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<th><strong>Title</strong></th>
<th>Accounting in crisis: a story of auditing, accounting, corporate governance and market failures</th>
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<td><strong>Authors(s)</strong></td>
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Accounting in Crisis: A story of Auditing, Accounting, Corporate Governance and Market Failures

Niamh Brennan

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Abstract

Recent accounting scandals are the product of multiple failings of auditing, accounting, corporate governance and of the market. In discussing the many factors that led to failure, this paper attempts to provide insights on regulatory inadequacies that contributed to these problems. At the centre is human failure – in particular greed and weakness. Reforms in progress are briefly examined, with the caveat that no reforms will ever fully cater for human weakness.
INTRODUCTION

This paper examines some of the factors that have contributed to recent accounting scandals. No one factor can be identified that caused these accounting failures. Multiple problems occurred simultaneously – failures in auditing, in accounting, in corporate governance, and in the market. These are discussed below.

WHAT IS CORPORATE GOVERNANCE?

Corporate governance refers to the system by which companies are directed and controlled. It can also be described as the balance of power reflecting the rights of owners, managers, lenders and other stakeholders (e.g., employees, government). When that balance of power is inappropriate (such as where there is excessive dominance by one individual such as the chief executive or company chairman), governance may be hampered and problems may emerge.

FINANCIAL REPORTING IN THE CONTEXT OF CORPORATE GOVERNANCE

Company owners (shareholders) are often separated or removed from the day-to-day operation of companies. They delegate that task to company management. As a result there are costs – the agents (company management) may act in their own personal interest rather than the personal interests of their owners (shareholders). These conflict-of-interest costs are referred to as agency costs. In the case of recent accounting scandals, these agency costs have in some cases been so high as to result in the “death” of the company.

The separation of ownership and control of companies also gives rise to information asymmetry between shareholders (and stakeholders) on the one hand, and company management on the other. Financial reporting bridges that information gap. Financial reports make public information previously only known to company management.

Company management prepare financial reports. These financial reports are made publicly available to users, i.e. shareholders and other stakeholders. Auditors are the “referees” in this process. They provide users of accounts with some assurance concerning the accounts. However, the nature of the assurance offered is unclear. Do they provide assurance on the accuracy of the accounts? Investors generally do not understand the nature of the assurance provided by auditors. Auditors refer to this as an expectations gap, i.e., the gap between the auditors’ actual standard of performance and the various public expectations of auditors’ performance (as opposed to their required standard of performance).

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

Company law requires directors to “lay before the annual general meeting” a profit and loss account and a balance sheet. Directors are responsible for preparing financial statements that give a “true and fair view”. Auditors are responsible for

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[3] Section 148 (1) and (2), Companies Act 1963
[4] Section 149 (1), Companies Act 1963
auditing the financial statements and reporting whether, in their opinion, the financial statements give a “true and fair” view.[5]

The Cadbury Report[6] on corporate governance (responding to perceived failures in accountability in the late 1980s) introduced a requirement that directors include a statement of responsibilities in annual reports. Cynics might suggest that this new recommendation was an effort to protect the sponsoring organisation – the accountancy profession! Both the statement of directors’ responsibilities, which generally appears in the directors’ report, and the statement of the respective responsibilities of directors and auditors, which appears in the auditor’s report, follow standard wording. It is hard to be convinced of their value when they are almost identically worded from company to company. The wording seems to have more to do with protecting auditors from litigation than with communicating meaningful information to shareholders.

OBJECTIVE OF AUDITS

An audit is an independent review of the financial statements. The output of an audit is the auditors’ report on the financial statements in which auditors express an opinion on whether the accounts give a “true and fair view”. The audit report is not a certificate – auditors do not certify the financial statements. A “clean” audit report does not guarantee the accuracy of the financial statements – as the auditors do not examine 100% of the transactions of the company. It is not the function of an audit to detect fraud (although fraud may come to light during an audit). The auditors give no opinion on the viability of the business.

