

**THE ROLE OF THE TRIPARTITE AUDIT FUNCTION  
IN SECURING CORPORATE ACCOUNTABILITY**

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# **THE ROLE OF THE TRIPARTITE AUDIT FUNCTION IN SECURING CORPORATE ACCOUNTABILITY**

Brenda A. Porter

## **Professional Summary**

This paper explores the questions of why corporate accountability arises and how it is discharged. It explains the relationship between corporate governance and accountability and the role of the audit function in securing corporate accountability. It also provides insights into changes occurring in the audit function and how these might be expected to develop.

Society facilitates the growth of economic entities by providing them with resources. As their command over resources increases, these entities gain significant economic, social and political power, and accountability is demanded of their managers as a check on possible abuse of this power. Historically, as companies have increased their power in society, those to whom and that for which their managers are held accountable have been extended. Today, the managers of large public companies are considered to be accountable to society as a whole for a wide range of corporate activities.

The discharge of corporate accountability has traditionally relied on the preparation and audit of accountability reports (financial statements). However, from the 1990s, responding to the increasing severity of the impact on society of unexpected corporate failures – and continued failures – maintaining responsible corporate governance was added as an accountability requirement. Further, as the activities for which companies are accountable have been extended (paralleling the growth of their ‘power’ in society), so corporate responsibility information has featured as an element of their accountability reports.

As these changes have occurred in the corporate accountability arena, so the need for a fully integrated tripartite audit function, comprising the company’s external and internal auditors, and its audit committee, has come to be recognised. To be effective, each member of the function must be strong, have operational independence from the company, and be staffed by personnel who are technically and professionally competent and possess the required personal qualities. However, as the activities for which corporate managers are accountable have been extended, so too has the skill-set of the members of the tripartite audit function. As a consequence, these are becoming increasingly multi-disciplinary in nature.

## 1. INTRODUCTION

Over the past three decades or so, the financial and commercial sectors of the western world have been rocked by the unexpected collapse of major public companies. The consequences of these corporate failures have been far reaching and – for many – calamitous. Large and small equity and debt holders have lost investments, employees have lost jobs (and with them, financial security and purchasing power), suppliers have lost outlets for their products, customers have lost sources of goods and/or services, and creditors have been forced to write off, often crippling, bad debts. The larger the failed company, the greater the devastation caused by its demise.

As has been all too evident in recent years, investigations of corporate debacles such as those of Enron, WorldCom and Tyco in the United States of America (USA), Bank of Credit & Commerce International (BCCI) and Barings Bank in the United Kingdom (UK), Parmalat in Italy, and HIH in Australia, have frequently uncovered instances of serious fraud and/or other malpractice by senior company officials,<sup>1</sup> reckless financial and business management practices, and/or ingenious creative accounting. Such revelations have prompted the public to demand greater corporate accountability, to question the mechanisms of corporate governance, and to criticise external auditors for failing to sound warning bells and blow the whistle. A review of media headlines shows that, in recent years, the public's demands, questions and criticism have become increasingly widespread and earnest. However, little consideration seems to have been given to the meaning of, and reasons for, corporate accountability, and the relationship between this, corporate governance and the tripartite audit function (comprising external auditors, internal auditors and audit committees). Based primarily on a review of relevant literature, this paper seeks to address these issues. More specifically, it distinguishes between the concepts of corporate accountability and corporate governance, explores the questions of 'to whom and for what company officials are accountable?' and how have these developed over time?, and examines the role of the tripartite audit function in securing responsible corporate governance and accountability. The conclusion is reached that, in the present socio-economic environment of the western world, the accountability demanded of major companies is extensive and increasing (paralleling and commensurate with the growth of their 'power' in society) and that, in order to discharge it

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<sup>1</sup> The terms 'senior company officials', 'company/corporate managers' and 'company/corporate managements' are used throughout this paper to embrace non-executive and executive directors and senior non-director executives of companies.

satisfactorily, effective corporate governance and a strong, independent, tripartite audit function are needed.

## **2. CONCEPTS OF CORPORATE ACCOUNTABILITY AND GOVERNANCE**

According to the Oxford English Dictionary, accountability means: “the quality of being accountable; liability to give account of, and answer for, discharge of duties or conduct”. This definition implicitly embodies the notion of exposure to punishment in the event of unsatisfactory discharge of duties. As Harris and Spannier (1976) point out, there is a distinction between answerability and accountability. People are answerable for their actions if some other person has the right to call upon them to explain why they acted in a particular way, but accountability goes further: it implies that if people fail to satisfy their obligations, and fail to give a satisfactory account of their actions, they will be liable to sanction. Following from this, corporate accountability denotes that if company managers fail to fulfil their obligations to parties such as shareholders, debt holders and creditors, and fail to give a satisfactory account of their actions, some form of sanction may follow. This may range from loss of popularity and/or position through to a fine or even imprisonment.

While corporate accountability is oriented towards parties external to the entity, corporate governance has an internal focus. According to the Committee on the Financial Aspects of Corporate Governance (CFACG, Cadbury committee, 1992, p.15) it is “the system by which companies are directed and controlled”. It involves company managements setting the company’s objectives (such that, *inter alia*, the company will meet its accountability obligations) and establishing and maintaining systems of control designed to ensure the objectives are met. Thus, among other things, corporate governance is the means by which company managers ensure the company fulfils its obligations to those to whom it is accountable thereby ensuring that neither they nor the company becomes liable to sanction. It follows that corporate governance is intimately related to, and to a large extent determined by, corporate accountability. Key questions are, therefore, how does corporate accountability arise? And, to whom and for what is it owed?

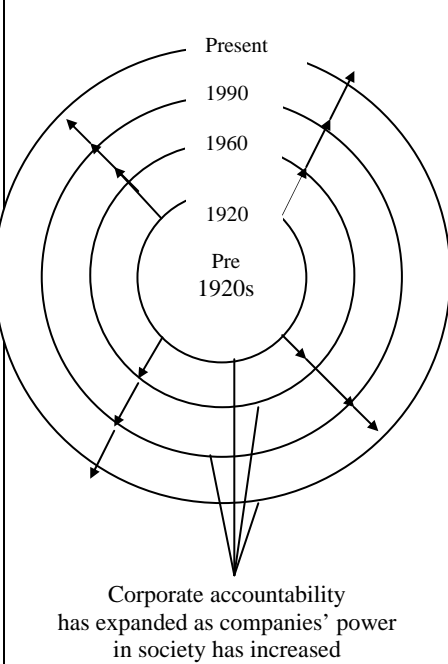
## **3. DEVELOPMENT OF CORPORATE ACCOUNTABILITY**

Economic entities can survive and grow only if financial and other resources are channelled to

them by individuals and groups in society. As their command over resources increases, these enterprises gain significant economic, social and political power (Schlusberg, 1969). However, in western democracies, when power is conferred on any individual or group in society, systems of checks and balances are put in place to prevent possible abuse of that power (Briloff, 1986). In the case of companies, accountability is demanded of their managers as a check on the power accorded them through the provision of resources. As Tricker (1982) has pointed out, business corporations exist with the consent of society and accept accountability as part of the cost of their right of freedom to exist and operate.

As society’s norms change over time, and as business enterprises grow in size and extend their power and influence in society, so changes occur in the extent of the accountability required of their managers. As is shown in summary form in Figure 1 and discussed below, since the early 1920s, those to whom and that for which corporate managers are accountable has been extended significantly.

**Figure 1: Extension of Corporate Accountability**

Society	Company Managers	Approximate Time Periods			
		Pre-1920s	1920s-1960s	1960s-1990s	1990s-present
	Accountable to...	Shareholders editors	Shareholders Creditors Investors Analysts	Shareholders Creditors Employees Suppliers Customers Investors Analysts Government (Stakeholders)	Shareholders Employees Creditors Suppliers Customers Investors Analysts Government General public (Society at large)
	Accountable for...	- Honest - Authorised use of funds	- Honest - Authorised - Efficient and - Effective use of funds	- Honest - Authorised - Efficient and - Effective use of funds - Socially responsible behaviour (e.g. pollution prevention)	- Honest - Authorised - Efficient and - Effective use of funds - Socially responsible behaviour (e.g. environmental, social and ethical) - Effective corporate governance

**(a) To whom are corporate managers accountable?**

According to Benston (1982) company managers are variously seen as accountable to three different, but progressively inclusive groups, namely, shareholders, stakeholders and society

in general.

