

# **Audit Within the Corporate Governance Paradigm: a Cornerstone Built on Shifting Sand?**

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## **Abstract**

This paper is a case study based investigation of aspects of the current paradigmatic approach to ‘good’ corporate governance with its focus on the interlinked roles of internal control and risk management procedures, internal audit and external audit, overseen and co-ordinated by a formal structure of board committees, in particular the audit committee. The evidence that we adduce from the study of six high profile cases of perceived accounting and governance failure provides limited assurance that this approach will in fact be cost effective or efficient in preventing further such cases of accounting and governance failure. In particular, issues as to fee dependence; lack of relevant knowledge and expertise; and social and psychological dependence upon executive management appear to have significantly and negatively affected the behaviour and judgement formation of the governance gatekeepers. This suggests that that further consideration of relevant economic, institutional and behavioural factors beyond the rational choice model of traditional economics and economic decision making should underpin future developments in required modes and structures of governance.

**Key words:** corporate governance, internal control, internal audit, external audit, audit committees.

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Paul Montague himself, who cannot be said to have been a man having his eyes open, in the City sense of the word, could not learn how the thing was progressing. At the regular meetings of the Board, which never sat for above half an hour, two or three papers were read by Miles Grendall. Melmotte himself would speak a few slow words, intended to be cheery, and always indicative of triumph, and then everybody would agree to everything, somebody would sign something, and the 'Board' for that day would be over. To Paul Montague this was very unsatisfactory. More than once or twice he endeavoured to stay the proceedings, not as disapproving, but 'simply as desirous of being made to understand'; but the silent scorn of his chairman put him out of countenance, and the opposition of his colleagues was a barrier which he was not strong enough to overcome. Lord Alfred Grendall would declare that he 'did not think all that was necessary'. Lord Nidderdale, with whom Montague had now become intimate at the Beargarden, would nudge him in the ribs and bid him hold his tongue. Mr Cohenlupe would make a little speech in fluent but broken English, assuring the Committee that everything was being done after the approved City fashion. Sir Felix, after the first two meetings was never there. And thus Paul Montague, with a sorely burdened conscience, was carried along as one of the Directors of the Great South Central Pacific and Mexican Railway Company.

Anthony Trollope, *The Way We Live Now*, 1875 (extract from Wordsworth Classic edition, 2001, pp.167-168).

## Introduction

From the late 1980s onwards there has developed a paradigmatic approach to 'good' corporate governance for companies in terms of an overall focus on appropriate internal control and risk management procedures within the relevant entity. Responsibilities for such procedures lie with board members (both executive and non-executive) supported by a formal structure of board committees; audit committee, nomination committee, remuneration committee and also by increased emphasis given to the role of audit, both internal and external, as a mechanism for ensuring appropriate governance procedures. The development of this paradigm was given significant impetus by the influential COSO report, (COSO, 1992) in the US and in the UK the work of the Cadbury Committee (see Collier, 1997), as subsequently revised and taken forward by the Greenbury<sup>1</sup> and Hampel Committees<sup>2</sup>, led to the development of the Combined Code covering various aspects of corporate governance.<sup>3</sup> The Code is not statutory and adherence to the Code is not mandatory - but the Stock Exchange listing rules issued under the aegis of the Financial Services Authority require disclosure of non-adherence.

Following the collapse of Enron and subsequently WorldCom, and against a background of a series of high profile cases of perceived inappropriate accounting and corporate irregularity, the Sarbanes-Oxley Act was passed in the US. This Act strengthened further the regulatory underpinnings of the governance paradigm outlined above, requiring management to report on the effectiveness of internal controls and the external auditor to give an opinion as to the suitability of that management assertion. The Act also requires the external auditor to report directly to the audit committee with respect to accounting policies which are critical to the overall picture presented by the financial statements, and further strengthens the position of the audit committee in terms of investigatory powers, resourcing, and the appointment and removal of the external auditor.<sup>4</sup>

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<sup>1</sup> 1995, available at [http://www.ecgi.org/codes/code.php?code\\_id=131](http://www.ecgi.org/codes/code.php?code_id=131)

<sup>2</sup> 1998, available at [http://www.ecgi.org/codes/documents/hampel\\_index.htm](http://www.ecgi.org/codes/documents/hampel_index.htm)

<sup>3</sup> The most recent version of the Combined Code, issued by the Financial Reporting Council in June 2006, can be found at <http://www.frc.org.uk/corporate/combinedcode.cfm>

<sup>4</sup> Text of the Act, passed in 2002, is available at:

In the UK, post Enron, the government together with the Financial Reporting Council set up a number of investigatory committees and commissioned reports *re* the role and duties of non-executive directors (Higgs, 2003)<sup>5</sup> and *re* the role and duties of audit committees (Smith, 2003).<sup>6</sup> In July 2003 a revised version of the Combined Code was published by the Financial Reporting Council. This, although not radically different from the previous version, did *inter alia* require that, for larger listed companies, non-executive directors should comprise at least half the board. The 2003 revision also provided for ‘a strengthened role for the audit committee in monitoring the integrity of the company’s financial reporting, reinforcing the independence of the external auditor and reviewing the management of financial and other risks’.<sup>7,8</sup>

However, although this paradigm commands widespread support from companies, the investing community, regulators and other stakeholders,<sup>9</sup> it has not gone entirely unchallenged. These challenges have come from those who consider that such a framework is both costly and likely to stifle enterprise and risk taking, from those who question the ability of non-executive directors to satisfactorily

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[http://fwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107\\_cong\\_public\\_laws&docid=fpubl204.107.pdf](http://fwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=fpubl204.107.pdf) and a summary of the Act prepared by the AICPA at:

[http://www.aicpa.org/info/sarbanes\\_oxley\\_summary.htm](http://www.aicpa.org/info/sarbanes_oxley_summary.htm)

<sup>5</sup> Available at [http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/higgsreport.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf)

<sup>6</sup> Available at <http://www.blindtiger.co.uk/IIA/uploads/48004ae5-f4b9de6f99-7c83/ACReport.pdf>

<sup>7</sup> FRC press notice 23 July 2003 available at <http://www.frc.org.uk/press/pub0311.html>

<sup>8</sup> See Solomon and Solomon (2004) for a review of the development of corporate governance and accountability relationships.

<sup>9</sup> There have also been a number of empirical studies which have provided evidence supportive of the benefits of separate aspects of the corporate governance ‘package’. For example, Becker et al. (1996) report higher audit quality to be associated with less earnings management activity. Beasley (1996) presents evidence that the presence of an audit committee is associated with a reduction in the probability of fraudulent financial reporting. Peasnell et al. (2001) find that in the UK more outside directors on the board are associated with reduced levels of earnings management (but find no such association with the presence or otherwise of an audit committee). Carcello and Neal (2003a) report that in the US the presence of executive directors on audit committees is associated with optimistic disclosures for companies experiencing financial distress, Carcello and Neal (2003b) that more independent audit committees are better able to protect external auditors from dismissal. Beekes et al. (2004) find that firms with a higher proportion of outside directors are more likely to recognise bad news in earnings on a timely basis (but are not more conservative in respect to recognising good news). Gramling et al (2005) suggest that internal audit has ‘a positive influence on the corporate governance, including reporting quality and firm performance’. However, although this stream of research may link ‘better’ corporate governance with certain features of ‘better’ financial reporting and disclosure, it does not directly address policy related issues as to whether the benefits from the imposition of corporate governance structures are likely to exceed the costs.

perform the variety of roles expected from them,<sup>10</sup> and from those who argue that the ‘approved’ governance mechanisms put in place have been demonstrably ineffective in checking corporate irregularity to date and are unlikely to be any more effective in the future (Clarke et al, 2003). The purpose of this study is to focus primarily on this latter line of argument and to seek, by means of a case study approach, to throw further light on those factors which have acted to limit its effectiveness and to consider whether they are likely to continue to do so in the future.

### Issues as to Methodology and Data

This paper does not seek to adopt or articulate any particular epistemological or theoretical perspective - beyond perhaps that of Milton and Lord Acton – to explain or underpin its findings. In terms of methodology it might perhaps be categorised as interpretative, archival based case study research. The advantages and disadvantages of such a research approach have been extensively rehearsed<sup>11</sup> and it is not the purpose of this paper to review them in any detail. The paper essentially comprises a review of six high profile cases of perceived accounting and governance failure. Through this review, the paper seeks to add to knowledge as to the strengths and limitations of the paradigm of ‘good’ corporate governance currently advocated in North America, Europe and, through the offices of the OECD, IFAC and others, worldwide. The cases, or perhaps vignettes might be a better description, relate to companies registered with the Securities and Exchange Commission (SEC) although all the companies are, or were, multinational and two, Shell and Hollinger, would not necessarily be perceived as US companies. Given the limited number of cases, seeking to derive inferences therefrom may be open to criticism on a number of grounds - in particular in respect to a lack of representativeness. There are approximately 10,000 publicly listed companies subject to SEC regulations in the United States and Francis (2004) suggests that the fact that SEC Accounting and Auditing Enforcement Releases through the ten year period (1994 – 2003) averaged only

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<sup>10</sup> See for example Ezzamel and Watson (1997), see also Spira (2003) and Spira and Bender (2004) for further discussion of this issue

<sup>11</sup> For a general overview of methodological issues relevant to the use of case study research in the widely drawn field of accounting and finance see Ryan et al. (2002).