Company law requires accounts to give a “true and fair view”. Company law requires auditors to report on whether accounts give a “true and fair view”. But what does the term “true and fair view” mean? It is not defined by legislation, or by the accounting profession. As a result, it is subject to considerable uncertainty and is therefore the most difficult and judgmental aspect of auditors’ responsibilities. The auditing profession acknowledges this uncertainty as follows:

“A degree of imprecision is inevitable in the preparation of all but the simplest of financial statements because of inherent uncertainties and the need to use judgment in making accounting estimates and selecting appropriate accounting policies. Accordingly, financial statements may be prepared in different ways and yet still present a true and fair view.”[7]

However, most investors do not understand that “financial statements may be prepared in different ways and yet still present a true and fair view.”

What is the purpose of an audit? The auditing professions own definition of an audit shown below highlights the imprecision and uncertainly associated with auditing. In particular, a number of terms in this definition should be noted:

• The audit provides “reasonable assurance” only
• The audit opinion is only on financial statements “taken as a whole”
• The audit opinion should not be interpreted as implying that the financial statements are “free from...mis-statement”
• The audit opinion only indicates that the financial statements are free from “material” mis-statement

“An audit...is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement”.[8]

Compounding this imprecision and uncertainty around auditing is the profession’s own description of an audit. Auditors “carry out procedures designed to obtain sufficient appropriate audit evidence...to determine with reasonable confidence whether the financial statements are free of material misstatement”. [9]

MATERIALITY

The auditing profession defines materiality as shown below. This definition begs a number of questions:
• How do auditors know what would reasonably influence decisions of users?
• Are auditors’ understandings of this phrase the same / consistent from individual to individual?

“A matter is material if its omission or mis-statement would reasonably influence the decisions of a user of financial statements”.[10]

At the start of every audit, the audit partner and staff on the audit select a level of materiality to apply to the audit. This is almost always expressed as a monetary amount. Modern auditing practices are based on methodologies that include statistical sampling. The extent of sampling and testing is a function of the level of materiality applied to an audit. Auditors have incentives to choose high levels of materiality - this reduces the amount of work to be done on the audit and therefore makes the audit less costly/more profitable. Auditors do not disclose materiality levels applied in audits. Investors (and users of accounts generally) therefore cannot understand the limits / margin of error inherent in the audit opinion being provided. Materiality levels are often considerably larger than average investors would guess. Why don’t auditors disclose this amount in audit reports? Then audit reports might have some meaning for shareholders by giving them a guide to the margin of error (crudely speaking) in the accounts. What effect would there be if materiality levels were disclosed? Would materiality come down, and the level of audit work increase? In a submission to the

public consultation process on the Central Bank and Financial Services Authority of Ireland (No.2) Bill, the author has called for such disclosure.\textsuperscript{[11]}

Materiality (in effect) builds flexibility into financial reporting. This can lead to abuse. Companies may intentionally record “small” errors within a defined percentage ceiling, so that auditors will not scrutinise such errors (as they are not material). Management excuse errors by arguing that the effect on the bottom line is so small as not to matter – it is immaterial. These small errors can build up and mislead the stock market and other stakeholders e.g. lenders, employees, creditors. This is illustrated by the quote below in relation to the Enron audit.

\begin{quote}
“The remainder of the earnings reductions of $92 million from 1997 through 2000 came from what Enron called “prior year proposed audit adjustments and reclassifications”... recommended by Arthur Andersen, Enron’s auditors, but not made because the auditors were persuaded the amounts were immaterial”\textsuperscript{[12]}
\end{quote}

\textbf{HOW DOES IT GO WRONG?}

We have already seen two limitations of audited financial reports:
1. The level of accuracy / the margin of error in audited accounts is not known as the phrase “true and fair view” is not defined and is a function of subject judgement.
2. The extent to which accounts are / are not free from mis-statement is not known as the term “material” is not precisely defined, nor is it disclosed by company auditors.