The traditional view is that corporate managers are accountable to their shareholders, the providers of financial resources. The need for this accountability is seen to arise from the separation of ‘property’ (ownership interests), vested in shareholders, from ‘power’ (control functions), exercised by management (Berle and Means, 1932). Managers are perceived to be in a position to use corporate assets for their own, rather than the shareholders’ benefit. Although increasingly challenged by those who subscribe to stakeholder and accountability theories (for example, Gray *et al.*, 1996; Swift, 2001), this view of corporate accountability remains widely accepted in western economies and underlies the accounting and audit requirements of companies and securities legislation in, for example, the USA, Canada, the UK, Australia and New Zealand.

Since the early 1970s, this view of accountability has been challenged as attention has been drawn to the fact that the survival and growth of companies depend, not only on the financial resources of shareholders, but on the joint contribution of all stakeholders, that is shareholders, debt holders, employees, suppliers, customers and the government (for example, Aiken, 1976). Those who espouse this view contend that company managers have an obligation to ensure that each stakeholder group is adequately rewarded for its contribution so that it will maintain its stake or interest in the organisation. However, other commentators regard even this view of corporate accountability as too restrictive. They are of the opinion that company managers are accountable to all those well-being is affected by the managers’ decisions and actions, that is, to society in general. This idea has been expressed by Rubenstein (1986) who posits that companies are accountable to three categories of stakeholders,<sup>2</sup> namely:

- (i) input stakeholders – employees, owners, suppliers and creditors;
- (ii) output stakeholders – consumers, distributors and users of the company’s product;
- (iii) environment stakeholders – the community and local and central government who influence, or are influenced by, the company’s performance.

The ‘accountable to society in general’ viewpoint gained considerable impetus as a result of its adoption by the Accounting Standards Steering Committee (ASSC) in its Corporate Report

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<sup>2</sup> The terms ‘senior company officials’, ‘company/corporate managers’ and ‘company/corporate managements’ are used throughout this paper to embrace non-executive and executive directors and senior non-director executives of companies.

(1975). After noting that it considers that significant economic entities<sup>3</sup> have public accountability, the Committee (ASSC, 1975) stated:

[this public accountability] arises from the custodial role played in the community by economic entities. ...Economic entities compete for resources of manpower, management and organisational skills, materials and energy, and they utilise community owned assets and facilities. They have a responsibility for the present and future livelihoods of employees, and because of the interdependence of all social groups, they are involved in the maintenance of standards of life and the creation of wealth for and on behalf of the community. (para. 1.3)

Whatever the details of the viewpoint adopted, it is clear from the literature that it is generally accepted that modern corporations are accountable to a wide range of groups in society in addition to their shareholders. This is reflected in today's societal expectation, and corporate acceptance, of companies reporting on their environmental, social, economic and/or ethical – as well as – financial performance.<sup>4</sup> Although written more than 20 years ago, Briloff (1986) conveys particularly clearly the attitude that characterises western society today. He says:

When we consider the total environment in which these corporate entities exist, and to which they relate, we see them as having compelling responsibilities to a broad spectrum of “publics”. This nexus of publics includes: management, shareholders, labor, government, customers, and consumers, as well as neighbors in the communities in which the corporation operates. Further, as concern for ecology and the well-being of consumers and posterity intensifies, this responsibility will extend to the total society and environment. And because of the multinational character of our major corporate entities, this responsibility and related accountability must be viewed on a universal canvas. (p.4)

From an historical perspective it is evident that, over the last 60 or so years, the groups to whom corporate managers are regarded as accountable have widened progressively – from shareholders, to input, output and environmental stakeholders, to the public at large. Writers such as Tricker (1982) have demonstrated that this extension of corporate accountability has

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<sup>3</sup> To the ASSC, significant economic entities are those organisations which command human, financial or material resources on such a scale that the results of their activities have significant economic implications for the community as a whole (para. 1.2). After noting that any definition of what constitutes 'significant' must be arbitrary and a matter of subjective judgement, the Report (Appendix 1) states that significant economic entities include:

- All listed companies
- Other economic entities which, on a consolidated basis, have
  - on average, more than 500 employees during a financial year; or
  - on average, capital employed (including loan capital and bank overdrafts) of over £2 million during a financial year; or
  - annual gross turnover or revenues in excess of £5 million.

(The money amounts were those applicable in 1975. The Report notes that they should be adjusted for inflation in later years).

<sup>4</sup> Details of the development of corporate responsibility reporting are provided in section 4(b) of this paper.

accompanied, and is a consequence of, the continuing and rapidly accelerating growth in the size and influence of business corporations which has characterised western economies particularly since the mid-twentieth century. As might be expected, a similar widening of accountability is reflected in the responsibilities for which corporate managers are held accountable.

**(b) For what are corporate managers accountable?**

In western societies it has traditionally been accepted that all persons who control or use the resources of others are responsible for their safe custody and for using them honestly and for their intended purpose. In general, until about the 1920s, this was the extent of the stewardship expected of company managers entrusted with the financial resources of shareholders and creditors. However, since that time, the accountability of these managers has been widened to embrace the efficient and effective (profitable) use of funds and, in more recent times, socially responsible behaviour and effective corporate governance.

During the period from the 1920s to 1960s, investment in business entities grew rapidly. Company ownership became highly diffused and a new class of small investors emerged. Unlike the shareholders of earlier years, who were few in number but closely bound to the companies they partially owned, the new breed of investors were little interested in the management or fortunes of 'their' companies *per se*. Instead, they were primarily concerned with the return they could earn on their investment and, if they perceived better returns could be earned elsewhere, they readily switched their allegiance from one company to another. In this new economic environment, company managers were regarded as accountable, not only for the honest, authorised use of the financial resources entrusted to them, but also for generating a reasonable return thereon (Bird, 1973).

There appears to have been little dissension regarding the extension of corporate managers' accountability to include the efficient and effective use of resources entrusted to their care. However, until the recent upsurge in public and political concern about the contribution of corporate entities to global climate change, considerable controversy surrounded their accountability for socially responsible behaviour. Indeed, according to Demers and Wayland (1982), the term 'corporate social responsibility' means different things to different people. That this situation remains current is reflected in the observation of Molenkamp, Chairman of KMPG's Global Sustainability Services: "...corporations are still busy finding their way in



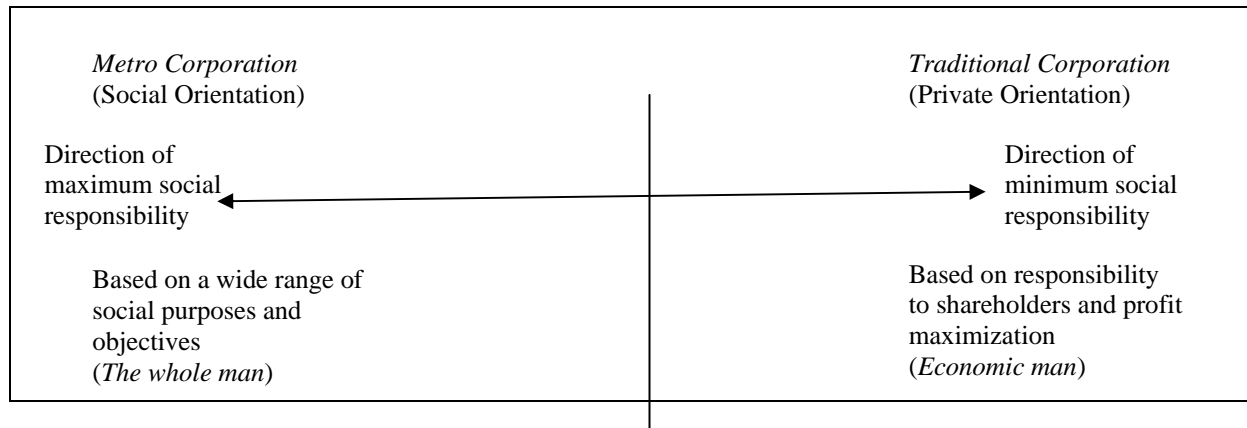
managing corporate [social] responsibility, which might mean something different for each company” (Molenkamp, in KPMG, 2005, p.3). Nevertheless, Davis (1973) provided a useful explanation of the concept which portrays the generally accepted understanding of its nature:

