The role of external auditors in corporate governance: agency problems and the management of risk

Ojo, Marianne

Oxford Brookes University

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ABSTRACT

This paper not only recommends means whereby principal-agent problems could be addressed, but also considers various ways in which the external auditor and audit committees contribute as corporate governance tools. The impact of bank regulations on risk taking and the need for a consideration of ownership structures are amongst other issues which are considered. In acknowledging the issues raised by ownership structures, it considers theories such as the banking theory and corporate governance theory. It also considers other alternatives whereby risk taking could be controlled. In recommending the external auditor's expertise to address principal agent problems, it draws attention to the audit committee's roles, both as a vital and complementary corporate governance tool. It also highlights the importance of measures which need to be in place if the external auditor's contribution to corporate governance is to be maximised.

Key Words: corporate governance, banking theory, risk, ownership structures, auditor, disclosure, principal, agent, regulation, moral hazard

The Role of External Auditors in Corporate Governance: Agency Problems and the Management of Risk

Marianne Ojo[1]

A. Introduction

Corporate governance, the process whereby directors of a company are monitored and controlled,[2] involves decision making, accountability and monitoring.[3] Two aspects which are considered to be fundamental to corporate governance are:[4] Supervision and monitoring of management performance (the enterprise aspect) and ensuring accountability of management to shareholders and other stakeholders (the accountability aspect).

Three key themes which are considered to have emerged from lessons learned from various corporate collapses are:[5] emphasis on "substance of the transaction"[6] rather than legal form, transparency and the management of risk. Since (in my opinion), the management of risk is considered to have the greatest impact and significance in the fields of regulation and corporate governance, amongst these three themes, it will constitute the starting point and the focus of the study. The topic will, in part, be considered by way of reference to the impact of regulations on risk taking and the need for a consideration of ownership structures. Subsequent sections will consider not only the contribution of audit committees to corporate governance, but also illustrate why the presence of such bodies is vital to ensuring accountability and supervision within a company. In highlighting why the external auditor is such an indispensable tool in corporate governance, the final section of this paper will attempt to demonstrate how the external auditor can help to resolve agency problems - whilst emphasising the audit committee's significance in complementing the external auditor's work.

B. Management of Risk

I. Impact of Bank Regulations on Risk Taking

Whilst the application of bank regulations could lead to lower levels of risk taking, it could also induce higher levels of risk taking.[7] Lower levels of risk taking may occur where owners are compelled to invest more of their personal wealth in the bank and the converse may occur where capital requirements do not compel owners to invest more of their wealth in the bank – although

[1]School of Social Sciences and Law, Oxford Brookes University. Email: marianneojo@brookes.ac.uk

[2] Cadbury Committee defines it as "the system by which companies are directed and controlled"

[3] See D Broadley, 'Auditing and its Role in Corporate Governance' 2006 Bank For International Settlements FSI Seminar on Corporate Governance for Banks

[4] See V Beattie, S Fearnley and R Brandt, *Behind Closed Doors: What Company Audit is Really About* (ICAEW) at page 26

[5] See House of Commons, Select Committee on Treasury, Minutes of Evidence (2002/03 Session) Appendix 6 Memorandum by the Institute of Chartered Accountants in England and Wales http://www.parliament.the-stationery-office.co.uk/pa/cm200203/cmselect/cmtrdind/439/439ap07.htm (last visited 29 June 2009)

[6] See particularly Financial Reporting Standard 5 " Reporting the Substance of Transactions"

[7] L Laeven and R Levine, ,Bank Governance, Regulations and Risk Taking' 2008 at page 4

they might encourage greater levels of capital to be generated.[8] However Laeven and Levine add that since the relationship between risk and regulation is critically dependent on individual banks' ownership structures, with the effect that the relationship between regulation and bank risk can vary according to ownership structure, a consideration of the impact of ownership structures is necessary in order to present a more accurate analysis of bank risk taking.[9] Further, they illustrate their assertion through a demonstration of how ownership structure associates with bank regulations to impact the risk taking behaviour of individual banks.[10]The following theories are considered:

- That the effect of regulation on risk is dependent on the relative influence of owners who exist within governance structures of individual banks
- That bank regulators influence risk taking incentives of owners in a different manner to those of managers (banking theory),
- That ownership structures affect the ability of owners to influence risk (corporate governance theory)

By merging the theories, they arrive at the conclusion that:[11]

Firstly, owners who have "diversified" their assets have greater incentives to indulge in higher levels of risk taking than managers who are non shareholders and that as a result, banks which have powerful and diversified owners are more likely to be riskier than "widely held banks" – provided other factors are constantly maintained. Secondly, bank regulations such as capital requirements and deposit insurance, generate effects which differ when considered in relation to incentives of owners as opposed to that of managers and that as a result, the "comparative power of shareholders relative to managers within each bank's corporate governance structure" influences the real impact of regulations on risk taking.