\textbf{INHERENT LIMITATIONS OF ACCOUNTING}

There are a number of other inherent limitations in using financial information. That company activities and transactions are recorded as financial information introduces consequent inherent limitations:
- Items must be capable of measurement in money terms.
- Items must be capable of reliable measurement.

As a result, some items are either incapable of being measured in money terms or incapable of being reliably measured. Examples include:
- Intellectual capital – many companies invest heavily (training etc) in their workforce, yet that asset is never recorded in the financial statements. Firstly the asset cannot be reliably measured in money terms. There is also an issue with ownership of the asset (staff may leave organisations and move to other positions). Another example of an intellectual capital asset not recorded in financial statements is customer loyalty developed over the years from company investments in customer relations. There are many more such intangible assets not recorded in accounts.

\textsuperscript{[11]} Brennan (2002).
\textsuperscript{[12]} \textit{New York Times} 9/11/01.
• Internally generated goodwill is not recognised in accounts, whereas externally acquired goodwill is. Thus, the same kind of asset (goodwill) is inconsistently treated in accounts. If the goodwill has been paid for (externally acquired goodwill), it can be reliably measured in money terms (at the amount paid for it) and can therefore be recorded. Such reliable measurement is not possible with internally generated goodwill.

Accounts are therefore missing some significant company assets. This explains why, for listed companies, market values are so different from the book values of assets recorded in the accounts.

Even where assets are capable of being recorded in money terms, they tend to be recorded at historic cost, i.e., at the amount the asset originally cost. The original cost may bear no resemblance to current asset values. One just has to consider the historic cost of an office building bought in 1970 compared with its value now in 2003, to get a sense of the inadequacy and inaccuracy of accounting in the way in which it records such an asset.

ACCOUNTING IS A “WORK OF ART”

The precise numbers and amounts in profit and loss accounts and balance sheets suggest a precision that does not exist. All transactions are measured in precise money amounts. Balance sheets must balance. The reality is that financial reports are the product of multiple subjective judgements by company directors. Accounting is an art, not a science!

All but the smallest businesses follow the accruals method of accounting in preparing their financial reports. Company law requires this basis of accounting. Financial statements that do not use the accruals basis of accounting will not show a “true and fair view”. Under the accruals method of accounting, transactions are recorded by reference to when they occur rather than when cash is received/paid. Using a somewhat extreme example, profit will be recorded in the construction company’s financial statements throughout a long-term (say five-year) contract, reflecting the work being done as the contract progresses, even if the cash from the customer is not received until the end of year five when the contract is completed. The accruals method of accounting (rather than cash accounting) is more suitable for giving a “true and fair view”, but introduces subjectivity into accounting. As transactions are recorded under the accruals method of accounting, estimates and judgements must be applied in deciding when to:
  • Book revenue; and
  • Record expenses.

The most common method of fraudulent financial reporting is recognising (i.e. recording as profit) revenue too soon, although the Worldcom scandal involved not recognising expenses in time.

THE HUMAN ELEMENT AND THE TEMPTATION TO MANAGE EARNINGS

Accounting is a human process and, as a result, has weaknesses. Stock markets are excessively focused on short-term quarterly / half yearly earnings announcements. This can pressurise some managements into managing earnings. Earnings can be managed by exploiting ambiguities in accounting rules.

There are two motivations to manage earnings:

1. *Market expectations*: Motivations to meet market earnings expectations may override common sense business practices. Stock markets can be unforgiving of companies that fail to meet earnings expectations (generally measured by financial analysts, as analyst forecasts).[15]

2. *Smooth earnings*: Share prices are lower for companies with erratic earnings patterns as such companies are perceived by the market to be riskier.[16] Managers are motivated to manage earnings to achieve a smooth pattern for the purposes of a higher share price. In good years, managers make overly prudent subjective judgements which have the effect of lowering profits. In bad years managers are less prudent and can release previous prudent provisions to the profit and loss account, thus increasing reported profits. Bad debt provisions would be suitable for such management, especially in financial institutions where the provisions are very large. A very small change in bad debt assumptions could have a material effect on amounts of reported profits. Academic research has shown that such practices are commonplace and have the effect of allowing companies to report profits which are artificially smooth.

