firms gained a unique role in influencing the current reform of the worlds’ generally accepted framework of corporate reporting, to which we devote our attention throughout this paper. Above we explained that the “big four” companies represent the world’s leading edge regarding their professional reputation. Nevertheless, these firms, as well as any other consulting firms, consist primarily of its individual people. These people are often rotating not only between the “big four” companies themselves (usually due to related salary-increase motivation). Regarding the more senior positions in these firms, certain professional relationships usually hold between these firms’ employees and the national and international standard setters and regulatory institutions. Often these relationships grow into the employment level, so that the ex-employees of the “big four” companies often become to work for standard setters and regulators and vice versa. (Robert Herz, a former IASB board member and a former PricewaterhouseCoopers partner, now chairman of the FASB, is a lighting example.) Due to that, the role of the “big four” player is indeed extremely strong, much stronger than generally assumed. In my opinion, this would be an interesting topic for further research, leaving it therefore outside the scope of this paper.

Historically, the consideration of company's internal control enabled the external auditor to plan the classical audit of financial statements and determine the nature, timing and extent of tests to be performed. However, the components of internal control were not tested in required depth in order to assess their quality. In other words, during the audit by an external firm, many crucial kinds of information were just accepted by auditors as "from above", and their further testing was outside of the scope of the audit engagement. Basically, with a notable amount of simplification, the unqualified auditors opinion was finally built on the principle as follows:

A) *What we checked was all right – in our archive we have solid amount of sophisticated test records to prove it.*

B) *Some of the issues were checked by the management itself and in our complex tests we related on the information provided by management. We did not re-check these issues, as the scope of our works and our audit fees stipulated in our audit agreement (engagement letter) do not cover works on such re-checking. Should there be a trouble, it would not be any of ours. It would be a trouble of management that gave us the wrong information.*

There are two major problems about this logic: First, should there really be a problem with the correctness of information provided by management to external auditors, according to pre-Sarbanes-Oxley legal arrangements, it would be a problem of managements indeed, but no clear personal responsibility of CFOs and CEOs would apply. In other words, should there be a trouble, neither auditors nor the management would be clearly responsible[20].

Second, for the investing public, and for some regulators, point B) of auditors' principles was not sufficiently clear. A notion went widespread, that if a company engaged some of the world's leading public accounting firms to audit it, and pays it an audit fee that usually greatly exceeds the fee of local audit companies, no single problem can be omitted as these companies cannot afford to underestimate anything. That is true, but the public accounting companies try to behave cost-efficient as they are

[20] As we describe in chapter 1.5., Sarbanes-Oxley Act of 2002 clearly defined the management's responsibility over the internal controlling.

businesses that need profit as everybody else (see chapter 2 for further analysis), so they do not perform any work outside of the scope agreed under the audit engagement and its fee arrangement. And the standard scope of pre-Enron audit engagement did build on notable amount of reliance on management without further testing.

In fact, the auditor was only required to gain a sufficient understanding of a company's internal control to plan the audit and determine the nature, timing and extent of tests to be performed – those directed at components of internal controls and other types of tests. The auditor's assessment of the control risk influenced the extent to which testing of internal control was performed. Since there was no requirement to disclose the nature of testing, investors may have assumed more testing of internal control than was actually performed.

As to the core of the second problem, the investors and public were simply overestimating the "guarantee" of the label *"audited by the big-four company"*. This occurrence is often denoted by the post-Enron language as the "expectation gap" – a gap between the reality and investors' and public expectation about the depth of audit assurance. In some cases, investors believed that the unqualified audit opinion on the financial statements also indicated that the company was well controlled by management – and this did not necessarily have to be true.

1.7.2. Auditors' New Duty

Sarbanes-Oxley established the Public Company Accounting Oversight Board (PCAOB[21]), in order to regulate the U.S. public auditing firms. The PCAOB's auditing standard No. 2 requires independent auditors to evaluate and test the design and operating effectiveness of the internal programmes and controls intended to mitigate the risks of fraud. This evaluation must assess *"the adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit…"* (PCAOB, 2004, par.24). Moreover, the Standard mandates, that the independent auditor cites, at minimum, "significant deficiency", and quotes that it is a

[21] To learn more about this organization please refer to www.pcaobus.org.

strong indicator of a material weakness if he determines the internal audit or risk assessment function to be ineffective.

Basically, the PCAOB requires independent auditors to evaluate the fraud-related activities of an internal audit function on an annual basis. If this evaluation finds an internal audit function to be deficient, the external auditor must, at minimum, issue a finding of a significant deficiency to the audit committee. He also must issue an "adverse opinion", if they conclude that the deficiencies rise to a material weakness.

Management's assertion and the related auditor's report on internal control over financial reporting for U.S. public companies created much greater transparency for investors about the effectiveness of internal systems and processes. In order to attest to management's assertion on the company's internal control, auditors need to evaluate the design and operating effectiveness of internal control over financial reporting and express an opinion whether management's assertion about the effectiveness of internal control is fairly presented. Of course, increasing of the scope of works within a standard audit engagement means an increase in the audit fees, however, the direct costs ultimately borne by investors will surely be offset by the indirect gains from rebuilding their trust in the quality of management's financial reports.

According to the common expectations and in the light of corporate transparency, the independent auditor attestation on the effectiveness of internal controls will have much greater scope of objectives than the objective of reliable financial reporting required by the Sarbanes-Oxley. Hand-in-hand with the growing complexity of the global economic environment, monitoring information will be more and more difficult and costly. Investors are therefore likely to regard such expanded control assurance favorable, especially when provided for objectives considered vital for specific industries[22]. Access to independent attestation on the broader range of management processes and representations will result in greater transparency and better protection for investors and others who provide the company's operating capital.

[22] For example, in the retail industry, the effectiveness of the supply chain management programme is both strategically and financially critical. Assessment of an independent company's team that specializes and has experience with this industry processes, can provide a great value for shareholders. Similarly, a diversified financial services company can provide its stakeholders with

1.8. The Financial Sector: A Special Case

The recent corporate failures that enforced the massive wave of public calling for corporate reporting framework review did not emerge only on the field of classical business corporations, but well concerned also the financial institutions[23].

Typically, as documented by many surveys[24], the financial services industry traditionally has to cope with even significantly more incidences of economic crime than other industries. This industry is an obvious target for lot of fraudsters, given the significant level of physical assets held and access of individual employees to huge financial transactions. Therefore, designing of efficient structures for internal controlling and overall fighting of misconduct and fraud in the financial sector institutions has to consider even more seriousness and specifics than doing the same in the standard business sector.

1.8.1. Strengthening of the Internal Controlling

Regarding the above, such huge challenging of the pre-Enron internal control systems together with the adoption of the Sarbanes-Oxley Act, updates of valid banking regulatory guidelines, new SEC rules and various stock exchanges' corporate governance requirements, have put a considerable pressure on financial institutions and their executives to ensure the effectiveness of internal audits.

During 2003, the U.S Federal Financial Institutions Examination Council (FFIEC[25]), the umbrella organization for U.S federal bank regulators, issued the revised

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significant value engaging an independent professional with assurance about controls on its compliance with certain applicable laws and regulations.

[23] Please recall the recent Enron-kind scandals of certain banks and insurance companies, such as ING Barings, Merill Lynch etc.

[24] For example, the "2003 Economic Crime Survey" scales the incidence of fraud by industry. From 12 industries regarded, the first two places were granted to banking and insurance industries. For more information, please refer to (PwC, 2003C).

[25] The Council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial

interagency policy statement on “The Internal Audit Function and its Outsourcing” (ANDERSON, R.J., ALBRIGHT, D.R., 2003), which outlines the crucial issues of financial institutions’ internal auditing, according to the Council. The main areas of concern can be in short summarized into four key areas as characterized below. Comparing to the similar issues that relate to the internal controls of standard business enterprises, here their ordering and importance on the principles-based approach are highlighted with much greater emphasis:

- STRUCTURE – The lines of intra-company controlling communication must be well designed, so that the internal audit function pertains its independence and objectivity. Specifically, assigning of a chief audit executive is recommended, reporting directly to the audit committee. No approving, designing or implementing of any operating policies by the internal audit executives should be allowed.
- MANAGEMENT – Hiring of the skilled personnel with specialist knowledge and sufficient ethical credit is defined as the chief audit executive’s greatest task.
- SCOPE – The audit committee should at least once a year review the internal audit plan in its complexity and timing.
- COMMUNICATION – The communication between the boards and internal auditors must be strongly enhanced, so that the both sides are well aware of significant issues. Ideally, the chief audit executive should regularly attend the boards’ meetings. In addition, channels for receiving, documenting and resolving the confidential and anonymous employee concerns about questionable or suspicious matters.

1.8.2. The Impact of Basel II

institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) and to make recommendations to promote uniformity in the supervision of financial institutions. To learn more, please visit www.ffiec.gov.

In January 2001, the Basel Committee on Banking Supervision[26] issued its first consultative paper, which was subsequently revised in the second and third consultative paper, for a New Basel Capital Accord (called Basel II). This standard, once finalized[27], will replace the currently valid Basel Capital Accord of 1988, ruling for the G10 banks' capital adequacy[28]. The current drafts of the Accord build on three mutually reinforcing pillars for evaluation of various risks that banks face. Pillar 1 updates the requirements for the banks' minimum capital adequacy, Pillar 2 prescribes the internal capital assessment and the supervisory review process and Pillar 3 deals with public disclosure requirements[29].

Obviously, the discussion of the impacts of the capital adequacy provisions of the Accord does not fall into the scope of this paper[30]. However, apart of these technical provisions (concentrated mainly in Pillar 1), Pillars 2 and 3 of Basel II contain many provisions of indeed high relevance regarding our point of interest.

Pillar 2 – Enhanced Internal Controls

In this chapter's discussion of reviewing the financial corporate world's internal control mechanisms and tools, we should stress especially provisions of Pillar 2. It addresses the key principles of supervisory review, risk management guidance and supervisory transparency and accountability with respect to the banking risks based on

[26] The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has about thirty technical working groups and task forces which also meet regularly. The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems.

[27] The Basel Committee intends for the new framework to be available for implementation in member jurisdictions as of year-end 2006. The most advanced approaches to risk measurement should be available for implementation as of year-end 2007, in order to allow banks and supervisors to benefit from an additional year of impact analysis or parallel capital calculations under the existing and new rules.

[28] This document, so-called Basle Capital Accord, sets down the agreement among the G-10 central banks to apply common minimum capital standards to their banking industries, to be achieved by end-year 1992. The standards are almost entirely addressed to credit risk, the main risk incurred by banks. The document consists of two main sections, which cover (a) the definition of capital and (b) the structure of risk weights.

[29] Entire wordings of the pillars, Basel Accord's historical developments, updates and many useful information can be found e.g. on internet pages of the Bank for Financial Settlements, www.bis.org.

[30] Lets only note, that according to recent European Commission's study, the general impact of Basel II proposals on the financial sector should be a small reduction in banks' capital requirements and thus a small stimulus to the economy.

(four) general principles outlined in significant detail. The internal controls are stressed as one of the main features of the banks' correct process for assessing their capital adequacy in relation to their risk profile and strategy to maintain their capital levels.

Regarding the proper internal controls, the necessity for the bank to ensure an independent review is stressed, regardless if secured from internal or external sources. *"The banks' boards of directors have a responsibility to ensure that management establishes a system for assessing the various risks, develops a system to relate risk to the bank's capital level, and establishes a method for monitoring a compliance with internal policies." (Pillar 2, par.744 at* http://www.bis.org/publ/bcbs107.htm). According to the Accord, the bank should conduct periodic reviews of its risk management process to secure its integrity, accuracy and reasonableness. Five areas for considerations are defined:

- Appropriateness of capital assessment process reflecting the specific the nature and complexity of the bank's operations;
- Identification of large exposures and risk concentrations;
- Accuracy and completeness of data inputs and into the assessment process;
- Reasonableness and validity of scenarios used in the assessment process;
- Stress testing and analysis of assumptions and inputs.

Pillar 3 – Disclosure Requirements

Regarding banks' disclosure requirements, through the various powers of the national bank regulators, Basel II aims to encourage the market discipline by developing a set of disclosure requirements, allowing any market participant to access and assess the key segments of the information about the banks' processes that lead to its capital adequacy determination. These disclosures are even required on the semi-annual basis, subject to certain exceptions[31]. Basel II's wording also minds the possible conflict with the broader disclosure requirements under the accounting standards as it stresses to be prevented. Authors of Basel II even intend to maintain an ongoing co-operational relationship with the accounting authorities in this field.

Specifically, under the provisions of Pillar 3, each bank should have a formal disclosure policy, approved by its board, that addresses the bank's approach to determining what disclosures are to be done and what are the internal controls over the disclosure processes. The disclosure areas are defined in considerable detail in the following scale:

- Capital structure;
- Capital adequacy;
- Risk exposure and assessment (credit risk, market risk, operational risk, equities, interest rate risk).

Finally …

Although the primary intention of the Basel II remains the regulation of the banks' capital adequacy, the widening of its scope in the above-mentioned directions has to be highly admired as (as surely noted by any reader) the general intentions are fully in accordance with the opinion of the majority of the world's specialist community on how to review the world's corporate reporting in order to prevent the repetition of Enron-kind mistakes. Regarding the particular tools of Basel II, although often running into significant detail, the principles-based approach is generally selected, which also has to be admired. Whether this approach is really correct, only the future can show.

[31] See par. 818 of the Pillar 3 at http://www.bis.org/publ/bcbs107.htm.