149 per year is indicative of a relatively low overall rate of corporate governance failure. However, Coffee (2005), drawing on reports from the US General Accounting Office and others, suggests a much more widespread malaise with a rapidly increasing trend in earnings restatements which rose eight fold between 1995 and 2004 to reach 414 in that year, with revenue recognition issues being the single factor responsible for most such restatements. It may also be that there are differences between the United States and other parts of the world in terms of the commercial environment which in turn impacts the effectiveness of different modes of corporate governance. Here Coffee (2005) suggests that a relatively much lower level of corporate irregularity in Europe over this period may be attributed to differing patterns of ownership and control between firms in Europe and the United States.<sup>12</sup>

Within the cases looked at there is significant variety in terms of the nature of the entity under examination. These differences relate in part to size although all are, or were, very large corporations, to the nature of their business, and to their pattern of ownership structure and perceived management style. There are also differences in the nature of the irregularities which took place, in that in four instances the primary impropriety related to accounting manipulation, whereas in the other two the main concerns related to inappropriate abstraction of corporate assets on a heroic scale by senior management - rather than on accounting issues *per se*. Further questions arise as to the extent to which the companies under examination had fully embraced and implemented the internal control and governance paradigm outlined above – although all complied with the minimum SEC requirements as to the presence of an audit committee and of course the need to undergo periodic external audit.

In terms of collection of the underlying information the main sources are *ex post* investigation, whether in terms of reports of bankruptcy examiners (Enron and WorldCom) or SEC action against the company, its officers, and on occasion its auditors. In two of the six cases (Enron and Hollinger) there are also the reports of inquiries internal to the company. In the majority of cases the information

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<sup>12</sup> See also Bush (2005) for a discussion of differences both conceptual and specific between the US and the UK models of corporate governance and regulation of financial reporting.

available is voluminous. For example, the various reports of the Enron bankruptcy examination run to more than two thousand pages including appendices, and the internal report on Hollinger, conducted by a committee advised by a previous chairman of the SEC, is over 500 pages in length. Furthermore the nature of the resources available to these enquiries, the cost of the Enron bankruptcy examination enquiry was approaching \$100m, and their (varied) powers with respect to investigation and compulsion of testimony,<sup>13</sup> mean that an enormous wealth of detail is provided. However compelling this might be, there are still issues as to the potential for bias in the manner and approach of certain of the inquiries - and normally settlements reached with the SEC do not necessarily imply full acceptance of the accuracy of the complaint made. In addition, the inquiries do not all have a common purpose: those of the bankruptcy examiners being focused more on claims over remaining assets, whereas those of the SEC relate more to a desire to prevent corporate irregularity and to ensure the provision of appropriate financial information to the capital markets. Although all of the inquiries identify failings in individual aspects of corporate governance, none of them was the purpose to investigate the wider issue of whether the overall corporate governance framework is appropriate.

The next, and most substantial section of the paper, sets out the nature of the issues of interest in the six cases chosen and seeks to identify those aspects of the nature and practice of corporate governance which are relevant to this paper.

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<sup>13</sup> For example, as an internal investigation the Hollinger enquiry reviewed more than 750,000 pages of documents (hard copy and electronic) and had access to the company's e-mail server. However, it had to negotiate to review documentation and files of the company's legal adviser and of the company's auditor (Breedon, 2004, pp. 79,80).

## The Cases

### **Enron**

Although the extent and scale of the *ex post* investigation of the collapse of Enron has been unprecedented, the most accessible studies are still those emanating from the internal enquiry set up by Enron shortly after the commencement of the SEC investigation (the Powers report: Powers et al., 2002) and the monumental enquiries of the bankruptcy examiners (Batson, 2002, 2003a,b,c; Goldin, 2003).<sup>14</sup> The Powers report focuses primarily on the scale of Enron's off balance sheet activities, transactions between Enron and its unconsolidated Special Purpose Entities (SPEs), the use of transactions with these SPEs to seek to protect Enron's reported profitability in the two years immediately ahead of its collapse, and the opportunity for improper personal benefit afforded to certain of Enron's senior executives from such transactions. The bankruptcy examiners' reports gives a wider perspective on the extent and manner of the manipulation of Enron's financial reporting in terms of income, cash flows and the balance sheet picture. The great majority of these manipulations were, individually, designed to comply with US GAAP and the details of the transactions giving rise to the manipulations were known to the auditors. However the bankruptcy examiner's (Batson) view was that, in a great many cases, the compliance with US GAAP was illusory and that overall the combined effect was a massive distortion of the financial statements. Details of this distortion which, in the opinion of the bankruptcy examiner, led to overstatement of profit by 96%, of operating cash flows by 105% and an understatement of liabilities by 116% in the final set of fully audited financial statements, those for the year end 31 December 2000, which are set out in the following table taken from the bankruptcy examiner's report<sup>15</sup>

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<sup>14</sup> There is also an extensive academic literature reviewing and interpreting aspects of the Enron saga – examples of which include Benston et al. (2003) and Benston (2006).

<sup>15</sup> p.48 of the second interim report (Batson, 2003a).

Table I: Enron year 2000 financial distortions.

	Net Income	Funds flow from Operations	Total Assets	Debt
As reported	<u>\$979.0</u>	<u>\$3,010.0</u>	<u>\$65,503.0</u>	<u>\$10,229.0</u>
Adjustments for:				
FAS 140 transactions: ('sale' of assets to unconsolidated SPEs)	(351.6)	(1,158.3)	812.5	1,353.4
Tax transactions	(269.1)	(60.6)		
Non-Economic Hedges	(345.7)		(867.0)	(150.0)
Share Trusts (non- consolidation vehicles)	29.7	(418.0)	(4,178.0)	4,871.0
Minority Interests (debt represented as minority interest)				1,740.0
Prepay transactions		1,527.0		4,016.3
Total adjustments	(936.7)	(3,163.9)	(4,123.5)	11,830.7
Total after adjustments	\$42.3	(\$153.9)	\$69,626.5	\$22,059.7
Adjustment as % of amount originally reported	(96%)	(105%)	6%	116%

Source: Batson, 2003a

On the face of it, Enron's corporate governance structure was a model of good practice. Enron's Audit and Compliance Committee, chaired by Robert Jaedicke Emeritus Professor of Accounting and former Dean of the Graduate School of Business at Stanford, and including Wendy Gramm, a former chair of the US Commodity Futures Trading Commission, and Lord Wakeham both a qualified accountant and a previous UK energy minister, was a distinguished one. The external audit was carried out by Arthur Andersen, one of the then Big Five auditors (in all the cases reviewed here the external auditor was one of the then Big Five). There was an active risk and compliance function internal to the firm. The only potential reservation would be that the internal audit function was

outsourced to Andersen, the external auditors, a practice which is now prohibited in the United States.<sup>16</sup>

It is arguable whether anything could have prevented the collapse of Enron subsequent to the initial revelations of financial irregularities. Nonetheless, a more effective corporate governance structure would have been able to check management excesses in terms of remuneration and would have both reduced the scale of the loss, and significantly affected where the losses fell by ensuring more appropriate financial reporting practices and the prevention of schemes whereby net cash outflows were incurred for the purpose of financial reporting manipulation.

In respect to the audit committee *ex post* enquiry gave rise to concerns as to its independence (in particular the acceptance by John Wakeham of consulting fees to represent Enron in Europe), close political and social relationships (Wendy Gramm<sup>17</sup>), the amount of time that members were able to devote to their duties, and the level of scepticism and enquiry that they employed in the conduct of their duties. The minutes of the relevant audit committee meetings show a very wide range of business being covered in a relatively short space of time - and with the basic pattern being that of presentations made by executive management. In that executive management controlled the information flows to the committee and the committee did not seek to engage in or commission any independent activity of enquiry or investigation, it was largely powerless to contest the assertions of management. Representatives of the external auditors were present at audit committee meetings, but their role was supportive of management. Although the committee members did periodically meet the auditors without any members of executive management being present,<sup>18</sup> at these meetings the external auditors did not raise any of their significant concerns as to the aggressive nature of the

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<sup>16</sup> The ability to purchase both external and internal audit from the same firm has been a source of controversy for some time and the SEC had brought into force rules (probably unworkable) limiting the extent to which clients could purchase internal audit from their external auditor. Post Sarbanes-Oxley there is now a complete prohibition of joint purchase.

<sup>17</sup> Wendy Gramm is the wife of a (now former) US Senator and as chair of the Commodities Futures Trading Commission in 1993 she had overseen significant deregulation of Enron's trading in energy futures – just ahead of leaving the Commission and joining Enron as a non-executive director. [http://en.wikipedia.org/wiki/Wendy\\_Lee\\_Gramm](http://en.wikipedia.org/wiki/Wendy_Lee_Gramm).

<sup>18</sup> Now a requirement of the Combined Code in the UK.

accounting practices employed by Enron.<sup>19</sup> Ironically the one area of corporate governance to escape censure *ex post* was the outsourcing of the internal audit to the external auditor. Here the bankruptcy examiner did not find any evidence that the joint provision weakened the audit, and indeed suggested that it had the advantage of allowing Andersen to render a separate opinion on the quality of internal control, and provided Andersen a good opportunity of gaining information about Enron which should have reinforced the knowledge gained from external audit procedures – although Andersen, where it had such insights did not make use of them in the manner which might have been expected from a reputational intermediary.