Both motivations to manage earnings are driven by management trying to operate in the best interests of shareholders (by keeping their share price high). However, what starts as minor accounting adjustments carried out in the best interest of shareholders, can end up as financial statement fraud. At what stage does earnings management (legitimate activity practiced widely) become earnings manipulation (financial statement fraud)? To what extent do earnings reports reflect the wishes of management, rather than the real underlying financial performance of the company? The widespread practice of managing earnings has led to the erosion of, and has raised questions concerning, the quality of reported earnings.

**EXPLOITING AMBIGUITIES IN THE RULES**

Many accounting and auditing failures have arisen from companies exploiting ambiguities in accounting rules. Companies may interpret accounting rules in very rigid or strict ways. This can have the effect that transactions are, technically speaking, accounted for in accordance with the rules. However, the substance of the transaction may not be properly accounted for. Companies may deliberately enter into or structure transactions with the objective of achieving desired financial accounting outcomes, which do not reflect the underlying substance of the transaction.

In the past, audit firms have earned considerable extra consulting revenue by devising clever schemes to circumvent and exploit accounting rules. The same firm (but probably not the same partner in the firm) is likely to be the company’s auditors. This

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begs the question: How can those audit firms provide an independent opinion – when they are auditing themselves (i.e. their own schemes to circumvent accounting rules)? US Securities and Exchange Commission chairman, Arthur Levitt, has referred to this exploitation of the accounting rules as a “culture of gamesmanship”.

“I’ve referred to this mind-set as a ‘culture of gamesmanship’. A mind-set that says ‘if a company is testing the limits of appropriate conduct then so can I’. If a rule doesn’t expressly prohibit it, then it’s fair game.”[17]

Such exploitation of accounting rules is harder under UK than under US Generally Accepted Accounting Principles (GAAP). Financial Reporting Statement FRS 5[18] (applicable in Ireland and the UK) is a principle-based (rather than rule-based) accounting standard and does not lay down precise rules that can be exploited. However, it would be idealistic to believe that manipulation of the rules is abolished completely by this accounting standard.

SAFEGUARDS

In companies with effective systems of corporate governance there are a number of safeguards that protect the financial reporting system and ensure that quality earnings are reported. These include:

• Audit committees
• Internal audit
• External audit

AUDIT COMMITTEES

The Stock Exchange’s Combined Code requires plcs to establish audit committees comprising at least three non-executive directors.[19] Under the Code, non-executive directors should be “independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement”. [20] For audit committees to work well non-executive directors should be willing to ask probing and tough questions. They should be proactive rather than reactive. They should have the necessary expertise – preferably a financial background. Meetings should be meaningful in terms of both frequency and length and should enable directors to fully exercise their duties and responsibilities. Duties and responsibilities should be clear. There should be good interaction between the audit committee, management and external auditors.

Why do audit committees not work? To answer this one needs to consider a number of interrelated questions:

• Who chooses non-executive members of boards/audit committees?

• On what basis are non-executive members of boards/audit committees chosen? Is it because they are tough/independent-minded people, or is it because they are part of a cosy club / establishment and won’t rock the boat?
• Does weak management welcome strong independent-minded directors with a tendency to ask tough questions - that might show up management inadequacies?
• What prevents the chief executive from removing audit committee chairmen / members who are asking the tough / right questions?
• Do management provide the audit committee will all the necessary information that would enable them to carry out their duties properly?
• What do the auditors do in situations where directors are removed for asking the right (but difficult) questions and in situations where management are not providing the audit committee with all the necessary information?

