

“Can Trust Be Regulated?”

**David A. Leslie, F.C.A.
Chairman and Chief Executive Officer
Ernst & Young LLP**

**Remarks to the Canadian Club
October 21, 2002**

TEXT AS PREPARED

Thank you, Nancy.

Head table guests, ladies and gentlemen.

Can trust be regulated? In a word: No!

But no business can survive without trust. Our economy cannot thrive without trust.

Not long ago, many participants in the capital markets could do no wrong. Today words and actions are met with scepticism and distrust – from governments and regulators, from the media, from investors, and from the general public.

To regain momentum in the markets we cannot allow this climate to continue.

We must turn our energies to rebuilding trust – and we are!

This rebuilding must start at the top. Boards of directors, corporate leadership, and those in the professions must back up words with actions. We must demonstrate integrity and honesty. We must demand quality and excellence. If trust is to be rebuilt, leaders must set this “tone at the top”.

PAUSE

But, what, exactly, is trust?

Trust is believing the other party is telling the truth. Trust is believing people will do what they say they’ll do. Trust is something that can’t be regulated.

Earlier this year, U.S. Senator Joe Lieberman wrote about a “credible handshake”. He wrote:

“Successful transactions ... are based on an understanding between two or more parties [and] we must believe the person at the other end of the bargain is not taking us for a ride”

At this moment, many people -- in Canada, in the U.S., and around the world -- feel they’ve been taken for a ride. This is one of the reasons for the current climate.

The capital markets can recover, if we move quickly and decisively to work towards rebuilding the lost trust.

The work has begun. The work will take time. The trust that was lost was built over decades. It cannot be rebuilt overnight.

Two things are clear to me.

One, we cannot regulate trust.

Two, because many groups contributed to the current market turmoil, it will take many groups to repair the system. Regulators, boards of directors, audit committees, shareholders, and the auditing profession are just some of the groups that must work together to rebuild trust in the markets.

In Canada, many have looked to groups like the Canadian Institute of Chartered Accountants, The Ontario Securities Commission, and the Office of the Superintendent of Financial Institutions, to somehow “fix the system” through rules and laws alone. The fact is, they can’t. And neither can the U.S. Securities and Exchange Commission, stock exchanges, or governments.

The reason is simple. We cannot regulate, or legislate, trust.

Trust cannot be created by the stroke of a pen. Trust is built over time, by delivering quality work and acting with integrity. By being consistent and stable, open and accountable. Every day.

No rule or law can guarantee these behaviours. What rules and laws can do is create a framework, or an environment, that supports and encourages these behaviours. And, for the most part, regulators in Canada and the U.S. are doing just that.

This past July, the CICA, the Canadian Securities Administrators, and OSFI announced several measures. In the U.S., the Sarbanes-Oxley Act was recently signed into law. The New York Stock Exchange, NASDAQ, and the TSX have all introduced new rules.

These new measures provide for better disclosure, more transparency, more stringent quality control, and greater independence requirements for directors and auditors. They demand a higher standard of excellence for financial reporting.

Penalties and criminal laws may prove to be effective disincentives to breaching corporate ethics, but new measures and penalties alone won't restore trust.

The auditing profession welcomes changes that will help maintain trust in the capital markets, and in the role the audit opinion plays in those markets. We support better disclosure and more independence for boards of directors and their audit committees. We support improved quality control measures for our profession. But some changes being discussed would do more harm than good.

Mandatory audit firm rotation is another idea that's being bandied about. This measure would require companies to change audit firms every few years. Such a requirement would reduce audit quality in the late years of the term. A better approach is to mandate the rotation of partners and staff on the engagement. This preserves institutional knowledge and audit quality, while assuring a continuous flow of fresh and objective eyes. It's good for our clients and it's good for our people.

We cannot regulate trust. Unfortunately, there are regulators and legislators who think we can. And in their zeal to act now, they may go too far.

Overreaction resulting in over-regulation is a very real danger. In some cases, such as I just mentioned, it could drive down quality. And, complying with regulations is a costly burden on business. It's vital that we don't introduce more regulation than is needed to assure the public that proper guidelines and safeguards are in place. We should not drive up the cost, and drive down the quality, of doing business in Canada.

