



AUDIT COMMITTEE INSTITUTE

Achieving Financial Reporting Transparency

KPMG IN CANADA

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Investors and other stakeholders want financial reporting to be timely, accurate and transparent. How does a company meet these expectations?

Over the past several years, the reporting of misstated financial information has jumped from the business pages to the front pages. Relentlessly, the press continues to report stories of corporate reporting scandals that have shaken investor confidence. In response, there is a renewed focus on financial reporting that is more timely, accurate and transparent. Many companies, however, struggle to deliver financial information that effectively simplifies the complex accounting and regulatory rules that drive the content of a company's periodic reporting documents.

So how does a company achieve transparency?

Transparent financial reporting goes beyond just getting the numbers right.

Transparent financial reporting goes beyond just getting the numbers right. Transparency is the ease with which a reader is able to obtain a meaningful analysis of a company's actions, its economic fundamentals and an understanding of the non-financial aspects of the business. It is a measure of how good management is at making financial information available in a candid, accurate and timely manner. A transparent financial report presents a clear and accurate picture of what is happening in the business.

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A company's ability to provide transparency in financial reporting is impacted by the attitudes of all those involved in the financial reporting process toward providing full, plain and fair disclosures. It is management's responsibility to prepare the company's financial reports. However, as overseers of the financial reporting process, the audit committee plays a key role in ensuring the transparency of the information presented. A diligent audit committee can act as a crucial check that all important information is being reflected in a company's public reports in a clear and understandable manner. In their oversight role, audit committee members can ask tough questions to satisfy themselves that management has fully disclosed the implications of its accounting policies, estimates and judgments. This will help to ensure that readers of this information have an accurate picture of the health and prospects of the company.

A company's financial reporting documents include the financial statements, MD&A, AIF and earnings press releases as well other disclosure documents such as corporate governance policies and executive compensation policies. Given the importance of the information reported in these documents, making sure it is communicated in a clear and concise manner is an important objective for both management and the audit committee. Following are some suggestions for audit committee members to consider when assessing the transparency of each of their company's reporting documents.

Financial Statements

As financial reporting standards increase in complexity, determining how to apply the standards in any particular circumstance can be a formidable challenge. It is all too easy to get lost in the details of the rules and lose sight of the bigger-picture issues that the rules were written to achieve.

While accuracy of the technical details is critical, when preparing financial statements it is equally important to step back and also assess whether the four basic characteristics, which need to be embodied in a set of financial statements to make them useful to investors, have been captured. Those characteristics are:

- Understandability
- Relevance
- Reliability
- Comparability and consistency

Understandability

Financial statement users are assumed to have a reasonable understanding of business and economic activities and accounting as well as a willingness to study the information with reasonable diligence. For the information provided in financial statements to be useful, it must be capable of being understood by users.

Relevance

The information provided in financial statements must be relevant to the decisions made by users. Information is relevant by its nature when it can influence the decisions of users by helping them evaluate the financial impact of past, present or future transactions and events, or confirm, or correct, previous evaluations.

Reliability

Information is reliable when it is in agreement with the actual underlying transactions and events, is capable of independent verification and is reasonably free from error and bias. Reliability is achieved through representational faithfulness, verifiability and neutrality.

There are four basic characteristics that need to be embodied in financial statements to make them useful to investors.

(a) Representational faithfulness

Representational faithfulness is achieved when transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transactions and events. Thus, transactions and events are accounted for and presented in a manner that conveys their substance rather than their legal or other form.

(b) Verifiability

The financial statement representation of a transaction or event is verifiable if knowledgeable and independent observers would concur that it is in agreement with the actual underlying transaction or event with a reasonable degree of precision. Verifiability focuses on the correct application of a basis of measurement rather than its appropriateness.

(c) Neutrality

Information is neutral when it is free from bias that would lead users toward making decisions that are influenced by the way the information is measured or presented. Bias in measurement occurs when a measure tends to consistently overstate or understate the items being measured. In the selection of accounting principles, bias may occur when the selection is made with the interests of particular users or with particular economic objectives in mind.

Financial statements that do not include everything necessary for faithful representation of transactions and events affecting the entity would be incomplete and, therefore, potentially biased.

The financial statements should paint a true picture of the economic resources and obligations of a company as well as how transactions and events have changed those resources and obligations.

Comparability and consistency

Comparability is important when comparing the financial statements of two different entities and when comparing the financial statements of the same entity over two periods or at two different points in time. Comparability in the financial statements of an entity is enhanced when the same accounting policies are used consistently from period to period.

Consistency helps prevent misconceptions that might result from the application of different accounting policies in different periods. When a change in accounting policy is deemed to be appropriate, disclosure of the effects of the change may be necessary to maintain comparability.

Assessing the Quality of Financial Statements

An audit committee's review of financial statements should focus on whether each of these characteristics is represented in the information. The financial statements should paint a true picture of the economic resources and obligations of a company as well as how transactions and events have changed those resources and obligations. The financial statements should be free from bias toward a predetermined result and they should present information on a basis consistent with prior periods.

