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Converging Numbers: Harmonization of Accounting Standards in the Context of the Role of the Auditor in Corporate Governance

Poonam Puri*

Introduction

The recent financial collapse of Enron and other corporate powerhouses as well as the demise of accounting firm Arthur Andersen brings into question the credibility of the auditor's role in corporate governance. This article comments on the harmonization of accounting standards within the context of the role of the auditor in corporate governance.

Separation of Ownership and Control—Corporate Governance

Berle and Mean's concerns about the separation of ownership and control in the large publicly held corporation are just as relevant in Canada today as they were in the United States in the 1930s.¹ The separation of ownership and control, that is, the separation of shareholding and management, causes concerns for managers acting in their own interests rather than in the best interests of shareholders.² In attempts to reduce the divergence of interests between those who control and those who own, we employ an

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¹ A. Berle & G. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933).

² Corporate law imposes a fiduciary duty on managers to act in the best interest of the corporation, which courts have generally interpreted as the best interests of shareholders. There is, however, a

array of market mechanisms and legal rules.³ Market mechanisms include contingent compensation packages, and the market for corporate control (take-overs) and the market for managers. Mandatory legal rules such as the duty of care and the duty of loyalty, and the threat of shareholder litigation also act to reduce the divergence between shareholder and management interests.

Another important legal rule requires a corporation to appoint an auditor to review and certify its financial statements.⁴ While most rules in corporate law are default rules reflecting the enabling nature of corporate law, this one is a mandatory rule.⁵

The auditor's purpose in corporate governance is to ensure greater accountability of management to shareholders and other stakeholders such as creditors, employees, and the government, all of whom have a financial interest in the assets controlled by management. The auditor's primary role is to bridge the information and credibility gaps that exist between top corporate management and these stakeholders.

Following generally accepted auditing standards (GAAS), the auditor is required to methodologically review and objectively examine the financial statements prepared by a

live debate on whether the best interests of the corporation should include only shareholders, or also, other stakeholders, such as creditors, employees, customers and the government.

³ See generally, A. Shleifer & R. Visney, "A Survey of Corporate Governance" (1997) 52 *Journal of Finance* 737.

⁴ Canadian Business Corporations Act, RS 1985, c. C-44, s.162(1) [hereinafter C.B.C.A.].

⁵ There is an exception in the C.B.C.A., however, for companies that do not distribute their securities to the public. See s. 163(1).

company's management and determine their accuracy in accordance with generally accepted accounting principles (GAAP)

An auditor's independence from her clients is considered to be one of the hallmarks of the accounting profession.⁶ Independence ensures that the auditor will be objective when obtaining, reviewing and reporting client information.

Corporate and securities law rules attempt to give some substance to the principle of auditor independence by legislating a specific framework of rights, responsibilities and duties under which the auditor must carry out her tasks.

Corporate law statutes expressly state that an auditor be independent from the corporation that she audits.⁷ Corporate law statutes also expressly state that the shareholders—not management—have the legal authority to appoint the auditor at the annual general meeting of shareholders⁸ As a result, the shareholders of a corporation are supposed to appoint the auditor at the annual general meeting of the corporation by ordinary resolution.⁹ The auditor is required to make a report on the financial statements before the shareholders at every annual general meeting.¹⁰ The auditor can demand all

⁶ See concerns about independence.

⁷ C.B.C.A., s. 161(1). Independence is defined in s.161(2).

⁸ C.B.C.A., s.162(1).

⁹ *Ibid.*

¹⁰ C.B.C.A., s. 155(1)(b).

relevant information and access to documents necessary to enable her to make the examination.¹¹

Safeguards have also been put into place at the commencement and termination of the relationship to ensure auditor independence. If management removes the current auditor or if the current auditor resigns, she is entitled to speak at the next annual general meeting to disclose to shareholders the reasons for disagreement and the termination of the relationship.¹² The corporation must make a statement at the termination of the relationship¹³ and the new auditor is also entitled to this information and may make a statement.¹⁴

Despite the presence of these safeguards in corporate statutes, the practical reality of the role of the auditor in corporate governance is starkly different than the theory suggests. Management of publicly held corporations selects the auditor. Widely dispersed, retail shareholders have little or no input in appointing an auditor in the same manner that shareholders have little input in the election of the board of directors. Although officially appointed by the shareholders, the auditors are paid by the management team and rely on them for continued employment. The auditors work

¹¹ C.B.C.A., s. 169 and 170.

