

February 5, 2009

## **Financial reporting in a time of crisis**

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San Francisco, California

Good evening and thank you to the Commonwealth Club for inviting me to speak here today. I'm well aware of the club's rich history, and I'm proud to have this opportunity to be with you tonight.

I've just returned from the annual meeting of the World Economic Forum, which is better known simply as "Davos." As you may know, this multi-day event brings together leaders in business and government, for discussions on a range of important topics. There were a number of useful discussions – some of them enlightening, one or two uplifting, many of them sobering.

As you probably know, Ernst & Young has operations in about 140 countries, and I seem to spend a great deal of my time across all of them. In conversations around the world, and certainly in Davos, I've heard a lot of blame directed at the United States, as the place that gave birth to the financial crisis that is impacting markets globally. The critics make a number of points. They talk about erosion in US fiscal discipline...reckless lending by mortgage lenders...and excessive leverage at financial institutions. They also point to the role of the credit-dependent American consumer...it's not just the banks that need deleveraging, it's the American consumer. The view is that the United States has created an illness in the financial system that has now infected everyone else. And you know what? I think a lot of these criticisms ring true.

Yet, at the same time, in the middle of this financial crisis, I also heard in Davos a sense of determination and hope. Many see that there are important opportunities right now, and are looking for leadership. Many believe that the combination of the financial crisis, an enhanced appreciation for global interconnectivity, and a new US Administration will create momentum for needed change and reform. In the early going, President Obama enjoys tremendous goodwill among political and business leaders the world over.

Today, I'd like to touch first on some of what I've seen unfold in the markets over the past year...and some concerns I have going forward. From there, I want to turn to a number of areas where I see the financial crisis presenting an immediate opportunity to foster global consistency in ways that are helpful to investors and market confidence. And I absolutely want to get to any questions you may have on your minds. It's a lot to cover in the allotted time, so I'll get right to it.

## The financial crisis and associated fears

The events of the past year have been just awful for nearly everyone operating in and around financial markets. There were many causes of the crisis, and it crossed many disciplines. The way I see it, this crisis came about due to:

- ▶ Too much leverage and both overuse and inappropriate use of poorly understood financial instruments.
- ▶ Bad loans...with weak underwriting standards and little, if any, due diligence.
- ▶ Unrealistic expectations that the economy would continue to grow, and home prices would continue to rise as far as the eye could see.
- ▶ A failure to understand exposures to risk, and to manage that exposure.
- ▶ And gaps in both the domestic and global regulatory systems.

We're now paying the price for those mistakes. Unemployment is high and going higher. The IPO market has dried up. Consumer confidence has plunged. And credit remains dangerously tight.

People often ask me what should be done in response to the economic crisis. My response has typically been to note five things that should *not* be done related to the US and global economy. I will touch on those five things in a moment, as well as a range of longer-term reforms I think we should consider pursuing. But first I'd like to briefly address two of the US economic issues that are being intensely debated right now.

First, with respect to the crisis in the banking sector, we need to remember that every banking crisis in history has been dealt with through a combination of three things – providing additional liquidity, raising capital, and a cleaning up of banks' balance sheets through a variety of public and private sector initiatives. We've already seen action to add liquidity and capital, but until we see balance sheets improve, many banks won't resume normal lending. Indeed, a recent Federal Reserve survey of domestic banks found that about 65 percent of them tightened lending standards on commercial and industrial loans to large and middle-market firms over the past three months. This is a real problem. Hundreds of companies have debt they need to roll over and refinance in 2009...and absent near-term freeing up of the credit markets, there may be substantial doubt regarding the ability of many of these to continue as a going concern. That is why you are hearing talk, globally, of "Good Bank-Bad Bank" plans or "Aggregator Banks" to deal with the bad assets. The solutions being discussed include, for instance, the government acquiring the assets or, alternatively, segregating the assets on the books of the bank and providing government guarantees. Any proposed solution would be accompanied by significant practical and policy challenges. But I think moving quickly in this direction – whatever model is selected – would not only be a good idea, but may well be critical to companies' ability to obtain financing.

Second, Congress and President Obama are considering a multi-billion dollar stimulus package. I won't try to comment on the specifics, since they remain in a state of flux. I do believe we need prompt action with a focus on real economic stimulus and should avoid using it as a mechanism to fund favored programs that don't have much immediate connection to the economy. My concern is that the political will to do what must be done to free up credit markets – which, again, I believe is critical – is at risk of being tapped out. But the new Administration is determined to provide leadership, and I believe they will.