There has been a considerable amount of research into removal of auditors, but little or no research into the removal of “troublesome” directors. Research of “sacked” directors would add considerably to our knowledge of the complex human interrelationships that undermine good governance.

INTERNAL AUDIT

Internal audit is another safeguard of quality accounting and financial reporting. For it to work properly, internal audit should be properly resourced (i.e. have adequate staff, with appropriate qualifications) and be independent of management. Best practice indicates that internal auditors should report directly to the audit committee, and should have access to the Chairman of the audit committee. However, best practice may not have gone far enough. The chief executive determines the pay and rations of the internal auditor. Material fraud is most likely to be perpetrated by senior management such as the chief executive and the financial director – only they have the power to override the internal controls in an organisation.[21] In such situations, would the chief executive make sure the internal auditor was properly resourced? Many staff working in internal audit hope to be promoted to more senior positions in their organisation. Are internal audit staff able to carry out their functions independently with such ambitions in mind? Maybe internal audit should be outsourced?

EXTERNAL AUDIT

A third safeguard, in addition to audit committees and internal audit, is the external audit function. For the external audit function to be effective, it must be independent of management. Auditors must understand that they report to shareholders, not to company management. This can be difficult when management negotiate the audit and other fees paid to the auditors.

An aspect of external auditing that is not sufficiently considered is the question of who chooses auditors. It is not as simple as the firm of auditor chosen. Audit firms are made up of individual partners with a spectrum of professional standards and outlook. For quality control reasons, firms attempt to adopt firm-specific, standardised auditing approaches. However, as explained earlier, accounting and auditing are a function of

[21] Paragraph 4.37, Brennan and Hennessy (2001),
multiple judgements. The judgements of individual audit partners will vary. Will clients select the most independent of those audit partners with the highest professional standards, or will clients choose individual audit partners who are more flexible in their subjective judgements? Do audit firms promote the most independent-minded individuals with the highest professional and ethical standards, or are those most likely to bring in the most revenue to the firm favoured?

There are a number of perceived threats to external audits, in particular those that affect auditor independence. These include:

- Non-audit fees
- Lengthy relationships with auditors
- Large fee income (and consequent dependency) from a single client
- Relationship between auditor and client

**Non-audit services**

Auditors earn a fee from external audits. They also earn fees from other non-audit work carried out for the client. This begs a number of questions:

- Should auditors be permitted to supply non-audit work to clients?
- Does the provision of non-audit work to clients impair auditor independence?

There are widespread adverse perceptions of the ability to provide an independent audit, when so much of the profitability of the audit practice depends on non-audit services (which are more profitable), as the quote below illustrates.

> “Too many auditors are being judged not just by how well they manage an audit, but by how well they cross-market their firms non-audit services”[22]

Non-audit work is currently permitted in all but a few European counties. In countries where non-audit work is not permitted, auditors have adopted mechanisms to circumvent that requirement.[23] An alternative to banning the provision of non-audit services by external auditors is to require disclosure of non-audit fees. This is a requirement in the UK but not currently in Ireland.[24]

**Lengthy relationships with auditors**

Many relationships between client and auditor span many years. Do excessively long relationships with external auditors impair auditor independence? On this issue, there are trade-offs between:

1. Length of auditor-client relationship and auditor independence
2. Length of auditor-client relationship and quality of service

[22] Levitt (2000)
[24] Section 42 of the Companies (Auditing and Accounting) Bill 2003 proposes that companies be required to disclose fees paid to the external auditors for non-audit work.
Research has found that significantly more audit failures occur in the first few years of new client relationships, where auditors are not familiar with client. Auditors have auditor rotation to deal with this problem, i.e. individual audit partners rotate but the same audit firm retains the audit. An alternative is client rotation where the audit firm changes. There are problems with this:

- Putting audits out to tender on a regular basis may encourage “low balling”. “Low balling” is where auditors quote a below-cost fee for the audit to capture the client, in the knowledge that more profitable non-audit business from the client will compensate for the uneconomic audit fee. Auditing is one service where cheapest is not best. Very low audit fees may result in impairment of audit quality.
- Client rotation may also result in a loss of knowledge about the client which could also impair audit quality.

