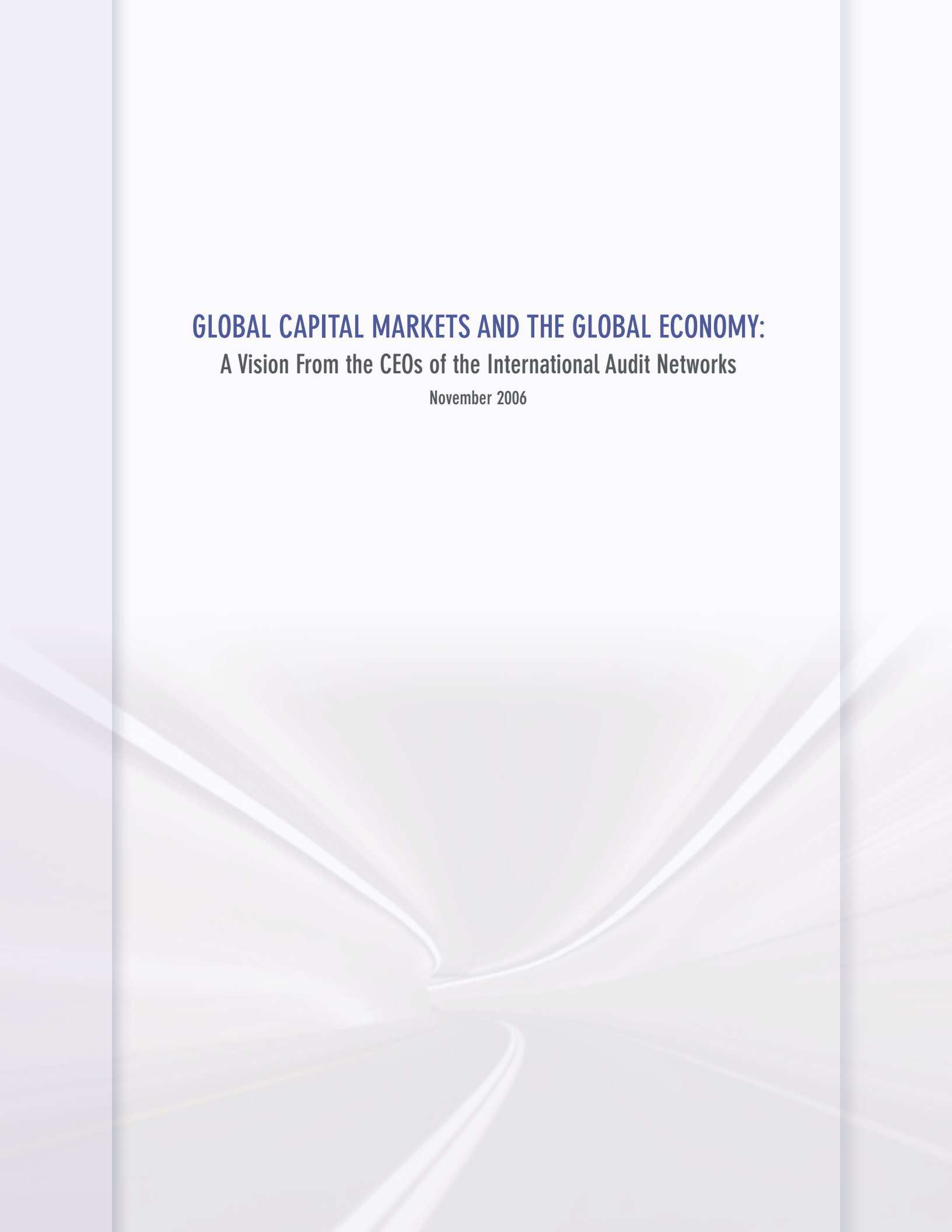




GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY:

A Vision From the CEOs of the International Audit Networks

November 2006

EXECUTIVE SUMMARY

Investor confidence is easily shaken, but hard to restore. In the wake of corporate scandals, regulators, issuers, investors and public company auditors have all had important roles in working to win back that trust. As the leaders of the six largest global audit networks, we have sought to play our part by rededicating ourselves to the highest standards of quality and ethical service. And we have backed that public commitment with massive new investments in training and audit technology. More so than other participants in capital markets, our profession has undergone a fundamental change from being largely self-regulated to regulated around the globe. But fully restoring investor confidence requires more. It also demands that all stakeholders look to the future and consider how investors' needs will change in a rapidly evolving global market.

It is in that spirit that we present this paper as the beginning of what we hope will be a robust dialogue about how global financial reporting and public company auditing procedures must adapt to better serve capital markets around the world.

This starts by looking to the future and asking what attributes will be necessary for capital market stability, efficiency and growth. While this is far from a comprehensive list, we believe the following six elements will be vital:

- Investor needs for information are well defined and met;
- The roles of the various stakeholders in these markets — preparers, regulators, investors, standards-setters and auditors — are aligned and supported by effective forums for continuous dialogue;
- The auditing profession is vibrant, sustainable and providing sufficient choice for all stakeholders in these markets;
- A new business reporting model is developed to deliver relevant and reliable information in a timely way;
- Large, collusive frauds are more and more rare; and
- Information is reported and audited pursuant to globally consistent standards.

As the CEOs of the six leading global audit networks, we believe we have a unique perspective and responsibility to serve as a facilitator for a conversation about how these core needs can be more fully met — now and in the future. Although our profession is, of course, foremost in our minds, we also believe that the ideas we advance in the following pages will benefit all stakeholders who care about the vitality and performance of our increasingly global capital markets.

Our views center on the continuing need for reliable, relevant and timely information about companies by all participants in capital markets. Over time, expectations about the content and timing of this information have been codified in reporting standards, as have the procedures by which auditors provide independent assurance about the reliability of company-provided information.

An Increasingly Globalized and Complex Economy

Many of the capital markets around the world changed radically and for the good following the stock market crash in 1929. The decline in share prices was of unprecedented speed and depth, largely reflecting the massive loss of confidence in the quality of information made available by companies and the brokerage houses that sold their stock. Some governments responded by enlisting the accounting profession to help restore that lost confidence. Publicly-traded companies were required to report regularly on their financial condition in conformance with what have come to be known as “generally accepted accounting principles” (GAAP). Governments required publicly-traded companies to engage audit professionals to attest to the fact that the information presented by company management actually did conform to those principles.

Of course, the world has changed dramatically in many different ways since the 1930s. Among other things, economies of different countries are much more closely linked — by trade and capital flows — than ever before. Technological change, especially in vastly improved transportation and communications, has abetted this process of “globalization.” Information about so many things and subjects is now so widely and instantaneously available that this is taken for granted, yet would have been broadly unforeseen even a short decade ago.

Business is now also much more complex than it was in earlier times. Contractual relationships are more complicated, and the financial instruments that companies issue to raise capital and hedge risks are far more sophisticated than the comparatively simple loans and stock shares that were issued and traded in preceding decades.

The Importance of Information in This New World

These changes in economic and business activity are having and will continue to have major implications for the kinds of information investors will need from corporate reports in the future:

- The value of many companies resides in various “intangible” assets (such as employee creativity and loyalty, and relationships with suppliers and customers). However, information to assess the value of these intangibles is not consistently reported.
- Billions of people around the world now have the ability to access information instantaneously. Yet when it comes to financial reports, investors must wait for companies to publish data only once a quarter, every six months or annually.
- The information technology revolution has made data customization easy to use and broadly expected. However, today’s financial reports remain largely one-size-fits-all, and are not sufficiently accessible to many investors.