This additional opinion rendered by Andersen – that management’s assertion that Enron’s system of internal control provided reasonable assurance that Enron’s financial statements did not contain material misstatements and that its assets were protected was accurate in all material aspects – is of course very similar to that now required by Section 404 of the Sarbanes-Oxley Act. Given Andersen’s knowledge that Andrew Fastow, the Chief Financial Officer of Enron, and other employees of Enron had financial interests in certain of the off balance sheet Special Purpose Entities (SPEs) with which Enron conducted a whole range of transactions, it is surprising that Andersen could come to this opinion, notwithstanding the fact that there were requirements for special Board approval of the deals between Enron and those SPEs in which Fastow and other employees were interested (approval which was often provided retrospectively on the basis of inadequate or misleading information as to the nature of the transactions).

## **WorldCom**

On June 9 2003, the U.S. Bankruptcy Court of New York issued an interim report (Thornburgh, 2003) which expanded on the court's earlier findings (Thornburgh, 2002) of lack of corporate governance, mismanagement, and concern regarding

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<sup>19</sup> Batson (2003b, pp. 131-155) provides detail as to Andersen’s interaction with the Enron audit committee).

the integrity of WorldCom's accounting and financial reporting functions.<sup>20</sup> Amongst the numerous incidents of mismanagement, corporate governance failure, and accounting irregularities, the most salient related to the overstatement of reported profitability by inappropriately capitalizing very significant elements of operating costs. In June 2002 and August 2002 WorldCom restated its previously filed financial figures by \$3.8 and \$3.3 billion respectively primarily in relation to this failure to charge operating costs to the profit and loss account appropriately. The trigger for these restatements in part was an internal audit investigation into the capitalization of operating costs – although this only took place after the departure of WorldCom's dominant chief executive and the replacement of Andersen as the external auditor by KPMG. Indeed an internal audit of capital expenditure a year previously had become aware of the existence of \$2.3 billion of 'corporate accruals' in relation to capital expenditure but had made no attempt to verify the nature and propriety of these 'accruals'.<sup>21</sup>

Internal audit at WorldCom was an in-house department first set up in a small way in 1993 but which had subsequently grown in numbers - although it was never heavily resourced relative to internal audit departments in other companies of a similar size.<sup>22</sup> Formally it had a dual reporting responsibility - reporting to both the Chief Financial Officer and to the audit committee, although the bankruptcy examiner had no doubt that its functional reporting responsibilities were to the Chief Financial Officer<sup>23</sup> and that its existence and role were very much at the behest of senior management: 'The viability of the Internal Audit Department was thus largely dependent on the whim of senior Management, and especially the CFO and CEO, with little more than deference being given to the Audit Committee.'<sup>24</sup> This perceived dependence upon executive management for

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<sup>20</sup> The final report (Thornburgh, 2004) focuses primarily on taxation issues and assessing potential legal liability of the various interested parties.

<sup>21</sup> Thornburgh (2003, p.187).

<sup>22</sup> An IIA study in 2002 suggested that its then complement of 27 personnel was approximately half that of internal audit departments in peer telecommunications companies and there was also a suggestion that the staff were relatively less well paid than the internal auditors in these companies (Thornburgh, 2003, p.191).

<sup>23</sup> "It is now clear that the Internal Audit Department, despite some dual reporting responsibility to the Company's Audit Committee, was never truly an independent department but rather reported to and was answerable to senior Management including the CFO, or Mr. Cannada, and the CEO". (Thornburgh, 2003, pp. 184-185).

<sup>24</sup> Thornburgh (2003, p. 185).

resources led to the work programme concentrating almost exclusively on operational aspects focusing on audits and projects that would be seen as adding 'value' to the company seeking to identify ways to maximise revenues, reduce costs and improve efficiencies.<sup>25</sup> It did not involve itself in financial auditing *per se*, and even when it did check accounting entries to subsidiary ledgers it did not normally follow these through to the general ledger – apparently to avoid the perception of the duplication of work with the external auditors Andersen.<sup>26</sup>

The report of the bankruptcy examiner also provides evidence of lack of uniform procedures within the internal audit department relating to the conduct of audits, preparation of reports, review of management responses and follow up procedures; a lack of co-operation with internal audit by line management; limited access by internal auditing staff to the company's computerised accounting and reporting systems; unwarranted influence by management in the preparation and negotiation of the internal audit reports; and a lack of a systematic approach in relation to highlighting serious internal control weaknesses and tracking of management responses and corrective action taken.<sup>27</sup>

Another aspect of the corporate governance paradigm highlighted by the WorldCom case relates to the co-operation and liaison, or rather lack of it, between the internal auditors, the external auditors and the audit committee. Similar to Enron, WorldCom had an audit committee constituted in accordance with the requirements of the Blue Ribbon Committee<sup>28</sup> and, over the relevant period, consisting of four non-executive directors with varying degrees of business experience and expertise. The committee met three to five times a year and at each meeting would, *inter alia*, receive an information pack prepared by the Director of Internal Audit and on occasion would receive presentations from

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<sup>25</sup> For example, "audits of the payment of commissions to the sales force, the classification of customer credits, the processing of local orders and calls, the review of pricing relationships with vendors, the adoption and integration of new information technology initiatives by various units of the Company, and various matters relating to the Company's capital expenditures" (Thornburgh, 2003, p.186)

<sup>26</sup> Thornburgh (2003, p.186).

<sup>27</sup> Thornburgh (2003, pp. 195-197).

<sup>28</sup> The Blue Ribbon Committee Report on Improving the Effectiveness of Corporate Audit Committees published in 1999 included ten recommendations for improving accountability in this field. These were adopted as mandatory (other than for foreign registrants) by the leading US stock exchanges in that year.

her. Formally, internal audit reported to the audit committee but as the report notes: ‘while most members of the Audit Committee perceived the Internal Audit Department as reporting to the Audit Committee, that was not the case, functionally or practically’.<sup>29</sup> Although the audit committee reviewed and approved the annual internal audit plan it did not have any input to changes made to that plan during the year, for example the diversion to line management activity referred to above.<sup>30</sup> The audit committee only received executive summaries of the actual audit reports, rarely the full reports. Perhaps more importantly, the members of the audit committee appear to have assumed there to be a much greater degree of co-ordination between internal audit and external audit than actually took place, and was not aware that Andersen did not receive copies of the internal audit reports.

In fact, communication between internal audit and external audit was very limited,<sup>31</sup> being largely restricted to joint attendance at the meetings of the audit committee. The external auditors placed little formal reliance upon the work of internal audit and, as noted above, internal audit was anxious not to give the impression of duplicating the work of the external auditors. The lack of communication between the two is highlighted in relation to the ability of the external auditor to provide annual reassurance to the audit committee on the absence of material weaknesses in the company’s systems of internal control, notwithstanding the existence of internal audit reports some of which documented significant such weaknesses. It also appears to have been a factor in the failure referred to above of internal audit to conduct meaningful financial audit, even when aware of circumstances which might have been expected to prompt further investigation.

## **Tyco**

Tyco is a manufacturing and service conglomerate involved in fire and security services, electronics, healthcare and specialty product and undersea

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<sup>29</sup> Thornburgh (2003, p.178).

<sup>30</sup> Thornburgh (2003, p.179).

<sup>31</sup> Thornburgh (2003, p.192).

telecommunications networks, its headquarters are in Bermuda. Here the issues of concern lay with the ability of senior management to obtain large and undisclosed loans from the company. The summary of the SEC complaint against its senior executives<sup>32</sup> commences:

*This is a looting case. It involves egregious, self-serving and clandestine misconduct by the three most senior executives at Tyco International Ltd. ("Tyco"). From at least 1996 until June of 2002, L. Dennis Kozlowski ("Kozlowski") (then Tyco's Chief Executive Officer) and Mark H. Swartz ("Swartz") (then Tyco's Chief Financial Officer) took hundreds of millions of dollars in secret, unauthorized and improper low interest or interest-free loans and compensation from Tyco.<sup>33</sup>*

Apart from this, and as detailed in the separate SEC enforcement release<sup>34</sup> in respect to the actions of Richard Scalzo the PwC partner in charge of the audit, there were accounting issues associated with year end adjustments and the treatment of bonuses and stock options, but the main issue was level of unauthorised and undisclosed borrowing. Here it is not clear how well informed the Tyco compensation committee was as to the scale of the borrowing – the greater part of which purported to be for the purpose of assisting senior employees to pay tax due on stock option awards - but the SEC enforcement release notes that Frank Walsh who served as the Chairman of the Board's Compensation Committee from 1998 through 2000 and as a member of the Board's Corporate Governance Committee and Lead Director in 2001 received, in 2001, an undisclosed \$20 million finder's fee in connection with the acquisition of The CIT Group, Inc., comprising a \$10 million payment directly to Walsh and a \$10 million contribution by Tyco to a charitable foundation chosen by Walsh.

A significant aspect of the SEC's case against Scalzo and PwC was the failure of the external auditors to identify at an early stage the fact that the loans supposedly to assist the payment of tax on stock options were in fact being utilised for a variety of other purposes, despite the fact that at an early stage they, the auditors, were provided with evidence strongly suggestive of this. The enforcement release

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<sup>32</sup> Available at <http://www.sec.gov/litigation/complaints/complr17722.htm>

<sup>33</sup> The third executive was Mark Belnick, the Chief Corporate Counsel to Tyco – although his loans were modest by comparison with those of Kozlowski and Swartz.

