Book 3, Chapter 5

CORPORATE REPORTING AND ACCOUNTABILITY

October 27, 1989

Mr. Chairman
Distinguished Guests
Capital Market Leaders
Ladies and Gentlemen

The 1990's will be an exciting decade for the Nigerian capital markets. My crystal ball reveals two competing forces which will bring both positive and negative developments as we try to meet the challenge of funding Nigeria's future growth.

On the positive side, there will be increasing demand for long term capital - both equity and debt. This demand will result from structural adjustment programmes which will systematically restructure both private and public sectors from top to bottom and which will place increasing demands on the private sector to be Nigeria's engine for growth. Growth, however, will only take place if there is new investment. Hence, political/economic pressures will increasingly develop which favour expansion of savings and equity investments. Funding will increasingly be hard to come by due to the scarcity and stringent conditions of external debt, the critical need to control inflation through strict monetary measures, and the impact of government privatization programmes. Attempts to improve the investment climate can be expected and these will in turn open up opportunities for dynamic development of the Nigerian capital markets.

These expanding opportunities will be accompanied by threats, or challenges, to the institutional framework of the capital markets. In my view, parts of the existing framework are already fragile and their failure or collapse will bring the need for urgent and pervasive reform. My topic today deals with one of the weak links in the chain - that of Corporate Reporting and Accountability.

I believe we have a serious challenge to face. Sound growth of our capital markets will require reliable information which accurately reflects Nigeria's new economic realities. We will need sound and responsible managements which are fully accountable to their various stakeholders. We will also need progressive institutions which respond to requirements on a timely basis.

My purpose today is therefore to persuade this audience that our pro-active leadership can make a major impact for the benefit of all users of corporate reports -- investors, financial institutions, customers, employees, governments and the public.

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I sincerely hope that straight talk can create a sense of urgency for us to address the relevant issues both indepth and on a timely basis. My Firm has built its hard earned reputation around the world first by speaking out on issues facing the accounting profession and users of corporate reports and, secondly, by fostering practices and reforms which nddress the relevant issues in the public interest.(1)

Following this tradition, my plan is to develop the topic under four headings -

- analysis of the economic forces at work,
- impact on corporate reporting and accountability,
- definition of emerging issues for the accounting profession, and
- the challenge of pro-active reform.

ECONOMIC FORCES AT WORK

Analysis of current economic realities(2) within Nigeria will help us assess the underlying trends, identify the relevant issues, and discern the courses of action open to us.

SAP has unleashed a number of economic forces with considerable sustainability and therefore relevant predictive value in assessing corporate reporting issues likely to emerge during the 1990's. Policy continuity (along the lines of SAP) can reasonably be expected given the global economic environment and Nigeria's need for foreign debt and investment to help fund its development. Continuation of SAP (with modifications) for the indefinite future will eventually create a favourable investment climate which will be increasingly conducive to private sector growth and expanding capital markets.

There are five economic forces at work which reenforce this conclusion and which are relevant for our analysis of corporate reporting.

First, market liberalization is fundamentally reshaping our private and public enterprises, with those that cannot (or will not) restructure going the way of the "dinosaur". Free markets are the proven cure for our addiction of living beyond our means and also the single most important determinant of a positive investment climate. While we can expect a tendency towards regulated or "administered" markets (for example, today's FX market intervention), the trend towards free markets should continue as long as Nigeria strongly depends for trade, loans and investment on the foreign sector. Market liberalization should result in clearcut "winners" and "losers" within the Nigerian economy thereby making reliable financial information increasingly valuable to those charged with allocating scarce resources to the best investment or loan opportunities.

Second, inflation has become increasingly critical to manage. In 1988 and 1989, its evil consequences became increasingly obvious since inflation undermined SAP and created pervasive social tensions. Inflation is universally recognized as destroying the middle class and undermining productivity due to investments being focused on things that hold their value rather than on productive earning assets. Latin American experience shows that inflation can be very difficult to cure since it tends to feed on itself once speculative spending habits become well established. Nigeria has made a start by finally introducing measures to mop up excess liquidity but it is clear that the cure for inflation will require strict monetary and fiscal controls over a lengthy time period as well as measures favouring investment and free market policies which foster non-inflationary growth. Recent steps have been in the right direction but it is too early to forecast a cure for our addiction. What is safe to say, however, is that there are already severe consequences on corporate reporting. We must particularly look at the issue of "phantom profits", which inflation creates under historical accounting conventions, since it is clearly an emerging issue for the accounting profession to address.

