PART 1

CORPORATE GOVERNANCE, THE ROLE OF THE AUDITORS AND THE LEGAL CONTEXT

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The development of corporate governance

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- Agency theory
- Corporate governance
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- Directors
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Learning objectives
After studying this chapter you should be able to:
- Understand the foundations of the modern company
- Understand and explain the outline development of company law
- Appreciate the implications of the theory of agency
- Understand the implications of the growth of executive power and the diversity of ownership
- Understand what corporate governance is and the need for it
- Recognise the relevance of the Sarbanes–Oxley legislation in the USA
- Detail the provisions of the Combined Code in the UK as to the role of directors and the structure of boards
- Understand the audit committee, its composition and role
All practising accountants should be familiar with the principles described in this chapter, and may feel that to include a chapter setting out a brief history of the development of the joint stock company and the growth of corporate governance simply constitutes an attempt at irrelevant padding by the author, who is merely trying to bulk out his book in order to make it look a more impressive volume on the bookshelf. ‘Old familiar territory to be glossed over,’ they will murmur wearily and flick through to the chapter on computer forensic investigations.

Students of accountancy may also feel that they know all about this stuff from their readings in corporate law, entrepreneurial finance or even auditing so, like the jaded practitioner, they too may be tempted to skip this bit and get into the practicalities of fraud investigation techniques.

This would be wrong.

The reason is this. There are fundamental structural principles which lie at the heart of some of the biggest corporate scandals in history and these principles must be clearly understood. It is important for forensic accountants to understand the context within which they have to work and it is equally important for them to have an understanding of the underlying causes of dysfunctional behaviour, and the inherent conflict between the psychology of managers and the aspirations of shareholders.

The modern world of corporate reporting encourages disclosure and openness as it moves inexorably towards embracing the principles encompassed within corporate social responsibility (CSR) and the enhanced disclosures envisaged by its promoters. Moral and ethical behaviour by directors and employees is a part of good corporate governance and is also a significant component of CSR. Understanding behaviour, both at the organisation level and at the level of the individual within the entity, is, as we will see, fundamental to the work of the forensic accountants in whatever work they are engaged, be it a fraud investigation, tracing and valuing assets in separation cases or quantifying damages claims.

It is also important for reporting investigators not only to know what has happened and where they, or more accurately their clients, are in ethical and moral terms but also just how far standards of behaviour may have fallen from the ideal.

The cynical may well ask how corporate governance initiatives, whether enforced by statute or as part of a semi-voluntary code, have prevented fraud and corruption: after all, we continue to see instances of corrupt and dysfunctional behaviour by corporations and an ever-increasing level of fraudulent activity by individuals. The answer is: we don’t know. We don’t know how bad it might have been, we only know what we have discovered.

What we do know is that there has to be a standard, a benchmark by which behaviour can be judged, and forensic accountants must know what that standard is. As we will see from succeeding chapters dysfunctional behaviour tends to flourish where corporate morality breaks down, either at the organisational or at the individual level. In this and later chapters we take time to consider what is right, which, we submit, is just as significant as discovering what is wrong.
Background to corporate activity

To understand the development of forensic accounting it is first necessary to consider a little history. This is important because forensic accounting, in many ways, derives from the role of the auditor, that unfashionable but critical spectre at the feast hosted by investors and enjoyed by managers. The external auditor has become one of the planks of sound corporate governance, one part of the critical checks and balances that help encourage companies towards levels of transparency and accountability which are hitherto unsurpassed in corporate reporting in the UK.

Once the corporation had finally developed as a legal entity in its own right, resulting in the mass ownership of shares becoming firmly separated from the management and control of the organisation’s activities on a day-to-day basis, the stage was set for the role of the auditor as arbitrator and judge. That role becomes increasingly significant where standards of corporate morality are or are seen to be declining. The corporate scandals in the USA and Europe in recent years involving misrepresentation, corruption and theft on a huge scale have increased the demand from both investors and regulators for auditors to be more efficient and more demanding of their clients in terms of their visible adherence to ethical principles and practical internal control systems.