<sup>34</sup> Available at <http://www.sec.gov/litigation/admin/34-48328.htm>

describes entries in working papers available to the auditors as follows:

*“Most of the 1997 line items for the Kozlowski account also include a brief description for each such item, and eighteen carry descriptions that are immediately recognizable as not being for the payment of taxes on the vesting of restricted stock. For example, one item reads "WINE CELLAR," another reads "NEW ENG WINE," another "BMW REG/TAX," another "ANGIE KOZLOWS," and thirteen read either "WALDORF," "WALDORF RENT," "WALDORF EXPEN," "WALDORF RENT A," or "WALDORF RENT S.””*

Notwithstanding an awareness of the extensive nature of the loans to management and a whole range of issues relating to accounting treatment and disclosure which raised serious questions as to the integrity of senior management PwC continued to conduct their audit as if these concerns were not present. As the relevant enforcement release notes:

*“In contrast to the requirements of GAAS, Scalzo conducted the financial statement audits for Tyco's fiscal years 1998, 1999, 2000, and 2001, under an assessment of risk that remained unchanged by facts and events that called into question the character and integrity of Tyco's most senior management. With regard to those facts and events, "the evidence obtained" did not cause him "to modify the nature, timing, and extent of other planned procedures." AU § 316.33. When it came to Tyco's most senior management, Scalzo did not reevaluate risk assessment as a result of conditions that arose during the course of fieldwork or as a result of audit test results. See AU § 316.25, .33. In fact, at no point during the course of his work as engagement partner for the Tyco audits did Scalzo reassess the level of audit risk with regard to executive compensation or related party transactions.”*

Apart from highlighting weaknesses in the audit approach, the Tyco case also illustrates external audit failings in bringing audit findings to the attention of the audit committee. The enforcement release separately refers to Scalzo's failure to inform the audit committee of his knowledge (as it was acquired over time) that loans designated to pay the tax on vesting stock had been used to exercise tens of millions of dollars of stock options; his knowledge of the existence of tens of millions of dollars of non-interest bearing loans made to senior executives or that Tyco's management had repeatedly rejected PwC's recommendation that these loans should be disclosed; his knowledge of the existence of 'last minute post-period adjustments' designed to offset expenses improperly against general reserves; and his knowledge that Tyco had provided false information about Walsh's finder's fee.

## Xerox

Xerox is a company incorporated in New York which manufactures, sells and leases document imaging products, services and supplies in the United States and 130 other countries. In the year 2000, Xerox employed approximately 92,500 people worldwide, 50,000 of them in the United States. Its accounting practices in the years immediately preceding and including the year 2000 were the subject of extensive investigation by the SEC as reflected in the following extract from the SEC complaint against its auditors KPMG.<sup>35</sup>

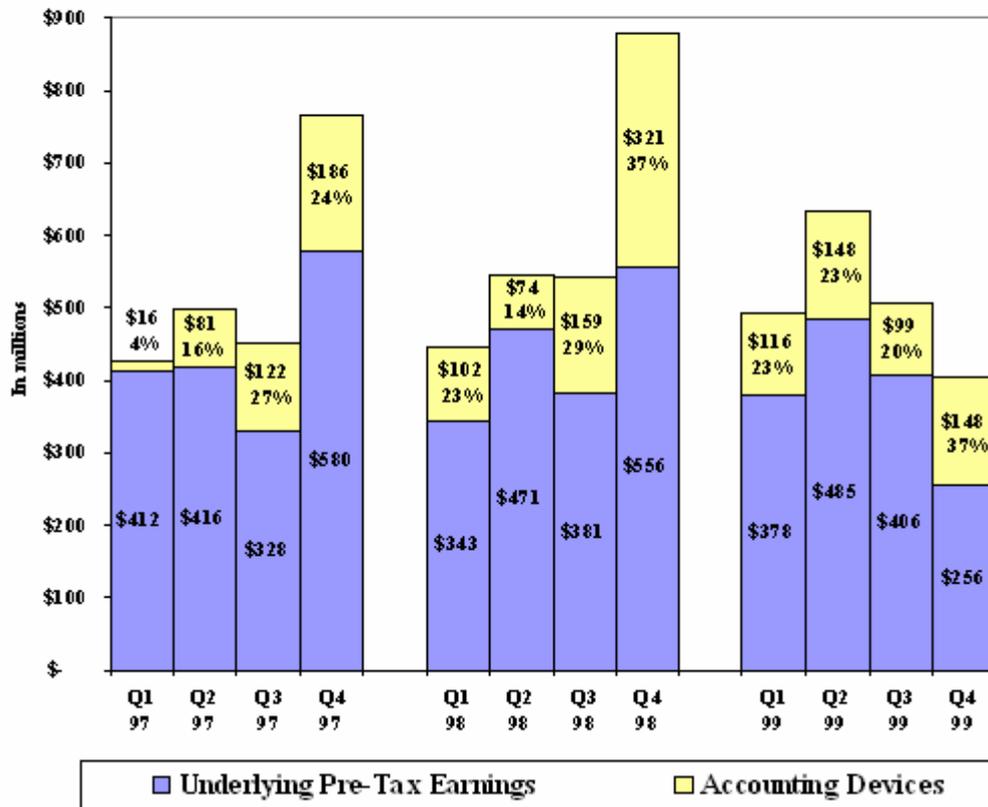
*“From at least 1997 through publication of the company's 2000 financial report, Xerox abandoned its obligation to accurately report its financial condition. Instead, the company defrauded its shareholders and the investing public by overstating its true equipment revenues by at least \$3 billion and its true earnings by approximately \$1.5 billion during the four-year period (before taxes, minority interest and equity income — hereinafter, "pre-tax earnings"). Xerox did so by using undisclosed manipulative accounting devices at the end of each financial reporting period which distorted the true picture of its business performance, always with the result that Xerox reported greater pre-tax earnings than would have been reported absent these devices. These devices (hereinafter referred to generally as "topside accounting devices") defeated the bedrock purpose of the accounting rules and public disclosure — to fairly, accurately and timely inform the public of the actual financial performance of the company. When Xerox finally restated its financial results for 1997-2000, it restated \$6.1 billion in equipment revenues and \$1.9 billion in pre-tax earnings — the largest restatement in U.S. history to that time. The defendants' fraudulent conduct allowed Xerox to inflate equipment revenues by approximately \$3 billion and inflate earnings by approximately \$1.2 billion in the company's 1997-2000 financial results.”*

The effect of the various accounting manipulations on the level of earnings in the various quarters from 1997 to 1999 can be gauged from the following table extracted from the SEC litigation release

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<sup>35</sup> Available at <http://www.sec.gov/litigation/complaints/comp17954.htm>

**Impact of Accounting Devices on Pre-Tax Earnings  
For the Quarters During 1997 - 1999  
(In Millions)**



Xerox employed a range of accounting devices to enable to manipulate its earnings numbers. Some were relatively straightforward (for example the creation of unnecessary reserves on acquisition which could subsequently be released to the income statement) others, relating to the valuation of the equipment leased by Xerox, were a little more complicated, but had the purpose of reducing the amount of the lease payments which could be characterised as interest or financing income in future years and increasing the amount of earnings which could be recognised immediately on completion of the lease agreement. In respect to corporate governance it was the auditors KPMG that drew the brunt of the SEC's wrath in its litigation complaint.<sup>36</sup> The SEC characterised the actions of the defendant KPMG partners in the following terms:

*“Although the defendants occasionally voiced concern to Xerox*

<sup>36</sup> This was settled in April 2005 with KPMG agreeing to pay \$22m and to give various undertakings as to improved audit practice (see <http://www.sec.gov/news/press/2005-59.htm>).

*management about the "topside accounting devices" developed and manipulated by senior corporate financial managers to increase revenue and earnings, the defendants did little or nothing when Xerox ignored their concerns and continued manipulating its financial results. The defendants then knowingly or recklessly set aside their reservations, failed in their professional duties as auditors, and gave a clean bill of health to Xerox's financial statements. Rather than put at risk a lucrative financial relationship with a premier client, the defendants failed to challenge Xerox's improper accounting actions and make the company accurately report its financial results."*

Neither the Xerox audit committee or the internal audit function appear as other than bit players in the separate SEC complaints against the Xerox senior management and the auditors, although there is passing reference to the extent to which KPMG communicated its concerns to the audit committee as the following extracts from the SEC's complaint illustrate:

*"Finally, Safran [the engagement partner who was ultimately removed from the audit at the request of Xerox] told Conway and Boyle [other involved KPMG partners] that KPMG had a "professional obligation" under GAAS to communicate his concerns to the Xerox Audit Committee. However, Conway, Safran and Boyle did not raise any such issues at the next Audit Committee meeting, and Safran ultimately signed off on the 1999 financial statements with Conway's and Boyle's knowledge and concurrence."*

In a report to the audit committee, also in early 2000, Safran stated: *"we believe the Company needs to improve its analytic processes and controls to confirm that the assumptions used are reasonable and that appropriate fair values are derived from existing methodologies."*

But he did not follow this through further and in October 2000,

*"[H]e sent the Xerox Audit Committee an analysis of Xerox's revenue allocation methods which did not mention the skepticism of KPMG auditors in Europe and accepted without question management representations that the margin normalization device was appropriate."*

In this respect the SEC concluded:

*"The defendants expressed muted doubts about topside accounting practices to Xerox management and to the Xerox Audit Committee in year-end letters and reports But the KPMG defendants did not comply with their professional obligation under GAAS or the securities laws*

*to require Xerox to change its financial reporting, or, if Xerox declined to do so, to qualify KPMG audit reports, issue no report at all, resign from the audit and, if necessary, notify the Commission that it had resigned because Xerox's financial reporting materially misrepresented the financial condition and operations of the company.”*

## **Shell**

Here the issues revolve around the overstatement in its financial statements of proved oil and gas reserves by Royal Dutch and the Shell Transport and Trading Company (Shell). Between January and May 2004 Shell announced reclassification of 4.47 billion barrels of oil, approximately 23% of previously reported ‘proved reserves’. In its 2004 enforcement release<sup>37</sup> the SEC attributed the overstatement to:

- i) Shell’s desire to create and maintain the appearance of a strong Reserves Replacement Ratio (a key performance indicator in the oil and gas industry)
- ii) The failure of Shell’s internal reserves estimation and reporting guidelines to conform to applicable regulations
- iii) The lack of effective internal controls over the reserves estimation and reporting processes.

