

Ethics and Financial Reporting: Delivering on the Commitment

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Thank you ...

The world of auditing and financial reporting has changed considerably since I first became a CA 32 years ago.

The business of our clients is much more complex. We auditors now must work much faster and, hopefully, smarter. Our assurance on the fairness of financial statements – once read by a handful of interested parties – now is accessible to, and in many cases important to, any shareholder, employee or interested party.

But as far as my colleagues and I are concerned, there is one thing that has not changed. It's very clear to us that the health of our capital markets depends, as it always has, on people behaving in an ethical way...on us being able to trust the words and deeds of others... and especially, on the integrity of corporate financial information.

Over the past year, we've seen huge corporate collapses caused directly by the unethical behaviour of senior executives – and huge losses for investors who relied on the financial information produced by those corporations. As a result, public trust towards corporations, their managers, their directors and their auditors has been damaged. And, public expectations regarding honesty, integrity and transparency have increased considerably.

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My objective today is to give you some insight into certain regulatory changes that are helping to address these expectations and promote trust in financial reporting.

Because I'm an auditor, I do want to spend some time talking about my profession – the public accounting profession – and how it works with management and audit committees to achieve this level of trust.

My profession has a critical role to play here – and it's a role that we take very seriously.

I am also going to talk about our role, and the roles of others in the financial reporting process... and how these roles have changed in the past year as a result of new rules and regulations.

I'm going to discuss the ways we carry out our role – for example, how we evaluate ethics, culture and tone at the top when we perform an audit. And, how what we discover about the ethical culture of the organization affects our audit work.

And finally, I'm going to talk about our own ethical obligations as auditors – and the ways that my firm, KPMG, supports those obligations.

So, let's start with the question – who's responsible for fair and transparent financial disclosure?

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We, the auditors, bear part of this responsibility. Our role is to represent the interests of a variety of stakeholders, to ensure they receive balanced, complete information about corporations' financial performance.

In doing so, we audit financial statements according to the standards of our profession and our firm.

Financial statements and related disclosures are the tools that a company uses to communicate its financial performance to its shareholders.

Shareholders want to know that financial statements and other financial information received are a fair representation of financial performance. They need assurance that this information can be trusted. That it tells, in a balanced manner, the story of the company's health and performance. The good and the bad.

Providing this assurance is a critical part of our job. But we can't do it alone – there are other players with important roles.

In fact, today's capital markets rely primarily on three parties to ensure ethical disclosure and active oversight.

The first party is **management** – the people who prepare the company's financial statements. Management is directly responsible for these financial statements... for the extent of the information disclosed, and for all estimates and assumptions used in getting to the final numbers.

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They are also responsible for the company's financial reporting process and internal control structure. This includes understanding, assessing and implementing policies to mitigate risk.

The **external auditor** is the second party. Essentially, the auditor's job is to evaluate how management has carried out its work, and to determine the reliability of the financial data presented by management. The auditor is accountable to the shareholders, through the audit committee and is responsible for auditing and reporting on the financial statements.

Finally, the **audit committee**... which is a sub-committee of the Board of Directors. These people oversee the company's financial reporting process and the related internal control structure. They play the role of a skeptical inquirer: a knowledgeable, independent voice that is not afraid to ask the tough questions of management and the auditors.

When this system works – and in the vast majority of cases it does work very well – investors get the product that they expect... financial information that presents a true and fair picture of the company's financial performance and health.

So what has changed? How is the system different than it was last year, when a series of financial scandals occurred?

Well, over the past 12 months the system has been strengthened. We have seen a number of important regulatory changes – in both Canada and the US – that affect all participants in the financial reporting process.

Management's responsibilities have increased. For example, the US Sarbanes-Oxley Act now requires CEOs and CFOs of US public companies to provide three types of assurances:

- One – they must personally certify the accuracy of the company's quarterly and annual filings.
- Two – they must certify that there are effective disclosure controls and procedures in place
- And three – they must provide an assessment of the internal controls over financial reporting.

These are US rules. But it is likely similar rules will be put in place in Canada, applying to Canadian management and their auditors.