So if these are a couple of things I hope do happen...let me turn now to some things I hope don't happen – either here in the US or around the world. And sadly, many of these things may be tempting to some, so I am quite concerned about them.

The first...is we can't retrench into protectionism – either here in the US or anywhere. It might be human nature for leaders in some parts of the world to think, "hey, let's protect our people by putting high walls around our country." Bad idea. The globalization of business has done more to lift economies and lift people the world over, including here in the US, than anything else I can think of. Protectionism, if it comes, would surely slow the recovery and likely would trigger political and market instability.

The second deals with the inevitable re-regulation of the business and financial world that will occur. While there is a clear need for regulatory reform and modernization in several areas, what we can't afford is regulation so binding that it stifles innovation and entrepreneurship. Getting the balance right will be key...providing protection for investors, but also encouraging prudent risk-taking. As this region of the country well knows, innovation and entrepreneurship are the engines of growth...growth that is needed now more than ever.

The third thing I hope doesn't happen is that government officials get too comfortable with state ownership in select industries and see it as a long-term solution. That is probably less a worry here in the United States...but could be a real issue in Europe and other places. To be clear...it was incredibly important during these unprecedented times to have government support both here and around the globe. But over the long term it is well understood that governments simply don't allocate capital as efficiently or effectively as free markets. And unquestionably, the longer state ownership goes on, the more the government or regulators will get involved in both corporate strategy and everyday business decisions. I don't think that is what anyone wants.

As an aside, I did hear a good analogy for this the other day. A colleague of mine said that, in the past, banking regulators and supervisors set the rules of the road. They established speed limits, requirements for seat belt use, airbags, and the like, but then let drivers go on their way...all the while monitoring the safety situation in the sector. But to get a picture of the regulators today, he said, just picture the driver's education instructor we all remember. The regulators are sitting in the front seat...with an extra set of foot pedals and steering wheel on the passenger side. In other words, they are right there...driving with you...ready to take control at any moment. None of us want the driver's ed teacher for the long-term...then or now!

The fourth thing I hope not to see is the financial reporting process getting politicized, particularly as it relates to accounting standards. The essence of financial reporting is to foster informed and efficient allocation of capital based on principles of transparency, consistency and comparability. But those principles are made vulnerable if there is too much political influence. This fear threatened to become reality last fall, during the height of the economic turmoil, when some Members of the US Congress tried to dictate the suspension of fair value accounting standards, at the behest of financial institutions. An even more focused effort took place in Europe, promoted largely by some of the big banks and insurance companies. This was dangerous. Not only because the effect on financial reporting would have been to suspend reality, reduce transparency, and obscure problems from investors. But also because political intervention in the setting of accounting standards threatens both the quality and comparability of the standards. It can't be the right answer to have individual countries or regions opting in or out of established accounting standards during challenging times. That certainly wouldn't be good for investors.

And the fifth and final thing I hope not to see, is a world in which people look only at the downside...on how bad the times are...on what they have to lose. Because doing so leads to paralysis by fear. Yes...we are in the midst of a difficult period, but difficult periods also create openings to do things differently, and look for new business niches. For the well capitalized and financed companies, now may be the time to drive toward consolidating an industry sector...Lord knows the reduced market caps of many companies now make them attractive targets. And I do hope that the entrepreneurial class, which is certainly well represented in this area, will see the current environment for what it is – as an opportunity to pursue bold new ideas.

### **An opportunity for global reform and modernization**

You know something, many of the best business leaders I speak with these days are operating with a mindset that “a crisis is a terrible thing to waste.” They are using the burning platform of the crisis to help drive change in their organization. This is clearly the way we are thinking at EY.

So, the way I see it, this crisis presents an opportunity not only for business leaders, but also for government officials and public policy leaders. Reform and modernization of financial regulation is a top priority for policymakers throughout the world – and certainly here in the United States. President Obama spoke to this shortly before his inauguration, saying that we need to reform our “weak and outdated regulatory system so that we can better withstand financial shocks and better protect consumers, investors, and businesses.”