In short, the same forces that are reshaping economies at all levels are driving the need to transform what kind of information various stakeholders want from companies, in what form, and at what frequency. In a world of “mass customization,” standard financial statements have less and less meaning and relevance. The future of auditing in such an environment lies in the need to verify that the *process* by which company-specific information is collected, sorted and reported is reliable and the information presented is relevant for decision making. Moreover, because many enterprises increasingly are doing business in multiple countries while investors increasingly are buying the shares of companies from around the world, stakeholders and investors in particular want to know that the information they are getting is compiled, classified, reported and audited on a consistent basis across countries.

The Role of Public Company Auditing

As leaders of the world’s largest global audit networks, we are committed to facilitating the changes that will continue to come to business reporting, as demanded by various stakeholders. We are also keenly aware of mistakes made by some members of our profession in recent years, and have instituted significant changes in both our operations and our focus to assure that history is not repeated. Nonetheless, there are a number of barriers that must be addressed to ensure our profession’s ability to deliver the services that stakeholders need now and in the future:

- There is a misalignment (which differs in nature and degree by country) among companies, users of information, regulators, policy makers, the media and the auditing profession. This misalignment perhaps is most apparent with respect to the “expectations gap” relating to material fraud and the ability of auditors to uncover it at reasonable cost.
- The auditing profession needs to develop the talent and expertise to deliver consistent, high-quality audit services in the coming environment, both through the hiring of outstanding individuals and the training of auditors in new auditing techniques (especially evolving information technology, fair

value models and expanded business information).

- Various legal and regulatory impediments are adversely affecting both client companies and audit professionals. Different legal and regulatory regimes make it more costly for companies to do business, while the increased liability risk inhibits companies from reporting the kinds of non-financial and forward-looking information that many stakeholders surely would find valuable.

The challenge now before all stakeholders in the capital markets is to overcome each of these barriers to provide more relevant and reliable company information and the appropriate level of assurance needed to garner trust and confidence in that information. This can be done, but only if all of these parties are actively involved in the solution.

Strengthening Financial Reporting and the Audit Function

Near-Term Measures: In the near term, the following “convergence” processes must be completed to benefit the global financial markets and their stakeholders:

- Complete the effort by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to harmonize differences between international and U.S. reporting standards, as currently envisioned. Complex rules must be resisted and withdrawn. Today’s rules can produce financial statements that virtually no one understands. Standards need to be principles-based.
- Launch and complete a similar process for the convergence of national audit standards, which should make use of the International Standards on Auditing (ISA) that already have been developed with the oversight of the Public Interest Oversight Board (PIOB) of the International Federation of Accountants (IFAC).
- Similarly, minimize national differences in the oversight of auditors and enforcement of relevant audit standards, including rules relating to the way auditors conduct their activities. The recently established Independent Forum of International Audit Regulators (IFIAR) may be the appropriate body to pursue this objective. We are encouraged by recent statements from the U.S. audit regulator, the Public Company Accounting Oversight Board (PCAOB), that it intends to join and actively participate in IFIAR.

Consistency in business reporting standards, audit standards and enforcement of audit standards is necessary to support a global economy with the lowest cost of capital. Alignment of the accounting profession and the regulators around common objectives and application of principles-based standards will enable companies to produce consistent global information. A sensible global regulatory framework also will reduce barriers to growth and entry by other audit firms or networks in our profession, thus providing increased choice for auditing services.

Longer-Run Measures: Over the longer run, experts agree that the current systems of reporting and auditing company information will need to change — toward the public release of more non-financial information (some or much of which may be industry-specific) customized to the user, and accessed far more frequently than is currently done. It is time, therefore, for all global capital markets stakeholders involved to launch a process that will lead to the development of a new business reporting model, with a clear identification of the role of the independent audit and requirements dictated by that model.

Our firms pledge to work with issuers, investors, regulators and other market participants to develop this new model including ways of disseminating a broad array of company information to users in a manner more suited to the Internet age than the traditional quarterly and annual reports.

To provide these services, our profession must be able, through market-based incentives and our workplace environments, to attract and retain individuals with broad training in multiple disciplines — in accounting, information technology, finance, tax and other business skills — to deal with a more

complex and global business environment. Among other things, this will require improvements in accountancy degree curricula and investments in continuous training on our part. Meanwhile, legal restrictions on the scope of services that can be provided by audit networks should be evaluated in light of the capital markets' clear interest in assuring the continued attractiveness of the profession and its ability to bring in and retain individuals with the requisite talent and skills as well as the need to assure auditor independence.

Audit networks cannot provide the services demanded without the requisite financial, technical and people resources. Audit firms and their global networks are not insurance companies. Legal and regulatory systems must reflect this reality. Individual auditors who engage in wrongdoing must be punished but without threatening the financial viability of their firms.

It is our belief that the broad reforms suggested here could give investors, businesses and watchdogs what they want and deserve: reliable and relevant information that is the lifeblood of thriving capital markets and the global economy itself. In order to make this vision a reality it will require the shared effort of all stakeholders in the capital markets. The world is changing quickly. It is time for business and the methods for assuring investors of the quality and reliability of business information to change as well.

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I. INTRODUCTION AND OVERVIEW

We live in an age of information and increasingly global activity — the movement of goods, services, ideas and capital across national borders. Indeed, the two make each other tick. A global economy — indeed any economy — cannot operate without information, about prices, quality of goods and services, and about companies.

This essay is about one type of information and its importance to all actors in the global economy: information about the performance of management and companies that make and deliver goods and services, and compete for capital.

As the leading international auditing networks, we have a clear stake in the quality, relevance and timeliness of that information, because it is our job to attest to it. That attestation function is crucial to the efficient allocation of capital and the continued growth of our global economy. The professionals in our firms know the importance of their jobs and they take great pride in what they do.

In the late 1990s and earlier this decade, however, in a small, but highly publicized number of cases in the United States, Europe and Japan, certain members of our profession failed to meet the standards of quality that govern our profession. The individuals (and in one case, an entire firm) were punished severely.

As a consequence of these errors, policy makers in both the public and private sectors changed the rules governing the auditing profession — and indeed much of the way the corporations they audited were governed. In many countries, entirely new agencies were created specifically to oversee the auditing profession.

Broadly speaking, these changes have reinforced the independence of auditors, and in our view, have improved the audits themselves. Furthermore, our firms have changed, putting much greater emphasis on audit quality in all of our work and in our compensation systems. But the changes mandated by law and by the oversight agencies have also generated much controversy — specifically, whether their benefits have outweighed their costs.

This debate will continue, all over the globe, and it should. If it can be shown that certain measures are proving too costly in comparison to the benefits they deliver, then the rules and practices should be reformed. Our networks pledge to work with all relevant parties — companies, regulators and investors, in particular — so that any warranted changes occur.

But there are even more important issues that impact the workings of the capital markets — and how firms do business. These larger and more fundamental issues, and the forces that give rise to them, are the main subjects of this essay. Some can be resolved in the near future, while others will play out over a longer time. Broadly speaking, we seek to address the following key questions:

- What information should public companies produce to better serve all stakeholders in business information — investors, analysts, employees, customers and policy makers — in a global market for capital?
- How can auditors best serve investors and other stakeholders in a global context?
- Should the rules and procedures governing information reporting and audits be the same in all countries?
- How should business reporting change over the longer run, given the steady march of technology and specifically the ability the Internet gives to investors to access information instantaneously?
- Similarly, what does the continuing globalization of economic activity (of capital markets and markets for goods and services), as well as the increasing complexity of business activities, and the financial instruments used to finance them, imply for the future of business?

- What implications will all of these changes have for the auditing of company-generated information and for the organizations that carry out this function?

Resolving these issues will require a full conversation among the many stakeholders in the system of financial reporting: investors, companies, analysts and yes, auditors. Of course, our networks also have a professional and financial stake in the outcomes. But so do all the stakeholders, by definition. In our case, we believe that, as an outgrowth of our expertise and experience, our networks have much to contribute to a discussion and resolution of these issues. Accordingly, we have written this

essay out of concern for the future transparency and vibrancy of global capital markets. We recognize that if these efforts fail, it will not only jeopardize our networks, but put at risk the security of the portfolios of millions of investors around the world, a risk that will only increase as globalization continues to unfold.