Throughout history there have always been thieves and deceivers. There have always been those who seek to profit at the expense of others. At one level then, auditors and managers are on the same side as they seek to protect the organisation’s assets or to catch the offenders and, hopefully, see them punished. Where auditors and managers part company is where it is the managers who seek to enrich themselves at the organisation’s expense in a way that the auditor would expose as illegal or immoral because, in that case, it is depriving the owners of the business of what is rightfully theirs.

When managers distort the financial statements so that their share options sell out at a good price, where they create fictitious assets to hide their own depredations, where they stick their noses so far into the trough that their feet leave the ground – this is where the external auditor steps in to expose this bad behaviour, this immorality, this betrayal of trust.

The problem is that external auditors have signally failed to do this over many years.

It has been said that not one major fraud, at least in the modern era, has been exposed by the external audit. Illegal or immoral behaviour has come to light because of whistle-blowers, because of internal auditors, because the house of cards the fraudsters have built is blown down by the cold winds of reality. When that happens, the post-mortem frequently reveals not only the greed and corruption of those who perpetrated the fraud but also the weakness of the external auditors and their apparent willingness to accede to the demands of the directors or, in other cases, the sheer ineptness of their actions.

In 1992, partly as a result of Robert Maxwell’s depredation of Mirror Group Newspapers and the scandal of BCCI, the Cadbury Report was published. In his report Sir Adrian Cadbury wrote ‘The central issue is to ensure that an appropriate relationship exists between the auditors and the management whose financial statements they are auditing.’
We will look in more detail at the role of both external and internal auditors later, but for now, it is sufficient to say that when alarms go off it is more likely to be the forensic accountant who is called in to sort through the stories and statements to try to ascertain the truth.

The forensic accountant’s role in the corporate world is to unpick the detail, unravel the complex schemes of fraudsters, reveal the clandestine behaviour of those who would steal the assets of someone else’s business, track down the money, reveal the corrupt and explain where it all went wrong so that lessons can be learned and it won’t happen again – until the next time.

It is the separation of ownership from control which is at the heart of corporate misbehaviour and it is this separation which has led to the development of what has come to be known as corporate governance, and with it the role of the forensic accountant. We need to understand how we got where we are before we can see where we might go, so we need to consider a little history.

The history of the modern company

Before the middle of the nineteenth century any entrepreneurs in the West wishing to risk their capital in a commercial venture had few choices. They could risk their own money and pledge their assets to secure further borrowings, rather as small business people do to this day, or they could go into partnership with other like-minded souls and so spread the risk, assuming they could find enough people to assist in financing the venture, which required a deal of trust and no little faith that all would turn out well.

Samuel Smiles expressed it inimitably:

The implicit trust which merchants are accustomed to confide in distant agents, separated from them perhaps by half the globe – often consigning vast wealth to persons, recommended only by their character, whom perhaps they have never seen – is probably the finest homage which men can render to one another.

(Smiles, 1982)

Much of medieval trading was regulated by Guilds whose role was to oversee the regulation of various craft trades, but the growing development of international trade required more formal structures out of which evolved regulated companies. Members of these companies could trade their own shares or stock, subject to the rules of the company, although they did not have limited liability for their members; legally they were akin to partnerships.

A company trades at law as a legal person, a single entity which comprises the investments of its members. The Crown has always had the right to grant charters of incorporation and such companies had, prior to 1844, to be set up either by Act of Parliament or by Royal Charter. The would-be entrepreneur had to have both friends in high places and a lot of capital in order to establish any serious business venture, particularly one involving any form of international trade, but the great advantage was that the granting of the charter conferred a legal personality on the company and, with it, limited liability for its members.

Despite the bureaucratic difficulties many very successful companies were set up in this way. Perhaps the most famous were:

- The Honourable East India Company granted exclusive trading rights in the East Indies by Royal Charter in 1600 and, arguably, inadvertent founder of the British Empire.
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- The Governor and Company of Adventurers of England trading into Hudson’s Bay formed by Royal Charter in 1670. Later known as the Hudson’s Bay Company and famous for opening up Canada and stimulating the market for fur.

