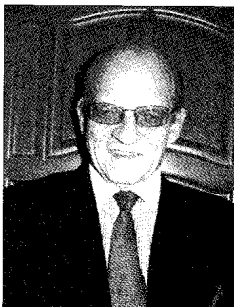


## Financial reforms and investments, an international and Russian perspective

(Art Franczek, President, American Institute of Business and Economics)



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Prior to coming to AIBEC Art served as a business consultant in Togliatti after working for many years as a Corporate Tax Manager for a Fortune 1000 company.

History tells us that great economic crises give rise to significant reforms. In 1929 the US Stock Market Crash resulted in the SEC Acts of 1933 and 1934 that among other things required listed companies to produce audited financial statements. In 1972 Watergate and the rampant corporate corruption bribes resulted in the Foreign Corrupt Practices Act of 1977 that required significant internal control procedures along with prohibiting US companies from making bribes... More recently, the scandals related to Enron, WorldCom, Parmalat and others gave rise to Sarbanes-Oxley in the US and comparable reforms in Europe. New financial reforms are currently being written to deal with the global sub prime crisis. The purpose of this article is to review some of the recent reforms such as Sarbanes-Oxley and to discuss some of the current trends in reforms that will have significant impact on international and Russian investments.

Several months ago I participated in a Corporate Governance conference in Moscow. One of the sessions had a panel that included David Tweedie, Chairman of the IASB, Robert Hertz, Chairman of the FASB, William McDonough, former chairman of the PCAOB, and Kathleen Casey, a Commissioner

of the SEC. The audience of 15 people included Senator Sarbanes and Congressman Oxley. Needless to say the discussion portrayed SOX in a favourable light pointing out how the EU has adopted similar legislation and how the improved transparency can reduce the cost of capital by about 15 percent. At the next session I attended on Shareholder Activism SOX was discussed. It was pointed out that many directors now need to take their lawyers to board meetings because of SOX. Other panellists mentioned that the indirect costs to the American economy were about 1.1 trillion dollars and the cost of compliance was 6 billion dollars annually. In addition it was mentioned how a significant percentage of IPOs are going to London rather than New York. I mention this story because in my mind it crystallizes many of the controversial issues relative to Sarbanes-Oxley.

Many of the provisions of SOX were a direct result of the Enron scandal. For example Section 302 requires the CEO and the CFO to certify that the company's financial statements do not contain any intentional material misstatements and it subjects the CEO or CFO to criminal penalties of 20 years in jail and a 5 million dollar fine if any are found. This provision is referred to as "the buck stops here" provision. Section 201 restricts the services that an outside audit firm can provide to the company it audits, this provision was put in because Arthur Andersen, Enron's audit firm, provided Enron with many consulting services and a conflict of interest was perceived. Section 802, which provides criminal penalties for altering documents, was a response to Arthur Andersen's shredding of documents that were requested by the SEC and it was part of their document retention policy. Section 806 protects "whistleblowers" and was put in because the Enron case was investigated due to an Enron employee who was a "whistleblower". Section 401 requires much stricter disclosures for Special Purpose Entities. Enron's extensive use of 3,000 SPEs in order to exclude many undesirable business transactions from its financial statements was a principal reason for Enron's demise.

The most onerous provision of SOX is Section 404. This section requires that the CFO and CEO attest to the effectiveness of the internal controls of their company and also requires that the company's audit firm review and attest to their effectiveness. This provision was put in SOX because many of the scandal ridden companies such as Enron and WorldCom outsourced their internal control function, sometimes to the audit firm. The implementation of section 404 can be very costly for a company.

The PCAOB has mandated that companies adopt COSO, a standardised internal control system, in order to fulfill the section 404 requirements.

No law, no matter how well intended, can be effective unless there are strong enforcement procedures. Title I. of Sarbanes-Oxley establishes the Public Company Accounting Oversight Board that has a wide range of authority. The PCAOB is responsible for registering accounting firms that perform audits of corporations. The required registration is a comprehensive process that requires detailed information on the CPAs who will be performing the audit and the audit firms must also disclose the fees collected from the corporation it has audited. Another important responsibility of the PCAOB is to establish Auditing Standards; these standards include auditing, quality control, ethics independence and other key audit areas. In 2003 shortly after the PCAOB was inaugurated the auditing standard AS2 was issued that provided rules-based detailed procedures on how to establish internal controls for a company. The PCAOB received many complaints from companies because AS2 was far too complicated and expensive to implement. The PCAOB subsequently issued auditing standard AS5 in July of 2007. AS5 is a principles-based standard and has been much easier for companies to implement.