¹² C.B.C.A., s. 168(5).

¹³ C.B.C.A., s. 168(5.1)(a).

¹⁴ C.B.C.A., s. 168(7) and 168(5.1)(b).

closely and develop relationships with management, not shareholders. Management may also provide the auditing firm with lucrative contracts for their non-auditing services. Auditors are also reluctant to report on perceived management misconduct because they do not want to develop a reputation as whistle-blowers in the corporate community. Although management has a legal duty to advise the shareholders as to why the previous auditor resigned, it often does not do so in a forthright manner.¹⁵ All this brings into question the degree of an auditor's independence from management. Because a corporation's audited financial statements constitute a primary source of information by which current and prospective stakeholders evaluate the firm, the practical reality of the structure of the audit relationship is very problematic. A large part of this problem derives from the fact that GAAP provides broad standards and principles, which allows management the ability to posture and affords auditors too much discretion in determining whether management's financial statements are fair, reasonable, and accurate.

Accounting Standards

Canadian GAAP are far from being a canonical set of rules that ensure identical accounting treatment of identical transactions. Rather than being specific rules, Canadian GAAP consists largely of principles and guidelines. GAAP tolerates a range of

¹⁵ C.B.C.A., s. 168(5.1)(a).

reasonable treatments, leaving the choice among alternatives to management. The purpose of GAAS is to permit auditors to determine whether financial statements “present fairly” the business and affairs of a corporation. At times, GAAP can result in two identical companies having two different sets of financial statements, both in compliance with GAAP

Financial statements that have the ability to be audited in compliance with GAAP, may in some contexts be misleading statements of financial position. Some may consider the flexibility in GAAP to be a strength, but the wide scope of discretion afforded to auditors may also be a cause for concern because it assists in creating an environment where auditors are more likely to succumb to pressure by management to report financial data in ways favourable to management.

Harmonization, Generally and Harmonization of Accounting Standards

Having set out a broad framework on corporate governance, the role of the auditor, and accounting standards, this section discusses harmonization. International harmonization has been attempted in a number of different areas including monetary and fiscal policy, contract law, banking law, securities regulation, intellectual property law, labour law, environmental law, food safety, product standards and liability law.¹⁶

¹⁶ David Leebron, “Claims for Harmonization: A Theoretical Framework” (1996) 27 C.B.L.J. 63.

As David Leebron has argued generally about harmonization, the debate over harmonization of accounting standards will be of a greater quality if the underlying assumptions and fundamental issues are expressly stated and analysed.¹⁷ Leebron has suggested that we ought to ask a number of questions regarding any argument to harmonize.

I use a modified version of Leebron's inventory of questions to analyze the issue of harmonization of accounting standards in a meaningful way.¹⁸ What is the basis of the claim that the accounting standards of two or more jurisdictions ought to be the same? Why do the accounting standards differ in the first place, and do the reasons for the difference suggest additional costs to the process of harmonization? What other costs might harmonization entail? What kind of harmonization is needed and to what degree must the accounting standards be harmonized? What should the scope of the harmonization effort be in order to realize any goals without unnecessary costs or distortions? Are there alternatives to harmonization (such as mutual recognition) that might serve the goals of the proposed harmonization without entailing some of its costs?¹⁹

Benefits of Harmonization of Accounting Standards

¹⁷ *Ibid.*

Harmonization of accounting standards is not an end in itself. It is a means of achieving certain laudable policy objectives. There appear to be two purposes in harmonizing accounting standards. The first is greater efficiency resulting from reduced transaction costs. The second is greater comparability of companies internationally.