- The infamous Company of Merchants of Great Britain trading in the South Seas – the South Sea Company, formed in 1711, legendary stock operator, creator of the South Sea Bubble, and harbinger of things to come. It is estimated that, at its height, the total value invested in the South Sea Company reached £500m, at eighteenth-century prices – twice the value of all the land in England at that time.

Of all of these it was the South Sea Company which was to have the most profound effect on the corporate governance of the day. A huge speculation in the affairs of the company, fuelled by claims which later proved to be fraudulent, led to a massive investing frenzy which, as all such frenzies do, ended catastrophically. The company crashed and many speculators were ruined. It was the Enron of its day, and just as Enron prompted the Sarbanes–Oxley legislation in the USA in the twenty-first century, in the eighteenth century the government of the day passed, in 1720, the so-called ‘Bubble Act’ in order, it said, to prevent further fraudulent activity.

This Act provided that all commercial undertakings (both corporations and partnerships) ‘tending to the common grievance, prejudice and inconvenience of His Majesty’s subjects’ would be illegal and void. The Act also banned speculative buying and selling of shares and outlawed stockbroking in such shares. Between 1720 and 1825, when the Bubble Act was repealed, shares could only legally be sold to persons genuinely taking over a role in running the corporation or partnership. The problem was, however, that whilst the Act suppressed unincorporated quasi-companies it did nothing to provide any alternative form of legal structure which could be used as a vehicle for trade.

Between 1720 and 1844 new businesses which might previously have been incorporated were operated, effectively, as partnerships based on an elaborate Deed of Settlement. In law these were classed as partnerships and the partners were, accordingly, jointly and severally liable for the debts of the business.

However, as the eighteenth century progressed and the industrial economy grew rapidly, driven by technological advances in textiles and the smelting of iron, there developed a need for expansion of transport links, which took the form of canals and waterways, to move goods and raw materials to the new manufacturing centres and markets of England. The problem was that, because of the Bubble Act, financiers were not prepared to put their hands in their pockets and put up the money if it meant that they might ultimately be responsible for all debts and liabilities of the business if it failed. The risks were often seen as too high to outweigh the possibility of reward. The governments of the day either could not or would not finance these much needed developments so many of these very early transport infrastructure projects were funded by wealthy landowning individuals.

An answer was needed and the corporate form appeared ideal. Parliament began to approve specific corporations to be created by Act of Parliament (‘Statutory Corporations’). An Act of Parliament would authorise the creation of a corporation for a specific and narrow purpose and allow it to bring and defend legal actions in its own name (so protecting the financiers from personal responsibility should the corporation fail).

The general view at the time was that corporations should only be created for very specific purposes. Adam Smith, author of the seminal tome The Wealth of
Nations and father of much of modern capitalist thinking, believed it was contrary to the public interest for any businesses or trades to be incorporated and that all should be run as partnerships. He believed in the ultimate aspect of laissez-faire economics – that all speculators should bear their own risk.

It was the rapid expansion of the railways and the increasing demand for what were then high-speed transport links which revolutionised the corporation. The huge sums needed to construct railways on an unprecedented scale, opening up the country for trade and pleasure, virtually compelled the creation of the modern joint stock company in the UK. Adam Smith’s vision was fulfilled, at least in part, as companies were formed to build railways across the country, many of which were doomed to failure at the start, but all of which were funded by private capital by speculators who took a risk.

In 1844, with the passing of the Act for the Registration, Incorporation and Regulation of Joint Stock Companies, the facility was given to the public to form joint stock companies by a simple act of registration. This did not permit limited liability but it did ease the difficulties in setting up corporations, and the stage was set for 1855 when the passing of the Limited Liability Act finally allowed shareholders to quantify their risk when investing in new business ventures using the new form of a limited liability company.

