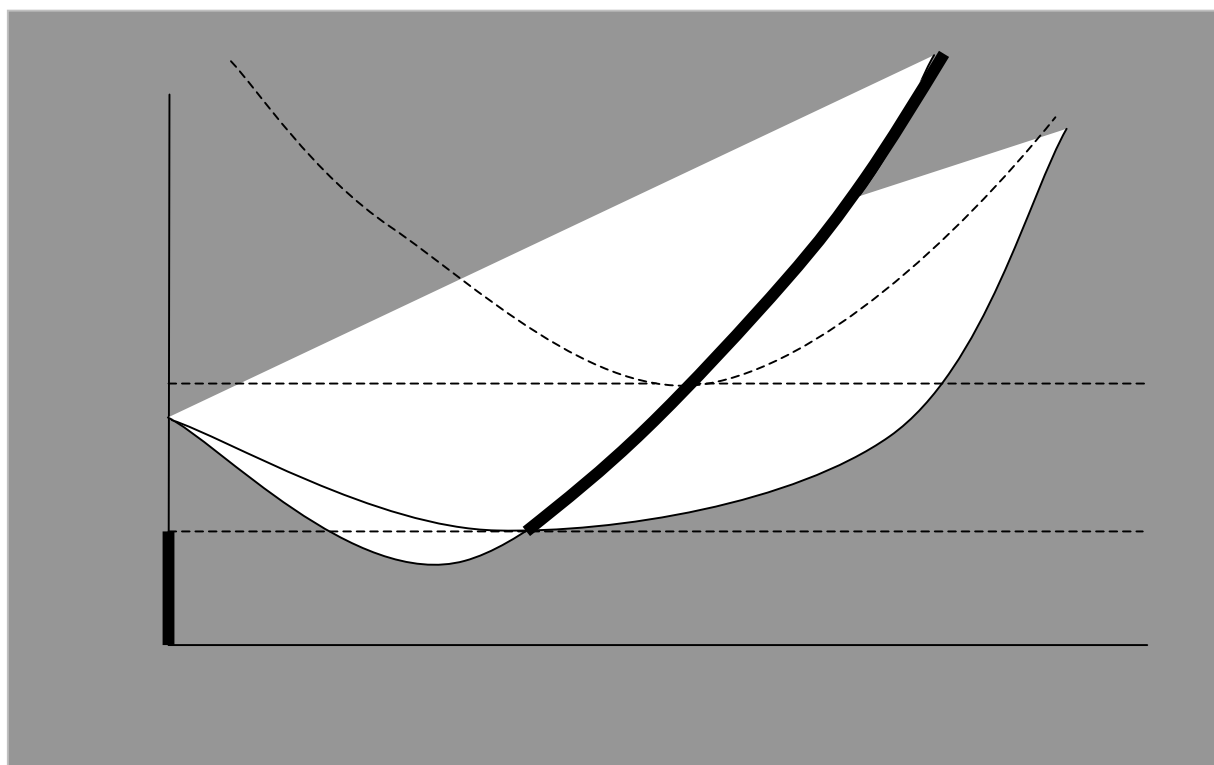
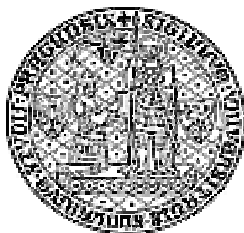


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Irena Jindřichovská: Response of Regulatory Bodies to
Financial Crises: role of auditors and international comparison



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In the light of recent crises capital markets are re-evaluating value relevance of financial information for price formation on the stock market. In this paper we investigate this issue through a comparison of recent developments in the US market as compared to Czech market. The paper identifies specific and significant contrasts between the US and Czech economies and draws conclusions on regulatory structures in developing as compared to advanced economies.

Keywords

Capital Markets, enforcement, regulation

1. Introduction

In this paper we seek to utilise some of the work of Ball et al. (2003) to review the interaction between accounting standards, preparer incentives and economic income in the Czech Republic and the USA. In particular we focus on the regulatory and market reactions to particular financial crises: Enron in the USA and Investicni a Postovni Banka in the Czech Republic. (Jindrichovska et al, 2004)

2. Investicni a Postovni Banka (IPB)

IPB was established in 1990 as a then new Czechoslovak bank and it rapidly gained market share. The bank management had two strategies from its origin – a strategy of business development and a strategy of ownership by its own management. The first strategy led to success in retail banking. At the same time, however, the credit expansion in the risky environment of a transforming economy and the conflict of interest within IPB led to a crisis. The bank acted at the same time as a creditor as well as an owner (through its subsidiaries) of a vast industrial empire.