2. EXTERNAL AUDITING

In this chapter we will argue in accordance with author's below-supported opinion, that although the Enron-kind mistakes and the resulting consequences were huge, they cannot be regarded as a mistake of the basically wrong system of information assurance as they often are. They happened as results of insufficient reaction of the entire corporate reporting system in many areas, described in this papers' chapters, to the needs of the global business world that rushes towards irrespective of anything. As well as many of other components of the corporate reporting system, the pre-Enron auditor's role does not need a systematic change, but it needs to be reviewed with respect to the needs of investors in the modern business world – the system should be maintained as no system better was ever invented. Just the system's tools have to be reviewed and updated according to the modern needs. Some of that work was already done, some is still to do. Certain significant issues are discussed below.

2.1. Approximative Audit Services Model ©

In recent business world, a unique network of relationships between companies and investors with the significant role of audit companies was naturally developed. This network consists of many single relationships between companies, investors, auditors and many other players. Recent developments showed certain shortcomings of the above-mentioned relationship network in the current institutional system and the huge consequences of those shortcomings in the form of collapses of certain significant companies and the collapse of one significant audit company.

Currently we are fighting in order to mitigate the risks of repetition of the huge above mentioned shortcomings' negative consequences. Three main groups of "players" have to review their understanding of their roles in the network with specific respect to the role of the world's leading audit (public accounting) companies. In order to contribute to the closer understanding of the role of the independent auditing companies in the world's business, in order to identify the basic spaces for their moral hazard, and in order to come to certain conclusions described below, we will continue with going through a simple microeconomic model, designed for this purpose.

The model does not have the ambition to tackle all the problematic issues that arise during the complex real-world interactions between the real-life business players[32], nor does it have the ambition to provide a full explanation of what went wrong in Enron or elsewhere. Its ambition is to provide arguments in the name of the current system of assurance of company data by private audit companies, as the system generally has all pre-dispositions to work well as needed by investors and companies.

The main characteristics of the behavior of three basic groups of players (defined as companies, investors and auditors) are provided. With respect to the intended simplicity and ease of understanding, and with respect to the scope of this paper, the model describes these transactions based on quite restrictive initial assumptions. As already indicated, these assumptions were selected in order to keep simple but true. Author believes that in none of the assumptions regarding the individual players' motivational factors, any significant difference from the real-life world was allowed. In fact, the assumptions were selected as the strongest determinants of participating players' approximative behavior according to the author's knowledge, so that the model's simplicity should not in any significant way harm the correctness and applicability of its conclusions.

The model is provided below:

2.1.1. General Assumptions

There is a simple world of three interacting groups of entities. First, there are hundred companies registered on the stock exchange (companies), which are reporting information about themselves to the second group – a million of investors. Also, there is a third group of five similar high-reputation public accounting firms (auditors), which

[32] As stated above in the text, the basic ambition of the model is to tackle the basic, principal issues. For example, only two principal sources of conflict of interest are analyzed. We are of course aware of much more conflicts of interest that the pre-Enron system gave space for. However, the model cannot target all of these issues in sufficient detail, so the particular issues are further analyzed in the discussion of further subchapters of this paper.

are hired by companies for providing audit services (assurance of the reported information). Auditors issue audit reports about the results of their work for investors.

Looking closer at the auditors' personnel structure, we assume that auditors are employing smart people of the two types that work together in audit teams: the experienced and the inexperienced. Let's assume, that the amount the auditor has to pay to its experienced staff is ten times higher than the amount he has to pay to its inexperienced staff.

Investors dispose of a limited and fragile good – their trust, which they allocate to companies. Investors have certain short-term information barriers, which do not allow them to gain trust in companies' reporting otherwise than based on the assurance reports issued by auditors.

Naturally, investors do not trust the companies. The only instrument that convinces them about the verity of disclosed information, and that therefore governs the allocation of investor trust, are the audit reports. The more investors believe in the correctness of auditor assurance about the verity of disclosed company information, the more trust they allocate to the company. Their trust to the company therefore depends on their trust to the quality of the audit report, which is determined by their trust into the quality of audit services rendered to the company by the auditor.

Due to the above-mentioned investors' short-term information barriers, they are not able to assess the audit quality directly. The only indicator of audit quality, which they have access to, is the reputation of auditors.

The companies, auditors, as well as investors are maximizing their utilities:

2.1.2. Companies' Utility

Companies' utility is increasing in the level of investors' trust allocated to them. The level of the allocated investors' trust is increasing in the quality of audit services rendered to that company as according to investors' opinion.

2.1.3. Auditors' Utility

Auditors' utility is increasing in the profit they achieve, which is obviously determined by the amount of dollars they charge to companies for audit services minus incurred costs.

2.1.4. Investors' Utility

Investors utility in our model is simply defined as increasing in the only factor – the correctness of allocation of their limited trust to particular companies based on the only source of accessible information – auditor reports. The more correct allocation, the better.

2.1.5. Audit Quality

The real audit quality (which investors cannot directly measure) is an increasing function of the total amount of hours of auditors' employees work, and of the percentage of those hours performed by the experienced auditors' staff.

2.1.6. Information Barriers In the Long-Term

Above we defined the information barriers of investors to be of a short-term kind. However, in the long-term (years), the information barriers fall and the natural relationship between the auditor's reputation and the quality of services he renders holds, so an auditor providing low-quality services or performing any kind of moral hazard, cannot infinitely maintain a good reputation.

2.1.7. Auditors' Revenues

Fees, which auditors charge to companies for audit services, are being fixed beforehand. The strongest determinant of fees is the particular auditor's reputation (the higher the reputation, the higher the agreed fee).

2.1.8. Auditors' Costs

Costs incurred by auditors are crucial to the analysis. We will further analyze only the costs, which are incurred by the auditor as for each single audit engagement, not i.e. as for the entire fiscal year. For simplicity, let's assume that the only costs incurred by auditors are the accumulated hourly wage costs of its experienced and inexperienced staff in the audit team for each particular audit engagement.

The total costs incurred during the completion of each audit engagement are therefore increasing in the amount of total hours spent by the audit team on each particular engagement and by the percentage of those hours of work performed by the experienced staff.

2.1.9. The First Space for Moral Hazard

Given the auditor's initially high reputation, in order to support the reputation the best way possible, each audit engagement should be done in great detail, so that many hours would be spent on the engagement with high contribution of working hours performed by the experienced audit team members. Doing the audit engagement this way means higher costs and lower profit and related utility in the short-term, but high and prevailing contribution to the long-term utility via supporting the reputation – the only primary source granting auditors' revenues.

However, the space for moral hazard of auditors' managing staff is obvious. The auditors know that the main factor, which is in fact securing their revenues, is their reputation. Therefore, in the name of increasing the short-term profit on certain audit engagements, the managing audit staff lacking its moral and ethical integrity can easily slide to a free ride on the reputation created by the hard-work of its predecessors, scamping the audit engagement with insufficient hours of work spent, with low participation of experienced staff, or with both.

2.1.10. Auditor Selection Issues

As indicated above, in the real-time decision-making process, companies maximizing their utility do not select their auditor according to the assumed audit quality, but according to the major criteria – the auditor's reputation in the eyes of investors.

Let's remind that we are in a simple world of five similar auditing firms having high reputation, so the rational companies competing for investors' trust are not seeking any other auditors apart of those five included in our simple world.

But which of the five firms to choose? They all have similarly high reputation, so this criterion is insufficient. To tackle this issue, we will introduce a new variable - willingness of auditors to deliberately ignore the critical findings about the verity of companies' reports in writing their audit opinions, which are subsequently disclosed to investors.

We will assume, that each company has some shortcomings in their reports that it wants to keep hidden to investors' eyes. Let's also assume, that any of the auditors are technically able to find out the most of those shortcomings in their entirety. There can be several attitudes of auditors to such shortcomings, which directly influence the companies' choice in selection of auditors – see the next subchapter.

2.1.11. The Second Space for Moral Hazard

The easiest way for the auditor how to treat such shortcomings would be not to communicate them at all with the company and simply write down the objections in the audit report for investors. This definitely is the most honest and correct way of doing the auditor's job – zero willingness to deliberately ignore the critical findings about the verity of companies' reports. However, such action is pretty undesirable for the client company as it would mean a certain loss of investors' trust into that company. Consequently, it would threaten the auditor's re-engagement by that company in the next periods. This solution is undesirable for the company, as well as for the auditor, so it is unlikely to happen frequently.

When considering the opposite easy way of treating the shortcomings – here we mean the case of high willingness to deliberately ignore the critical findings about the verity of companies' reports – we come again to similar space for auditors' managements' moral hazard as the one already outlined above. Auditors may increase the likelihood of being hired by the particular companies and subsequently increase their short-term profit by giving signals of increased will to ignore the shortcomings in their audit report. However, acting so, auditors perform the same free ride on their historically created reputation as the one outlined above – they are contributing to the loss of reputation, which in the long term costs them much more than the single profit increase from the single moral hazard.

Above we outlined the two extreme variants, none of which we denoted as the right one. However, there is a solution to this issue, which would most probably be followed by the auditors which do not want to lose customers, as well as they do not want to lose their reputation. After discovering the shortcomings, the auditor can communicate them together with the customer company and before issuing an auditor report for investors, he can provide the company with the advice and necessary time for their elimination. The adjustments done by the company in order to mitigate the shortcomings objected by the auditor can be well documented in the auditor report, which would certainly be appreciated by the investors as they will see signals of improvements and that the audit was actually really helpful to them. In effect, only those adjustments that the company is unwilling or unable to eliminate, will finally appear in the auditor's critical part of the report.

2.1.12. Conclusions

From the above we can conclude, that such a system of relationships between companies, auditors and investors can easily work, all subjects converging to their optimae.

Companies, which have the will to disclose the information correctly, gain the desired trust of investors and will be generally well-off. Those, which lie in their reports to investors, reach only poor utility levels as the investors will not trust them – they will most probably find auditors' objections (of course not all of the above-mentioned shortcomings are possible to suddenly mitigate) against the untrue points in their statements in audit reports.

Note, that in our model there is no difference for companies in whether they disclose information, which means good or bad news for investors. The more verity in the disclosed information, the better for the companies' wealth, regardless whether the information is good or bad.

In our optimal (and fully rational, therefore likely) case, all of our five auditors are reaching approximately equal levels of profit, as they all are well aware of the fact, that if they want to maintain their high utility levels in the long-term, they have to consider the long-term effects of their actions. For that reason they efficiently prevent any kind of moral-hazardous actions of their employees and in order to support the trust into their assurance, they are trying to render services of the highest possible standard.

Should any auditor repeatedly try to free ride on the level of his high reputation, the loss of reputation would inevitably come as a direct consequence of the fall of investor information barriers in the long-term. We defined the reputation of our five audit companies to be similar, so any grater loss of reputation means a loss of interest of companies to engage such an auditor, which stands him completely out of the game. After such an occurrence, the amount of auditors would shrink by one to four, the engagements previously done by the fifth (finished) auditor would be spread between the remaining four, and the remaining auditors would try to prevent any misbehavior even more strictly than before, and the system would work without further disturbances.

We have clearly shown, that the system of assurance of the information disclosed by companies by the independent, but private and business-oriented audit companies under the current institutional framework has no systematic mistakes that would from the long-term point of view need any systematic reform. There is no doubt that this market-based systematic solution involves less space for misbehavior, than any regulation-based system, not even with any kind of participation of state or any other regulatory institution instead of private audit companies. Under current system, any long-term misconducts of auditor companies costs them their reputation, and makes them go bankrupt. As they are aware of that, they try to prevent such behavior and in accordance with the needs of investors they try to behave indeed independently, providing really objective assurance of information.

2.2. Sarbanes-Oxley Revisited And Beyond

Above we outlined the notion that the current system of assurance of reported information by independent, business-based audit firms needs no replacement or review of its basic roots, as we proved about its main socially needful systematic components to be all right. Nevertheless, we also stated that the traditionally used tools of auditing system should be carefully reviewed in order to keep the modern audit able to provide the required quality assurance.

Above we also said that lots of work in reviewing of the system's tool has already been done, while still a considerable amount of work is yet to be done. In chapter 1.5. we introduced the Sarbanes-Oxley Act of 2002 and the subsequent SEC rules to be the soundest Post-Enron tool that appeared in the U.S. as the first and huge tangible step in reconstruction of the pre-Enron mistakes of corporate reporting. In this subchapter we will devote our attention to the Sarbanes-Oxley provisions relating to external audit services as they more-less represent the world-wide direction of the general reform of the auditors' role in the reconstruction of the corporate reporting system, not only its U.S. platform. We will therefore characterize the issues tackled by the Act, directly providing further comments on the particular issues.

2.2.1. General Intentions of the Act

Sarbanes-Oxley tries to prevent many particular possible conflicts of interest, which ensue from the pre-Enron framework of relationships between companies and auditors[33]. It mandates specific actions to improve corporate reporting, establishing parameters for how the key players, i.e. corporate managements, boards and audit

[33] We did not address the most of these particular issues in the basic model as the model addresses (for the above-mentioned simplicity reasons) the core principal issues only.

committees, internal and external auditors, analysts and other investment professionals, must interrelate.

Sarbanes-Oxley has imposed many restrictions and responsibilities on the company executives, which we already commented in part 1.5. of this paper. It has also established various new responsibilities for the boards of directors and their audit committees of the companies, including the appointment and compensation of the independent external auditors and overseeing of their work in order to support the independence of the external auditor from management. Moreover, the audit committee now must pre-approve all services rendered by the external auditor to the audited company to ensure, that any conflict of interest cannot take place and that the auditor's independent role is not threatened. Similarly, each audit committee must comprise independent directors, at least one of which meets the specified criteria for an "audit committee financial expert"[34].

