The role of external auditor in corporate governance

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External Auditors check company's accounts and report to the company based on the accounts. Basically, the concern is how external auditors conduct these duties effectively. Legislations, such as The Companies Act 1965, have made great efforts to ensure external auditors conduct their duties and obligations effectively. The Code of Corporate Governance in 2001 and the amendment in 2007 have further enhanced the effectiveness of audit in the interests of stockholders and shareholders. In light of the recent scandals involving external auditors in the world, there is a growing concern for corporate governance globally as there is increased reliance by the stockholders and shareholders on external auditors.

This study examines the role of external auditors in the corporate governance framework. The study then reviews the financial scandals involving auditors occurred in the world and investigate the role of external auditor in the collapse of the companies.

Introduction

Corporate governance is a central and dynamic aspect of business. It is very important for corporate success and social welfare. In the wake of Enron, HIH Insurance and other similar cases, countries around the world have reacted quickly by pre-examining similar events domestically. As a speedy response to these corporate failures, the USA issued the Sarbanes-Oxly Act in July 2002, and in UK, the Higgs Report and the Smith Report were published in January 2003 (Solomon, 2007).

Nowadays corporate governance is a globally debated topic with many characteristics (Nobel, 1998). However, the concern is whether auditors play an important role in the framework of corporate governance.

Corporate Governance

Corporate governance is the relationship among various participants in determining the direction and performance of corporations. The main participants are the shareholders, the management and the board of directors.

Corporate governance is the process whereby directors of a company are monitored and controlled. There are two areas considered to be fundamental to corporate governance, one is supervision and monitoring of management performance and the other is ensuring accountability of management to shareholders and other stakeholders (Marianne, 2009).

Till now, probably the two most important basic elements of good corporate governance have been " full disclosure" and the presence of independent directors and auditors, who each has their own ways to confirm that the data provided by the corporation are true and fairly stated. The contents of full disclosure are listed out in regulatory demands and professional pronouncements, and companies are expected to fully comply. The independence of the outside director and external auditor means the directors and auditors will have to distance themselves considerably to assure shareholders that they have conducted their tasks (Bavly, 2004).

Role of External Auditors in Corporate Governance

External auditors play a key role in the corporate governance framework. They conduct one of the most important corporate governance checks that help to monitor management's activities. The audit of financial statement makes disclosures more reliable, thus increasing confidence in the company's transparency.

The role of external auditors is to make sure that Board of Directors and the management are acting responsibly towards the shareholders' investment interests. By keeping objectivity, the external auditors can add value to shareholders by ensuring that the company's internal controls are strong and effective. And by working with the audit committee and liaising with internal auditors, external auditors can help to facilitate a more effective oversight of the financial reporting process by the Board of Directors (Hassan, 2004).

However, the " audit expectations gap' needs to be acknowledged, as the audit function can only do so much on the fraud. The external auditor can not be expected to find every fraud and error during an audit. In accordance with the Cadbury Report, it is important to know that the external auditor's role is not to prepare the financial statements, nor to provide assurance that the data in the financial statements are correct, nor to guarantee that the company will continue as a going concern, but the external auditors have to state in the annual report that the financial statements show a true and fair view. The Cadbury Report highlighted that there was no doubt on whether there should be an audit but rather how the audit could be ensured to conduct effectively and objectively by the external auditors (Solomon, 2007).

Auditor Independence

External auditors are expected to be independent of the company and report on the company objectively. Actually, auditors can only play their role effectively if they are independent (Peel & O'Donnell, 1995). They have to conduct their tasks in the most independent and reliable manner to provide investing public with the level of assurance to make their decisions based on the financial statements.

According to the Cadbury Report, auditor independence could be affected due to the close relationship between auditors and company managers and due to the auditor's intention to develop a constructive relationship with their clients. There are a number of threats to auditor independence, one of which is to provide non-audit services since non-audit services are lucrative. Auditors can obtain the contracts for non-audit services only if they maintain a good relationship with the management.

The Cadbury Report stressed that a balance is needed to be achieved in such way that external auditors will work with, not against, company management, but in doing so they need to serve shareholders. This is a difficult path. The easiest way to ensure this balance being attained is suggested to establish audit committees and develop effective accounting standards.