Social responsibility ... refers to the firm's consideration of, and response to, issues beyond the narrow economic, technical, and legal requirements of the firm. It is the firm's obligation to evaluate in its decision-making process the effects of its decisions on the external social system in a manner that will accomplish social benefits along with the traditional economic gains which the firm seeks. ...A firm is not being socially responsible if it merely complies with the minimum requirements of the law. ...Social responsibility goes one step further. It is a firm's acceptance of a social obligation beyond the requirements of law. (pp.312-313)

Opinion differs widely as to the appropriate level of social responsibility to be expected of corporations. Eells (1960) depicted the range of views on a continuum, as shown in Figure 2. At the right extreme of the continuum is the traditional corporation. This is based on the view of the corporation as nothing more than the organisational arm of its shareholders, with profit maximisation for its owners as its sole legitimate function. According to Friedman (1962), probably the best-known protagonist of this viewpoint: “few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible” (p.133). He explained (1971, pp.13-14) that company directors are no more than employees and, as such, their primary responsibility is to conduct the company’s business in accordance with the wishes of the owners, given that those wishes conform to society's basic rules of law and ethical custom. Any social actions beyond this amount to an involuntary redistribution of assets. To the extent that these actions reduce profits and dividends, shareholders suffer; to the extent that they raise prices, customers suffer; and to the extent that they lower the wages of employees, they suffer.

At the other extreme of Eells’ continuum is the social corporation. This reflects the view that corporations possess a wide range of social purposes and objectives. It is a kind of ‘metro-corp’ (mother corporation) with many interest groups under its protection. Its managers are seen to be responsible for maintaining a balance between the interests of the various groups and for the well-being of their members. At the extreme left are the social activists who promote the pursuit of social objectives as the primary goal of corporations – if necessary to the detriment of the traditional economic goals of business such as long-term survival, profits, and the production of goods and services. They demand that company managers focus on the

**Figure 2: Eells' Continuum of Social Responsibility**



well-being of employees, customers, the environment, and society in general.

Others, whose views are reflected by commentators such as Demers and Wayland (1982) and Davis (1973, 1976), adopt a less extreme stance. They regard business managers as being responsible (and accountable) for both achieving economic goals and behaving in a socially responsible manner. Demers and Wayland (1982) emphasise that the modern world in which business operates is extremely complex and that business is part of a network of interrelationships. Given this network environment, corporate managers have a responsibility to consider the impact of their decisions on the welfare of all groups within the network. Similarly, Davis (1976) explains: "economic activities in the social system are so related to everything else in the system that business must operate with social responsibility towards all those that it affects" (pp.15-16).

Davis (1973) also contends that companies are accountable for social responsibility because of the power they wield in society. The enormous impact of corporate entities on things such as energy consumption, environmental pollution, health and safety and equal employment opportunities – issues involving society as a whole – renders these entities accountable to the public and forces them to accept responsibility. This view accords with that expressed by the Research and Policy Committee of the Committee for Economic Development (CED, 1971), namely: "the great growth of corporations in size, market power, and impact on society has naturally brought with it a commensurate growth in responsibilities; in a democratic society, power sooner or later begets equivalent accountability" (p.21).

Company managers' accountability for corporate social responsibility remains subject to wide (but rapidly narrowing) differences of opinion. Nevertheless, it is evident from the literature

that, in western societies, the majority of company managers and society in general adopt a stance that lies in the centre zone of Eells' continuum, but to the left of centre. It is also clear that, particularly since the early 1990s (and society's growing awareness of environmental, especially climate change, issues), both corporate managers and society as a whole have been shifting to the left at an accelerating rate. This is reflected, for example, in the progressive, and accelerating, adoption of environmental and social (and, more recently, broader sustainability and corporate responsibility) reporting by companies (Gilmour and Caplan, 2001; KPMG, 2005; Context, 2006) and the growing body of shareholders interested in investing in 'environmentally, socially and/or ethically responsible' companies or investment funds. Molenkamp (in KPMG, 2005) comments on the development of corporate responsibility reporting as follows:

When we [KPMG] published our first survey [of corporate responsibility reporting] in 1993, we did not expect that in less than a decade the number of top companies in industrialized countries producing these kinds of reports would almost triple. Neither did we expect that corporate environmental reporting would be the 'icebreaker' for a much wider form of corporate responsibility (CR) reporting in the form of sustainability, triple bottom line or corporate social responsibility (CSR) reporting. Reporting aimed at communicating with stakeholders not only on environmental performance but also in an integrated manner on environmental, social and economic performance; to be transparent and accountable. (KPMG, 2005, p.3)

In response to investors' desire to invest in environmentally, socially and/or ethically responsible companies or investment funds, the Dow Jones Sustainability Index (DJSI) and the FTSE4Good index were established in the USA (in 1991) and the UK (in 2001), respectively. In October 2007, companies included in the DJSI (World) had a total market capitalization of \$US13 trillion (SAM, 2007). In Europe, in January 2006, funds invested in 'responsible investments' amounted to more than €1,313 billion; in the UK alone, such investment exceeded €800 billion (about £536 billion), [Ethical Investment Research Services (EIRiS), 2007, p. 20]. Reflecting Molenkamp's observations (cited above), EIRiS notes in its 2007 report:

The value of responsible investment funds under management has grown rapidly in the past ten years. ...In addition, increasing numbers of mainstream investors are beginning to incorporate consideration of ESG [environmental, social and governance] factors into their investment decisions. Consequently, companies are motivated to behave responsibly [and to be accountable for so acting] in order to access this growing volume of investment funds. (p.19)

The extent of the accountability expected of company managers for corporate responsibility since the 1990s is conveyed by Gilmour and Caplan's (2001) in their observation:

The global investor community has begun to develop a consensus view of the behaviour companies are expected to exhibit, and the kind of information they should report. ...Analysts and investors are now asking about sustainability-related performance issues alongside financial measures. BP and Coca-Cola are two examples of large companies that faced questions on environmental and social issues at their recent annual general meetings. BP was asked about adapting to climate change, and Coca-Cola about the extent to which its bottles and cans could be recycled. (p.44)

The general acceptance of the notion that, at least significant, companies should be held accountable for behaving in a socially responsible manner is reflected in the inclusion in the UK Companies Act 2006 (s.418) of a requirement for the directors of quoted companies to include in the business review section of their directors' report, to the extent necessary for readers of the company's annual report to understand the development, performance and position of the company's business, information about environmental matters (including the impact of the company's business on the environment), the company's employees, and social and community issues.

Since the early 1990s, not only have company managements increasingly been held accountable for corporate responsibility, they have also increasingly been held accountable for effective corporate governance. The first significant report on corporate governance was published in the UK in 1992 by the Committee on the Financial Aspects of Corporate Governance (CFACG; the Cadbury Committee). This Committee was established in 1991 by the Financial Reporting Council, the London Stock Exchange and the Institute of Chartered Accountants in England and Wales "to address the financial aspects of corporate governance" (CFACG, para 2.1). It was prompted by the 1987 Stockmarket crash, the unexpected failure of companies such as BCCI and Barings Bank, the collapse of the Maxwell Empire and the public outcry about the apparently unjustified level of, and increases in, directors' remuneration.