While harmonizing accounting standards is not necessary to make interjurisdictional activity possible in capital markets, it will make it more efficient. Harmonization will reduce overall transaction costs because some Canadian companies, (which also issue securities in the U.S.), would no longer need to prepare reconciliation statements or an entirely new set of financial statements to comply with U.S. GAAP. As well, foreign issuers would not have to prepare reconciliations to comply with Canadian GAAP.

When a company converts its financial statements prepared in accordance with Canadian GAAP into U.S. GAAP, net profits decrease by approximately 10 percent, because U.S. GAAP are more strict with respect to reporting of revenue and expenses. There is no indication in the Canadian Securities Administrators Policy Paper on Harmonization of Accounting Standards of how many Canadian and foreign companies listed in Canada will benefit from harmonizing accounting standards.

When Canadian companies are thinking about raising capital on public markets, our biggest competitor is the U.S. Is there a real concern that some of these companies

¹⁸ *Ibid.*

would bypass Canadian capital markets in the absence of harmonization? Would we witness a large increase in the number of foreign issuers listed in the U.S. who also decide to list or sell securities in Canada if we were to achieve greater harmonization of accounting standards?

If, instead of outright harmonization, we adopt a system of mutual recognition of accounting standards so that Canadian issuers could use U.S. GAAP for financial reporting under corporate and securities laws, the efficiency gains would be minimal, since these Canadian companies would still be required to comply with Canadian GAAP for Canadian income tax and other purposes.

If we create a rule allowing foreign issuers to comply with a foreign jurisdiction's GAAP when doing business in Canada, the transaction costs would be reduced for the foreign company. However, the costs would be shifted to third parties—such as retail and institutional shareholders and other stakeholders—who may need to prepare their own reconciliation of the foreign financial statements to Canadian GAAP, for comparability purposes.

The second purpose of harmonization of accounting standards is greater comparability. The argument is that certain Canadian companies would become more competitive in attracting capital and credit if they could report their financial statements in U.S. GAAP

¹⁹ *Ibid.*

because the relevant comparison peer group is large U.S. and other foreign companies. If, rather than harmonizing accounting rules, we opt for a less drastic option as suggested in the C.S.A. Policy Paper and allow Canadian companies to choose whether they want to comply with Canadian or US GAAP, then comparability of Canadian companies with each other is actually reduced. It also imposes costs on retail and institutional investors who are trying to compare one Canadian company with another Canadian company on the basis of the same financial reporting rules.

Sources and Legitimacy of Differences in Accounting Standards

Differences in accounting standards might have value and harmonization may sometimes be achieved at the cost of eliminating or reducing those differences. In evaluating the claim that accounting standards ought to be harmonized, we must ask why different jurisdictions have adopted different standards in the first place.

The question of why jurisdictions adopt different laws and why Canadian GAAP differs from that of other jurisdictions is extremely complex. To answer it requires tools from many disciplines, including economics, politics, sociology, and public choice theory.²⁰ Jurisdictions might differ in many ways, all of which affect the laws and policies they adopt.

²⁰ *Ibid.*

Jurisdictions may differ in endowments. Policy decisions both affect and are affected by national resources. Jurisdictions differ in the level and quality of financial disclosure required of companies, but the level and quality of financial disclosure is itself a function of the resources that are allocated to ensuring fair and efficient capital markets

Jurisdictions may also differ in the preferences and ideologies of its citizens. Identical resources do not result in identical social choices. Preferences for accounting standards vary. The U.S. prefers specific, rule-like, accounting standards, whereas Canada's accounting standards are slightly more general and formulated as principles.

The costs of harmonizing accounting standards will depend on the reason for the difference in the first place. There are a number of significant differences Canadian and U.S. GAAP including accounting for foreign currency denominated debt, business combination transactions, accounting changes, income taxes, extraordinary items, interest capitalization, and pension costs.