As long as regulators realize there are limits to what can, and should, be regulated, I believe their moves can foster renewed trust in the markets. Regulators can establish, and enforce, real penalties for non-compliance. Slaps on the wrist will no longer do.

Regulators can look for ways to bring more consistency, transparency, accountability, and quality to global markets. This would make it easier to do business globally, and enable investors worldwide to make better decisions.

Global adoption of a single approach to accounting and financial reporting would be a significant move forward in this regard.

There are encouraging signs that we may see a convergence of global accounting standards. The U.S. Financial Accounting Standards Board and the International Accounting Standards Board are agreed on the need for common, high-quality accounting standards across the major capital markets. They recently met to continue work in this area. This will do much to restore investor confidence in the markets.

The causes of the most publicized financial scandals cannot be pinned on only one or two failures. Serious flaws in the behaviour of many have led to the general meltdown in confidence. We have to bear in mind that human nature will always be a factor.

The Power Report (John Power was appointed to analyze what happened at Enron) tells us that Enron failed because of greed, broken governance, mismanagement, and miscommunication. In other words, because of human factors. A code of ethics isn't worth much if you plan to go to the board to have it waived when it doesn't suit you. This was the case with Enron. The tone at the top failed.

This is all the more reason to do what we can to embed independence, integrity, honesty and objectivity in our governance processes. This is all the more reason for business leaders to set the tone at the top.

Some boards of directors, by failing to set the tone at the top, have lost the public's trust. Boards must move quickly, and many are, to change this public perception.

Obviously, the board has certain obligations to fulfill, such as appointing the CEO and approving corporate strategy. There are rules in place dealing with director independence. But, in terms of rebuilding trust, I believe that boards must set the tone at the top by adhering to best practices.

Best practices dictate that directors play roles that enable them to make the best contribution to the company's governance. They must have the knowledge and experience needed to perform their assigned role. They must truly understand the company's risk and contingency plans. The board may delegate the risk management review to the audit committee, or to a dedicated risk management

committee, but all the directors must know the factors that could create a company crisis and how the company plans to deal with these factors.

While many boards have taken steps to ensure they're able to fulfill this role, some need to reflect on how they measure up against best practices. Best practices recognize that directorship is a duty. Boards need to review their composition and make changes necessary to ensure their quality.

Finally, best practices dictate that processes be in place that give the board accurate, objective, and timely information from their auditors and other advisors. This would include separate meetings and executive sessions with these advisors.

No regulation can guarantee the competency of board members. No rule or law can ensure that board members are in the right roles. It is up to the directors themselves to set the tone on these best practices.

Of course, audit committees have come under brutal scrutiny in the post-Enron world.

As more questions arise about the quality of financial reporting, more questions are raised about audit committees.

The audit committee is responsible for overseeing the other participants in the financial reporting process. Other participants include management, internal auditors, and outside, independent auditors. Just as with the board itself, the audit committee must play its role in setting the tone at the top by adhering to best practices - - practices that have stood the test of time and which have been proven to work.

Now, I have some good news here. It's my experience that many audit committees are ahead of the regulators. Meetings are longer, and there are more *in camera* sessions. Audit committees are meeting the day before the board meeting to ensure they have enough time to cover important matters. They're meeting as many as eight times a year; they're benchmarking; they're setting their own agendas, and addressing scope of service matters with respect to their auditor.

This year my partners and I, collectively, have met with the audit committees and boards of clients. We've seen the character of these meetings change over the past few months. They're asking more questions. They're asking about their internal

controls, the scope of our audit, and which business risks need their attention. They're even asking why we're the right audit firm for them. They're carefully reviewing the non-audit services we provide. They carefully scrutinize fees. This is all good.

The audit committee must understand the company's internal controls, especially the control environment - - which I've been calling the "tone at the top". The audit committee must understand the risk of misleading financial reporting and the legal, regulatory and ethical matters affecting financial reporting.

Some people are suggesting that sweeping changes are needed in respect to audit committees. I don't agree. We do, however, have to make sure that current requirements and guidelines are followed.

Like the board itself, audit committees need to immediately assess their effectiveness and make any improvements necessary to meet best practices and set the right tone at the top.

Audit committee members must be qualified, independent, committed, and inquisitive. I don't agree that all audit committee members need to be chartered accountants. But, if an audit committee member declares that he or she is "not a numbers person" -- they need to be contributing in some other, relevant area. In fact, it's my experience that non-accountants often ask the best questions at audit committees.

