PART 6

Accountability

CHAPTER 30

Corporate governance

30.1 Introduction

The main aim of this chapter is to create an awareness of what constitutes good corporate governance – how to achieve it, the threats to achieving it and the role of accountants and auditors.

Objectives

By the end of this chapter, you should be able to:

- understand the concept of corporate governance;
- have an awareness of how and why governance mechanisms may differ from jurisdiction to jurisdiction;
- have an appreciation of the role which accounting and auditing play in the governance process;
- have a greater sensitivity to areas of potential conflicts of interest.

30.2 The concept

When we pause to contemplate the contribution of corporations to our standard of living, we are reminded how important their contribution is to most aspects of our existence. It is therefore vital that they operate as good citizens. However, the complexity of their operations makes it difficult for stakeholders to be able to assess the culture of a corporation. Just as corporations are complex, stakeholders also have different perspectives.

30.2.1 Stakeholder perspectives

A stakeholder perspective addresses all the parties whose continued support is necessary to ensure the satisfactory performance of the business. The parties are normally seen as one of the following categories: financiers, employees, trade unions representing employees, shareholders, customers, governments and suppliers. However, a category cannot be viewed as being homogeneous and there may be conflicting interests within it. For example, shareholders could include dominant and minority shareholders, individual and institutional shareholders, short-term and long-term investors, domestic and foreign investors – the list is unending – further there are employee shareholders, government shareholders,

environmentalist shareholders. Trade unions may be representing different groups of employees within the same company and have different objectives, power and understanding of the economic position of the company.

As well as there being conflicting interest, there are also differences in the influence that a stakeholder can exert. For example, dominant shareholders and institutional investors have a greater ability to hold management to account and achieve good corporate governance outcomes.

We have described the complexity of a stakeholder perspective which assumes that each stakeholder will pursue their individual view of what constitutes good governance. There is also a systems perspective.

30.2.2 A systems perspective

Corporations do not act in a vacuum. They form part of society and their corporate operations are influenced by the history, institutions and cultural expectations of society. A systems perspective recognises that an entity is not independent but is interdependent with its environment. Good corporate governance attempts to set up institutions and procedures to ensure that it achieves equilibrium with its environment. The objective is to minimise conflicts of interest and have a system that is fair to all parties so that all are able to achieve personal, corporate and societal objectives. There is no unique or universal system but rather governance systems with varying degrees of being able to match corporate and societal objectives.

30.3 Corporate governance effect on corporate behaviour

Corporate governance is defined by Oman[1] as:

> private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs ('corporate insiders') on the one hand, and those who invest resources in corporations on the other. Investors can include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow.

What actions and information would flow from such a relationship under good governance?

Actions by management

- Compliance with the laws and norms of society.
- Act as a good citizen.
- Fair treatment of employees – avoiding discrimination.
- Striving to achieve the company objectives in a manner which does not involve excessive risks.
- Balancing short- and long-term performance.
- Establishing mechanisms to ensure that managers are acting in the interests of shareholders and are not directly or indirectly using their knowledge or positions to gain inappropriate benefits at the expense of shareholders.
- Establishing mechanisms for resolving conflicts of interests.

- Establishing mechanisms for whistle-blowing so that if inappropriate behaviour is taking place it is highlighted as quickly as possible so as to minimise the cost to the organisation and society.

Information flows:

- Providing lenders and suppliers with relevant, reliable and timely information that allows them to assess the performance, solvency and financial stability of the business.
- Providing confirmation that excessive risks are not being taken.
- Providing investors with an independent opinion that the financial statements are a fair representation.

This list does not cover all eventualities but is intended to indicate what could be expected from corporate governance – good being determined by the degree that the actions and information flows achieve fair outcomes.

The objective is to influence behaviour so that all parties act within the spirit of good governance. The actions and information flows above have been oriented towards business entities but we should expect all organisations to behave in the same way. For example, in the case of a not-for-profit enterprise such as a charity it is important that the money raised be used in a manner consistent with the uses envisaged by the donors and that an appropriate balance be achieved between administrative costs and the money devoted to assisting the beneficiaries of the charity.

30.4 Pressures on good governance behaviour vary over time

History shows that business behaviour is influenced by where we are in the economic cycle, whether it's a time of boom or bust.

30.4.1 Behaviour in boom times

During the booms there has always been a tendency to be over-optimistic and to expect the good times to continue indefinitely. In such periods there is a tendency for everyone to focus on making profits. The safeguards that are in the system to prevent conflicts of interest and to limit undesirable behaviour are seen as slowing down the business and causing genuine opportunities to be missed. Over-optimism leads to a business taking risks that the shareholders had not sanctioned and is, to that extent, excessive.

This is accompanied by a tendency to water down the controls or to simply ignore them. When that happens there will always be some unethical individuals who will exploit some of the opportunities for themselves rather than for the business.

30.4.2 Behaviour in bust times

We see a repetitive reaction from bust to bust. When it occurs some of the malpractices will come to light, there will be a public outcry and governance procedures will be tightened up. Although controls are weakly enforced during boom times, it is a fact of life that vigilance is required at all times. Fraud, misrepresentation, misappropriation and anti-social behaviour will be constantly with us and robust corporate governance systems need to be in place and monitored.

The ideal would be that the controls in place develop a culture that make individuals constrain their own behaviour to that which is ethical, having previously sensitised themselves

to recognise the potential conflicts of interest. It is interesting to see the approach taken by the professional accounting bodies which are concentrating on sensitising students and members to ethical issues.

30.5 Types of past unethical behaviour

Some of the unethical behaviour which has been identified in earlier periods and which our governance systems should attempt to prevent are listed below:

- Looting – this is a term applied to executives who strip corporations of money for their own use i.e. misappropriation of funds. The misappropriation is often concealed by normal corporate activities such as entering into transactions with associates of the management or dominant shareholders at inflated prices or by falsifying the accounting records and financial statements.

  For example, in the US the SEC filed a complaint[2] against Richard E. McDonald, former CEO and chairman of World Health Alternatives, Inc. ('World Health'):

  > The Commission's complaint alleges that McDonald was the principal architect of a wide-ranging financial fraud at World Health by which McDonald misappropriated approximately $6.4 million for his personal benefit. Also named as defendants are Deanna Seruga of Pittsburgh, the company's former controller and a CPA, . . .
  >
  > A key aspect of the fraud involved the manipulation of World Health's accounting entries . . . repeatedly falsified accounting entries in World Health's financial books and records, understating expenses and liabilities. This made the Company appear more financially sound, and masked McDonald's misappropriation of funds.

- Insider trading particularly around major events. The regulators are refining their techniques for identifying insider trading if it relates to the use of sensitive information such as a forthcoming takeover because there is a specific date when the takeover is announced. Transactions occurring just before that date can be investigated if there has been an unexpected level of activity in the shares. Even then it is incredibly difficult to prove and there have been few convictions. It is even more difficult to identify that it has occurred if the information relates to internal business activity such as the successful development of a new drug or product.
- Excessive remuneration so that the rewards flow disproportionately to management compared to other stakeholders and often with the major risks being borne by the other stakeholders.
- Excessive risk taking which is hidden from shareholders and stakeholders until after the catastrophe has struck.
- Unsuccessful managers being given golden handshakes to leave and thus being rewarded for poor performance.
- Auditors, bankers, lawyers, credit rating agencies, and stock analysts, who might put their fees before the interests of the public for honest reporting.
- Directors who did not stand up to authoritarian managing directors or seriously question their ill advised plans.
- Management setting incentives for employees which encourage action which is not in the firm's interests leading to rogue trading (several banks) or emphasise project formulation over successful implementation (market to market accounting at Enron).

30.6 Different jurisdictions have different governance priorities

The predominant conflicts of interest will vary from country to country depending on each country's history, economic and legal developments, norms and religion.

England and United States, with their similar legal histories with considerable reliance on stock exchanges for the financing of public companies need an active, efficient capital market. This leads to their focus being on potential conflicts between management and shareholders.

Australia has been encouraging higher levels of investment through compulsory superannuation providing institutions with access to large amounts of cash during the recent economic downturn. The overlevered companies almost guaranteed the institutional investors major capital gains through the issue of new shares at substantial discounts. This followed a period when some companies made issues to institutions on terms which handed tax advantages to them whilst not giving the same advantages to retail/individual shareholders. Individual shareholders perceived that there were conflicts of interests in that management in raising capital quickly and with little administration from institutions were generating conflicts between individual and institutional investors. As a result, several major companies then made offers to individual shareholders at discounts to the market.

In south-east Asia, because many of the large corporations have substantial shareholdings owned by members of a single family, the emphasis has been on avoiding conflicts between family and minority shareholders.

In some countries the presence of significant state investments in listed companies has created a different set of conflicts to be managed. China is an example of this but it is also true in some Middle Eastern countries. The country's economic and social objectives may not coincide with investor interests.

In countries in which the banks are the major suppliers of finance, as opposed to the lesser role of the stock market in such jurisdictions, there may be greater control over management because the banks can demand detailed information, but there is the potential for conflicts between the interests of bankers and other investors. Germany provides an example of a different legal history with companies having both a board of directors made up of investors as well as an advisory board representing both management and employees. This reflects the recognition that there is a need to reconcile both management and employee long-term interests and to ensure that both groups are motivated to achieve the organisation's long-term goals.

In Muslim countries companies should not be involved in activities related to alcohol and gambling; they cannot pay or charge interest and they have religious obligations to make a minimum level of donations. In the event that they have no alternative but to receive interest, such money has to be given to charity. Thus Muslim companies need a corporate governance mechanism to ensure that they comply with their religious obligations.

From the above we can see how the governance priorities differ from country to country. They result from the role of the political institutions, the stage of economic development, the diversity of stakeholder perspectives and a country's heritage in so far as it shapes the law, the religion and the social norms.

Just as governance priorities differ, so do the institutions and methods for controlling corporate governance. The institutions include statutory bodies enforcing detailed prescriptive requirements, statutory bodies that encourage voluntary adoption of good practices with disclosure through to private sector bodies trying to influence their membership to give due attention to corporate governance philosophies.

