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

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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.

Finally the paper will propose criteria which should determine whether or not executives should be compensated, as well as consolidate on why (compensation) incentives should be aimed at generating improved long term performance and results rather than a focus on short term performance and results.

Key Words: corporate governance, banking theory, risk, ownership structures, auditor, disclosure, principal, agent, regulation, moral hazard, Efficient Markets Hypothesis, value relevance, compensation schemes, fair value accounting, Finance Theory

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

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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).

The level of monitoring undertaken by an agent, on behalf of its principal, is a primary determinant of the level of performance which can be attained by a firm. It is frequently contended that less dispersed ownership (ie concentrated ownership) generally results in greater monitoring on the part of the agents or management of the firm.

According to Maher and Andersson, concentrated ownership not only brings more effective monitoring of management, but also aids in overcoming the agency problems arising from the separation of ownership and control – even though they admit that certain costs, namely, that of low liquidity and reduced possibilities for risk diversification, exist.[5]

Three key themes which are considered to have emerged from lessons learned from various

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1 Email:marianneojo@hotmail.com
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 M Maher and T Andersson, „Corporate Governance: Effects on Firm Performance and Economic Growth“ OECD 1999 at page 3. They add that „one of the consequences of rent extraction in insider systems is the lack of liquidity in secondary markets as investors withhold funds – with the resulting consequence that capital markets in insider systems tend to be much less well developed than those found in outsider systems.“ see ibid at page 25

corporate collapses are:[6]

emphasis on “substance of the transaction”[7] 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 sections 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.

Whilst the level of compensation is also necessary in motivating agents or executives, incentives should be aimed at generating improved long term performance and results rather than a focus on short term performance and results. Therefore rewards should be tied to those schemes which would encourage greater focus on long term results. Such incentives would also discourage behaviour which results in high risk taking levels. Stock options, as well as dispersed ownership systems are considered to encourage „short termist behaviour“.[8]

For these reasons, the involvement of other actors such as the State or banks in corporate governance will be highlighted under section B - given the disadvantages of having an excessively powerful and dominating agent. However, the section will firstly also illustrate that bank regulations could also impact risk taking levels – both negatively and positively.

6 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-stationeryoffice.co.uk/pa/cm200203/cmselect/cmtrdind/439/439ap07.htm (last visited 29 June 2009)

7 See particularly Financial Reporting Standard 5 “ Reporting the Substance of Transactions”

8 See M Maher and T Andersson, „Corporate Governance: Effects on Firm Performance and Economic Growth“ OECD 1999 at page 23; Maher and Andersson also argue that „executive compensation geared to align the interest of managers with those of shareholders may serve to exacerbate short-termist behaviour.“ It is added that a preferrable approach would be to limit executive remuneration or have it more closely linked to corporate performance.

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.[9]

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 they might encourage greater levels of capital to be generated.[10]

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.[11]

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.[12]

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)

9 L Laeven and R Levine, ‚Bank Governance, Regulations and Risk Taking' 2008 at page 4

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

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

12 ibid at page 5

By merging the theories, they arrive at the conclusion that:[13]

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”[14]

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,[15] Alchian and Demsetz,[16] namely, that the advantage of the corporate form (by way of sole proprietorships or partnerships) is attributable to the limited liability of equity claims.[17]

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.[18]

13 See ibid
14 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
15 HG Manne, „Our Two Corporate Systems: Law and Economics“ 1967 Virginia Law Review 53 at pages 259-284
16 A Alchian and H Demsetz “Production, Information Costs and Economic Organisation” 1972
17 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
18 See ibid at page 36 of 78

One of their solutions to the puzzling questions is that the key lies with transaction costs.[19]

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).[20] John, Saunders and Senbet[21] 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.[22]

B.II Involvement of Banks in Long Term Financing and Correspondingly Low Liquidity Levels

From the perspective of long term results and performance, Maher and Andersson argue that whilst dispersed ownership has the perceived benefits of generating higher liquidity, that it may not provide „the right incentives to encourage long-term relationships that are vital for certain types of investment."[23] In addressing their concern that one challenge faced by policymakers constitutes the design of a good corporate governance framework „which can secure the benefits associated with controlling shareholders acting as direct monitors, while at the same time ensuring that they do not impinge upon the development of equity markets by expropriating excessive rents", we now focus on the role of banks and auditors in the corporate governance process.