The Cadbury Committee explained: "Corporate governance is the system by which companies are directed and controlled. Boards of Directors are responsible for the governance of their companies ... [They] must be free to drive their companies forward, but

exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance” (CFACG, 1992, paras 1.1, 2.5). A key element of its report was a Code of Best Practice – a set of good corporate governance practices based on the principles of “openness, integrity and accountability” (paras 3.2). The Code included provisions such as the following:

- 1.1 The Board [of directors] should meet regularly, retain full and effective control over the company and monitor the executive management.
- 1.4 The Board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.
- 4.1 It is the Board’s duty to present a balanced and understandable assessment of the company’s position.
- 4.3 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.
- 4.5 The directors should report on the effectiveness of the company’s system of internal control.
- 4.6 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

Since 1992, a series of reports on corporate governance have been published in the UK (for example, the Greenbury Committee Report on Directors’ Remuneration, 1995; Reports of the Committee on Corporate Governance, 1998a, 1998b; the Higgs Report; 2002, the Smith Report, 2002; and the Financial Reporting Council’s (FRC) Combined Code of Corporate Governance, 2003, 2006<sup>5</sup>). Similar reports have been published in virtually all countries of the western world. In each country some form of Code of Best Practice (or Code of Corporate Governance) has also been promulgated.

Over the past decade, as various corporate governance reports and Codes have been published, so the governance requirements (and thus the accountability) of company managements have been extended. They are now explicitly accountable for maintaining appropriate mechanisms to ensure their company is effectively governed and, more particularly, controlled.

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<sup>5</sup> The Combined Code on Corporate Governance (FRC, 2006) essentially consolidated the recommendations of earlier reports – in particular, those of the Cadbury Committee (1992); the Hampel Committee (1998a); the Greenbury Committee (1995); Higgs on non-executive directors (2003); and Smith on audit committees (2003). It also supersedes the FRC’s 2003 Combined Code on Corporate Governance (FRC, 2003) which, in turn, replaced the Combined Code of the Committee on Corporate Governance (1998b).

#### **4. DISCHARGE OF CORPORATE ACCOUNTABILITY**

Accountability has been seen to place two obligations on corporate managers, namely:

- a) to render an account of their dealings with the resources entrusted to them: that is, to provide accountability reports;
- b) to submit these reports to examination (or independent audit) by, or on behalf of, those to whom they are accountable (Bird, 1973).

As the accountability demanded of corporate managers has been extended over the past 80 or so years, so the nature of the accountability reports, and their independent audit, has similarly changed. Each of these components of securing accountability is discussed below.

##### **(a) Accountability reports: Reporting to whom? about what?**

Traditionally, it has been accepted that the accounting process, which culminates in published financial reports, is the primary means by which company managers discharge their accountability (see, for example, Ijiri, 1975; ASSC, 1975). As might be expected, corporate financial reports have changed over time, reflecting changes in the accountability required of company managers. As noted earlier, until about the 1920s the stewardship of company managers was confined, in the main, to the safe custody and honest, authorised use of financial resources entrusted to them, and they were accountable only to their company's shareholders and creditors. During this period, the Balance Sheet was usually the only financial statement produced and it was generally regarded as a private communication between the company and its shareholders, although in some cases the communication was extended to banks and other lenders (Porter *et al.*, 2008, Ch. 2).

As investment in economic organisations increased during the 1920s-1960s period, and the efficient and effective (profitable) use of financial resources was added to the accountability required of company managers, so the Income Statement (Profit & Loss Account) joined the Balance Sheet as an accountability report. At the same time, as the number of investors and analysts in financial markets increased, these groups came to be recognised as having a legitimate interest in companies' financial statements.

Since the 1960s, corporate financial (or, more correctly annual) reports have assumed an increasingly public character. This reflects the extension of those to whom company managers are regarded as accountable. In a research study commissioned by the Canadian

Institute of Chartered Accountants (CICA), Stamp (1980) found that at least fifteen groups of users have a legitimate interest in the published financial statements of public companies. These include shareholders, creditors, employees, analysts, customers, suppliers, Government Departments, regulatory agencies, and the public. The ASSC (1975) similarly identified a wide range of groups in society with a 'reasonable right' to information about reporting entities. Such a right was seen to exist where the activities of an organisation impinged, or might impinge, on the interests of the group in question.

At the same time as the groups recognised as having a legitimate right to information about corporate entities have been extended, so too has the content of accountability reports. Although the information contained in the Balance Sheet and Income Statement has remained of prime importance, accounting literature shows that, particularly since the 1970s, there has been an increasing demand for companies to provide more information of both a financial and non-financial nature, on a widening range of corporate activities. The trend is reflected, for example, in the additional statements identified in the Corporate Report (ASSC, 1975, p.48) as those that significant economic entities<sup>6</sup> should be required to publish. These are as follows:

- A statement of value added, showing how the benefits of the efforts of an enterprise are shared between employees, providers of capital, the state and reinvestment.
- An employment report, showing the size and composition of the workforce relying on the enterprise for its livelihood, the work contribution of employees and the benefits earned.
- A statement of money exchanges with government, showing the financial relationship between the enterprise and the state.
- A statement of transactions in foreign currency, showing the direct cash dealings of the reporting entity between the home country and abroad.
- A statement of future prospects, showing likely future profit, employment and investment levels.
- A statement of corporate objectives, showing management's policies and medium term strategic targets.

Although the Report did not recommend these organisations be required to provide information on their social behaviour, it expressed the belief that social accounting would be an area of growing concern to corporate report users (pp. 57-58).

The Commission on Auditors' Responsibilities (CAR, 1978) similarly recommended that companies be required to include additional statements in their annual reports. They

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<sup>6</sup> See footnote 3 for the ASSC's definition of significant economic entities.

suggested the inclusion of, *inter alia*:

- a statement describing all material uncertainties in the financial information and explaining their effect on earnings and financial position;
- a code of conduct, setting out the corporation's policies regarding illegal or questionable acts, and an auditor's report on compliance with the stated policies;
- a statement of legal claims and litigation against the corporation;
- a statement on the adequacy of the company's internal controls and management's response to weaknesses drawn to its attention by the auditors.

Like the ASSC, CAR did not address the issue of corporate responsibility beyond considering the question of illegal or questionable acts committed by company officials.<sup>7</sup> Nevertheless, it is interesting to observe that much of the information called for by the ASSC and CAR is now routinely provided in companies' annual reports, although not necessarily in the formal, discrete statements envisaged by the authors of those reports.

Since the early 1980s, many writers (for example, Gray *et al.*, 1987; Mathews, 1984; Demers and Wayland, 1982) have espoused the view that company managers should be required to provide social accountability reports. Their calls seem to have been heeded; since the early 1990s, as company managers' accountability has been extended to embrace environmental and social performance, so reporting on these issues has become more commonplace. In 2000, McKay noted: "The number of companies publishing some sort of environmental report has increased exponentially over the last 10 years" (2000, p.1) and, in 2001, Gilmour and Caplan observed:

PricewaterhouseCoopers took a snapshot of what the top 100 global companies by market capitalisation (taken from last year's Financial Times 500 listings) are disclosing. Almost all of these publish some kind of commentary on social and environmental issues in their annual reports and accounts. Just under half also produced a separate report covering either environmental or corporate citizenship or both. (2001, p.45)

Along similar lines, KPMG's 2005 triennial International Survey of Corporate Responsibility Reporting, which analyses trends in corporate responsibility (CR) reporting by the world's largest companies [including the largest 250 (by market capitalisation) of the Fortune 500 (F250) and the largest 100 companies in each of 16 countries] found that, between 2002 and 2005, the number of F250 companies producing separate CR reports increased from 112 (42

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<sup>7</sup> It is significant that CAR conducted its research and wrote its report during, and shortly after, the time of the Watergate scandal and the revelations which led to the passing of the Foreign Corrupt Practices Act of 1977.



per cent) to 129 (52 per cent). In the UK, the increase in the number of the largest 100 companies publishing such reports was even more marked – from 49 in 2002 to 71 in 2005 (KPMG, 2005, pp. 9-10). KPMG’s survey also found that the reasons most commonly cited by the surveyed companies for engaging in CR activity are business drivers, investor preferences and the regulatory framework.