In response to questions such as: i) why the corporate form of organization consisting of "widely diffuse" ownership is so common - given the existence of "positive agency costs"[12] ii) why the growth of equity in such organisations has been immense and iii) why many individuals are willing to entrust a huge proportion of their wealth to be managed by people with little interest in their welfare, Jensen and Meckling refer to the argument put forward by Manne[13], Alchian and Demsetz[14], namely, that the advantage of the corporate form (by way of sole proprietorships or

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[8] See ibid; Also see D Kim and A Santomero, ‚Risk in Banking and Capital Regulation' 1994 Journal of Finance 43 at 1219-1233

[9] L Laeven and R Levine, ‚Bank Governance, Regulations and Risk Taking' 2008 Journal of Financial Economics at page 6

[10] ibid at page 5

[11] See ibid

[12] In Jensen and Meckling's view, "The existence and size of the agency costs depends on the nature of the monitoring costs, the tastes of managers for non-pecuniary benefits and the supply of potential managers who are capable of financing the entire venture out of their personal wealth. If monitoring costs are zero, agency costs will be zero or if there are enough 100 percent owner-managers available to own and run all the firms in an industry (competitive or not) then agency costs in that industry will also be zero". See M Jensen and W Meckling „Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" 1976 at pages 34 and 35 of 78

[13] HG Manne, „Our Two Corporate Systems: Law and Economics" 1967 Virginia Law Review 53 at pages 259-284

[14] A Alchian and H Demsetz "Production, Information Costs and Economic Organisation" 1972

partnerships) is attributable to the limited liability of equity claims.[15] However Jensen and Meckling are of the opinion that such argument does not provide sufficient explanation since limited liability is considered just to be a means of transferring basic risk – and not eliminating it.[16] One of their solutions to the puzzling questions is that the key lies with transaction costs.[17] The existence of unlimited liability, in their view, would place cost obligations (related monitoring liabilities and wealth of other owners) on shareholders and that such costs would be much higher than payment obligations of a premium consisting of higher interest rates to creditors of the company (in return for an acceptance of a contract which would accord limited liability to shareholders).[18]

John, Saunders and Senbet[19] contend that focussing bank regulations on bank capital ratios may prove to be an ineffective means of controlling risk taking. They seek to address the issue by recommending a more direct mechanism which would not only impact incentives in bank risk taking, but which also illustrates that bank owners select an "optimal management compensation structure" that compels the bank's management to make optimal choices.[20]

II. Effective Audit Committees - Role of the Audit Committee in Corporate Governance

According to Article 1 paragraph 24 of the 2006 Directive on Statutory Audits,[21] audit committees and an effective internal control system not only help to minimise financial, operational and compliance risks, but also "enhance the quality of financial reporting."

As well as playing a fundamental role in transmitting financial results to the general public, the audit committee serves as representative of shareholder interests and is required to facilitate a process whereby management, external auditors and the chief executive can be questioned and held to account[22] - if need be. The audit committee is not only responsible for monitoring the financial reporting process, but also the effectiveness of the company's internal controls, the internal audit – where applicable, and risk management systems.[23] It is also assigned with the task of monitoring the statutory audit of the annual and consolidated accounts. The audit committee contribution in facilitating the fulfilment of the external auditor's role in corporate governance will be considered in the following section.

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[15] M Jensen and W Meckling „Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" 1976 <http://papers.ssrn.com/sol3/paper.taf?ABSTRACT_ID=94043> at page 35 of 78 Also see Journal of Financial Economics Volume 3 No 4 at pages 305 -360

[16] See ibid at page 36 of 78

[17] ibid

[18] As a result, the creditors would assume risk liability for any non payment of debts – should bankruptcy occur; ibid

[19] See K John, A Saunders and LW Senbet, 'A Theory of Bank Regulation and Management Compensation' The Review of Financial Studies 2000 Volume 13 No 1 at pages 95-125

[20] ibid at page 95

[21] Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts amending Council Directives 78/ 660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

[22] S Green, *Sarbanes Oxley and the Board of Directors: Techniques and Best Practices for Corporate Governance* 2005 John Wiley and Sons at page 66

[23] See Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts, Article 41(2) (a) and (b)

C. Contribution of External Auditors in Helping to Resolve Agency Problems.

Corporate governance aims to resolve problems which arise from the principal-agent relationship, whereby owners have an interest in maximising the value of their shares – whereas managers tend to be more interested in "the private consumption of firm resources and the growth of the firm".[24] It addresses such problems through the contract drafting process and others measures which are developed.[25] One measure which could contribute to corporate governance efforts in addressing the agency problem is the external auditor's involvement. Such involvement will be discussed in part, with reference to the Sarbanes Oxley Act's contribution to corporate governance. As of now, the engagement of the external auditor as a means of addressing agency problems will be considered.