Audit committee responsibilities are changing as well. Now, under Sarbanes-Oxley ...

- All members of a public company's audit committee must be independent of management.
- The corporation must disclose whether the audit committee includes at least one designated financial expert.

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- Audit Committees will now be directly responsible for the appointment, compensation and oversight of the auditor.
- And, they must oversee the auditor's independence – by, among other things, pre-approving all non-audit services provided by their audit firms and monitoring partner rotation.

Once again, these are US regulations for US-listed companies – but we have every expectation that Canadian companies, auditors as well as regulators will harmonize these procedures in many cases.

There are new rules in place for auditors as well. Here in Canada, our profession has voluntarily worked with the regulators to create the Canadian Public Accountability Board, or “CPAB”. The founding Chair of CPAB is Gordon Thiessen, former Governor of the Bank of Canada.

This Board, which is independent of the CA profession, will oversee the firms that audit Canadian public companies. This is a very significant change for us because until last year our profession had been self regulated throughout its entire history.

CPAB will inspect the audit quality of the large CA firms. It will be able to impose tough sanctions on auditors that do not comply with its regulations.

The CA profession has also drafted new standards governing the independence of auditors from the clients they serve. The standards identify a list of nine non-audit services that are considered inappropriate for auditors

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to perform for their audit clients. They also provide guidelines for the periodic rotation of audit firm partners providing audit services to a client.

At KPMG, we welcome all these changes, and we believe they are good for investors and for our profession. They are reasonable and appropriate. They will contribute to greater transparency in financial reporting, and will help restore confidence in the financial markets.

So far, I've spent quite a bit of time describing the financial reporting system itself, Now, I'd like to speak to the work that we, as auditors, do to provide assurance on financial statements.

What is this work, anyway? And what factors affect it?

One of the most important things we do as auditors is to assess risks in the business.

To do this, we start at the top. First we work to understand the business, its risks – both internal and external – and the impact they can have on the financial statements.

Once we understand the business risks, we look at the company's internal control environment.

We study the “tone at the top” – the way management operates, its ability to override internal controls.

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We analyze how information flows and gets into the financial statements.
We test transactions to the extent we consider necessary.

Once we've done all this, we are in a position to report to the Audit Committee as to the fairness and transparency of the financial information that management has produced.

In addition to our direct responsibilities for financial reporting, we have an obligation – an OBLIGATION – to report to the audit committee any financial statement frauds and any other illegal acts that we've uncovered.

The mere fact that companies know there will be an audit of their statements, that misdeeds must and will be reported, acts as an important deterrent to unethical behaviour.

One factor stands out as critical to the success of our work, and I have already mentioned it. It's that elusive thing called "tone at the top" – the tone that is set by management.

It makes our job a lot easier if the tone at the top is open and collaborative. It is much easier to work in an open environment where people are encouraged to speak their minds. There, we can find out what we need to know in order to provide assurance on financial statements that speak clearly to the financial condition of the company.

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It also is more difficult to hide fraud in such an environment. So, we can certainly make a case that those with the power to set the tone of a company should consider a model of openness.

The attitudes and preferences of audit committees also have a big influence on our work. Let me explain.

Auditors are obliged to have discussions with the audit committee about the “gray areas” of a company’s financial reporting – the judgement calls that management has made in preparing the financial statements. Audit committees will often have these discussions with us *in camera* – that is, without the CFO and other members of management present – and this is healthy.

Over the past few months, we have noticed a change in the way that audit committees are approaching their role.

Audit committee meetings are lasting longer and being held more frequently. Members are better prepared and are asking more detailed questions of both management and auditors.

We think all this is good. We prefer it when audit committee members are tough-minded, when they have the confidence **NOT** to unquestionably accept on what is put before them. Better that they challenge, that they become actively engaged, that they work hard to fully understand the implications of accounting policies, disclosures and judgments.

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There's another critical factor that affects our audit work. It's called "knowing whom you are dealing with."

To appreciate our role, you have to understand that auditing is really a people business. "Number crunching" does not adequately describe what we do. We are equally interested in the people who create the numbers and make the decisions. We're interested in their characteristics, motivations, and, of course, their ethics and reputation.