The enforcement release details how the manner in which Shell established its reserve figures was deficient both in terms of over-optimism and in failing to comply with SEC rules and interpretative guidance. It highlights deficiencies in the training and supervision of the staff of the operating units responsible for estimating and reporting proved reserves in the first instance (estimation and reporting practices were largely decentralised), and is also critical of the internal reserves audit function. It describes this function in the following terms:

*“Shell’s decentralized system required an effective internal reserves audit function. To perform this function Shell historically had engaged as Group Reserves Auditor a retired Shell petroleum engineer – who worked only part-*

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<sup>37</sup> Available at <http://www.sec.gov/litigation/litreleases/lr18844.htm>

*time and was provided limited resources and no staff to audit its vast worldwide operations. Although the Group Reserves Auditor was an experienced reservoir engineer, he received scant, if any, training on such critical matters as how he should conduct his work and the rules and standards on which his opinions should be based. He also lacked authority to require operating unit compliance with either Commission rules or Group reserves guidelines. Moreover, he reported to the management of Shell's exploration and production division...which were the same people he audited."*

The Group Reserves Auditor both visited operating units on a periodic basis to assess the operating units' systems and issued an annual report on the reasonableness of Shell's year-end total reserves summary. The SEC notes that each operating unit was visited only once every four or more years (and that in nearly five years from January 1999 to September 2003 none of the systems were assessed as anything but 'good' or 'satisfactory') and also that until his February 2004 report the overall report focused as much on whether the reserve estimates complied with Shell's guidelines as whether they complied with the Commission's requirements. The enforcement release also questions the independence of the internal auditor and his willingness to maintain reserves notwithstanding local management reservations, and his encouragement to local management to provide support in terms of documented development plans for the booking of reserves for uneconomic projects.

However, when the internal auditor did raise concerns, for example in 2000, 2001 and 2002 in relation to whether reserves reported in Nigeria were justifiable, given that they depended upon underlying assumptions as to improvements in economic stability in the country, and upon increases in allowed production quotas ahead of licence expiration, these concerns were ignored by the Shell central management. Only following concerns expressed by other reserves personnel and the conclusion in the internal auditor's report of September 2003 that the Nigerian reserves reporting was 'unsatisfactory', did central management begin to move toward a full and comprehensive review of reserves.

Similarly, the January 2002 report of the internal auditor on the 2001 proved reserves, noted that recent SEC clarifications of FASB reserves guidelines showed then current Shell practice to be too lenient in some cases and called both for a

review of Shell's guidelines and closer alignment with SEC guidance and industry practice. However, again the reactions of senior management, as documented by the SEC complaint, were relatively low key – although the existence of potential problems were noted there was no action to de-book any of the proved reserves. Even as the management concerns became more pressing through 2002 and 2003, Shell continued to book large questionable reserves and, importantly, information provided to the Group Audit Committee failed to highlight these concerns. For example, a note written in August 2003 and presented to the audit committee for its October 2003 meeting suggested that much of the potential exposure from possible non-compliance with SEC regulations was offset by non-disclosure of certain reserves relating to gas production.

In addition, at the meeting in October, management failed to update the committee with information as to the unsatisfactory internal audit report on Nigeria or other developments relating to their mounting worries as to the reserves position.

## **Hollinger**

The Hollinger group was very largely the creation of Conrad Black. Born to a wealthy Canadian establishment family he built up, from the 1960s onwards, a newspaper and publishing empire initially in Canada alone, but latterly expanding to include significant titles in the US (led by the Chicago Sun Times), the UK (led by the Daily and Sunday Telegraph) and Israel (the Jerusalem Daily Post). As the business interests expanded, a corporate structure evolved marked both by quite high levels of debt and perhaps more importantly by a pyramid arrangement together with shares with different voting rights whereby Conrad Black supported by some key associates and by virtue of a majority stake in Ravelston, the company at the head of the pyramid, was able to retain all but complete control of the business entities, notwithstanding an equity stake which, together with that of Radler, his chief associate, amounting to just over 18% by value of the principal operating holding company Hollinger International Inc. (the appendix illustrates the group structure). Following significant losses in 2002 (and 2003) and

allegations of impropriety by a significant minority shareholder, Tweedy Browne (an investment and broking company),<sup>38</sup> in June 2003 a special internal committee, advised by a former SEC chairman, was set up by Hollinger primarily to investigate the allegations of impropriety and breach of fiduciary duty. This committee made its investigations against a background of keen SEC interest and court actions relating to a bitter dispute over the sale of the UK titles which saw Black and his associates forced out of the company. The 513 page report (the Breeden Report<sup>39</sup>) filed with the SEC<sup>40</sup> and published in August 2004 is uncompromising in its support for these allegations. It states on its opening page:

*“[T]his story is about how Hollinger was systematically manipulated and used by its controlling shareholders for their sole benefit, and in a manner that violated every concept of fiduciary duty. Not once or twice, but on dozens of occasions Hollinger was victimized by its controlling shareholders as they transferred to themselves and their affiliates more than \$400 million in the last seven years.<sup>1</sup> The aggregate cash taken by Hollinger’s former CEO Conrad M. Black<sup>2</sup> and its former COO F. David Radler and their associates represented 95.2% of Hollinger’s entire adjusted net income during 1997-2003.”*

The mechanisms by which it is alleged the controlling shareholders benefited themselves at the expense of the other shareholders were many and varied. They included:

- Excessive ‘management fees’ paid to Ravelston the company at the top of the pyramid owned by Black and associates

*“Diverting to Black and Radler through Ravelston nearly \$200million in excessive and unjustifiable management fees. The requests for such fees were accompanied by misrepresentations and failures to make full disclosure of relevant information to the Audit Committee, grossly inflated charges for personnel costs, and in effect billing the Company for debt service and other costs unrelated to services provided to Hollinger.”<sup>41</sup>*

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<sup>38</sup> Originally in Form 13D filing on 20 May 2003 available at <http://www.sec.gov/Archives/edgar/data/868512/000095013503003218/0000950135-03-003218-index.htm>

<sup>39</sup> Available at

<http://www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.htm>

<sup>40</sup> And which formed the basis of the SEC’s complaint against Black and others filed in November 2004 (available at <http://www.sec.gov/litigation/complaints/comp18969.pdf>).

<sup>41</sup> Breeden (2004, p.10).

- Payments for the agreement of Black and associates not to compete with other parties subsequent to the sale of particular titles

*“Causing Hollinger to pay more than \$90 million in supposed consideration for the execution of non-competition agreements by Black, Radler, Boulbee, Atkinson, Ravelston and HLG in connection with sales of publications belonging to Hollinger. More than \$47 million of this amount went directly to Hollinger officers who should not have required any individual compensation to adhere to agreements to which Hollinger was a party, while approximately \$26 million went to Ravelston in a duplication of payments that had already been made to Ravelston’s principals individually. All of these payments were made on terms that were unfair to Hollinger and represented unjustifiable waste of assets that rightfully belonged to all Hollinger shareholders.”<sup>42</sup>*

- The sale of assets to Black and associates at less than their market value

*“Transferring income-generating Hollinger assets to entities secretly controlled by Black and Radler for free, or at prices known to be below market value. This was accomplished by concealing key facts from, or making misrepresentations to, Hollinger’s Audit Committee and Board.”<sup>43</sup>*

- A reduction in the price of assets sold by Hollinger for the purpose of enabling Black and associates to receive subsequent management fees from the purchasers

*“Allowing sales proceeds to Hollinger to be reduced by \$39 million in order to offset a side deal negotiated by Black in which CanWest agreed to pay Black and Radler \$3.9 million in perpetuity through Ravelston. This was accomplished by misrepresentations to the Audit Committee and the Board, and was not properly disclosed in SEC filings.”<sup>44</sup>*

Although these make up the greater part of the estimated improper enrichment of \$400m the Report documents relentlessly a continuous tale of what it terms ‘corporate kleptocracy’ including the more headline grabbing use of company assets for personal perquisites for Black and his wife, an incentivisation scheme on a portfolio of hi-tech investments which paid Black and associates \$5.3m notwithstanding overall portfolio losses of \$67.8m and much else besides.

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<sup>42</sup> Breeden (2004, p. 10).

<sup>43</sup> Breeden (2004, p. 10).

<sup>44</sup> Breeden (2004, p. 11).