Regarding the external auditors themselves, Sarbanes-Oxley builds on the devise of the 1934 Securities Exchange Act[35], reaffirming the necessity for the financial statement audit process and the need for the auditor to keep its independence from management. It establishes the obligation of the auditor to report directly to the audit committee and the scope of services that the independent auditor may provide to the company is restricted. Further, Sarbanes-Oxley extends the traditional scope of reported information that the auditors attest to include the newly required management assertions regarding the effectiveness of the company's internal controlling.

2.2.2. Audit Committee Relationship

As mentioned above, the function of hiring and firing auditors was shifted from managements to audit committees of boards of directors. The conflict of interest related that is fought here is obvious: If the management is the only entity responsible for

[34] The financial expert of the audit committee is defined in Section 407 of the Act – see Appendix to this paper. Similar requirements for the audit committee members' financial literacy are defined by the NYSE and NASDAQ.

[35] The 1934 Securities Exchange Act established the requirement that companies who wish to raise capital on the U.S. stock exchange, have to engage external auditors to provide independent assurance to shareholders on the fairness of the fairness of the reported financial information in accordance with the generally accepted accounting principles.

nomination and receiving reports from the auditors, and at the same time being the one actually controlled by auditors' work, there is a higher motivation for the auditor to act at the account of his reputation in the name of managements' current needs (see part 2.2. of this paper where the related space for moral hazard is analyzed closer).

The point of the Sarbanes-Oxley regulation is to separate the two above-mentioned roles as follows: management is the entity being in fact actually controlled, so it should be kept off the other function – hiring and firing of auditors[36,37]. This function was switched to audit committees, which consist of corporate boards of directors' selected members. The board, representing the interests of shareholders, has therefore the traditional power to nominate and oversee management, having the added leverage of nomination of auditors and having a unique access to the information discovered by them.

Regarding the reporting obligation to audit committees, Section 204 of the Act requires the auditors to communicate the following issues to the committee before filing the audit report with the SEC:

- Any accounting policies that were subject to auditors critical concern;
- Any alternative methods to actually used accounting policies that were discussed with management;
- Other material written communications relating to audit performed between the management and the auditor.

We have shown that responsibilities of the audit committees relating to external auditing services are huge. The Act nominates the Committees with hiring and oversight of auditors, establishing of an employee fraud reporting system. The Act and the NYSE

[36] The legislation namely states: *"Audit committee, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting)for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee."(Sarbanes_Oxley Act, Section 301 at www.sarbanes-oxley.com).*

[37] Of course, auditors and managements still maintain the close working contact during the audit engagements. However, the independent nature of their working relationship is strengthened through deeper involvement of the audit committee.

listing standards enumerate many other areas for which the audit committees are responsible, such as examination of financial statements, assessments of risks, etc.

For the audit committees, selection of the right people can mean a key to the success of improving the company's corporate reporting. And even for the best-selected board-members to ensure success in fulfilling their entrusted competency, it means huge requirements for their education. The initial and ongoing education of every audit committee member should therefore not in any case be underestimated and the audit committee should be remunerated well for its performance to ensure that the right people of the right qualifications are performing this crucial function. Similarly, frequent consultations of the audit committee members with the third-side independent specialist advisors is assumed to frequently take place.

2.2.3. Audit and non-Audit Services

In order to address another option for the conflict of interest, the Sarbanes-Oxley Act introduced the obligation for any services – audit and non-audit – that are provided by the auditing firm to the same company to be pre-approved by the audit committee[38]. Given that the non-audit services typically represent financial advisory or accounting services, the purpose of this regulation is obvious – the auditor must not audit its own work or the work of his colleague, which he daily meets in the lift or during the lunchtime at work.

What does it mean in practice? Assume the case of a company C, having the world-wide 2003 audit contract with the audit-company A. (A world-wide contract for audit services is quite frequent in practice of the international huge companies, so that the auditor A provides audit service not only to the (e.g. U.S.-based) mother company, but as well to all its subsidiaries around the world[39]). In practice it means, that when the

[38] According to the Act, the pre-approval policies must be disclosed to the public. The requirements are applicable to services provided by the principal auditor to an SEC-issuer audit client and its subsidiaries and to a registered management investment company.

[39] Given that, interesting situations often happen in case of the smallest subsidiary companies in distant countries from the mother company. Due to intra-company rules the subsidiary often cannot opt for any other audit firm and it has to use the same high-reputation audit firm as the mother. The audit fees paid by the small subsidiaries may easily reach the amount close to the yearly turnover of the subsidiary.

mother company or any subsidiary accepts the offer for services from the non-audit services manager of the audit company A, the services can be provided only after the audit manager communicates with the client company audit committee their pre-approval for the non-audit services to be provided (unless the service is a subject of any of the various defined exemptions).

With respect to the complexity and instant developments in the ownership structures, such as long-run mergers and acquisitions processes that are so typical for the current business world, the process of communication necessary for obtaining the required approvals often involve many confusions of all parties. Given the current time-management reality of the top managers on both auditor and client companies, the price paid in general for the current wording of the SEC rules S-O based provisions is considerably high.

It is however worth noting that the previous paragraphs should not according to the intention of the author be understood in a way, that the pre-approval provisions are unnecessary of even contra-productive. The notion that the author wants to express, is that the typical American "rules-based" handwrite can be felt from the hereby mentioned pre-approval provisions. Especially with respect to the complicated international ownership structures of many companies, a little more of the "principles-based" approach to the regulation of this issue could mean large savings on administrative procedures in many particular cases.

2.2.4. Pre-Approval Requirements

As stated above, any services, provided by the auditing firm, must be pre-approved by the audit committee of the client company[40]. The pre-approval policies, adopted by the audit committees, must be accomplished by any of the three following methods:

[40] For the SEC-registered companies, this requirement became effective on 6 May 2003 already. Services that commenced prior to that date that are now impermissible had to be concluded by 6 May 2004.

- The audit committee may establish a framework of engagement types that are subject to approvals on periodic basis, i.e. annually, based on stipulated policies.
- The committee may select the approach of approving each individual engagement on an as-needed basis prior to engaging the independent auditor.
- The audit committee may opt for a combination of the two approaches above.

In case of selection of any of the first or the third approaches, the stipulated policies must be developed in significant detail, i.e. descriptive as far as to the characteristics of particular services. The responsibilities related the pre-approving of non-audit services may not in any case be in any form delegated to managements. The generally strict formulation of the Act in this regard includes also one waiver. Certain services do not have to become subject to pre-approval of the audit committee, defined as:

- Services, which do not aggregate to more than 5% of total fees paid to the auditor in the fiscal year when services were provided;
- Services that were not recognized as non-audit services at the time of their provision;
- Services that are brought to the attention of the audit committee promptly and approved prior to the audit completion.

It is worth to note that even before the adoption of Sarbanes-Oxley, jurisdictions existed that restricted the scope of services that auditors were prevented to provide to companies under their audit. But the Act has significantly widened the list of such services[41].

In order to increase transparency, the Act introduced not only the obligatory disclosure of pre-approval policies, but also the disclosure of audit and non-audit services provided to the company in the proxy statements and annual reports. The basic specification of rendered audit and non-audit services, including the related fees, must be disclosed to investors. For easier investors' understanding, the services and fees information is to be divided into four categories as follows:

- Audit fees

  (core audit services and certain other closely related services defined in detail)
- Audit-related fees

  (employee benefit plan audits, internal audits, etc.)
- Tax fees

  (tax compliance, planning, and other ongoing tax advice services)
- All other fees

  (any services provided by the audit company, which are not mentioned in any of the above categories)

In a table below, we provide a few examples of services, that are generally prohibited to be provided by the auditing company to the audited company:

Table 2.1.: Few Examples of Generally Prohibited Services

Type of services	**Description**
Accounting	Preparation of accounting records, financial statements or the source data.
Financial information systems designing and implementation	Auditors may not design and implement the hardware or software systems relating to generation or circulation of financial information in the audited company.
Actuarial services	Any actuarial services relating to determination of amounts booked in the financial reporting systems.
Internal audit outsourcing	Generally, where auditor provides external audit, he cannot provide the internal one.
Management and HR functions	The auditor's role may include any services relating to operational or other management of the audited company, certain narrowly defined exemptions allowed.
Brokerage, investment advisory	Auditor may not anyhow affect the companies decisions regarding the company's investments and related activities.

Source: PwC (2003A), p.34

Similarly, few examples of services are mentioned below, which are generally not prohibited to be provided by the auditing company to the audited company:

[41] This resulted in restructuring of many world's leading auditing and consulting firms, separating their major business segments into separated entities.

Table 2.2.: Few Examples of Generally Non-Prohibited Services

Type of services
Advisory services relating to the internal audit
Due diligences, audits or review of the third parties for contractation purposes
Design and implementation of software of hardware systems, unrelated to financial information of the company
Non-recurring, one-off internal audits of discrete items, being not outsourcing in substance
Reviews of compliance with SEC or other similar rules
General advice regarding the company's business operations
Consultations and recommendations relating to risk management policies
Tax advisory services
Internal investigations

Source: PwC (2003A), p.36

2.2.5. Employment and Personal Issues

Regarding the possible impact of the constant outflow of senior employees from audit firms to their business client companies on auditor independence, Sarbanes-Oxley has shown the direction of current world trends in this area, strengthening applicable restrictions. Any member of the audit engagement team cannot be employed by the audited company in any of its financial reporting-related positions (such as chief financial, executive, or operating officer, director etc.) sooner than after one year after the termination of audit[42]of that company (cooling-off period).

Also, any partner of the auditing firm, who is directly responsible for audit on the particular company, cannot keep this responsibility more than five years, with the cooling-off period of another five years. That means, that in case of hiring the same auditor by the client company for more than five years, the responsible audit partners have to be "rotating"[43].

[42] According to the legislation, this one-year period starts as of the day when the issuer company files its annual report for the year, in which the audit service was provided. That means, that the nominal one-year cooling-off period can in fact be closer to the two-years' time.
Exceptions to this provisions also exist. I.e., this provision does not apply on audit team-members, who worked on the particular engagement for less than ten hours, or to those audit team members employed by the auditor for emergency or other unusual situation.

[43] This is what related to the rotation of the audit partners in one auditing firm. In the name of securing the auditor independence, many debates has been lead as well about the rotation of the entire auditing firms. These debated have usually no clear conclusions. Some say that the change of auditors is generally of negative influence, as it always takes considerable time for the new auditor to get the

Moreover, the Act goes even that far, that it regulates the way the audit partners are compensated: Typically, as mentioned on more places throughout this paper, audit companies often have more services to sell to their client companies apart of the audit itself[44]. As increasing the scope of provided services is in the best interest of audit companies, financial rewards of audit partners for successful selling of more services to the audited companies became a frequent standard. It might have happened, that the audit partner could in fact devote more of his skills to selling of services to the audited company, than to his core responsibility – the audit quality.

Although many provisions of the Act are regarded as rather revolutionary, with high contribution to the improvement of corporate reporting's shortcomings, its provisions relating to the personal employment are often commented as rather cosmetic, with only restricted influence on real change. Especially the finally mentioned partner remuneration issue: the interest of audit partners in selling other non-audit services to audited companies cannot be eliminated. Banning direct remuneration for such sales of services cannot prevent many ways of awarding the partners indirectly. After all, the public accounting firms generally represent the leading edge of specialist knowledge, providing advice to their clients on how to find indirect ways of solution of many similar restrictions to their businesses. No doubt that they will find the way on the filed of their own business.

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right orientation in the firms way of reporting. On the other hand, this opinion is often opposed by the opposite, saying that maintaining the same auditor for years is negative, because the traditional auditor is losing the ability of fresh critical look on the reports. As an example of the latter point of view, the Commission on Public Trust and Private Enterprise even recommends to consider change of the auditor one or more of the following conditions are met: "*(1) if the audit company has been employed by the company for a substantial period of time. e.g. over 10 years; (2) if one or more former partners or managers of the audit firm are employed by the company; (3) if significant non-audit services are provided to that company – even if approved by the audit committee (*COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003*, p.40).*

[44] As commented on previously, the scope of services that the auditor company provides to one client company, was for the sake of maintaining auditor independence significantly restricted in the recent time. However, many other services remained permissible and frequent to be provided by the auditor companies after the pre-approval or even without – such as the tax advisory services.

2.3. Other Issues

2.3.1. Auditors' Contribution to Fraud Fighting

In this paper we devoted significant space for the modern top-tier interest of internal auditing – the issue of fraud. Fraud however is a phenomenon that needs to be fought on every possible front, so also concerning the external auditing, modern regulatory institutional environment must be kept up to date.

As commented above, Sarbanes-Oxley in its paragraph No 302 requires the management to notify the audit committee and the independent auditor of any fraud, regardless its materiality, by any of company executives or by any internal control structure participant. We have discussed the increased responsibility of management over the verity of corporate reports in part 1.5. of this paper, and here the management's responsibility is further widened. (Whereas, of course, the overseeing responsibility of auditors and the assurance responsibility of auditors is also stressed). This increase and accent of responsibility of managements represents the overall trend of reforming the modern corporate governance structure with respect to the financial reporting issues, which was enforced by the recently revealed Enron-kind reporting shortcomings: the stress on the management's role of agents hired by shareholders, which should not act in any other interest than the interest of shareholders, bearing all the related responsibility.