Even though monitoring costs – unlike agency costs, cannot be avoided (as is the case with 100% owner management scenarios), they could be minimised. The external auditor would facilitate a situation whereby managers are encouraged or compelled to be held more accountable. Through an appropriate application of accounting policies, the external auditor could help facilitate a position whereby creative accounting practices and hyper inflation/inflation of figures are discouraged. Penalties could be imposed on managers and directors who intentionally or recklessly inflate or manipulate accounting figures and financial statements. Such penalties could arise in the form of a reduction of such managers' (and directors') annual bonuses , remuneration or even pensions. The likelihood of a qualified audit opinion (as regards the auditor's findings on the financial statements) is considered to be less effective as a deterrent to such managers – particularly where an individual manager or few managers are responsible for fraudulent related acts.

Apportionment of liability on a proportionate basis would also produce a more equitable result – than is the case where a qualified opinion is issued by the auditor. The financial audit remains an important aspect of corporate governance that makes management accountable to shareholders for its stewardship of a company.[26] In this regard, attention is drawn to the importance of audit committees. Audit committees do not only serve as internal monitoring devices which support good corporate governance, they are also considered to be mechanisms of ensuring that an appropriate relationship exists between the auditor and the management whose financial statements are being audited.[27] Prior to corporate governance reforms in many jurisdictions, the pressures faced by external auditors from directors in many firms constituted the focus of several major issues. Furthermore "creative accounting" practices were widespread. The audit serves as a signalling mechanism to shareholders of a company that information provided by the company's

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[24] See S Vitols, ‚Corporate Governance versus Economic Governance: Banks and Industrial Restructuring in the US and Germany' 1995 < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=607641> (last visited 14 January 2011)
[25] See ibid
[26] S Fearnley and V Beattie, *Auditor Independence and Non-audit Services: a Literature Review* (2002) at page 1 ICAEW, London
[27] See V Beattie, S Fearnley and R Brandt, *Behind Closed Doors: What the Company Audit is Really About* (Institute of Chartered Accountants in England and Wales 2001) at page 29; Also see Cadbury Report 1992

directors can be relied upon. Auditing standards have a role to play in ensuring that factors such as objectivity, integrity and independence, factors which are essentially in the external auditor's performance of his responsibilities, are respected. However attention has been drawn to the importance of other issues such as enforcement and disclosure standards:

"The quality of reported financial information, however, is influenced not simply by the quality of accounting standards, but also by other institutional factors [corporate governance, the legal system, and the existence and enforcement of laws governing investor protection and disclosure standards] that affect the demand for and the supply of financial information."[28]

The crucial role played by enforcement in investor protection laws and disclosure standards in corporate governance has also been highlighted.[29] It is contended that investor ownership is not only likely to be diffuse, but that ownership is likely to be distinct from control in common law countries.[30] For effective enforcement to take place, shareholder litigation and bankruptcy laws may be vital routes to ensuring that investor rights are protected.[31]

According to Hopt[32], an improvement of corporate governance in Europe, in the aftermath of Enron would require the involvement of intermediaries such as external auditors. Furthermore, he notes that the control of the Board by auditors is not only the "most common", but also the "most prominent control mechanism"[33].

Restrictions on the outsourcing of any internal audit functions to a client firm's external auditor, a consequence of the Sarbanes Oxley Act of 2002, is attributed to independence concerns.[34]

According to Abbott and others, outsourcing routine internal audit activities not only constitutes a threat to external auditor's independence – given its repetitive nature, but could also impair internal audit independence and generate disagreements relating to financial reporting and internal control issues between the external auditor and management.[35] Arguments for engaging

[28] See GG Mueller 'The Role of Financial Reporting' at page 109 <http://www.bos.frb.org/economic/conf/conf44/cf44_8.pdf> (last visited 14 January 2011) and also SP Kotheri, 'The role of financial reporting in reducing financial risks in the market'http://www.bos.frb.org/economic/conf/conf44/cf44_6.pdf