What Are Audits and Why Are They Important?

Public companies prepare and issue financial statements that reflect their performance over some recent period, typically a quarter or a year, and that conform with the accounting standards that apply in their home countries (the subject of which accounting standards apply is increasingly important in a global context and is discussed later in the text). Preparation of the financial statements is management's responsibility.

The purpose of an auditor is to express an opinion on the financial statements. The nature of that opinion is made clear by the auditing rules set forth by the Public Company Accounting Oversight Board (PCAOB) in the United States, which are typical of similar rules used in most other countries. In the words of the PCAOB, an "auditor has a responsibility to plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud." (AU Section 110, emphasis added).

The underscored words are important. That auditors are charged with obtaining "reasonable assurance" that the financial statements are free from "material misstatement" means, by definition, that they cannot catch *every misstatement* — only those that are material and that can be found out through reasonable effort. In essence, auditors must do the best they can, given the fact that they are not running the companies whose accounts they are charged with auditing.

Even with these limitations, the importance of audits of public companies is uncontested. Capital markets could not function unless investors have some reasonable idea of the performance and financial position of the companies whose securities they buy and sell.

For example, the European Commission's Communication on the Statutory Audit in the European Union (Com 98/C 143/03) stated that the requirement to have accounts audited by a qualified professional was designed to protect the public interest.

The new business reporting system must be designed so that it best serves investors and other stakeholders in the reliability and relevance of business information. Such a system should give users the same choices and abilities to access relevant business information as consumers and producers now have when purchasing goods and services over the Internet. In such a world where users increasingly will want to customize the information they receive, the *process* for recording and classifying business information will be as important, if not more important, than the static formats in which today's financial information is reported. Our jobs, as auditors, must therefore change to increasingly focus on those business processes. Standards-setters, regulators and policy makers must change along with us.

Indeed, as auditors of the major public corporations in the world, we often stand at the vortex of the significant changes taking place in the world's capital markets. At the same time, our networks provide needed stability in times of great turbulence. We have just witnessed the most extensive set of financial scandals since the Great Depression. Many "dot.com" enterprises went from literally garage operations to public companies to failed enterprises all in the space of a few years. Since then, major public policy changes have affected our profession, our clients and investors.

We, the CEOs of the world's largest global audit networks, believe it is appropriate — and indeed necessary — that we now provide our views on what business reporting should look like in the years ahead. Just as we did in the 1930s, when policy makers called on the audit profession to assure the public that business information could be relied upon, our firms can and will serve as a force for stability and integrity in the financial markets, currently and in the years ahead.

Meeting these responsibilities will require, among other things, our continued ability to attract men and women of skill and integrity to our profession. We presume, therefore, that the liability and regulatory system governing the auditing profession will be reformed in a way that protects investors without putting the financial well-being of our networks at risk unfairly. It is well

known that the liability exposure of all current lawsuits outstanding against our networks substantially exceeds our combined capital. Our firms are not and can never be the insurers of last resort for the capital markets, where capital flows *each day* are orders of magnitude larger than our combined capital bases, and where the market value of *each* of many large enterprises easily exceeds our combined capital by many times. A regulatory and judicial system that clearly penalized those at fault rather than a system that inappropriately puts entire firms at risk would provide the proper incentives to discourage negligent or fraudulent audits without destroying the networks themselves.

Next year, in the U.S., our firms will be conducting a series of roundtables with key stakeholders in company reporting to hear what information they want public companies to produce and what auditor assurance they want on that information. We are also eager to learn from similar listening processes elsewhere as the solutions, in the end, need to be global. We want this document to be the beginning, and not the end, of a dialogue about the future of business reporting, and one in which we hope to engage all other stakeholders.

II. BETTER SERVING GLOBAL CAPITAL MARKETS, NOW AND IN THE NEAR FUTURE

“Globalization” may be a cliché, but it is a fact of economic life. Goods, services, capital and even people move more easily across national borders than ever before. Capital, the funds used to finance all this activity, has long been perhaps the most internationally mobile of all factors of production. Modern technology, especially the Internet, has made it even more so.

As markets undergo this rapid process of globalization, the public company audit profession, as the independent eyes and ears for investors and other stakeholders, is uniquely positioned to help ensure stability and efficiency at this time of change. In fulfilling this function, the profession can enable investors to make better, more informed decisions when weighing risks against rewards. By assuring fuller transparency of the financial status of companies, audit networks confer at least three important benefits for the global economy:

- Audits improve the allocation of capital among companies, wherever they are located, facilitating investors’ decisions to channel funds to those enterprises offering the highest risk-adjusted returns.
- Audits help insulate the global financial system against systemic risk. The Asian and subsequent financial crises during 1997-98 amply demonstrated that financial contagions are more likely to spread in the *absence* of transparency.
- By empowering investors with the right information, audits facilitate good corporate governance, inducing corporate managers of all companies to act in ways that maximize the interest of all their stakeholders.

In short, quality public company audits both serve and work through investors to benefit global capital markets. The globalization of the investment community will become increasingly important as the populations of most developed countries age and sell some of the securities in their retirement portfolios (or their pension funds do the same), often if not primarily to investors in the developing world. Similarly, firms in the developing world will want to continue accessing developed country investors, in order to finance their expansion. Wherever they are located, investors will make the best decisions if the companies whose securities are offered for sale consistently provide reliable and useful information.

Given our independence and experience, we are in an ideal position to provide value to investors throughout the world. And by helping facilitate the stability and strength of capital markets, our networks can help stimulate economic growth as well, which recent economic research has linked to the development of capital markets.

We can do all this, however, only if the rules by which public companies report and which govern our

The Increasing Globalization of Capital Markets

Globalization refers to the increasing inter-linkages among countries in the trade of goods and services, of capital flows, and to a much lesser extent, movement of people. Given our role in assuring the reliability of company information, we have a special interest and stake in the globalization of financial flows, especially in cross-border purchases of company securities.

The table below dramatically highlights the volumes of total cross-border capital flows into and out of a sample of industrialized countries, over the 1999-2003 period.*

	Capital Inflows		Capital Outflows	
	Billion \$	% of GDP	Billion \$	% of GDP
United States	4,167	38	1,922	17
Euro Area	3,569	44	3,609	44
United Kingdom	2,387	133	2,247	125
Switzerland	343	111	510	165
Canada	223	26	297	34
Australia	212	42	124	24
Sweden	190	63	223	74
Denmark	143	68	167	79
Norway	121	55	196	89
Japan	106	3	664	15

*Source: Philip R. Lane and Gian Maria Milesi-Ferretti, "Financial Globalization and Exchange Rates." IMF Working Paper WP/05/3, January 2005.

The coin of the realm in capital markets is reliable and useful information about the securities that are traded there. As noted in the previous box, independent audits are necessary to help ensure that the information public companies produce is as reliable as it can reasonably be given the inherent constraints under which audit networks operate.

Information is most useful, meanwhile, when it is provided in a format and context investors can best understand. Accounting standards provide the format. The nature of those standards provides the context. As we discuss in the text, an increasingly global capital market demands a single set of global accounting and auditing standards so that investors can make meaningful comparisons of the financial performance and status of the public firms whose securities they buy and sell.

audits are global, if the regulators who oversee us become more formally coordinated, and if we continue to improve the consistency of audits across the different countries in which our networks operate.

Ultimately, what investors and other stakeholders of public companies want and need is information that is relevant, reliable, timely, simply presented and *comparable across jurisdictions* so that all stakeholders have a way not only of accurately measuring past performance, but more importantly, making the best possible projections of future company performance. In a global setting, this objective can be attained only if earnings, cash flow or any other item of interest means the same thing in the United States, as it does in Europe, Japan, China, Brazil, Russia, India or any other part of the world (as is already true for many products that public companies now produce and sell throughout the world).