Auditors should not in any case underestimate their role in deterring fraud using the frequently mentioned put-off of the following kind: *"Our role is only to assure the verity of the financial reports. Should they be built on fraudulent basis, it is none of our problems as we are not paid for spending time over this".* Although the auditor cannot bear the full responsibility over assuring investors that no fraud could influence the assured corporate reports, during the actual audit work he has so many opportunities to detect indications of fraudulent practices, which nobody else has. Therefore, if the corporate world wants to seize all the opportunities how to prevent Enron-kind occurrences, this channel should be utilized.

For the above-mentioned reasons, auditors should ensure that their staff is well trained to be able to notice indications of fraud, which they might meet during their communications with the company executives and during their analysis and testing of materials submitted to them by the company's executive and non-executive staff. Principles-based approach to this issue must be at maximum stressed over the superstructure of rules. Should the auditor detect any signals of possible fraud presence, he should immediately and fully report about his findings to the audit committee, so that the signals can be appropriately investigated and consequent actions taken. Auditors should also report to the audit committee in any case they come to the opinion that fraud prevention is not sufficient in any significant area relating to corporate financial reporting.

The above-suggested attitude can be after all understood from the SEC final rule regarding the management's certification of financial statements under par No 302 of the Act and from the fact that auditors are required to issue statements also on this certification. *"The certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles and is not otherwise limited by reference to generally accepted accounting principles. We believe that Congress intended this statement to provide assurance that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles."* (U.S. SECURITIES AND EXCHANGE COMMISSION, 2003).

2.3.2. Audit Opinion

The traditional output of every audit is a statement issued by the audit company, which is usually called "audit opinion". Traditional practice was based on the pass/fail model, i.e. apart of the basic facts about the company's accounting and the attached financial statements the audit report included only the phrase, that the auditor came to "unqualified[45]" or "qualified[46]" opinion (or the opinion is in fact refused to be issued) without further specifications of issues revealed and other information so valuable to investors.

Above we described principles that should be followed on the way towards better auditors' role in current corporate reporting and what in fact implicitly represent the public's belief what the auditors really do. Enron's investors were used for reading unqualified audit opinions for many years, the bigger was their confusion over its sudden bankruptcy. The problem was, that the wide public assigned more to the words of unqualified audit statements than what these words actually meant. This difference is often called the "expectation gap[47]" (as explained in part 1.7.1. of this paper).

Lots of work has already been done in order to reform the pre-Enron auditing standards. However, this process does not go fast enough and the expectation gap persists till today. The audit opinions still lack comprehensive information that would ensure accountability. In order to provide investors with sufficient information for their rational investment decisions, audit opinions must better respond to the market demands to say more about the health of the business. Today's institutional environment does not allow this expansion of the audit opinion, what in fact prevents investors from getting the required information in sufficient scope.

How to tackle the problem of expectation gap and insufficient information for investors resulting from audits? Instead of "moving the Mountain towards Mohammed", more rational attitude is for Mohammed to come to the Mountain: instead of trying to manipulate the public's expectations about the weak role audit in fact plays, better approach would be, with the support of standard setters and market regulators to try to increase the scope and responsibilities of audits, increase the information value of audit opinions and through that to close the expectation gap from the opposite side.

[45] I.e. that the consolidated financial statements give true and fair view and present fairly, in all material respects, the financial position of the company and that the results of its operations and cash flows are in accordance with International Accounting Standards.
[46] I.e. that the financial statements include certain material shortcomings.
[47] Please mind the difference between this term "expectation gap" and the term "audit lag", which denotes the time from closing of the client's fiscal year and the date of the audit report.

2.3.3. The Global GAAS

We discussed that broadening the information value of future audit opinions is one of the targets to which the review of current audit practices should lead. But for the same reasons as we provide in chapter 3 of this paper, it is strictly necessary to keep in mind the international harmonization of the regulatory framework for auditing and the resulting value of audit opinions – the development of truly global generally accepted accounting standards (GAAS) is needed.

In order to come to the really global GAAS, the best of the world's current global standards (i.e. U.S.GAAS, U.K.GAAS, etc.) must be taken, most likely under the leadership of the International Auditing and Assurance Standards Board (IAASB[48]), the group that establishes current ISA. The process has already started, but these efforts must go further and close international co-operation should be accelerated, so that it could come to successful end in the rational term.

2.3.4. Continuous Auditing

Taking a brief glance into a more distant future of auditing, specialist community concludes that more intensive concentration is necessary on auditing systems and processes that produce the information, rather than working for constantly increasing amount of hours and frequency on ex-post verification of the reliability of the output data.

Important step towards the above-mentioned direction of the continuous auditing is the ongoing concentration on quarterly reporting. Further shortages of the periods in which the market demands information about companies should inevitably lead to continuous auditing, of course only once the institutional framework will keep pace with the natural market-driven development. The ongoing assurance would therefore be provided on how the information is produced. Every user of that information would also know that the assurance had been provided.

[48] The IAASB is functioning as an independent standard-setting body in the name of the International Federation of Accountants and is charged with establishing high-quality auditing, assurance, quality control, and related services standards, thereby improving the quality and uniformity of practice throughout the world. It

Continuous auditing, hand-in-hand with the ongoing migration of reporting towards the internet (see chapter 5 of this paper) and the resulting increase in the tempo and frequency of information disclosure, offers two lines of improvements over the historical “static” system. In the first, internal line, it provides instant monitor for the company executives regarding the possible systematic mistakes and the determination of anomalies. In the external direction, investors greatly appreciate the instant access to verified information about the company. Moreover, the company can benefit from continuous audited reporting in many other ways: The potential customers want assurance over the critical information and when they find it, sales can increase. The banks with easier way of monitoring the covenants can borrow money more easy. It is not complicated to think about many more examples.

Once we conclude that playing with the cards open is beneficial, it is necessary to note that playing with the cards open means not to show the cards once a year or once a quarter, but it means leaving at least certain cards open on the table for the entire time of the game. And if we want the information in the cards to be assured, its assurers must be able to provide assurance instantly, not only once a year or once a quarter. Otherwise showing-off the unassured information in the cards has very limited sense.

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publishes guidance for financial statement audits in International Standards on Auditing (ISAs), and the International Audit Practice Statements (IAPSs).

3. ACCOUNTING STANDARDS

In theory, there is a worldwide-shared and supported notion, that cross-national differences in rules governing the format, scope and overall quality of disclosed corporate information presents a large and hard-to-overcome barrier to the motion of capital resources (capital liquidity) across countries. The positive effect, that harmonization of national accounting standards towards a united and indeed generally accepted and accounting standards would have, is therefore hardly ever impeached.

In practice, these days almost every country is using its own set of accounting standards and rules. Many versions of generally accepted national accounting principles (local GAAPs) therefore exist. These local standards vary one to each other in many regards[49] and so does the quality and usefulness of the information that is disclosed by the companies according to the respective rules.

Moreover, after the time of Enron and other huge corporate scandals, many important principles of the original accounting standards were seriously challenged. Enron had triggered a crucial mission for the world's accounting professional bodies – urgently to review the principal shortcomings of valid accounting standards and to eliminate them hand-in-hand with national accounting standards harmonization. The companies' financial reports should therefore converge to a united form of the following attributes:

- The investor at one side of the civilized world should be able to directly understand the financial report of the company doing business at the other side without any extensive additional cost for transformation of that information into the form he can easily follow;

[49] To provide some examples on the issues that vary the most across the different national standards, we can mention: The recognition of a *revenue* – which transaction is recognized as a revenue, in which amount and at what time. The distinction of a *liability* and of en *equity* – the line between the two largely varies as many instrument have both equity and liability features. The way of accounting of *share-based compensation* of the company employees – as already explained in the previous chapter, there is quite passionate discussion about the way of recording the employee stock compensation and each country's regulators have derived their own opinion of what is a correct treatment.

- The reports must provide a true and fair view of the company's financial condition, so that any interested person can rely on the verity of the reports without hiring a fraud investigator – the system of accounting standards must provide clear framework of definitions, so that everybody would have a clear idea of what exactly is included in any particular line of the report as well as he must be sure that there are no significant lines of the report anywhere hidden.

The mission is therefore to develop a set of global accounting standards, which would be accepted indeed globally all over the civilized world and which would not include the shortcomings revealed during the last few years. In the following subchapter 3.1. we will concentrate on the first of the two above-mentioned issues – on the convergence of national accounting standards into one generally accepted GAAP, while in subsequent section 3.2. we will concentrate on the latter issue - we will comment several of revealed shortcomings.

3.1. Convergence issues

"Because the world 's equity markets have become increasingly integrated and because countries tended to develop their reporting practices independently of one another, a pressing need now exists to bridge the international information gap." (OXELHEIM, L., 2003, page 37)

3.1.1. The Search for the Right Framework for Truly Global Standards

Similar as regarding the world's capital gravitation, traditionally two major "centres" competing for its accounting standards to become global exist: the American (U.S. GAAP) and the (rather) European (IAS - IFRS). In Europe, the process of creating global standards was recently approached very seriously. The outright adoption of International Financial Reporting Standards (IFRS) or convergence with these standards is now a truly global phenomenon that is rapidly gathering pace. The entire European Union, Australia, Russia, several countries in the Middle East and Africa and many other countries have decided to adopt a massive, mandatory switch to IFRS standards. On the other hand, the U.S., South Africa, Singapore or Malaysia are committed more to local standards convergence with the IFRS benchmark.

In other words, we have two prevailing accounting standards – as a starting point on the way to the truly global standards. Although the majority of basic principles of the two are the same, there are significant differences in details however. The basic difference between the U.S. GAAP and the IFRS is fairly much characterized by the historical conceptual difference between the two accounting standard systems. Whereas the American system is rather rule-based and there is a tendency to provide its users with instructions in significant detail, the IFRS is much more based on broader principles.

Although the U.S. GAAP "detailed" system seems to be more efficient in the natural world people's environment of high propensity to cheat, the recent corporate catastrophes indicate that somewhere might be a conceptual mistake. Critics often argue that the U.S. GAAP attitude provides the market participants with a cookery book for what to do via its detailed provision on what not in any case to do, blurring the actual principles by a forest of specific regulations. As the old proverb says, the forest often cannot be seen because of the trees. Nobody can grant that the more general – principles based – system will ensure that all the mistakes that lead to Enron and other corporate scandals will not be repeated, but there is a rational reason to assume that it can do more than the U.S. GAAP.

No matter whether the European patriots like it or not, the United States stock market (still) appears to work as the center of gravitation for the world's capital. However, as we already mentioned above, somewhere else in the world were done the most significant and tangible steps towards the development of global set of accounting standards embodied in the IFRS – in this regard the United States were overtook by the Old Continent. Although it may seem strange with respect to the criticized decisional heaviness of Europe's complicated administrative structures, Europe soon realized and started to act accordingly to the fact that if the European registered companies will report according to the truly global set of accounting standards, it would be much easier for them to raise the capital necessary for growth. *"If you need to raise capital, you* *have to go to the US"* no longer has to be true. In this field, the Euro-American long-run race for world's economic primacy had very positive influence and Europe seems to win this lap.

3.1.2. The IASB Efforts and the IFRS

At the beginning, we must say that considerable efforts were already done in order to achieve the global GAAP and all the process has moved far from the visionary stage. The global standards, whose development begun in 2001 by the IASB (International Accounting Standards Board[50], successor of former IASC – International Accounting Standards Committee), and which were called the International Financial Reporting Standards, have already been launched in first parts called IFRS 1 (First-time Adoption Procedures[51]), IFRS 2 (Share-Bases Payments[52]), IFRS 3 (Business Combinations[53]),

[50] The board includes 14 liaisons closely related to standard-setting bodies in Australia, Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States. This 14-member body is based in London and has a complete responsibility for all technical matters including the preparation and issuing of International Accounting Standards (IFRS) and exposure drafts, both of which must include any dissenting opinions of its members, and final approval of interpretations by the International Financial Reporting Interpretations Committee (IFRIC). The American "counterpart" of the IFRS's IASB happens to be the FASB – Financial Accounting Standards Board, being overseen by the FAF – Financial Accounting Foundation. The FAF has 16 trustees, 11 of whom are nominated by the constituent organizations (accounting firms and corporate community) and five of whom are elected by the FAF trustees. Both the IASB and the FASB has many times been subject of many accusations of conflicts of interest of its members. These people are linked to their "mother" organizations, what gave them the unique level of experience that allows them to co-author the world's accounting standards. On the other hand, their "mother" organizations have their own interests which are so hard to separate from "their" individual people's actions in the IASB of FASB. Anyway, no better idea of whom to entrust with the issue of designing the global accounting standards was not yet introduced.

[51] IFRS 1, First-time Adoption of International Financial Reporting Standards, sets out the procedures that an entity must follow when it adopts IFRS for the first time as the basis for preparing its general purpose financial statements.

[52] IFRS 2 deals with the concept of share-based payments, which is broader than employee share options provision. IFRS 2 encompasses the issuance of shares, or rights to shares, in return for services and goods. Examples of items included in the scope of IFRS 2 are share appreciation rights, employee share purchase plans, employee share ownership plans, share option plans and plans where the issuance of shares (or rights to shares) may depend on market or non-market related conditions.

[53] Under this standard IFRS 3, all business combinations have to be accounted for as acquisitions. It also requires to identify, value and subsequently track many intangible assets.
Specifically, goodwill is no longer amortized, but instead it has to be tested for impairment at least annually. Intangible assets acquired in a deal must be separated from goodwill, valued and recognized at the balance sheet.
Traditionally, markets have made the (often negative) judgments about the acquisitions different to the managements views. When the deal proposal was not popular, the share price was driven down. Under the IFRS 3 it will be clearer what assets have been bought, other than goodwill, and how they perform. In case they do not, a charge will appear in the P/L.

