How US and UK Auditing Practices Became Muddled to Muddle Corporate Governance Principles

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ABSTRACT

This paper considers how auditing practices became muddled in the US and the UK to create muddled corporate governance principles. The US 1933 law that required corporations to appoint an auditor was based on the prospectus provisions in the UK 1929 Companies Act to protect investors from fraud. However, this is not the purpose of UK statutory audits whose legal role is to protect the company and provide shareholders with intelligence for voting on the election and remuneration of directors whether or not the company issues shares or whether it has shares publicly traded. The UK statutory auditor only reports to the shareholders who approve his appointment and remuneration. The US auditor is appointed by the directors and reports to both directors and shareholders to subrogate the reason for having an auditor to identify conflicts between them.

The establishment of an audit committee with independent directors cannot remove the conflicts. These are exacerbated by the Sarbanes-Oxley Act and the UK Combined Code that require audit committees to provide oversight of the auditor. Some European countries avoid these conflicts by having the auditor controlled by a shareholder committee or "watchdog board". Audit practices were muddled by corporations not establishing a shareholder audit committee as provided in the model constitution attached to the UK 1862 Companies Act. There are compelling arguments to conclude that convergence of audit practices on those found currently in the US or UK are not in the best interest of directors or auditors in reducing their conflicts or safeguarding investors, the proprietary rights of shareholders or self-governance.

Key words: Audit Committees, Auditing, Audit Standards, Corporate Governance, Conflicts, Cross border, Shareholder panel, Watchdog boards

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1.0 Introduction

This paper considers how auditing practices became muddled in the US and the UK to create muddled corporate governance principles. While the purpose of the US audit is to protect investors from fraud, the legal role of UK annual statutory audits is to carry out a governance role for shareholders. This role can also be used to protect investors.

The practice of auditing can be traced back to trusted persons being appointed to report on the stewardship of city officers in British medieval towns, cities and municipalities or the servants of Kings and their Lords. The audit function was also carried out by the owners' representative on the sailing ships of early trading companies. In these situations one agent of the Principal would be checking upon another agent of the same Principal. A practice that can be traced back to the Roman Senate appointing two Consuls is adopted today by requiring two individuals to execute the launch of nuclear weapons.

International trading provided the context for developing corporate concepts in England (Turnbull 2003b). The incentive for the English Sovereign to grant a Royal Charter to form a company was to privatize the cost of colonizing foreign lands and to raise revenues by obtaining a share or "royalty" of the goods traded[2]. Stock control was achieved by all the goods of a returning ship being publicly auctioned from a royally guarded bond store located on the dock next to the ship. The ship was also auctioned to a successor trading syndicate or venture to crystallize all residual values. These processes simplified the auditing of revenue sharing as might be specified in the charter instrument.

As a result of the collapse of the South Sea Bubble company the English Parliament made it illegal in 1720 for more than 20 persons to become associated in a business venture without obtaining a Royal Charter or an Act of Parliament. This forced business associations to incorporate and be subject to statutory audits during the 19th and 20th centuries. During this time self-enforcing corporate concepts developed in continental Europe from deeds of association established under common law rather than by statute law[3].

When the UK Parliament introduced the facility for citizens to incorporate without a Royal Charter or special act of Parliament in 1844, the need for a "statutory audit" was included. More than one auditor could be appointed and he did not have to be an accountant. The salary of the auditors was determined by the Commissioners of the Treasury and became a charge upon the company. The UK 1845 Companies Clauses Act authorized elected auditors to hire accountants (O'Connor 2004: 14). The audited accounts and balance sheet being filed for public inspection at the government Registrar of Joint Stock Companies. The UK 1856 Joint Stock Companies Act added the provision for 20% of

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[2] Another incentive was to avoid Protestant English trading ventures fighting among themselves instead of against the Catholics who the Pope had given exclusive rights to trade internationally. The division of world trading and colonizing rights by the Pope to only Spain and Portugal in 1494 was a contributing factor for Henry VIII to establish a separate church in the 16th century. In a similar manner the hegemony of English companies over the economies of US colonies in the 18th century contributed to them fighting for their political independence.

[3] A two tiered board was created by lead investors forming a supervisory board so that directors could avoid personal liability by not becoming involved in management of the business in the same way investors in limited liability partnerships are protected from business liabilities. To provide an exit for minority investors and/or to change management, deeds of association terminated at a set time to require the establishment of a new deed if the business was to continue. US States also had political reasons for adopting "sun-set" provisions as noted in the text. To protect management from the liabilities of the enterprise the deeds of common law associations would require the business to be wound up and/or be recapitalized when shareholders funds became depleted by predetermined degree.

stock holders by number and value to request a government inspector to examine the affairs of the company. This provided protection for minority investors at a time when family control was prevalent. The idea that governments or stock exchanges should appoint auditors has been recently proposed, and is discussed in Section 4 (Alternative Auditing Practices).

The US audit was modeled on the UK 1929 prospectus audits commissioned by directors to inform investors in acquiring new share issues (O'Connor 2004: 51). Unlike a prospectus audit, a UK annual statutory audit is not directly concerned with share value. UK statutory audits are required for companies that do not issue shares or do not have their shares publicly traded. In the US, audits are only required for companies that have their shares publicly traded. A governance role has little relevance in the US as shareholders accept restricted powers. Dallas (1988: 87) points out that "While shareholders have the right to elect directors, which presumably they want to do, no provision is made under state law for nomination" of directors.