[29] Ibid; For further information on the impact of regulations and disclosure requirements on risk taking levels, please refer to M Ojo, „The Impact of Capital and Disclosure Requirements on Risks and Risk Taking Incentives" <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1547023> and http://mpra.ub.uni-muenchen.de/20404/1/MPRA_paper_20404.pdf and also M Ojo, „Preparing for Basel IV : why liquidity risks still present a challenge to regulators in prudential supervision (II)" <http://mpra.ub.uni-muenchen.de/27778/> and <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1732304>

[30] See SP Kotheri, 'The role of financial reporting in reducing financial risks in the market' at page 99 http://www.bos.frb.org/economic/conf/conf44/cf44_6.pdf

[31] ibid

[32] K Hopt, 'Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron' CGI Law Working Paper No. 05/2002 at page 476 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=356102>

[33] ibid at page 497

[34] See Abbott and others, 'Corporate Governance, Audit Quality and the Sarbanes Oxley Act: Evidence from Internal Audit Outsourcing'2007 at page1

[35] see ibid at page 2 and page 12

the external auditor to undertake non routine tasks include the fact that non routine tasks are not only non repetitive by nature, they also require specialised knowledge which internal auditors may not be able to acquire in house.[36] Further, the use of external auditors in performing non routine tasks may be more efficient.[37]

Safeguards which exist to ensure that threats to auditor's independence are mitigated include: prohibitions, restrictions, policies, procedures and the requirement for disclosures.[38] As a means of achieving maximum degree of harmonisation, EU member states are permitted to impose additional national audit procedures or requirements.[39]

Furthermore, Article 22 paragraph 1of the Directive[40] states that "Member States shall ensure that when carrying out a statutory audit, the statutory auditor and/or the audit firm is independent of the audited entity and is not involved in the decision-taking of the audited entity." Where any direct or indirect financial or business relationship exists between the statutory auditor, audit firm or branch of audit firm and the audited firm(and this includes the provision of additional non audit services), and an "objective, reasonable and informed third party" would deduce that the statutory auditor's independence is being compromised, member states are required to ensure that such a statutory auditor or audit firm does not perform the audit.[41] In response to a situation whereby the external auditor is affected by threats,[42] the statutory auditor is required to ensure that safeguards aimed at mitigating such threats are applied.[43]

D. Conclusion

External auditors can impact the risk taking incentives of management through an appropriate application of accounting policies. However, it is also important to ensure that rules (in the event of a breach of accounting polices)are correspondingly enforced. The external auditor's responsibilities and the audit committee's role in corporate governance are fundamental complements in helping to achieve the desired aims of corporate governance. Safeguards are

[36] ibid at page 3

[37] Other advantages which have been identified in engaging the external auditor's expertise – as opposed to that of an outside service provider include: i) Synergies which are derived from "knowledge spillovers" between the outsourcing of particular audits and which would generate a more comprehensive financial statement audit; ii) the fact that the external auditor's knowledge of the client's accounting systems and functions facilitates collaborative efforts between the internal and external auditors – which in turn generates greater efficiency; and that iii) the external auditor's knowledge of the client's accounting systems could also reduce the risk of "budget overruns". See ibid at page 16

[38] See Article 1 paragraph 11 Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts

[39] Only where these can be attributed to specific national legal requirements which are related to the scope of the statutory audit of annual or consolidated accounts – which implies that those requirements should not have been covered by international auditing standards which have been adopted ; see ibid at Article 1 paragraph 13

[40] Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts

[41] See paragraph 2

[42] For example, self-review, self interest, advocacy, familiarity, or trust and intimidation threats

[43] See ibid; Where the significance of the threats, in comparison to the applied safeguards is such that external auditor's independence is compromised, the auditor is required not to undertake the statutory audit; paragraph 2.

necessary to ensure that the external auditor's expertise is maximised. Even though external auditors play a vital role in corporate governance, through their involvement and their examination of financial statement and accounting policies[44], several areas continue to give rise to problems. IFRS (International Financial Reporting Standard) 32 and 39, two reporting standards which deal with off-balance sheet instruments and which created problems in the Parmalat and Enron cases, still constitute a challenge for the IASB. Off balance sheet instruments created problems in the afore mentioned cases owing to the fact that they were not reflected in the balance sheet – even though their sizes could have been as large as two to three times global GDP. The IASB will also face further challenges of reconciling these standards at a global level – with the US in particular. Further challenges also include contentious circumstances which exist under financial reporting standards and bank rules. Under IFRS 32 what may be referred to as equity may not be permitted under bank regulation.

[44] For further problems, including the difficulty of comprehending complex products, see S Green, *Sarbanes Oxley and the Board of Directors: Techniques and Best Practices for Corporate Governance* 2005 John Wiley and Sons at page 66

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