IFRS 4 (Insurance Contracts[54]) and IFRS 5 (Non-Current Assets Held For Sale and Discontinued Operations[55]).[56]

In short, the publicly declared objectives of the IASB can be summarized as follows:

- To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require accurate, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users to make correct economic decisions;
- To promote the use and rigorous application of those standards;
- To bring about convergence of national accounting standards and International Financial Reporting Standards to high quality solutions.

Although the feasibility of the tough timing of the operation is pretty often criticized, the European intention is to introduce the IFRS rules for all companies listed on the EU-member countries' stock exchanges as soon as from 2005[57,58]. "*The plan calls for all listed companies in the European Union to report their financial results using the International Financial Reporting Standards by 2005. This applies to approximately 8,700 listed companies, representing about 25 percent of the world's total market capitalization. If the United States, with approximately 52 percent of the world's market capitalization, and Japan, accounting for another 9 percent, were also to adopt these*

[54] This "first phase" standard on insurance contracts copes with the definition for insurance contracts and enables insurers to find a way towards IFRS. It should be stressed, that this standard is only a first gradual step for the insurance business in transition to IFRS (effective from January 2005). Further standards, i.e. on reclassification of some insurance contracts as financial instruments or revaluation of asset value, are expected: from 2007, a phase-two standard should be launched with target on measurement of contracts.
[55] The main objective of the IFRS 5 is to converge the as-of-now IFRS measurement and presentation requirements for non-current assets (held for sale). Affected companies will be required to have new balance sheet line items, both for assets for sale and associated liabilities.
[56] For learning more about the particular IFRSs please visit e.g. www.iasplus.com/standard.
[57] I.e. for the period beginning on or after 1 January 2004.
[58] This will be an important milestone in implementation of these standards all over the world, demonstrating, that they are not anything theoretical that would never come to practice. For example in Australia, the Australian Accounting Standards Board (AASB) has already decided to significantly review its standards to implement local standards according to IFRS principles starting as soon as from 2005. Already now, this decision not to implement the IFRS per se, but to go gradually, initialized a wave of critics calling for elimination of the remaining detail

IFRS standards, they would for all practical purposes become global. Any other country that wanted to participate in the global economy would have virtually no choice but to use IFRS." (DI PIAZZA, S.A., ECCLES, R.G., 2002, page 50).

The acceleration of the IASB's efforts towards the 2005 deadline and beyond is often criticized for overly speed of the process, which has negative influence on the quality of the standards issued and on the corporations' ability to comply with them[59]. On the other hand, there are many sound arguments supporting the IASB's aggressive timing: "*The efficient capital markets cannot tolerate a four-year delay for the publication of an over 600-page statement on derivatives or a 20-year delay for the publication of a standard relating to off-balance sheet, special purpose entities ... We believe, that the FASB and the IASB must give greater recognition to the need for timely responses to important accounting issues ... The balance in the process of adopting accounting principles between soliciting multiple opinions, on the one hand, and timeliness in response to issues, on the other hand, must shift towards timeliness of response" (*COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003*, pp. 42 to 44).*

Anyway, once the IFRS will be truly finalized and launched, indeed huge voluntary move towards IFRS can be expected. In increasingly competitive markets, IFRS allows companies to benchmark themselves against their competitors worldwide, and allows investors and others to compare the company's performance with competitors globally. Those companies that do not make themselves comparable, or that will be prevented to do so by a local legislation, will be in a disadvantage and their ability to attract capital necessary for value-creation will be considerably reduced – enough for thinking about joining the "IFRS community". Below we provide a comparative table, showing the different stage of attitude to IFRS from 2005:

specifics of Australian standards. Therefore it seems that the adoption of IFRS will anyway soon be enforced by the market itself.

[59] Especially, 2005 and 2006 will be the busy times for the first-time adopters of IFRS that are also U.S. registrants. These companies will have to tackle two changes at a time: They will need to reconfigure their budget and information systems to be IFRS-compliant. At the same time, they will need to ensure that their financial reporting controls satisfy the requirements of Sarbanes-Oxley and get auditor's confirmation.

Table 3.1.: Which companies will report under IFRS in 2005[60]?

Country	Listed companies	Private companies		Country	Listed companies	Private companies
Australia	*Mandatory*	*Mandatory*		**Japan**	*Prohibited*	*Prohibited*
Austria	*Mandatory*	*Permitted*		**Luxembourg**	*Mandatory*	*Prohibited*
Belgium	*Mandatory*	*Mandatory*		**Netherlands**	*Mandatory*	*Permitted*
China	*Prohibited*	*Prohibited*		**Norway**	*Mandatory*	*Permitted*
Czech Rep.	*Mandatory*	*Permitted*		**Poland**	*Mandatory*	*Permitted*
Denmark	*Mandatory*	*Permitted*		**Portugal**	*Mandatory*	*Permitted*
Finland	*Mandatory*	*Permitted*		**Russia**	*Prohibited*	*Permitted*
France	*Mandatory*	*Permitted*		**South Africa**	*Mandatory*	*Permitted*
Germany	*Mandatory*	*Permitted*		**Spain**	*Mandatory*	*Permitted*
Greece	*Mandatory*	*Prohibited*		**Sweden**	*Mandatory*	*Permitted*
HongKong	*Prohibited*	*Prohibited*		**Switzerland**	*Mandatory* *(IFRS or US GAAP)*	*Prohibited*
Ireland	*Mandatory*	*Permitted*		**UK**	*Mandatory*	*Permitted*
Italy	*Mandatory*	*Permitted*		**U.S.**	*Prohibited*	*Permitted*

Source: (PwC 2004, page 7.)

3.1.3. The Case of the United States

This chapter is to say that in Europe, a great deal of work towards the harmonization of the accounting standards was done. However, this is definitely not to say that the United States do not do enough in order to reform the local corporate reporting framework embodied it the U.S. GAAP, or that the U.S. regulators ignore the accounting standards mistakes of the pre-Enron time. The opposite is true. Nevertheless, many critics have challenged the overly concentration on the inner, U.S.-only solutions of the post-Enron crisis without sufficient regard to the world's accounting standards convergence. Nobody doubts the correct idea behind and positive effect of these U.S. regulations, but a certain lack of co-ordination with the IFRS has been observed.

[60] Please note that this table is to provide a general look at the worldwide situation with IFRS implementation. Information in the table is therefore much simplified and cannot therefore be treated as completely exact. For instance, in Australia the adoption of IFRS is mandatory only for large private companies, not for small and medium sized. Similarly, in Switzerland, the option to select either IFRS of U.S. GAAP for the listed companies is possible. Dealing with all such individual modifications is not he purpose of this general overlook and of this paper.

It is a pleasure to note, that recently the U.S. will to co-operate becomes much more tangible[61]. This must be highly admitted, whereas the interests of both European and American patriots in the race for world's economic leadership must not prevail over the simple rationality.

As we already mentioned above, there is no power that would push the United States and its Securities Exchange Commission to adopt the IFRS, neither the IASB members to accept the U.S. GAAP as their own. Only the market itself can secure the true convergence of the U.S. GAAP and the IFRS[62]. No doubt that it does, but the speed of this process will depend solely on the attitude of the participating parties, particularly on the American will to participate in these efforts[63]. This still reminds the prisoner's dilemma: once the parties co-operate, they both gain more than if they compete in a wrong way.

"I think the SEC is very keen that we bring the IFRS and U.S. GAAP closer together. The fact that we started a convergence project and are close to finishing an improvements project indicates that we're not sure that IFRS are not the right quality yet. Our objective is that by 2005 they will be. A few differences with U.S. GAAP are likely to remain, at that stage, but the idea is to remove as many of the reconciling items as possible." (Sir David Tweedie, IASB Chairman in PwC 2004*, p. 22)*

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[61] During the last months a significant signals of the increasing will to co-operate from the U.S. side have been observed. For example, the SEC has recently suggested to remove its compulsory reconciliation from IFRS to U.S. GAAP for non-U.S. registrants. Further, at the time of composing this paper (Spring 2004), many other exposure drafts (EDs)were seriously considered by the Financial Accounting Standards Board aimed at the convergence with the IFRS. These EDs included proposed changes to the following: Voluntary changes in accounting policies; Changes to the calculation of the EPS figure; Asset exchanges that would require a gain or loss to be recognized on the exchange of similar productive assets; Unusual (abnormal) costs amounts of idle capacity and spoilage costs would be excluded from the cost of inventory and expensed as incurred; review of standards for the classification of liabilities; etc.

[62] Many "models" of the convergence were outlined. Convergence could be reached either through explicit agreement of IFRS and U.S.GAAP supporters and through subsequent "merge" of the two frameworks taking the better of both or through letting only the market competition to work – the companies themselves would determine through their preference, which of the standards is more convenient and though determine the form of the resulting global standards. Probably, the real-life way of convergence would be somewhere inbetween.

[63] *"…Nobody has the best answers, so why don't we just make sure that we can get the best from all of us? We expect the FASB to change some of the American standards and we'll have to change some of the older international standards too. Both sides are committed to a global solution and it definitely helps that Bob Herz, a former IASB board member and former PricewaterhouseCoopers partner, is now a chairman of the FASB."* (Sir David Tweedie, IASB Chairman in PwC 2004*, p. 22)*.

3.1.4. Implementation Issues

There still are many challenges and a long way to go. As one can imagine, harmonization of accounting standards of the worlds economically strongest nations is not an easy task and requires true and intensive direct and indirect co-operation of the national standard setters themselves as well as via all significant intermediating bodies such as the IOSCO (International Organization of Securities Commissions[64]) etc.

As mentioned above, the cooperation of countries' regulators is of crucial importance as no global organization in the world has the power to force neither any local standard setter nor any single company to report within the IFRS framework. Even throughout the EU states, the national standards still differ from the IFRS, a press-ahead of the national standard setters and the companies itself must therefore be significant for the timely move to IFRS to be successful.

Making the IFRS a set of standards of truly global nature requires a true voluntary participation of standard setters of all the nations that want to join the IFRS community. This can only be achieved if all the regulatory bodies influencing the process of corporate reporting reform will maintain the current tempo and intensity of making the necessary steps towards the reform. For the EU members, the first practical steps of the registered companies and of all the engaged state structures (ministries, financial offices, etc.) should already have begun in order to catch the deadline[65]. The up-to-date experience only confirms that for those, who did not start yet[66], the situation is

[64] To learn more, please visit www.iosco.org.
[65] For example, in the Czech Republic, the balance sheets of the companies reporting under IFRS will be significantly enriched by many new items together with all related P/L consequences. Adopting the IFRS will bring many new items to the balance sheets and correct coping with this issue deserves many trainings and software modifications. The typical items that will newly appear in the balance sheets will be: Assets and liabilities resulting from the the financial leasing for the lessors; Financial assets and relating loans, which do not meet their definition criteria under IAS 39 (final formulation of which is however still being reconsidered during 2004…); certain derivatives not defined as derivatives according to the Czech accounting standards; reserves for certain liabilities (e.g. in case of non-agreement-backed liabilities); intangible assets acquired during the business acquisitions, etc.
[66] On this place I would like to note, that as a result of the tough 2005 deadline for the IFRS implementation, the decisions of the registered company's managements about the specific way and timing of the transition to IFRS was extremely hard: Still during the first half of 2004, significant part of the Standards' wordings were not yet amended as final. A question whether to wait for the final standards or to start with the transition towards something that was not 100-percent certain was quite hard to answer.

alarming: Those, who have already adopted the change admit that they seriously underestimated what was involved.

The steps recently done certainly must be highly appreciated, but not only these first steps are sufficient for completion of the mission. All participants of the process must therefore prove that their post-Enron efforts to reform the reporting framework were not intended just to regain the lost trust, good name and power of themselves sooner than their competition, but on the effective long-run accounting standards reform targeted on trust into the entire framework of corporate reporting. All participants must be well informed and understood that such process is beneficial to all – including them.

3.1.5. Enforcement Issues

Interesting point that the countries adopting the IFRS will have to face, is creation of the local enforcement function, that is crucial for securing the local companies' compliance and the public trust into the newly introduced standards. The problem is that whereas the IFRS standards are to be set globally "from above" through the central efforts of IASB, the enforcement of particular companies compliance with these standards will always depend on responsible bodies of the participating local countries. With respect to the current cross-country differences in the form of enforcement of local accounting standards, this will be a challenge requiring the close and effective co-operation between the IASB and local national enforcement bodies[67]. Hopefully this will be possible to secure without allowing the omnipresent and insurmountable

[67] In 2003, a special Committee was set up to advise the European Commission in this regard. It was called CESR (Committee of European Securities Regulators) and comprises the national securities regulators in the current EU member states, plus Norway and Iceland. As a response to demands for co-ordinated and consistent enforcement of IFRS. At the time of writing this paper, one final standard and one draft standard were issued for the national standard setters to implement in their states.
The first and final standard – "Enforcement of Financial Information in Europe" – defines 21 basic principles for the national regulators. These include principles such as: Enforcement activities to be performed by the "competent independent administrative authorities"; Financial statements to be selected for review partly on the basis of risk, not just on a random basis; A range of sanctions to be available; etc.
The second – draft standard "Co-ordination of Enforcement Activities" includes co-ordination principles such as: "European Enforcers" regular sessions to be held in order to discuss the particular issues; To develop a database of national enforcers' decisions as a practical tool that should be consulted in taking further decisions; etc.

people's desire to create administrative procedures to grow too much, so that the costs would not be overly.