Prior and personal relationships between auditors and clients

It is not uncommon for clients to recruit financial staff from their auditors. This could lead to an erosion of auditor independence. It could be difficult for audit staff to audit their former colleagues. Research has shown that the more senior the staff moving from auditor to client the more likely auditor independence is threatened. The relationship between auditors and senior management of Élan and its effect on the independence on the auditors has provoked comment.

> "Donal Geaney and Tom Lynch are reputed to be the brains behind the sophisticated financial structures that the company is now trying to unwind with the objective of improving transparency. Both are former partners in KPMG, the long-time Élan auditor. A number of other senior executives come from the same firm (e.g., Shane Cooke who replaced Tom Lynch as CFO in Summer 2001 and Liam Daniel, Company Secretary). One of the non-executive directors on Élan’s board is Laurence Crowley, another former KPMG partner. The relationship between Élan and KPMG raises questions regarding the independence of the company’s auditors."[27]

Relative size of fees from clients

Large fees from a single client could impair independence because of excessive dependency on that client for profitability of the practice. The current limit of the Institute of Chartered Accountants in Ireland (ICAI) is 15% (10% for plcs) of gross fee income from a single client. Members of the Institute must affirm to ICAI that the ethical guidelines (including this requirement) have been observed. The limit applies to firms. However, firms are made up of individual partners who are under pressure to contribute to the fee income of the practice. Should the limit apply at firm level or at individual audit partner level? Another consideration is whether the limit of 10%/15% is too high.

Is self-regulation possible

In the US, a system of peer review operates whereby accounting firms review each other’s work every three years. The US Securities and Exchange Commission (SEC) uncovered serious flaws in “peer reviews”. Deloitte and Touche LLP conducted a peer review of Arthur Andersen (Enron’s auditors) for the year ended 31 August 2001. The review concluded that Andersen’s system of accounting and auditing quality had “been deemed to provide reasonable assurance of compliance with professional standards”, following what Andersen called “the most extensive peer review in the firm’s history”. With the benefit of hindsight, it is hard to be impressed by this peer review, given that Andersen no longer exists, post-Enron.

“Big five accounting firms repeatedly unearthed what the SEC staff considered major flaws in the way audits were conducted – but nevertheless gave each other clean bills of health in public reports of the reviews.”

Wall Street Journal 30 January 2002

A modified version of peer review applies in Ireland. The big-four (and possibly other international) accountancy practices in Ireland are subjected to peer review where partners in other (non-Irish) offices of the international practice review the Dublin practice. In addition, a system of practice review is operated in Ireland by ICAI. Thus, in Ireland, there is both peer review and practice review.

OTHER SAFEGUARDS

Financial reports are only one method of communication between management, shareholders and stakeholders. In a good system failures in financial reports (whether accounting, auditing or corporate governance failures) should be highlighted by other methods of corporate communication. These include briefings by management of large investors and investment analysts, analysts’ reports and investigative financial journalists. Large investors, analysts and investigative financial journalists are sophisticated users of financial statements. Whereas small shareholders may not understand the intricacies of accounting, such sophisticated users might be expected to see through some of the creative accounting by companies subsequently found to have engaged in fraudulent financial reporting. Clearly, these other avenues of information for investors did not work to prevent the recent accounting scandals.

ROLE OF ANALYSTS

There are a number of reasons why analysts did not protect shareholders better and provide warning signals in advance. Many analyst firms are too close to company management. Such firms prefer their analysts to hype client shares and thereby increase the firms’ prospects of other lucrative consultancy work. As a result, honest, independent analyst opinion was seen as a “negative” by employer firms.

