# Financial Reporting Supply Chain

***Extracted from a project commissioned by the International Federation of Accountants (IFAC)***
***A research survey by CIMA (Chartered Institute of Management Accountants) Team***

The financial reporting supply chain refers to the people and processes involved in the preparation, approval, audit, analysis and use of financial reports. All links in the chain need to be of high quality and closely connected to supply high quality financial reporting.

The cycle both starts and ends with the investors and other stakeholders, who want to make informed economic decisions about a company and, therefore, require financial information to do so. Subsequently, it is management that, under the general direction of the board of directors (supervisory board), prepares the financial information for eventual approval by the board and, in some countries, the general meeting of shareholders. The auditors interact with management and the board while auditing the financial information and provide independent opinions. The media and others distribute financial information, and analysts and credit-rating agencies evaluate it, to be used by the investors and other stakeholders.

Also within the chain there are the various standard setters in the areas of corporate governance, financial reporting and auditing; the regulators, who enforce those standards and professionals, such as investment bankers and lawyers, who provide advice to the other participants.

## Corporate Governance Has Improved

Respondents felt that corporate governance clearly has become better over the last five years. This view was held across all types of respondents and regardless of the respondent's country of origin. Respondents gave a number of reasons for this improvement. For example, boards of directors have become more aware of their responsibilities to provide meaningful reports and to act in a responsible way to all stakeholders. A respondent commented, “Directors of listed companies and statutory bodies have become more knowledgeable about financial reporting, take their responsibilities more seriously and appear to be more independent in carrying out their fiduciary duties.”

Many respondents commented that changes to law and regulation have improved corporate governance. Other respondents pointed to increased communication as a reason for improvement. In one respondent's words, “Governance has dramatically improved. There has been an improvement of dialogue between directors and investors.”

Respondents felt that overall the balance between the costs and benefits of corporate governance had become better over the last five years. While this result was consistent regardless of the type of respondent, regulators were the most positive, while users were among the least positive and felt that the balance had remained about the same.

Looking across regions, there was also little difference between respondents. According to an Asian respondent, “The benefits of corporate governance outweigh negatives. The challenge is to not lose sight of business realities.” A European respondent commented that the cost-benefit balance has stayed about the same, and that in places where costs rose at the expense of benefit, this increase in costs has now ended.

### The Positive Aspects of Corporate Governance

In describing the good things that have happened over the last five years in corporate governance, the issues mentioned most often were:

- o Increased awareness that good governance counts
- o New codes and standards
- o Improvements in board structure
- o Improved risk management and internal control
- o More disclosure and transparency in business and financial reporting

### Increased Awareness that Good Governance Counts

Virtually all respondents felt that past scandals and failures in corporate governance have sparked the increased focus on improving corporate governance. Good governance counts because it makes directors and management more aware of their responsibilities to act in a responsible way to all stakeholders and to provide useful reports and also contributes to corporate effectiveness.

Respondents observed that, although most boards want to do what is right, corporate governance also has become better due to more external pressure coming from regulators, stock exchanges and, especially, investors. One respondent noted, “In addition to the government and financial market regulators, professional bodies have also put considerable efforts into promoting corporate governance.” Greater public scrutiny has helped too. For example, a respondent observed, “The 'name and shame' environment in the UK has increased awareness of issues; companies don't want to be in the newspaper.”

### New Codes and Standards

Changes to the codes, standards and rules governing companies and boards of directors in the past five years were widely felt by respondents to have led to improvements in governance. A respondent from the US commented, "Corporate governance has significantly improved due to the SOX1 Act as boards are now much more involved and there is more clarity around their responsibilities." Respondents also considered that making management explicitly responsible for the information used by third parties was a positive development that had improved corporate governance.

Many respondents preferred the principles-based codes and standards to the more rules-based approach of the US. "Luckily, the UK did not fall in the SOX trap," a respondent noted. Having a 'comply or explain' provision was seen as one of the key strengths of principles-based codes. This approach has lead to companies applying a sensible approach to corporate governance and has resulted in useful additional disclosures. Respondents also felt that increased oversight and enforcement were contributing to better corporate governance.

**Improvements in Board Structure**

Many respondents mentioned improvements in board structure as an important reason for improved corporate governance. The key improvement in board structure mentioned by respondents was recognition of the importance of independent, non-executive directors. "The independent non-executive director provides a useful check and balance," one respondent commented. Non-executive directors, a respondent commented, "have a greater awareness of the expectations that shareholders and others have for them." Various respondents also had the following to say: "Directors that did not do their homework got increasingly concerned about liability and stopped serving as directors";

"New directors have a good understanding of the company and the industry in which it operates and are more knowledgeable about financial reporting"; "Boards are much more aware of board responsibilities"; and "They are conscious of the need to add value for shareholders."