Of course, in a system such as the above mentioned – the principles based system – it is harder to find out and to prove whether the particular company complies with the defined broad principles of "good behavior", comparing to the cookery book based detailed system. No doubt that it will remain primarily the auditors' (in general) task to find out and to provide assurance about the company's compliance and to keep themselves able to do so. To stay optimistic, there is no specific reason to assume that the auditors will not, especially after the post-Enron environment, where they are doing their best to retain the endangered credibility, which is the major condition for their successful business existence. We devote chapter 2 to external auditors' role in reforming the world's corporate reporting framework.

3.2. Historical Shortcomings to Overcome

As mentioned in the introduction to this chapter, after the time of Enron and other huge corporate scandals, many important principles of the original accounting standards were seriously challenged. As these principal shortcomings are regarded to be a direct cause of these scandals, the unprecedented wave of efforts to precisely define and eliminate them has been started and lasts. This chapter will try discuss the shortcomings that have been identified as the most problematic and that have been mostly criticized and attempted to reform since the Enron collapse. These include:

- The concept of historical cost value as a prevailing valuation principle, which often leads to huge differences between the booked value and the market value;
- Accounting treatment of intangible assets that may significantly influence company value;
- Accounting definition of earnings, whose practical usage during the last years is rather limited;
- The definition of the corporate entity, which allows to hide significant accounting operations into the structure outside of the entity covered by the financial reports' scope.

We will take a closer look at the above-mentioned shortcomings in the subchapters below:

3.2.1. The Principle of the Historical Costs Value

"Even the best country-GAAP standards have come under criticism since they are all based for the most part on an historical cost model. Today's more complex business environment challenges the relevance of historical cost information and is putting strain on this model. The capital markets focus on value and ... value can be substantially different from historical cost" (DI PIAZZA, S.A., ECCLES, R.G. (2002, page 33).

The question of valuation principles remains one of the hottest issues lying on the table of negotiations about the accounting standards reform. Although the currently prevailing system of local GAAP valuation is a model mixed as a historical cost/fair value cost[68], which is very often criticized, hardly anybody dares to say that the principle of historical cost can and should be entirely replaced by the system of true (or "fair" or "market") value, at least not at the moment. Although the theoretically desired optimum is to have a fully market-based valuation, and there are ways how to shift closer to it for certain items, being restricted by the current valuation and analytic methods, certain share of the historical cost valuation will have to persist.

As indicated above, the most relevant critic about the fair value attitude is concerned about the objectivity of the measurement method. Another detractors of this attitude argue that valuation by fair value, if we abstract from the particular method selected, supports volatility of company earnings (and consequently of stock prices) as the market goes up ad down. Whereas nothing remains than to agree with the first of the critical points above, a clear argument can be said against the latter. Of course, earnings and stock price volatility is generally not anything welcome. However, if the market conditions are in reality such volatile, and if we want to have a true picture about the

[68] Again, a bit more of a critical light is shed on the U.S.GAAP standard than on IAS-based standards. Although in the latest period this difference diminishes, in the pre-Enron era IAS was much more open to revaluations of selected items

company value, we have to bear the reality that also the true value of the company will naturally be volatile[69]. Anyway, given the current situation's real measurement restrictions, we will have to tolerate a mixed valuation model for a couple of years longer.

3.2.2. Intangible Assets

Although it may not seem from the first sight, the intangible assets happen to be one of the crucial factors influencing the market value of the company. The market-to-book ratio[70]of the listed companies in the United States currently reaches approx. 4. That means that the value of the company booked in the balance sheet represents only approx 25% of the value that the company is assigned by the market. The vast part of this great overhang of the market value is generated by the value of intangible assets[71]that does not enter into the balance sheet according to current GAAPs.

Probably the most frequently cited criticism of the local GAAPs treatment of certain types of intangible assets (e.g. research and development costs) is their expensing into the current period. Such a treatment inadequately decreases earnings of the current period, although these costs typically serve for securing and maintaining the profit of more periods than just the current. If instead the GAAPs would allow to capitalize these assets into the company balance sheet, the relating cost could be distributed in more periods via depreciation, so that the resulting current earnings would not be biased in the periods of investments into such assets[72].

(selected assets, real estate) than the U.S.GAAP, which allowed the real value principle only with respect to some types of financial assets.

[69] For a fairly detailed analysis of external macroeconomic factors' influence on company earnings and their volatility in the light of currently reviewed accounting standards, please refer to Oxelheim, 2003.

[70] This ratio measures the value assigned to the company by the market over the value of the company's book value on the balance sheet (i.e. the difference between the recorded assets and liabilities)

[71] The market value of the company is usually increased also by the aggregate value that investors assign to the non-financial value-drivers or the difference between the market and the balance sheet value of the assets booked. On the other hand, the market value of the company is usually decreased by the expected unrecorded stock option costs and off-balance sheet sources of financing.

[72] The IFRS standards already try to cope with this issue, allowing the company to capitalize more intangibles on the balance sheet (on the cost basis) than any other GAAPs. More specifically, both IFRS and U.S. GAAP allow not to capitalize the research costs. Regarding the development costs, the IFRS allows to capitalize those that meet stringent criteria. U.S. GAAP generally says to expense all research as well as development costs (apart of items like website development etc.)

Not for all GAAP-unrecorded intangibles the solution is the same easy as for the assets mentioned in the previous paragraph. For example, the intellectual capital, know-how, customer loyalty or brand equity are also generally perceived as assets increasing the company value, which would deserve a true-value record on the balance sheet, but no generally acceptable methodology of valuation is currently available[73]. Regarding the solution of this problem, in this particular respect I share the idea of critics of true-value attitude in any case to everything. I would say that the target of the accounting standards reform is not to equalize the market and the book value of corporate entities. In this respect, the mission is to secure that the company reports can provide the public with as much undistorted information about the company financial situation as possible. The value of factors like a customer loyalty can be easily estimated based on e.g. industry benchmark and I think that designing of complicated methodologies for its valuation so that it can be reflected in the balance sheet would not be the optimal attitude, at least not at this time when there are more urgent issues to solve.

3.2.3. Company Earnings

The most frequent critics about the GAAP attitude to company earnings is concerned about quite different definition of earnings that the worldwide analytics and financial reports users actually use and the definition by GAAP. *"I don't know anyone who uses GAAP net income anymore for anything"* (Lehman Brothers analytic Robert Willens in DI PIAZZA, S.A., ECCLES, R.G., 2002, page 34). The P/E ratio has lost its historical role of almost unique prevailing figure for forming expectations about the future company value. With respect to the value of the company, the last years' experience urges for greater accent on cash earnings and on other important factors determining the company value. As a result, companies are developing their own measures of GAAP-undefined cash earnings, which is difficult to understand for external user of that information. A generally accepted, used and up-to-date standard of earnings definition is missing.

[73] Many other assets are not required to be included in the balance sheet according to GAAP, although they directly influence the company value such as leased assets, assets in so-called Special Purpose Vehicles or fully depreciated assets, which still retain a real value.

Moreover, recent years have proved that the GAAPs definition of earnings provides the company CEOs and CFOs with a comfortable space for influencing and manipulation of this figure in accordance with their personal interests[74]. (HERVÉ, S., LEBAS, M., 2002) on page 603 calls these practices as an "Earnings management" and defines them as *"In these ... practices, management artificially manages earnings to achieve or meet some pre-established level of "expected" earnings (e.g. analyst forecasts, management's prior estimates or continuation of some earnings trend)."*

The definition of revenue nicely illustrates the significant attitudinal difference between the IFRS and the U.S.GAAP. Whereas the IFRS defines revenues based on several criteria, which require the recognition of revenue when risks rewards are transferred and the revenue can be measured reliably, the U.S.GAAP builds on four basic criteria, similar to IFRS, but which are then extended by huge amount of detailed guidance, which is quite hard to follow.

Although there is no doubt that management of earnings in the name of private interest is a practice that must be prevented, the empirical research provides an interesting evidence that allows us to think somewhat less worried about it: Most of the empirical research on this topic shows very weak relationship between meeting the market expectations on earnings and the actual stock price changes.

3.2.4. Corporate Entity Definition

As well as with many other accounting standards issues, there is a disagreement between the attitude to consolidation between the majority of the local GAAPs (especially the U.S) and the International Accounting Standards. Experience (Enron) has shown that the consolidation in the broad sense, i.e. including the recognition of SPVs, joint ventures or other similar specific investment exposures is crucially

[74] Favorite tools that can be used for managing the earnings are for example the following instruments: provision generating and cancellation (or releasing); "as-convenient" setting of the date of recognition of profit on long-term contracts; attitudes to valuation of assets; changes in asset-depreciation policy; selection of what to capitalize and what to expense; etc. Specific area of interest in this regard are the construction contracts. The recognition of revenue can with respect to their nature highly influence earnings. Specific treatment is therefore provided for these contracts both in IFRS and in U.S.GAPP standards. Important way of recording these revenues is so-called percentage of completion method. Insisting on this method provides definitely limits on earnings manipulation by managements and again, IFRS is a bit more strict in this respect.

important as these exposures can considerably influence the picture about the financial condition of the company.

Traditionally, the U.S. GAAP attitude to consolidation used to be somewhat “weaker” than the IAS attitude. Whereas the IAS defines the subsidiary based on the principle of exercising the *real control*, the U.S. GAAP builds the definition more on the *size of the financial stake* owned by the mother company. Particularly, the IFRS focuses on the concept of the real power to control in determining whether a parent/subsidiary relationship exists. This “control” means the parent’s ability to govern the financial and operating policies of a subsidiary to obtain benefits. Companies acquired are included from the date of effective control gain. In U.S. GAAP, the dual consolidation decision model is required. All consolidation decisions should be evaluated under variable interest model as well as under the traditional consolidation models. Variable-interest-entities (VIEs), in which a parent does not have a controlling voting interest, but the parent absorbs the majority of entity’s expected losses or returns, also must be consolidated.

The contrast is especially evident in case of the SPVs. IAS orders to consolidate in any case where the nature of the relation indicates that the mother company controls the SPV, which is judged based on pre-defined set of indicators[75]. Although the U.S. GAAP explicitly defines the specific criteria for asset transfers to unconsolidated SPVs, in fact it orders to consolidate only after the assessment of the potential of significant risks and gains resulting from the ownership of the SPV.

On the other hand, whereas the U.S.GAAP does not provide exemptions regarding the consolidated reports preparation, the IFRS is less strict: It allows the exemption that applies to a parent that is wholly owned or the owners of the minority interests have been informed about and do not object to the parent that not presenting consolidated financial statements and its securities that are publicly traded; it is not in the process of issuing securities in the public securities markets; and the immediate or ultimate parent publishes consolidated financial statements that comply with IFRS. Anyway, although

[75] To provide few examples of such indicators we can mention: The SPV is performing its operations on behalf of the mother company. The mother company has the effective decisional rights that are able to secure the majority of the SPV’s

after the Enron scandal, many efforts were done in the United States in order to eliminate the shortcomings of the consolidation rules by U.S.GAAP, still these rules are in this respect mostly regarded as the weaker alternative to the IFRS (IFRS 3) attitude (see part 3.1.2. of this paper).

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profits for the mother company. The mother company bears the majority of the risk that stems from SPVs operations or assets in property.

4. MANAGEMENTS' ROLE

When speaking about reviewing the pre-Enron shortcomings of the corporate reporting systems, in the light of corporate reporting transparency, the system of top management compensation proved to play a considerable role. Thorough investigations of recent corporate scandals have confirmed this fact on evidence of many examples of perverse executive reward systems[76], which led to distorted incentives and motivated managements to act in clear contrast with shareholders' long-term interests. These untidy actions had to be subsequently hidden deep into complicacy of corporate reports.

Concentration of overly power and control over corporations in hands of top executive officers contributed during the last two decades to unprecedented violation of basic principles of *shareholder* model of corporate governance and shifted it much toward its concurrent model of what is often called a *stakeholder* model. The new model had become to be characterized by a high degree of managerial autonomy combined with low accountability to shareholders. "*The realities of corporate life came closer to a philosopher-king model of corporate capitalism than to the shareholder-dominated model beloved of economic liberals*" (Plender, J., 2003, page 23).

The issue of management incentives became one of the core issues in discussions about the corporate reporting reform. What turned out to be quite surprising for many – the revealed magnitude and extensiveness of the above-mentioned phenomenon of excessive "rewards for failure" and other distortions of corporate executive compensation systems[77]. It was proved, that this phenomenon, described by the Federal Reserve Chairman Alan Greenspan as *infectious greed*, had directly contributed to

[76] Enron's Chairman, Ken Lay, realized gains on stock options of $123.4 million exercised in 2000. WorldCom's CEO (Chief Executive Officer), Bernard Ebbers, was provided by the company a loan of $408.2 million (COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003, page 5).

[77] Calculations of an article "You bought, they sold" in Fortune, Sept. 2, 2002, p.64 in (COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003, page 5) state that, since 1999, executives at 25 companies whose stock price declined 75 percent or more from their peak in the period January 1999 through May 2002 "walked away" with the total amount of $23 billion. Another numbers of S&P published in the same source (COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003, page 5) say that in 1992, the median CEO total compensation equaled $1.8 million, while the same number in 2000 reached $6.1 million. Further, CEO compensation rose by 340 percent

many cases of manipulating corporate reports and to a resulting unprecedented loss of confidence in corporate reporting.