30.6.1 Future developments

Corporate governance requirements are less developed in the European Union (EU) countries (except the UK) and Japan. What about the future? Developments in the EU, Japan, China, Russia and other Eastern Bloc (former communist) countries are leading to a model of much wider ownership of shares (i.e. like the US and the UK). For example, in 2006 the market capitalisation as a percentage of GDP in China was 50%, Italy 52% and Spain 95%.

In the EU, restrictions on who may hold shares in major companies are inconsistent with the Union's desire for the free movement of goods and capital, so there will be a trend for a greater proportion of companies' shares being listed on a stock exchange.

In China, Russia and the former communist countries in Eastern Europe, the economies are being changed from state-controlled businesses to privately owned companies. The 'model' of these companies is similar to those in the US and UK. So, the trend is towards the US and UK model of companies' shares being listed on their national stock exchange. This trend to wider share ownership will slowly encourage the development of corporate governance criteria similar to those in the US and the UK. It is for some countries a real cultural shift and it will take time for the concept of good corporate governance to be applied. The following is an extract from an OECD Note of a meeting on Corporate Governance Development in State-owned Enterprises in Russia:[3]

> Finally, as stressed by investors, the OECD, and government officials at this expert's meeting, the emergence of a true corporate governance culture is vital. Such a culture-based approach should involve the understanding of the principles and values behind corporate governance, and replace the 'box-ticking' mechanistic approach in which superficial institutions fulfill certain criteria but do not bring real benefits in terms of effective achievement of corporate goals. This would complement the creation of specific incentives intended to guide the behaviour of economic actors.

30.7 The effect on capital markets of good corporate governance

Good governance is important to facilitate large-scale commerce. The mechanism of legal structures such as limited liability of companies exist because they allow the capital of many investors to be combined in the pursuit of economic activities which need large quantities of capital to be economically viable. There are also statutory provisions relating to directors' duties and shareholder rights. This is a good backcloth which is necessary but not sufficient to ensure the effective working of the capital market.

In addition there has to be a high level of trust by shareholders in their relationship with the management. Firstly, they need to believe the company will deal with them in an honest and prudent manner and act diligently. This means that shareholders need to be confident that:

- their money will be invested in ventures of an appropriate degree of risk;
- efforts will be made to achieve a competitive return on equity;
- management will not take personal advantage of their greater knowledge of events in the business;
- the company will provide a flow of information that will contribute to the market fairly valuing shares at the times of purchase and sale.

Failure to achieve appropriate levels of trust will lead to the risk of the loss of potential investors or the provision of lesser amounts of funds at higher costs. Similarly if other

stakeholders, such as the bank, do not trust the management, there will be fewer participants and the terms will be less favourable. Another way of addressing this is to say that people have a strong sense of what is or is not fair. Whilst economic necessity may lead to participation, the level of commitment is influenced by the perceived fairness of the transaction.

Also from a macro perspective, the more efficient and effective the individual firms, the better allocation of resources and the higher the average standard of living. If management as a group is not diligent in its activities and fair in its treatment of stakeholders, there will be lower standards of living both economically and socially.

In addition the current focus on corporate social responsibility could be seen as a response to governance failures by some companies. For example, some managers ignored externalities such as the costs to society of rectifying pollution because management was only judged on the financial results of the firm, and not the net benefit to society.

30.8 The role of accounting in corporate governance

Accounting can contribute to the corporate governance process by acting as a control process and by providing economic information relevant to evaluating the effectiveness of corporate controls.

30.8.1 Control processes

In some jurisdictions the company and the external auditors have to explicitly state that the company has adequate internal controls and the accounts have integrity. In other jurisdictions it is implied that if the company receives a clean audit report that the internal controls are good and that the accounts have integrity.

In the US when the explicit requirement was introduced many companies spent considerable sums after the introduction of the Sarbanes–Oxley Act 2002 in upgrading their systems, particularly as the CEO and CFO were made personally liable for the effectiveness of the internal controls.

There is an opportunity cost in CEOs focusing on compliance issues rather than on strategic issues and an actual cost in upgrading systems. This led to some arguing that the costs were unjustified.

Whilst the need to consider cost benefit considerations in relation to all corporate governance measures is a valid concern, it is also important to remember the costs of bad corporate governance. These take the form of direct losses by shareholders, employees, customers and suppliers. There are also the indirect losses in the form of reluctance to invest in the stock market, credit squeezes and the loss of confidence in the economy leading to depressions, unemployment and under employment. However it is common for the costs of poor governance to be forgotten by each new generation, hence boom and bust. Obviously good governance will not stop all fraud but it will stop it from being so widespread.

The internal control systems should limit the ability of management to misdirect resources to their personal use. Thus internal controls combined with an internal audit unit should make it more difficult for senior managers to misappropriate resources. Naturally we know that the more senior the manager the more likely it is that they can override the internal controls or pressure others to do so. It can be argued that such a situation justifies the requirement that the internal audit unit (if one exists) should report to members of the board who are independent directors (presumably the audit committee of the board), however, that is not often the case.

30.8.2 Comprehensive financial statements

There are two aspects, namely, the financial data and the narrative.

Comprehensive financial data

There has been a serious problem with the use by companies of off balance sheet finance and special purpose entities which conceal certain of the company's activities.

For example, in the case of Enron, assets whose value were expected to have to be written down or were vulnerable to substantial market fluctuations were sold to special purpose entities which were intended to have 3% or more outside ownership. Under US rules at that time if the 3% condition was met then the special purpose entity's financial affairs did not have to be consolidated. The exclusion of such items led to the accounts being misleading. It could be argued that the legislators who created such loopholes were also responsible for encouraging poor corporate governance as were accounting bodies which did not speak against such legislation. Further, it could be argued that all instances of off balance sheet financing should be brought back onto the statement of financial position or being fully disclosed in some other way. In effect it should be an ongoing matter to identify all instances where full and frank disclosures are not occurring and to amend the rules to prevent poor corporate governance.

The use of such off balance sheet devices, or sales with the obligation to repurchase at a later date at a specified price, is a clear sign that management is breaching the intent of good corporate governance. The use of off balance sheet items of the investment bank Lehman Brothers is a good example of this.

Comprehensive narrative information

The financial data are backward looking. Comprehensive information would also include items which are likely to be very important in the future even though they are not currently required to be reported. This could in many jurisdictions include matters relating to future sustainability and comprehensive assessments of environmental impacts. Other future oriented information would have to relate to the company's strategic drivers and opportunities.

Annual reports can also be used as devices to disclose information which is solely oriented to corporate governance. For example, the disclosure of related party transactions is intended to make it more difficult for a major shareholder to exploit the company for their own benefit. Whilst the disclosure does not prevent that, it allows shareholders to view the level of activity and if they find the level of activity a matter of concern they can raise the issue at an annual general meeting.

There is a more general issue of the need for the board of directors to identify and report the potential risks which could have a significant impact on the organisation. These could include major reliance on individual suppliers, insurers, products, financiers or customers; exposure to environmental or product liabilities; or regulatory approvals of medical products.

In more recent times banks and other financial institutions misled investors when they did not disclose in a clear and unambiguous way the level of risks they were taking in relation to subprime mortgages. This size of exposure even if insured with other institutions was a breach of good corporate governance as it exposed the company to potentially fatal levels of risk. Accounting regulations were inadequate to ensure such information was adequately quantified and disclosed to the board and shareholders and bank regulators.

30.9 External audits in corporate governance

External audits are intended to increase participation in financial investing and to lower the cost of funds. They may be *ad hoc* reports or audit reports giving an opinion on the fair view of annual financial statements.

Ad hoc reports

In the case of lending to companies it is not uncommon for lenders to impose restrictions to protect the interests of the lenders. Such restrictions or covenants include compliance with certain ratios such as liquidity and leverage or gearing ratios. Auditors then report to lenders or trustees for groups of lenders on the level of compliance. In this way auditors facilitate the flows of funds at good rates.

Statutory audit reports

Similarly for shareholders the audit report is intended to create confidence that the financial statements are presenting a fair view of financial performance and position. If that confidence is undermined by examples of auditors failing to detect misrepresentation or being party to it, the public becomes wary of holding shares, share prices in the market tend to fall and the availability of new funds shrinks.

For the audit report to perform its role adequately, a number of things need to occur:

- Managers have to be perceived to be reporting in a forthright manner.
- That perception has to be reinforced by a review by independent people who should be in a good position to judge whether those accounts provide a fair representation of the company's achievements and current position – it is often recommended that the accounts be reviewed by directors who are independent of management and that those directors be assisted by internal and external auditors.
- The external auditors reviewing the accounts have industry knowledge and professional competence and identify with the needs of investors as the primary users of the accounts.
- The results of the audit are communicated in a clear manner.

To achieve the above, a number of corporate governance procedures are in place or have been recommended to ensure that auditor independence is not called into question.

30.9.1 Auditor independence

The external auditors should keep in mind that their main responsibility is to shareholders. However, there is a potential governance conflict in that for all practical purposes they are appointed by the board, their remuneration is agreed with the board and their day-to-day dealings are with the management. Appointments and remuneration have to be approved by the shareholders but this is normally a rubber stamping exercise.

It is not uncommon for auditors to talk of the management as the customer which is of course the wrong mindset. To reduce the identification with management and loss of independence arising from a personal interest in the financial performance of the client, a number of controls are often put in place, for example:

Financial threats to independence:

- Auditors and close relatives should not have shares or options in the company, particularly if the value of their financial interest could be directly affected by their decisions.

- Auditors must not accept contingency fees or gifts nor should relatives or close associates receive benefits.
- The audit firm is precluded from undertaking non-audit work for the company so it does not have to consider the loss of lucrative consulting contracts when making audit decisions. This is a contentious issue with some advocating that auditors should not undertake non-audit work, whereas the client might consider that to be cost effective. All the indications are that current practice will continue with disclosure of the amounts involved.