In addition, respondents felt the wider adoption, the increased competence and the improved operation of audit committees have created a key mechanism to bring internal and external audit and management together to the benefit of good corporate governance. Other committees of the board, such as the nomination and remuneration committees, were also considered to add value.

**Improved Risk Management and Internal Control**

Respondents generally felt that increased emphasis on risk management and internal control by executive management and boards had led to improved business operations and better reporting. "The level of engagement is higher and working procedures are improved," one respondent replied.

However, many respondents objected to the way some elements had been applied. For example, the documentation and the testing of controls were often felt to be too detailed and laborious. In the words of one respondent, "The bottom-up approach to the documentation of internal controls over financial reporting (and the resulting identification and testing obligation of many detailed controls) proved to be grossly inefficient and ineffective, which ultimately provided little value to shareholders." Also, the auditor sign-off on top of the management sign-off on internal control was seen as redundant by some respondents.

**More Disclosure and Transparency in Business and Financial Reporting**

Respondents appreciated increased disclosures, for example, on company risks, opportunities and strategic decisions, executive pay, and on related parties. They also mentioned more informative annual reports, more informative corporate websites, more standardized financial reports, and more transparent general shareholders meetings.

Respondents felt this enabled users to get more information about the company and also improved accountability.

## Areas of Concern in Corporate Governance

In describing the less desirable things with respect to corporate governance, respondents were concerned about the following:

- o Governance in name but not in spirit
- o Overregulation
- o The development of a checklist mentality
- o Personal risk and liability for company directors and senior management
- o Cost-benefit concerns

**Governance in Name but Not in Spirit**

Many respondents felt that many changes that have been made were made in "letter," not in "spirit." They shared the view that quite a few companies are pushed to improve their governance more by the regulatory bodies than by their own/inner self-discipline mechanism. In their opinion, numerous companies and boards of directors consider governance as yet another certification, and still think that forming committees and hiring consultants to write polices solves the problem. Companies quickly adopt the easy-to-comply-with governance, but seem slower to adopt the more painful measures. It is "lip service to corporate governance rather than real corporate governance," as one respondent put it.

Respondents noted that there are (still) some individuals who think they are above best practice, for example, "Directors who still believe that they are the company and do not always act in the interests of shareholders."

Respondents felt that fostering a culture for corporate governance is far more than a compliance exercise and warned that compliance in form rather than substance provides a false sense of security.

**Overregulation**

Respondents recognized that the financial reporting scandals of some years ago really let investors down. Many were skeptical, however, about the response. “Additional regulation tends to be a knee-jerk reaction to a corporate failure,” said one respondent, and “governance principles are currently drowned in a whole pile of rules,” according to another. Some feel the result is that “regulation now feels more over bearing and is constantly being raised.”

Respondents especially disliked what one respondent called “the increased prescriptiveness of regulatory frame-works that encourages legalistic compliance rather than principles-oriented 'better' practice.” And many felt that the US has gone overboard with its SOX and compliance disclosure. “This has led to a greater disclosure burden, higher costs, and many companies view it as an exercise in compliance rather than embracing the spirit of good governance,” another respondent noted.

**The Development of a Checklist Mentality**

It was felt that overregulation had created a situation where people focus now too much on compliance and are not talking about matters such as strategy and building a business. There is also too much focus on rules instead of integrity. This might create a culture of simply following rules instead of thinking about how to deal with governance aspects in general. “Increasing the amount of box ticking is unhelpful as it doesn't make people think,” a respondent commented.

Respondents signaled a preoccupation with governance rather than making the company achieve and prosper. As a result, the potential exists that compliance activities are taking too much time and attention and real risk areas could be overlooked. Many believe that companies have become too risk averse and are avoiding risk rather than managing it.

An external auditor commented, “Directors [are] spending more and more time in compliance issues and losing sight of operational issues.” Another respondent recommended that boards take responsibility and “review their agendas and see how much time they spend on the various topics like compliance versus strategy and find a balance.”

**Personal Risk and Liability for Company Directors and Senior Management**

The personal risk and liability faced by company directors was an issue raised by some respondents as it had caused some directors to reevaluate their board positions. Respondents also commented that it is more difficult to recruit new board members and senior management level people due to increased legal liability exposures. “It is not worth taking the risk anymore to assume a board or CEO/CFO position,” one respondent said.

Some respondents observed a level of paranoia which has caused some directors to be overly skeptical and distrustful of the action of management, which has led to inefficient business decisions. They point out the need to allow directors some protection, because now they are too risk adverse. As one respondent put it, “They should only get charged when their wrongdoing is willful.”

**Cost-Benefit Concerns**

The majority of respondents felt that the balance between the costs and benefits of corporate governance had become better. However, many respondents expressed concerns that the costs of certain regulations, especially section 404 of the US Sarbanes-Oxley Act, have vastly outweighed the benefits.

Many respondents felt there was a need for continuous vigilance against having a governance-at-all-costs mentality.