4.1. Stock Options

Probably the most significant feature of what went wrong about executive incentives in the past years is what is often called similarly to "stock option culture in the boardroom". During 1990s, the system of "remunerating" company executives using company stock options has gained excessive popularity[78]. It happened due to several reasons:

- Certain legal frameworks had enabled companies in their tax returns to deduct the management classical *cash* compensation in a limited amount only[79];
- Stock options provided attractive relation between the huge value they could present for their holder and the cost of this value that the company reported to shareholders (stock options issues were legally expensed to P/Ls in zero values[80] as their strike prices usually equaled the share market prices at the times of their issues);

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versus the rise of standard employee compensation in the amount of 36 percent in the recent ten-year period.

[78] 79 percent of the increase in the median CEO compensation from 1992 to 2000 was due to long-term incentives, primarily stock options. In 1992 options formed 27 percent of the median CEO compensation , whereas by 2000 options formed 60 percent of the same figure (COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003, page 6).

[79] The valid wording of the US Internal Revenue Code in its Section 162(m) had limited the tax deductibility of cash compensation of the company executives to $1 million.

[80] Accounting treatment of stock options in the last years, after this matter was brought to light, became a subject of passionate academic and professional debates. Guiding the accounting treatment of stock options by politics and doing what the public wants – expensing the options in some way, so that a *number* will appear in companys P/L account instead of previous *zero* – seems not to be largely supported by accounting professionals. One of strong arguments against the "let's-just-have-an-expense" attitude says that the costs of stock options under this attitude would be booked twice: "*This is not to deny that stock options represent a cost. It is just that the cost is borne not by the company but by the existing stockholders in their personal holdings, through dilution. This cost is fully reflected under current accounting standards in the diluted earnings per share figure. Placing an options expense in the numerator of the EPS figure while leaving its effects in the denominator would be a clear case of double-counting*" (Column in The Wall Street Journal of Fred Sellers, Accounting Associate Proffessor, Southwestern University; in (COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE, 2003, page 13)).

What I think we should conclude over this debate and take it as a particular suggestion for improvement in transparency of corporate reporting, is the necessity

- No automatic shareholder voting had to take place in order to permit or veto granting of these options to management.

The zero influence of stock options on companies' profit and loss accounts had blurred the actual costs of these options to companies' owners (i.e. shareholders), although these costs were fully borne by them through *dilution*[81] of shareholder value of corporate equity. Moreover, in order to limit/compensate this loss of value to shareholders, companies were often buying back their own stock on the open market, frequently even using debt instruments. This inevitably supported the transfer of wealth and control over companies from outside investors to inside managers.

When trying to explain what is so evil about stock options, let us simplify the world a little bit in the following few lines, in order to explain the principles: In the previous paragraph we mentioned that one channel, through which the shareholders suffer of owning shares of a company being managed by the people being compensated mostly through stock options – the dilution. That was the direct channel, however whose overall negative impact was usually not that crucial as the one we are going to mention below.

The more serious channel is the indirect one, let me explain: However insufficient we might find it, it was many times proved that the company's stock is priced by the market strongly based on the company's current and predicted level of earnings. Therefore, when a manager owns so many stock options, so that the significance of these options value greatly exceeds the significance of the manager's official cash salary, the manager has a strong incentive to act in the name of the company's disclosed

of including the "EPS after dilution" indicator in corporate reports on some "sunny place". If this is a measure of real cost of stock options to shareholders, and we are urging for corporate transparency and disclosure, this indicator should not be forgotten to be highlighted in company reports to public.

[81] The cost of dilution resulting from stock options is measured in the "EPS after dilution" figure. According to IAS 33, § 24, in order to calculate this figure, *"The net profit attributable to ordinary shareholders and the weighted average number of shares outstanding should be adjusted for the effects of all dilutive potential ordinary shares"* Under these "dilutive potential ordinary shares" are understood "*financial instruments of other contracts, that may entitle its holder to ordinary shares*" – which a stock option typically is. The above-mentioned adjustment means, still in the wording of IAS 33, mainly adjustments by "*dividends on dilutive potential ordinary shares which have been deducted in arriving at the net profit attributable to ordinary shareholders and … any other changes in income or expense that would result from the conversion of the dilutive potential ordinary*

earnings instead of devoting his energy to the company's wise strategic leadership. There are many ways how to influence the nominal accounting earnings and their "distribution" over time (depreciation policy, reserves, provisions, long-term contracts, etc... – see also part 3.2. of this paper). Many of these earnings-manipulative actions in the name of management's stock options value are likely to be – and many times actually were – in direct contrast with wise strategic long-term management and definitely is an issue that urges for a regulatory restriction.

I have noticed quite a significant disagreement between various authors' ideas over what should be done about stock options as a predominant component of executive and/or other employee compensation. I share the opinion that stock options can under certain specific circumstances present an appropriate and effective tool for certain type of companies (start-up companies, high-tech companies or similar companies with substantial part of intellectual capital of employees), whereas generally their usage should be very carefully considered.

Anyway, the basic idea is generally shared: Not to repeat the mistakes of the past years, under no circumstances the usage of stock options should be guided by the untidy reasons mentioned above. The company boards should keep extremely careful eye on how each top manager is compensated and for what. As an evident conflict of interest is present, the management itself can under no circumstances have possibility to influence the level of its own compensation in any other way than by showing-off an excessive work performance. Finally, the actual reasons and expected impact of stock options introduction, whichever they may be, should always be properly and truly disclosed to shareholders including providing them with all regular ways to influence the decision to introduce them.

I don't think that formulation of any regulatory ban on usage of stock options would generally have positive effect in achieving corporate transparency. Guiding the company boards and their compensation committees to decide on careful and wise usage of this tool using well-formulated regulatory general principle framework and its enforceability could mean much more.

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shares" Detailed way of calculation and more comments illustrated on several examples is provided e.g. by (HERVÉ, S., LEBAS, M., 2002), chapter 15).

4.2. Of Some More Shortcomings

The wide usage and abuse of stock options as a tool for compensating managements was generally regarded as the main evil. However, they were not the only element supportive to management misconduct and widespread rise of subsequent manipulations of corporate reports in recent years.

Should there be the only legislative gap creating a space for stock options misuse in otherwise entirely perfect regulatory and ethical environment, no such crisis of management misconduct and greedy actions contrasting to shareholders' interests would have emerged. Options have only ex-post become the most visible attribute of what went wrong about management compensation. Of course, there were much more shortcomings of the system that led to the crisis. Some of further management compensation issues are mentioned below.

- Serious failure in management compensation area was the underestimating attitude of companies' boards, whose compensation committees[82] became too lax in their duty to monitor and regulate remuneration of their managers;
- External consultants were often engaged by the boards to provide advisory on this topic. As the relation between these consultants and managements had often shifted too far from being independent[83], all the process negated its purpose;
- In fact, the final decisions about management compensation were at almost sole discretion of managements itself;
- Equity-based incentives (including the above-mentioned stock options) resulted in a strong motivation to manage companies in the name of one

[82] *Compensation committee* is a body of selected directors (board members) that is actually responsible for execution of board's duties with respect to management compensation. Its main duty therefore is to retain management at a reasonable and cost-effective manner, considering relevant factors such as motivation and retention of executives under given company economics. It usually is comprised of a Chair (who leads the Committee and represents it i.e. on shareholder meetings) and of several directors of the Board (who should be independent from the company apart of their Board member relationship and remuneration).

[83] Independency of external consultants was aggressively regulated mainly though the Sarbanes-Oxley Act of 2002. Chapter 2 of this paper is dedicated to this issue in more detail.

indicator – the stock price. This practice gained enormous popularity and has even gained its own widespread term – *the earnings game*.

- The unprecedented bull market led to enormous increase in executive compensation. High amounts that flew to managers' personal accounts lost any relation to their actual operating performance and personal contribution to value creation.

4.3. Space for Improvements - Remedy Suggestions

We have discussed some particular suggestions for future usage of stock options – the most widely used and abused instrument of top managements' compensation in the past years – already in subchapter 4.1., devoted to stock options.

Below I would therefore like to provide some more general and specific indications about how the system of management compensation and incentives could be improved in order to move closer to the desired target – to get rid of management practices of acting in contrast to shareholders' interest, while trying to hide these practices in corporate reports.

The Compensation Committees in cooperation with hired external independent consultants should definitely try to set such a system of management compensation that is as much *performance-based* as possible. Compensation transparently tied to company long-term goals provides much more motivation for managements to act in the name of these goals instead of devoting time and energy to stock option speculations and corporate reports manipulations.

Compensation of managements should definitely be *transparent* with respect to anyone who a rational reason to ask for information about it. Clear correlation between costs of particular managers and their expected benefits to the corporation in the form of their personal contribution to corporate value creation[84,85] should be disclosed.

[84] This principle seems evident, but according to author's opinion, compliance with it is often very loose. For low and medium-level managers, who are on their way-up in the company hierarchy, the correlation between value creation and salary usually holds. But as these managers are approaching higher levels of management, their contribution to value creation becomes harder to measure and there are much less

Under very thorough consideration, *equity-based compensation*, including stock options discussed in detail above, can be under specific circumstances an effective form of incentive compensation, especially if it is designed to promote specific long-term goals of the company. This can be true especially with respect not to company

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people who can actually pose the question "How much have you earned for the company in the past month?" without losing a job. Finally, at the top level of management, there is nobody who in reality can effectively challenge the volume of executive compensation apart of the Board through its Compensation Committee. The situation where management-owner decides about its compensation itself is natural in a "*stakeholder model*". But in a model, where managers are hired agents of the owners – shareholders, such a situation is very undesirable. The role of the Board in regulation of the executive compensation should be therefore highly stressed as it remains the only real source of effective control over the amounts that go to managers' accounts and reasons for that.

[85] Although it may seem that one of my objectives is to criticize that generally the top management rewards are inadequately too high, I would like to stress that it is not my purpose. I would not like to judge whether the overall level of these compensations is adequate or socially fair. My objective is not to discuss the *volume* of these compensations as of my interest are solely *motivation effects of their structure*. Nevertheless I would like to mention that I find very interesting the discussion about these compensations in the light of effects on the general "market of top managers". The following is given: Stock options are the major source of top managements' compensation; We agree that majority of these stock option compensations are used contra-productively or inefficiently; We therefore agree that most of them should be replaced by some more incentive-providing instruments. Questions follow: How managers will react to the new situation of their compensation restructuring? Will the compensation restructuring have any impact on the general level of amounts paid to them? Won't companies that introduce management compensation restructuring as the first suffer of outflow of some good managers to competition? Let's take these questions to be an interesting topic for further research.

executives, but to non-executive staff. Anyway, costs incurred by these instruments in the form of dilution or in any other form must be well disclosed to shareholders.

In cases where equity-based compensations was introduced as reasonable and cost-effective way of compensation, employee holdings of received shares should absolutely be encouraged to be of long-term nature. This principle should hold especially with respect to top executives. In their case strictly enforceable restrictions on executives' shares disposal (such as minimum holding periods or obligation to publicly announce any intention to sell or buy company shares) seem to be efficient means of encouraging long-term convergence of shareholders' and managements' interests.

5. REPORTING FORMAT MATTERS

Modern investors need to take critical decisions based on correct and timely information from the corporate world. However, they typically face annual and quarterly issued paper-, pdf-, or html-based static company financial reports of various standards, which in fact often represent their only primary source of information about each particular company. For this reason, i.e. because the current corporate reporting formats provide too little too late, all the corporate information users often have not many other options but to turn to secondary sources – information re-distributors, where due to manual processing and re-ordering of information and due to many other possible reasons the quality and timeliness of information may be harmed.

5.1. The Internet

Definitely we need to note that the evolution of information formats in the recent years has reached enormous tempo[86]. However, as the internet becomes to be a primary platform for communication and commerce, and as significant work is being done on standardization of contents of corporate reports worldwide (see chapter 3 of this paper), it is possible to say that the great opportunities for introduction of an efficient and indeed standard digital information format, allowed by current technologies, are not yet fully explored. Corporate reporting on electronic equivalents of paper sheets, regardless of the quality and graphics of their content, are not anything sufficient for the needs of today's business environment.

With respect to corporate reports, the internet still serves rather as an electronic piece of paper. Anyone willing to analyze the financial data has often no choice but to transfer the data into his spreadsheet or into whichever analytical software manually. Such process is not very comfortable for its time-consuming nature. Moreover, any manual transfer of data is unlikely to be free of mistakes. The data have to be found on the right

[86] Many specific transaction-oriented standard specifications were developed, which bring particular eases into the circulation and processing of particular kinds of financial information. We mean standards such as FpML, Fix, FinXml. OFX or XML/EDI.

place, well understood, adjusted into the necessary definition standard and input into the analytical software.

Specifically, to analyze the data by analytical software, every piece of data, such as e.g. the annual EBITDA, has to be manually transferred into appropriate input "bins" of the software. The software knows, that its appropriate bins are manually fed with the appropriate numbers, e.g. the bin for EBITDA by the EBITDA figure etc, so the analysis can run. The factor, who determines, which number from the company report is EBITDA, where does he find it and where does he find the EBITDA input bin in the analytical software, is hardly ever something else than human.

5.2. A New Reporting Language – the XBRL

In the previous paragraph we outlined the scheme of physical labor-intensive data search, recognition and input, which has to take place before almost every software analysis of corporate reports. What would solve the situation - if the world agreed on a common reporting language, which would allow the corporate data to be published in a unified format, so that everybody could download and re-use it directly, without any previous studying of the language itself. To prevent the current analyses' shortcomings mentioned above, each piece of data published in the language would have to be compatible with any analytical software, so that the laborious human interference in data gathering would no longer be necessary.