The legal role of a UK audit is to counter any self-serving presentation in the accounts to provide a basis for shareholder/members, to exercise their governance rights in determining the appointment, remuneration, retirement of directors and any other matters that requires their vote. The ability of UK auditors to protect investors arises from their obligation to attest that the accounts are true and fair. However, auditing standards do not require identification of self-serving valuations, judgments and other treatments on which the accounts are based. As a result they fail to provide a basis for meeting the statutory reason for having an audit in the UK and other countries like Australia, Canada (except Quebec), India, Ireland, Hong Kong, Malaysia, New Zealand and South Africa (Bush 2004).

Under UK law, shareholders are also referred to as "members" of the company. Companies may be formed without issuing shares with their liabilities limited by the guarantee of their members. Companies limited by guarantee are used to incorporate not-for-profit enterprises like schools, hospitals and professional associations. As the company does not issue securities it can advertise for members without a prospectus. The guarantee of members may only be of nominal value and in many professional associations the annual membership fee is commonly much higher than the contingent liability of an individual member to guarantee the liabilities of the company.

The US auditor is appointed by the directors and reports to both the directors and shareholders. As pointed out by O'Connor (2004: 3): "Agents cannot successfully serve two principals with potentially adverse interests. The concept of 'auditor independence', and the labyrinth rules promulgated to try to define and enforce it, have arisen as a major issue primarily because of this legally mandated divided allegiance of auditors". The OECD (2004: 22) perpetuates this conflict of interest for both auditors and directors by stating that the auditor should report to both "the board and shareholders". An auditor is appointed because there can be conflicts of interest between "the board and shareholders".

The Sarbanes-Oxley Act (SOX) has enshrined in its Statute the cause of the problem it was supposed to eliminate and so has introduced, in the words of Romano (2004), "quack corporate governance". The Act relies on what it defines as "independent" directors to manage their legally mandated conflict of interest between shareholders or investors. However, this in turn introduces a conflict of interest between executives and non-non executive directors when a check on management is most required. As documented by Romano (2004) the research literature does not provide compelling evidence that the integrity of audits is improved by the appointment of "independent" directors.

UK auditors are appointed by shareholders and report to shareholders and so in theory avoid the conflict of the Auditor being accountable to two different constituencies. However, in practice the directors and auditors also have a conflict of interest because directors are required to manage the auditor on behalf of the shareholders. This conflict is ignored and so exacerbated by the UK Combined Code on Corporate Governance (Code 2003).

The auditing conflicts in the US and the UK are avoided in some European countries where the auditor is appointed by shareholders, reports to shareholders and is controlled by a shareholder panel or "watchdog board". This arrangement was part of the UK Company Clauses Act of 1845 and provided for in a model constitution attached to the UK 1862 companies Act (O'Connor 2004: 17). Auditing practices in the UK and the US got muddled when corporate constitutions did not establish a *shareholder* audit committee.

In the following Second section the history of US auditing practices is outlined and how the US diverged from the UK practice and most other places around the world. The third Section considers the inconsistencies and conflicts in UK audit practices. The fourth Section considers suggestions put forward by UK and US scholars and investors to overcome problems in their respective jurisdictions. Also identified are arrangements found in Europe that reduce or eliminate conflicts for auditors and directors.

The paper concludes that international convergence of corporate governance practices based on current US or UK audit practices would be counter productive in reducing auditor and director conflicts or for furthering investor protection, the proprietary rights of shareholders or self-governance.

A fundamental difference between the US and the UK is that Parliament in the UK determines company law while Congress does not as discussed in the next Section.

2.0 Historical outline of US auditing practices

The US constitution reserved for the States the power to create and manage corporations. Such was the concern after the war of independence that corporations might be used by foreigners to control local economies. The constitutions of some States would not allow their legislatures to grant a corporate charter without a citizen plebiscite (Grossman and Adams 1993: 8). Many States limited the life of corporate charters and withdrew the charter if the enterprise created "harms" or entered into activities for which it was not authorized. "Delaware voters passed a constitutional amendment in 1831 limiting all corporate charters to twenty years", (Grossman and Adams 1993: 12).

Up until the mid 19th century, US corporations were in effect audited directly by citizens and regulated by State legislatures. This was at a time when directors were elected on a democratic one vote per investor basis rather than by a plutocratic one vote per share. The New Jersey Supreme Court ruled in 1834 that corporate constitutions with one vote per share were illegal (Dunlavy 1998).

The tight local democratic supervision and regulation of corporations was cast aside by the growth and influence of giant enterprises that emerged at the end of the 19th century. According to Friedman (1973) "they bought and sold governments". By 1886, the Supreme Court of the US gave corporations the same rights as citizens under the constitution. States competed with each other to introduce more and more liberal conditions for corporations to obtain charters and to operate. This created a "Race to

the Bottom" in corporate de-regulation (O'Connor 2004: 30). The result was that by the beginning of the 20th century, few States required corporations to present accounts so there was no need for auditors to be appointed.

However, during the boom from 1925–1929 almost 70% of corporations quoted on the New Stock Exchange had agreements to provide annual or quarterly reports to stock holders with 25% of listed firms providing both annual and quarterly reports. As a reaction to the Wall Street crash of 1929, competition for creditability significantly improved the situation. By 1933, "all of the 1157 listed firms provided annual reports, 60 percent also provided quarterly reports, and 85 percent underwent annual audits by CPAs with the results made publicly available" (O'Connor 2004: 40). O'Connor states that this "rapid rise in the use of audited statements may have been mainly a marketing ploy, or more generously, a quality signaling best practice, to attract investors in a quickly crowding field of issuance". But the incentive to appoint Auditors may have also been encouraged by their ability to provide a check on management to protect the interests of directors.