Familiarity threats:

- Appointments, terminations and the remuneration of auditors should be handled by the audit committee.
- Auditors should not have worked for the company or its associates.
- Audit partners should be rotated periodically so the audit is looked at with fresh eyes.
- Audit tests should vary so that employees cannot anticipate what will be audited.
- It is not desirable that audit staff be transferred to senior positions in a client company. This happens but it does mean that they will continue to have close relations with the auditors and knowledge of their audit procedures. Clients might regard this as a cost benefit.

However, the above are indications and not to be seen as taking a rule-based approach. Good governance is not just a matter of compliance with rules as ways can always be found to comply with rules whilst not complying with their spirit. It is really a question of behaviour – good governance depends on the auditors behaving independently, with professional competence and identifying with shareholders and other stakeholders whose interests they are supposed to be protecting. Failing to do this leads to what is described as the expectation gap.

30.9.2 The expectation gap

Another area of corporate governance and auditing relates to the expectation gap. The gap is between the stakeholders' expectation of the outcomes that can be expected from the auditors' performance and the outcomes that could reasonably be expected given the audit work that should have been performed.

The stakeholders' expectation is that the auditor guarantees that the financial statements are accurate, that every transaction has been 100% checked and any fraud would have been detected. The auditors' expectation is that the audit work carried out should identify material errors and misstatements based on a judgmental or statistical sampling approach.

There have been a number of high profile corporate failures and irregularities, for example, in the US, Enron failed having inflated its earnings and hidden liabilities in SPEs (special purpose entities). In 2008 the same problem of hiding liabilities appears to have occurred with Lehman Brothers where according to the Examiner's report[4] Lehman used what amounted to financial engineering to temporarily shuffle $50 billion of troubled assets off its books in the months before its collapse in September 2008 to conceal its dependence on borrowed money, and Senior Lehman executives as well as the bank's accountants at Ernst & Young were aware of the moves. In Italy, Parmalat, created a false paper trail and created assets where none existed; and in the US, the senior management of Tyco looted the company.

This raises the questions such as (a) Were the auditors independent? (b) Did they carry out the work with due professional competence? and (c) Did they rely unduly on management representations?

30.9.3 Lack of independence – Enron

The following is an extract from the United Nations Conference on Trade and Development G-24 Discussion Paper Series:[5]

> Regarding auditing good corporate governance requires high-quality standards for preparation and disclosure, and independence for the external auditor. Enron's external auditor was Arthur Andersen, which also provided the firm with extensive internal auditing and consulting services. Some idea of its relative importance in these different roles during the period leading up to Enron's insolvency is indicated by the fact that in 2000 consultancy fees (at $27 million) accounted for more than 50 per cent of the approximately $52 million earned by Andersen for work on Enron . . . the following assessment by the Powers Committee: The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, . . . Both the Powers Committee and bodies of the United States Senate which have investigated Enron's collapse have taken the view that lack of independence linked to its multiple consultancy roles was a crucial factor in Andersen's failure to fulfill its obligations as Enron's external auditor.

30.9.4 Failure to carry out audit in accordance with audit standards – TYCO

The following is an extract[6] from an SEC finding 2003–95:

> **SEC Finds PricewaterhouseCoopers's Engagement Partner Recklessly Issued Fraudulent Audit Report and Engaged in Improper Professional Conduct**
> The Commission's Order finds that multiple and repeated facts provided notice to Scalzo regarding the integrity of Tyco's senior management and that Scalzo was reckless in not taking appropriate audit steps in the face of this information. By the end of the Tyco annual audit for its fiscal year ended Sept. 30, 1998, if not before, those facts were sufficient to obligate Scalzo, pursuant to generally accepted auditing standards (GAAS), to re-evaluate the risk assessment of the Tyco audits and to perform additional audit procedures, including further audit testing of certain items (most notably, certain executive benefits, executive compensation, and related party transactions). Scalzo did not take sufficient steps in these regards. Accordingly, Scalzo recklessly failed to conduct the audits in accordance with GAAS. The Order, therefore, finds that Scalzo engaged in improper professional conduct. The Commission denies him the privilege of practicing before the Commission as an accountant.
>
> Investors rely on auditors and are betrayed when auditors fail to conduct diligent audits, [according to Thomas C. Newkirk, Associate Director of Enforcement at the Securities and Exchange Commission]. In this case, senior management was looting the company, and Scalzo was confronted with numerous warning signs about management's integrity. Scalzo is not being sanctioned because he did not discover the looting; he is being charged because he did not look despite these warnings.

30.9.5 Undue reliance on management representations – Structural Dynamics Research Corporation

In the normal course of an audit it is usual to obtain a letter of representation from management, for example, providing information regarding a subsequent event occurring after year end and the existence of off balance sheet contingencies. It is confirmation to the auditor that

management has made full disclosure of all material activities and transactions in its financial records and statements.

However, the representations do not absolve the auditor from obtaining sufficient and appropriate audit evidence. The following is an extract[7] from an SEC finding relating to two CPAs who were auditing a company which had improperly recorded sales and then written them off in the following accounting period:

> Despite the fact that the language in FEC purchase orders clearly stated the orders were conditional and subject to cancellation, the auditors accepted the controller's explanation and did not take exception to the recognition of revenue on these orders. This undue reliance on management's representations constitutes insufficient professional skepticism by Present (the engagement partner).
>
> Moreover, Present failed to corroborate management's representations regarding conditional purchase orders with sufficient additional evidence that these sales were properly recorded . . . Overall, Present failed to exercise due professional care in the performance of the audit.

In each of the above there is good reason for the expectation gap in that the audit had not been conducted in accordance with generally accepted audit standards and there was a lack of due professional care. If the auditors have been negligent then they are liable to be sued in a civil action. In the UK the profession has sought to obtain a statutory limit on their liability and, failing that, some have registered as limited liability partnerships – the path taken by Ernst & Young in 1996 and KPMG in 2002. In Australia some accountants operate under a statutory limit on their liability and in return ensure they have a minimum level of professional indemnity insurance.

30.9.6 Detection of fraud

An audit is designed to obtain evidence that the financial statements present a fair view and do not contain material misstatements. It is not a forensic investigation commissioned to detect fraud. Such an investigation would be expensive and in the majority of cases not be cost effective. It has been argued that auditors should be required to carry out a fraud and detection role to avoid public concerns that arise when hearing about the high-profile corporate failures. However, it would appear that it is not so much a question of making every audit a forensic investigation to detect fraud but rather enforcing the exercise of due professional care in the conduct of all audits. The audit standards reinforce this when they emphasise the importance of scepticism.

30.9.7 Enforcing audit standards

There are international audit standards. These are set by the International Auditing and Assurance Standards Board (IAASB) which sets high quality standards dealing with auditing and quality control and which facilitates the convergence of national and international standards.

Whilst the standards are international, the enforcement of the standards is carried out nationally. National practice varies. In the UK, the Financial Reporting Council (FRC) is the independent regulator for corporate reporting and corporate governance. Through several of its operating bodies (the Auditing Practices Board, the Professional Oversight Board for Accountancy and the Accountancy Investigation and Discipline Board) the FRC has primary responsibility for setting, monitoring and enforcement of auditing standards in the UK.

30.9.8 Educating users

Many surveys have shown that there has been a considerable difference between auditors and audit report users regarding auditors' responsibilities for discovering fraud and predicting failure. Users of published financial statements need to be made aware that auditors rely on systems reviews and *sample testing* to evaluate the company annual report. Based on those evaluations they form an opinion on the *likelihood* that the accounts provide a true and fair view or fairly present the accounts. However they cannot guarantee the accounts are 100% accurate.

A number of major companies collapsed without warning signs and the public criticised the auditors. In response to these pressures auditors have modified their audit standards to place more emphasis on scepticism. It is difficult, however, when there are such high-profile corporate failures to persuade the public that lack of due professional care is not endemic. Audit firms have their own governance procedures within the firms.

30.9.9 Governance within audit firms

Within the audit practices there is also the need to apply systems to ensure that audits are conducted in accordance with the spirit of the intent of the process, that there are adequate reviews of the performance of individual auditors and that the individual partners do not take advantage of their positions of trust.

The greatest control mechanism within an audit firm is the culture of the firm. Arthur Wyatt made the following observation:[8]

> The leadership of the various firms needs to understand that the internal culture of firms needs a substantial amount of attention if the reputation of the firms is to be restored. No piece of legislation is likely to solve the behavioural changes that have evolved within the past thirty years.

In particular Wyatt was drawing on his experience in Arthur Andersen and his observation of competitors. He indicated that in earlier times there was a culture of placing the maintenance of standards ahead of retention of clients, the smaller size of firms meant there was more informal monitoring of compliance with firm rules and ethical standards. Promotion was more likely to flow to those with the greatest technical expertise and compliance with ethical standards, rather than an ability to bring in more fees. The values of conservative accountants predominated over the risk taking orientation of consultants.

The large accounting firms separated from their consulting arms following public pressure only to evolve new consulting activities. Wyatt was saying that the growth and risk orientations of consulting are incompatible with the values needed to perform auditing in a manner which is independent in attitude. Also they need to have a sense of the importance of lobbying for quality forthright accounting standards and of taking a strong stand in audits.

Having established the appropriate attitudes, the systems of review must be able to identify and correct deviations, and to reinforce a conservative culture.

Also the firm needs controls in place to ensure its partners and its staff do not undertake activities incompatible with the firm's function as an auditor, for example, do not engage in insider trading based on information gained whilst conducting an audit, or are not feeling pressured to give favourable audit reports because of the possible impact on their personal investments.

It has been suggested that auditors are very conscious of the possibility of being sued over substandard audits. The ability of this device to influence behaviour depends on the

awareness of the individual auditors of the likelihood of being sued, what the costs will be to them personally and how that compares to rewards of being a good revenue generator.

30.10 Corporate governance in relation to the board of directors

A properly functioning board makes for good corporate governance. What do we mean by properly functioning? It means that (a) there is no one person dominating the Board and (b) there are independent board members and (c) the board committees have independent members who are not unduly influenced by the executive directors. We will now discuss each of these points.