Here we highlight several of the most *immediate* challenges that confront policy makers at the national and international levels as they seek to ensure the timely dissemination of company information that best serves investors. In the next section, we look out further and envision how continuing demands by investors for relevant information and advances in technology *over the longer run* will lead to a new company reporting model, and how our profession must adapt so that it can play a constructive role in enabling all company stakeholders to benefit in the changed global economy.

Converge Reporting Standards

Global capital markets and investors want to be able to compare the financial information reported by companies regardless of the country in which they are incorporated or conduct

business. For this purpose, it is necessary that the principles for reporting financial information be as close to identical in all countries as possible. One noted survey confirmed this to be the case four years ago, when it found that the overwhelming majority of institutional investors — those with the resources to analyze company financial statements consistently on their own — on both sides of the Atlantic wanted all public companies wherever located to report their results under a single world standard.¹

Further, we believe that investors want professional judgment to be fully exercised. This is not possible in an environment and under a set of accounting rules that risk turning auditors and financial management

¹ McKinsey & Co., McKinsey Global Investor Opinion Survey on Corporate Governance, July 2002.

into “box checkers.” Yet, this is what can happen under U.S. Generally Accepted Accounting Principles (GAAP). The main reason, in our view, is that the U.S. litigation environment has driven preparers of financial statements and auditors to want and, in turn, accounting standard-setters to develop, “rules” based standards, which attempt to spell out in great detail exactly how information should be accounted for in a wide variety of circumstances. The more detail that is required, the less room there is for judgment, by the public companies that prepare their financial statements, and by the auditors who are asked to attest to them. Rules increase complexity and actually can decrease the meaningfulness of information.

Some believe less judgment means less risk of liability. Yet ironically, a liability-driven environment — promoted by its defenders as one that protects investors — actually does the opposite. Excessively detailed accounting guidance and the checking of audit boxes it generates provides only a veneer of reliability and relevance. The companies whose accounts are being checked in this manner may comply with the letter of the rules but not their spirit. In the process, investors can be misled into believing that some companies are financially sound when in fact they are not. One of the most important lessons from the recent spate of financial reporting scandals is that the world’s complex business transactions cannot be communicated through proscriptive rules: clarity relies on adhering to sound principles applied with expert judgment.

Think of any typical entrepreneurial enterprise, for example. It cannot be successful unless its founders have the imagination and flexibility to constantly make *judgments* about what products and services to produce or provide that will best serve consumers. Even seasoned, established firms are more successful when their employees have the freedom to make judgments — on the shop floor as well as in the executive suite — about how to improve productivity and quality, all in the interest of making the company a better place to work and one better suited to deliver what consumers truly want.

In all of these cases, the most successful managers lay down some general principles or modes of behavior — like treating their co-workers and their customers as they would want to be treated — and perhaps some targets for performance (often rewarded with monetary incentives when achieved). They then let their employees use their training and experience to figure out how best to achieve the targets, while complying with the broad principles that define a business “culture.” Simply put, successful leaders in any organization want their employees to exercise their *judgment*. Indeed, employees and managers who cannot work in such environments are not likely to be hired in the first place.

Why should accounting and auditing be any different?

Toward a Single Global Company Reporting Model

Until recently, countries required public companies doing business in their jurisdictions to comply with their own national “Generally Accepted Accounting Principles” or GAAP. In the early 1970s, many national securities regulators and accounting standards-setting bodies began to recognize the need for a common set of reporting standards, given the (already then) increasing global nature of selling and buying company securities. The result was the formation, in 1973, of the International Accounting Standards Committee, a 15-member body affiliated loosely with the International Federation of Accountants (IFAC).

Eventually, the IASC forged an agreement with the International Organization of Securities Commissioners (IOSCO) to develop International Accounting Standards (IAS) for companies doing business in multiple countries and accessing international capital markets. In 2000, IOSCO recommended that its member regulatory bodies permit multinational issuers of securities to use IAS for cross-border securities offerings and listings, subject to “reconciliations” with national GAAPs. These reconciliations, however, resulted in duplication, as companies choosing IAS had to prepare statements under two accounting conventions.

In the United States, since 1973, the SEC has delegated the setting of GAAP to the Financial Accounting Standards Board (FASB), an independent private-sector body, with seven full-time members and a chairman. The trustees of the Financial Accounting Foundation oversee FASB, while input for its standards is provided both from FASB’s advisory council and from the SEC.

In 2001, the IASC reorganized its membership to include representatives of national standards-setters, and renamed itself the International Accounting Standards Board (IASB), and the standards it issued the International Financial Reporting Standards (IFRS). The new structure and standards have elicited widespread support from national standards-setters around the world, most notably the European Union, which required companies listed on its national exchanges to begin using IFRS in 2005. China will adopt an IFRS accounting-based system in 2007.

The United States remains one of the only major countries not to allow foreign companies to use IFRS or to require those standards for all companies listed on its exchanges. However, in 2003, the FASB launched a “convergence process” to “harmonize” U.S. GAAP and IFRS. That process is under way and making progress. Accordingly, the SEC’s staff reportedly is working toward allowing foreign issuers of securities in the United States to report solely on the basis of IFRS, without the need for reconciliation with U.S. GAAP, by some time in 2009.

Accountants and auditors are trained professionals who have the ability, by virtue of their education and professional experience, to apply the *spirit* of broad principles in deciding how to account for and report financial and other information. Rules that allow this judgment to be exercised will produce better, more reliable, and more useful information just as the exercise of judgment enables other companies to provide better and more useful products and services.

This fundamental proposition fortunately has been recognized and, for the most part, embodied in another set of principles-based accounting standards — those developed by an international body of accounting experts, the International Accounting Standards Board. The result, International Financial Reporting Standards (IFRS), has been accepted in many nations and capital markets around the world — the United States a notable exception. IFRS is principles-based rather than rules-based precisely because it does *not* try to anticipate every business situation and spell out detailed exceptions for each of them.

Toward A Single Set of Global Audit Standards

The movement to develop and adopt a single set of global audit standards — apart from the national “Generally Accepted Audit Standards” (GAAS) — is not as far along as the effort to harmonize financial reporting standards.

In large part, this is because national audit standards are incorporated in national laws, or in legislation that expressly delegates the setting of those standards to national standard-setters. For example, in the United States, for decades GAAS was set by the leading professional accounting body, the American Institute of Certified Public Accountants (AICPA). After the financial reporting scandals several years ago, the U.S. Congress instructed the newly created PCAOB to set audit standards for audits of public companies.

There is a body of international standards on auditing (ISA), and these are followed in many countries. ISAs are becoming as universal as their financial reporting counterparts, IFRS. ISAs are set by a separate board under the oversight of the independent Public Interest Oversight Board (PIOB) of the International Federation of Accountants (IFAC), the profession’s major international professional body. The PIOB has considerable independence from IFAC, since it has representatives from the leading official financial bodies: the International Organization of Securities Commissioners (IOSCO), the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the European Commission and the World Bank.

National bodies charged with setting audit standards already meet informally to exchange information and views. As discussed in the text, globalization of the capital markets suggests that this process be formalized, and that one of the first steps is to produce and abide by a global set of audit standards designed to assure uniformity in audit quality across countries.

In short, IFRS is based on allowing companies and their auditors to apply broad principles to complex transactions rather than giving detailed instructions on how to do so. It is our experience that this makes eminent sense (and should be reflected in liability rules and regulatory enforcement). In financial reporting, as is true in the rest of life, people and firms typically deliver what is expected of them. Admittedly, survey evidence from the United Kingdom, where IFRS went into effect for the 2005 reporting year, suggests that this may not yet be the view of officers of public companies that are just beginning to prepare their financial statements under the new international standards — transition difficulties are to be expected. But it is noteworthy that the same surveys indicate that a clear majority of institutional investors are finding that the international standards have improved transparency. The fact that the IASB has announced that no *new* IFRS standards will be effective until 2009, meanwhile, will ease any transition difficulties for preparers, who understandably need time to comply with a different reporting regime.

