

# finding the balance

STRONG ARGUMENTS ARE BEING MADE ON THE WORLD STAGE THAT FINANCIAL RULES AND REGULATIONS NEED AN URGENT MAKEOVER TO PREVENT FUTURE MELTDOWNS. **JULES MUIS**, VETERAN OF THE LEADERSHIP ECHELONS OF THE WORLD BANK, THE EUROPEAN COMMISSION AND ERNST & YOUNG EXPLAINS THE REFORMS THAT HE RECKONS SHOULD BE MADE TO OVERHAUL THE INTERNATIONAL FINANCIAL ARCHITECTURE TO PREVENT ANOTHER GLOBAL CRISIS.

**1** *Regulators should provide systemic risk assurance statements*

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“There will only be a solid international financial infrastructure if the securities regulators, the central banks, and the other financial regulators across the globe are willing to provide results-based assurance statements on the absence of material systemic risks that might impair the orderly functioning of the markets. They should at least attest - if necessary negatively formulated - that they do not see or know about any systemic issues that may impair the orderly functioning of the financial markets. I am not even talking about the fair or the efficient functioning here, just the orderly functioning, because that was what actually caused the chaos.

“The financial regulators should also be held to account if they misrepresent a financial situation or stick their heads in the sand. That would make them think things through much more carefully than



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the open-ended reporting format that they have at this particular moment. They would have to acknowledge to the world what they see and what they don't see.

“The issuance of systemic risk assurance statements by regulators would also help the private sector, because you cannot rely solely on the banks and their

auditors to identify and assess the systemic risk of the magnitude as we have seen over the last couple of years.”

**2** *Provide full-fledged fair value overviews*

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“One cannot properly risk-manage or make investment decisions on a financial institution without knowing its full fair value status, even if it is just an approximation: better to be approximately right than precisely wrong. Therefore, especially financial institutions should provide full-fledged fair value overviews—if not in their primary financial accounts, then at least in the explanatory notes (dual reporting). Had financial organizations presented such financial statements, it would have put their boards of directors - and actually all of us - in a much better position to know the institution's real risk profile, as compared to the schizophrenic mixed-attribute accounting model with piecemeal application of fair value, which is what we have at this moment.”



**3 Dog tag all traded derivatives**

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 “All traded derivatives should have mandatory dog tags with a barcode expressing and vouching for the risk profile of the instrument in reasonably accessible, standardized risk language. Preferably, this should be supplemented with disclosure of the accounting treatment of the seller, as this will help keep them honest and will limit retrofitting or rationalizing the accounting treatment at one’s convenience.”

“I have been harping on the need for mandatory dog-tagging of derivatives for at least the last 15 years. Informally, I got a lot of positive interest in the idea, but absolutely no action. It was too much at odds with the prevailing deregulation ideology.”

**4 Perform a public-sector self-assessment**

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 “In the public sector, we should perform a self-assessment on the question

**About Jules Muis**

Jules Muis had a long career as a public accountant at Ernst & Young where he held major management responsibilities, serving as executive partner (Europe). He also served as the first director - general of the International Audit Service of the European Commission from 2001-2004, where he laid the groundwork for building a modern, independent internal directorate general for the Commission. Previously, from 1994-2000, he was vice - president and controller of the World Bank where he played a leading role in introducing modern controllership, placing a particular emphasis on anti-corruption policies.



In his 2005 publication *A Survival Kit for Accountants and Auditors in a Turbo Derivative World*, Muis predicted the breakdown of the financial systems. In the wake of the financial crisis he has been expert witness for the US Treasury Department and the Dutch Parliamentary Investigatory Committee. In 2009 he became the chair of the Oversight Committee of a European accountancy education quality enhancement project called “Common Content”. In March 2010, Jules joined the Audit Committee of the International Criminal Court (ICC) in The Hague as an external member.

of whether we are just patching up past weaknesses based on political opportunism, or introducing substantive financial regulatory reform that is ahead of the curve. The difference is simply the residual inherent risk that we need to be aware of before we declare victory that this time we really have it right. The first thing any revamped oversight body should do is to go through a systemic assurance statement as a dry run to explore the limits of its oversight ability and to manage expectations. This will give us an idea of whether we indeed have a cohesive new architecture, or one similar to the old architecture, with only a new wrapper around it.”

**5 The audit profession should develop its potential to give early warning**

“The audit profession should investigate its own lack of willingness to point out systemic disconnects in the financial system early on. The profession needs to face its fear of, for example, exception reporting, its presence marked by clean audit opinions only - even when the financial world fell apart.”

“Dozens of huge financial institutions keeled over without the audit profession coming up with anything else besides a clean opinion. What does that mean for the real value of an audit opinion beyond ‘better than nothing’ at best; and putting those it serves on the wrong foot at worst?”