30.10.1 Separation of chairperson of the board and the senior executive

One of the roles of a board is to evaluate the executive management team and where necessary to remove non-performing executives. This is important in the sense that the senior executive (variously titled CEO, Chief Executive Officer, MD, Managing Director, Executive Director, Director General) and their team are being supervised. Where the senior executive has a forceful personality there is a real need for someone who can constructively challenge and make sure that major decisions are seriously reviewed. It is hard for subordinates to tell their boss that a strategy is wrong or too risky – an independent chairperson can.

30.10.2 Independent board members

To ensure that the company can appoint independent directors, the company should have a nominating committee for board and audit committee appointments so that board members are not beholden to the CEO for their positions. Those committees should not include management.

30.10.3 Audit committees

To ensure that the audit committee of the board of directors is independent, it is normally recommended that the chair of the audit committee be a person of high prestige who is knowledgeable in accounting and independent of management. Some believe that all members of the audit committee should be independent of management and of any substantial shareholders. Independence also requires the ability to look at events and scrutinise them from the perspectives of the relevant stakeholders. Independence is a state of mind which is much more difficult to achieve when there are personal connections with the CEO.

30.11 Executive remuneration

It is worth reinforcing the fact that the objective of corporate governance is to focus management on achieving the objectives of the company whilst keeping risks to appropriate levels and positioning the firm for a prosperous future. At the same time, sufficient safeguards must be in place to reduce the risks of resources being inappropriately diverted to any group at the expense of other groups involved.

Since management is the group with the most discretion and power, it is important to ensure they do not obtain excessive remuneration or perks, or be allowed to shirk, or to gamble with company resources by taking excessive risks.

30.11.1 What is fair?

Companies should pay enough, and no more than enough, to attract suitable directors and part of the remuneration should be linked to individual and corporate performance. In deciding whether something is fair or not, we tend to base it on a comparison. The problem is how to choose the comparator. This is true when looking at remuneration. For instance, a matter which has attracted considerable attention is executive remuneration. It is suggested that the heat which such matters generate is not just a matter of envy, although there may be elements of that, but relates to concepts of fairness. So what is fair? Management probably looks at fairness by comparing their remuneration with that of other executives; employees probably compare it with what other employees get, and institutional shareholders probably compare it with what they earn, and individual shareholders probably assess it in light of the company's performance.

The statistics show[9] that in recent years the remuneration of executives relative to the average employee has been considerably higher than it was twenty years ago and the remuneration of the top executive compared to the average of the next four executives is also better than in the past. That seems intuitively unfair – but is it a valid comparison to be referring back to a relationship that existed twenty years ago? Perhaps the question should be whether this higher relative remuneration reflects a greater contribution to performance, or does it reflect that as businesses increase in size the remuneration of the chief executive tends to increase to reflect the higher responsibilities, or has it been achieved because directors have been effectively able to set their own remuneration?

30.11.2 How to set criteria – in principle

There are a number of issues that will require a judgement to be made:

- What is the right balance between short-term performance and long-term performance?
- What if there are revenues and costs that are beyond the control or influence of management? Should these be excluded from the measure?
- Also to the extent that performance may be influenced by general economic conditions should the managers be assessed on absolute performance or relative performance?
  - What if management has achieved an increase in profit but not at the same rate as a peer group? For example, assume that a firm had increased return on investment by 2% to 12% but the peer group showed medium increases from 14% to 17%. Should there be a bonus? Should it be on a proportional basis?
  - Similarly, if the performance fell from 10% to minus 3% during an economic down turn, and competitors earned minus 5%, should the managers get a bonus even though shareholders saw their share price fall considerably?

Often companies resort to outside consultants but the observation has been made that one doesn't hear of outside consultants recommending a pay cut and are in part responsible for the ratcheting up levels of remuneration.

30.11.3 Where do accountants feature in setting directors' remuneration?

The equity of the remuneration is not normally seen as an accounting matter, but accountants should ensure transparent disclosure of the performance criteria and of the payments. In some jurisdictions there is legislation setting out in some detail what has to be disclosed.

30.11.4 Performance criteria

Directors are expected to produce increases in the share price and dividends. Traditional measures have been largely based on growth in earnings per share (EPS), which has encouraged companies to seek to increase short-term earnings at the expense of long-term earnings, e.g. by cutting back capital programmes. Even worse, concentrating on growth in earnings per share can result in a reduction in shareholder value, e.g. by companies borrowing and investing in projects that produce a return in excess of the interest charge, but less than the return expected by equity investors.

30.11.5 What alternatives are there?

It is interesting to identify the suggested criteria because they could have an impact on the financial information that has to be disclosed in the annual accounts. Suggested criteria include the following:

- **Relative share price increase**, i.e. using market comparisons. Grand Met has revised its scheme so that, before executives gain any benefit from their share options, Grand Met's share price must outperform the FT All-Share Index over a three-year period, i.e. the scheme focuses management on value creation.[10] If this policy is adopted, it would be helpful for the annual accounts to contain details of share price and index movements. Comparative share price schemes should also, in the opinion of the Association of British Insurers, be conditional on a secondary performance criterion, validating sustained and significant improvement in underlying financial performance over the same period.
- **Indicators related to business drivers**, i.e. using internal data. Schemes would need to identify business drivers appropriate to each company, such as customer satisfaction or process times, growth in sales, gross profit, profit before interest and tax, cash flow and return on shareholders' funds.
- **Indicators based on factors such as size and complexity**. Schemes would need to take account of factors such as market capitalisation, turnover, number of employees, breadth of product and markets, risk, regulatory and competitive environment, and rates of change experienced by the organisation. This information could again be disclosed in the business review section of the annual report.

The indications are that there will be a growth in the number of firms offering schemes. However, regulators will need to keep a close eye on the position to avoid schemes creeping in that avoid the existing disclosure requirements. For example, there has been a growth in long-term incentive plans, under which free shares are offered in the future if the executive remains with the company and achieves a certain performance level. This is a perfectly healthy development that retains staff, but such schemes fall outside the definition of a share option plan and allow companies to avoid disclosure.

One of the problems is the innovative nature of the remuneration packages that companies might adopt and the fact that there is no uniquely correct scheme. The Association of British Insurers, in its publication *Share Option and Profit Sharing Incentive Schemes* (February 1995), commented on this very point:

> There is growing acceptance that the benefit arising from the exercise of options should be linked to the underlying financial performance of the company.
>
> Initially, attention focused on performance criteria showing real growth in normalised earnings, however, a number of other criteria have subsequently emerged.

> The circumstances of each individual company will vary and there is a reluctance, therefore, on the part of institutional investors to indicate a general preference for any particular measurement. On the other hand, a considerable number of companies have stated that they welcome indications of the sort of formulae that are considered to be acceptable. It is felt that remuneration committees should have discretion to select the formula which is felt to be most appropriate to the circumstances of the company in question. Nevertheless . . . it is important that whatever criterion is chosen . . . the formula should be supported by, or give clear evidence of, sustained improvement in the underlying financial performance of the group in question.

30.11.6 The role of share options

Share options have been offered to managers to encourage them to align their interest with those of the shareholders so that management incentives reflect the capital and income benefits they achieve for the shareholders. However, the match is not perfect because, if the managers and the company perform poorly, the worst outcome for managers is they receive no bonus but shareholders have their total investment at risk.

30.11.7 How to measure the benefit of an option?

The issue of share options raises some difficult measurement issues. What amount should the shareholders be told when voting on directors' remuneration? Should it be the value at the time of issue (grant date) and no subsequent accounting be required irrespective of the future fluctuations in the value of the option? Should it be performance related and the value reported at the date they are entitled to exercise the option?

30.12 Market forces and corporate governance

Another corporate governance mechanism is said to be the markets. These are (a) the market for gaining control, (b) the market for executives and (c) the market to replace executives.

30.12.1 The market for gaining control

If managers are inefficient, too greedy or reckless then the value of the company will fall. When that happens, an entrepreneurial manager or venture capitalist will recognise the potential for making the company more profitable and will make a takeover offer. If successful, the new owners will remove the old management and install a new experienced team. The threat of a takeover will place a limit on the extent to which management can coast or divert resources to excessive rewards. However, there is also the possibility that otherwise good managers will focus on short-term results to make it more difficult to take over their company.

30.12.2 The market for executives

If managers have ambitions to become managing directors at larger or more prestigious organisations, they will supposedly seek to achieve good economic returns to make them more marketable which results in good governance. However, good governance might be less of a concern if the focus is more on self-promotion and good public relations.

30.12.3 The market for removing directors

In general, individual shareholders have little prospect of removing a director or controlling their remuneration. It is the large investment and insurance firms that have the power to block resolutions which they believe are not in the interests of shareholders. The extent to which they exercise such powers varies from country to country depending on the requirements of the law and the traditions in the particular country. There is a major question over who imposes good governance on the superannuation and investment funds. There is generally little if any involvement of fund members in the supervision of fund managers.

30.12.4 Insider trading

Insider trading involves a person taking advantage of information which isn't available to the public to make an unfair gain or to transfer a loss to another party. Proven examples include directors selling shares before the announcement of unexpected poor results, an executive in a ratings firm using knowledge of an about-to-be announced takeover offer to tip off a friend to trade in shares and options, a senior executive in an investment bank gaining entry to the building at night to find out what his colleagues were working on and then traded on that information.

To discourage such activities most companies and audit firms expressly forbid it. It is also common practice for boards of directors to preclude directors from trading in shares in the periods leading up to major announcements such as quarterly/half yearly earnings, dividend changes, announcements of major changes in mineral reserves, or preceding disclosure of major takeovers.

Also most countries forbid separate briefings to analysts without the same information being released to the public at the same time.

There is no doubt that insider trading takes place as academic research looking at specific events shows abnormal returns being made immediately before the announcement of major events. This signifies that some people who know what is going to happen trade on that knowledge. In that sense the markets are not fair. However, proving it has traditionally been very difficult. To overcome that the laws have been made clearer, police investigative powers have been strengthened, and more resources have been put into investigating such cases.