At a time when many States did not require companies to publish accounts and so have auditors; audit committees were developed by directors to protect them rather than shareholders or investors. As reported by Guthrie and Turnbull (1995), financiers commonly requested directors to sign "negative pledges" when advancing funds to a US company early in the 20th century. Like shareholder agreements with contemporary venture capitalists these pledges required that management did not spend funds on excessive remuneration, loans to officers, investments not approved by the financier and so on. The directors became personally liable for the loan only if the pledges were not honored. This provided a compelling incentive for NEDs to meet separately with the auditor to check on how corporate funds were applied.

The incentive for establishing audit committees had nothing to do with how they are used to today to oversee how the financial statements are presented to shareholders or investors. The auditor simply had to follow the money trail to protect the directors who were his client. The auditor did not make judgments on the timing of recognizing income or expenses, or the value of liabilities and assets, or which accounting policies to adopt.

The Securities Act of 1933 introduced Federal regulation only as permitted by the US constitution. Congress could only regulate securities issued or traded between States. The aim of the 1933 Act was to prevent fraud from the issue of securities to interstate investors. This forced disclosure that could also be used by intrastate investors[4].

The 1933 US Act required companies to lodge a registration statement with their accounts audited by an independent public or certified accountant. The Act was modeled on the prospectus provisions of the UK 1929 companies Act. These provisions did not require a balance sheet, only a "certified profit and loss statement" for the previous three years (O'Connor 2004: 51). UK prospectus information is concerned with the economic performance of the company. This is different from the legal role for UK statutory audits which is to carry out a governance role as discussed in the following Section.

[4] The constitutions of Canada and Australia have similar provisions as the US. National corporate law only became possible in Australia by each State and Territory delegating their corporate powers to the Federal government in 1991. A description of the process of Australia consolidating State Laws nationally is provided at <http://www.law-bridge.net/english/e-art1.htm>.

A prospectus may be described in the UK as an "Investment Circular". It presents a one time window into the economic history and prospects of a company. The independent accountants report is commissioned by and addressed to the directors. If the securities are being listed it is also addressed to the broker/advisor to the issue[5]. This is different from annual statutory accounts where the auditor is appointed by shareholders and reports to shareholders – except for the first accounts issued by a company when it is the directors who appoint the auditor.

The requirements for audited accounts for newly issued shares in the US 1933 Act was carried over into the US 1934 Act for the interstate sale of existing shares. The 1934 Act was introduced to regulate stock exchanges and *secondary* exchanges of corporate securities. This explains how the auditing of annual accounts in the US adopted UK prospectus audit practices that are not used in the UK for annual statutory accounts.

O'Connor (2004: 61) reports that the US 1933 Act "left it open as to who would hire and set compensation for the auditors. This responsibility fell to management and/or the board of directors ─ the very parties whom the auditors were supposed to be checking upon!" O'Connor (2004: 59) points out that the Securities and Exchange Commission (SEC) then had:

> to make sure the accountant-as-auditor was independent of the client, so as to be able to render an objective and accurate opinion, became ever more difficult. The result was a labyrinth compendium of principle, rules, interpretations, and no-action letters whose sole constant feature seemed to be change. The most recent revision to this bramble bush is the auditor independence provisions of the Sarbanes-Oxley Act of 2002.

O'Connor (2004: 60) states that "the problem of auditor independence was created by the federal securities laws: initially, through the statutory audit provision for prospectuses in the '33 Act, and then exacerbated by the *de facto* extension of this audit to an annual requirement under the '34 Act". O'Connor (2004: 62) observed:

> Thus, the American accountant/auditor is placed in the untenable position of the agent serving many masters with conflicting interests. In such an imbroglio, is it any wonder that the group who hires, fires, and sets compensation for the auditor becomes the *de facto* client? Over time, laudable efforts to establish protections such as audit committees of company boards that would insulate auditors from the direct influence of management have been instituted. But these still fail to take the simple step of pushing control of the audit relationship back to shareholders where it belongs.

Rather than remove the conflicts of interest for auditors and directors created by the SEC mandated rules, SOX has exacerbated the problem by enshrining them in the Statute. As stated by Romano, (2004): "The learning of the literature, which was available when Congress was legislating, is that SOX's corporate governance provisions were ill-conceived. The political environment explains why Congress would enact legislation with such mismatched means and ends." The intrinsically flawed US auditing architecture is being adopted by companies registered in other countries who are seeking to have their securities traded in the US.

There are a number of other reasons why other countries are being encouraged to enshrine the US audit practices in their own economies. First, the US is seen as the prime role model for other market economies to emulate. Second, as noted earlier, the OECD Corporate Governance Principles follow US practice. Third, corporate governance rating agencies typically base their metrics on OECD like

[5] Refer to the UK Auditing Practices Board requirements for "Investment Circulars and Reporting Accountants" at <http://www.asb.org.uk/images/uploaded/documents/SIR_100.pdf>.

principles and this creates market forces for corporations outside the US to adopt US practices. Fourth, the size and influence of US markets provides practical incentives to follow the US model. Fifth, the World Bank, IMF, international and bi-lateral finance and aid agencies proselytize and encourage so called "good governance" using the US and/or OECD[6] Principles. The sixth and most insidious influence is that of the big international accounting firms. The US remains their most important client base. It is understandable that they assume that the US approach represents the most creditable, relevant and advanced development of audit practices. Indeed, as noted by Hatherly (1995: 504) there is a belief that existing practices "represent the natural order of things" to provide a basis for insinuating US practices around the globe.