“I have advocated for years that we should take away the clean-opinion toy from the audit profession, at least for a limited time. Just wean them off the addiction. It would be a powerful signal that the audit profession understands its signaling responsibilities. Auditors would then be forced to think carefully about the next best option. We probably would see - as we should have seen in the past - a lot more disclaimers of opinion. A well-informed and explained disclaimer, or even a simple middle paragraph in which auditors would indicate they understood the stress points in the financial statements, would be a much better signal to



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the users that something is amiss.”

“Moving forward, national accountancy organizations should be charged with inventorying, bottom up, systemic disconnects that are difficult to voice for individual audit firms fearful of offending clients, and synthesizing them in an anonymous fashion. A global organization such as IFAC should leverage those national findings, pull them all together, publish the conclusions annually, and fill the global voids. IFAC has a golden opportunity to put substance in the potentially powerful signaling role of the audit profession if the will, self confidence, and professional courage are there.”

**6 Include a sustainability paragraph and related scorecard**

“Organizations, both in the public and the private sectors, should include a sustainability paragraph and related performance



*We should restore the good old-fashioned controller, also defined as ‘the sandpaper of the corporation,’ to its old professional dignity: responsible for the integrity of the numbers and substantive robustness of the corporate control systems, and reporting directly to the organization’s chief executive officer or chairman.”*

scorecard in their business report. They should use that paragraph to explain their operating philosophy and policies with regard to their financial, social, and environmental sustainability efforts; their risk appetite on all relevant fronts; their trade-offs between the shorter and longer term; how they fare against those benchmarks in practice; and what timelines they foresee for bridging any gaps.”

**7 Restore balance in “checks and balances”**

“When I tried to analyze what went wrong in corporate governance leading up to the crisis, the following question stood out: ‘After all the governance reforms over the last decades and lessons drawn from financial crises past, why is it we don’t seem to be able to get it right?’ One of the reasons, I think, is that we grossly underestimated the fact that the term ‘checks and balances’ is a painful misnomer. We have too many checks and too few balances in our international financial infrastructure, as well as within our organizations. Just look at the corrosive effect of turning the risk and control guidance of the Committee of Sponsoring Organizations or the Sarbanes-Oxley Act into a box-ticking procedural marathon that somehow missed the key question of who calls the shots, and to what end. Or turning the CFO into an all-powerful money manager, with the privilege of also controlling the controller. We ignore substance over form as a guiding principle. Instead, we prefer to hide behind a maze of rules and processes. It allows us a convenient state of denial as to the true state of our corporate governance, and to ignore the gravitational power of ‘might makes right’ in much we regulate.”

“Taking into account the inherent limitations of checks and balances, we still have to restore their own balance, both in the public and the private sector. In particular, I would challenge the following two ‘sacred cows’:

- Strip the CFO of his or her incompatible double role as bean-maker and bean-counter at the same time; and

- *Strengthen the international oversight function by introducing supranational information access rights and empowering of global oversight and monitoring functions, such as the Financial Stability Board for starters.”*

**8 Split the CFO function into a manager role and a controller/accounting role**

“Over the last 10 years, many CFOs have carved out such a broad function for themselves that, in my view, they are combining responsibilities that are incompatible with the fundamentals of checks and balances. Many CFOs nowadays are not only responsible for the proper functioning of the controls and for the integrity of the numbers, but they are also major game-makers in their financial management function. They are the ones who make money out of money, particularly in organizations, such as banks, where money management is the core business. You run into a conflict of inter-

est if you combine an obvious management function with the controlling and accounting for it, in particular when the job is strongly bonus-driven. I know I generalize, but there is something not OK with the current CFOs. CFOs had their chance to play a visible signaling role leading up to the crisis, and missed the opportunity.

“Therefore, I would strongly favor splitting the CFO role into an officer in charge of ‘bean-making’ and an officer in charge of ‘bean-counting,’ in particular for organizations that have financial management as a standalone profit center, such as banks and insurance companies, but also others. We should restore the good old-fashioned controller, also defined as ‘the sandpaper of the corporation,’ to its old professional dignity: responsible for the integrity of the numbers and substantive robustness of the corporate control systems, and reporting directly to the organization’s chief executive officer or chairman.”

**9 Establish better global coordination and oversight**

“The biggest risk that will come out of the current reforms is that we might make some progress in the area of international regulation (the ‘checks’), but that at the same time we will continue to have a disjointed international financial architecture (the ‘balances’). Who pulls it all together globally? Moreover, the various financial actors will continue to go for self-interested national solutions first, and seek international architectural solutions that will allow them to continue pointing their fingers at each other when things go wrong. Therefore, we need a supranational oversight body for systemic risks in the markets, not just with monitoring responsibilities, but backed up by trans-border information access rights, such as a truly empowered, accountable, and well-resourced Financial Stability Board. I know it is very unpopular, but if you go for less, the next crisis will be waiting in the wings.”