As companies grew in size, responding to increasing industrialisation and the growth of markets, the ownership and control of companies became increasingly separated. In particular in the UK and USA, with the protection given to minority shareholders, the shareholder base became much more diverse. This, incidentally, is not necessarily true of companies in countries which do not have a system of common law like that of the UK which relies on precedent and an independent judiciary. The most common form of ownership around the world is the family firm or controlling shareholders.

However, in the UK, and the USA, the growth in share ownership has seen a trend towards both institutional ownership of large blocks of shares and widely dispersed ownership by large numbers of individual shareholders, what has been called ‘ownership without power’. Institutions which hold shares as investments are coming under increasing pressure to adopt some of the rights of ownership, particularly in curbing what has been seen, in some cases, as excessive remuneration voted to directors. This has reinforced calls for improved transparency in reporting to correct the imbalance in financial reporting. Directors have lots of information, shareholders relatively little, which will, in the longer term, enable shareholders to assume more of the responsibilities of ownership and make boards of directors more accountable.

The growth of disclosure

After 1855 shareholders were protected from risk, other than the risk to the sum invested, and anyone could set up a company – and did. Students of Victorian business history will discover that new companies were set up for all sorts of reasons and individuals were encouraged to speculate in the new companies. Many investors, of course, lost their money due to fraud, incompetence or over-ambition but many companies succeeded due to the Victorians’ penchant for persistence, hard work and ingenuity.

Initially there was a distinct lack of accountability by these companies. The Act of 1844 had required the production of accounts and some attempt at auditing
them, but these requirements were repealed by the Act of 1855. Arguments advanced at the time against financial disclosure included the following, rather wonderful, propositions:

- As there is no totally reliable way of accounting for the success or otherwise of a business it is best not to attempt it.
- The books could easily be manipulated by dishonest directors (although quite why this was an argument against even attempting disclosure is hard to see).
- Disclosure would prejudice commercial secrecy and operators of companies would not like their operations to be known – even by their own shareholders.
- Too much disclosure would create a false sense of security among investors.

That is not to say there was no accountability at all, but it was rather selective. Put simply, as the financially astute, the ‘insiders’, were very much of the same social class or milieu and moved in the same circles they didn’t need publicly available information, in fact they tended to rather discourage the idea. ‘Outside’ shareholders, those not in the know, were simply seen as passive investors who took the risk of losing their investment if the business failed.

Accountability really began in 1900 with the requirement to publish an audited balance sheet. The audit itself was first introduced in 1879 when banking companies were required to have an audit, a concept which was not generally extended until 1900. A balance sheet was not required to be submitted to the Registrar of Companies until 1908, following the passing of the 1907 Companies Act, and private companies were exempted from this requirement. The 1929 Act required a balance sheet and profit and loss account to be presented to the shareholders annually but it was the 1948 Act, following the recommendations of the Cohen Report, that required greatly increased disclosure of the company’s financial affairs and the actions of directors.

A key aspect of the Companies Act 1948 was that, for the first time, auditors were required to have a professional qualification and it was that Act which laid the foundations of the modern auditing profession.

Various Companies Acts have followed since then. In turn each one made its mark by:

- tightening the legal restrictions on directors and on the company itself
- setting rules concerning the issues of shares and the payment of dividends
- setting the rules for minimum capital requirements for public companies, and
- most pertinent to our purpose, regulating the content of accounts, increasing accounting disclosure, the requirements for accounts preparation and the records to be kept.

The expansion of legislation has increased the level of compliance required and the consequent need for companies to create financial systems to both gather and present the information legally required and to control its internal financial procedures.

Legislation has continued to this day, culminating in the mammoth Companies Act 2006, the largest piece of legislation ever passed in the UK.

Scotland

In Scotland the legal position for companies was different from that in England. Both regulated and joint stock companies existed there from about the end of the seventeenth century. Scotland’s legal system is heavily based in common law
which is, broadly, law set by cases and precedent rather than by statute. The common law in Scotland allowed the formation of joint stock companies with transferable shares under the management of directors. It was recognised that a company was a legal person and had a personality separate from that of the directors who managed it and its owners. Scottish common law companies had a lot in common with English ‘deed of settlement’ companies.