## What Needs to be Done Next in Corporate Governance?

Respondents were asked to think about how to further improve corporate governance in their respective countries and to prioritize a number of different measures that might achieve this goal. The measures respondents considered to be of high priority were:

- Continue to focus on the behavioral and cultural aspects of governance
- Review existing rules as many have been introduced as a response to crises
- Further improve the quality of directors
- Better relate remuneration to performance
- Expand view from compliance governance to business governance

**Continue to Focus on the Behavioral and Cultural Aspects of Governance**

Across the different types of respondents, continuous attention to the behavioral and cultural aspects of governance was considered to be the most important priority. One respondent expressed his “lingering concern that the importance of corporate governance will fade from radar screens, leaving the door open for future governance failures.” Another respondent added, “There is some fatigue about corporate governance.”

Ethics is not only important within companies. One respondent advised, “The ethical dimension social, cultural and personal behavior is fundamentally important throughout the whole financial reporting supply chain.” Another commented, “It is good to improve accounting and auditing, but banks, financial advisers and analysts, credit raters and lawyers should also adhere to a code of ethics.” Still another said, "More attention should be given to governance arrangements of institutional investors themselves, like pension funds and equity/fund management groups" because there are "…lots of conflicts of interests that are inadequately disclosed." Finally, a respondent commented, "Companies are mirrors of the societies in which they operate and they influence each other. Therefore, improved corporate governance has a positive impact on societal governance and vice versa."

**Review Existing Rules as Many Have Been Introduced as a Response to Crises**

Several respondents proposed a review of the regulation that has been introduced as a response to the crises, based on the experiences so far. Others observed that this is already happening in some countries. Comments included: "The Combined Code in the UK has recently been reviewed and found satisfactory; the principles are becoming much better understood," and "The Australian Stock Exchange recently refreshed its principles of corporate governance." Respondents also commented that the approach of some countries was to let the US go first through the process and then adopt what worked and reject what went wrong.

Respondents thought that in developing countries, there should be a focus on the basic principles that underlie good financial reporting, including the existence of a market economy, respect for the rule of law and legal protection for minority shareholders. Many respondents shared the opinion that emphasis needs to be given to improving skills as in some developing countries there is a lack of competent accounting and auditing professionals. Removing impediments to capital flows to allow foreign ownership of domestic companies might also improve corporate governance, according to some respondents, as foreign owners would bring with them skills, experience and expectations with respect to good financial reporting.

**Further Improve the Quality of Directors**

Respondents considered that generally the best people to oversee management are non-executive directors. Therefore, independence of directors is seen as fundamental to good governance. In the words of one respondent, "More independent directors would generally be healthier for governance and making sure that management is 'doing the good thing.'" Many respondents considered that separation of the roles of chairman and CEO is logical and effective. "One runs the company and one runs the board," said one respondent. "They are different roles and it is hard to do both," and "Otherwise there is a risk of a less well-controlled CEO," were other comments made.

For many respondents, the crucial point is the quality of who you get on the board, focusing on substance rather than on form. A better selection processes and annual reviews might help to improve the quality of non-executive directors. Another suggestion was to increase the ability of shareholders to remove directors.

Respondents also recognized the need for (at least) some directors to have significant experience, as one respondent stated, "Directors who have been on boards a long time have accumulated wisdom and skills that are of benefit to the company."

**Better Relate Remuneration to Performance**

According to the survey results, executive remuneration is still an issue, especially as it is difficult to relate remuneration to performance. Respondents held strong views: "Remuneration is the biggest area of trouble [because there is] very little correlation between remuneration and performance," and "A Pandora's Box is opened with all these performance incentives." Another respondent commented, "A lot of compensation is now totally at random" and this was detrimental to the quality of corporate governance as "all or most accounting scandals involve compensation."

Respondents felt that there needed to be a better alignment of compensation with longer term company performance. Alternatives to current remuneration structures included a larger amount of pay in the form of "plain old fashioned salary," and equity only for exceptional performance. As well, respondents considered that there should be more transparency in executive compensation.

**Expand View from Compliance Governance to Business Governance**

According to many respondents, there is a need to consolidate the current position and to move on to other areas, as one of them pointedly said, "Compliance is done. Now we need to go back to business." There is too much compliance governance instead of business governance not only to satisfy regulators, but also because many institutional investors put too much emphasis on compliance with governance rules. Respondents also felt that the overemphasis on internal control over financial reporting should be reconsidered.

Governance should not be a separate pillar mainly concerned with compliance, but "a more integrated way of running your business effectively and efficiently," a respondent commented. Furthermore, control processes should be more embedded in the business processes, and should be designed by people who have experience with the area of organization, people and processes.

And what could institutional investors do to help companies making this transition? Responses included: "They should have a more constructive relationship with management of companies in which they invest," and "Make sure that the dialogue is about long term issues, strategy, overall risk, whether they got the right people in place etcetera."