8 The Audit function and the role of regulation

8.1 Introduction

One of the issues which affects the running of a company is that the owners and managers have different sets of information, with managers generally having more information than owners or investors. Agency theory provides one way to deal with this which we discuss in this chapter. Regulation and rating agencies also help and we discuss these. So too does audit. In this chapter we discuss all of these in the context of governance.

8.2 The role of audit

The general definition of an audit is an evaluation but it is normally taken to mean an evaluation of the financial and other records of business and is undertaken on behalf of the owners of a business by some independent experts. The purpose is to ensure that the information presented in the published accounts provides a "true and fair" view of the activities of the business and that the balance sheet provides a realistic assessment of the assets and liabilities of the business. It is undertaken on behalf of owners and investors who tend to need to rely on this information for their assessment.

In the UK, and most countries, audit is a statutory function which must be undertaken by someone appropriately qualified – either a qualified auditor or a qualified accountant with appropriate experience. Increasingly also other information – such as environmental impact assessments are subject to audit by appropriately qualified people. This kind of audit is growing in importance but is not yet subject to control such as for financial auditing.

Although auditors are supposedly impartial they are appointed by the Board of Directors of the company and receive remuneration from the company. This has raised questions about their actual independence from the company and this is one important issue as far as governance is concerned. It should be noted also that an impartial assessment is not always arrived at. For example the accounts of Enron were always audited and confirmed, although the auditors – Arthur Andersen – went out of business at the same time as Enron did. But more recently the accounts of Lehman Bros were also audited and confirmed. Thus the role and impartiality of auditors remains an problematic subject

8.3 The Audit Committee

Every company must have an audit committee. This is an operating committee of the Board of Directors charged with oversight of financial reporting and disclosure. Committee members are drawn from members of the company's board of directors. It should contain independent directors and at least one member must be qualified as a financial expert. The role of audit committees continues to evolve as a result of the passing of the Sarbanes-Oxley Act 2002.

Responsibilities of the audit committee typically include:

- Overseeing the financial reporting and disclosure process.
- Monitoring choice of accounting policies and principles.
- Overseeing hiring, performance and independence of the external auditors.
- Overseeing regulatory compliance, ethics, and whistleblower hotlines.
- Monitoring the internal control process.
- Overseeing the performance of the internal function.
- Discussing risk management policies and practices with management.

8.4 Agency theory and asymmetric power

Agency theory argues that managers merely act as custodians of the organisation and its operational activities and places upon them the burden of managing in the best interest of the owners of that business[23]. According to agency theory all other stakeholders of the business are largely irrelevant and if they benefit from the business then this is coincidental to the activities of management in running the business to serve shareholders. This focus upon shareholders alone as the intended beneficiaries of a business has been questioned considerably from many perspectives, which argue that it is either not the way in which a business is actually run or that it is a view which does not meet the needs of society in general.

Conversely stakeholder theory argues that there are a whole variety of stakeholders involved in the organisation and each deserves some return for their involvement. According to stakeholder theory therefore benefit is maximised if the business is operated by its management on behalf of all stakeholders and returns are divided appropriately amongst those stakeholders, in some way which is acceptable to all. Unfortunately a mechanism for dividing returns amongst all stakeholders which has universal acceptance does not exist, and stakeholder theory is significantly lacking in suggestions in this respect. Nevertheless this theory has some acceptance and is based upon the premise that operating a business in this manner achieves as one of its outcomes the maximisation of returns to shareholders, as part of the process of maximising returns to all other stakeholders.

These two theories can be regarded as competing explanations of the operations of a firm, which lead to different operational foci and to different implications for the measurement, and reporting of performance. It is significant however that both theories have one feature in common. This is that the management of the firm is believed to be acting on behalf of others, either shareholders or stakeholders more generally. They do so, not because they are the kind of people who behave altruistically, but because they are rewarded appropriately and much effort is therefore devoted to the creation of reward schemes which motivate these managers to achieve the desired ends. This is the subject of Agency Theory.