Analyst staff trying to act ethically put their careers in jeopardy for such honest assessment. In the early 1990s, Terry Smith, an analyst at Union Bank of Switzerland
(UBS) criticised the accounting techniques of some of UBS’s clients.\[29\] UBS unsuccessfully tried to ban his book, and Smith later acrimoniously parted company with his employer. Firms have dismissed analysts who adversely commented on clients. Daniel Scotto, an experienced 49 year-old analyst, claims to have been dismissed for downgrading his recommendation on Enron. He lowered his firm’s recommendation from a “buy” to “neutral”. He also advised his clients that Enron might be a “source of funds” (i.e. consider selling Enron shares to raise money for other investments). He said investors should understand that powerful companies like Enron won’t tolerate dissent – “You couldn’t ask the hard questions, because it was viewed as offensive”\[30\]

“…Daniel Scotto, the bond analyst…for BNP Paribas says he was forced out…because he told his clients in August that Enron securities ‘should be sold at all costs and sold now’.”

“If he had gone with a sell rating, he says, I’d have been taken out to the guillotine that very day”

“The motto for the Street should be ‘don’t ask, don’t tell’”\[30\]

Another problem with analysts is the mis-match in time frame between them and their clients. Analysts have a short-term focus and they react to quarterly and interim earnings announcements. This is notwithstanding that many of their institutional investor clients manage large pensions funds where long-term performance is more important to members of the fund. Thus, there is a mis-match between the analysts’ focus and the future-pensioner client being advised.

**SUMMARY AND CONCLUSIONS**

A number of initiatives are in progress to reform the system and tighten up regulations. These include the Higgs Report\[31\] to enhance the effectiveness of non-executive directors and the Smith Report\[32\] on audit committees.

Some of the key recommendations of the Higgs Report include:

- Enhancing independence of non-executive directors – to qualify as independent non-executives, they must not be former employees, have a material business relationship with the company, no close family ties, no cross directorships, not represent a significant shareholder and not serve more than nine years.

- Formalise the process of recruiting and appointing directors and company chairman

- Introducing systematic performance evaluation by company boards

- Requiring regular training of directors, including induction programmes for non-executive directors.

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\[29\] Smith (1992).
\[30\] The Wall Street Journal 30/1/2002
\[31\] Higgs (2003).
\[32\] Smith (2003).
Some of the key recommendations of the Smith Report on audit committees include:

- Audit committees should comprise no less than three independent non-executive directors.
- At least one of the independent non-executive directors should possess “recent and relevant financial experience”.
- Audit committees to be responsible for making recommendations to the board concerning the appointment of the external auditor and for monitoring the external auditor’s independence, objectivity and effectiveness.
- Audit committees should develop and implement policy on the engagement of the external auditor to supply non-audit services.

Key to the successful corporate governance is independence of boards and of individual non-executive directors. The Higgs Report proposes to considerably strengthen the definition of independent directors. If the changes recommended by the Smith Report, taken together with those of the Higgs Report, are adopted, corporate governance will be considerably enhanced.

The failures discussed in this paper are a function of multiple weaknesses, including:

- Human weakness: greed, lack of personal accountability, putting oneself first, lack of concern for others such as shareholders, employees, pensioners, deliberate ignorance of implications and consequences of actions taken.
- Institutional weakness: failures in financial reporting, capital market regulation and corporate governance mechanisms with professionals taking an blindly optimistic view of the clients’ position.
- Regulatory weakness: in the regulation of auditors, in corporate board practices and in brokerage practices in financial institutions.
- Professional weakness: failure in professional behaviour (putting their clients’ interests before their own, serving the public interest not their own).

At the centre of corporate failure is human weakness – in particular greed and self-interest. No reforms will ever fully cater for human weakness. Individuals who wish to defraud or manipulate the system will always find a way to do so, notwithstanding even the best regulations.
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