It's the actions of people that ultimately set the ethical environment of a corporation.

That's why we spend so much time and resources learning about the senior people that we deal with.

I can tell you, for example, that we follow strict procedures when considering a company as a new client. We must obtain the agreement of the engagement partner, a second partner and our professional practice group.

We also have a forensic unit that performs rigorous background checks on management, the Board of Directors, company activities and history.

Our reputation means everything to us and we would be remiss if we did not do our own due diligence before accepting an engagement. We do resign from accounts, and we do reject engagement opportunities if we believe they are not appropriate for us.

I'd also like to repeat a point that you've probably hear many times before – accounting is more of an art than a science. Business transactions are inherently very complex, and often it is not easy to account for them. In arriving at the final numbers, management makes many estimates and judgement calls. And we, as auditors must determine if those judgements result in fair and transparent disclosure.

This is the hardest part of our work. Here, there are few black and white choices, and many gray areas where the auditor's judgment is required. To be comfortable with your choices as an auditor, you have to trust management.... trust them to provide you with all necessary information, and trust them to be open with respect to the judgements and estimates they are making.

Which leads us to my last topic: the ethical environment of our profession, and my own organization.

Our profession has always been focused on maintaining the independence and integrity of its members.

Some of the reasons why are obvious ... we don't want to be criticized for a professional mistake, we don't want to be disciplined – either individually or as a firm. But even more... we are deeply concerned about the credibility of our profession... and as a profession, we must always put the public's interest first.

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What steps do auditors take to protect this credibility?

Certainly, policies and procedures are part of the story. Every chartered accountant is bound by the Rules of Professional Conduct of the provincial CA Institutes. On top of this, the individual firms – and KPMG is no exception – have extensive written policies that aim to reinforce independence and ethics.

On every audit we require an independent review by a concurring partner who otherwise has nothing to do with the engagement. He or she must be satisfied with proposed accounting treatments – and if not, he or she has the right to require that a change be made.

We also have a national professional practice group that provides an independent review of complex accounting treatments. These reviews are even more rigorous than the CA profession's quality control standards.

We have a saying at KPMG – “if you fly alone, you die alone”. You can imagine what that means. Dialogue is a critical part of our internal checks and balances. Consultation – a very low-tech exercise – is one of the most important elements in our ethical framework.

Remember when I talked earlier about the dangers of working in a culture that doesn't encourage openness? I can't emphasize this enough. We tell our folks that whenever their antenna is raised, whenever something doesn't seem right – or there are tough questions with no easy answer... discuss it with someone else. Let's not make this YOUR call. The more viewpoints,

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the more perspective, the better the chance of making the correct and most ethical decision. If you encounter disagreement – move it up the chain, follow the process. Make it KPMG’s decision.

In our view, an ethical culture demands that we professionally challenge each other.

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At the beginning of this speech, I said that health of our capital markets depends on people behaving in an ethical way. I’d like to return to that theme for a moment as I conclude.

Today I’ve told you about the various regulatory systems that help to preserve trust in our markets. I’ve talked about how these systems have been enhanced following the corporate scandals of last year. I’ve talked about the roles and responsibilities of company management, audit committees and auditors in maintaining the integrity of financial reporting.

All these checks and balances are sound and necessary – but by themselves they will not result in ethical financial reporting. Why? Because, in my view, ethics start, not with rules, but with people.

If the people responsible for financial information are honest and ethical, then their work products will be worthy of trust.

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If people are unethical, no regulations, professional standards or penalties in existence will guarantee the integrity of their companies' financial statements.

A business leader who is known to be honest and trustworthy will influence the attitudes and behaviour of the people around them.

If that leader creates an open and trusting environment, then people will not be afraid to speak out when someone in the company behaves in an unethical way.

If a leader is ethical and honest, his values of trust, honesty and transparency will establish that a culture in an organization. If not

You all are or will be leaders of organizations. Remember your personal responsibility for ethical behaviour; remember how it will affect an organization; remember how important your personal reputation is; never endanger it.

Thank you very much.