8.5 Agency Theory

It is important to recognise that the firm is assumed to exist for the benefit of its owners who are assumed to be solely interested in the maximisation of their wealth. Managers, on the other hand, are the decision-makers in an organisation and they are implicitly assumed to automatically act in the best interests of owners, either because they are also the owners, or because they share the same interests. In other words, managers are assumed to make the same decisions that owners would make, irrespective of the effect on their personal interests.

Managers are, therefore, assumed to assess objectively alternative actions, and always select the option favoured by the owners of the firm. The management accountant, therefore, is then concerned with providing the 'right' information combined with the 'right' decision-model which will help the manager make the 'right' decision. An obvious criticism of this approach, however, is that it fails to recognise that managers may not share the same interests as owners, and that this is likely to impact upon real-world decision-making. Agency theory attempts to address this problem, by providing a more realistic representation of decision-making.

Agency theory therefore recognises that people are unlikely to ignore their own self interest in making decisions; in other words people do not behave altruistically. It is a relatively new approach to analysing decision-making which provides a framework within which the political and behavioural aspects of decision-making can be considered as part of the decision making process. The theory is therefore positive rather than normative as it seeks to understand and explain what happens in practice rather than seeking to prescribe what ought to happen. It recognises that the manager is an agent of the owners of the firm, whose actions the management accounting system seeks to influence.

Under Agency Theory both principal and agent are assumed to be rational economic persons: in other words they know what they are doing and they act consistently and rationally. They are both assumed to be motivated by self-interest alone, although the theory recognises that they possess different preferences, beliefs and information. Agency Theory provides a means of establishing a contract between the principal and the agent which will lead to optimal performance by the agent on behalf of the principal. The most important aspect is that information is not evenly distributed between managers and owners. This problem is known as 'information asymmetry' and has two separate, though related elements: moral hazard and adverse selection.

8.5.1 Moral hazard

Moral hazard arises where it is difficult or costly for owners to observe or infer the amount of effort exerted by managers. In such a situation, there is an inevitable temptation for managers to avoid working to the terms of the agreed employment contract, since owners are unable to assess the 'true picture'. Managers may also have the incentive as well as the means to conceal the 'true picture' by misrepresenting the actual outcomes reported to the owners. Accounting provides one such means for misrepresentation through its ability to represent outcomes from any course of action in more than one way.

8.5.2 Adverse selection

Whereas moral hazard relates to the 'post-decision' consequences of information asymmetry, adverse selection is concerned with the 'pre-decision' situation. Since all the information that is available to the manager at the time a decision is made is not also available to the owner, then the owner cannot be sure that the manager made the right decision in the circumstances. In addition, the manager has no incentive to reveal what he knows since this will then make it easier for the principal to properly assess his actions in the future. This is known as 'information impactedness'.

The existence of 'information asymmetry' means that for owners to obtain relevant information concerning the manager's effort, they must either rely on the communications received from the managers themselves, or must incur monitoring costs. An example of monitoring costs would include the annual audit of the firm's financial statements; indeed such auditing of financial statements was instituted as a means of safeguarding such investments in firms made by those who had no part in the operational activity of the firm. In the context of the agency relationship between top management and divisional management, such monitoring costs would include the cost of employing head office staff to monitor the performance of divisions.

8.6 Conclusions concerning the theory

The theory devises many ways to overcome these problems but these are specialist and beyond the scope of this book. Agency Theory has been developed from the Organisational Failure Framework of Williamson. It seems to offer some pointers as to how firms can be managed better but has problems as far as practical application is concerned. It is based upon one key assumption – that every party to a transaction acts in a rational manner in order to maximise his / her utility. This assumes of course that the evaluation of utility undertaken by every individual can be precisely calculated and thus that the same decision would always be made by the same individual in exactly the same set of circumstances. Nevertheless it helps us to understand corporate behaviour.

8.7 Rating Agencies

A rating agency is a company that devises credit rating – assessments of the risk involved – for various financial instruments and their issuers. In some cases, the servicers of the underlying debt are also given ratings. In most cases, the issuers of such securities are companies, state and local governments, not-for-profit organisations and NGOs or national governments issuing debt-like securities (eg bonds) that can be traded on a secondary market. A credit rating for an issuer takes into consideration the issuer's credit worthiness (i.e., its ability to pay back the loan), and affects the rate of interest applied to the particular security being issued. In theory the role of the rating agency is to provide an impartial assessment – based upon their expertise and research – to potential lenders in order to compensate for the inevitable information asymmetry between borrower and lender.