It comes as a surprise to many governance commentators, that US laws, regulations and stock exchange listing rules provide inferior protection for minority shareholders and investors than that provided in other much less influential countries. The management friendly US jurisdictions provides an incentive for foreign multinational corporations to move their domicile to the US in the same way US companies raced to the bottom to change their domicile to Delaware. According to Bush (2004) "The State of Delaware creates no framework for public financial reporting".

The ability of Delaware registered corporations to facilitate continued family control and/or allow a family control block to be disposed of, without providing adequate protection for minority shareholders, provides one explanation of why Australian registered News Corporations Limited moved its registered domicile in November 2004 to Delaware.

The Australian Audit regime, like those of other former British colonies is very similar to that found in the UK (Bush 2004). Notwithstanding the suggestion by O'Connor (2004) that the UK system has advantages over the US audit regime, governance practices in the UK create conflicts of interests for auditors and directors that are considered in the next Section.

3.0 UK auditing practices

The legal role of the UK audit was articulated in a case considered in the House of Lords in 1990 between Caparo Industries Plc (Caparo) and Dickman, the auditor of Fidelity Industries Plc (Fidelity). Caparo (1990) acquired all the shares in Fidelity in late 1984 relying on information in the audited accounts sent to shareholders. Caparo alleged that the audited accounts of Fidelity should have reported a loss rather than a profit. However, Caparo lost the case on appeal as the Law Lords considered that the audit carried out a governance role rather than an economic one.

The principles developed by the case were summarized in Appendix 6 of FACG (1992: 81) that stated:

> The case has established that in the absence of special features, auditors are not regarded as owing a duty of care to prevent loss to anyone relying on their report except (a) the company, and (b) the shareholders as a body. In the absence of special features, no duty of care is owed in particular to-individual shareholders,

[6] A critique of the OECD Corporate Governance Principles prepared by the author is posted in The Corporate Library, at <http://www.thecorporatelibrary.com/special/turnbull/Turnbull-OECDfailure.pdf>. The critique is based on a submission published by the OECD at <http://www.oecd.org/dataoecd/38/22/27211386.pdf>. Alternative "Self-enforcing Corporate Governance Principles" are posted for discussion by members of the European Corporate Governance Institute at <http://f4.grp.yahoofs.com/v1/cOJ6QWcDM6yAen7T-jZjiWeIjbgUyivoWpWznrVC_QiVb-3HaXW71R1MVVdOsNXwwMcLxHhWJ1saPVSRC7hkiZqXw8rdErM_eLJK/Self-enforceing%20Principles/Draft%20Principals%20Sept%2013%2C%202004.doc>.

> subscribers to new shares, purchasers or intended purchasers of shares from third parties including those conducting takeover bids, bankers or other lenders to the company, or persons doing business with the company.

The arguments put forward by the Law Lords would have little relevance for corporations registered in jurisdictions that did not make it practical for shareholders to hold directors accountable for their stewardship such as found in the State of Delaware (Bush 2004; Dallas 1997). Lord Justice Oliver (Caparo 1990: 16) in his judgment asked the rhetorical question as to what is the purpose of holding an annual meeting and what is the purpose of the directors presenting accounts and having them audited. He answered these questions by pointing out that:

> This is the only occasion in each year upon which the general body of shareholders is given the opportunity to consider, to criticise and to comment upon the conduct by the board of the company's affairs, to vote upon the directors' recommendation as to dividends, to approve or disapprove the directors' remuneration and, if thought desirable, to remove and replace all or any of the directors. It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

To counter the argument that the purpose of the audit was to inform investors of the economic value of the company Lord Oliver (Caparo 1990: 17) went on to say:

> I find it difficult to believe, however, that the legislature, in enacting provisions clearly aimed primarily at the protection of the company and its informed control by the body of its proprietors, can have been inspired also by consideration for the public at large and investors in the market in particular.

The view of Lord Oliver in providing shareholders with “reliable intelligence for the purpose of enabling them to scrutinize the conduct of the company’s affairs” was supported by Lord Bridge who quotes a 1896 judgment on the role of the auditor in that there is, “No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them” (Caparo 1990: 11). However, because corporations have not established a *shareholder* audit committee as set out in the model corporate constitution attached to the UK Joint Stock Company Act of 1862 Auditors now treat the directors and the company as their client rather than the shareholders. This was noted by Lord Bridge who stated:

> In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client (Caparo 1990: 12).

This explains how UK audit practices got muddled.

As the auditor in the UK is appointed by shareholders to report to shareholders, conflicts of interests are introduced when the auditor is controlled by the directors and remunerated by the company. The facts of the situation described by Lord Bridge is quite different from those that applied to the UK Joint Stock Companies Act of 1844 referred to earlier when the auditor was required to be a shareholder and was paid by the “Commissioners of the Treasury” (O’Connor 2004: 14).

There is considerable latitude in the corporate laws of the US, UK and many other countries around the world, to allow shareholders to determine how much power they delegate to directors in the corporate constitution that they adopt. Stock exchange listing rules and/or regulators could provide a basis for initiating the most appropriate or consistent changes.

The constitutions of publicly traded corporations in the US and the UK provide directors with what Monks and Sykes (2002: 12) describe as "inappropriate powers" that create conflicts of interests for directors and the auditors. Introducing so called "independent" directors and audit committees cannot remove the structural conflicts built into corporate constitutions. When executive fraud is suspected by the auditor, independent directors become subject to a conflict of loyalty with the executive directors on who they may depend upon for their board position and remuneration. But as pointed out Hatherly (1995: 536) there is "no explicit statutory duty for the auditors to report to members on the state of internal control, whether the company is a going concern, or on fraudulent or illegal activity except where these matters impact on the true and fair view given in the financial statements".