Global regulatory reform comes with an important opportunity. The ongoing financial crisis has revealed a lot about the relative weaknesses of the global financial system. One weakness that has come into sharper focus is the inconsistency of financial regulation, throughout the world. Simply put, what’s legal in some countries isn’t legal in others. Regulatory and legal differences between countries are inevitable, and will never disappear completely. We, at Ernst & Young, with a presence in 140 countries, deal with this every day. But going forward, there is an opportunity to bridge these differences.

Given the widespread recognition of the need for change, policymakers have an opportunity to move forward in a coordinated way. While this can take different forms, the ultimate objective is clear: for nations to emerge from the financial crisis with new regulations that address the shortcomings in the current regulatory infrastructure and do so in a way that promotes stability and integration across the global economy. And to further enhance cooperation and integration even more, the countries that have not adopted International Financial Reporting Standards should do so. The G-20 leaders, in their summit Declaration last November, recognized the value of a single high-quality global accounting standard. Indeed, adoption of IFRS would help to bring greater transparency, and uniformity, to global business – and that helps to drive economic partnerships and greater prosperity.

And the G-20 leaders last November also did something else. They emphasized the importance of global regulatory cooperation and collaboration. As they take their regulatory reform efforts forward, and meet again this April in London, they have a real chance to press for greater legal and regulatory convergence among nations. And this needs to be done with careful consideration of best practices and reforms that have proven successful.

Strong corporate governance is fundamental to the health of a company, and to the well-being of a country’s economy. The OECD Corporate Governance Principles are the internationally recognized standard of best practice for corporate governance. They were first formulated ten years ago and refreshed five

years ago. They contain important principles that speak to shareholder rights, independent board members, the responsibilities of boards and audit committees, and even what we would call whistle-blower programs. Yet many countries around the world do not have measures in place that match up with these principles. It really is pretty much all over the map.

The US, for example, is viewed as being weak on measures related to executive compensation – also known as “say on pay” – and shareholder access to the proxy process, which is aimed at making it easier for independent directors to be elected to corporate boards. Other countries are viewed as weak in other areas of corporate governance. The focus on companies’ internal controls over financial reporting in the US isn’t present elsewhere.

The fact is...corporate governance has a real effect on how companies in any jurisdiction operate...yet the differences in practices aren’t well understood by the investing public who spread their money around the globe. The question is...would we, or would we not, be better off if governance practices were stronger and more aligned around the world. I think the answer is we very much would.

To that end, the G-20 could encourage all countries to move more quickly to embrace and implement best practices consistent with the international corporate governance principles, as well as adopt other internationally-agreed standards, such as International Financial Reporting Standards, and hold each other accountable for timely action.

I think this is particularly important because, over the last two months, we have seen the global challenges of an economic crisis intensified with renewed concerns around fraud. While I don’t know the particulars of the Madoff matter in the US and the Satyam fraud in India, we have seen that those who are determined to lie, create false documents and conspire have the potential to circumvent regulatory requirements and standards.

That said, strong corporate governance may well be the best defense against fraud. To be clear, many reforms that were put in place in the US by the Sarbanes-Oxley Act don’t exist everywhere in the world. And even here in the US, not every entity is required to maintain an anti-fraud whistle-blower program, or independent audit committees, or CEO certifications, or internal control reporting – even though the entity’s activities may have significant implications for the public interest. Similarly, they’re not all subject to a law that says it is illegal to lie to the auditor. The point is...there are many reforms that have been implemented in some sectors – such as the public company space – and in some geographies that may have application in others...and could have great benefit if applied more broadly.

### **Regulation of the accounting profession**

If global consistency and strong governance is good for the corporate community...it is also good for my profession.

Nearly seven years ago, the Sarbanes-Oxley Act dramatically changed corporate governance in the United States. And the Act also mandated an end to 100 years of self-regulation with respect to auditors of public companies...creating an independent oversight authority that regulates the audit profession. This principle – independent regulation of the audit profession – is one that should be adopted throughout the world. Let me explain why.

While everyone in the US accounting profession wasn't entirely keen on the idea of an independent regulatory authority at the time it was proposed, we embraced the change. Today, that authority – the Public Company Accounting Oversight Board, or PCAOB – is recognized as having strengthened the quality of audits at public companies. In fact, the importance of independent oversight to audit quality has been widely recognized and the PCAOB now has counterparts in many countries around the world.