And asking questions is the main role of the audit committee. Members should be sceptical when reviewing financial data and reports. They should be able, and encouraged, to do their own due diligence. It's their responsibility to put meaningful and probing questions to management, the internal auditors, and the external auditors.

Warren Buffet has a set of questions for the auditor. They include: If you were the CFO would you disclose this, and if not, why not? If you were the CFO would you be happy with the internal controls, if not, why not? – Very good question.

Of course, one cannot ask meaningful, probing questions without knowledge and up-to-date information. Audit committee members need to understand internal controls, the risk of fraud, and financial reporting risks. If there's a knowledge gap

in any of these areas, fill it. Audit committees can have their own advisors to coach them on the issues.

Communications between the audit committee and the board, management, and the internal and external auditors must be frequent and candid.

Both the auditors and management should expect to be challenged by questions raised by board and audit committee members; and both management and the auditors have a duty to be honest and forthright in their responses. There's no other way to set the tone at the top.

I encourage boards and their audit committees to take this level of interest in their relationship with their auditors. It's best practice. It's what the best-governed companies have been doing for years.

Finally, what can my profession, the auditing profession, do to maintain trust?

It's a difficult time for our profession. We were shocked by the demise of Arthur Andersen, and saddened to see so many careers ruined by the actions of so few.

Last month, in an interview in *The Financial Times*, Paul Volcker, the former chairman of the U.S. Federal Reserve suggested that our profession was, and I quote:

“corrupted by our envy of the lucrative investment-banking sector”

He went on to say that:

“accounting firms felt that auditing was a dead-end job and rewards in the future would depend on diversification....discipline was lost”

Well, we weren't, and aren't, corrupted by greed. We've never lost our discipline. And I don't know any auditors who wish they were investment bankers.

I've been asked before if we ever walk away from clients when we don't see eye-to-eye on issues related to the financial statements. Absolutely! We don't often encounter such situations, but when we do, our accountability requires us to walk away.

Auditing has never been a dead-end job. Auditing is the essential core of our profession. Our profession diversified into areas such as consulting in response to clients' needs.

Furthermore, our profession was recently accused of not wanting to “step up to the plate”.

Well, let me tell you this: Ernst & Young, and the entire auditing profession, has stepped up to the plate.

We've long played a leadership role in bringing positive change to the capital markets, and we will continue to use our insight and experience to maintain the trust that's been so deeply shaken.

Ernst & Young has consistently led reform to strengthen our profession and increase investor confidence in financial reporting and capital markets. Two years ago we supported proposals to limit the types of services firms can offer audit clients. We were the first to exit the consulting business, not because there was some rule that said we had to, but because it was the right thing to do.

Nonetheless, I fully support new measures that will strengthen independence and enhance quality in our profession. But, again, I caution against costly and unnecessary regulations that drive up business costs and do little or nothing to maintain trust and make Canada an attractive place to invest.

Years ago, when I was in training, we heard a lot about quality. Quality was about a promise to meet, and exceed, the highest standards. Quality was a sacred trust, sharing a prominent place with other important values such as integrity. Quality was implicit in what we did, and it is still embedded in what we do now. It's a simple equation. Trust = quality, integrity and independence.

But the time has come to make quality explicit. By raising the profile of the ideals of quality work, we'll raise our own dedication to quality. We'll also enhance the broader expectations and perceptions of our clients, and the public at large, that the auditing profession operates on the principle of quality. Quality people setting the tone at the top equals quality work. Quality work equals quality results and satisfaction, which equals: trust.

Markets have been battered by the events of the past year. So have regulators, boards, and the auditing profession. But I believe a great deal of good can come from what we've learned. These events spurred us to search out and strengthen financial reporting practices, in regulations, and in the auditing profession.

Because no one group was responsible for what happened, no one group can repair the damage. No act of legislation or rule making can, by itself, restore trust in the markets. Yet I am confident that regulators, boards of directors, and the auditing profession can work together to re-create an environment in which trust exists; to ensure the quality of our financial reporting; to put the capital markets on solid footing again. And most important of all, to keep the Canadian capital markets safe, competitive, and attractive to investors.

No, trust cannot be regulated. But it can be earned.