The PCAOB is also responsible for conducting inspections of registered public accounting firms, conducting investigations and providing disciplinary procedures and enforcing SOX compliance. During the last several years the PCAOB has issued major fines and penalties against all of the Big Four firms for failure to provide adequate audit procedures in areas such as valuation, IT controls and the departure from GAAP. The PCAOB has made itself clear to all that there will be serious consequences for those firms who violate audit procedures.

The significance of the PCAOB may be greatly enhanced in several years when GAAP and IFRS complete their convergence project. SEC chairman Christopher Cox has said he wants to propose a "public policy oversight board that will oversee the IASB. Mr Cox said that the oversight body should be made up of national securities regulators and makes the IASB's governance consistent with the requirements of Sarbanes-Oxley. It must be noted that the EU has adopted most of the provisions of SOX that are mainly reflected in the 8th Directive; the EU has some difficulty enforcing these because of the inconsistent application of some EU countries. Cox's proposals should help to make SOX a worldwide standard that will have effective enforcement procedures.

On the 27th of August 2008, the SEC approved for public comment a long awaited proposed "roadmap" related to the eventual use of International Financial Reporting Standards (IFRS) by US companies. The roadmap anticipates mandatory reporting under IFRS beginning in 2014, 2015 or 2016 depending on the size of the issuer and provides for early adoption in 2009 by a small number of very large companies that meet certain criteria. The objective of this convergence project is to establish a high quality global reporting system that can allow companies to attract capital at a reduced cost through a transparent accounting system. The convergence of GAAP, a rules-based accounting system and IFRS, a principles-based accounting system involves many different issues. The FASB and the IASB are currently working on convergence projects in Intangible Assets, Leases, Post Employment Benefits, Revenue Recognition, Consolidations and SPEs and Business Combinations.

The current sub prime crisis that is engulfing the world's financial markets has many causes such as predatory lending practices, poor government regulation, and the encouragement of sub-prime loans by Fannie and Freddie, loose monetary policy and other reasons. The driver of sub-prime loans for a number of years was the widespread practice of securitization among many financial institutions. The alchemy of securitization turned illiquid mortgages into liquid securities, available for sale. These were now financed by short-term debt, vulnerable to every fluctuation in the market. Whereas before securitization, the underlying mortgages generally ended up with investors who held them to maturity and not for sale. Hundreds of billions of dollars in CDOs generated from the securitization process were now required to be reported at fair value on their balance sheets under GAAP and IFRS. Fair value for these securities can be easily determined if they are listed on an exchange. However most of these CDOs were not listed and their value had to be determined by some sort of financial model or by an ABX index for sub prime mortgages. Many blame fair value for causing the credit crisis, arguing that it can cause a downward spiral in prices by encouraging institutions to sell assets quickly and forcing them to take write-downs that do not reflect the "true value of the underlying assets." The fair value issue is a high priority issue as IFRS and GAAP move toward convergence. Provisions concerning the use of Fair Value were also included in the recent 700 billion dollar Wall Street bailout package.

The last few months have demonstrated that Russia is not immune from fluctuations in the inter-

national financial markets. The RTS has declined by over 50% largely because foreign investors have fled the market due to the sub-prime crisis; in fact the Russian stock exchanges seem to stop trading on a regular basis because of declines in value. The price of oil has declined in recent weeks because of the world economic downturn. The lack of liquidity in Russia has caused a significant decrease in auto sales and mortgage lending. Many IPOs and other major deals have been put on hold because of the worldwide liquidity crisis.

All of the reforms I have discussed are designed to improve transparency, corporate governance and to facilitate the international movement of capital. We can expect many more reforms in the near future as governments respond to the sub-prime crisis.

For the past few years Russia has had little incentive to adopt many financial reforms such as the adoption of IFRS (Russia has adopted about 20 out of 42 IFRS standards) because it was generating huge cash reserves from oil related revenues. Just as the sub-prime crisis will motivate governments around the world to adopt significant reforms perhaps Russia will adopt these reforms as it further integrates into the world economy. If it does so it will create a more positive business environment for investment.