Maher and Andersson's consolidate the points that dispersed ownership systems (notably those which operate in the UK and the US), do not encourage long term relationships, by adding that German and Japanese systems of corporate governance are characterised by long term relationships

19 ibid

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

21 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

22 ibid at page 95

23 M Maher and T Andersson, „Corporate Governance: Effects on Firm Performance and Economic Growth" OECD 1999 at page 23

with banks which, in their opinion, encourage bank financing, whilst firms in the US and UK benefit from high levels of equity capital.[24]

From the above, it can be seen that compensation incentives for the agent would immensely benefit the shareholders if they are tied in to long term compensation arrangements, whilst the period of financing appears also to be of immense benefit if on a long term basis – as is the case with concentrated ownerships – with certain investments.

How could monitoring be facilitated and enhanced – such that board ownership of shares does not constitute the most effective or most relied upon means or incentive whereby agents are inclined to better monitor the affairs of the firm? The involvement of banks in long term financing does not constitute the only merit to be derived from banks' involvement in corporate ownership structures. The use of external auditors by banks also provides for greater monitoring of firms.

If insider trading could be discouraged – since consequently, agents have less incentives to act in their own interests where less opportunities for insider trading exist, this would reduce the need for monitoring. However, it has also been highlighted by several sources[25] that board ownership of shares, that is an existence of agents' interests in the firm, could also have a positive effect on performance – hence effective corporate governance measures which serve to ensure that adequate monitoring and corporate governance arrangements are in place, appear to offer the best alternative.

In this sense external auditors will not only be able to play vital roles in corporate and financial reporting – hence reducing information asymmetries which may exist between principal and agent, but will also be supported through such internal monitoring devices as audit committees.

24 See ibid at page 25
25 See S Bhagat and B Bolton, „Corporate Governance and Firm Performance" Journal of Corporate Finance 14 (2008) 257 -273 at page 271. Bhagat and Bolton also add that „efforts to improve corporate governance should focus on stock ownership of board members – since it is positively related to both future operating performance, and to the probability of disciplinary management turnover in poorly performing firms." It is however cautioned that „proponents of board independence should note the negative relation between board independence and future operating performance – hence if the purpose of board independence is to improve performance, then such efforts might be misguided. However, if the purpose of board independence is to discipline managment of poorly performing firms, then board independence has its merits." see ibid at page 272

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

According to Article 1 paragraph 24 of the 2006 Directive on Statutory Audits,[26] 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[27] - 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.[28] 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.

C II. 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".[29]

It addresses such problems through the contract drafting process and others measures which are

26 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

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

28 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)

29 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)

developed.[30]

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 held responsible for fraudulent related acts. In such a case, a „scapegoat" or few scapegoats would be held to account for the negligent acts of others who should also have been brought to book for their actions.

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.[31]

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.[32]

30 See ibid
31 S Fearnley and V Beattie, Auditor Independence and Non-audit Services: a Literature Review (2002)at page 1 ICAEW, London
32 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

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 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."[33]

The crucial role played by enforcement in investor protection laws and disclosure standards in corporate governance has also been highlighted.[34]

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.[35] For effective enforcement to take place, shareholder litigation and bankruptcy laws may be vital routes to ensuring that investor rights are protected.[36]

According to Hopt,[37] an improvement of corporate governance in Europe, in the aftermath of Enron

33 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

34 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.unimuenchen.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>

35 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

36 ibid

37 K Hopt, 'Modern Company and Capital Market Problems: Improving European Corporate Governance After

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."[38]

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.[39]

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.[40]

Arguments for engaging 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.[41] Further, the use of external auditors in performing non routine tasks may be more efficient.[42]

Safeguards which exist to ensure that threats to auditor's independence are mitigated include: prohibitions, restrictions, policies, procedures and the requirement for disclosures.[43]
As a means of achieving maximum degree of harmonisation, EU member states are permitted to impose additional national audit procedures or requirements.[44]

Enron' CGI Law Working Paper No. 05/2002 at page 476 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=356102>

38 ibid at page 497

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

40 see ibid at page 2 and page 12

41 ibid at page 3

42 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

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

44 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

Furthermore, Article 22 paragraph 1of the Directive[45] 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.[46]

In response to a situation whereby the external auditor is affected by threats,[47] the statutory auditor is required to ensure that safeguards aimed at mitigating such threats are applied.[48]

D. Fair Values and the Finance Theory

In order for external auditors to effectively carry out their tasks, the use of fair value measures, in certain instances, as the basic measure for IFRS, merits reconsideration. Where particularly complex and difficult to value financial products are involved, other measurement bases could be employed where (and if) greater relevance and certainty would be derived. Other measures such as historical cost, that is. Where vital characteristics of accounting information, characteristics such as understandability, relevance, comparability, faithful representation, prudence and predictability *inter alia*, would be compromised then a combination of measures such as the historical cost, current cost, realizable value and present value could be incorporated to achieve the best results which would enhance the value of accounting information.