As set out in its proxy filings (Form D14) the governance structure of Hollinger over the relevant time period comprised a Board of Directors (executive and non-executive), an Executive Committee, an Audit Committee, a Compensation Committee and a Stock Option Committee. There was no separate Nominating Committee. Throughout the period from early 1998 through to 2002 the composition of all of these Committees was unchanged. The Audit Committee comprised three non-executive directors, Richard Burt, a director since 1994, former US ambassador to West Germany, chief negotiator in strategic arms reduction talks from 1989 to 1991 and subsequently a partner in McKinsey; Marie – Josee Kravis, a director since 1996 and a senior fellow of the Hudson Institute since 1994; and, the Chairman, James Thompson, a director since 1994, governor of the state of Illinois from 1977 to 1991. The Compensation Committee had just two members (Burt and Thompson) as did the Stock Option Committee. Thompson chaired both of these Committees as well. Both the Audit Committee and the Compensation Committee had established charters detailing their composition and responsibilities and the specific responsibilities of the audit committee were set out annually in the proxy filing 14A made to the SEC. This filing made clear the responsibility of the Audit Committee for reviewing both the level of management fees charged by the holding company and other related party transactions, it stated:

*“In addition, pursuant to the Services Agreements, the Audit Committee is responsible for reviewing the cost of services charged by Ravelston... The Audit Committee also has authority to recommend to the Board policies and procedures for dealing with conflicts of interest and to review the application of such policies and procedures.”<sup>45</sup>*

However, in the outcome the exercise of this responsibility left much to be desired and, although acknowledging that on many occasions the Audit Committee received inappropriate and misleading information from the executive directors, the Report is relentlessly critical of the performance of the Audit Committee. For example in respect to the management fees charged:

*“The Audit Committee never asked for (or seemed to think it worth knowing) any information about Ravelston’s overall costs, revenues or profits. They*

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<sup>45</sup> Hollinger International Form 14A (2001, p. 13).

*did not ask for a breakdown of indirect costs Ravelston was proposing to charge to Hollinger, such as taxes, pensions, occupancy, IT and security, or take any steps to verify that Hollinger's fees were supporting only services for Hollinger. The Audit Committee never reviewed any data concerning levels of executive compensation at comparable firms, in order to determine whether Black and Radler were being compensated consistent with reasonable market levels. More fundamentally, the Audit Committee didn't appear to understand exactly what services Ravelston actually provided for Hollinger, or what the cost or value of those services might be. It does not appear that the Audit Committee ever considered the threshold question of why Hollinger outsourced its senior management (other than that it had always been done that way), or whether it would be more cost effective for Hollinger to hire its own executives directly.'*<sup>46</sup>

Further:

*"Given the magnitude of the management fee requests, it is incomprehensible that the Audit Committee never demanded that Ravelston provide any supporting data to justify them.'*<sup>47</sup>

and the approval of the various non-compete arrangements, in particular those relating to the CanWest purchase:

*"Despite the serious misrepresentations [made by one of the executive directors], the Audit Committee approved \$51.8 million in payments to Black and his Ravelston associates in a September 11, 2000 meeting that lasted only 55 minutes. They did not appoint one of the Committee members to negotiate the purported non-compete fees (or the "break fee"), and they did not seek any advice from any financial or legal experts independent of Black and Ravelston about the appropriateness or amounts of the payments. The Audit Committee didn't consider less costly alternatives for Hollinger, or even ask the obvious question of why Black, Radler and the other individuals were entitled to receive payments for doing something they were already obligated to do by virtue of their status as Hollinger officers (since Hollinger had also signed a non-compete agreement with CanWest), or which Ravelston could be required to do as a condition of receiving further management fees.'*<sup>48</sup>

and in circumstances where the audit committee was in possession of full information but failed to act in a meaningful way. For example in respect to the incentivisation plan:

*"The Audit Committee displayed a similarly detached approach in reviewing many of the other related-party transactions covered in this Report. For*

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<sup>46</sup> Breeden (2004, p. 495).

<sup>47</sup> Breeden (2004, p. 496).

<sup>48</sup> Breeden (2004, p. 500).

*example, they approved the Digital Incentive Plan without obtaining independent legal or financial advice concerning the structure of the plan or whether its terms were, as Radler had represented, consistent with industry practice. The Audit Committee was provided with copies of the Digital Incentive Plan, including its description of how net gains, and therefore incentive bonuses, would be calculated. The Committee did not, however, question why: (i) there was no offset for losing investments; (ii) the plan was to be administered by Black, Radler and Colson, who had direct financial interests in the outcome of their decisions, rather than a disinterested committee; (iii) the “amount realized” on investments was to be calculated as of the date the investments’ underlying securities became marketable (instead of when Digital received the proceeds); or (iv) why Hollinger management deserved additional incentive payments or compensation to manage Digital’s investments when they were already being generously (and, as the Special Committee has found, excessively) compensated through the management services agreement.’<sup>49</sup>*

In attempting to determine why, if the conclusions of the special report are accepted, the audit committee failed so spectacularly, aspects of interest include those relating to the expertise of the audit committee, the nature of their appointment and potential fee dependence, and their personal and social relationships with executive management.

In terms of expertise two of the committee members, Burt and Thompson, had extensive political experience and Kravis had been a high profile economist/journalist. Thompson is a trained lawyer and Kravis had worked as a financial analyst in the early years of her career - but it is open to question whether they satisfied the Audit Committee Charter requirements that each of the members of the committee should be financially literate and that ‘at least one member of the Audit Committee shall have accounting or related financial management expertise’. However, perhaps unlike the situation at Enron where the complexity of the certain of the transactions and the nature of the financial instruments employed obfuscated the more basic lack of integrity of senior management it is difficult to say that this was the case at Hollinger. Given that a key aspect of the breach of fiduciary duty related to the straightforward charging of management fees by a company higher up the chain of control, charges which increased very significantly while overall revenues remained static or fell, the requisite level of financial literacy should not have been that onerous. It is

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<sup>49</sup> Breeden (2004, p. 503).

perhaps a little ironic that Burt, a leading player in cold war negotiations as to disarmament, was not able to put that experience to good use in such a situation but in fact the negotiations, such as they were, lay between Radler (Black's executive associate) and Thompson and were described by the Report as:

*“Radler, wearing his Ravelston shareholder hat, submitting an annual management fee proposal — in most years, simply the dollar amount that Ravelston wanted to be paid — to Thompson, as Chairman of the Audit Committee. After a cursory discussion, Thompson would agree to the proposal.”*

In this respect as the Report notes:

*“Thompson in particular would never claim to be a businessman, or an expert in financial analytics. However, he is a highly experienced lawyer, and he understands the fiduciary duties that Black and Radler had as controlling shareholders?”<sup>50,51</sup>*

Of course the audit committee members were dependent upon executive management for their information as to the transactions that they were required to approve, and in circumstances where executive management had a compelling incentive to mislead the audit committee, and appears to have done so on a number of occasions, this lack of an independent knowledge base greatly restricted the effectiveness of the committee. This reliance upon executive management for information and a reluctance to seek alternative sources of information or to use their powers to commission independent advice is referred to throughout the Report:

*“In performing our work, the Special Committee discovered a pattern of misleading statements to the Board and the Audit Committee surrounding*

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<sup>50</sup> Breeden (2004, p. 36).

<sup>51</sup> For example his report as independent counsel to the ULLICO board charged with investigating alleged improper stock trades by certain of the directors of ULLICO (a trade union associated insurance company), a report which was presented to the US Senate in 2003, focuses primarily on the fiduciary duties of directors. It also states: ‘A properly functioning and active audit committee is a key component of corporate governance. The Board’s audit committee which until recently had not been keeping minutes, historically has been passive. The Audit Committee could benefit from the addition of more members with financial expertise.’ – which might perhaps be construed as a classic example of the pot calling the kettle black. (see [http://www.p4du.org/UNION%20CORRUPTION/ULLICO%20Scandal/2003\\_04\\_04\\_ULLICO\\_ThompsonRpt.pdf](http://www.p4du.org/UNION%20CORRUPTION/ULLICO%20Scandal/2003_04_04_ULLICO_ThompsonRpt.pdf))

*related-party transactions. In addition to making false statements, we also found many cases in which Black, Radler, Kipnis or others failed to tell the Board or the Audit Committee key facts necessary to fully understand transactions or payments as to which partial information was given. "Lying by omission" can be just as misleading as making a false statement, and unfortunately both occurred in connection with Hollinger's Board"*

*"The Special Committee believes that the misrepresentations and partial information given to the Audit Committee, coupled with the lack of warnings from any of Hollinger's outside advisors, was a significant part of the reason why the Audit Committee behaved with such lassitude in the face of the abusive transactions."*

However it continues:

*"These reasons do not seem enough, however, to justify the Audit Committee's passivity and its acquiescence to everything Black proposed."*

And in this context it is necessary to consider the independence of the non-executive directors and their financial and other links with Black and his associates. The financial remuneration of the non-executive directors was not negligible, in 2000 each director was entitled to an annual directors fee of \$32,500 and a fee of \$3,000 for each board or committee meeting attended. In 2000 the full board met on six occasions, the audit committee met on three occasions and the compensation committee met twice. Attendance at all of these meetings would have given rise to remuneration of \$59,500 for Kravis and more than \$65,000 for Burt and Thompson. In addition to this there was a modest, but again not negligible, annual stock option entitlement for non-executive directors which appears to have taken up fully or nearly so by all those entitled.