In 1996 the IPB had problems as an increasing proportion of bad debts in its portfolio began to appear. IPB was under the pressure of capital inadequacy and it faced a potential insolvency problem. The bank itself did not perceive any problems as it felt it had sufficient deposits from individuals. It was alleged in the press (PBJ, 2000a) that Coopers & Lybrand, their auditors, were requesting additional provisions to cover bad debts for the 1996 year-end. The bank sacked Coopers & Lybrand and bought in Ernst and Young who carried out a fresh audit for the 1996 year-end. The subsequent accounts for IPB for 1996 showed the bank earning a profit. KPMG were also asked to tender for the same audit, but according to one of its partners, “in the time that we were given, we refused to do it”, (PBJ, 2001). Though the new auditor in 1997 approved the 1996 annual report, it required the bank to increase its share capital by 11 bill. CZK. Also, one of the extraordinary audits for the year 1997 showed that the value of the bank was negative. IPB managed to hide these problems and postpone the day when they would become apparent. However it was clear that the majority of these problems started already in 1996. (Kudrna et al., 2002)

The Czech state sold its minority share in IPB to Nomura in 1998, hoping to have found a strategic partner who would help to improve the capital adequacy situation of IPB by injecting 6 bill CZK. Initially, Nomura’s entry was perceived as a positive signal and the bank’s deposits increased. Nomura, however, did not act as a strategic partner. Instead, it concentrated on selling off significant stakes in Czech industrial companies held in portfolios of investment funds owned and managed by IPB.

The situation of the bank did not improve and it gradually started losing credibility. IPB got into even more dramatic problems in February 2000 when many creditors started withdrawing short-term deposits. CNB had to impose forced administration. The situation was finally resolved by selling IPB to CSOB (Ceskoslovenska Obchodni Banka). (CNB, 2000c).

2.1 Circular ownership

In general, investment funds that were established by banks during the voucher privatization could not include banks in their portfolio to prevent circular ownership. The way around it was to establish an investment management company as a “go between”. Then the fund could own the bank, which became its “grandmother”. This was formally legal.

Incestuous ownership was particularly well developed in the IPB Group. The bank management officially owned negligible percentage of the bank shares, but through a chain of informal structures, relationships and option agreements it governed a substantial stake of the bank. And gradually it became an owner *de facto* (beneficial owner) even if there were different owners *de iure* (nominal owners). ‘There was evident management effort to rule the bank through subsidiaries and other firms mutually owned by bank. The management made various steps (1) to manage the ownership stakes and (2) to prevent entry of strong strategic investor.’ (Kudrna et al., 2002; 29)

The Czechoslovak voucher privatization was a big opportunity to increase management’s influence. IPB was privatized in the first wave of voucher privatization and various investment privatization funds gained 43% of its shares. Out of this 20% was directly owned by PIAS (Prvni investicni akciová společnost) controlled and managed by IPB management. Part of the remaining 23% was controlled either by direct agreement with other investment funds or by the purchase of shares by friendly companies. Furthermore, the position of the management was strengthened by a gradual reduction in the state share of ownership. The state minority stake was finally sold to a Japanese investor, who acted in concert with IPB management. Another example of cross ownership stemmed from the fact that, the bank acted as both creditor and owner of many industrial companies. This led to significant conflicts of interest. The original justification for this behavior was that the bank wanted to facilitate the reform of Czech industry and merge companies together to establish viable groups in different sectors.

3. Reaction of regulatory bodies (CNB and the Chamber of Auditors)

Bank supervision incorporates substantial regulatory measures over the banking sector. However, these measures are largely connected with administrative hearings conducted through the courts of law. When the central bank wants to try a bank or its shareholders the CNB has to present sufficiently conclusive proofs. On the other hand, the Bank Supervision department has rather limited possibilities to react in a situation where the bank management systematically distorts the information about economic results and its auditor signs such distorted reports. (CNB, 2000c) During its final days the IPB obstructed the control procedure. This did not allow the CNB to identify early and conclusively the real state of the bank. Furthermore, the CNB had to act very cautiously to avoid damage to IPB, as any decision could lead to irrevocable changes on the inter-bank market. Moreover, with regard to the position

of IPB, the bank's failure would lead not only to instability in the banking sector but it would also impact on the economy as a whole.