Third, the restructuring and relative downsizing of the public sector will help control inflation and will increasingly shift responsibility for the economy to the private sector. The privatization/commercialization programme is particularly encouraging as it should result in improved economic results (through improved management, subsidy elimination, etc.) and freed up funds (through sale of shares or assets to the private sector). It is hoped that current measures are but a forerunner of broader actions to get government out of those economic activities which can be effectively accomplished by the private sector. Success in this area will be particularly conducive to a better investment climate and international confidence/support for Nigeria. It will also bring increased needs for corporate reporting by government corporations to their various stakeholders.

Fourth, funding will become increasingly critical to correct undercapitalization of existing businesses, to assist the restructuring or survival of many businesses and financial institutions, and to ultimately provide financing for new investments. The present tight liquidity position and the well known problems of bank loan portfolios are but symptomatic of the longer term shortage of funding which Nigeria faces. If SAP works as it should, a gradual shift to equity funding will occur and will be a sign that sustainable recovery is underway. In the interim, there will be a fierce fight for loan funds and, assuming continued tight liquidity, there will be many businesses and financial institutions which do not survive because of lack of funding. As we shall see, these business failures will create particular pressures for reform in corporate reporting.

Lastly, foreign exchange (FX) transactions and rates will remain a central policy issue with real growth of FX supply unlikely to be strong until these markets are fully determined by supply and demand. Current practices discourage exports, foreign investments, return of flight capital, and local sourcing. Since these are precisely the activities needed to stimulate sustainable growth, FX policies which create the right incentives are particularly important to a favourable capital market outlook. Accounting for FX transactions will in turn become increasingly important for sound corporate reporting.

Taken together, these five economic forces are at work to create the future economic environment which will impact corporate reporting. While one can not forecast the economic outlook with any reasonable degree of certainty, we can conclude that the continuation of economic restructuring will create an environment for similar dynamic change in corporate reporting.

IMPACT ON CORPORATE REPORTING AND ACCOUNTABILITY

Our brief analysis of the economic forces at work have helped us conclude that continued restructuring of the Nigerian economy lies ahead and that there will be an inevitable impact on corporate reporting and accountability. Lets now turn our attention to what this impact is likely to be.

It will be useful to first define what we mean by corporate reporting and accountability. Then we can utilize experience gained abroad to discern what impact the economy is likely to have on them.

Corporate reporting refers to audited accounts which are published externally as distinct from management accounts which are used internally to manage the business. The Companies Act, 1968 establishes the basic requirement for each company to furnish audited accounts, which give a true and fair view of the state of affairs, to its members. The Nigerian Stock Exchange, as you are well aware, has established its own additional requirements. Management and the Board have the primary responsibility for their accounts and Annual Report, with very strong linkage and reliance on independent external auditors who express their own opinion.

Auditing standards and accounting principles are established by the accounting profession(3), through the Institute of Chartered Accountants of Nigeria (ICAN), which is essentially a self regulating body. Thus far, guidance to the profession through specific Nigerian accounting standards is comparatively limited (particularly in comparison to the U.S. or UK) and relate primarily to fundamental principles. International Accounting Standards (promulgated by the International Accounting Standards Committee of which Nigeria is a member) are broader in scope but viewed by ICAN as for guidance but not mandatory. At this stage in the development of the Nigerian accounting profession, auditing and accounting practices vary widely between accounting firms. Corporate reporting consequently also varies widely between companies thereby making comparability difficult even within the same industry.

Lack of comparability in corporate reporting is a danger signal - and hence very germane to today's analysis. Periods of dynamic economic change throughout the world have repeatedly brought on reform in the accounting profession for two reasons. First, comparable accounting and reporting becomes increasingly necessary for report users to properly evaluate winners and losers, thereby facilitating decisions to shift resources to better opportunities. Secondly, business failures (which typically involve "surprises" in subsequent corporate reports) lead to a great deal of debate about accounting and auditing standards as well as reporting practices. In the U.S. and increasingly throughout the world, business failures have also led to litigation against auditing firms (as well as companies and individual directors).

In my view, the economic forces at work in Nigeria during the 1990's are likely to be strong enough to require the Nigerian accounting profession to evolve rapidly towards improved reporting practices. It is therefore pertinent to ask what specifically will trigger the need for reform <u>in Nigeria</u> ?