The recent failures of such agencies has been well documented. Too often they gave high ratings to bonds that subsequently defaulted. Their investment grade ratings of many sub-prime mortgage-backed securities were a primary cause of the recent crisis. Such faulty assessments have allowed companies to raise capital that they later wasted while denying more deserving companies capital they could have used to create jobs. The losses borne by bond investors have been huge and the government has absorbed many of these losses to prevent the total collapse of the financial system. More recently they have been overcompensating for their rash assessments by downgrading – to an extreme extent – their assessed creditworthiness of governments and causing yet more financial chaos.

A credit rating is a statement about the future. An investment grade rating should indicate that a bond is unlikely to default. Since the future is unpredictable, some investment grade bonds will default. However, defaults should be uncommon. Rating agencies have been criticised for having too close a relationship with company management, possibly opening themselves to undue influence or the vulnerability of being misled. Also information about ratings changes from the larger agencies spreads quickly so they charge debt issuers, rather than investors, for their ratings. This has led to accusations that these agencies are plagued by conflicts of interest that might inhibit them from providing accurate and honest ratings.

At the same time, the largest agencies (Moody's and Standard & Poor's) are often seen as agents of market forces, that drive companies to consider how a proposed activity might affect their credit rating, possibly at the expense of employees, the environment, or long-term research and development. The lowering of a credit score by an agency can create a vicious cycle, as not only interest rates for that company would go up, but other contracts with financial institutions may be affected adversely, causing an increase in expenses and ensuing decrease in credit worthiness. This happens to countries also which is another cause of economic crisis, or prevention of economic recovery. Sadly these agencies have a track record of not just over rating securities and their lenders in the first instance but overcompensating in downgrading as a reaction. So their actual role in compensating for information asymmetry has been shown to be somewhat questionable.

8.8 Regulation

Economic theory has suggested that competition and free market forces are the preferable environment within which economic entities and industries should operate. The reason for this is that competitive forces provide incentives for economic efficiency and equitable distribution. If market forces are expected not to be capable of providing the correct incentives to the companies there is a need for government intervention. This is known as regulation which is used as a substitute for the missing market forces. The purpose of such regulation is to ensure that no party is able to exploit their unequal position for gain and to ensure that efficiency incentives and equitable distribution are achieved.

Often the method of regulation which has been accepted is that of self regulation – with an industry effectively policing its members. Sometimes, as with the auditing industry, this has proved to be ineffective and external regulators have been appointed. Each regulator has the role of addressing and balancing up the needs of the various stakeholders of their respective industry. The stakeholders of regulated industries or markets include the press, customers and their pressure groups, shareholders, City analysts, and the government. Each of the stakeholders is interested in a different aspect of performance and so views the performance of the industry from a different perspective (Crowther 1996) in order to reach different conclusions. From this list of stakeholders the prime concern has been with addressing the needs of the two dominant stakeholders: shareholders and customers.

Within Western capitalist societies the emphasis is very much on companies providing returns to the shareholders and therefore they are a dominant stakeholder. In the case of the regulated industries the regulators have also been given the task of protecting the customers who would otherwise be 'gouged' by monopoly abuses (Veljanovski, 1991). In terms of customers the prime focus is upon domestic customers, possibly because these are the most numerous and in the weakest bargaining position, or possibly because these are the people who will vote for a government (which appoints the regulator) in the next election. 'Sliding scale' regulation is more specifically oriented to the idea of ensuring consumers are not abused at the expense of shareholders. It allows greater returns to shareholders only if consumer prices are reduced (National Consumer Council, 1989). This form of regulation was popular in the UK at the start of this century and has attracted interest recently as it has been suggested that other forms of regulation fail to deliver an equitable distribution.