Nowadays, of course, statutory company law applies throughout the United Kingdom.

**Agency theory**

Although political and even cultural influences have a bearing, it is arguable that the legal status of the entity through which business is conducted is perhaps the biggest influence on the need for strong corporate governance.

History shows that the need for funding business expansion, and the consequent rise of the publicly owned joint stock company, had the effect of slowly separating the ownership of the business from its day-to-day control. When merchant adventurers risked most of their own capital on a venture they tended to watch closely over it, indeed many merchants travelled with their goods to oversee operations themselves or they appointed agents whose honesty and reliability were tried and tested and who relied upon their reputation to stay in business. Partners watched each other; if only because of the danger that a defaulting or defrauding partner could disappear leaving the remaining partners liable for the debts of the business. There was, inevitably, a large element of trust in their dealings.

Even with companies the size of, say, the East India Company, which at its height maintained its own army and navy, the Court of Directors in London received regular reports from a network of agents and they were accountable to the monarch and to Parliament.

However, the introduction of limited liability and the consequent opening up of share ownership to the wider public dramatically widened this gap between ownership and control.

The managers or directors of the business (defined here as ‘agents’) were given the freedom to run the business without the day-to-day involvement of the owners, the providers of the capital (defined here as ‘principals’). They were entrusted with the principals’ money and their role, it was hoped, was:

- to use that investment to create profits which the principals could receive by way of dividend, and
- to expand that initial capital on behalf of owners so increasing the value of their investment.

Their primary role as agents was, and still is, the preservation of the assets of the business and to act always in the best interests of their principals, the shareholders. In return the agents should receive suitable remuneration, concomitant with their status and their level of success in making money for their principals. Thus everybody should get something out of the arrangement – or so it seems. In fact things don’t always work out quite as well as might be anticipated because, as usual, human nature gets in the way.
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It is this that lies behind the concept known as agency theory. Agency theory holds that agents do not, necessarily, take decisions in the best interests of their principals. It states that the objectives or goals of principals and agents mostly conflict and, where they do, agents will, naturally, make the choice which benefits themselves the most, choices which may not be the most beneficial decision for the principals. This is summarised quite simply in Table 1.1.

Agency theory is a relatively simple principle to grasp, but its ramifications are extensive and have important implications for how organisations conduct themselves and what their operational culture might be.

The Institute of Chartered Accountants in England and Wales, in November 2006, put it this way:

In principle the agency model assumes that no agents are trustworthy and if they can make themselves richer at the expense of their principals they will. The poor principal, so the argument goes, has no alternative but to compensate the agent well for their endeavours so that they will not be tempted to go into business for themselves using the principal’s assets to do so.

The origin of auditing goes back to times scarcely less remote than that of accounting . . . Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another the advisability of some kind of check upon the fidelity of the former would become apparent.

Clearly this is not universally true, but the extent to which principals don’t trust their agents will tend to govern the level of the monitoring mechanisms principals need to create for the overview of their agents’ activities and also to decide the extent to which agents’ compensation levels are considered to be acceptable by the agent, even if they are considered to be excessive by the principal.

Upon this principle rests the foundation of the modern auditing profession and, in the latter part of the twentieth century and the early part of the twenty-first, the establishment of modern corporate governance.

One of the differences between principals and agents tends to arise because of the different views of the time horizon each party holds. Research indicates that, broadly, principals – individual investors (as opposed to speculators) – tend to view their investment as relatively long term. They require their money to be secure, first of all, and then they will look for steady growth and, possibly a regular dividend. Research also indicates that investors, generally, are more influenced by the prospect of capital growth than a regular income. Dividend returns on capital invested tend to be fairly low: many investors could receive a greater level of income

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<td>Principal</td>
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Table 1.1 Agency theory
from investment in bonds or some other forms of investment such as property, however they would not achieve the same levels (hopefully) of capital growth.