It seems that a reporting language of the above mentioned characteristics was invented. The language is called XBRL – the eXtensible Business Reporting Language[87]. Although the majority of businesses still regard it as a futuristic tool, hesitating with its implementation, the progressive part of corporate world is already getting used to its virtues in a fast-increasing tempo[88]. It enables to exchange data

[87] The language was recently developed by the consortium XBRL.org, which was founded by 13 member prestigious organizations related to corporate reporting and currently comprises and is supported by over 250 of them.
Technically, it is a dialect of the Extensible Markup Language (XML), which allows denoting data by their unified definitions and names. The language is recognized as the most important and revolutionary internet standard after the adoption of HTML, crucial for today's internet. The World Wide Web (WWW) consortium recommended the XML as a standard for internet-based information in February 1998.

[88] Many world's corporate giants already successful use the XBRL reporting (mostly alternatively, apart of issuing their reports in traditional formats). Between

(financial as well as non-financial) between otherwise incompatible software applications through the usage of informational tags that self-describe the underlying data, determining for each piece of information, what an information exactly is. The language also allows to authorize the data, so their safety and verity is not more endangered than any other secured internet paper-kind page of the company.

5.2.1. Functional Virtues

Like with the majority of software tools, users of XBRL-based data do not have to study, how to write or read the XBRL tags (the metadata, or data about the data). On the contrary, they can directly start its usage as its functioning is quite easy-to-follow[89]. They only have to know, that if they have access to data in XBRL, it is enough to decide, which data they want to analyze, click them in their analytical software[90] and the software is able to find them and take them up into its appropriate input bins.

To explain fully, we come back to our example of the EBITDA figure. If the company report its data in XBRL, its EBITDA figure is specifically tagged. The analytical software used for analysis of that company's data, is already instructed to find the EBITDA (between other supplied data). It checks the tags of all the provided data and immediately finds the right one, without the risk of finding the EBIDTA for the wrong company, in wrong currency, for wrong period, in wrong unites or EBITDA according to wrong accounting standards. The appropriate EBITDA bin is therefore fed by the appropriate number and is ready for analysis automatically, without human interference.

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these giants belong e.g. Edgar-Online, Morgan Stanley, Microsoft, Reuters, Oracle, Tohmatsu etc. etc.

[89] Has anyone seen any Visual Basic, php, or any other script, would he find the XBRL file as similar from the first glance. It consists of lines of specific words, numbers and symbols, so that opening the xbrl file itself has no meaning for the majority of its users.
Luckily knowing the language itself is not necessary, same as using macro in excel. You do not have to know, how to record the macro, but you do not have troubles to use it.
In the case of xbrl file its usage is the same easy: On one side, a software engineer easily encodes the company financial information into the xbrl-based file and puts it on the company web. On the other side, another software engineer enables the analytical software to read the xbrl files. Afterwards, anyone who wants to analyze the published company information, just easily downloads the xbrl file from the company web into his (enabled) analytical software and he can directly start using the data without asking his assistant to previously rewrite the data into that software.

[90] A 2003 study conducted in the United States shows that the full two thirds of financial software vendors have XBRL-enabled at least one of their major products

As we mentioned above, the XBRL already moved far from visionary stage and is well alive, being used by many prominent business enterprises. These companies do not use it just for their sympathy to pioneering a new analytic tool, but for the material reason of tangible immediate benefits and savings[91] resulting from XBRL usage in reporting. In general, XBRL helps to:

- Allocate scarce resources from the laborious data-shoveling onto more value-creative tasks;
- Increase data accuracy by minimizing the risk stemming from manual transcription of pasting;
- Support of data integrity and decreasing the likelihood of deliberate data biasing by anyone through the elimination of human factor;
- Increase the ease of tracing the information directly to its originating source;
- Prompt the access to company reported information for faster, more informed decisions of investors;
- Strengthen the management ability to control through direct information supplies from enterprise systems to monitoring tools;
- To benefit the entire stakeholder community;
- To streamline and reduce the overall costs associate with preparing the company's financial information.

5.2.2. Broader Advantages

The apparent interdependence of the successful developments of the unified generally accepted accounting standards (currently being developed as the IFRS –see chapter 3 of this paper) and of the unified reporting language XBRL can be in fact well utilized. The worldwide adoption of IFRS does not mean just a modification of the contents of financial statements. Companies, regulators, creditors, investors and financial analysts

or were to do so by December 2004. Those vendors include giants such as Oracle, Microsoft, SAP, PeopleSoft, Fujitsu and many others.

[91] According to qualified specialist estimates, XML-based internet technologies, which the XBRL definitely is, can save companies as much as 60 percent over the traditional information publishing methods.

will have to succeed in facing the challenge of adapting the overburdened reporting systems and processes to contend with the current changes that IFRS demands.

The universal reporting language XBRL provides an opportunity for the company to ease their meeting of the IFRS reporting requirements by using their existing information systems. The International Accounting Standards Committee Foundation (the IASCF[92]) is currently working on providing series of XBRL taxonomies for IFRS reporting, which will serve for companies to re-classify and re-aggregate their data in their current systems to conform with IFRS.

5.2.3. The Regulators

Regarding the attitude of regulators, first significant notices of understanding of the XBRL's benefits and positive approach to its introduction have been witnessed worldwide[93]. These first steps can soon be expected to gain much more popularity and get much more widespread on the regulators side. New regulation institutions will join those who already adopted the XBRL standards and those starting implementation will require companies to file their reports in XBRL-enabled forms.

In the lines above, we provided many tangible reasons, why it has sense to regard the XBRL as a tool of great capacity for improving the quality of the world's corporate reporting. Those companies, which did not yet consider its employment, should review their attitude fast, in the name of their own, and their investors' wealth.

[92] For more information, please see www.iasb.org.
[93] To provide few examples, we can mention the Australian Tax Office, Dutch Authority for the Financial Markets, Tokyo Stock Exchange, Korea exchange KOSDAQ, U.S. Federal Deposit Insurance Corporation, etc. Further, XBRL plans were announced e.g. by Spanish, British, Japanese central banks, by Luxembourg Stock Exchange, Toronto Stock Exchange, etc.

CONCLUSION

Reforming the world's corporate reporting framework is apparently an extremely complex and difficult task, which indeed requires a lot to be sacrificed by all the market participants, so that corporate transparency and accountability is secured and maintained.

In the post-Enron era, a significant amount of work has already been done and investors' trust in corporate reports is being slowly recovered. However, even more work is in front of us and the current tempo of reforms is generally insufficient. Lots of work on reforms in the right direction commenced, but what counts are the results. The willingness to reforming the corporate reporting cannot in any case fade as a wave of fashion, otherwise another Enrons will keep on emerging.

It was a totally unnecessary, great, and expensive mistake, that the current pace of reforms was triggered only by the earthquake of corporate scandals in the U.S and elsewhere in the developed world in the fall of 2001 and after. The effectiveness of the worldwide capital markets depends on the trust of the public, which depends on the timely, complete, relevant and reliable information. The corporate world should learn from this unforgettable mistake, and the meaning of the term *corporate transparency* should not be underestimated anymore.

In the introduction to this paper we set the hypothesis that the that transparency of the corporate reports can be approached by rather open and wise attitude of companies, fully understanding the tangible benefits of information disclosure, being regulated by the principles-based up-to-date regulations. Apparently, enforcement of compliance with the principles-based rules is harder than with "simple" specific rules, but it is not impossible. Regulators, auditors and others have to commit themselves to keeping qualified to do so. According to author's opinion, transparency cannot be secured through the labyrinth of rigid, excessive and swelling regulations – this approach has already failed once and another system deserves its trial.

Throughout the specific parts of this paper, author hopes he successfully managed to provide a sufficient amount of particular arguments and relevant information supportive to the above-mentioned hypothesis. Moreover, through assessment of reached accomplishments, analyses of particular issues and outlining of possibly beneficial ways for the specific inter-related areas of corporate reporting, author believes he attributed to the general understanding of what went wrong with corporate reporting and what might be the right solutions.

APPENDICES

(Source: www.sarbanes-oxley.com)

Brief Summary of the Sarbanes – Oxley Act of 2002

In total, the Act contains 11 titles, in which it stipulates new standards of corporate accountability. In some cases, the new measures are defined in the Act itself, in other cases the SEC is required to issue the specific rules for implementation of principles defined in the Act. The brief summary of contents of each of the 11 titles of the Act is provided below:

Title I – Public Company Oversight Board

Under the provisions of this title, the independent non-governmental institution – the Public Company Oversight Board – is established including its main responsibilities to oversee the audits of the publicly registered companies in order to protect the confidence of investors and public into the independent audit reports. Public accounting firms are required to register with the board and the additional criteria for their auditing of public companies are set.

Title II – Auditor Independence

Specific actions are required from the registered public accounting firms (auditors) and the audit committees of the companies in order to increase the auditor independence. Some of the services that may be provided to the company by its auditing firm, mainly those raising the option of the conflict of interest, are banned to be provided by this auditing firm.

Title III – *Corporate Responsibility*

The company audit committee is required to be independent and to undertake specific additional responsibilities. The CEO and CFO must certify quarterly and yearly company reports to the SEC, including their assessment of the effectiveness of the internal controls. Requires the SEC to issue rules requiring attorneys in certain roles to report violations of securities laws to company CEO or chief legal counsel and, if no action is taken, to the audit committee of the company.

Title IV – Enhanced *Financial* Disclosures

The scope of disclosure of company financial information is broadened, including a report on the effectiveness of the internal controls and procedures for financial reporting, along with the external auditor attestation of that report, and disclosures regarding the off-balance sheet transactions and pro forma financial information. Disclosure regarding the company code of ethics including certain waivers is required. Accelerated disclosures regarding the certain transactions involving the company securities are defined.

Title V – Analyst *Conflict* of Interest

Requires the SEC to adopt rules addressing the conflicts of interest that may appear when securities analysts recommend equity securities in their research reports and public appearances.

Title VI – Commission *Resources* and Authority

Additional sources of funding for the SEC is defined and the SEC's authority to censure and impose certain prohibitions on persons and entities are broadened.

Title VII – Studies and Reports

The federal regulatory bodies are directed to monitor consolidations of public accounting firms. The title further copes with several other issues, such as violations and enforcement actions involving the securities laws, roles of investment banks and financial advisors, etc.

Title VIII – *Corporate* and Criminal Fraud Accountability

The criminal penalties for altering documents, defrauding shareholders, and other similar obstructions of justice are defined as much more tough than before. The debts became non-dischargeable when incurred in violation of securities fraud laws. Employees of companies providing evidence on fraud are protected.

Title IX – White-Collar *Crime* Penalty Enhancements

Any person who attempts to commit a white-collar (i.e., administrative) crime shall be treated under the law as if the person had committed the crime. The CEOs and CFOs are required to certify their periodic reports to the SEC that their financial statements fully comply with the Securities Exchange Act of 1934, and penalties for certifying a misleading or fraudulent report are imposed.

Title X – Corporate *Tax* Returns

The CEO should sign the company's federal income tax return.

Title XI – Corporate Fraud and Accountability

Additional authority to regulatory bodies and courts is provided in order to strengthen the penalization, including fines and imprisonment, for the widely defined scope of actions involving corporate fraud.

Section 302 – Corporate Responsibility for Financial Reports

(a) REGULATIONS REQUIRED – The commission shall, by rule, require, for each company filing periodical reports under sections 13(a) and 15(d) of the Securities Exchange Act of 1934, the principal executive officer of officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that –

(1) the signing officer has reviewed the report;
(2) based on the officer's knowledge, the report does not contain any untrue statement or material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
(3) based on the officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
(4) the signing officers –

(A.) are responsible for establishing and maintaining the internal controls;
(B.) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
(C.) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
(D.) have presented in the report their conclusions about the effectiveness of their internal controls based of their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent functions) –

(A.) all significant deficiencies in the design or operation of internal controls, which could adversely affect the issuer's ability to record, process, summarize, and report the financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
(B.) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in any other factors that could significantly affect internal controls subsequent to the date of their

evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) FOREIGN REINCORPORATIONS HAVE NO EFFECT – Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement under this section 302, by any issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices from inside of the United States to outside of the United States.

(c) DEADLINE – The rules required by subsection (a) shall be effective not later than 30 days after the enactment of this Act.

Section 404 – MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

(a) RULES REQUIRED – The Commission shall prescribe rules requiring each annual report requires by sections 13(a) and 15(d) of the Securities Exchange Act of 1934, to contain an internal control report which shall –

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for the financial reporting.

(b) INTERNAL CONTROL PROCEDURES AND REPORTING – With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Section 407 – DISCLOSURE OF AUDIT COMMITTEE FINANCIAL EXPERT

(a) RULES DEFINING THE "FINANCIAL EXPERTS" - The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to section 13(a) and 15(d) of the Securities Exchange Act of 1934, to disclose, whether or not, and if not, the reasons therefore, the audit committee of that issuer is composed of at least one member who is a financial expert, as such term is defined by the Commission.

(b) CONSIDERATIONS – In defining the term "financial expert" for the purposes of subsection (a), the Commission shall whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance or similar functions –

(1) an understanding of generally accepted accounting principles and financial statements;
(2) experience in –

(A.) the preparation or auditing of financial statements of generally comparable issuers; and
(B.) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
(C.) experience with internal accounting controls; and
(D.) an understanding of audit committee functions.

(c) DEADLINE FOR RULEMAKING – the commission shall –

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and
(2) issue final rules to implement this section, not late than 189 days after the date of enactment.

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