The Cadbury Report recommended all companies to establish audit committees. Audit committees serve as representative of shareholder interests. They are not only responsible for monitoring financial reporting process to support good corporate governance, they are also considered to

be able to ensure an appropriate relationship exists between the external auditor and the management whose financial statements are being audited (Hassan, 2004). The Smith Report issued in 2003 highlighted that the audit committee needs to be proactive and raise the concern with directors rather than brush them under the carpet. The Report also stressed that all members of audit committee should be independent non-executive directors. Company's annual reports should disclose detailed information on the role and responsibilities of their audit committee.

Lessons from Financial Scandals

4. 1 Collapse of Enron

Enron, the energy trading company based on Texas is the first scandal shaking up the auditing profession. It has led to a crisis to the confidence on auditors and the reliability of financial reporting (Holm & Laursen, 2007). The audit quality and the independence of external auditors were questioned. In this case, Enron's audit and accounting function were fraudulent. Arthur Andersen, the auditor of Enron, has been involved in Enron's fraudulent accounting and auditing. Failure of the audit function is one of the key factors contributing to the company's collapse.

Enron created " The Raptors", four special purpose entities (SPEs). SPEs are established in order that a company can form a joint venture with other interested parties to conduct a specific transaction. This transaction will not subject the other parties to the risks more generally associated with the company's operations. U. S Generally Accepted Accounting Principles (GAPP) allows companies to record the gains and losses of SPEs without reporting

their assets and liabilities in certain instances. In this way, Enron avoided adding more than $1 billion debt to its balance sheet without consolidating certain SPEs (Jenkins, 2003). But the problems are, when the losses of these entities quickly rose into billions of dollars, these entities were brought into the core financial statements. It then became clear that Enron itself had great losses. The corporation’s stock price dropped sharply, and the company went into bankruptcy in December 2001 (Brown, 2005).

Examples of Enron’s devious accounting exist widely in the corporation. The company recorded profits, for example, from a joint venture with Blockbuster Video that was never materialized (The Economist, 7 February 2002). In 2002, Enron restated its accounts, which is actually a process that reduced reported profits by $600 million (The Economist, 6 December 2001). In fact, the process resulted in a cumulative profit decrease of $591 million and a rise in debt of $628 million for the financial statements from 1997 to 2000. The difference between the profit figures was mainly attributed to the earlier omission of three off-balance sheet entities. Such profit inflation enabled the company to raise its earnings per share (EPS).

The company not only manipulated the accounting figures to inflate the earnings, but it also was found to remove substantial amounts of debt from its accounts by setting up a number of off-balance sheet entities. Such special purpose entities can be used to hide a company’s liabilities from the balance sheet, in order to make the financial statements look much better than they really are (The Economist, 2 May 2002). It means substantial number of liabilities did not have to be disclosed on Enron’s financial statements, because they were mainly attributed to another legal entity.

All these issues raise the question, “ why did Enron’s auditor allow this type of activity?” This is because the conflicts of interest exist between the external auditor and the management.

Conflicts of Interest

Conflicts of interest are a frequent problem in the audit profession. Although independent appointment of external auditors by company’s shareholders is regularly replaced by subjective appointment by the company management, the auditor is all too often appreciated to the company’s senior management.

Further, conflicts of interest arise from interactive functions of audit and consultancy. Arthur Andersen has been blamed to apply loose standards in their audits because of conflict of interest over the subatantial consulting fees collected from Enron. In 2000, Andersen collected $25 million for auditing Enron’s books in addition to $27 million for consulting services. In 2001, Arthur Anderson earned US$55 million for provision of non-audit services (Brown, 2005). Although Arthur Andersen reported on the company’s accounts, they did not report fraud to the shareholders. This is because the fraud was committed by the management. Kenneth Lay, the Chief Executive Officer (CEO) from Feb 1986 until Feb 2001, took home US$ 152 million although the company was facing a loss. If Andersen were to report, they probably will not be appointed in the following years or be engaged in non-audit services (Krishnan, L, 2009).

Especially, close relationships are established over time between companies and their external auditors. It can again affect independent judgment and

impact on the auditing function. In this case, there are regular exchanges of employees within Enron from Arthur Anderson. Such conflicts of interest affect the corporate governance function.

Serious conflicts of interest have also arisen among members of Enron's internal audit committee, which causes the internal audit committee did not perform its functions of internal control and of checking the external auditing function. For example, Lord Wakeham, a member of the audit committee, was at the same time having a consulting contract with Enron (The Economist, 7February2002). This shows that people in responsible positions should have detected fraudulent activities if they were independent. Enron's board of directors was composed of a number of members who have been shown to be willing to conduct fraudulent activity. It is also because the non-executive directors were compromised by conflicts of interest.