Agents and managers, on the other hand, tend to want short-term gains such as bonuses, perks or share options which can be cashed in relatively quickly to make a low taxed profit. This encourages short-term decision making or decision making designed to protect or increase the share price rather than the more long-term strategic approach required by investors. It is for this reason, of course, that managers can be tempted to ‘improve’ results when reporting.

Another factor which has increased the power and control of managers and which, it has been argued, is also culpable in fostering short-term decision making, is the investment community itself, which is often looking to gain short-term profits from portfolio management investment rather than for strategic approaches centred on strategies which stress the need for:

(a) survival, and
(b) long-term growth.

In the modern era we have seen the rise of private hedge funds which use huge amounts of borrowed money to purchase businesses which they then ‘improve’ so as to maximise their return. These businesses are often sold on after a few years, hopefully repaying the borrowed funds and realising a capital profit. Clearly the return on investment has to be substantial to make the deals attractive so management emphasis is on cost reduction, heavy marketing and operational efficiencies. Hedge funds are about managers, not about owners. What is not at a premium in these companies is research leading to product development or long-term investment in corporate infrastructures.

In the modern world the increasing size of corporations has resulted in the fragmentation of share ownership. In many cases large investors are not individual shareholders but are themselves institutions which are looking for a commercial return on their investment. The private individual shareholder prepared to hold their investment in a single company, as opposed to some sort of composite investment fund, over the longer term and to accept moderate levels of growth in return for security of their investment is now very much a minority shareholder. It can thus be argued that today it is largely managers who now control shares in companies run by other managers. The agents have control, as demonstrated by Berle and Means (Exhibit 1.1) as long ago as 1932.

All of these factors have combined to give managers of big companies extraordinary power, to the extent that major multinationals are bigger than some countries and decisions made in their boardrooms can have an effect on national economies. The recent banking crisis created by the decisions of major international banks to abandon risk management in favour of huge but illusory gains is a striking example of this. It took the combined economies of most of the developed countries of the world to avoid a global collapse of the entire banking system – such is the power, or destructive potential, of company managers.

The separation of ownership from control and the increasing power of company managers in large corporations encourages them to do two things:

- Take risks in order to maximise short-term advantage. This might mean an aggressive acquisition programme funded by short-term borrowing, overseas expansion into foreign markets, or aggressive marketing of products to drive up market share in the short term.
Adopt aggressive accounting practices which may, in extreme cases, amount to fraudulent manipulation of the figures. The classic cases in recent years of this are the cases in the USA of Enron and WorldCom where managers actively colluded in misleading investors in order to maintain an otherwise unsustainable share price, enriching themselves in the process.

Agency theory is the structural framework on which the principles of corporate governance are based and what follows from it. As we will see it can be argued that workplace malfeasance, involving employees at all levels in the organisation, starts from this divorcing of ownership from control and the consequent need for strong corporate governance. As we will see, where corporate governance is weak that weakness forms the context for much of the bad behaviour of managers within organisations and, consequently, following their lead, also by their staff.

Adolf Berle and Gardiner Means published their seminal work *The Modern Corporation and Private Property* in 1932. In it they stated that as corporations grew, the financing requirements made it increasingly difficult for individuals to maintain majority shareholdings, which meant shareholding became divided and fragmented among larger and larger numbers of individuals and other investing bodies.

As shareholding became more diverse and diffuse the one constant in the company was the management: *de facto* power thereby devolved upon them.

As companies grew in size and power a relatively large amount of total corporate wealth became concentrated into relatively few huge corporations. Managers in these corporations were able to disburse company resources in the way that primarily suited them, i.e. through reinvestment or even enhanced pay, rather than as dividends.

These companies had an impact on society as they were able to open or close factories and branches, thus influencing the lives of millions of people without any real form of democratic accountability.

Exhibit 1.1 The modern corporation – Berle and Means

Adolf Berle and Gardiner Means published their seminal work *The Modern Corporation and Private Property* in 1932. In it they stated that as corporations grew, the financing requirements made it increasingly difficult for individuals to maintain majority shareholdings, which meant shareholding became divided and fragmented among larger and larger numbers of individuals and other investing bodies.

