A Crises in Confidence - Restoring Credibility to the Bottom Line

Speech by Isabel Meharry , President FEI Canada
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I'd first like to say how pleased I am to see all of you here at the first Marcus Evans Canadian CFO Summit. On behalf of Financial Executive International in Canada, I would like to thank our hosts for this opportunity to speak to you. In case your not familiar with FEI, we are the single largest organisation in North America representing top level finance executives in industry. Together with our sister organisation based in New York, we represent the interests of over 16,000 CFOs, EVPs Finance, Treasurers and Controllers in North America. We play a critical role in the policy making process in both Canada and the US and on your behalf, act as advocates to the standard setting and regulatory community. As President of FEI Canada it's my job to listen to the concerns of senior financial officers across the country. Another part of my job is to keep you and your finance colleagues informed about the major issues that will impact your companies.

I've been asked here today to discuss the Crises in Confidence in the North American Capital Markets and to talk about how we, as financial executives can help restore Credibility to the Bottom line. I don't think there's much debate over whether the scandals that have emerged since Enron have shaken investor confidence. Stock market performance over the past two years, in addition to reflecting the general economic malaise in the US, has clearly responded to the ongoing barrage of earnings misstatements and indictments of senior executives. Just ask any mutual fund manager today what happens when investors get nervous. …..And people ARE nervous. Particularly in the US. They see governance problems in every sector of the economy. In the companies that finance their homes. In the companies that hold their pensions. And…. with the indictment of Martha Stewart…..even in the companies that represent motherhood and apple pie. At the same time, people see the leaders of industry drawing personal salaries that are higher than the total GDP of some third world countries.

Take the tiny African country of Sao Tome for example, (which by the was has recently discovered that it's sitting on about two million barrels of crude oil.) It's GDP in 2002 was 50 million US dollars. That same year, Steven Jobs, CEO of Apple Computer earned almost 90 million. We don't have to look to these extremes in CEO compensation to understand why investors are a little confused. According to *The New York Times*, in 2002 the average median pay of a CEO was $8.52 million. This meant that while shareholders lost an average of about 2.3 trillion, CEOs got a 6 percent pay raise. In my opinion it really doesn't get much worse than this when in comes to shaking investor confidence ,,, and almost two years later, the newspapers continue to remind us daily of the corporate wrongdoings.

To recap, in last month's news headlines …..Two of the world's largest financial institutions, Morgan Stanley and SSB have been dragged into the investigation of alleged

accounting irregularities at mortgage giant Freddie Mac. The Office of Federal Housing Enterprise Oversight in the US, which oversees Freddie Mac and Fannie Mae, is now looking into whether these banks actually helped Freddie Mac create deals to hide big gains and smooth out earnings. Also that month, The Securities and Exchange Commission filed charges in federal court in San Diego against three former executives of Gateway Inc. for fraudulently manipulating earnings to meet Wall Street analysts' expectations. The SEC's complaint alleges that when the trio realized Gateway's results were going to come in short of Wall Street expectations, they engineered a fraudulent scheme to "close the gap" between analysts' expectations and the company's actual revenue and earnings.

This included contacting individuals whose credit applications had previously been denied by the company, and offering them pre-approved financing to facilitate sales. The sales campaign to high-risk customers contributed more than 5 percent of Gateway's second-quarter revenues.
The entire scheme looks like the typical cook-book of accounting manipulations

- reduce loan loss reserves,
- recognize revenue from a consignment sale,
- recognize revenue from a purported bill-and-hold sale,
- accelerate purported revenue from payments by America Online for bundling its Internet service with a Gateway PC purchase,
- record revenue from the sale of the company's fixed assets,
- make a variety of additional undisclosed accounting adjustments

As a result, Gateway announced that for the third quarter of 2000,
- it exceeded analysts' expectations for revenue by $30 million,
- met analysts' expectations for earnings per share of 46 cents,
- and experienced year-over-year revenue growth of 16 percent.
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The actions by the three executives caused Gateway's net income for the third quarter of 2000 to be overstated by more than 10 cents, or 30 percent, and inflated reported revenue by $154 million US , or 6.5 percent.

Last but not least, the US mutual funds industry has been dealt several blows over the past few weeks. On Monday November 3rd, Lawrence Lasser was discharged from his duties as CEO of Boston based Putnam Investments following a probe into "market-timing" practices.

I don't expect he will be alone. The SEC predicts that as many as one in ten top fund-management groups and more than a quarter of brokers may have allowed, or even encouraged, clients to engage in illegal "late trading". This certainly doesn't bode well for the industry. After all was said and done, investors pulled over 14 billion out of Putnam since the investigation began.