30.13 Risk management

There is a growing pressure internationally for a company to disclose its risk management policy. In any company there is a range of risks that have to be managed. It is not a matter of just avoiding risks but rather of systematically analysing the risks and then deciding how to decide what risks should be borne, which to avoid, and how to minimise the possible adverse consequences of those which it is not economical to shift. A good governance system will ensure that comprehensive risk management occurs as a normal course of events.

There is a variety of approaches which could be adopted to the process of identifying the types of risks associated with a company. In this chapter we will discuss briefly strategic, operational, legal/regulatory and financial risks.

30.13.1 Strategic risks

Strategic risk is associated with maintaining the attractiveness and economic viability of the product and service offerings. In other words, current product decisions have to be made

with a strong sense of their probable future consequences. To do that the business has to be constantly monitoring trends in the current markets, potential merging of markets,[11] shifting demographics and consumer tastes, technological developments, political developments and regulations so as to capitalise on opportunities and to counter threats. It must be remembered that to do nothing may involve as much or more risk as entering into new ventures. When entering into new projects there needs to be a thorough risk analysis to ensure there are no false assumptions in the projections, that there has been pilot testing, and the question of what is the exit strategy if the project fails has been seriously considered and costed.

30.13.2 Operational risks

Operational risks include those that are very familiar such as possible interruption to operations, fire, floods, accidental or malicious product contamination, quality issues, systems security, impacts on ability of staff to run the business in the event of an influenza pandemic, occupational health and safety, security, and public liability. This list is not exhaustive but rather illustrative. Each business will be different and must be looked at as a separate exercise. Once the list has been identified then questions could be asked such as – can we insure this risk? If so, is it desirable to do so? The question is, should this event happen could we comfortably bear the cost? If the answer is no then we should insure at least for the amount we couldn't afford to bear.

Another possible question is whether there are ways we could transfer the risk. This could involve outsourcing some of the work. However, that in itself creates risks such as dependence, quality control, reliability of delivery, lack of involvement in technological developments, and financial risks associated with the subcontractor.

In relation to risks like occupational health and safety, the steps involve identification of potential hazards, identifying the best physical process for handling them, and developing standard ways of operating. Then training personnel in those standard operating procedures, and then regularly checking to ensure those procedures are being followed.

Also there is a need to ensure that remuneration and other policies do not work counter to the standard operating procedures. A factory that rewards staff on the basis of volume of output may encourage short cuts which jeopardise safety.

The likelihood of one policy undermining another policy needs to be investigated. Consider a bank which has a policy of reducing risks by purchasing forward currency only to match expected customer demands. However, if it rewards traders on profits made then it is encouraging traders to ignore policy to get more remuneration. This is made worse if supervisors stress profitability all the time.

What areas of supply are critical? Do you have multiple suppliers to protect against normal hazards such as strikes at the supplier, adverse weather conditions blocking supply, or threats to supply caused by political factors?

In some companies a small number of key staff members are critical to their operations. Are there processes to monitor the level of staff morale and to act on the results?

30.13.3 Legal and regulatory risks

This refers to the possibility that the firm will breach its legal or regulatory requirements and thus expose the company to fines and injury to its reputation. This involves being aware of the requirements of each country in which it operates or in which its products and services are used. Further, the staff of the company need to know of the relevant requirements which apply to their activities. They should also have access to advice in order to avoid problems or to address issues that do arise. Once again, standard operating procedures and standard

documentation can help reduce the risks. In some companies the protection of intellectual property should be of considerable relevance.

30.13.4 Financial risks

Financial risk management refers to the protection of assets from misappropriation and the avoidance of the incurrence of inappropriate liabilities, together with the financial management of cash flows so that the business can pay its obligations as they fall due. Accountants are very familiar with the protections provided by internal control systems supported by internal audits.

However, the recent global financial crisis has highlighted weaknesses in risk management. For example, the assumptions regarding the likelihood of sources of debt finance being rolled over were too optimistic and often items were looked at in isolation. By looking at it in isolation, the risk associated with an item was assessed on the assumption that an adverse event affected only that item whilst everything else was normal. However, when all parts of the economy deteriorated at the same time the impact of an adverse event was greater than expected.

Consider a property development company which is largely financed by debt. To reduce risk the company spread its investments across all types of properties (residential units, houses, industrial, office blocks, and shopping centres) and across several major cities. It did its stress analysis assuming one segment at a time (say, shopping centres) fell 15% in value. Under that analysis whichever segment fell, with the other segments remaining static, the company had more than sufficient asset backing to roll over its debt. However, during the great financial crisis all segments fell 12% to 20% with an overall fall of 17%, causing the debt financiers to question whether the asset backing was sufficient given the economists forecasting a further 5% fall in real estate prices.

Whilst it is not feasible to address all risk elements, the essential point is that each company needs to identify the risks that could pose serious threats to the prosperity of the business and put in place procedures to manage those risks. It should also be kept in mind that it is not a one off process but needs to be continually monitored. Every time the business changes its strategy or operations, and/or is involved in a takeover, or there is a change in laws the risk management programme has to be reviewed. With any programme there is a tendency for processes to slip either because of complacency or as a result of staff changes. This needs to be guarded against.

30.14 Corporate governance, legislation and codes

Investors looking to the safety and adequacy of the return on their investment are influenced by their level of confidence in the ability of the directors to achieve this. Good governance has not been fully defined and various reports have attempted to set out principles and practices which they perceive to be helpful in making directors accountable. These principles and practices are set out in a variety of Acts, e.g. Sarbanes–Oxley in the US and the Companies Act and regulations in the UK, and codes such as the Singapore Code of Corporate Governance 2005 and the UK Corporate Governance Code (formerly the Combined Code).

The various laws and codes that have been published set out principles and recommended best practice relating to the board of directors, directors' remuneration, relations with shareholders, accountability and audit. We now comment briefly on the position in Hong Kong, Malaysia and Singapore where there are common themes coming through from reviews – namely, how to make directors more accountable.

30.14.1 HK Code of Corporate Governance

There is a Hong Kong Code of Corporate Governance which was revised in 2005. Grant Thornton reviewed[12] the operation of the code in 2008 and commented:

> **Improved compliance**
> Our analysis makes it clear that overall compliance is improving. The year 2008 witnessed an increase in the compliance rate of HSCI companies to 62%. This shows that Hong Kong companies are making efforts to comply with the Code and improve their level of transparency . . . Our review notes that they still lag far behind expectations in many areas, and they should adhere to the Code's principles and best practices with greater determination.

The review then commented[13] on areas where performance needed to be improved. One of these was the problem of the lack of independence on the board:

> A low level of independence on a company's board or committees greatly affects its ability to make objective decisions and critically monitor its performance . . . The Code requires that at least three INEDs should sit on the board . . . Even so, very few companies provide detailed and thorough information about their annual review of INED independence. The perception of independence will continue to be a strong element expected of top Hong Kong companies, as it is globally. Companies should therefore strive to improve their disclosures on this issue . . . the number of companies reporting that only INEDs serve on their audit committee remained unchanged at 60% . . . still far short of full compliance . . . The compliance rate is far lower where the composition of remuneration committees was concerned. Only 19% of companies had only INEDs serving on this committee.
>
> Another key area that is far more relevant to Hong Kong is the direct involvement and controlling influence of family members. Our business environment has a high concentration of familial involvement. While this is not an issue in itself, it should be properly handled in order to avoid perceptions of impaired objectivity or conflicts of interest . . . Even a higher percentage, 30%, noted that familial relationships existed within the board. The low involvement of INEDs further compounds the issue of independence, and companies should address these points.

30.14.2 Malaysian Code on Corporate Governance

The Malaysian Code on Corporate Governance was revised in 2007. The key amendments[14] to the code were designed to strengthen (a) the board of directors by spelling out the eligibility criteria for appointment of directors and the role of the nominating committee, and (b) the audit committees by spelling out that the committees should comprise only non-executive directors, all of whom should be able to read, analyse and interpret financial statements so that they will be able to effectively discharge their functions.

30.14.3 Singapore Code of Corporate Governance

A report[15] on the operation of the Singapore Code of Corporate Governance 2005 was carried out in 2007 for the Monetary Authority of Singapore and Singapore Exchange. The objective was to improve corporate governance standards to enhance Singapore's reputation as an international financial centre, help attract international investment, improve the liquidity of its stock markets, and reduce the cost of capital for its companies. There were a number of suggestions relating to directors' independence such as:

> The proportion of directors who are labeled as independent generally meets the Code's recommendations. Nevertheless, there are concerns about the amount of influence which controlling shareholders have over the appointment of independent directors, the process by which independent directors are typically appointed, the relatively small pool from which independent directors are drawn, and how nominating committees are assessing the independence of directors. These could affect the ability or willingness of independent directors to act independently . . .
>
> Regulators should consider supporting the creation of an online directors' register to increase the pool of independent directors and to assist companies in finding independent director candidates.

There is a Corporate Governance & Financial Reporting Centre (CGFRC) at the National University of Singapore[16] which aims to promote best practices in corporate governance and financial reporting.

30.14.4 Codes as a partial solution

As the nature of business and expectations of society change, the governance requirements evolve to reflect the new laws and regulations. By anticipating changing requirements, companies can prepare for the future. At the same time they should identify the special areas of potential conflict in their own operations and develop policies to manage those relationships.

Good governance is a question of having the right attitudes. All the corporate governance codes will not achieve much if they focus on form rather than substance. Codes work because people want to achieve good governance. People can always find ways around rules. Further, rules cannot cover all cases so good governance needs a commitment to the fundamental idea of fairness.

The research on whether good governance leads to lower cost of capital is very mixed reflecting both the difficulty of identifying the impact of good governance and the fact that some engage with the spirit of the concept and some don't. There are those who question the impact of good corporate governance and supporting the case of those who doubt that there is a positive impact on performance is an Australian research project[17] looking at companies in the S&P/ASX 200 index which found that companies which the researcher classified as having poor corporate governance outperformed companies classified as having good corporate governance over a range of measures including EBITDA growth and return on assets. There is an ongoing need for further research, particularly as to the effect on smaller listed companies, and it will be interesting to await the outcome.