The rise in fair value accounting is considered to be attributed to Finance Theory – which is premised on the Efficient Markets Hypothesis. Whilst fair value accounting certainly has its merits and is considered by many as a justifiable basis for the adoption of IFRS, its inability to contribute the desired level of relevance to the value of accounting information – so called value-relevance characteristics which are essential and vital for information within capital markets (as well as

45 Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts
46 See paragraph 2
47 For example, self-review, self interest, advocacy, familiarity, or trust and intimidation threats
48 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.

information essential to other corporate and business spheres), are flaws not only associated with its implementation, but also attributes which increasingly link it to the Finance Theory.

The influence and role of Finance Theory in the use of off-balance sheet instruments during Enron, as well as other creative accounting practices is ironically, partly, contributory to the decision to introduce IFRS – a post Enron consequence. However, it appears that part of the underlying problems in the case of Enron – namely the need for more value relevance of accounting information, appears, to a large extent, to have been ignored.

Kirkpatrick states that „another area where accounting standards have been put to the test concerns fair values of assets which either trade in thin markets or in no markets at all.“[49] Since markets with relatively few large clients are considered to be thin markets, it could inferred that such capital markets which operate in concentrated ownership systems (insider systems) which are typical of Europe (excluding the UK), and which are less developed than those of the UK and the U.S, will be more affected by fair value measures.

Hence the „short termist behaviour“ relating to compensation appears to affect outsider systems, to a larger extent, whilst fair value measurements, it appears, will be more problematic for insider systems. Hence incorporating more actors such as banks might appear to be the logical solution to addressing „short termist“ executive compensation issues with outsider systems – whilst the involvement of external auditors through banks, could also facilitate a greater degree of monitoring and accountability to the shareholders.

As regards insider systems, executive compensation still requires redress – even if not really at the same scale as that required by outsider systems. Fair values as primary bases for the adoption of IFRS will require careful consideration – given many flaws which have also been revealed from the recent Financial Crisis.

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49 G Kirkpatrick, „The Corporate Governance Lessons from the Financial Crisis“ Financial Market Trends ISSN 1995-2864 OECD 2009 at page 26

E. 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 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,[50] several areas continue to give rise to problems.

IAS (International Accounting Standards) 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 IAS 32 what may be referred to as equity may not be permitted under bank regulation.

The role of executive compensation in exacerbating levels of risk taking by executives, as well as the contribution of fair values to risks and uncertainties, have been demonstrated in the recent Financial Crisis. The external auditor has roles to play in both situations – through an engagement with banks whose involvement not only mitigates instances of „short termist" behaviours, but also facilitates greater monitoring and accountability in the corporate governance process. Furthermore, through the application and incorporation of appropriate measures and accounting policies, the external auditor is able to influence financial reporting in such a way as to ensure that bases of measurement reflect the desirable qualities and attributes of accounting information.

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50 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

Remuneration packages and compensation for executives should be dependent on their ability to comply with capital and liquidity requirements – such requirements aimed at containing and preventing risk contagion. Whilst flaws have been exposed with capital adequacy requirements and stress testing in the recent Financial Crisis – with certain firms operating within minimum capital adequacy requirements, and still collapsing, liquidity requirements also need to be complied with – particularly in the said jurisdictions that have lower availability of liquidity. Having said this, it also needs to be re-iterated that Bear Stearns and Northern Rock were operating within stipulated capital adequacy requirements but were facing low liquidity levels when they crashed. In rewarding executives for compliance with capital and liquidity requirements, such compensation will not only help secure the profitability and performance of such complying firms, but will also help to avoid systemic contagion which could arise as a result of liquidity and systemic risks.

Regulatory convergence – with the adoption of Basel III globally, as well as strict compliance with, and enforcement of Basel capital and liquidity standards, would not only facilitate consistency in the application and interpretation of regulatory standards, but would also introduce greater degree of certainty and comparability which would greatly assist the ambit and scope of the application of international accounting standards.

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