The establishment of audit committees in either the US or the UK can exacerbate conflicts. This is because audit committees provide a more intimate and frequent basis for bonding the external auditor to the directors rather than to the shareholders who use the information. The opportunity for greater interaction between the auditor and the directors is recommended by the FACG report that states that "The external auditor should normally attend audit committee meetings, as should the finance director" (FACG 1992: 27). These provisions have been followed by the Code (2003: 20-21).

Bazerman, Morgan, and Loewenstein, (1997) identified five reasons why external audits fail that are relevant to either the US or the UK:

> First, the people who will be hurt by any misrepresentations are "statistical" – an auditor cannot identify them at the time the decision is made. People tend to be far less concerned about imposing harm on statistical victims than on known victims. Many people might lose a small amount of money, but it isn't clear who will. In contrast, the auditor is likely to be well acquainted with the people within the client firm who would be hurt by a negative opinion on the audit.
>
> Second, the negative consequence on a negative opinion are likely to be immediate –loss of a client's friendship, potential loss of the contract, and possible unemployment – whereas the effects of positive report when a negative report was appropriate are likely to be down played because they are delayed.
>
> Third, auditors form an ongoing relationship with the organizations they audit, and any deterioration in the audited company is likely to unfold gradually. Auditor may unknowingly adapt to small imperfections in the company's financial practices.
>
> Fourth, financial reporting standards are often flexible or ambiguous, so it may be easy for an auditor to rationalize a judgment that is consistent with self-interest rather with the interest of the users.
>
> Fifth, people have a remarkable ability to mislead themselves about the nature of trade-offs, to rationalize to themselves and others the accuracy of their biased judgments.

The analysis of Bazerman, Morgan, and Loewenstein, (1997) has since been validated by experiments reported by Bazerman, Loewenstein, and Moore, (2002)

In the context of the UK where companies are governed by single or "unitary" board, like they are in the US, it is impractical for shareholders to manage and pay the auditor so directors are forced to act as the agent for shareholders in this regard. As the role of the auditor is to act "antagonistically" this creates a fundamental conflict of interest for the auditor. In addition, even the most ethical and conscientious director is placed in the position of exerting power over the auditor and so perceived to be in a conflict of interest situation that corporate constitutions and the law generally require directors to avoid.

While many people, including some scholars, consider that directors always act as agents for the shareholders this is not their normal legal relationship. Directors are Principals of the company not its agents. They are the mind and soul of the company. The confusion arises because Directors are elected by, and are accountable to shareholders, but their fiduciary duty is different being to the company as a whole. The legal entity that is the company is quite a different legal entity from any one shareholder or even all the shareholders as a whole.

Technically, managers become the agents of the company and so agents of the directors. However, as a practical matter, with widely dispersed shareholders, managers form "power coalitions" as described by Dallas (1988: 28) to co-opt directors to make them the agents of the managers!

But as pointed out by Bazerman and his various colleagues, auditors unconsciously and so unwittingly become agents of the directors. Directors become a "tool" of an internal coalition in which management is the "dominant coalition member" (Dallas 1988:29). Auditors then became agents of management to subrogate the very purpose of appointing auditors.

The more truly independent directors become the less likely they will possess company specific or industry specific knowledge and authority to question management. Indeed, the truly independent director will become the most susceptible to becoming a tool of management. In any event, the appointment of truly independent directors cannot remove the embedded conflicts of interests between directors and shareholders as established in corporate constitutions. The reason why auditors are appointed in either the UK or the US is because of this fundamental conflict. If conflicts did not arise then only internal auditors would be required. To avoid confronting this fundamental conflict of interest it is in the self-interest of accounting firms, their profession bodies and standard setters to encourage directors to use auditors as a check on management rather than a check on directors. This approach also facilitates members of accounting firms to join the boards of companies.

In the UK, auditors report to shareholders as a basis for making *all* directors accountable including any "independent" and/or members of the audit committee. This is because the legal role of a UK statutory audit is to counter any self-serving biases in the accounts to provide shareholders with "intelligence" on how to vote for the re-election, remuneration and dismissal of the directors or any other matter that requires their participation.

However, accounting and auditing standards focus on the economic role of the financial statements. Accounting standards are concerned with economic materiality not bias, or "permissible business puffery" that does not constitute fraud as accepted by the US Federal District Court of Eastern Virginia (Davis 2004). In countries that follow the UK system, accounting standards institutionalize the muddle. *For an audit to carry out a governance role, different accounting and auditing standards are required so that the auditor can report the degree that the accounts may be self-serving as well as being true and fair.*

Even with principled based accounting there are many options in how accounts are prepared. There are also many ways judgments can be biased in recognizing the time that income and expenses are recorded and the basis for valuing assets and liabilities as well as options in accounting treatments. A "governance audit" would identify how there might be bias in the core assumptions, judgments and practices that were used in attesting that the accounts were true and fair.

The need for companies to maximize shareholder wealth is widely quoted but this is not a requirement of the law as most companies are not publicly traded and they may be not for profit companies. The duty of directors is generally to act in the best interest of the company as a whole. A legal need to maximize shareholder wealth would then depend upon the corporate constitution specifying this as an objective, but this apparently is not generally specified. However, in jurisdictions like the UK where shareholders have the power to nominate and dismiss directors, there is a practical political need to maximize shareholder value so that directors can obtain shareholder support to get nominated, re-elected and remunerated by shareholders.

FACG (1992: 11) stated that the Caparo case exposed two widely held misconceptions:

> (a) that the audit report is a guarantee as to the accuracy of the accounts, and perhaps even as to the soundness of the company; (b) that anyone (including investors and creditors) can rely on the audit, not only in a general sense but also very specifically by being able to sue the auditors if they are negligent.