“A so-called ‘coordinated approach’ simply no longer suffices. In an ever more connected financial system, you need real management. We need an empowered supranational oversight body that calls the shots, that has the authority to cut the crap of regulatory arbitrage and to rein in countries jockeying for a better competitive position by advertising themselves as ‘regulation light,’ and is accountable through results-based systemic assurance statements.”

“I know surrendering national sovereignty is not very popular. However, if you go for less than a supranational oversight body, for the status quo, the resulting international financial architecture simply will not be able to deal with the challenges and pressure points of the complex global financial dynamics.”

“The reality of having gigantic global fund flows, but not a global regulator, will be with us for some time to come. Incremental global reform without supranational oversight is just buying time and raising expectations, waiting for the next accident to happen. I hope I have it wrong.”



**10** *The public sector should set the example in governance, accounting, and auditing*

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“The good news is that the audit function generally works much better in the private sector. The governmental accountability offices of this world - thanks to their robust independence statute - actually do qualify their opinions on public sector accounts quite often and articulate them clearly. The bad news is that too few seem to be listening to their warnings: the US Government Accountability Office (GAO), for example, has now issued for the 15th year in a row a disclaimer on the US federal accounts and an adverse opinion on its controls framework. Is there anybody listening?”

“The main governance problem in the public sector is that it has a totally underdeveloped concept of the controller. Public sector controllers are generally much too low in the pecking order. There are seldom internal assurance statements from the bottom up; internal governance is much too silo-based. Therefore, the governance structure in many public sector organizations is very fragmented and vulnerable to manipulation. In my own country, I would not know who the controller was, and I know that goes for many countries.”

“The good news in the area of accounting is that International Public Sector Accounting Standards (IPSASs) are making good headway into becoming the dominant public sector reporting language, but much remains to be done. For example, neither the country I am from (the Netherlands) nor the country where I live (the US) has accepted IPSASs. We should also carefully investigate evasive governmental accounting acrobatics following the recent bailouts just to avoid bailed-out companies and their debts appearing on national balance sheets. My advice: expose it and learn from it!” ■

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*This is the edited version of the article that was first published at [web.ifac.org/download/2.3-muis-the-flying-dutchman-final.pdf](http://web.ifac.org/download/2.3-muis-the-flying-dutchman-final.pdf)*

## Key Recommendations

- 1 The private and public sector should be looked upon as two wings of a plane - both must be sound for it to fly safely. Therefore, both the public and the private sectors need to get their acts together to pull the financial system successfully out of this crisis.
- 2 Get it right at the macro level: securities regulators, central banks, and other financial regulators across the globe should provide results-based assurance statements on the absence of material systemic risks that might impair the orderly functioning of the markets.
- 3 Financial institutions should provide mandatory integral fair value overviews beyond their mixed-attribute accounts—at least in the explanatory notes (dual reporting).
- 4 Get it right at the entry level and keep derivatives traders more honest; all traded derivatives should have mandatory dog tags, with a barcode expressing and vouching for the risk profile of the instrument in reasonably accessible, standardized risk language.
- 5 The public sector should perform a self-assessment to explore the limits of governmental oversight and to manage expectations. This will give us an idea as to whether we have a cohesive new architecture or an architecture that is similar to the old one.
- 6 The audit profession should investigate shifting the focus of audit reports from conformation to information, to indicate it understands the stress points in financial statements. National accountancy organizations should be charged with inventorying, bottom up, systemic disconnects and synthesizing them in an anonymous fashion, and a global organization such as IFAC should pull them all together and publish global conclusions.
- 7 Organizations should include a sustainability paragraph and related scorecard in their business report to explain their operating philosophy and policies with regard to their financial, social, and environmental sustainability efforts; their risk appetite on all relevant fronts; their trade-offs between the shorter and longer term; how they fare against those benchmarks in practice; and what timelines they foresee for bridging any gaps.
- 8 Restore the balance in “checks and balances,” both in the public and the private sectors. There should be more substance over form.
- 9 Acknowledge “might makes right” as the overriding governance principle.
- 10 The CFO function, especially in financial organizations, should be split into a managerial role and a controller/accounting role, restoring the controller to its old professional dignity: responsible for the integrity of the numbers and substantive robustness of the corporate control systems.
- 11 The reality of having gigantic global fund flows necessitates the establishment of a supranational oversight body for systemic risks in the markets.