Some publicity has been given to the links between the charitable donations of Hollinger made to bodies associated with the executive and non-executive directors. This aspect is covered in some detail in the Report although it appears that only in the case of Kravis were donations made (of \$50,000 and \$40,000) to bodies where a personal interest was identified. It is also true that the members of the audit committee did not obtain personal pecuniary benefit from any of the irregularities, other than their declared remuneration. As the report notes:

*"The Special Committee wishes to emphasize, however, that with the notable exception of Perle, none of Hollinger's non-Black Group directors derived*

*any financial or other improper personal benefits from their service on Hollinger's Board. Unlike Black and Radler, Hollinger's independent directors did not enrich themselves at the Company's expense, did not misappropriate corporate opportunities belonging to Hollinger, and did not in any other way engage in self-dealing.*<sup>52</sup>

## Reflections and Insights

Insights gathered from the review of the above cases may be indicative that neither individually nor collectively can the component parts of the present paradigm of 'good' corporate governance be taken to provide that level of reassurance and protection for investors and other corporate stakeholders which the regulators on both sides of the Atlantic and further afield believe them to be capable of. Whereas the activity and practice of external audit has come under, to a greater or lesser extent, searching examination over the last twenty years, there has been a lesser critical focus on the role and practice of audit committees and hardly any on that of internal audit. In this respect the evidence presented above may be interpreted as reinforcing the view that there are commonalities in the forces that shape the activities and function of these separate governance activities which are likely to seriously weaken their ability to fulfil the role ascribed to them by regulators and others. These are to an extent overlapping and interrelated but for discussion purposes may be categorised in terms of: fee dependence, lack of both expertise and the possession of an independent knowledge base, and social and psychological dependence. To take each in turn:

### **Fee dependence**

Non-executive directors, external auditors, and internal auditors are remunerated by the company. If they consider that this stream of remuneration is likely to cease consequent upon their behaviour then that behaviour may, and indeed is likely to be, modified accordingly. Fee dependence issues relating to external auditors have been extensively aired over many years with particular concerns being raised both as to dependence at individual and office level – the loss of a

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<sup>52</sup> Breeden (2004, p. 493).

major client will almost inevitably adversely affect an individual's remuneration and standing within the audit firm – and as to the enhanced dependence caused by the associated provision of non-audit services to audit clients.<sup>53</sup> Notwithstanding the regulatory attempts to mitigate fee dependence issues, for example in terms of strengthening the powers of audit committees with respect to determining auditor remuneration and in prohibition of audit partner remuneration being linked to the sale of non-audit services, arguably fee dependence contributed to external audit failure in a number of the above cases, perhaps most notably at Xerox where the SEC noted that:

*“Each of the KPMG defendants was aware that Xerox was a star client of the firm. KPMG had been Xerox's auditor for 40 years and had generated over \$56 million in non-audit fees during 1997-2000, as well as \$26 million in audit fees. No KPMG defendant wanted to risk antagonizing the client or resigning the engagement.”*<sup>54</sup>

The levels of the remuneration of non-executive directors varied in the cases under consideration – with the \$20m finder's fee received by the Lead Director of the Tyco Corporate Governance Committee a significant outlier. However even at the more modest levels of remuneration exhibited elsewhere the amounts are far from negligible either in terms of an individual income or in relation to the number of hours worked.<sup>55</sup> It would require a major reappraisal of conventional beliefs and theories about human nature to believe the amounts involved would not be relevant to the individuals concerned – the more so if patronage over corporate charitable giving was perceived to be part of the compensation package. Again the nomination committee is seen as an intervening factor between executive management and the appointment of non-executive directors, and it may well be significant that Hollinger had no nomination committee – but the appointments to the nominating committee and the overlap between the various committees may call into doubt how effective this has been in the past or will be in the future.

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<sup>53</sup> See for example Gwilliam (2003).

<sup>54</sup> SEC complaint against KPMG, available at <http://www.sec.gov/litigation/complaints/comp17954.htm>

<sup>55</sup> In the UK the Higgs report (Higgs, 2003) reported that the average remuneration of a FTSE 100 non-executive director was £44,000 per annum.

Internal audit has historically been entirely dependent upon executive management for resources and powers and as employees internal auditors were in a position with little more protection than other employees if they wished to challenge senior management. A gain it is by ensuring that internal auditors report directly to the audit committee and by requiring an audit committee role in approval of the work programme of the internal audit function that it has been sought to mitigate the threat to internal auditor independence - but it is difficult to see how this can be effective. Of course outsourcing the internal audit function changes the situation – but an outsourced internal auditor is just as fee dependent as an external auditor and with rather less protection in circumstances in which external management seek a change of appointment.

### **Knowledge and Expertise**

Audit committees, external auditors and internal auditors each have to possess competence, knowledge and the power to investigate matters of concern if they are to fulfil their duties appropriately. Wolnizer (1987) and Power (1997), have both identified the critical need for auditors to have a knowledge base, whether pre-existing or as a result of search and evidential inquiry, which enables them to form an independent opinion as to the quality of financial reporting. In the absence of such knowledge, an audit is likely to degenerate into no more than an acceptance of management representation and be of correspondingly little value. Indeed some would argue that as business activity becomes ever more complex as a consequence of globalisation and expansion of markets for services and products, then it is the provision of non-audit services which both adds value to the client and provides the auditor with the essential understanding of the mode and nature of the client's activities, an understanding which will underpin the audit opinion.

In the cases outlined above the extent of the knowledge of the parties differed in each case. Arguably in none of the cases did any of the parties have the full knowledge of the facts as revealed by subsequent events and *ex post* investigation, but there is little doubt that in respect to Enron and Xerox the external auditors

were aware of the nature of the questionable accounting practices being followed but accepted them as appropriate. In Tyco the auditor was clearly aware of factors indicative of impropriety but appears to have limited the extent and depth of further investigation which would have revealed the full scale of these improprieties. In Hollinger, as documented by the Breeden report, KPMG appear to have played a role which was neither central nor peripheral.<sup>56</sup> They were auditors for all the main companies in the pyramid and cannot have been unaware of the level of management fees charged or the relationship, if any, between these fees and costs incurred - but they appear to have raised little if any concern. The report notes that neither KPMG nor Torys (Hollinger's legal advisers) alerted the audit committee to any concerns as to either the level of management fees or the propriety of the non-compete payments.<sup>57</sup>

In WorldCom it is not clear whether Andersen was aware of the significant level of 'corporate accruals' – although perhaps they should have been, and the extent and nature of external auditor responsibility for the failings of the Shell disclosures as to proven reserves is still under investigation.<sup>58</sup> Although external auditors have both the capability, and the statutory power to investigate matters to the full and, subject to control over work programme and resources, internal auditors too are well placed to investigate irregularity and accounting manipulation, this is not so with respect to audit committees and non-executive directors more generally. A number of the cases, for example Enron, Hollinger, Xerox document a lack of understanding by audit committee members of the issues at stake, a lack of understanding exacerbated by an inadequately sceptical approach, control of information flows (including internal audit reports) to the audit committee by executive management, and a striking reluctance by external auditors to articulate their concerns to audit committees.

The board's expertise may not always extend to that of the accountants involved in external audits, but they have a duty to be sceptical and to ask questions if they

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<sup>56</sup> In January 2006 Hollinger International announced that it would not be pursuing a claim against KPMG.

<sup>57</sup> Breeden (2004, p. 36).

<sup>58</sup> A number of Dutch pension funds are currently bringing a legal action against Shell, PricewaterhouseCoopers and KPMG in respect to losses which they consider to be attributable to the overstatement of reserves.

do not understand a transaction. In the surveyed cases, they apparently did not do this. Still, insufficient knowledge and expertise may not always be at the heart of the issue. In the case of Hollinger, no deep accounting knowledge, *per se*, was required, just a degree of common sense and a sense of scepticism before signing away shareholders' money. It is one thing to argue incompetence in view of complicated (or obscure) accounting or legal details, or ignorance of facts and accounting procedures, but it is another to, effectively, sign blank cheques, as at Hollinger, or to waive corporate codes of conduct to allow executives to engage in activities which represent open conflicts of interest, as at Enron.

### **Social and Psychological Dependence**

Whereas issues of fee dependence have been extensively discussed, at least in respect to external audits, wider, largely non-economic, relationships in terms of familiarity, bonding, and socialisation have been accorded much less prominence although arguably they may play at least as an important part in determining the relationship between executive management and non-executive directors/external audit/internal audit. They have received some attention in respect to external audit<sup>59</sup> and issues as to the interlocking nature of directorships have also been explored extensively in the economics and corporate governance literature.<sup>60,61</sup> Another line of inquiry investigates the effects of heuristics and bias, and group decision making on the quality of judgement and choice making of agents within corporate governance.<sup>62</sup>

Details emerging from investigations of the cases outlined above indicate that auditors may have known, and certainly were in a position to know, that particular accounting treatments were highly questionable. These gatekeepers (Coffee, 2001) would appear to have lowered their guard – or perhaps even looked the

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<sup>59</sup> For example, Gwilliam (2003).

<sup>60</sup> For example, Cosh and Hughes (1987).

<sup>61</sup> Although the evidence does not permit a full examination of the relationships between executive management, auditors and non-executive directors nor issues as to the factors which determined their appointment, some of the evidence discussed above does highlight the nature of the links between executive and non-executive directors, as for example in respect to Enron and Hollinger, which give rise to concern.