But FACG ignored the point that the purpose of appointing an external auditor is the potential conflict of interest between directors and shareholders. Also ignored was the point of Justice Lord Bridge that role of the Auditor is to act "antagonistically" to the directors. The denial of the existence of conflicts by FACG is supported by the fact that the word "conflict" is used only three times in the report on pages 19, 20, & 46. Even then the word is not used in relation to either NEDs or the relationship of the auditor to the Directors. With regard to executive directors, the report only recognized "potential conflicts" on page 20.

By ignoring what Monks & Sykes (2002: 12) describe as the "inappropriate powers" of a unitary board and their manifold intrinsic conflicts of interest identified by Turnbull (2000c), FACG (1992: 11) was able to state that "The basic system of corporate governance in Britain is Sound". This view was consistent with the stated aim of the report to "strengthen the unitary board system and increase its effectiveness, not replace it" (FACG 1992: 11). However, this objective was in conflict with a proposal at that time by the UK Auditing Practices Board for auditors to be controlled by a shareholder panel (Hatherly 1995: 538).

The conflict created by directors controlling the auditor is analogous to a university (shareholders) allowing students (directors) to nominate, manage and remunerate the examiner appointed by the university/shareholders to examine the student/directors! Such a situation would be completely unacceptable in academe but astoundingly it is mostly accepted as the natural order of things in the world of business as illustrated by current laws, codes, accounting and auditing standards and governance practices.

The ability of directors to control the auditor is an "inappropriate power" in furthering the ability of an auditor to be independent of directors in either the US or the UK. Board Audit Committees do not change the power relationship and exacerbate the independence of auditors as noted above when they are used to control the external auditor. On the other hand, Audit Committees that are used to control the internal auditor provide a way to mediate the conflicts that are inherent in an employee of management reporting on the integrity of management. It is with internal auditing that Audit Committees can add value in reducing risk in financial communications, especially if the directors are supervised by a dominant shareholder.

FACG (1992: 58) recommended the adoption of audit committees as "Best Practice" in the UK. The recommendation was supported by pointing out that the New York Stock Exchange had mandated them in 1978 and the belief of the American Treadway Commission in 1987 that they increased the integrity of financial reports (FACG 1992: 26). Audit Committees that follow the US role of controlling the auditor are now specified in Sections C.3.2 and C.3.6 of the UK Combined Code (2003: 20/21).

This explains how UK auditing practices became muddled. It only makes sense for audit committees to appoint, remunerate and control internal auditors. Audit committees who also manage the external auditor exacerbate conflicts and muddle the role of external auditors. Bush (2004: 34) notes that NEDs may use external auditors to check on management when their role is to act for the shareholders to check on the directors. In any event, as noted by Hatherly (1995: 541) "Non-executive directors cannot be impartial towards accounting outcomes".

Hatherly (1995: 541), a former member of the UK/Ireland Auditing Practices Board states: "As a means of facilitating the current statutory role whereby the auditor is accountable to members, the audit committee is both conceptually unsound and practically difficult".

A former Audit Partner of one of the big four audit firms in the UK confirms this view by stating that:

> There are two fundamental problems with independent audit. The first is that it isn't independent at all. It is in reality – and, as things stand, inevitably –closely aligned with the company management. The second problem is that it is an uncompetitive market, dominated by four large firms" (Hayward 2003).

However, auditors can become independent of a unitary board when there is a dominant shareholder to select, appoint, remunerate and supervise the directors and how they control the auditor. The dominant shareholder becomes an informal supervisory board as found in a number of European jurisdictions. The presence of a dominant investor is a typical situation for most PTCs around the world as noted by Porta, Lopez-de-Silanes and Schleifer (1999).

Surprisingly this situation is also significant with the largest US corporations as reported by *The Economist* (2003) who stated: "Even in the United States, the founding family is an influential investor in more than one third of the Standard & Poor's 500 companies". While dominant shareholders can provide effective oversight of executives and protect the independence of the auditor from management it also means that a dominant investor can enter into related party transactions that disadvantage the company. Coffee (2005) reports a number of corporate failures arising from such activities.

Coffee (2005) notes that the presence of a dominant shareholder makes NEDs powerless and/or unwilling to prevent a dominant shareholder and/or dominant management expropriating value from the company. This is just the situation when investor protection is most required, a point not considered in the report by Higgs (2003) to the UK government on "The role and effectiveness of independent directors". In any event as pointed out, above the Caparo case makes the appointment of Independent directors irrelevant to audit quality. Their appointment is more likely to be counter productive according to the research finding by Bazerman, et al. cited above.

The UK Combined Code like SOX entrenches the conflicts of interests for auditors and directors. It requires companies to have an audit committee to make recommendations on the "appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor". It also requires the audit committee to both "develop and

implement policy on the engagement of the external auditor to supply non-audit services". Imagine the public outrage if students had this power over their examiners? The charter of some audit committees even gives them the power to determine "all audit engagement fees and programs as well as all non-audit engagements" (Telstra 2004: 172). Telstra[7] is publicly traded both in the US and Australia where it is registered under a legal system that is similar to the UK.

There is considerable difficulty in introducing reforms to the flawed US laws and the flawed codes, practices and habits of thinking in the UK and other jurisdictions that follow the practices of either.

The problem is reinforced by accounting and legal scholars[8] who ignore the conflicts of interest inherent in audit committees of companies governed by a unitary board. It goes against common sense that an auditor recommended by directors, managed and paid by them can be considered independent of them when checking their reports. The auditor "naturally, and rightly, regards the company as his client" as stated by Lord Justice Bridge (Caparo 1990: 12). Yet auditing standards set by accountants and accepted in law abuse both the English language and auditors by requiring that they attest in their reports that they are "independent".