To effectively make an assessment as to whether the financial statements embody these characteristics, audit committees should obtain an understanding of how the information was generated by asking questions such as:

- Has the company changed the methodology used to calculate accounting estimates year over year? If so, why and what is the financial statement impact of such changes?
- Are the accounting policies selected by the company of high quality? Were other choices available under GAAP, and if so, why did the company choose a particular policy?
- Has the company engaged in complex transactions that are not in the normal course of operations? If so, what was the business purpose of the transaction? Do the disclosures in the financial statements adequately describe the substance of the transactions?
- Has the company entered into significant off-balance-sheet transactions? If so, what is the business purpose of the transactions? Do the financial statements disclose adequate information about those transactions?
- How does the company define a related party? Has the company entered into transactions with related parties that are outside the normal course of operations? What was the business purpose for such transactions? Is the disclosure in the financial statements adequate?

Audit committee members should ask other questions about the quality of earnings and how any industry-specific trends have impacted the company's results. Committee members should be comfortable with those areas that require considerable judgment and they should assess the effectiveness of the financial statements in communicating in plain English.

There are stories of companies that have searched for loopholes in accounting rules that allowed them to achieve certain results. Active participation by the audit committee in assessing the quality of a company's reported results will help in curbing this "show me where it says I can't" attitude.

In their review, the audit committee should also be aware of potential risk factors and red flags that warrant further scrutiny. Such red flags and risk factors might include:

- competitive factors such as a high degree of vulnerability to rapid changes (e.g., changes in technology, product obsolescence, changes in interest rates or a decline in customer demand coupled by declining margins)
- liquidity issues including significant pressure to obtain additional financing, high reliance on debt, pending debt repayment obligations or other debt covenant requirements

The external auditors can be a valuable resource for the audit committee to turn to in its review of the financial statements.

- information that indicates that the personal financial situation of management is threatened by the company's financial performance arising from the following:
 - significant financial interests in the entity
 - significant portions of their compensation (e.g., bonuses, stock options and earn-out arrangements) being contingent upon achieving aggressive targets for share price, operating results, financial position or cash flow
 - personal guarantees of debts of the company

High-stress work environments, recurring turnover at the senior management level, strained relationships between the external auditors and management, excessive interest of non-financial management in the selection of accounting policies and the determination of significant accounting estimates are other risk factors that should cause the audit committee to be more vigilant and alert as these risk factors may create pressure on management to manipulate reported earnings. The audit committee should ask whether it has been tough enough in examining the reasons these circumstances arose as well as whether such factors might have negatively impacted the quality of the reported financial results.

The Role of the External Auditors

The external auditors can be a valuable resource for the audit committee to turn to in its review of the financial statements. Clear, candid and open communications between the audit committee and the auditors can shed significant light on issues that the audit committee should pursue with management.

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Management Discussion and Analysis, Earnings Press Releases and Other Continuous Disclosure Documents

The objective of MD&A is to provide investors with a narrative explanation, through the eyes of management, of how a company performed during the period. The regulatory rules related to MD&A specify that in writing the MD&A, management's objective should be to improve a company's overall financial disclosure by giving a balanced discussion of its results of operations and financial condition. The MD&A should:

- help current and prospective investors understand what the financial statements show and do not show
- discuss material information that may not be fully reflected in the financial statements
- discuss important trends and risks that have affected the financial statements and that are reasonably likely to affect them in the future

When reviewing MD&A, the audit committee should consider whether management has succeeded in delivering the open and honest look at the company's operations intended by the rules.

- provide information about the quality and potential variability of a company's earnings and cash flows to assist investors in determining if past performance is indicative of future performance

When reviewing MD&A, the audit committee should consider whether management has succeeded in delivering the open and honest look at the company's operations intended by the rules. In addition to considering whether the MD&A complies with regulatory requirements, the audit committee should consider whether the document:

- describes core businesses and strategies and the related assumptions
- discusses business risks, risk management strategies and sensitivity analysis
- reviews past performance compared with goals, objectives and targets, and more importantly provides reasons for variances
- discusses future prospects and the extent to which past performance is indicative of future performance

When evaluating the content of MD&A, the audit committee should understand the process used by management to identify material information. The committee should question content that is immaterial or that does not promote an understanding of the company's financial condition, liquidity and capital resources, changes in financial condition, and results of operations.

When reviewing earnings press releases, the audit committee should consider whether they present a balanced perspective of operating performance.

When reviewing earnings press releases, the audit committee should consider whether they present a balanced perspective of operating performance. Such releases should ordinarily include analysis of operating results and a discussion of both the positive and negative factors that significantly affected revenue, profitability and other key financial indicators that measure the health of the company. Information contained in earnings press releases should be prepared consistently from period to period and, where non-GAAP measures have been used, the audit committee should consider whether management has sufficiently explained why such financial measures provide useful information to investors and how management uses the non-GAAP financial measures.

One effective process that companies may consider to assist in the development of these external disclosure documents is the establishment of a disclosure committee. Canadian regulatory requirements do not require companies to establish disclosure committees and whether or not such a committee is necessary may depend upon the size and complexity of the organization as well as the level of involvement that the CEO and CFO have in day to day operations. However, if a variety of dedicated individuals from various functions within the company are on the committee, it has the potential to add significant value and improve the quality of external disclosures.