Clearly, abuses like these are making it exceedingly difficult for us to convince investors that corporate malfeasance isn't an epidemic. Even though we know that great majority of us manage our companies with prudence and integrity to the best of our abilities.

So how can we recover from this? Thus far we've been attacking the problem primarily on the regulatory front.

We know that over the past two years regulators and standard setters have been focused on increasing the accountability of senior officers, improving the credibility and transparency in financial reports, ensuring non-bias of both the external auditor and audit committees and in increasing shareholder representation. I won't go into detail here, but generally speaking the arsenal of new controls surrounding governance include:

CEO/CFO Certification
New MD&A and Continuous Disclosure Rules
New Accounting Standards
Rotation of Audit Partners
New Auditing Standards respecting independent testing
New responsibilities of Audit Committees and Independence Requirements
Financial Literacy of Audit Committee and AC Financial Expert
Director independence and shareholder proxy rights

Some of these measures have been met with quite a bit of resistance, while others have been applauded. I suppose it depends on which audience you're sitting in. For example, I don't imagine I have to convince anyone out there of the value of the Audit Committee Financial Expert requirement. However, I may have a bit more trouble convincing you of the benefit of CFO/CEO certification, or the effectiveness assessment of your financial controls. ….or even more controversial , independent testing of effectiveness by the external auditor.

Most of these measures have inspired a great deal of debate and a certain amount of frustration. Let's take CEO/CFO certification SOX 404 in the US and Multilateral Instrument 52-109 of the Canadian securities regulators. On the upside, if successful, the CEO/CFO certifications are expected to have the benefits of curtailing corporate malfeasance, enhancing the value of the CFO, and renewing emphasis on ethical conduct. As a derivative benefit, complying with CEO/CFO certification rules are expected to cause companies to re-evaluate their control practices on an ongoing basis, which will hopefully result in continual improvement in the overall control environment.

On the downside, many people are concerned that CEO/CFO certification will merely create risk averse managers and produce substantial administrative costs , not to mention boost auditors fees. While we don't have any results about how these new rules will restore investor confidence, we certainly have some preliminary results that tell us what the initial impacts on the company have been. First, we've learned from the US experience that there have been some significant conceptual and practical challenges to meeting the internal control certification requirements of SOX 404.

To refresh your memory, Sarbanes Oxley 404 requires the management of a public company to assess and certify to the effectiveness of the company's disclosure controls and internal controls for financial reporting. In order to assess the effectiveness of both

disclosure controls and the internal controls for financial reporting CFOs have to understand the distinction between the two. In the US this resulted in a considerable amount of confusion. Ultimately, the SEC provided some guidance on it, however, there remains significant overlap between the areas. This has proven to create some additional complexities in the assessment process. Internal controls over financial reporting could be subsumed in disclosure controls and some disclosure controls could be subsumed in financial controls. For example, disclosure controls and procedures will include those components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles. However, the SEC recognized that many companies will design their disclosure controls and procedures so that they do not include all components of internal control over financial reporting. They have therefore separated the two types of controls.

As you know this is not only a US issue. Canadian companies that file in the US are are subject to the same rules applied to US domestic public companies filing with the SEC.
In Canada, while the term "internal controls" has been used instead of internal controls over financial reporting, it's likely that the same distinctions and overlaps will exist. On the implementation side, one of the major challenges has been establishing a paper trail for the internal control audit. Not only are CEOs and CFOs required to certify that their financial controls are effective, the SEC has stipulated that a company must also document both the design of the internal controls and the testing process that was used to evaluate them. Currently there's no explicit requirement like this in Canada . However, I expect that a similar level of rigour will be necessary in Canada for audit purposes. Those of you who are in the beginning stages of documentation may wish to look to some us examples of how this distinction was dealt with. Specifically, Guidant Corporation and ATT are both well into the documentation stage of SOX 404. In Canada, you might want to look take a look at what the Royal Bank and Bell Canada are doing.

CFOs should be prepared to factor documentation into their costs estimates. Both AT&T and Guidant Corporate suggest that 1% of the workforce is a good estimate of how much internal man-power it will take to comply with SOX 404. Preliminary data from the US suggests that these costs could be significant. A recent CFO Magazine survey has concluded that nearly half of public companies in the US will spend at least $US500,000 each on complying with the new rules. Going forward, the finance executives in the study said they expect costs to increase by an average of 4.1% in the second year and decline by an average of 2.5% thereafter. The bulk of the cost increased comes from the administrative work gather and certifying information. According to the survey , 76% of compliance costs are for added internal resources, and 24% are for external assistance.