A Parliamentary Committee criticised the slow reaction of CNB to internal developments in IPB disregarding the fact that IPB continually misinformed the CNB by providing information that did not provide a true and fair view on its financial position. CNB held the opinion that IPB had failed to fulfil its reporting obligations and that it was the fault of IPB representatives who were responsible for deferring any effective solution. Even the auditors did not signal the true situation of the bank. For this reason the CNB started legal proceedings against IPB management. To cope with a problem of such size and complexity was not within CNB capabilities, as it also concerned many industrial companies through inter-connected ownership. The CNB therefore asked the state for support. (CNB, 2000b)

After the collapse of IPB, the Chamber of Auditors also investigated the role of the auditors in their audit of IPB. 'It took them almost three years...and finally..the Czech Chamber's investigation resulted in a \$25,000 fine for Ernst and Young, which has since replaced its management and drawn closer to the international auditing firm.' (PBJ, 2003)

4. The Enron scandal

In October 2001, Enron revealed that there were some problems with the figures it had reported in its financial statements. Over the next few months these problems unravelled to reveal one of the largest cases of financial misreporting for some years. By July 2002, when the USA had enacted new laws to deal with the perceived inadequacies of the preparation and enforcement of financial reports, Enron's auditors, Arthur Andersen had also imploded. Though it is difficult to know as yet the full extent to which the auditors of Enron up to 2001 had misled the investing public the damage that was caused to the reputation of Arthur Andersen, though admissions that they had 'shredded documents' amongst other issues, led to their demise as an international audit firm. (Michaels, 2002)

Public opinion polls in the USA showed rising concern about the quality of financial information. In March 2002 a third of respondents thought the problem was confined to a few isolated cases. By June, at least two thirds of them thought most companies might hide shadow operations. However corporate ethics hardly figures in the mid term elections yet. The American Enterprise Institute argued there had been no break in the overall pattern of attitudes to business as a whole, although the numbers are showing a decline in confidence but no backlash against business as such. The bubble is deflating rather than bursting. The scandals at Enron, WorldCom and the rest may simply be too recent to have had their full effect. (The Economist, July 6, 2002)

Most of the misbehaviour seems to be related in some way to the huge incentives Wall Street provided in the past decade for reporting rising earnings quarter after quarter, or rather, earnings that exceeded ever rising expectations. The half dozen firms, which responded to this incentive "improving" their accounting results, cannot be the only ones. The likelihood is that many more will emerge.

5. The US regulatory response

The US regulatory response to the Enron crisis¹ was to enact the *Sarbanes Oxley* (SBA) legislation in July 2002. The SBA provided for the setting up of a Public Company Accounting Oversight Board (board). All accounting firms that prepare audit reports for issuers in the USA are to register with this board. The board also has responsibility for establishing rules on auditor independence and any other standards relating to audit work, inspections of all audit firms and conducting investigations and disciplinary proceedings where appropriate against accounting firms (Hermsen et al., 2002). There are also requirements concerning listed company audit committees, the provision of non-audit services by auditors (detailed prohibitions on the provision by auditors of particular services such as valuation services and financial systems design), declarations by directors and executive officers and expanded information in the filing form for companies (the form 20F). For example, the chief executive officer and chief financial officer must certify that the form 20-F is materially accurate and complete and, amongst other aspects, that the information in the report 'fairly presents, in all material respects, the financial conditions and results of the operations of the issuer' (Hermsen et al., 2002:111). There are also increased penalties for accounting irregularities and financial fraud. As stated, 'the legislation...creates a new oversight board for the accounting industry, until now a largely self-regulated profession.' After a 'succession of scandals from Enron to WorldCom Accountants now face a tougher regime. Maximum jail time for executives who commit fraud is quadrupled to 20 years and a new crime of securities fraud will have a maximum sentence of 25 years.' (Guardian Newspapers, 2002). Over the last 18 months, these parts of the SBA have come into force.