In respect of business drivers, KPMG (2005) reported:

[T]he most common driver for sustainability, as reported by 74 percent of the companies, is economic reasons. ... [These] were either directly linked to increased shareholder value [identified by 39 percent of companies] or market share [reported by 21 percent] or indirectly linked through increased business opportunities, innovation, reputation and reduced risk. (p.18)

EIRiS (2007) adds to these findings by explaining the importance of business drivers as a motivator for engaging in CR activity. It states:

For certain companies, there is undoubtedly a positive financial case for adopting and enhancing responsible business practices. Companies may increase sales and profitability by increasing their appeal in the ethical consumer market. The number of consumers making ethical purchases is on the rise ...In addition, responsible business has the potential to improve financial performance by delivering improvements in staff attitudes and productivity and enhancements to internal processes. Lowering operating costs can also be achieved alongside environmental performance improvements. As a straightforward example, cutting energy usage decreases both costs and CO<sub>2</sub> emissions. (p.17)

The significance of investor preferences for ‘environmentally, socially and/or ethically responsible’ companies and investment funds was noted earlier. However, it is pertinent to observe that globally, investor pressure on companies has been facilitated, and strengthened, by wider (and more probing) media coverage of corporate activities and access to the internet. These developments have resulted in increased public awareness of corporate responsibility issues and much greater scrutiny of company activities than previously and, as a consequence, their managers are subject to increased demands by stakeholders for greater accountability. Company managers discharge this accountability (at least in part) by producing environmental and/or social (or, as is increasingly common, sustainability or CR) reports.

The third reason cited by KPMG’s survey respondents for engaging in CR activity is that of legislation and regulations governing environmental and social performance, and the reporting of that performance. In some cases, the regulatory framework impacts on corporate

activities such that it renders it beneficial for companies to make relevant disclosures to shareholders and other stakeholders. For example, a significant number of large companies (particularly in the USA, but increasingly in the UK and elsewhere in the western world) face enormous liabilities as a result of breaching environmental laws or regulations, or through ‘inheriting’ them through transactions such as acquisitions.

As a response to the growing concern of investors, other stakeholders and society in general about companies’ environmental performance and liabilities, regulatory authorities are demanding or encouraging companies to provide increased environmental disclosures. In 1993 in the USA, for example, the Securities and Exchange Commission (SEC) prescribed increased, and more prominent disclosure of existing and potential environment-related liabilities. In 1994, SEC Commissioner Richard Roberts observed that increased public awareness of environmental issues had brought:

Increased pressure to bear on the SEC to ensure that publicly-held companies are disclosing in a full, fair, and timely manner the present and potential environmental costs of an economically material nature. My view is that the company owes this to the investing public. (as cited, Beets and Souther, 1999, p. 130)

In Europe and the UK too, companies are subject to increasing regulatory pressure to disclose environmental information. In Denmark and the Netherlands, for example, legislation requires environmental reporting by major companies. In the UK, investors (particularly institutional investors) have been urged by influential bodies such as the Association of British Insurers (ABI) to pay due regard to companies’ environmental, social and similar performance, in addition to financial indicators, when making investment decisions. This, in turn, has put increased pressure on companies to disclose the relevant information. However, more significantly, as noted earlier, the UK Parliament has taken the first steps (in the UK Companies Act 2006) towards forcing, at least quoted, companies to disclose environmental and social information. It seems likely, given the growth in CR reporting, that in time, listed and other public companies in the UK will be subject to similar – if not more extensive – requirements.

MacKay (2000), identified a further reason (additional to those cited by KPMG’s survey respondents) for companies to adopt environmental (or CR) reporting. She explained:

Companies produce environmental reports partly out of a growing concern for the environment, but mostly because they get into trouble if they don’t. There is now significant pressure from the

government and the environmental lobby for companies to report environmental and social data. ... Large companies that don't report are 'named and shamed' by environmental pressure groups. (pp.1-2)

The extension of corporate management's accountability for CR issues is reflected in the content and titles of their CR reports. Until the late 1980s, companies' voluntary disclosures of CR-related activities focused, almost exclusively, on environmental issues, and reports issued separately from their annual reports were generally entitled 'Environmental Report'. During the 1990s, companies came under increasing pressure to pay due regard to social issues and to disclose information relating to their social performance. In response, many companies began to publish both environmental and social information – either within their annual reports or as separate 'Environmental and Social Reports'. From the mid- to late-1990s, as the Fédération des Experts Comptables Européens (FEE, 2001) explains, many companies went further and produced sustainability reports:

“Sustainability” and “sustainable development” are terms which came to prominence following the Brundtland Report<sup>8</sup> which argued that human development should meet the needs of the present without compromising the ability of future generations to meet their own needs. ... Sustainability reports have evolved from a process – which started with the appearance of environmental reports. ... Separate environmental and social reports are still being produced, but “sustainability” reports aim to give a more comprehensive “triple bottom line” approach to stakeholder accountability. It ... is still a minority of, typically, larger organisations, which is producing such reports – but the numbers are increasing all the time. (p.1)

As may be seen from Figure 3, by 2005, a majority of the F250 companies included in KPMG's survey of CR reporting used 'Sustainability' in the title of their CR reports.<sup>9</sup>

**Figure 3: Titles of corporate responsibility reports of F250 companies in 2002 and 2005**

Titles given to CR reports by F250 companies publishing separate reports	2002		2005	
	No.	%	No.	%
Sustainability (environmental, social and economic) reports	16	14	88	68
Environmental and social reports	11	10	22	17
Environmental and health and safety reports	82	73	17	13
Social reports	3	3	2	2

Source: KPMG, 2005, p.9

<sup>8</sup> World Commission on Environment and Development, (1987), *Our Common Future*, Oxford University Press, Oxford.

<sup>9</sup> KPMG (2005) and EIRiS (2007) note that, in recent years, CR reporting has been extended further to embrace ethical and/or governance issues. This reflects a further extension of the matters for which corporate managements are being held accountable.

Just as accountability for CR has been manifested in the provision of CR reports (however titled) managements' accountability for effective corporate governance is reflected in the provision of corporate governance reports. As noted earlier, since publication of the Cadbury Report and its Code of Best Practice in 1992, similar reports (complete with Codes of Corporate Governance or their equivalent) have been published in virtually all western countries. However, mere compliance with a Code of Corporate Governance is not sufficient to secure accountability for effective corporate governance: to achieve this objective, company managements need to provide relevant accountability reports. Recognising this, in 1993, the London Stock Exchange made it a listing requirement for companies to include in their annual reports a statement of compliance with the Code of Best Practice [or, more correctly, in today's terms – The Combined Code of Corporate Governance (FRC, 2006)] or a statement disclosing the respects in which they had not complied and the reasons for their departure from the Code's provisions. Stock Exchanges in most other western countries have introduced a similar reporting requirement as a condition of listing on the Exchange.

#### **(b) Submitting Accountability Reports to Audit**

As noted at the beginning of section 4, in order to secure the accountability of company managers, they are not only required to provide reports on the matters for which they are held accountable (traditionally, the use of financial resources entrusted to their care), they are also required to submit these reports to independent audit.

Until a couple of decades ago, the term 'corporate accountability reports' was generally interpreted to mean companies' annual audited financial statements. This reflects the legal requirement in countries such as the UK, Canada, New Zealand and Australia for companies to provide financial statements annually to their shareholders. The information contained in these statements is governed by the disclosure requirements of the relevant country's companies and securities legislation and the accountancy profession's financial reporting standards.<sup>10</sup> Additionally, the information is required to be independently audited – and the audit conducted in accordance with the profession's auditing standards.<sup>11</sup>

However, as indicated above, company annual reports provide a wide range of information in

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<sup>10</sup> In most countries this amounts (or by the end of 2008 is likely to amount) to International Financial Reporting Standards (or a national variant thereof).

<sup>11</sup> In most countries, from December 2009, most public companies' financial statements will be audited in accordance with International Standards on Auditing (or a national variant thereof).

addition to the traditional financial statements. This additional information varies greatly in quantity and quality and little is (as yet) subject to audit. Nevertheless, as Bird (1973) and Normanton (1966), among others, have noted, to secure accountability merely producing reports is not enough. For accountability to be effective an independent monitoring mechanism or audit is needed. Indeed, in relation to financial statements, Normanton (1966) suggested that accountability is an abstraction which is only given reality by the process of audit. He noted that accounts must be technically correct, as this is essential to the prevention of fraud, but they do not and cannot provide an adequate public record of policy and transactions. He argued that accounts hide more than they reveal. Although annual accounts may not legally conceal criminal sins, they can and do conceal other kinds of sins. (Today such 'sins' are generally embraced by the term 'creative accounting'.) These, according to Normanton, can be, and frequently are, lost without trace among the headings and summary totals provided in the financial statements. He concluded that without audit there can be no accountability.