The basic cause will be business failure, particularly among financial institutions. Banks will either fail or require rescue primarily due to bad loans which they cannot recover; secondarily due to increased competition within the banking industry; and thirdly due to undercapitalization. Insurance companies will likewise go through a similar shakeout period - one which will centre particularly on those companies which for some time have not been adequately reinsured. These failures in the finance world will combine to create a domino effect among their customers, particularly the many highly leveraged and undercapitalized companies which figure prominently as "bad loans". The result will be much like an earthquake effect throughout the economy. While I don't know whether we'll see 6.9 on the Richter scale (per the recent San Francisco disaster), I do expect sufficient "unexpected" business failures to raise questions such as - how reliable are corporate reports? and where were the auditors?

These questions will be reinforced by the information needs of increasingly sophisticated users of corporate reports, particularly in three areas -

- financial institutions as they increasingly move towards longer term loans and equity funding for deals where underlying profitability and cash flow become relatively more important than collateral and guarantees.

- investors as they become increasingly sophisticated and as more innovation is seen in mergers, acquisitions, management buy outs, and other financing arrangements.

- management and Directors as they become increasingly aware of overstated earnings and excessive taxes - both due to phantom profits caused by inflation and due to punitive excess profit taxes. The consequent lack of internal funding for expansion will cause pressure for lower taxes - and more realistic reporting to deal with inflationary distortions.

These twin forces - business failures and increased user sophistication - will combine to produce a demand first for quality earnings and secondly for quality reporting. While the direction of these forces is obvious, it is not clear how fast business failures, increased sophistication and the resulting reform will take place. We may have a number of years to put our house in order, but from the standpoint of this audience - and the accounting profession - it would appear prudent to treat the matter like a timebomb ticking and to move with deliberate haste towards fundamental reform.

EMERGING ISSUES

The accounting profession should move urgently towards damage control - as well as longer term reform - by addressing the higher priority emerging issues.

The emerging issues break down into two categories -
(1) accounting principles and reporting standards and
(2) auditing standards

Issues related to accounting principles and reporting standards must primarily focus on correcting those practices which make comparability of corporate reports misleading. Primary areas of concern are -

- deferred taxes
- foreign currency gains and losses
- pension costs
- depreciation (both lives and asset classes)
- leases (particularly sale/leaseback transactions)
- investments (particularly income recognition and diminution of value)
- income recognition on long term contracts

Each of these issues must be addressed by ICAN and specific guidelines established and made mandatory to improve comparability of reporting. These issues are urgent and can be qickly addressed due to the wealth of practice experience existing offshore which can be tailored to Nigerian circumstances.

Less easy to address - due to lesser success offshore - is the impact inflation has had in undermining the relevance of historical cost accounts. Inflation distorts operating results since historical depreciation becomes inadequate to recover asset replacement costs, inventory holding gains are produced, and overstated profits are both taxed excessively and distributed to shareholders. The result is undercapitalized companies which are unable to fund future growth. While we must accept there are no easy answers and reporting reform must logically accompany tax reform, inflation accounting is clearly a topic which must be addressed.

Our second category was auditing standards. Here the challenge is both to articulate and to foster compliance with improved auditing standards. The purpose of auditing standards is to guide the scope of audit work, the organization/conduct of audits and the auditing techniques utilized towards an increasingly professional and reliable audit engagement. While history teaches that auditing reform and increased discipline are more frequently provoked by business failures, litigation against auditors and governmental intervention in the profession, the handwriting is sufficiently on the wall for ICAN to begin to treat auditing standards as a priority. This area has received considerable attention in the UK and US, with major firms conducting extensive internal quality control reviews and the introduction of peer reviews where firms review each other as to audit quality. Nigeria should evolve a step at a time but awareness of offshore developments can help us to waste little time in re-inventing the wheel.

I would be remiss to leave this topic, however, without emphasizing the unhealthy state of the accounting firms in Nigeria today. The problem is largely economic and serious enough to give senior partners concern as to the survival of their firms. The problem revolves around low levels of audit fees brought about by PPIB controls and the related staffing problem which loss of experienced professionals to new banks has caused throughout the accounting profession. Auditing firms have not been able to increase productivity sufficiently to offset freezes on audit rates. Hence two "facts of life" have emerged. First, the underpayment of young professionals which are the lifeblood of healthy auditing firms. Second, the tendency to reduce audit quality. The emergence of new banks (who can afford to pay for talent) has literally stripped the larger firms of their young talent and eventual future leadership. The extent of audit quality reduction will only be known once business failures and pressure for quality earnings (and quality corporate reporting) work their way through the system. I am sure that audit fees must rise dramatically - perhaps doubling or tripling - to correct the problem of attracting and retaining top quality talent and to assure the survival of major firms as we know them today. I am even more concerned that economic problems will distract us from facing the problems of improved corporate reporting which this paper advances as being so critical for us to address today. My hope is that accounting firms do not become so preoccupied with internal economics that we take our attention away from the emerging issues that our profession must address with urgency. Obviously, we will sorely need the support and joint efforts of those primarily responsible for corporate reporting -- the shareholders, Boards and managements of corporations, as they have the primary responsibility for corporate reporting and accountability.