Another problem in promoting reform is that the large international audit firms and many boutique governance advisers obtain significant consulting fees from promoting the current practices. This could make it difficult to charge fees for alternative and/or contrary advice.

An additional problem is the resistance in the US and the UK to move away from a unitary board. The irony is that the majority of publicly traded companies in the US and a substantial number in the UK are governed by what is in effect a two tiered board from the presence of a dominant shareholder or by a financier who has obtained governance powers through their loan agreement. Financiers typically obtain governance powers in a Leverage Buy-Out (LBO). The organising LBO Association that procures the funding acts like a supervisory board. Jensen (1993: 869) states that this represents "a proven model of governance structure". Strategic decisions and monitoring are carried out by the LBO Association with their decisions endorsed by the statutory board that becomes responsible for day to day operations.

The advantages of two and more tiered boards is that beside providing checks and balances they can reduce information overload, and what the economic literature refers to as "bounded rationality" (Williamson 1985: 5). The de-facto two tiered board created by a dominant active shareholder introduces a decomposition of decision making labour into strategic and operating decisions in a way analogous to that found in multidivisional firms (Williamson 1985: 279). It is the dominant

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[7] In a letter to the author of October 27, 2004, the Auditor General of the Commonwealth of Australia, in his capacity as the Auditor of the government controlled publicly traded Telstra Corporations Limited, responded to most of the 40 questions raised by the author on how he and Ernst & Young could properly carry out their duties. The letter is posted on the Telstra webpage at <http://www.telstra.com.au/communications/shareholder/docs/electronic_agm_questions.pdf>.

[8] The inherent conflict of interest of Directors controlling the Auditor was also ignored in the 2001 report commissioned by the Australian Government on the 'Independence of Australian Company Auditors' by a Melbourne University Law Professor. In Part 2, "Summary of recommendations", page 13 he states that "There can be no doubt that a well structured and well functioning audit committee can play a very important role in ensuring that the auditor is independent of the company" as reported at <http://cclsr.law.unimelb.edu.au/research-papers/audit-ind-report/audit-ind.html>. The statement compounds confusion by suggesting that directors are independent of the company when they are the Principals of the company

shareholder that controls the auditor, composition of the board, their remuneration, the appointment of the Chief Executive Officer and strategic decisions. The statutory board may implement these decisions but their main activity is concerned with operating performance and compliance.

Not-with-standing the institutional inertia to entertain a different approach to corporate governance reform, the fundamental problems in the existing system and its recent reforms is gaining wider recognition by scholars as noted above and more importantly by some influential investors. The National Association of Pension Funds (NAPF) which collectively own the majority of shares in UK PTCs, made a submission to the UK government in December 2004. *Accountancy Age* (2004) reported that: "In a letter to minister Jacqui Smith, NAPF recommends alternative arrangements be introduced for the appointment and oversight of auditors, such as using a shareholder panel or a regulator". This is consistent with the proposals of a number of scholars and commentators discussed in the next Section.

The fundamental conflict of interest in the Anglophone unitary board system of corporate governance requires removing from directors their "inappropriate powers" that Monks and Sykes (2002) stated "is thus the litmus test for any worthwhile reform of shareholder capitalism". This result can be achieved in a number of ways as is next considered.

4.0 Alternative Auditing practices

This section provides a brief review of some alternative audit arrangements for consideration. The literature on this topic is rapidly increasing with new approaches being proposed.

Six alternative arrangements were analyzed by Professor Hatherly (1995: 541). Three alternatives were dependent upon external agencies that he described as "Macro options" and three involved changes in the constitutional architecture of corporations that he described as "Micro options".

The Micro options were to have an Audit Committee accountable to directors, a Shareholder Panel accountable to shareholders and a Stakeholder Panel accountable to Stakeholders. The Macro options were a Stock Exchange Panel accountable to shareholders and an Audit Commission accountable to either stakeholders or the public interest. His recommendation was for a Shareholder Panel consistent with the proposals of Guthrie and Turnbull (1995), Murray (1998), Turnbull (2000a) and practices found in some European countries.

Dallas (1997), a legal scholar recommended the reform of US corporate boards by establishing a dual board with a board ombudsperson to remove or manage board conflicts of interests. A comparison of this proposal with that of the Corporate Governance Board proposed by Murray (1998), a Shareholder Panel and a "Corporate Senate" is presented in Turnbull (2003a).

Shapiro (2004) considered the US problem of "Dealing with two masters: The present dilemma of the 'independent auditor'" and analyzed three strategies for reform. His analysis was not based on the work of Hatherly (1995) and none of his three strategies considered a shareholder panel.

The first strategy was to have the government to appoint auditors. A Democratic Representative from Ohio introduced a Bill to establish a Federal Bureau Audits within the SEC in the spring of 2002 but this was rejected by Congress.

The second strategy was to improve the process of auditing. Four ideas were analyzed. One idea was to encourage a market for audit quality to create a 'race for the top' rather than a race to the bottom in providing a "loss leader" to gain consulting work from audit clients. Another idea was to adopt the "British Solution: Enforced Self-Regulation" by adopting principles based accounting to replace the detailed US GAAP. A third idea was "Raw Information Disclosure" to allow analysts to construct their own accounts and/or for users to "Hire your own Auditor". A fourth idea was related to the first to generate a "Market for Good Disclosure" by the company being audited.