And then there's the issue of auditors fees. The range in estimates of the increase in the auditors fees is quite varied. From the companies perspective, many are hoping, perhaps a bit optimistically, not to pay more than 35% more. However, the audit community anticipates that the audit fee will double in the first year. In Canada, an OSC external consultant estimated the net present value of the industry-wide costs of compliance over a 10 year horizon to be $120 million to $140 million. Given that companies are generally smaller

here, it's not likely that compliance will burn as much cash as in the US. However, based upon the experience of some of our interjurisdictional listers members' in Canada, we have to conclude that the Canadian study tends to underestimates the costs.

The costs identified in the analysis, were limited to an increase in internal hours spent by the CEO and CFO; a small increase in CFO salaries and increased expenditures on auditors and lawyers. It tended to ignore the increase in time expended by the internal staff involved in the preparation of the issuer's financial information, and involved in reviewing, monitoring and testing internal control systems to provide a basis for certification.

Derivative Impacts

-40% say "very little" effect on current processes
-CFOs will work 15 more days per year
- finance department will add staff
- longer board meetings and double the work load
- premiums paid
-late 10k filings up
-adversarial relationships have evolved
-costs of third –party accounting firms
-CFO compensation packages will rise

Other polls in the US suggest that CFOs will be working an extra 15 days per year and the finance department at mid-sized and large sized companies will increase the number of hours worked by two hours per week for each staffer. BCE has added 50 more finance people to work on SOX 404 alone. Companies are also experiencing longer board meetings, board service is now twice the work-load, and premiums have to be paid to the D& Os. Also, late 10-k filings are up by 30%. According to some CFOs in the US, the relationship between CFOs and external auditors has become more adversarial. Complying with SOX is also expected to hurt companies in the 30 million and less revenue range because CFOs in those companies focus on operations and raising funds, rather than non-revenue producing activities. They are therefore hiring third-party accounting firms to mitigate certification risks. US companies in this group can expect to pay about $US 150,000 annually. Ironically, the added risk is bringing about higher salaries for CFOs.

The CFO survey that I referred to before asked about whether or not the internal control effectiveness assessment would result in a change to their current internal control environment. Forty percent of the CFOs involved in study said that the increased monitoring of internal controls will have "very little" or no effect on their current processes and 30% claimed that the benefits will out way the costs. Another of the immediate impacts of CEO/CFO certification on companies, is that CFOs have been spreading the risk throughout the organisation. Most CFOs involved in SOX certification here and in the US have created a "chain of sub-certifications" with their direct reports. The direct reports in turn may require the same of their respective direct reports, and so on. Of the 300 companies involved in the SFO survey, 83% reported that they have adopted upward certifications. In another study, Financial Executive Research Foundation (FERF) found

that lower level sub-certification ranged along a continuum that included as many as 250 individual letters from three to 26 business units. The same research showed that most companies used disclosure committees with 6 to 16 members to facilitate updates to management, and that certification involved a variety of functions including legal, tax, controllers group, communications, planning/development, and internal audit. In addition, most companies set up anonymous help-lines that provide for proper notification to internal audit and audit committees and companies generally are using third party security vendors to screen complaints.

Clearly, we know that certification is going to take up a lot of our time and energy. Our challenge in the coming year will be to try to avoid some of the pitfalls of certification that have occurred in the US through keeping ourselves informed by reading available case studies, and consulting with colleagues who have already gone through the process.
One thing that has created some concern among CFOs in the US is how to certify the controls of their outsourced financial processes. For example, will they be required to assess the effectiveness of their billing or collections services? Ultimately, will suppliers be required to certify to the effectiveness of their controls as part of the service provider agreement and how will the contracting company verify this? Will non-public companies have a certification standard to turn to like ISO for example?

These have been some of the major impacts on US companies to date. The overall impact on restoring investor confidence won't be known for quite a while. In fact we may never be able to determine whether these efforts are restoring investor confidence. However, what we do know is that the role of CFO is central to this effort. It's clear that with the changing regulatory regime in North America, CFOs are now expected to accept personal accountability for the transparency and accuracy of their company's financial reports. They are expected to attest that the controls and procedures are in place that will allow them to make fair and accurate representations according to GAAP. However, and perhaps most significantly, corporate finance executives are expected to act as the ethical conscience of their organisations.

I believe that Canadian CFOs are in a unique position to meet these challenges head on by virtue of our history in Canada, the nature of Canadian GAAP and a reputation for having one of the best records of corporate governance anywhere. In my view we have to make the investor community aware of our history of professional integrity, our unique governance environment and record. We also need to make them aware that corporate ethics is not something that is being taken for granted, but something that plays a major role in how our companies are being run now and in the future.