<sup>62</sup> For example, Prentice (2000); Langevoort (1998, 2001a,b); Fanto (2004).

other way when warning signs were clearly visible. This view is not uniformly shared, Morrison (2004) for example argues that Arthur Andersen was made a scapegoat by US federal authorities for its involvement with Enron. Given that the conviction for obstruction of justice which effectively ended Andersen's existence was subsequently overturned on appeal, there is some merit in Morrison's argument as to the manner in which the criminal case against Andersen was handled. However, the string of poor quality audits in which the firm had previously been involved (as evidenced by *ex post* SEC investigation) does not support a positive interpretation of the quality of internal control within the firm (Turner, 2005). Furthermore, in recent years all of the then Big Five accounting firms have, to a greater or lesser extent been associated with issues of accounting and audit quality at major clients which might be seen as an indication of generic problems of large auditing firm culture which cannot be attributed just to the failings of individual partners or firms.

While, as noted by Clarke et al. (2003), the flexibility provided by accounting standards and the nature of accruals accounting, which some would see as representative of systemic defects in the understanding and practice of financial reporting indubitably make the task of auditors and other parties with governance responsibilities we think that it is incontrovertible that the failings identified in the cases we have considered go far beyond those which can be wholly attributed to the imprecise nature of financial reporting in an uncertain world. Rather they raise more fundamental questions as to why gatekeepers so frequently either fail to be aware of, or even acquiesce in, improper behaviour and practices of executive management.

Here we would argue that the standard corporate governance template - which is implicitly based on the rational choice model of traditional economics and the role of conventional governance mechanisms in the minimization of agency problems fails to take sufficient account of the psychological and social pressures on monitors and gatekeepers, pressures in addition to those posed by both insufficient knowledge and fee dependence. Issues of conflict of interest and bias as well as those relating to the potential for poor group decision making (Janis, 1972) may mean that proposals for the further reform of corporate governance,

including codes of best practice, additional layers of oversight, and greater penalties for breaches of relevant laws will impose additional costs without commensurate benefit in terms of improved financial reporting and managerial behaviour.

Waves of corporate fraud occurred with some degree of regularity throughout recent history. The frequent recurrence of scandals may point to potentially inadequate or inappropriate legislative responses, and gives rise to the question whether more fundamental issues are being overlooked. Corporate scandals generally lead to changes in legislation.<sup>63</sup> Often, what are seen as specific and/or unique causes of a scandal are met with specific changes to particular rules, laws and codes of best practice. Quite predictably, technical fixes are sought for what are presumed to be purely technical issues. Typical responses to corporate fraud, thus, focus on stronger penalties and additional layers of oversight or regulation. However, these have been tried in the past with little success (Coffee, 2003; Clarke et al., 2003).<sup>64</sup> The problem with this type of response is, that a few years down the road, trust in corporate governance is likely again tested by the recurrence of similar misdeeds. The particular financial instruments or vehicles used in those new cases may have changed, as specific earlier loopholes have been closed by legislation following the previous bout of scandals, but the general pattern remains.<sup>65</sup> Even strong enforcement of strict laws, while no doubt deterring some wrongdoing, do not seem to ensure a satisfactory convergence of the interests between principal and agent.

The economist's standard model on how individuals form judgements, update their beliefs, and make decisions has been broadly adopted by accounting, legal

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<sup>63</sup> Banner (1997) argues that most major legislation regulating securities markets followed a sustained financial market crash.

<sup>64</sup> Historically, the safeguards, rules and sanctions put in place after one wave of perceived corporate scandals (which are more commonly uncovered in times of recession than of economic expansion) have often proved to be inadequate in preventing the next wave. The Sarbanes-Oxley Act, in large parts, would appear to follow tradition by elaborating standards of existing law and regulation which had either not been fully enforced, or were deemed not sufficiently visible (Cunningham, 2003).

<sup>65</sup> Although the sophistication and complexity may have changed, over time there have been familiar themes in accounting fraud and financial reporting manipulation: for example in terms of the timing of recognition of earnings, the construction of imaginary earnings, underestimation of liabilities, concealment of unsuccessful trading positions.

scholars, and policy makers (Posner, 2003; Williams, 2004). Much of the prior research on corporate governance, policy recommendations, legal practice and conventional means for minimizing the agency problem is also premised on the assumption of strongly rational agents with long-term time horizons and stable and consistent preferences (Shleifer and Vishny, 1997; Prentice, 2000). In contrast, observations and cognitive psychology suggest that individuals (and groups) regularly and predictably fall short of these normative standards as applied in traditional economics (Rabin, 2002). There is a growing awareness in the governance literature of the importance of a better understanding of human decision making behaviour than is provided by the neo-classical rational choice model alone (Coffee, 2001; Langevoort, 2001a).

Findings from cognitive psychology and behavioural studies document that decision making is not exclusively based on logical reasoning, but is also subject to numerous heuristics and cognitive biases (Tversky and Kahneman, 1974; Kahneman and Tversky, 1979; Fischhoff, 2002), affect (Slovic et al., 2002, 2004), visceral factors (Schelling, 1984; Loewenstein, 1996; Loewenstein and Lerner, 2003), and pressures towards conformity with the group or authority (Asch, 1951; Janis, 1972). Divergence from utility maximization over time adds a temporal dimension to this literature (Strotz, 1955; Thaler, 1981; Laibson, 1997). These influences tend to steer human judgement, inference and behaviour away from the predicted outcome of expected utility theory and can lead to systematic violations of the normative assumptions central to the economist's rational model. If these insights are useful in describing how executive managers and their monitors behave, this would seriously question the efficacy of many existing rules and regulations on corporate governance, as these strongly rely on the assumptions of the rational actor model. At the very least, these insights would suggest the need for significant modifications to the monitoring model of corporate governance.

Although it may be argued that corporate governance failure is ultimately attributable to ethical failings on behalf of individuals, we would suggest that this is too simplistic an interpretation which does not fully take into account systematic cognitive and affective biases and other psychological pressures on human judgement and decision making. These can influence agents' perception,

judgement and behaviour in ways and with a persistence which tend to be largely ignored by models of choice behaviour which assume utility maximization. Such effects may underlie patterns of acquiescence to, and rationalization of, the actions of management, as well as self-rationalization of own actions by monitors and gatekeepers.

Auditors and board directors are, for example, subject to the common human preference for immediate gratification, typically with insufficient regard for potential negative future consequences. The gratification from a bonus, re-election to a board of directors, renewal of an auditing contract, or the prospects of employment in a client's firm, is certain and experienced in the present or the immediate future. In contrast, expected damage from questionable activities, including reputational damage, legal or financial sanctions, and loss of career, is merely potential and in the future. The magnitude of such negative outcomes tends to be discounted and further reduced in perceived severity and probability by self-serving justifications.

Gatekeeper failure may, hence, frequently be less sinister than commonly assumed and legislation primarily based on deterrence may be less effective than is sometimes hoped for, as underlying (and largely unconscious) judgement and decision making processes may be a major contributing factor to what ultimately becomes fraudulent, imprudent and destructive behaviour of senior management, and the acquiescence of their monitors and gatekeepers to such activities. The introduction of a rigorous regulatory regime, the standard response to corporate scandals, might as a result not necessarily prove a panacea for the demonstrated weaknesses in corporate governance.

This is of particular relevance to expectations which assume a relationship between traditional governance indicators and firm performance, elsewhere found to be less than convincing (Larcker et al., 2005). Brennan (2003), for example, defines accounting as "an art, not a science", and suggests that "the precise numbers and amounts in profit and loss accounts and balance sheets suggest a precision that does not exist... ..The reality is that financial reports are the product of multiple subjective judgements by company directors." Accounting

uncertainty thus would appear to place auditors in the unenviable centre of the complex interactions of a raft of heuristics and cognitive influences, which affect their own judgement and question the feasibility of an auditor's work to escape self-serving bias. Issues of definition and feasibility of independence respective boards of directors further compound such concerns, which highlights not only ambiguities *re* the role of directors but also, and emphatically so, the limited ability of boards to monitor and control the actions of senior management, in part also as a result of social and psychological influences on individual and collective decision making.<sup>66</sup>

## **Conclusion**

The evidence presented in this paper – based on study of six major corporate cause celebres – provides at best muted support for the viewpoint that seeking to reinforce the existing corporate governance structure along the lines advocated in both North America and the UK will necessarily act to prevent any such future failure of corporate governance. If anything the evidence is indicative of an extended layer of regulation which, unless there is further consideration of the appropriate institutional structure within which 'good' corporate governance can take place, is likely to be both costly and ineffective. The increase in costs is already with us in terms of increased expenditure on internal audit and burgeoning fees for audit firms (primarily linked to advice on internal control) and non-executive directors. Measurement of the actual or potential benefits in terms of improved information to the capital markets and a check on management excess and profligacy is of course much less easy to achieve – however the cases reviewed above suggest that to accept uncritically the received and paradigmatic wisdom as to what constitutes 'better' corporate governance without further consideration of the interaction between relevant economic, institutional, behavioural and case specific forces might be unwise.

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<sup>66</sup> See Brennan (2006) for an elaboration on an 'expectations gap' which, as applied to directors, describes the possible difference in opinion between investors' expectations and the reality of a boards' contribution to firm performance (also the minimization of agency cost).

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## Appendix: Hollinger group structure

### Black and Radler's Effective Economic Ownership in Hollinger As of December 31, 2002