30.15 Corporate governance – the UK experience

In the UK there have been a number of initiatives in attempts to achieve good corporate governance through (a) legislation, (b) the UK Corporate Governance Code, (c) supplementary reports, (d) non-executive directors (NEDs), (e) shareholder activism and (f) audit. We discuss each of these briefly below.

30.15.1 Legislation

Legislation is in place that attempts to ensure that investors receive sufficient information to make informed judgements. For example, there are requirements for the audit of financial statements and disclosure of directors' remuneration. There could be a case for increased

statutory involvement in the affairs of a company by, for example, putting a limit on benefits and specifying how share options should be structured. However, the government has gone down the road of disclosure and transparency in reporting. There is still a need for further statutory requirements, such as fuller disclosure in the summary financial statements and improved voting mechanisms to avoid the high rate of proxy voting.

30.15.2 The UK Corporate Governance Code

The code is issued by the Financial Reporting Council (FRC). It is not a rule book but is principles-based and sets out best practice. It relies for its effectiveness on disclosure by requiring companies listed on a stock exchange to explain if they do not comply with its provisions.

The original code made an interesting development by separating its proposals into two parts:

- Part 1 containing Principles of Good Governance (Main and Supplementary) relating to
  - A: directors
  - B: directors' remuneration
  - C: relations with shareholders
  - D: accountability and audit.
- Part 2 containing Codes of Best Practice with procedures to make the Principles operational.

The code is regularly reviewed and updated but continues to distinguish between broad principles which companies are largely free to choose their own method of implementing. The detailed code provisions are those which companies are required to say whether they have complied with and, where they have not complied, to explain why not. The intention is to combine flexibility over detailed implementation with clarity where there was non-compliance.

The principles and code provisions relating to the board of directors are set out below to illustrate the code's approach. The six principles that relate to directors cover:

A1 the board

A2 chairman and chief executive

A3 board balance and independence

A4 appointments to the board

A5 information and professional development

A6 performance evaluation

As an illustration of the level of detail, the Principles (A1) and Provisions (A1.1 to A1.5) relating to **the board** are set out below.

A1 The Board

Main Principle

Every company should be headed by an effective board, which is collectively responsible for the success of the company.

Supporting Principles

- The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed.

- The board should
  - set the company's strategic aims;
  - ensure that the necessary financial and human resources are in place for the company to meet its objectives; and
- review management performance.
- The board should
  - set the company's values and standards; and
  - ensure that its obligations to its shareholders and others are understood and met.
- All directors must take decisions objectively in the interests of the company.
- As part of their role as members of a unitary board, non-executive directors should
  - constructively challenge and help develop proposals on strategy;
  - scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
  - satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.
- As non-executive directors they
  - are responsible for determining appropriate levels of remuneration of executive directors; and
  - have a prime role in appointing, and where necessary removing, executive directors, and in succession planning.

Code Provisions

A.1.1 The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

A.1.2 The annual report should identify the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees. It should also set out the number of meetings of the board and those committees, and individual attendance by directors.

A.1.3 The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.

A.1.4 Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.

A.1.5 The company should arrange appropriate insurance cover in respect of legal action against its directors.

Revisions to the code

The code is regularly updated to reflect changes in perception of best practice. For example, a change was made which allowed the company chairman to sit on the remuneration committee provided he is considered independent on appointment and makes the use of proxies more transparent. Transparency was improved by allowing shareholders who vote by proxy the option of withholding their vote on a resolution and encouraging companies to publish details of proxies where votes are taken on a show of hands. It also removed the restriction on an individual chairing more than one FTSE 100 company because this was felt to be over-prescriptive and for listed companies outside the FTSE 350, allowed the company chairman to be a member of, but not chair, the audit committee provided that he or she was independent on appointment as chairman although there would still need to be two independent non-executive directors.

30.15.3 Supplementary reports

The code has been supplemented by a number of reports dealing with specific aspects of corporate governance. We discuss briefly three of these reports, namely, the Myners Report, the Smith Report and the Higgs Report.

Myners Report[18]

This was a Treasury Report issued in 2001 titled *Developing a Winning Partnership* which considered how companies and institutional investors were working together. It dealt with the role of the chair of the board when trustees were making an investment decision, for example, recommending that the chair of the board should be responsible for ensuring that trustees taking investment decisions are familiar with investment issues and that the board has sufficient trustees for that purpose and for funds with more than 5,000 members, the chair of the board and at least one-third of trustees should be familiar with investment issues (even where investment decisions have been delegated to an investment subcommittee).

Smith Report (2003)

This produced recommendations on the membership and functions of audit committees. Its recommendations on audit committees were that there should be at least three members, all independent NEDs with at least one member having significant, recent and relevant financial experience. It also recommended that the committee should monitor the integrity of the financial statements and the external auditor's independence, objectivity and effectiveness; review the company's internal financial control system and effectiveness of internal audit; recommend the appointment of the external auditor, and approve their remuneration.

The Higgs Report[19]

This report issued in 2003 made recommendations relating to the membership of NEDs on the board, their appointment, independence, effectiveness, and the appointment of a senior NED. It recommended that the main roles for NEDs was to constructively challenge and contribute to the development of strategy, scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance, satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible and be responsible for determining the appropriate level of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management in succession planning.

The code is periodically revised to adopt recommendations based on reports such as those above. This is one of the strengths of the code that it continually attempts to review current practice and improve the corporate governance regime.

30.15.4 NEDs

The main function of non-executive directors is to ensure that the executive directors are pursuing policies consistent with shareholders' interests.[20]

Review of their contribution

Considering the qualities that are required, the Cadbury Report recommended that the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. Research[21] indicated that they are concerned to maintain their reputation in the external market in order to maintain their marketability.

NEDs on many boards bring added or essential commercial and financial expertise. For example, on a routine basis as members of the audit committee or, on an *ad hoc* basis, providing experience when a company is preparing to float or having specific industry knowledge, as explained in the following extract from the 2007 Beazley Group plc Annual Report:

> **The Board**
> The board consists of a non-executive chairman, Jonathan Agnew, together with five independent non-executive directors, of which Andy Pomfret is the senior non-executive director, and seven executive directors, of which Andrew Beazley is chief executive.
>
> All five of the non-executive directors, who have been appointed for specified terms, are considered by the board to be independent of management and free of any relationship which could materially interfere with the exercise of their independent judgement. Given that the business of the group is insurance underwriting organised by line of business in divisions, the board continues to consider it appropriate that some of the underwriting heads of the major divisions should be executive directors.
>
> Notwithstanding that the company is included in the FTSE 250 index, it does not consider it desirable to increase the number of non-executive directors to outnumber the executive directors since the range of skills and experience of the existing non-executive director is sufficient and the increased size of the board would make it unwieldy. Indeed the board intends over the medium term to reduce its size to some extent, provided that this can be achieved without significantly impairing the underwriting experience represented on it.
>
> The fees of non-executive directors, other than the chairman, are determined by the board. When setting fee levels consideration is given to levels in comparable companies for comparable services. No non-executive director participates in the company's incentive arrangements or pension plan.
>
> Non-executive directors are appointed for fixed terms, normally for three years, and may be reappointed for future terms. Non-executive directors are typically appointed through a selection process that includes the candidate bringing the desired competence and skills to the group. The board has identified several key competencies for non-executive directors to complement the existing skill-set of the executive directors. These competencies are as follows: Insurance sector expertise; Asset management skills; Public company and corporate governance experience; Risk management skills; and Finance skills.

However, NEDs are not and never can be a universal panacea. It has to be recognised that there may be constraints:

- They might have divided loyalties having been nominated by the chairman, the CEO or other board member.
- They might have other NED appointments and/or executive appointments which limit the time they can give to the company's affairs.
- They are not full-time directors.
- They cannot have the same detailed knowledge of the company as executive directors, particularly in relation to strategic planning.
- They might not have access to all relevant information if the company has a complex geographic or group organisation.
- They might not have the technical knowledge to be effective in a committee of which they are a member.
- They do not have a voting majority on the board.
- They might not be able to restrain an overbearing CEO, particularly if the CEO is also the chairman.

With so many caveats, it would not be unreasonable to assume that NEDs could not easily divert a dominant CEO or executive directors from a planned course of action. In such cases, their influence on good corporate governance is reduced unless the interest of directors and shareholders already happen to coincide. However if the issue is serious enough for one or more independent director to resign it is likely that the market will certainly take note.

There is great reliance placed on the use of NEDs as one mechanisms for achieving good corporate governance. Attention has been directed towards their role in setting directors' remuneration but their remit is much wider. It is also to consider a company's strategic planning and, in this, there is mixed evidence as to whether there is a positive or negative correlation between the proportion of independent directors and performance.

Investors, auditors and regulators need to be aware of conditions that can neuter NEDs, e.g. where there is a national culture of disregard for corporate guidelines and a strong CEO who is also chairman, as in the case of Parmalat.[22] Regulators, such as the FSA in the UK, have the responsibility for regulating financial services – if the regulators are unable to ensure good corporate governance, it is unreal to expect NEDs to do so in such a situation.

The public does not have the information to assess these situations and has to rely on auditors and institutional investors who have analytical expertise. Problems only tend to become known to the public when there is force on a company. This can come about for a number of reasons: e.g. if a company has to make a significant restatement of its financial statements or a company is acquired and the new management want to clean up the statement of financial position.