Accordingly, if there is to be convergence to a single set of accounting standards or something very close to it — as we believe the increasing globalization of capital markets demands — the resulting standards should be those that permit judgment rather than stifle it, and those that reflect simplicity over complexity. Today, this favors movement toward IFRS rather than U.S. GAAP. Both systems have merits and neither are perfect but IFRS is relatively more principles-based. The preceding box provides further detail about the two main accounting standards (U.S. GAAP and IFRS), who sets them, and the encouraging progress that is made toward harmonizing them.

Converge Auditing Standards

The logical companion to the convergence in reporting standards is convergence toward a single global set of audit standards. Indeed, whether or not the reporting model converges, there is a strong, if not overwhelming, case for ensuring that professional auditors use the same techniques and methods in all countries to opine on whether public companies’ financial statements represent a true

and fair view and are “free of material misstatement.”

Put differently, investors in global markets and other stakeholders, at a minimum, should want to know that the *quality* of audits is the same regardless of where they are conducted. Otherwise, investors inevitably will demand a “risk premium” — in the form of a lower purchase price or a higher dividend or interest rate (in the case of a bond) — in order to be induced to purchase a security issued by companies in countries that have demonstrably weaker audit standards, or perhaps worse, where the quality of audits is unknown. Countries that are interested in promoting the growth of their economies and their companies therefore have a clear interest in promoting audit quality, and ideally ensuring that audits of companies within their jurisdictions are deemed to be as reliable as audits of companies in other jurisdictions.

In our view, investors thus would be advantaged by truly global audit standards. This can be achieved if a process were launched that would harmonize the current IFAC audit standards (see accompanying box) with national audit standards (in much the same way that the IASB and FASB are now engaged in harmonizing financial reporting standards).

Converge Enforcement and Other Related Rules Governing Audit Networks

Even if all national authorities ultimately accept financial reporting and auditing standards developed by international bodies, it is highly unlikely that at any time soon they will cede authority to supervise, and if necessary, discipline wayward auditors and corporate executives. Legal enforcement powers are important elements of national sovereignty that are not easily given up in any sphere of activity, and we anticipate no immediate change in this direction specifically for professional audits.

However, as global audit networks operating in an increasingly global environment, we believe that both national regulators and investors would benefit from more uniformity among countries in both the legal standards and the nature of sanctions for enforcement actions that affect members of our profession. Multiple enforcement and other standards affecting the audit profession raise the costs of performing audits, and decrease the comparability of audits performed in different countries. In so doing, these costs raise barriers to entry or expansion by other audit networks (a subject discussed shortly). One example of how multiple versions of just one standard — relating to the “independence” of the auditor — can complicate the activities of audit networks is highlighted in the accompanying box.

How can national authorities retain their sovereign enforcement powers yet bring about greater convergence? A good start has been made by the formation of the Independent Forum of Independent Audit Regulators (IFIAR).

The Complications of the Many Meanings of Auditor Independence

It is widely accepted around the world — as it should be — that public companies’ financial statements must be audited by “independent” auditors in order to give users of the statements reasonable assurance that they comply with applicable financial reporting standards.

Yet like many seemingly simple terms, the meaning of “independence” has been given different interpretations by different countries. The International Federation of Accountants has adopted a set of principles-based criteria to establish independence, but few countries have adopted independence standards of their own that are fully consistent with the IFAC standards.

The multiplicity of independence standards — which, given the centrality of independence to the audit process, imply a multiplicity of enforcement regimes — can make it difficult for audit networks to enter into audit engagements with multinational companies. At a minimum, this raises the costs of operations, and in some occasions, can make it impossible for the networks to accept assignments. This raises costs for preparers and can limit their choice of auditors (a subject discussed in a later box).

A recent, compelling example of the complications that can arise is provided by the new code of ethics for auditors adopted in 2006 in France. This code applies a highly restrictive set of “scope of service” requirements to all auditors conducting statutory audits in France, which severely limit the non-audit activities of auditors conducting such audits. Whether or not they are so intended, these requirements have extraterritorial application to companies outside France, since they limit who can conduct an audit of French subsidiaries of companies incorporated outside the country. As a result, the French law “exports” the independence requirements for audits in France to the rest of the world.

Universal adoption of one set of independence standards — perhaps those of IFAC — could help avoid the complications associated with multiple definitions of independence. At a minimum, regulators or overseers of auditors could agree, as outlined in the text, that their standards do not apply to local subsidiaries of foreign companies.

IFIAR may become the functional equivalent for audit regulators that the Basel Committee is for banking supervision: by exchanging information about the latest enforcement techniques, and where appropriate, setting common standards or practices that the national authorities would adopt or seek to have adopted through statutory or other means in their home countries (as countries represented on the Basel Committee have done for bank capital standards).

Fundamentally, regulators need to collaborate with other market participants not only to align standards but to allow preparers and auditors to utilize sound judgment in applying these standards. Additionally, collaboration among national regulators in the inspection and enforcement actions of preparers and auditors will reduce the costs of regulatory oversight on the capital markets and can work to increase confidence of investors that information quality is globally consistent across the capital markets.

Confront the “Expectations Gap” Regarding Fraud Detection

Perhaps no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud — or *intentional material misstatement* of financial information by public companies. After all, fraud was at the center of various corporate financial reporting scandals earlier this decade. Allegations of fraud are central in the ongoing lawsuits brought by investors against individuals and companies, as well as against audit networks for alleged failures to uncover them.

It is essential that all parties engaged in business reporting — employees, management, directors, auditors and policy makers — put in place appropriate procedures and policies to prevent and detect fraud. Nonetheless, there is a significant “expectations gap” between what various stakeholders believe auditors do or should do in detecting fraud, and what audit networks are actually *capable* of doing, at the prices that companies or investors are willing to pay for audits.

As summarized in the accompanying box, prevailing audit standards require auditors to conduct audits with a “healthy degree of skepticism,” always recognizing the possibility that fraud could occur. The standards give guidance about what auditors can do to uncover fraud if it exists.

But there are limits to what auditors can reasonably uncover, given the limits inherent in today’s audits. Specifically, unless companies or investors are willing to pay auditors to police all of a company’s transactions, auditors are limited to using indirect means to ascertain whether fraud has occurred. These methods include examinations of accounts and records where the principal aim is to look for anomalies, interviews of company employees and management that are *not* “under oath,” and reviews of the companies’ “internal controls” over the spending of funds (a specific requirement in the United States under Section 404 of the Sarbanes-Oxley Act, enacted in 2002). These methods clearly are useful, indeed essential, to preventing and discovering fraud. But they are not foolproof, nor can they be expected to be.

Hence, the “expectations gap” arises because many investors, policy makers and the media believe that the auditor’s main function is to detect all fraud, and thus, where it materializes and auditors have failed to find it, the auditors are often presumed to be at fault. Given the inherent limitations of any outside party to discover the presence of fraud, the restrictions governing the methods auditors are allowed to use, and the cost constraints of the audit itself, this presumption is not aligned with the current auditing standards.

What is sorely needed is a constructive dialogue among investors, other company stakeholders, policy makers and our own professionals about what should be done to close or at least narrow the “expectations gap” relating to fraud. Given the globalization of capital markets, it is vital that this conversation include stakeholders in public companies and capital markets throughout the world. We are committed, also, to working with others to develop ways to prevent fraud from occurring.

These conversations must recognize, however, that our profession is committed to continuously improving our abilities and methods to detect fraud. We are doing this through the commitment of resources to support research into new methodologies and technologies that should expand our ability to uncover fraud.