8.9 The 2008 financial crisis

The recent financial crisis, much as previous ones, has highlighted failures in governance and failures in regulation. Indeed some writers, in their desire for scapegoating, have argued that the regulators are more guilty even than the perpetrators and should be sanctioned accordingly. There is of course one flaw in this argument and one problem with managing the prevention of future financial crisis (Grabel 2003) and this is concerned with the recognition of and regulation of a truly global market for finance. The liberalisation of financial markets instigated by the Washington consensus has made the free movement of funds a fact of financial life and has encouraged the parcelling together of doubtful debts into mystery parcels to be sold around the world[24]. And of course the operators in all financial markets, always ready to accept a gamble in the hope of ever larger profits and bonuses have been quick to respond.

Regulators inevitably, according to their founders, must focus upon a local market while finance escapes them through its ability to migrate around the world. Effectively this means that any realistic form of regulation does not and cannot exist (Becker & Westbrook 1998). One consequence of this regulatory failure of course is that contamination spreads and the dubious practices developed in one financial market become the norm in other markets. When the inevitable crisis appears this too spreads from one country to another as all economies are affected by both the consequences of dubious lending practices and by the ensuing crisis of confidence. This calls attention to the fact – recognised but mostly ignored in the financial models used to legitimate financial activity – that the financial market is a global market and a corollary of this is that any regulatory regime must also be global. Therefore we highlight the problems with the current regime and argue that perhaps a global regulatory authority capable of sanctioning even the most powerful actors in the market, including national and transnational governments, is necessary in the current global environment (see Chapter 10).

8.10 Failures in regulation

One thing which is apparent is that the current financial crisis, much as previous ones, has highlighted failures in regulation just as much as failures in governance. Indeed this has been a focus of much attention and some have argued that the regulators are more culpable even than the perpetrators and should be sanctioned accordingly. Equally of course it is the function of government, in Lockean (1690) tradition to implement the Social Contract (Rousseau 1762) and introduce regulation to curb the exercise of power and to protect the less powerful for a better operation of the markets. Clearly this has not worked – not because the principle is flawed but because economic reality has changed, encouraged by the Washington consensus and fostered by such people as Gordon Brown, former Prime Minister of the UK.[25] Indeed many people hold the policies of Brown, in relaxing regulation to impotence in order to encourage banks into the UK as being a prime cause of the ensuing financial crisis regarded as inevitable by many. The situation could be regarded as a house of cards ready to collapse at the slightest breeze. Inevitably this breeze did arrive in the form of the sub-prime lending scandal in the US! From this the contamination spread from one country to another as all economies are affected by both the consequences of dubious lending practices and by the ensuing crisis of confidence.

So it is wrong to single out regulators for blame. Their overseers must accept responsibility for encouraging profligacy. The crisis is of course made much worse by bank lending policy and financial profligacy,[26] with bank lenders being secure in the expectation that there was no risk because governments would step in to rescue them[27] from dire consequences of their irresponsibility. Indeed the government bodies – with press complicity – have sought to disguise the fact that such lending has been completely irresponsible by falling back on semiotics to create the term toxic debt to disguise the reality of complete irresponsibility bordering on lunacy. The language being used from these people tends therefore to be used as a device for corrupting thought (Orwell 1970) by being used as an instrument to prevent thought about the various alternative realities of bank lending policy.

The role of regulation is essentially to compensate for the inefficiencies and inequities of the market place. In other words it is to ensure that everyone gets a more fair chance in transacting with each other while seeking to minimise the costs of doing so. Unfortunately the transaction cost minimisation imperative has assumed superordinacy at the expense of fairness. This is a part of the problem. The main part of the problem however is one which no-one seems to be addressing – or even recognising. This is that the market based model of economic activity is a combative one – one in which the winner takes all is the basis for behaviour. This has led to the kind of recklessness which we have witnessed and which has led directly to the crisis.

8.11 Conclusions

The issues we have discussed in this chapter are important for the governance of companies. They are also controversial as there is a general agreement about some of the problems but no general agreement about possible solutions. Nevertheless these issues affect many aspects of governance which are referred to in other chapters of this book.

8.12 References

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8.14 Self-test questions

1. What is meant by information asymmetry?
2. What is the main purpose of audit and how does the Audit Committee help this purpose?
3. How do rating agencies help to solve information asymmetry?
4. What is the purpose of regulation?
5. What is the difference between moral hazard and adverse selection?