Support for Normanton's position was provided by the results of a study conducted by Webley for the Christian Association of Business Executives in 1973, reported by Medawar (1978). According to Medawar, Webley found that about half of his sample of 400 managers agreed with the proposition: "Many managers find themselves forced to resort to practices which they acknowledge are shady, but which appear necessary to survive". Medawar also reported that in seminars which he (Medawar) conducted at a prestigious business school in the USA, he found that the large majority of both public and private sector managers were unable to agree with the proposition that the public would be reassured if it knew exactly what went on in business. Some of the revelations that have come to light as corporate debacles (such as those of Enron, WorldCom, Parmalat and HIH) have been investigated, similarly provide stark support for Normanton's contention and Webley's and Medawar's findings.

In monitoring the fairness of the financial statements and other information produced by corporate managements, external auditors are in a unique position. They alone have the statutory right to examine the detailed records and other relevant evidence relating to a reporting entity, and to seek the information and explanations they require to perform their duties as auditors. Further, external auditors, as members of the accountancy profession, may be expected to have the capabilities, competence, expertise, independence, integrity and other qualities necessary to carry out monitoring duties on behalf of those to whom the organisation

is accountable.

However, during the 1970s, it became evident that the two-fold approach to securing corporate accountability (that is, requiring corporate managers to produce accountability reports and to subject these to audit) is inadequate. As companies grew in size and extended their influence in society, so the extent and severity of the impact of their unexpected failure increased. Further, as the corporate failures were investigated, all too often, instances of misconduct and recklessness by senior company officials came to light. It became clear that the two-fold approach to securing the expanded level of accountability (commensurate with the increased ‘power’ companies wielded in society) was insufficient: more was needed. It seems that, during the 1970s, politicians, regulators and the public believed that the answer lay in strengthening the external audit function – and audit committees<sup>12</sup> were identified as the means to accomplish this.

In 1970, audit committees were "virtually unheard of" (CICA, 1981, p.1); today they are a normal feature of corporate life in most, if not all, countries of the developed world. The timing and details of their development has varied from country to country but, interestingly, in each case it has been stimulated by unexpected corporate failure and/or reports of misconduct by senior executives or directors (Porter 1993). It seems that regulators and the public believed that, had the external auditors been properly independent of their audit clients’ managements and performed their duties with due skill and care, then warning bells would have been sounded in at least some of the cases. Following on from this, it was generally reasoned that if audit committees were established, with a majority (if not solely) of non-executive directors, to oversee the appointment of external auditors and the external audit function, then unexpected corporate failure and undetected misconduct by senior officials would be reduced significantly, if not eliminated.

The literature reveals that, until the late 1970s, audit committees were regarded, almost exclusively, as a means of strengthening the external audit function. This is reflected in the duties required of them at the time. For example, under the Ontario Business Corporations Act 1970<sup>13</sup> audit committees were required:

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<sup>12</sup> An audit committee is a committee of the board of directors (or equivalent) which has delegated responsibility from that body, *inter alia*, for overseeing the entity’s financial reporting process and audit function.

<sup>13</sup> The Ontario Business Corporations Act 1970 (which resulted from an enquiry into the collapse of Atlantic Acceptance Corporation in 1965), embodied the world’s first legislative requirement for public companies to establish audit

- to review the company's financial statements before their submission to the full board for approval; and
- to confer with the external auditor(s) at the instigation of either the audit committee or the auditor(s) (CICA, 1981).

Other duties commonly performed by audit committees in the pre-1980 period were:

- approving the appointment and retention of the company's external auditors;
- reviewing the scope of the audit and fees charged by the external auditors;
- discussing with the external auditors the opinion rendered and any problems encountered during the audit (Apostolou and Strawser, 1990).

The role of audit committees in strengthening the external audit process accords with the two-fold approach to securing corporate accountability which prevailed until the late-1980s. However, as the BCCI, Barings Bank, Enron, WorldCom, Parmalat, HIH, and other debacles bear witness, corporate failures and revelations of misdeeds by company officials continued: it became evident that the two-fold approach to securing accountability, even with audit committees (at least ostensibly) strengthening the external audit function, is inadequate. As a consequence, since the early 1990s there has been a growing recognition by regulators, investors and the public that, in order to secure greater corporate accountability, not only should corporate managements be required to prepare accountability reports and subject them to audit, they should also be required to establish and maintain mechanisms responsible corporate governance. Amongst these mechanisms, internal audit plays a key role.

## **5. THE TRIPARTITE AUDIT FUNCTION**

The development of corporate accountability during the past three decades or so has resulted in fundamental changes in the audit function; more particularly, it has prompted recognition of a need for an effective and fully integrated tripartite audit function, comprising (i) external auditors, (ii) internal auditors and (iii) an audit committee. In order to be effective in securing adequate discharge of accountability by company managements, each member of the trinity must be strong, have operational independence from the company, and be staffed by personnel who are technically and professionally competent, well-informed about business

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committees. The Act required all public companies incorporated in Ontario on or after 1 January 1971 to appoint an audit committee consisting of not less than three directors, the majority of whom were to be independent of the company. Similar legislation became effective in British Columbia in 1973, for federally incorporated companies in 1975, and for public companies incorporated in Manitoba and Saskatchewan in 1976 and 1977, respectively (Porter 1993).

matters in general, and about the company in particular, and equipped with the personal attributes of integrity, objectivity, diligence, intelligence, and an independent attitude of mind. As is reflected in Figure 4, each member of the audit function must also have clearly defined duties which complement and interlock with those of the other members. Additionally, frequent, open and effective communication must be maintained between the three members.