The crises with Enron, and subsequently WorldCom, in the USA led to a market response, with a decline in share prices and the demise of Arthur Andersen, and a regulatory response, the SBA. These were all on a much larger scale than the responses in the Czech Republic.

6. Monitoring and sanctions in the Czech Republic

Currently, monitoring of financial statements is carried out by three organisations: the Czech Trade registry, the Czech Securities Commission and the Czech National Bank.

There is a requirement to file audited financial statements with the Czech Trade Registry. However, as has been noted in previous research and reports (Sucher and Zelenka, 1998; ROSC, 2003) though this is a requirement in many cases it is not observed. In those financial statements, which were filed, some substantial non-compliance with Czech regulations has also been observed (ROSC, 2003).

The current enforcement of compliance with financial reporting standards, noted in the Accounting Act, 2001 article 37, was dealt with by the tax inspectorate. In the Act, 2003, it is now stated that penalties will be levied on accounting units, which are obliged to prepare IFRS financial reports, and do not do so,² and the Tax Inspectorate should collect these penalties. The penalties for non-compliance with financial reporting regulations had been increased to a maximum of 6% of balance sheet gross assets.

¹ And the issues that arose with financial reporting at WorldCom, where it was revealed that worthless WorldCom had "improved" its financial results by 3.9 billion dollars through misrepresenting revenue and assets (Economist, 2002, p.45).

² article 37(1c) and 37 (2b)

The Czech Securities Commission also reviews the financial statements of listed companies for completeness and obvious errors. On its website it carries all the latest publications from the Centre for European Securities Regulation (CESR) which suggest how IFRS compliance should be enforced. On the website, there is a comment that,

‘The Commission, together with the Ministry of Finance and the Czech National Bank, is creating conditions for the performance of supervisory activities over the so-called consolidated financial groups.’

As noted in the FEE survey referred to above, ‘The Czech National Bank enforces the rules for banks and provides a specific review of certain bank operations in addition to the common mechanism applied in the case of other enterprises’ (FEE, 2001). However, it is not yet clear what these conditions (referred to on the website above) might be. The Commission has certainly not had the technical resources to enforce accounting standards until now (ROSC, 2003). Therefore a large burden of the enforcement of compliance falls on the auditors.

7. Conclusion and directions for further research

The regulatory and market responses to the crisis with IPB contrast sharply with those to the crisis in the USA with Enron. In the Czech Republic, there has been no major overhaul of either the financial reporting or audit enforcement regime, except in so far as it related to the conditions for joining the European Union. The audit firm concerned has not collapsed and disappeared. Indeed, ironically, it has continued to grow and has locally absorbed the audit firm, Arthur Andersen that did collapse following the Enron crisis in the USA. One could argue that this is a ‘bad thing’, however, on the other hand, it could indicate that expectations for high quality financial reporting and enforcement through audit, were never that high in the Czech Republic, compared to the USA, and investors had other means to assess the worth (or lack of it) of enterprises. The lack of a properly functioning legal system, capable of interpreting and enforcing the law is particularly important here.

In the Czech Republic, this latter presumption has particular problems. As our research on the movement in share prices and the reaction of accounting income to changes in economic income indicate, there are some odd findings which may indicate that movements in share prices may not reflect those that would arise in a semi-strong efficient stock market.

This in part might flow from the particular institutional context in the Czech Republic – which reflects some of the circularity in the arguments of Ball et al., (2003). Where there may be extensive cross holdings of companies, and it is perceived that enforcement of compliance with financial reporting standards does not work (Sucher and Kosmala MacLulich, forthcoming) then investors may use alternative, informal, insider information to establish what is actually happening with particular enterprises. The response to the crisis over IPB is an example of this. There was ample coverage in the local business press of developments at IPB, yet, unlike with Enron, there was no immediate regulatory response for reasons outlined above. It is likely that responses were informal and insider oriented.

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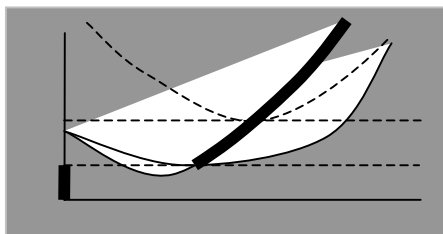
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