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Is corporate governance a modern fantasy?

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Is corporate governance a modern fantasy?

Andrew Higson discusses the reality of financial reporting and asks if corporate governance still has a role to play in the modern business world.

What is the difference between the collapse of Enron and the recent collapse of the banking sector? Well, the obvious answer is that Enron's demise was not as significant. Yet, in the wake of Enron's collapse, the Sarbanes-Oxley Act was rushed into law in the USA in order to cure the perceived corporate ills of, and give back credibility to, corporate America. Organisations around the world have since spent thousands of hours becoming Sarbanes-Oxley compliant in order to be able to continue trading with companies in the USA.

At the centre of Sarbanes-Oxley was its focus on strengthening corporate governance procedures to prevent fraud and mismanagement – but the chaos in the banking sector must raise a question over the success of Sarbanes-Oxley and, more significantly, over the whole idea of corporate governance.

Driving forces

The prime responsibility for any business failure must rest with its top management. So what caused management to get things so wrong? Management's motivations provide the driving force behind the way financial statements (often viewed as the public face of an organisation's indication of performance) are prepared and presented. These motivations may range from meeting profit targets (so as to satisfy City expectations or earn personal bonuses) to ensuring the survival of the business. The rewards for hitting these short-term targets may merely reinforce this behaviour.

Motivational aspects permeate the whole

way in which an organisation is run and the way in which its results are presented to the outside world. So where does this leave the non-executive directors? One of the main elements in the recent development of corporate governance has been the growth in the use of non-executive directors. One of their roles is to challenge and contribute to the development of the company's strategy. It is clear from the collapse in the banking sector that the non-executives were unable to limit the actions of management. This sudden collapse can be seen to have arisen from the actions and motivations of senior managers rather than from failures in internal controls – which were a primary focus of Sarbanes-Oxley.

The assessment of corporate performance is an important part of corporate governance. The problem is how to judge corporate performance – and its associated risks.

Financial reporting

Financial statements are often, unquestioningly, taken as a fundamental indicator of corporate performance. But what do they really show, and what is their purpose? In the UK during the 1990s there was the 'statement of principles' debate, where the accounting standard-setters focused on the decision-usefulness of financial statements – to which their critics objected. Decision-usefulness, however, won through, with its emphasis on the relevance and reliability of the data in the financial statements to enable users to take economic decisions, and its downplaying of the fundamental accounting concepts (a

key one being prudence).

This was not the only change. As a result of the primacy of the needs of users, the focus of the financial statements moved from the income statement (emphasising income and expenditure) to the balance sheet (with the emphasis on the assets and liability approach). The consequence has been the rise of comprehensive income, with its focus on fair values and mark-to-market accounting. So a profession that had been noted for prudence and conservatism was suddenly at the forefront of innovative financial disclosure. Whilst it could be argued that the 'prudent' approach may have understated corporate performance, it probably limited the risks associated with the financial figures. The comprehensive income approach attempts to 'capture' financial performance in a wider sense, but has probably increased the risks associated with the financial data – a factor that does not seem to have received much attention.

The recent focus of the standard-setters on unspecified users taking unspecified decisions, at unspecified times, with unspecified success seems to be a dubious basis to underpin the production of financial reporting standards, and, indeed, there is the distinct possibility that standard-setters are building on shifting sands that will not provide a firm foundation for the production of a consistent and coherent set of standards. Consequently, there is a danger is that financial statements may mean all things to all people – with an overreliance on external auditors 'to see that things are right'.



External auditors

What are the implications for the external auditors? One presumes that the external auditor's report would imply that the financial statements were 'fit for purpose'. However, the focus on decision-usefulness has not been endorsed by them – the audit report says nothing about this. Indeed, following the Bannerman case in 2002, some auditors in the UK added a paragraph to their audit reports specifically to deny liability for users taking decisions based on financial statements audited by them.

Also, decision-usefulness was not endorsed by the UK Company Law Review Report in 2001. Therefore, we have a situation where the standard-setters are saying that the objective of financial statements is decision-usefulness, yet this stance seems to have limited support from those who have given this issue serious consideration (other than some vocal users of the financial statements).

Both accounting and auditing are often considered to be technical subjects. However, this perception of technical precision tends to underestimate the complexities of external reporting and the real nature of the management-auditor relationship. As has already been noted, management are keenly interested in the picture that is portrayed in the financial statements. The very nature of financial reporting means that a whole multitude of judgments and estimates have to be made during the compilation of the statements – hence the potential for bias. If management intend to smooth profits, even auditors admit that this is very difficult to detect. The treatment of an item in the financial statements may be acceptable, questionable or unacceptable, depending on the motivations behind it. Perhaps, therefore, the external audit

should be viewed in the context of the audit of management's motivations – and there should be questions over whether the financial statements are really free from bias.

When it comes to fraud, the classification of an action often depends on the motivations behind it (e.g. was it deliberate or accidental?). So at what point does bias become fraud? The dividing line between the two, in certain circumstances, may at the very least be very fine. Often it is the passage of time that makes things clear – a luxury the external auditors frequently do not have.

The financial reporting expectations gap

In terms of assessing corporate performance, the external auditors say nothing about corporate or management performance. Nor do they comment on economy, efficiency and effectiveness in their audit reports – or the associated risks. This raises the question that, if the auditors says nothing about these things, how are the users expected to form their own opinions? If one thinks about the word 'performance' in a theatrical sense, it could be defined as 'an act of make-believe aimed at enchanting an audience'. I am sure we can all think of situations where this description would be applicable to various organisations' financial statements!

There has been much discussion of the audit expectations gap. Indeed, it has been a driving force behind the expansion of the audit report in the early 1990s and has focused the debate about the responsibilities of the auditor. Compared to the recognition given to the audit expectations gap, the possibility of a financial reporting expectations gap comprising an audit expectations gap and a financial statement expectations gap

has almost been ignored. The inability to communicate the limitations of the financial statements and the preoccupation of the accounting standard-setters with satisfying user needs may be central to this financial statements expectations gap. Simply attempting to tackle the audit expectations gap whilst ignoring the financial statements expectations gap would seem to be doomed to failure.

The future

The last couple of decades have seen an increasing focus on corporate governance. Whilst there have been some criticisms of individual aspects of corporate governance, in general there seems to have been a consensus regarding its importance and desirability. However, I would suggest that the current situation requires a fundamental review of the nature of corporate governance and its relationship with financial reporting. With the collapse of the banking sector, I would suggest that it is difficult to think of any greater condemnation of the current system of corporate governance – a system that had been specifically 'strengthened' following the collapse of Enron. The situation has not been helped by the accountancy profession's inability to be clear about the scope and limitations of the financial statements in the age of the knowledge economy. One has to start to consider the possibility that organisations are becoming too large and too complex to be effectively controlled and monitored and that corporate governance may in fact be a modern fantasy.

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