However, on a positive note, the presence of NEDs is perceived to be indicative of good corporate governance and a research report[23] indicated that good governance has a positive impact on investor confidence. The research examined 654 UK FTSE All-Share companies from 2003 to 2007 using unique governance data from the ABI's Institutional Voting and Information Service (IVIS). The service issues colour coded guidance to highlight breaches of governance best practice, with red being the most serious. An extract from the ABI research is as follows:

> New research from the ABI (Association of British Insurers) shows that companies with the best corporate governance records have produced returns 18% higher than those with poor governance. It was also revealed that a breach of governance best practice

(known as a red top in the ABI's guidance) reduces a company's industry-adjusted return on assets (ROA) by an average of 1 percentage point a year. For even the best performing companies, (those within the top quartile of ROA performance), that equates to an actual fall of 8.6% in returns per year.

The research also shows that shareholders investing in a poorly governed company suffer from low returns. £100 invested in a company with no corporate governance problems leads to an average return of £120 but if invested in the worst governed companies the return would have been just £102.

There are many highly talented, well-experienced NEDs but their ability to influence good governance should not be overestimated. They are always described as the *independent* directors. However, it is difficult to be confident when nominations are made by the board, future appointments might be affected if they prove difficult, i.e. challenging. Their effectiveness might be reduced if they have limited time, limited access to documents, limited respect from full-time executive directors and limited expertise within the remuneration and/or audit committees. When a company is prospering their influence could be extremely beneficial; when there are problems they may not have the authority to ensure good governance.

30.15.5 Shareholders

In the UK the need for good corporate governance is affected by how widely shares are held.

In the US and the UK, a large number of financial institutions and individuals hold shares in listed companies, so there is a greater need for corporate governance requirements. In Japan and most European countries (except the UK) shares in listed companies tend to be held by a small number of banks, financial institutions and individuals. Where there are few shareholders in a company, they can question the directors directly, so there is less need for corporate governance requirements.

The following table is an extract from the UK Office of National Statistics[24] showing the holdings in UK shares:

Beneficial ownership of UK shares 2006 and 2008

	Pounds (bn)		*Percentages*	
	2006	*2008*	*2006*	*2008*
Rest of the world	742.4	481.1	40.0	41.5
Insurance companies	272.8	154.9	14.7	13.4
Pensions funds	235.8	148.8	12.7	12.8
Individuals	238.5	117.8	12.8	10.2
Unit trusts	30.0	21.3	1.6	1.8
Investment trusts	45.1	22.1	2.4	1.9
Other financial institutions	179.1	115.3	9.6	10.0
Charities	16.1	8.7	0.9	0.8
Private non-financial companies	33.5	34.7	1.8	3.0
Public sector	2.0	13.0	0.1	1.1
Banks	63.0	40.6	3.4	3.5
Total	1858.3	1158.3	100.0	100.0

At the end of 2008 the UK Stock Market was valued at £1,158.4 billion, a decrease of £699.8 billion (37.7 per cent) since the end of 2006.

Figures for end-2008 show that: Investors from outside the UK owned 41.5 per cent of UK shares listed on the UK Stock Exchange, up from 40.0 per cent at end-2006. Rest of the world investors held £481.1 billion of shares – down from £742.4 billion at end-2006.

Individual shareholder influence on corporate governance

With the Rest of the world holding 41.5% and individual shareholders having fallen to just over 10% it is difficult for this group to exercise any significant group influence on management behaviour. In passing legislation, there is an implicit view that individual shareholders have a responsibility to achieve good corporate governance. Statutes can provide for disclosure and be fine-tuned in response to changing needs but they are not intended to replace shareholder activism. When the economy is booming there is a temptation to sit back, collect the dividends and capital gains, bin the annual report and post in-proxy forms.

Shareholder influence has to rely on that exercised by the institutional investors.

Large-block investors' influence on corporate governance

There is mixed evidence about the influence of large-block shareholders. The following is an extract from a Department of Trade and Industry Report:[25]

> The report observed from a review of economics, corporate finance and 'law and economics' research literature that there was no unambiguous evidence that presence of large-block and institutional investors among the firm's shareholders performed monitoring and resource functions of 'good' corporate governance. However, management and business strategy research suggests that it does have a significant effect on *critical* organisational decisions, such as executive turnover, value-enhancing business strategy, and limitations on anti-takeover defences.

Feedback from the experts' evaluation of the governance roles of various types of shareholders provided the following pattern:[26]

	Mean	*Standard deviation*
Pension funds, mutual funds, foundations	4.58	1.50
Private equity funds	4.52	1.76
Individual (non-family) blockholders	4.36	1.70
Family blockholders	4.20	1.63
Corporate pension funds	3.85	1.55
Insurance companies	3.69	1.69
Banks	3.31	1.49
Dispersed individual shareholders	2.18	1.41

The highest scores were assigned to the governance roles of pension funds, mutual funds, foundations and private equity investors:

> Some respondents also suggested that various associations of institutional investors such as NAPF, ABI, etc., play strong governance roles, as do individual blockholders and family owners. At the other end of the spectrum are dispersed individual shareholders whose governance roles received the lowest score. However, it must be kept in mind that none of the individual scores is above 5 indicating that, on average, our experts were rather sceptical about the effectiveness of large blockholders from the 'good' governance perspective.[27]

A further related factor is that US and UK companies have tended to have a low gearing with most of the finance provided by shareholders. However, in other countries the gearing of companies is much higher, which indicates that most finance for companies comes from banks. If the majority of the finance is provided by shareholders, then there is a greater need for corporate governance requirements than if finance is in the form of loans where the

lenders are able to stipulate conditions and loan covenants, e.g. the maximum level of gearing and action available to them if interest payments or capital repayments are missed.

However, institutional investors do not represent a majority in any company. Their role is to achieve the best return on the funds under their management consistent with their attitude to environmental and social issues. Their expertise has been largely directed towards the strategic management and performance of the company with, perhaps an excessive concern with short-term gains. Issues such as directors' remuneration issues might well be of far less significance than the return on their investment.

The Walker Review of Corporate Governance of UK Banking Industry[28]

This reviewed corporate governance in the UK banking industry and financial institutions and made recommendations on the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively; the balance of skills, experience and independence required on the boards; the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees and the role of institutional shareholders in engaging effectively with companies and monitoring of boards. The role of the institutional investors is important and a stewardship code has been proposed.

The Stewardship Code

The code consists of seven principles which, if followed, should benefit corporate governance. The principles are:

1 **Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.** Such a policy should include how investee companies will be monitored with an active dialogue on the board and its policy on voting and the use made of proxy voting.

2 **Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.** Such a policy should include how to manage conflicts of interest when, for example, voting on matters affecting a parent company or client.

3 **Institutional investors should monitor when it is necessary to enter into an active dialogue with their boards.** Such monitoring should include satisfying themselves that the board and sub-committee structures are effective, and that independent directors provide adequate oversight and maintain a clear audit trail of the institution's decisions. The objective is to identify problems at an early stage to minimise any loss of shareholder value.

4 **Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.** Such guidelines should say the circumstances when they will actively intervene. Instances when institutional investors may want to intervene include when they have concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters. If there are concerns, then any action could escalate from meetings with management specifically to discuss the concerns through to requisitioning an EGM, possibly to change the board.

5 **Institutional investors should be willing to act collectively with other investors where appropriate.** Such action is proposed in extreme cases when the risks posed threaten the ability of the company to continue.

6 **Institutional investors should have a clear policy on voting and disclosure of voting activity.** Institutional investors should seek to vote all shares held. They should not automatically support the board and if they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution.

7 **Institutional investors should report periodically on their stewardship and voting activities.** Such reports should be made regularly and explain how they have discharged their responsibilities. However, it is recognised that confidentiality in specific situations may well be crucial to achieving a positive outcome.

The FRC proposes to extend these principles to all listed companies.

Legal safeguards

Corporate governance has to react to changing circumstances and threats. It evolves and will continue to need to be revised and updated. The law provides minimum safeguards but in the ever changing complexities of global trade and finance good governance is dependent on the behaviour of directors and their commitment to principles and values. The UK system is heavily dependent on codes which set out principles and the requirement for directors to explain if they fail to comply. The Governance Code and Stewardship Code will rely for their effectiveness on investor engagement. This recognises that investors cannot delegate all responsibility to their agents, the directors, accept their dividends and be dormant principals.

UK experience and international initiatives

It is interesting to note that what constitutes good corporate governance is evolving with new initiatives being taken globally.

For example, The OECD is responding to weaknesses in corporate governance that became apparent in the financial crisis by developing recommendations for improvements in board practices, the remuneration process and how shareholders should actively exercise their rights. It is also reviewing governance in relation to risk management which featured as such a threat in the way financial institutions conducted their business. However, there is some concern that measures that might be essential for the control of the financial sector should not be imposed arbitrarily on non-financial sector organisations.

30.15.6 Audit

Auditors are subject to professional oversight to ensure that they are independent, up-to-date and competent. However, where there is a determined effort to mislead the auditors, for example, creating false paper trails and misstatement at the highest level, then there is the risk that fraud will be missed.

There have been allegations of audit negligence in some high-profile corporate failures, in some of which auditors have been found liable. In part, the financial crisis arising from issues such as the use of special purpose entities and complex financial instruments has been made more difficult for auditors as it is quite clear that pressure groups, such as the investment banks, have influenced the regulators to allow, or not question, practices that have since been found to be highly risky and unreported.

In general, the audit appears to be a reliable mechanism for ensuring that the financial statements give a true and fair view.

Summary

Good governance is achieved when all parties feel that they have been fairly treated. It is achieved when behaviour is prompted by the idea of fairness to all parties. Independent behaviour is expected of the NEDs and auditors and they are expected to have the strength of character to act professionally with proper regard for the interest of the shareholders. The shareholders in turn should be exercising their rights and not be inert. They have a role to play and it is not fair to sit on their hands and complain.

Good corporate governance cannot be achieved by rules alone. The principle-based approach such as that of the FRC with the UK Corporate Governance Code recognises that it is behaviour that is the key – it sets out broad principles and a recommended set of provisions/rules which are indicative of good practice and disclosure is required if there is reason why they are not appropriate in a specific situation.

Good corporate governance depends on directors behaving in the best interest of shareholders. Corporate governance mechanisms to achieve this include legislation, corporate governance codes, appointment of NEDs, shareholder activism and audit. Such mechanisms are necessary when companies are financed largely by equity capital. It is noticeable that they are being developed in many countries in response to wider share ownership.