At the same time, we believe it is useful to consider additional ideas for enhancing fraud detection, which we briefly outline below. There are arguments for and against each of these concepts, and thus we do not necessarily embrace any one or all of them. But we believe that, collectively, they have sufficient merit that these options ought to be seriously debated by stakeholders and policy makers. We welcome and encourage others to offer their suggestions as well.

Subject All Public Companies to a Forensic Audit on a Regular Basis:

The most aggressive, but costly and intrusive way of rooting out fraud is to require all public companies to undergo a forensic audit on a regular basis (perhaps every three or five years). Unlike the indirect means already described that are employed to detect fraud in a conventional audit, a forensic audit is akin to a police investigation. Forensic auditors scrutinize all records of companies, including emails, and would be able, if not required, to question all company employees, and to require statements under oath. It might be necessary for an audit network or a specialized forensic auditor to complete a forensic audit with the aid of independent attorneys (not those who have represented the audit client in other engagements).

Subject All Public Companies to a Forensic Audit on a Random Basis:

A less onerous and costly version of the forensic audit proposal would be to subject a sample of public companies on every exchange to a forensic audit on a random basis. Though such a system might uncover fewer frauds, the deterrent effect could still be the same, as all companies, and their managements, would know that they could be subject to forensic-level scrutiny at any time.

Other “Choice-Based” Options: Whether or not policy makers choose to require or suggest forensic audits on any bases, it may be possible to close the “expectations gap” by introducing more choice regarding the intensity of audits for fraud. For example, since forensic audits are conducted primarily for the benefit of investors, one possibility would be to let shareholders decide on the intensity of the fraud detection effort they want auditors to perform. Shareholders could be assisted in making this decision by disclosure in the proxy materials of the costs of the different levels of audits, as well as the historical experience of the company with fraud. A different choice model would be to allow boards, or audit committees of boards as elected representatives of shareholders, to decide on the level of fraud-detection intensity.

A principal advantage of allowing investors or board or audit committee members to choose the fraud-detection level is that this would move away from a “one-size-fits-all” approach to fraud detection to one tailored by investors’ expectations about the company. In addition, the possibility that the relevant decision makers *might* at any time vote to conduct a forensic audit could act as a powerful deterrent to managers or employees from engaging in fraud.

The Challenges of Detecting Fraud

By definition, fraud is difficult to detect by any outsider because the essence of the activity is concealment — hiding from managers, directors, and ultimately investors material information about the company and often the diversion of company funds to the perpetrators.

The U.S. fraud standard (SAS 99) and its international counterpart (IAS 240) contain very similar directions to auditors relating to fraud. Both require auditors to conduct their audits with a “healthy degree of skepticism.” And both lay down a number of specific requirements that auditors are instructed to follow, including:

- Considering the company’s internal controls and procedures, and how these are actually implemented, when planning the audit;
- Designing and conducting audit procedures to respond to the risk that management could override the internal controls and procedures;
- Identifying specific risks where fraud may occur;
- Considering whether any misstatement uncovered during the audit may be indicative of fraud;
- Obtaining written representations from management relating to fraud;
- Communicating with appropriate managers and the board if the auditor finds indications that fraud may have occurred.

Even when auditors follow all these guidelines, there are inherent limits to what any outside audit can uncover relating to fraud, especially if senior management has been involved in perpetrating it.

The Evolution of Global Audit Networks and Legal Impediments To Further Integration

Our six global audit networks have evolved (albeit at different speeds and in different ways) over time in response to the needs of globally active firms for audit networks of global reach, with the expertise to audit increasingly complex business activities. This has required on our part extensive internal investment in recruitment and training of our personnel and investment in technology (hardware and software). On a number of occasions, mergers have facilitated our growth to meet market demands.

Our firms are structured legally as networks of national firms, rather than as single global operations, initially because of national differences in educational and licensing requirements. Other legal and policy-related factors since have assumed more important roles in inhibiting further integration.

For example, differences in liability regimes among countries — and specifically, the more expansive liability system in the United States relative to the rest of the world — discourage our national firms and their partners or members from being part of a single legal enterprise in which every partner or member of the entity in any part of the world could be held legally responsible for judgments or settlements reached in the most restrictive jurisdiction (typically the United States).

Limits on audit firm ownership in some countries, which can require that all owners or partners of a firm conducting audits in a jurisdiction be licensed to practice in that jurisdiction, can inhibit the national firms' being part of a larger, multinational or global enterprise. Many countries also prohibit or significantly restrict limited liability forms of ownership, which also has the same inhibiting effect. And some countries' (or regions') data privacy and professional secrecy laws can make it impossible for globally integrated audit firms to conduct business in those countries through any other means than the current network arrangements that are common to all of our audit firms.

Enable Networks to Integrate Further to Strengthen Audit Quality

While global rules and coordinated national enforcement are essential prerequisites to assuring the production and dissemination of company information that is uniformly relevant, reliable and comparable across countries, our international audit networks must be able to deliver those outcomes.

Currently, because of our global structure, we believe we are able to deliver a relatively seamless audit product. But there is always room for improvement, and in that spirit, some of us believe it may be desirable to further integrate our firms — not just information systems and training, which are already integrated but such key functions as the ability to hire and fire, determine compensation levels (in part to reward audit performance), share profits and to make centralized investment decisions.

As shown in the accompanying box, various national rules or legal environments, however, inhibit our ability to achieve such further integration. We therefore urge national regulators and policy makers to work together to remove such impediments. The creation of the multinational regulatory council, earlier suggested, could be the forum in which work on this agenda can begin and be pursued.

Of course, we recognize that it may be difficult any time soon to gain widespread consensus on some, if not all, of these issues. For this reason, as an interim measure, it may be possible for some audit networks to integrate further, first on a regional basis, where national laws permit. Indeed, there already has been some movement in this direction with the recent announcements of merging national firms within audit networks in Europe. But while we believe we are able to deliver high quality audits of global companies, our networks cannot become truly global in a corporate sense without further liberalization and harmonization of national rules.

Concentration in the Audit Profession

Concerns are expressed about auditor concentration, but there is no doubt among us that at the same time there is vigorous competition in our profession. There are substantial economies of scale in auditing and worldwide networks require significant investments. Thus choice may always be somewhat limited for the largest multinational companies, but even with limited choice,

healthy competition exists in the marketplace.

There is, however, much greater choice among auditors for companies in the middle-to-lower ranges of market capitalization in virtually all capital markets throughout the world. Market-based actions could occur to foster even more choice in this market segment, including:

- Audit firms outside the Big Four clearly communicating their capabilities and target markets,
- Regulators publicizing the audit capabilities of non-Big Four networks,
- Audit committees being more attuned to capabilities in this market segment, and

- Investors and other influencers being more encouraging to companies to engage non-Big Four networks.

While competition is not an issue, the marketplace tells us more choice for the very largest companies would be desirable. This cannot occur, however, without certain changes in policies that lower the risks in our profession so other large networks will be willing to make the investments needed to serve the very largest companies. Some of these policy measures have been discussed in other contexts, but are also highly relevant to any discussion of how the audit services market can be further broadened.

Focus Enforcement: It is essential, going forward, for enforcement authorities to focus penalties for any auditor wrongdoing or negligence they may uncover on those directly implicated in such activities, rather than on the *entire firms* that employ them or with which they may be affiliated. That the current audit services market is competitive does not mean that it can afford to lose another major network, through a liquidation-forcing liability verdict or criminal prosecution. Indeed, there now is widespread recognition throughout the global enforcement community that the loss of another major audit network would have a major deleterious impact on the capital markets.

Liability Reform: In a related vein, measures to limit audit firms' exposure to liability would reduce the risk that all firms, and especially smaller audit firms, have in taking on large company audit assignments. Thus, meaningful liability reform should reduce concentration in the audit services market.

