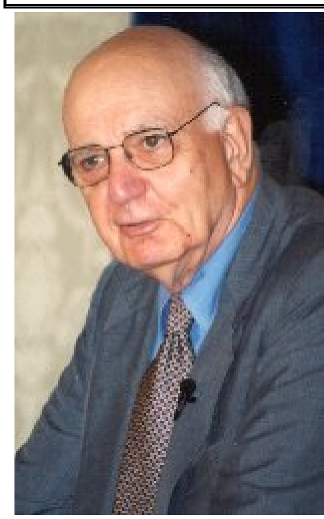
Enhancing Financial Transparency

July 24, 2002

Summary

In response to the recent wave of corporate accounting controversies that has shaken investor confidence in U.S. financial markets, the FDIC gathered prominent policymakers, academic experts, and business and accounting professionals on June 4, 2002 to participate in a daylong symposium addressing transparency issues. Participants in the "Enhancing Financial Transparency" conference discussed the strengths and flaws inherent in the U.S. financial reporting process and suggested ways of modifying not only the reporting mechanism, but also the accounting standards that underlie financial statements, audit opinions, credit ratings and analyst reports. Ethics and compliance were important areas of concern, as participants identified the growing need to instill ethical conduct as a core value in corporate America. This issue of *FYI* and an accompanying *Bank Trends* report summarize the comments provided by participants in the June FDIC symposium.



Paul Volcker calls for action, stating that "We can't legislate ethics, but we sure can point in appropriate directions."

The collapse of Enron in December 2001 underlined the issue of accounting transparency in the minds of investors in U.S. financial markets. As revelations of accounting improprieties have continued, investors appear less certain of how to assess companies' profitability and performance and more likely to question the accuracy of financial reports. Investors and regulators alike need dependable financial disclosures if they are to assert effective market discipline; without such oversight, investors cannot trust market values. This need has become more acute in recent years as individual investors have increasingly taken charge of their own investment portfolios and retirement funds.

Charged with maintaining public confidence in the U.S. banking system, the FDIC shares responsibility for safeguarding the vitality of our financial markets and institutions. To this end, the FDIC hosted a June 4, 2002 symposium entitled "Enhancing Financial Transparency" to address timely issues concerning financial reporting, accounting standards and regulatory remedies. This issue of *FYI* provides a high-level summary of the issues discussed at the symposium. A description of the comments made by symposium participants is provided in an accompanying *Bank Trends* report. The summaries synthesize the participants' views, and do not necessarily express the opinions of the FDIC.

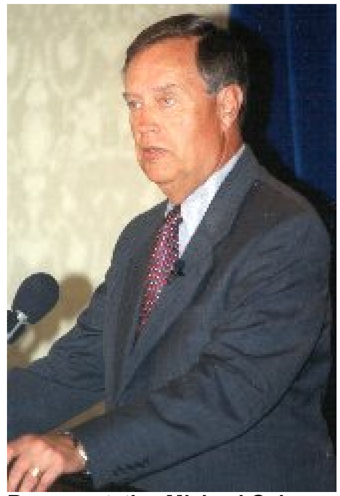
One of the largest problems facing today's investors is that poor quality financial reports preclude effective, informative fundamental analysis. The reasons for inaccurate financial reporting are varied -- a small, but dangerous, minority of companies actively intends to defraud the investor, while others may set forth information that is misleading but technically conforms to legal standards. In particular, the rise of stock option compensation has increased the incentives to misreport key information. For instance, companies have increased their reliance on *pro forma* earnings, which can include hypothetical transactions, and the use of similar techniques. Many other companies simply find it difficult to present financial information in compliance with complex, evolving accounting standards. To facilitate investor access to the "right" information, corporations should stress timeliness and plain language in their financial reports, and analysts should recognize the need for comprehensive manual analysis that can handle the financial details that even the most sophisticated computer model could miss. Individual investors should also receive appropriate education to help them decipher financial statements.

The accounting standards themselves can be another obstacle to financial transparency. Today's standards are increasingly criticized as convoluted and out-of-date; they are not seen as applicable to a financial era that is change-driven and risk-focused. Instead, a more generalized approach, which would allow audits to assess the overall financial health of an organization and identify emerging risks rather than focus on strict compliance with standards, might be more appropriate. Consistency, both across U.S. financial reports and internationally, is also desirable. Standardized definitions of such key concepts as earnings and earnings per share would facilitate comparisons of companies' financials. In addition, international convergence is important in today's global marketplace; while the U.S. accounting system is superior in some respects, international accounting organizations can offer guidance in other areas. The standards setting process, too, should be modernized and streamlined to ensure that guidelines can be altered, created, or eliminated as changing conditions dictate.

The acceptance of ethical behavior as a key corporate value is essential to achieving financial transparency. Because there will never be enough "accounting cops" to constantly monitor every organization, corporations need to be encouraged to practice self-compliance and incentives should be structured so as to promote ethical conduct at all levels of the corporate hierarchy. Suggested corporate strategies include the creation of ethics hotlines, the installation of corporate officers dedicated to governing ethics and compliance, and the development of codes of conduct to be signed by all employees. Auditor independence is also crucial to the ethical ideal, as serious conflicts of interest can exist when accountants and their clients have relationships that go beyond the professional audit function.

Consideration of the problems associated with financial reporting, accounting standards and ethics and compliance has led to the proposal of several regulatory changes to improve financial transparency. There are many opinions regarding the form that such changes should take. While some conference panelists championed stronger government regulation as the only way to ensure an effective financial reporting structure, other participants questioned the need for additional regulation, preferring to let market forces and private oversight bodies perform the regulatory role. Advocates of stronger regulation would enhance enforcement by increasing the staffing and resources of the Securities and Exchange Commission (SEC), and would seek to improve corporations' internal audits by requiring audit committee members to possess appropriate skill sets and accept greater responsibilities.

As pressure mounts to remedy the current investor insecurity and prevent future accounting scandals and financial collapse, policymakers have incorporated some of the suggested technical, cultural and regulatory reforms into specific policy initiatives. President Bush has outlined a ten-point plan to bolster corporate responsibility and protect the investor by controlling the quality of financial disclosures, increasing corporate officers' accountability, stressing the independence of the audit process and creating an independent regulatory body. The House of Representatives passed the Corporate and Auditing Accountability, Responsibility and Transparency Act (CAARTA) in April 2002 and the Senate passed its version of the legislation, the Public Company Accounting and Investor Protection Act, in July. Both bills would clarify and limit the permissible relationships between accounting firms and their clients, impose stronger penalties for corporate fraud, and establish some form of accounting oversight board. While there are important differences between these executive and legislative proposals, each stresses the need for government involvement in overseeing the accounting profession and financial reporting infrastructure. Although the policy process is often lengthy and contentious enough to bar meaningful reform, financial transparency issues have gained a degree of import and salience that demands policymakers' dedicated attention.



Representative Michael Oxley outlines his accounting reform legislation, which was passed by the House of Representatives in April.

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