However, even in the United States, not every auditor of public-interest entities needs to be registered with and overseen by the PCAOB. There are a range of entities which, by virtue of their nature of activities or size (such as holding billions of dollars of investors' money), operate in a sphere where there are public-interest implications. Examples include non-public financial institutions and insurance companies, broker-dealers, investment advisers, and pension funds, at least those of a certain size. Recognizing the benefits of independent oversight by the PCAOB and its global counterparts, I believe we should challenge the remaining vestiges of audit profession self-regulation as it relates to auditors of these types of public-interest entities across the globe.

As we have seen in the United States, Europe and elsewhere, independent oversight can enhance the quality of audits and promote investor confidence. But only about half of the G-20 countries have auditor oversight bodies that are independent of the profession and members of the International Forum of Independent Audit Regulators. While we can't flip a switch, we can and should commit to supporting consistent and independent oversight everywhere as warranted by the public interest, to improve audit quality and support global economic activity and regulatory cooperation.

### **The need for a global capital markets working group**

Well, there is clearly a lot of work ahead, and before I close, I'd like to touch on an idea I raised last March, when I spoke to the US Chamber of Commerce in Washington. I noted then that the emerging financial instability highlighted the need for some mechanism, organization, or collective agreement to facilitate a continual global discussion of market trends and developments. Sadly, this need has become even greater since I first talked about it.

The dialogue that I am convinced needs to take place must have the active involvement of issuers, auditors, and investors, as well as governments and regulators. A regular discussion, involving both the private sector *and* the public sector, can inform public-policy considerations *and* private-sector practices. Today, no such institutionalized public-private dialogue exists. In my opinion, that is leaving the world's capital markets and the regulatory system less informed and more vulnerable to volatility. This formalized dialogue, which could take the form of a global capital markets working group, could help ensure that market participants and regulatory authorities maintain a focus that's consistent with the realities of today's interconnected, complex, and dynamic markets. As finance ministers think about their next steps in dealing with the financial crisis, I really hope they consider establishing such a group.

### **Conclusion**

To conclude, the turmoil of the past year has been very difficult for everyone in and around financial markets – and now we're seeing how this turmoil is impacting all sectors of the economy throughout the world, leading to rising unemployment and reduced rates of economic growth.

Amidst these dark clouds, it's difficult to see any rays of sunlight. But as I said earlier, this crisis does create an opportunity to modernize financial regulation in a way that will help to prevent future financial meltdowns, while also promoting global economic stability and opportunity. But we need to act in a thoughtful, deliberate way, because we literally can't afford to make mistakes in the coming round of regulatory reforms.

One of the biggest mistakes, in my view, would be for national legislatures and other policymakers to take action in isolation. Laws, rules and policies *will change* as a result of this crisis. And as they do, the changes can either drive the world closer together or drive us farther apart. With the interconnected nature of global economic activity and the ability to raise or invest money anywhere in the world from anywhere in the world, we need to seize this opportunity to come closer together, and not allow the changes that will happen drive us further apart. That is my plea.

The people of Ernst & Young – all 140,000 of them in 140 countries – are committed to doing everything we can on these and other issues. We're facing different cultures, different languages, different regulators, and even different standards in some cases across jurisdictions. While this makes our job challenging, it also gives us a platform and motivation to inform the debate and drive rules, standards and practices toward greater consistency and quality around the globe.

But I recognize that effective regulatory systems and policies won't be enough, because even the best regulation can be trumped by bad judgment and bad behavior. We know that our work is a fundamental element supporting growth and stability, and your confidence in the financial and capital markets.

That is why my message to our people is the same wherever I go.

I have long considered my most important responsibility to be doing everything I can to ensure that the people of Ernst & Young wake up every day knowing what is right and what is wrong, and knowing that no matter what, nothing is more important than their own personal leadership and integrity.

I want our people to know, that if something smells wrong, if something is making them uncomfortable – whether it's at a client or inside Ernst & Young – it is not just OK for them to raise their hand, it is *their job* to raise their hand and speak out.

This is a message that can't be emphasized enough.

There's a lot of work ahead and Ernst & Young will be a constructive partner in this work...interacting with regulators, investors, issuers, and our colleagues in the audit profession to help create the conditions for rejuvenation of the US economy, and economies throughout the world. If you have ideas on how we can do this more effectively...please let me know.

And with that...I just want to say thank you to the Commonwealth Club for hosting this important event at this important time.