If these differences between Canadian and American accounting standards derive from differences in policies and preferences (for example, differences in income tax policies and practices or difference in public and private retirement plan policies), then harmonization certainly means that at least one jurisdiction will lose something of value if a new standard is implemented. Care ought to be taken in examining why Canada has opted for certain accounting standards as opposed to others. Careful attention ought to

be paid to our unique income tax system and the unique attributes of our public and private pension systems.

Comparative corporate governance may provide some insight on the historical differences in accounting standards, and possibilities for their convergence in the future.

Historically, the corporate governance structures and policies of bank centred economies such as Germany and Japan have been quite different from those found in public capital market centered economies such as Canada, the U.S. and England.

Accounting standards in Germany look like broad statements of policy and principle.

They are briefly stated and function at a very general level. On the other hand, American accounting standards are much more comprehensive, specific, and rule-like. Canadian GAAP, while more similar to U.S. than German GAAP, operates at quite a general level where principles are articulated but specific rules are not set out.

In my view, the difference in accounting standards can in part be explained by the historical fact that the banks provided most of the capital requirements to German corporations, and as a result, had access to financial information about the company.

They also had the sophistication to interpret the financial data. As a result, there was not as much of a demand for specific, rule-like accounting standards. Standards that operated at the level of principle and policy were sufficient. The same cannot be said in Canada or the U.S., where corporations rely much more heavily on public capital

markets to raise funds. Since retail shareholders in the U.S. have little ability to access or understand a corporation's financial data, they rely significantly on the auditor's seal of approval that the financial statements fairly and accurately reflect the financial picture of the company. There was a greater dependency on auditors and a greater need for more specific rule-like accounting standards.

In harmonizing accounting standards, we need to pay attention to their level of specificity. When accounting standards are written in a detailed fashion, clever managers and accountants will find ways to get around the precise wording of the rules. When accounting standards are generally stated, perhaps too much faith is placed in the hands of the auditor who must apply the standards objectively and in good faith.

This dilemma is similar to the one encountered when drafting legislation. Should legislators draft clear, specific, bright-line rules that clever lawyers will be able to manoeuvre around? Or should the legislators set out general policies and principles and rely on the good faith of the parties who use such laws and the good judgment and the independence of the judges who interpret them?

Given the poor judgment that has been exercised by some auditors in the recent past, perhaps specific, rule-like accounting standards are more appropriate. But, given that the U.S. has the most rule-like standards of all jurisdictions, and was not able to avert the collapse of Enron, where does this leave us? Clearly this means that we cannot rely

exclusively on changes to accounting standards to solve the corporate governance crisis that we currently face.

Conclusion

Before any conclusions can be drawn on harmonizing accounting standards, one must pay serious attention to the costs and benefits of harmonization and the reasons for historical differences in accounting standards. Harmonization can be achieved through a number of different procedures. My view is that, rather than simply adopting U.S. GAAP or passing over authority on accounting standards to an international institution, control over accounting standards ought to remain within Canadian institutions. Making decisions about accounting standards at a more local level has both substantive and procedural value.²¹ The substantive value is that the local population (Canadian companies, auditors and stakeholders) is able to implement choices that better reflect its ideologies, preferences, and resources.²² The procedural value of localism is one of participation, or having a more meaningful say and more direct influence over the policies that affect the quality and quantity of accounting standards.²³

Implicit in the claim for harmonization of accounting standards is that Canada is less competitive in the global capital markets if our standards are different than those of other jurisdictions and in particular, the United States. Even if we do harmonize

²¹ *Ibid.*

²² *Ibid.*

²³ *Ibid.*

accounting standards, comparability may be difficult to achieve because accounting standards almost always provide more than one method to report a transaction or matter.

The auditor plays a vital role in ensuring that managers act not in their own interests, but in the best interests of the stakeholders whose capital they control. As recent events in the corporate world have highlighted, the auditor's role in corporate governance is in a state of crisis. Any movement toward harmonization of accounting standards must be pursued in conjunction with other reforms so as to improve the role of the auditor in corporate governance.