CHALLENGE OF PRO-ACTIVE REFORM

Our analysis thus far has established that sustained economic forces will bring intense pressure for reform of Nigeria's corporate reporting practices (along with auditing standards) and that the accounting profession should play a lead role in such reform by addressing several key emerging issues. We have also concluded that those with primary responsibility - the corporations themselves - must play a particularly important role due to the professions possible preoccupation with its own internal economic and staffing problems.

Such leadership can only be taken on by the large corporations - particularly those who are members of the Nigerian Stock Exchange - and the regulatory institutions such as the Nigerian Stock Exchange (NSE) and the Securities and Exchange Commission (SEC). Such leadership will be much more successful if it is <u>pro-active</u>. By pro-active, I mean the type of management which diagnoses current problems and emerging issues, then focuses on strategic management of future changes so as to achieve a pre-determined purpose, or end result. Our analysis of problems has identified a number of emerging corporate reporting issues which create obstacles to achieving stronger Nigerian capital markets. My remaining task is to challenge the Nigerian Stock Exchange, its members and sister institutions, to play a pro-active leadership role in improving corporate reporting and accountability.

In my view, the challenge of pro-active leadership can be focused at three levels -

- . the individual company,
- . the accounting profession, and
- . the regulatory system.

At the individual company level, there is a need to go beyond the myopia of immediate financial results and to set higher standards for corporate reporting and accountability to the public. Corporate leadership should give attention to the following priorities -

- . <u>increased quality of earnings</u> - by using more conservative accounting practices particularly based on more realistic assessment of corporate reports of suppliers, customers and related parties. Financial institutions can be particularly pro-active, both in their own accounts and in their insistence on obtaining reliable accounts to support their credit decisions.

- . <u>improved comparability of results</u> - by industry wide action to apply preferable and comparable accounting and reporting principles rather than reach for the lowest acceptable reporting practice in order to maximize current earnings.

- . <u>emphasis on better auditing</u> - by establishing Audit Committees which serve to hold both internal and external auditors to higher standards of performance. Board involvement directly with auditors can greatly support their independence, objectivity and standards of practice.

- . <u>emphasis on better reporting</u> - by improving the content and presentation of Annual Reports plus striving to upgrade the communications with shareholders particularly at Annual General Meetings. Shareholder education can be a valuable by-product as well as generally improving the sophistication of financial analysis.

- . <u>emphasis on economic results</u> - by showing the impact of inflation on corporate earnings, companies can both educate the shareholders and prepare the way for much needed tax reform. In addition, there is a general need to educate the public as to the role of profits in a capitalist economy, particularly as inflation is greatly overstating profits today under historical cost reporting.

At the accounting profession level, support as well as pressure to raise standards will be useful to supplement the profession's own efforts. <u>Support</u> is needed to improve research and development of accounting, reporting and auditing standards - with the Nigerian Accounting Standards Board being particularly important. Funding is an important need but even more critical is time and effort dedicated by professionals from industry and the banking community. <u>Pressure</u> can most constructively be applied through industry efforts to improve reporting practices, through establishment of Audit Committees, and through institutional reform.

At the institutional level, pro-active leadership can best be focused on the regulatory system itself - particularly the NSE and SEC, but also working to reform reporting and disclosure requirements set down by CBN, tax authorities, and other governmental bodies. The aim should be to foster a self-regulating system - by improving practices of the capital market participants and the accounting profession - because history shows that government regulatory systems tend to be overly bureaucratic and inflexible - thereby being particularly slow to adapt to changing economic conditions. Regulatory changes should therefore encourage responsible private sector development based on self regulation. For example, it would be much more constructive to mandate the establishment of Audit Committees for quoted companies than to get government directly involved in establishing and monitoring accounting, reporting and auditing standards/practices.