Plain English Principles

Financial statements, MD&A and earnings press releases should always be written using plain English principles. A plain English document uses words economically and at a level that the intended audience can understand. When reviewing financial statements, MD&A and earnings press releases, the audit committee should consider the extent to which management has incorporated such principles. The committee should consider whether the documents:

- have been written in a language that investors will understand
- highlight information that is important to investors
- have omitted important information

Other principles that the audit committee should look for in these documents include:

- eliminating redundant information – reading the same information two or three times can bore and even trouble readers
- using effective organization – for example:
 - present the big picture before the details; an individual piece of information means more to readers if they know how it fits into the big picture
 - use descriptive headers and subheaders to break the document into manageable sections
 - always group related information together to help identify and eliminate repetitious information

Writing financial statements, MD&A and earnings press releases is, of course, not the responsibility of the audit committee, but the audit committee can provide valuable reminders to management of some of these basic principles.

Other Documents

MD&A and earnings press releases are just two of the continuous disclosure documents that investors look to for information and which audit committees are responsible to review. The regulatory rules related to audit committees also require that the audit committee be satisfied that there are adequate procedures in place for the review of the issuer's public disclosure of financial information extracted or derived from the issuer's financial statements, MD&A and annual and interim press releases. It is not clear from the rules what these disclosures encompass, but they may include, for example, financial disclosures made in speeches by senior or financial executives, or financial disclosures made in analyst calls. Audit committees should ensure that they have considered this responsibility and questioned management about the nature of other potential disclosures of financial information and the processes in place to ensure the accuracy of those disclosures.

When reviewing financial statements, MD&A and earnings press releases, the audit committee should consider the extent to which management has incorporated plain English principles.

The review of other disclosure documents, including the AIF, the statement of executive compensation and the information circular is not a regulated responsibility of the audit committee but the audit committee should encourage management to draft these documents with the same level of care and attention to transparency as is given to the financial statements and MD&A.

The audit committee should encourage management to consider providing information beyond what the rules require in each of these documents. Such actions demonstrate a commitment to keeping the capital markets well informed.

Other Corporate Governance Disclosures

In late 2004, the CSA issued for comment a national instrument on corporate governance disclosures that will require issuers to disclose their corporate governance practices. These disclosures are important because they provide investors with insight into the processes by which a company is governed and allow investors to draw their own conclusions as to the adequacy of the governance practices.

The rule describes a set of practices that should be used as guidelines against which a company can compare its own practices. Complying with these requirements is an important step in achieving transparency in corporate governance disclosures. However, companies that are considered amongst the best in class are those that implement practices and provide disclosures that go beyond merely what is required.

Providing additional information concerning the specific practices of the board and audit committee can clearly distinguish one company from another. For example, the corporate governance rule suggests that the board of directors should adopt a mandate in which it explicitly assumes responsibility for things such as:

- to the extent feasible, satisfying itself not only of the integrity of the CEO and other executive officers but also that the CEO and other executive officers create a culture of integrity throughout the company
- the identification of the principal risks of the company's business, and ensuring the implementation of appropriate systems to manage these risks
- adopting a communication policy for the company

Rather than simply disclosing that the board has assumed responsibility for these activities, companies could expand the disclosure to address how the board fulfills these obligations.

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Beyond Review

At the top of the financial reporting pyramid, the audit committee is in a key position to foster a financial reporting environment where there is zero tolerance for anything but clear and candid disclosures and where unethical behaviour will not be tolerated. Through their own actions, audit committee members can influence the behaviours of others by setting the tone for what is expected.

One of the practices recommended in the corporate governance rules is ongoing education for board members. By being on top of new accounting and regulatory developments, audit committee members will be in a better position to ask probing questions and to make informed decisions about the implications of management's decisions regarding accounting policies, disclosures and judgments. Continuing education will also give audit committee members the confidence to pursue the questions they need to ask until they get the right answers. In addition, audit committee members who pursue continuing education will demonstrate to management that they are committed to being responsible and effective members of the financial reporting process. When actions speak louder than words, such behaviour from audit committee members can encourage similar behaviours among others in the financial reporting process.

Responsible Reporting

Achieving transparency in financial reporting is not easy because it cannot be achieved by simply ticking the boxes of a transparency checklist. Transparency results from the desire to do the right thing and to disclose all pertinent information, even when the news is not good, and to present a balanced picture of the financial health of the company. It is the result of a thorough and well-thought-out approach to communications with the capital markets and finding the right amount of information to communicate in the right format at the right time. While compliance with the rules governing financial reporting is important, the best disclosures are those that go beyond what is merely required and instead focus on telling it like it really is.

Whether in the financial statements, MD&A, AIF, press releases or other continuous disclosure documents, be committed to communicate, openly and honestly, and in a fully informative manner. Transparent financial reporting helps investors make more informed decisions, and such decisions are necessary for a fair capital market system.

Transparent financial reporting is the result of a thorough and well-thought-out approach to communications.

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