I believe that the new regulatory environment provides an opportunity for us to reinforce the standards of professional ethics and integrity that have always been the foundation of the accounting profession in this country. Each professional accounting designation in Canada has its own stringent code of professional ethics, which are all broadly reflected in FEI Canada's own code. This code commits our members to:

act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships;

provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.

comply with rules and regulations of federal, state provincial and local governments, and other appropriate private and public regulatory agencies;

act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated;

respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose;

confidential information acquired in the course of one's work will not be used for personal advantage;

share knowledge and maintain skills important and relevant to constituents' needs;

proactively promote ethical behaviour as a responsible partner among peers, in the work environment and the community; achieve responsible use of a control over all assets and resources employed or entrusted.

While the codes of ethics of the various accounting bodies in Canada may not be worded in exactly the same way, we are clearly in agreement with the principles upon which they are based. I believe that these principles have always been valued and as the cornerstone of our accounting profession in Canada…and widely recognized by external stakeholders as well including the retail and institutional investor.

Even at the height of concerns over auditor independence , professional accountants were held in high esteem. You might be surprised to hear that an independent study commissioned by the CICA showed that even in the height of the accounting scandals in the US, CAs were ranked number one in terms of their reputation for ethical practices compared to other professional groups such as doctors, lawyers, bankers and other executives. I think it's time to take the opportunity to build on this reputation and make it widely known to the average investor through whatever means possible.

Second, investors should be aware of the differences between the compensation environment in Canada vs the US and the nature of Canadian GAAP. Canadian CFOs haven't been placed in placed in the same conflict of interest position as our counterparts in the US. Senior finance officers just don't have the same incentives or opportunities to pump up share prices. We simply don't use stock-based compensation to the same extent. Furthermore, because we take a more principles based approach to standard setting in Canada, our GAAP is not conducive to the type of financial engineering that caused so many problems in the US. In the last year there has been some movement towards principles based standards in the US, or

as the SEC would call it, "objectives based standards." This, in my mind, demonstrates that US and other international standards setters recognize the virtues of the Canadian GAAP, and the potential for removing the incentive towards financial engineering along with other difficulties created by extremely complex accounting rules.

Third, Canadian corporate governance practices support high standards of financial management. We have excellent board oversight in Canada, which provides strong incentives and support to our financial management team. In fact, according to a recent US study , Canadian companies have the best corporate governance practices in the world. The study looked at board accountability, disclosure, executive compensation, shareholder rights, ownership base (widely or narrowly held) takeover provisions, corporate behaviour and social responsibility across 1600 companies and 15 countries. Of a possible rating of 10, Canada scored 7.2, the highest rating of all. Two Canadian companies, BCE and Alcan received perfect scores.

As CFOs we should be extremely proud of our professional history, our governing principles and track records**.** However, we must also be aware of the potential for continuous improvement. I feel that we can still do more to instill confidence in the investment community through a directed and purposeful program of ethics communications strategy. This follows from the good work done by one of our own distinguished Canadians.

Last year the International Federation of Accountants set up a task force for rebuilding public confidence in financial reporting. The task force was Chaired by former Bank of Canada Governor John Crow. Mr Crow and his task force made observations and recommendations for action beyond compliance. CFOs should provide the ethical leadership for the company, and ensure that that this leadership translates into concrete actions and measurable conduct. Ethics policies will have to be widely distributed and ethics training programs might be implemented to better enable people to face difficult ethical questions. The board will have to be actively involved in monitoring the ethical conduct of management. This in turn has to be communicated to shareholders as part of the systematic reporting of company results.

It is my hope that with diligent adherence to compliance combined with a renewed focus on corporate ethics programs and communication, we will be well on our way to restoring investor confidence in the bottom line. In my view these efforts will also improve the overall performance of your company. Firms that go to these lengths to build investor confidence will be viewed as less risky, will face lower capital charges and gain competitive advantage over companies that merely stick to the compliance check list.

Furthermore, I believe that there will be process improvements and efficiency gains in the assessment of your internal control systems. ….

If we really focus on fixing some of the weakness, we will improve the cost-benefit ratio.

Most companies that I'm familiar with have never done a complete assessment of their financial and disclosure controls with the view to reducing systemic risk. This is a huge opportunity for CFOs today. How many times have we really wanted to know where the weaknesses were but have been unable to evaluate our entire system of financial and disclosure controls. We have that opportunity now. Imagine if you were a CIO. You've just been given the mandate and budget to fix the weaknesses in your IT architecture and legacy systems. You'd be pretty excited. You are probably in the strongest you have ever been in to get things done. I encourage you to see the opportunities instead of merely seeing a drain on your time and resources. CFOs have never before played such a critical role in their companies and in the economy as a whole. With that, I would like to thank you for your attention today and look forward to meeting many of you over the next two days.