4. 2 Collapse of HIH Insurance

In Australia, the collapse of HIH Insurance Ltd was observed as the beginning of the reflection into external auditors' role. HIH is one of Australia's biggest insurers, comprising several separate government-licensed insurance companies, including HIH Casualty & General Insurance Ltd, FAI General Insurance Ltd, CIC Insurance Ltd and World Marine & General Insurances Ltd. On 15 March 2001, HIH went into provisional liquidation with losses of A$ 800 million (Peursem, Zhou, Flood & Buttimore, 2007).

HIH is one of the largest corporate collapses in Australian history. Similar issues arise as in the Enron case. HIH is claimed to mislead investors by providing incorrect financial reports to the market and HIH's auditor, Arthur

Andersen, may have played a part in its collapse. Andersen conducted the external audits for HIH from 1971 until its collapse in 2001. Their contribution to the failure of HIH is considered in the following sections:

Audit Practices

As part of audit process, auditors will conduct a risk assessment to determine the structure and plan of the audit. Andersen assessed the risk of HIH and deemed it a maximum risk client, however, the engagement team of Andersen had not prepared the risk management plan and therefore the senior management team at Anderson did not review and approve the plan (Peursem, Zhou, Flood & Buttimore, 2007).

At the end, the auditor simply drew the wrong conclusions. Andersen signed off HIH’s annual report for the 30th June 2000 and stated that it was a going concern with net assets of $939 million. Nine months later, HIH collapsed with debts of $5. 3 billion (Peursem, Zhou, Flood & Buttimore, 2007). Andersen used HIH management reports and forecasts and did not obtain sufficient evidence to get the conclusions they did. The liquidator could not find the documentation on the reasons for considering HIH as a going concern. This implies that Anderson failed to produce sufficient working papers to prove that the audit actually is conducted.

Auditor Independence

Andersen had a close relationship with HIH. By the time of liquidation, three former Anderson partners who had conducted HIH financial audit work held positions on the HIH board of directors. This obvious lack of independence between the board of directors and the auditors indicated that the best

interests of HIH may have not always be a priority. Anderson's failure in producing adequate working papers or in obtaining adequate evidence to support their findings have serious concerns on the quality of the audit they did.

A significant independence issue is also reflected in the form of Anderson's payment to HIH Chairman, Geoffrey Cohen for consultancy fees. These fees totaled $190, 887 in nine years and included the use of Anderson's office and secretary. These fees were not disclosed to the remaining board members in the annual general meetings (Peursem, Zhou, Flood & Buttimore, 2007). The close and complicated financial relationship between the auditors and HIH chairman raise further questions in this case.

Finally, the threat to auditor independence is that Andersen provided both audit and non-audit services to HIH. It raises a question on how can an auditor provide an independent opinion on the financial statements when he may play a role in guiding the preparation of the statements?

The Royal Commission in Australia, which investigates the collapse of HIH, has found that the largest corporate collapse in Australia was not due to fraud but the result of attempting to cover the cracks on the overpriced acquisition. Anderson's role in it appeared to be substantial.

Modern Approach to External Auditors' Role in Corporate Governance

External auditors now have to take a much stricter approach to their clients (Bourne, 1995). There is an increasing view to support that external auditors should take on a more proactive role (Baxt, 1970).

The Companies Act has set the stipulation on appointment, eligibility, qualification, disqualification and removal of external auditors (Davies & Prentice, 2003). The intention is to ensure that auditors are able to carry out audit in an impersonal, objective and professional way. It is also to ensure that auditors are independent of the company. The reason for such emphasis is to ensure the external auditors are not in a position of conflict of interests.

When there is conflict of interest, disclosure must be made to shareholders and stakeholders. Alternatively, there should be prohibition to the provision of non-audit services to the company where they act as auditors. To ensure auditors are truly independent and not in a conflict of interest, auditors should be rotated every year. Thereafter there should be a gap of five years before the same auditors are appointed by the company.

Conclusion

External auditors have an essential role in corporate governance through their involvement and their examination of financial statements. The external auditor’s role in corporate governance is a fundamental complement to achieve the desired objective of corporate governance. Therefore, the duties and obligations of external auditors must be expanded for the rights and interests of shareholders and stakeholders. There must be a modern approach to the auditors’ role in the corporate governance framework.