**(i) External auditors**

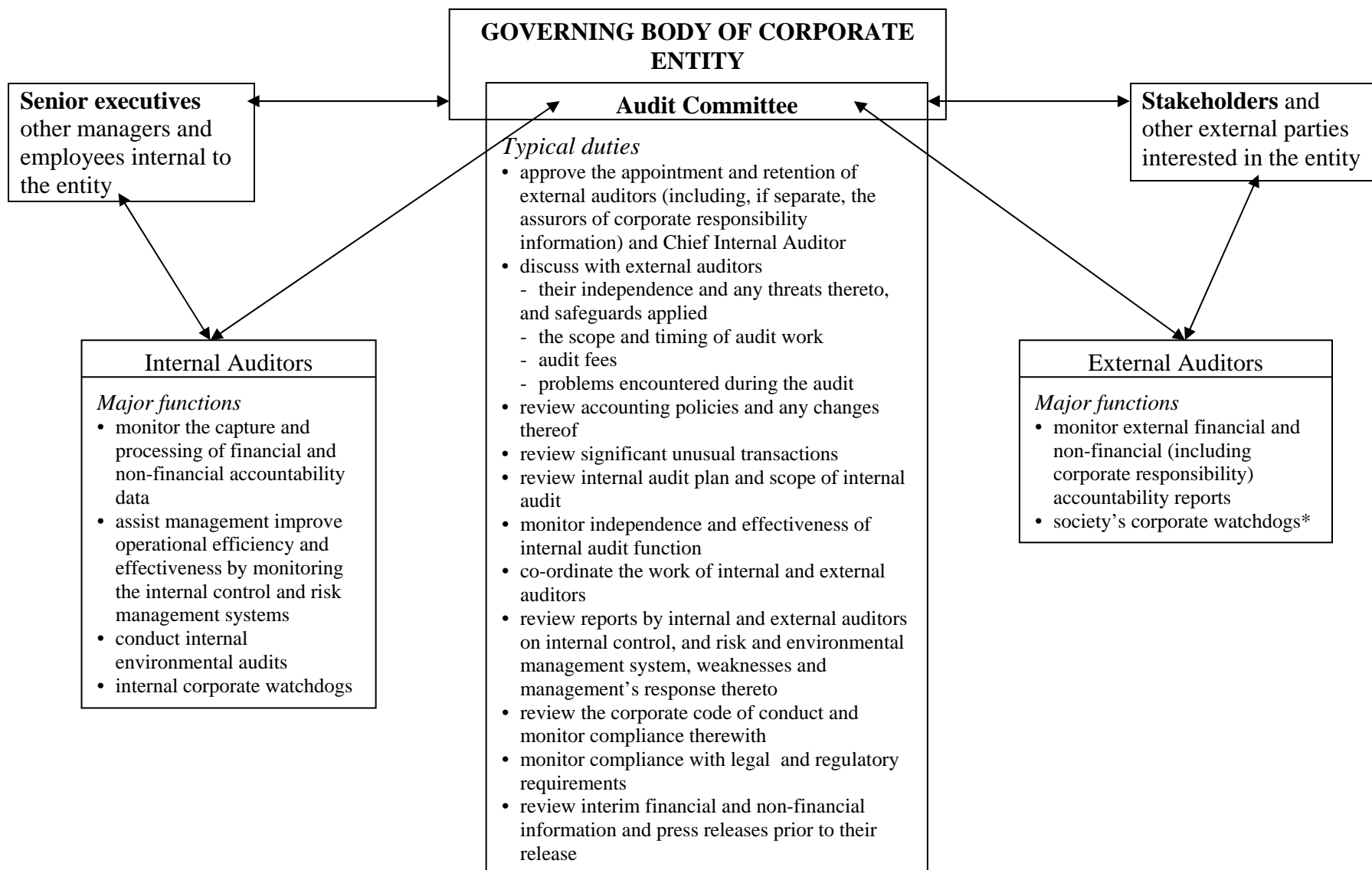
As might be expected, given the role of external auditors in securing corporate accountability, as the scope of that accountability has been extended, so too have auditors' responsibilities. Traditionally, external auditors focused their attention on their auditees' financial information. This remains their primary area of concern but, during the past couple of decades, their responsibilities – as embodied in auditing standards – have been made more explicit and exacting. This applies, for example, in respect of assessing and reporting on auditees' status as going concerns, and detecting and reporting corporate fraud and other illegal acts (especially when senior company officers are, or may be, implicated). Auditing standards now also explicitly require auditors, *inter alia*, to read all the information that accompanies audited financial statements (for example, in their auditees' annual reports) to ensure it is not inconsistent with the financial statements and does not contain material misstatements of fact. Further, in many jurisdictions, some of the non-financial information presented in companies' annual reports is required to be audited or reviewed by the external auditors. For example, in the UK, the Companies Act 2006 requires auditors to report (in the audit report) whether the directors' report is consistent with the financial statements (s.496) and to audit, and report on, the 'auditable part' of the directors' remuneration report (s.497). Additionally, the United Kingdom Listing Authority<sup>14</sup> requires the auditors of listed companies to review their auditees' Corporate Governance Compliance Statement in respect of the nine accountability and audit provisions of The Combined Code on Corporate Governance (FRC, 2006) that are subject to auditor review. Along similar lines, the USA's Sarbanes-Oxley Act of 2002 requires the auditors of any public company subject to the USA's security laws (in effect, any company registered with the SEC or listed on an USA Stock Exchange, or any significant subsidiary thereof wherever in the world it may be located) to "attest to and report on"

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<sup>14</sup> Regulatory responsibility for companies listed on the London Stock Exchange passed from the London Stock Exchange to the Financial Services Authority (FSA) in 2000. The FSA has delegated its responsibilities for listed companies to the United Kingdom Listing Authority (UKLA). To all intents and purposes the UKLA constitutes a division of the FSA.



**Figure 4: Interrelationship of external and internal auditors and the audit committee – The Tripartite audit function:**



\*This function of external auditors is discussed in Porter (1992)

management's assessment of the effectiveness of the company's "internal control structure and procedures for financial reporting" (s.404).

It is interesting to note that in many jurisdictions the legal and regulatory responsibilities of external auditors are so extensive that International Auditing Standard (ISA) 700: The independent auditor's report on general purpose financial statements (Revised 2004)<sup>15</sup> embodies a two part audit opinion – one on the audited financial statements and the other on the auditor's 'Other legal and regulatory requirements'.

The extended responsibilities of external auditors in respect of securing greater corporate accountability is also reflected in the fact that companies that provide CR information are increasingly having their CR reports externally audited (or assured).<sup>16</sup> According to KPMG (2005), of the 112 F250 companies that produced separate CR reports in 2002, 32 (29 per cent) had their reports externally assured; in 2005, 39 (30 per cent) of the 129 companies producing such reports did so.<sup>17</sup> The desire by companies to have their CR information externally assured reflects a recognition by company managements that merely providing accountability information is not enough; to discharge their accountability, independent audit (or assurance) of the information is necessary.

The independent assurance of CR information has introduced a new dimension into the external auditing arena. A review of assurance statements issued on corporate responsibility reports in the UK in 2006, for example, reveals that, while some are assured by the major accountancy firms (for example, Ernst & Young's assurance of BP's 2006 sustainability report), the majority are assured by specialist consultants (for example, Lloyd's Register Quality Assurance assured BT's 2006 sustainability report). MacKay (2000) notes that when it comes to assuring CR information each group of professionals have strengths and weakness:

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<sup>15</sup> During 2008, ISA 700 is being redrafted as part of the International Auditing and Assurance Board's Clarity Project. The format, but not the content, of ISA 700 will change as a result of the redrafting. Additionally, it is proposed to change the title of the Standard to: Forming an opinion and reporting on financial statements.

<sup>16</sup> The term 'assurance' is usually used in place of 'audit' to indicate the lower level of assurance that is provided by the assurer on the 'truth and fairness' of the CR information compared with that provided by an external auditor on audited financial statements (FEE, 2002).

<sup>17</sup> Of the 49 largest 100 companies in the UK that produced separate CR reports in 2002, 26 (53 per cent) had them externally assured; in 2005, the number had increased to 38 (54 per cent) of the 71 companies producing such reports.

The Big Five<sup>18</sup> trade on their audit experience, their sophisticated audit methodologies and their global brands. The consultants trade on their specialisation in environmental consultancy and their environmental expertise. The Big Five employ environmental specialists and the consultants employ auditors.

They both poach each other's staff and KPMG'S environmental audit division was augmented some years ago by a mass defection of environmental audit experts from a client – The Body Shop. ...The consultants can ... be relied on to use words such as correct, accurate and complete in their reports; auditors generally balk at saying anything stronger than “properly collated”. ...Whatever the reasons ... more environmental reports in the UK are verified by firms of consultants than by firms of auditors. (p.2)

Companies' use of consultants to assure their CR information may result, at least in part, from their fear of breaching the independence of their financial statement auditors. This is reflected, for example, in the reported likelihood of BAE Systems, Britain's largest defence company, excluding KPMG (its financial statements auditor) “on conflict of interest grounds” from conducting BAE's planned external audit of its ethical conduct (Sukhraj, 2008). It thus seems that, although the responsibilities of external auditors have been broadened and made more exacting as corporate accountability has been extended, the advent of submitting CR information to independent assurance is resulting in new (non-accountant) players auditing (or assuring) some of the accountability information. It may be that in the future, as the range of accountability information provided by companies increases (as seems likely, given recent history), different types of information will be audited (or assured) by different groups of specialists; alternatively, teams of external auditors may be expected to become increasingly multidisciplinary in nature. It may also be that some of the work of external auditors will be undertaken by internal auditors.

## **(ii) Internal auditors**

As the accountability expected of corporate managements has been extended, and responsible corporate governance has been added to the preparation and audit of accountability reports as an element in securing that accountability, so the contribution of internal auditors has come to be recognised [see, for example, The Combined Code on Corporate Governance (FRC, 2006),

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<sup>18</sup> MacKay is referring to Arthur Andersen, Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers. Andersen's did not collapse until 2002 – after MacKay's statement.

the Sarbanes-Oxley Act of 2002, and the Report of the National Commission on Fraudulent Financial Reporting (NCFRR; Treadway Report, 1987).

Internal control has been defined as:

a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievements of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting;
- compliance with applicable laws and regulations.

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected data derived from such statements ...The third deals with complying with those laws and regulations to which the entity is subject. [Committee of the Sponsoring Organisations of the Treadway Commission (COSO), 1992, Executive Summary, p.1)

Until fairly recently, internal auditors tended to focus on the second category of internal controls noted above. However, over the past couple of decades, just as the orientation of external auditors has been broadened from focusing solely on financial reporting to embrace non-financial information, so the orientation of internal auditors has been broadened to embrace all three categories of internal controls.