Scope of Service Reform: National governments can reduce auditor concentration by relaxing current scope of service restrictions that go beyond those needed to maintain auditor independence and objectivity. Currently, audit firms that engage in non-audit activities for company clients in jurisdictions that excessively limit what audit firms can do thereby become ineligible to perform audit services for the same clients. This effectively reduces choice among audit service providers, especially where countries (such as France) apply scope of service restrictions beyond their national boundaries.

In sum, a variety of measures can be taken by national governments — ideally in concert or in coordination with others — both to preserve and enhance choice of auditors available to companies throughout the world. It is important, however, that in pursuing this objective countries do not artificially tilt the playing field by favoring or subsidizing locally based audit firms. Measures of this kind are inconsistent with the norms of global commerce established by international trade agreements.

III. LOOKING AHEAD: WHAT COMPANY REPORTING CAN AND COULD BE

To this point, we have addressed ways in which policy makers can improve the functioning of global capital markets based largely on the current model of company reporting. This model assumes that the companies continue to issue financial statements and qualitative information in well-established formats and on a regular basis. Ideally, these activities will be conducted on the basis of conventions that are internationally accepted and verified in ways that are also consistent across countries.

But a brave new world of company reporting is already visible, and may be only a few short years away from widespread implementation and use. It is a world made possible by digitization and the Internet, which have already revolutionized the way goods and services are developed, manufactured or made available, and delivered throughout the world.

One aspect of this revolution that is directly relevant to the future of company reporting is the ability the Internet is giving consumers and businesses to customize the products and services they purchase. With a cursor and the simple click of a mouse anyone who has access to a computer and Internet — billions of people, in other words — can quickly order precisely what they want over the Internet, in whatever size, shape, color or other dimension that sellers offer. Rather than stock goods on the shelf, or in some warehouse, the Internet allows retailers to take orders first and then have manufacturers make

XBRL: An Important Enabler

Just as the Internet is rapidly changing the way individuals and businesses engage in commercial and social activities, a major project under way in the financial arena — the Global XBRL Initiative — promises to revolutionize the way investors, governments and companies themselves use, analyze and generate information. This revolution, in turn, must eventually transform the way this information is verified.

XBRL is an acronym that stands for “Extensible Business Reporting Language.” It is the financial equivalent for the language of the Internet — “HTML.”

In plain language, XBRL is a format that any data generator can use to input its data. The Global XBRL Initiative defines the categories to which the data belong. In other words, what counts as revenue, expense, asset or liability, at multiple levels of detail? Once the data are so formatted, users can retrieve them, put them in any standard spreadsheet software, and then view or manipulate them in any way they want. Users can ask “what if” questions, construct any number of graphs (with current, past and projected future data), compare companies against peers (however defined), view information in any language, any currency, and even under different accounting conventions (U.S. GAAP or IFRS, for example) — and get the answers virtually instantaneously, at the touch of a computer mouse.

There are multiple users who would benefit from being able to access XBRL-formatted information: investors, analysts, governments, public companies (for internal and external reasons), employees, consumers, non-governmental organizations, and yes, auditors. XBRL opens a brave new world of information access and lower costs, for users and generators of data alike. Our networks also believe that companies that adopt XBRL should see significant savings in their internal and external audit costs over time.

In fact this new world is already here for the approximately 40,000 companies that already use XBRL to input their data. Some countries, such as China, Spain, The Netherlands and the United Kingdom, have required companies to use XBRL. U.S. banking authorities have required U.S. banks to file their financial reports in XBRL beginning in 2006 (having successfully tested the filing system in 2005). As for other companies, the SEC is encouraging the adoption of XBRL, and is hoping that peer pressure and investor demand will lead to its widespread use. Given the rapidly growing number of companies around the world that are adopting the XBRL, this is a plausible outcome. For further information see www.xbrl.com.

whatever it is that buyers want.

It takes only a bit of imagination to realize that digitization and Internet can enable users of company data to customize what information they want and how they want it presented, in much the same way that they are now able to customize the products and services they are now able to purchase. For example, some investors may want to know the earnings, cash flows, and perhaps other variables for a company currently and over some past period. Others may want each of these variables compared to other companies in the same industry or a similar “peer group,” or compared to averages for the market as a whole (or some portion thereof). And why, in a world where most public companies’ financial records are, or soon will be, in digitized form, should investors and other parties have to wait for a full quarter to receive pertinent financial information?

Technology allows far more frequent disclosures, even daily, although with different levels of assurance about its accuracy than for financial statements that are subject to regular audits. Why shouldn’t investors at least have access to information thus disclosed more frequently (assuming that the processes for generating that information have been audited)?

Until recently, there was no standard way of presenting company-specific information to the public. But that is no longer true. As described in the accompanying box, over the past decade, accounting firms, public companies and regulators throughout the world have worked together on an initiative to categorize or “tag” a broad range of information and data that public companies have or can generate, and to make all of it easily accessible through the Internet. This global “XBRL” initiative, or perhaps other reporting-related technologies, are likely at some point to revolutionize the entire company reporting model — what information is presented and how, and how it is audited.

Even in the age of customized, personalized financial reporting that the new technologies will make possible, however, many investors, analysts and other stakeholders, also still will want standardized reports issued by public companies on a regular basis. But from what we have been hearing from investors, they want these reports to contain more relevant information than just the financial statements and the footnotes explaining them. The large discrepancies between the “book” and “market” values of many, if not most, public companies similarly provide strong evidence of the limited usefulness of statements of assets and liabilities that are based on historical costs. Clearly, a range of “intangibles” that are not well measured, or not measured at all, under current accounting conventions are driving company performance.

Investors and other stakeholders in business information understandably want to know what those intangibles are, and how they might plausibly affect how businesses perform *in the future*.

Yet financial statements are *backward looking* documents. They tell how a company *has* performed in some recent period. Perhaps some of the information contained in the financials is indicative of future performance, but much of it is not.

But what should the new public reporting model look like? How might it be developed? And what implications would a new model have for audits, our audit networks, and for all users of company information? We address now each of these important questions in turn.

What Should the New Reporting Model Look Like and How Should It Be Produced?

The new model should be driven by the wants of *investors and other users of company information*, and the information produced should be forward-looking, even though it may be historical in fact. For example, the following measures are all non-financial in character but are likely to be predictive, to varying degrees, of how well a company will perform in the future: innovative success (perhaps measured by patents recently awarded), measures of customer satisfaction, product or service defects or awards, and measures of employee satisfaction (perhaps approximated by turnover), among other non-financial variables.

Just a few plausible scenarios can powerfully illustrate how the routine disclosure of such non-financial indicators could be far more useful to investors than current financial statements alone:

- Consider a retailer with strong growth in reported income, achieved largely by an expansion of outlets in different countries, but nonetheless one with a decline in repeat purchases by customers. The latter statistic could well be the proverbial canary in the mineshaft that would signal to investors that the company's stock merits a "sell" rather than a "buy."
- Imagine a manufacturer with slowly growing income, and relatively flat sales around the world, which nonetheless has numerous patented innovations in the pipeline waiting to be introduced. Such a company may merit a strong "buy" even though the financial data alone probably would suggest otherwise.
- Or what about the company with rapid earnings growth, but high and increasing levels of employee turnover? Investors knowing only the company's financial performance would be likely to buy or at least hold the company's stock. Investors who knew that the company was having trouble retaining its real asset — its workforce — very likely would think otherwise.

Knowing that the kinds of information illustrated in each of the examples would be routinely available to the investing public should provide powerful incentives to corporate executives to manage their companies in ways that benefit not only their shareholders, but their employees, customers and the wider economies in which they conduct business. In particular, companies that look likely to prosper but in fact may be in trouble would have stronger incentives to take corrective action sooner than otherwise. Conversely, companies whose prospects are really brighter than current financial data may indicate may not be penalized by investors, and

Previous Efforts to Develop a New Reporting Model

Much of today's financial reporting model in the United States has evolved through issuing new reporting standards in response to solving the reporting needs for individual transactions. The end result is a piecemeal reporting model that is not overly responsive to investor needs. The accounting profession has recognized for some time that the current financial reporting model may become increasingly irrelevant to investors wanting information relevant to their assessing the future performance of companies.