Corporate governance best practice is being regularly reviewed and improved as, for example, steps being taken to improve the ability of NEDs to exercise an effective corporate governance role.

REVIEW QUESTIONS

1 Explain in your own words what you understand corporate governance to mean.

2 Explain why governance procedures may vary from country to country.

3 What are the implications of governance for audit practices.

4 The Association of British Insurers held the view that options should be exercised only if the company's earnings per share growth exceeded that of the retail price index. The National Association of Pension Funds preferred the criterion to be a company's outperformance of the FTA All-Share Index.

(a) Discuss the reasons for the differences in approach.

(b) Discuss the implication of each approach to the financial reporting regulators and the auditors.

5 Research[29] suggests that companies whose managers own a significant proportion of the voting share capital tend to violate the UK Corporate Governance Code recommendations on board composition far more frequently than other companies. Discuss the advantages and disadvantages of enforcing greater compliance.

6 Good corporate governance is a myth – Just look at these frauds and irregularities:

- Enron www.sec.gov/litigation/litreleases/lr18582.htm
- WorldCom www.sec.gov/litigation/litreleases/lr17588.htm
- Xerox Corporation www.sec.gov/litigation/complaints/complr17465.htm
- Dell www.sec.gov/news/press/2010/2010-131.htm
- Lehman http://lehmanreport.jenner.com/VOLUME%201.pdf

How realistic is it to expect good governance to combat similar future behaviour?

7 'Stronger corporate governance legislation is emerging globally but true success will only come from self-regulation, increased internal controls and the strong ethical corporate culture that organisations create.' Discuss.

8 In the modern commercial world, auditors provide numerous other services to complement their audit work. These services include the following:

(a) Accountancy and book-keeping assistance, e.g. in the maintenance of ledgers and in the preparation of monthly and annual accounts.

(b) Secretarial help, e.g. ensuring that the company has complied with the Companies Act in the maintenance of shareholder registers and in the completion of annual returns to Companies House.

(c) Consultancy services, e.g. advice on the design of information systems and organisational structures, advice on the choice of computer equipment and software packages, and advice on the recruitment of new executives.

(d) Investigation work, e.g. appraisals of companies that might be taken over.

(e) Receivership work, e.g. when the firm assumes the role of receiver or liquidator on behalf of an audit client.

(f) Taxation work, e.g. tax planning advice and preparation of tax returns to the Inland Revenue for both the company and the company's senior management.

Discuss:

(i) Whether any of these activities is unacceptable as a separate activity because it might weaken an auditor's independence.

(ii) The advantages and disadvantages to the shareholders of the audit firm providing this range of service.

9 The following is an extract from the *Sunday Times* of 8 March 2009:

> Marc Jobling, the ABI's assistant director of investment affairs said: 'Pay consultants are a big contributor to the problems around executive pay. We have heard of some who admit that they work for both management and independent directors – which is a clear conflict of interest and not acceptable. We believe that remuneration consultants, whose livelihood appears to depend on pushing an ever-upward spiral in executive pay, should be obliged to develop a code of ethics.'

Discuss the types of issues which should be included in such a code of ethics and how effective they would be in achieving good corporate governance.

10 There has been much criticism of the effectiveness of non-executive directors following failures such as Enron. Some consider that their interests are too close to those of the executive directors and they have neither the time nor the professional support to allow them to be effective monitors of the executive directors. Draft a job specification and personal criteria that you think would allay these criticisms.

11 In 2000, the chairman of the US Securities and Exchange Commission (SEC), Arthur Levitt, proposed that other services provided by audit firms to their audit clients should be severely restricted, probably solely to audit and tax work.[31] Discuss why this still has not happened.

12 Discuss how remuneration policies may affect good corporate governance.

13 Discuss the major risks which will need to be managed by a pharmaceutical company and the extreme to which these should be disclosed.

14 Egypt is a country in which many of the public companies have substantial shareholders in the form of founding families or government shareholders. How do you think that would affect corporate governance?

15 Discuss whether corporate governance has any particular relevance to banks.

16 'Management will become accountable only when shareholders receive information on corporate strategy, future-based plans and budgets, and actual results with explanations of variances.' Discuss whether this is necessary, feasible and in the company's interest.

17 The Chartered Institute of Management Accountants (CIMA) has warned that linking directors' pay to EPS or return on assets is open to abuse, since these are not the objective measures they might appear.

(a) Identify five ways in which the directors might manipulate the EPS and return on assets without breaching existing standards.

(b) Suggest two alternative bases for setting criteria for bonuses.

18 Review reporting requirements in relation to disclosure of related party transactions and discuss their adequacy in relation to the avoidance of conflicts of interest.

19 Summarise the approach of the UK Financial Reporting Council to governance in audit practices and discuss in what situations audit independence could be compromised.

20 Discuss the extent to which a trade union is able to contribute to good corporate governance.

EXERCISES

Question 1: Scenario – Fred Paris

Manufacturing Co has been negotiating with Fred Paris regarding the sale of some property that represented an old manufacturing site which is now surplus to requirements. Because part of the site was used for manufacturing, it has to be decontaminated before it can be subdivided as a new housing development. This has complicated negotiations. Fred is a property developer and he has a private company (Paris Property Development Pty Ltd) and is also a major (15%) shareholder of FP Development of which he is chairman. The negotiators for Manufacturing Co note that the documents keep switching between Paris Property Development and FP Development and they use that as feedback as to how well they are negotiating. Is there a corporate governance failure? Discuss.

Question 2: Scenario – Harvey Storm

Harvey Storm is chief executive of West Wing Savings and Loans. Harvey authorises a loan to Middleman Properties secured on the land it is about to purchase. Middleman Properties has little money of its own. Middleman Properties subdivides the land and builds houses on them. It offers buyers a house and finance package under which West Wing provides the house loans up to 97% of the house price even to couples with poor credit ratings. This allows Middleman Properties to ask for higher prices for the houses.

Middleman Properties appoints Frontman Homes as the selling agent who kindly provides buyers with the free services of a solicitor to handle all the legal aspects including the conveyancing. Most of the profits from the developments are paid to Frontman Homes as commissions. Harvey Storm's wife has a 20% interest in Frontman Homes. Are these corporate governance failures? Discuss.

Question 3: Scenario – Conglomerate plc

Conglomerate plc was a family company which was so successful that the founding Alexander family could not fully finance its expansion. So the company was floated on the stock exchange with the Alexander family holding 'A' class shares and the public holding 'B' class shares. 'A' class shares held the right to appoint six of the eleven directors. 'B' class shares could appoint five directors and had the same dividend rights as the 'A' class shares. The company could not be wound up unless a resolution was passed by 75% or more of 'A' class shareholders. Is there any risk of a governance failure? Discuss.

Question 4: Scenario – White plc

The board of White plc is discussing the filling of a vacant position arising from the death of Lord White. A list of possible candidates is as follows:

(a) Lord Sperring who is a well known company director and who was the managing director of Sperring Manufacturers before he switched to being a professional director.

(b) John Spate, B.Eng., PhD who is managing director of a successful, innovative high technology company and will be taking retirement in four months time.

(c) Gerald Stewart B.Com who is the retired managing director of Spry and Montgomery advertising agency which operates in six countries being England and five other commonwealth countries.

The managing director leads the discussion and focuses on the likelihood of the three candidates being able to work in harmony with other members of the board and suggests that John Spate is too radical to be a member of the board of White plc. The other members of the board agree that he has a history of looking at things differently and would tend to distract the board.

The chairman of the board suggests that Lord Sperring is very well connected in the business community and would be able to open many doors for the managing director. It was unanimously agreed that the chairman should approach Lord Sperring to see if he would be willing to join the board.

Critically discuss the appointment process.

Question 5

(a) Describe the value to the audit client of the audit firm providing consultancy services.

(b) Why is it undesirable for audit firms to provide consultancy services to audit clients?

(c) Why do audit firms want to continue to provide consultancy services to audit clients?

Question 6

How is the relationship between the audit firm and the audit client different for:

(a) the provision of statutory audit when the auditor reports to the shareholders;

(b) the provision of consultancy services by audit firms?

Question 7

Why is there a prohibition of auditors owning shares in client companies? Is this prohibition reasonable?

Discuss.

Question 8

The financial statements of Rolls-Royce plc (aero engine manufacturer) for the year ended 31 December 1999 disclose the following matters in relation to the directors:

(a) Remuneration committee

The remuneration committee, which operates within agreed terms of reference, has responsibility for making recommendations to the board on the Group's general policy towards executive remuneration. The committee also determines, on the board's behalf, the specific remuneration packages of the executive directors and a number of senior executives.

The membership of the committee consists exclusively of independent non-executive directors (*the financial statements disclose the names of these directors*). The committee meets regularly and has access to professional advice from inside and outside the Company.

The Chairman of the Company (*a part-time executive director*) and the Chief Executive (*an executive director*) generally attend meetings but are not present during any discussion of their own emoluments.

(b) Base salary

The committee believes that in order to attract and retain executive directors of the right calibre and to provide them with adequate incentives to deliver the Group's objectives, the Group should pursue a policy of offering median-level base salaries for its executive directors, and through the performance-related schemes, the opportunity of upper quartile earnings for upper quartile performance.

(c) Annual performance award scheme

The scheme enables a maximum performance award of up to 60% of salary to be paid to executive directors for exceptional performance against pre-determined targets based upon return on capital employed with a tapered and reducing scale of maximum percentages for senior employees. The targets are set by the committee based upon the Group's annual operating plans. Such payments do not form part of pensionable earnings. One-third of total awards made are paid in Rolls-Royce shares which are held in trust for two years, with release normally being conditional on the individual remaining in the Group's employment until the end of the period. The required shares are purchased on the open market. This arrangement provides a strong link between performance and remuneration and provides a culture of share ownership amongst the Group's senior management.

Required:
Comment on the notes to the financial statements included above.

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