The importance of an effective system of internal control in securing responsible corporate governance was recognised by the Cadbury Committee in 1992. In its Report (CFACG, 1992) it notes: "an effective internal control system is an essential part of the efficient management of a company", and it recommended that directors report, in their company's annual report, on the effectiveness of their company's system of internal control<sup>19</sup> and that auditors report on the directors' statement (CFACG, 1992, p.27).<sup>20</sup> In the UK, the auditing profession (largely as a consequence of fearing increased exposure to legal liability) lobbied strongly (and, to date, successfully) against the imposition of this duty. However, as noted earlier, the auditors of companies to which the USA's Sarbanes-Oxley Act of 2002 applies are required to "attest to and report on" management's assessment of the effectiveness of their company's internal controls (s.404).

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<sup>19</sup> As noted in section 3(b) of this paper, this recommendation was incorporated in the Code of Best Practice (cl. 4.5).

<sup>20</sup> The recommendation that auditors report on the directors' internal control statement is reflective of the need for statements to be audited in order to secure accountability.

Similar to that of external auditors, the role of internal auditors has been broadened during the past couple of decades to embrace general corporate governance and accountability matters. In addition to having responsibility for the effective and efficient operation of the company's internal financial controls, indicated in Figure 4, internal auditors frequently have responsibility, *inter alia*, for:

- the company's entire internal control system,
- ensuring that all risks faced by the entity are identified in a timely manner and effectively managed,
- developing and implementing the company's code of conduct,
- ensuring that corporate fraud and/or other illegal acts are detected promptly and reported to an appropriate level of management, and
- for conducting internal environmental audits and the audit of environmental management systems (Porter *et al.*, 2008, Chs 4, 17).

Given their extended responsibilities, it is clear that the required skill-set required of internal auditors has widened significantly in recent years. It may be, as applies to external auditors, that different groups of professionals will be employed to undertake the internal audits of specialised areas within the organisation (for example, forensic auditing and the audits of environmental management systems). Alternatively, it may be that teams of internal auditors will become increasingly multi-disciplinary in nature. In either event, as the competence, capabilities and experience of internal auditors increases with respect to all aspects (financial and non-financial) of their organisation, it seems likely that much of the detailed work currently undertaken by the external auditors (or assurers) will pass into the domain of the internal auditors. As pointed out by the Institute of Chartered Accountants of Scotland's (ICAS) Research Committee (ICAS, 1993) in relation to external financial statement auditors, external auditors may be expected to assume an increasingly 'external assessor' function. This function would involve external auditors (whether auditing financial or assuring CR information) assessing and, *cet par*, relying on the work of the auditee's internal auditors in a similar manner to that which, in some financial statement audits, the external auditors currently rely on the work of experts and/or the auditors of components of the auditee. If the audit function develops in this way, the audit committee will play an increasingly important role in ensuring co-ordination and co-operation between, and the independence of, the internal and external auditors.

### **(iii) Audit Committees**

Like the role of internal auditors, during the past couple of decades, that of audit committees has been broadened from one focused almost exclusively on the external financial reporting process, to one concerned with corporate governance in general. This role is reflected, for example, in a South African report on audit committees (South African Institute of Chartered Accountants, 1991) which states:

The establishment and operation of an effective audit committee assists directors in the discharge of their duties relating to the safeguarding of assets, the operation of adequate systems and controls, risk management, and the preparation of financial statements. ...An audit committee's overriding objective is to see that management has created and maintained an effective control environment in the organisation. (pp.6-7)

The broad role of audit committees is reflected in the duties they are now typically expected to perform. As shown in Figure 4, these include overseeing the internal and external audit functions of the company, ensuring that the work of the internal and external auditors is properly co-ordinated, reviewing the company's code of conduct and monitoring compliance therewith, reviewing reports by the internal and external auditors on weaknesses in the company's internal control, risk management, and environmental management systems and management's response thereto, and monitoring the company's compliance with legal and regulatory requirements (Porter 1993).

As for external and internal auditing, as the role of audit committees has broadened to embrace corporate governance and other corporate responsibility matters, so the skill-set required of audit committees members may be expected to have expanded. However, audit committees are frequently comprised of three non-executive, independent, directors (or their equivalent) and they cannot be expected to possess the requisite competence to discharge unaided all of their responsibilities. Apart from the necessary attributes of integrity, diligence, intelligence, objectivity, professionalism, and competence in their specialist discipline, the most important attributes of audit committee members are: (i) an ability to ask probing questions and not to be too easily satisfied with answers, and (ii) an ability to recognise and obtain assistance from appropriate experts as and when they need it. Where audit committees seek and use the assistance of experts, the 'audit committee' may be viewed as a multidisciplinary 'team'.

## **6. CORPORATE ACCOUNTABILITY AND THE TRIPARTITE AUDIT FUNCTION**

In this paper it has been proposed that, as financial and other resources are channelled to economic entities, these enterprises gain power and influence in society. To counter possible abuse of that power, accountability is demanded of their managers. Historically, as corporate entities have grown in size and their impact on society has increased, so the accountability demanded of their managers has been extended in terms of to whom and for what they are accountable. Today, the managers of large public companies are considered to be accountable to society as a whole for a wide range of corporate activities.

At the same time as corporate accountability has been extended, so too have the requirements for effecting its satisfactory discharge. Until a couple of decades or so ago, in order to discharge their accountability, corporate managers were required to produce accountability reports in the form of annual financial statements and to submit these to independent (external) audit. However, since the 1970s, the extent and severity of the impact of unexpected corporate failures, and revelations of instances of misconduct and reckless management by senior company officials, have demonstrated that the two-fold approach to securing corporate accountability is inadequate. Initially, attempts were made to strengthen the external audit function by means of establishing audit committees comprised of non-executive directors. However, unexpected corporate failures and revelations of misconduct by corporate officials continued and, since the early 1990s, it has been recognised that an additional element is needed to secure the accountability of corporate managements – that of responsible corporate governance. This development seems to mark a move to a new stage in the corporate accountability arena, one in which the central role is played by the members of the tripartite audit function – external auditors, internal auditors and the audit committee. Each of these ‘members’ (whether constituted by a single multidisciplinary team or separate groups of specialists) has a distinct and critical role to play but their roles are interlocking and mutually supportive.

- External auditors have the task of ensuring that the accountability (financial and non-financial) reports produced by the audit client’s directors provide a fair reflection of the company's activities and its financial and, in relevant cases, its environmental, social, and/or ethical performance.
- Internal auditors are primarily responsible for monitoring the internal control, and risk

and environmental management, systems established by the company's directors to control corporate activities and to ensure they are directed towards meeting the company's objectives – that is, for corporate governance.

- The audit committee has a pivotal and unifying role: it is responsible for overseeing and co-ordinating the internal and external audit functions, and for reviewing the financial and non-financial accountability reports before they are submitted to the full board for approval and, subsequently, publication.

In the present socio-economic environment of the western world, with its sophisticated financial and product markets and advanced information technology, corporate entities have been able to grow to an unprecedented size. Multinational companies, represented in numerous countries, commanding vast quantities of financial and other resources, and affecting to a greater or lesser extent the lives and well-being of millions of people, are now commonplace.<sup>21</sup> The managers of these and other major corporate entities have clearly been accorded significant power. However, in return, they are subject to commensurate accountability requirements. In securing this accountability, reliance is placed on the members of the tripartite audit function. Together, they are charged with the task of ensuring that companies maintain responsible corporate governance and provide reliable accountability reports.

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<sup>21</sup> In December 2000, according to the Corporate Accountability Project (CAP): "Of the world's 100 largest economic entities, 51 are now corporations and 49 are countries". General Motors, Wal-Mart, Exxon Mobil, Ford Motors and DaimlerChrysler were, respectively, the world's 23<sup>rd</sup>, 25<sup>th</sup>, 26<sup>th</sup>, 27<sup>th</sup> and 28<sup>th</sup> largest economic entities (CAP, 2000).



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