In 1991, the profession's official body in the United States, the American Institute of Certified Public Accountants, appointed a special committee to look into ways of improving the reporting model. The subsequent report, since known as the 'Jenkins report' (after the name of its chairman, Edmund Jenkins), concluded that future "business reporting" should serve the interests of users and be forward-looking. The focus on "business" was deliberate, signaling that users deserved more than just financial information. The report identified a number of possible business measures that would be of use to investors and other users of company information, including product reject rates, market shares, measures of customer satisfaction, patents, among others. The committee even outlined a hypothetical model report that might become routine in the future.

In 1998, the Financial Accounting Standards Board in the United States went further, establishing working groups covering different industries, with the intent of identifying disclosures that companies were actually making that extended beyond financial statements. Many public companies, however, opposed efforts by the FASB (or any other body) to require these additional disclosures, on the grounds of cost and potential liability.

thus find it easier to borrow funds for expansion, to retain or expand their customer base, and to retain or recruit new employees.

In short, good information matters — a lot. The critical question is what kinds of non-financial data should public companies be reporting. Investors and other stakeholders need to get engaged and weigh-in or change will be marginal at best.

To develop a new company reporting model will require a *global* conversation of a broad range of investors (individual and institutional), other users, company preparers, regulators and standards-setters. We believe our networks can help facilitate that conversation and indeed help start the conversation. We stand ready to host conversations among all the key stakeholders in business information about what a new reporting model should look like. The process should be one from the “bottom up,” rather than one imposed from the “top down” by a single global standard-setter or regulator.

Whatever new model emerges from this process should generate information that is capable of being easily accessed through new Internet-based reporting technologies. It may be necessary for the public and private sectors to take measures to prevent intermediaries from misusing the information categorized by the new reporting technologies in ways that mislead investors.

Implications of the New Financial Reporting Model for Auditing in the Future

In an environment of user-determined customization, users are likely to care less about the formats that have historically dominated the disclosure of company information — balance sheets, income statements and statements of cash flows — and far more about new formats that could be developed by our profession, analysts and users themselves. In such a world, users therefore will want to be assured of the reliability of the specific information they choose to access, which underscores the importance of auditing the technology (hardware and software) that produces it and the reliability of the systems of “tagging” the data.

Indeed, eventually users may not be as interested in the *financial reporting* or *accounting conventions* toward which the world is in the process of now converging. That is because users may not use the traditional financial statements themselves, preferring instead to put much greater weight on the non-financial information that will be part of a new business reporting model, or to generate their own financial reports. In such a world, the tagging process — or the system used to put information in different categories — becomes paramount, and audits of that process likewise become the heart of a new model for those who supply audit services (increasing the importance of auditing of companies’ “internal controls” over the tagging of company data).

A world of customization also is one where consumers and users of information will be accustomed to making fine distinctions, and to deciding what level of “granularity” they are willing to pay for. This is a very different world than the one we currently inhabit, which is much more “black and white.” For example, the current audit opinion is like an “on and off” switch: either a company’s financial statements do or do not comply with prevailing accounting conventions. There is no “in-between.”

But in an environment where fine distinctions can and will be made, consumers and users may not be satisfied with being able to pay for and receive an “off or on” or “comply/do not comply” audit opinion. Just as most of us have become accustomed to the use of rheostats to finely adjust the volume of the music we hear or the intensity of light in our homes, users of financial information may demand from public companies the ability to receive more finely nuanced opinions from auditors about the *degree* of a company’s compliance with a given set of standards, or the relative conservatism of judgments compared to peer groups. Or more boldly, investors even may want the auditor’s views about the overall health and future prospects of the companies they audit. Regulators and the liability system in any country should accommodate these types of requests.

Implications for Audit Networks

Both elements of any new reporting model — any standardized reports containing more than financial information and the customized information that investors are likely to seek once it becomes widely available — will require new skills to be developed and refined within our networks, among our existing partners and managers, and our new recruits. We are committed to meeting this challenge, to developing and maintaining expertise in auditing non-financial as well as financial information reported by companies, and exercising our judgment, borne of our experience and expertise.

IV. BENEFITS OF THE BRAVE NEW WORLD IN COMPANY REPORTING

How will investors and other company stakeholders benefit from the brave new world made possible by new financial reporting technologies and a new reporting model? Although we can envision some ways in which the investing world will change — for the better — we will be the first to admit how difficult it is to forecast the full implications of new technologies and new methods. History provides ample caution. Every major innovation — from electricity, to the automobile, to the personal computer — has produced changes that would have been difficult or even impossible to predict at the outset.

We expect the same thing to happen with the coming revolution in business reporting. Nonetheless, here are a few of the changes that can be glimpsed even now.

More Efficient Markets: Better information about public companies, disclosed more frequently and in a more user-friendly format, will improve the ability of investors to assess the value of companies. In this process, markets will become more efficient, and improve the allocation of capital and talent — within and across national boundaries — by rewarding those companies and their shareholders that deliver the greatest value.

More Financial Stability than Otherwise: Better and more timely information enhances transparency, which in turn should enhance financial stability. A more open world is one where financial contagions and the economic disruption they can bring in their wake are less likely.

More Investor Focus on the Long Run: Finally, and perhaps counter-intuitively, more frequently reported information may reverse some or much of the “short-term-ism” about which corporate managers and others have long complained. Once investors have almost real-time access to financial and other information about companies, forecasting “quarterly” profit numbers will no longer be relevant, while forecasts of daily or weekly profits will be pointless. As a result, by having more frequent information, investors and their companies may begin looking over longer time horizons. The disclosure of more useful, non-financial forward-looking information should reinforce this outcome, along with continued compensation reforms by public companies themselves that reward long-term performance.

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Training Future Audit Professionals

Twenty years ago, it was rare to find an auditor using a personal computer. Today, it would be almost impossible to find an auditor without one, or without the skills to operate any of a wide variety of software programs that companies now use to organize and analyze information about their operations.

We couldn't operate without having professionals with this expertise. Accounting and audit standards today are both more numerous and complex than just a short time ago. For example the body of IFAC's International Standards on Auditing, including the Code of Ethics, today run to over 1,000 pages of text. Our audit networks have advances in university education to thank for providing our new recruits with a much higher level of technical sophistication than was common just two decades ago. But each of our networks also must invest heavily to continue training all of our personnel — partners included — to keep up with new standards and new technologies. In the past, most of our training was classroom based. But today, with auditors on assignment virtually full time throughout the year, the networks make increased use of technology and virtual learning environments, making use of closed circuit television and taped programs, web and pc-based interactive learning programs, and live training sessions communicated by satellite video and webcasts.

In addition, much of our training is industry-specific, since auditing of particular industries requires specialized knowledge. Much of this information is imparted through informal office meetings and regular consultations with industrial specialists.

It is a truism that information is power. The primary purpose of company reporting is to empower investors, who through the purchases and sales of securities drive the growth of capital markets and economies around the world.

Our audit networks play a vital role in this process, providing assurance to the best of our abilities that the information that public companies produce is consistent with applicable standards and complex transactions are presented consistent with their economic substance, so that material misstatements are a rare occurrence. In the short run, in our increasingly global economy, investors are better served if those standards are also global — that is, uniform across countries. Over the longer run, continuing changes in technology and demands by investors for even more useful information are likely to lead to revolutionary changes in company reporting. Our profession stands ready to facilitate that revolution by engaging in a dialogue with investors, companies, policymakers and other stakeholders around the world.

The world is rapidly changing. Let us begin the conversation. It promises to be lively.