Shapiro identified problems for all the above proposals and recommended a third strategy based on corporations purchasing Financial Statement Insurance (FSI). This proposal had been put forward by an accounting professor from New York University (Ronen 2003) and developed by Cunningham (2004), a legal scholar. Shareholders would be given the option to have the financial accounts insured against misstatement. The insurer would then hire the auditor rather than the directors and determine the scope and quality of the audit according to how much insurance was purchased. A crucial feature of this proposal is that the policy coverage amount and the premium cost of the corporation's FSI policy be made public. There are many details to consider, including if it could be made to work without it being mandated by the SEC.

The FSI proposal is based on the US concern for the audit to carry out an economic role of avoiding fraud in the interstate issuing or trading of shares. One question that needs to be considered for application in the UK is if it could also be used to carry out a governance role? This would seem questionable given the judgment made in the Federal Court of East Virginia on June 15, 2004 against a class action by shareholders of Cable & Wireless (C&W).

The judges threw out most of the class action led by the Ontario Teachers Pension Plan against the auditors that went along with C&W executives releasing misleading and inaccurate information in the audited accounts that amounted to what the court described as "permissible business puffery" or "mismanagement" (Davis 2004). This was because under US law auditors are accountable to the directors and so are not required to report incompetence that did not represent fraud! This is not withstanding C&W is registered in the UK where the auditors are accountable only to the shareholders.

The FIS proposal needs to be compared and evaluated with European audit practices that avoid the inherent conflicts found in the US and UK. There are many different arrangements in Europe to consider. Many European countries have a two tiered board with the auditor appointed by shareholders like in the UK. Shareholders appoint a supervisory board and this board then appoints a management board. In some larger German companies employees appoint representatives to the supervisory board. No individual can be on both boards so conflicts of interest and loyalty between members of the two boards are minimized or eliminated. In this way, two tiered board enhances the independence requirements over that provided by audit committees in the US or the UK. However, the conflict remains of the auditor being managed by directors, on behalf of the shareholders.

Conflicts between directors and auditors are removed with shareholders electing an audit committee to create a dual board as found in some European countries. Dual boards are both elected by shareholders while a two tiered board shareholders only elect on board that supervisors the executive board that they appoint. With a dual board, the secondary board carries out the role of a "shareholder panel" or "watchdog board". The arrangements may differ within a country. The corporate constitutions of French Insurance companies, Banks, and finance companies establish a *Censeurs* to check on financial

matters. As French companies have a supervisory board a three board structure is created. State owned French companies have a *Cour des comptes* to check and investigate financial matters. Other arrangements are described in Hungary by Lempert (2003), in Italy by Melis (2004), in Russia by Gitins (2002) and in Spain by Turnbull (1995).

The separately elected audit committee of Russian companies removes the inherent conflicts of interests in the US arrangements that SOX mandates and then tries to manage them. However, companies with such superior audit independence and integrity cannot meet the conditions of SOX. This is because SOX requires members of the audit committee to be directors. Members of an audit committee elected independently by shareholders to create a dual board are not directors and so do not meet the conditions of SOX (Gitins 2002). This indicates how US laws are forcing an international race to the bottom rather to the top in audit quality.

Different types of audits and different standards for audits are required in different situations. One size does not fit all. Different stakeholders have different interests and so may require financial reports prepared in different ways. Financiers and employees may wish to be advised on the market value of the net assets in case the business fails. Depositors in financial institutions are concerned with liquidity as well as net worth. Policy holders in insurance companies may need information on the long term viability of the company and re-insurance arrangements.

The inherent conflicts of interest in US and UK audit practices presented above should be of special concern to prudential regulators. Financial Statement Insurance might well be a useful approach for them to develop. However, the FSI approach may not be relevant to improving corporate governance or what the Caparo Law Lords described as the “proprietary” rights or ownership rights of shareholders to vote their shares to hold directors to account.

In researching material for this paper, one is overwhelmed with the plethora of codes of conduct, ethics, and professional behavior and so called “best practices”. Also by the many and varied detailed accounting and auditing standards, guidelines on internal control, independence of directors and corporate governance principles. They represent intrusive prescriptive complex band-aids that do not address the fundamental flaws of the dominant governance systems. What are required are some fundamental changes that introduce self-enforcing relationships as found in natural systems and in automated machinery and devices.

If the science of governance found in nature and used to design robotic machinery was applied to design the architecture of corporations, there would be little need for many of the laws, regulations and codes (Turnbull 2002). Self-regulation cannot be reliable without the introduction of a division of power to create checks and balances and interdependency between those who govern and those who are governed (Turnbull 1997). To minimize the role of government, corporations need to become more self-governing as demonstrated by sustainable employee owned enterprises (Turnbull 2000b).

The take home message is that every effort should be taken by countries around the world to resist the hegemony of the fundamentally flawed US auditing practices. Yale legal scholar, Romano (2004) has recommended that “SOX corporate governance provisions should be stripped of their mandatory force and rendered optional. Other nations, such as the members of the European Union who have been revising their corporation codes, would be well advised to avoid Congress' policy blunder”.

Auditors managed by a shareholder panel controlled by minority investors by being elected on a democratic basis of one vote per investor represent such a self-enforcing approach. Coffee (2005) also concluded that minority shareholders need to control the auditor. How this might be implemented is described by Turnbull (2000a, c, 2003).

A major reassessment is required by governance opinion leaders and influential institutions like the OECD, World Bank and governance rating agencies. The above discussion identifies compelling reasons to conclude that convergence of audit practices on those found in the US or UK is not in the best interest of directors or auditors in reducing their conflicts or safeguarding investors, the proprietary rights of shareholders or self-governance.

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