There is also much to do to improve the environment for corporate reporting and accountability. Quoted companies generally are responsible citizens who fully comply with laws, foreign exchange regulations, payment of taxes, avoidance of corruption, etc. The widespread lack of similar compliance by other institutions and individuals works against Nigeria by undermining the investment climate generally and the development of capital market specifically. The reform measures suggested today must therefore be linked up to wider efforts to generally improve all areas of legal compliance and responsible citizenship by both the private and public sector.

The challenge is therefore particularly urgent because there will be a tendency for many to say that reform can't succeed in Nigeria because of prevalent business practices noted above. This "ostrich" posture, however, would be self defeating because when the crisis comes the quoted companies will attract the most criticism and be the hardest hit by reform.

Pro-active leadership is therefore the indicated prescription and the Nigerian Stock Exchange should be the focal point for such leadership to emerge. The NSE provides a forum for the quoted companies to act in unison and its leadership can encourage both members and the accounting profession towards self-regulating reform.

The risk of inaction is obvious - because economic restructuring and business failures are sure to lie ahead thereby causing the need for reform in corporate reporting and accountability. The choice is not between reform or status quo; it is between pro-active, private sector reform or after-the-fact, bureaucratic reform. The choice to me is clear - and I urge the participants in Nigerian capital markets and the accounting profession to take the initiative while there is still time.

CONCLUSION

Today's message is simple. I hope it is compelling because voluntary and anticipatory reform is always preferable to enforced and reactive reforms which will follow a crisis in corporate reporting.

Analysis of economic forces at work (particularly SAP and its successors) provides highly reliable indicators of continued, fundamental and largely irreversable restructuring of all sectors within the Nigerian economy.

These economic forces can predictably expose current weaknesses in corporate reporting and accountability and lead us to conclude that economic restructuring will bring an urgent and pervasive need for reform. Business failures and increasingly sophisticated information requirements will then cause intense pressures for reform, just as has been the pattern throughout the world.

Just how much time we have available to anticipate these reforms is highly dbatable. But there can be little debate as to its inevitability - and as to the preference of this audience for anticipatory rather than enforced reform. The key to self regulation - which is clearly preferable for the accounting profession and capital market institutions - is responsible leadership which anticipates future needs and acts in the public interest to continuously improve corporate reporting and accountability.

We have a choice. We can let the crisis come or we can be pro-active. The only responsible choice, however, is to be pro-active and to provide the leadership needed for sound development of Nigeria's financial systems and healthy capital markets. The warning signals are clear and I hope we will put the time available to good use.

Thank you.

RICHARD L. KRAMER
MANAGING PARTNER
ARTHUR ANDERSEN & CO.

NOTES

(1) Arthur Andersen & Co. played a particularly prominent and catalytic role in the United States during the 1950's and 1960's at which time major reforms in the U.S. accounting profession were initiated. Professional and government institutions were also established which are now continuously evolving to bring accounting and reporting requirements into line with the needs of financial markets and users of audited accounts. Leadership in this effort was sparked by Leonard Spacek (the successor to Arthur Andersen as our Managing Partner). His speeches from 1956 to 1972 are a treasure trove for the serious reader to study in depth. See " A Search for Fairness in Financial Reporting To The Public" , Vol. I&II by Leonard Spacek.

(2) Such analysis is fundamental to perspective planning, since priority attention must be given to global environment interactions with Nigeria. In this regard, Peter Drucker's recent book is highly recommended - The New Realities, Harper & Row, 1989.

(3) It is our Firm's belief that accountants, due to their independence, have considerable responsibility in establishing the framework for corporate accountability and making sure that accounting reflects economic reality. The concept is put clearly by our former Managing Partner, Leonard Spacek, who is credited with provoking much needed reform in the U.S. accounting profession:

> "Accounting is not just bookkeeping; it is concerned with accountability of the business to each segment of the economy. The accountability must be based upon economic rights established by law and upon sound accounting principles which the accountant enforces. But these principles will not be accepted until the accountant supplies the reasons why they produce an accounting that is fair to each segment according to their rights - whether that segment be investor, consumer, labor, government or the public." (Spacek, Vol. I, page 191)

He goes on to state -

> "Accounting is, in every sense of the word, nothing but a scoreboard; a scoreboard only tells the truth by the standards and rules established for the game. And the truth can be determined whether our economy goes forward or goes backward or is destroyed. No statement of truth can be reliable if either a ceiling or a floor has been predetermined for it. Therefore, accountants as a profession "... "cannot allow anyone to control how the truth of accountability is to be told. However, accountants do have the responsibility of establishing why accounting principles result in the truth and in fairness for each segment of society." (Spacek, Vol. I, page 195).