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Source: Berle and Means (1932)

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Corporate governance

The UK’s business community has always prided itself on its long tradition of fair dealing and low-key regulation in contrast to the heavy-handed enforcement favoured by its brasher, more strident commercial cousin on the other side of the Atlantic. The UK, business people like to think, has a long tradition of gentlemanly fair dealing and incorruptibility.

For many years, prior to the 1990s, the system of company regulation was broadly structured around the various Companies Acts 1948 to 1989, bits of which were in force, and life for the auditors and company directors was one uncluttered by the need for excessive compliance because there was relatively little they had to comply with.

The auditing profession had belatedly woken up to the idea of Auditing Standards, previously the province of the individual professional bodies such as the Institute of Chartered Accountants in England and Wales (ICAEW), which issued ‘Guidance to Members’. During the 1980s the then Auditing Practices Committee issued about ten standards which governed the carrying out of routine audit work. The business community required an occasional intervention by what was then known
as the Board of Trade when a particularly egregious scandal emerged but otherwise the surface of the corporate lake remained relatively placid and unruffled.

Then, in the latter part of the 1980s, the UK suffered a series of corporate scandals which began to undermine the trust investors had in the gentlemanly approach. The biggest and most notorious scandal was that involving the larger than life Robert Maxwell whose empire, based around his Maxwell Communications Corporation (MCC) finally exploded. It took with it not only suppliers and lenders but also the assets amounting to some £700m belonging to the Mirror Group newspapers pension scheme which Maxwell had ‘borrowed’ in a desperate attempt to prop up the ailing MCC. Maxwell was a physically imposing and domineering individual who ran his companies as his personal fiefdom, acting as both chairman and chief executive. The non-executive directors on the MCC board, reputable people all, did little apart from lend MCC an aura of respectability. To make matters worse the auditors signally failed to pick up the transfers Maxwell was making from the Mirror Group pension scheme, even though they were in a position to do so.

Maxwell’s shenanigans, whilst undoubtedly the most shocking, were only one of several cases of corporate failure around that time which worried both investors and regulators alike and prompted vociferous calls in the media for action. Other legendary exploits included:

- Polly Peck – run by rogue businessman Asil Nadir who decamped to the Turkish Republic of Northern Cyprus, where he remains to this day under threat of arrest, should he leave, on charges of fraud and theft of £34m. He also was responsible for the downfall of then Northern Ireland minister Michael Mates when it was revealed he had paid Mates to ask questions in the House of Commons.
- The Bank of Credit and Commerce International which proved to be a haven for money launderers and drug smugglers, closed down in 1991 by legislators worldwide.
- Coloroll under the management of media golden boy John Ashcroft, which collapsed in 1990 with debts of around £400m created largely by an aggressive but injudicious acquisitions programme.

The prevailing mood was ‘something must be done’ and so the City, alarmed both by the loss of investor confidence and the prospect of government regulation, reacted quickly and commissioned Sir Adrian Cadbury to come up with some good practice proposals which would:

- reinforce the responsibilities of executive directors
- separate the role of chairman and chief executive
- strengthen the role of the non-executive director
- make the case for audit committees of the board
- restate the principal responsibilities of auditors, and
- reinforce the links between shareholders, boards and auditors.

This Cadbury duly did and his report (imaginatively entitled The Cadbury Report) issued in 1992 formed the foundation of what was to become the Combined Code, a part of the Stock Exchange listing agreement to which all companies wishing to have their shares listed on the London Stock Exchange must comply.

It was Cadbury who first defined what we know today as corporate governance. The definition of corporate governance most often quoted, at least in auditing textbooks, is the one contained in the Cadbury Report ‘the system by which companies are directed and controlled’.
This definition was all very well for the time, but as various reports post-Cadbury have refined and enhanced his initial concepts so the definition of what corporate governance actually is has also been refined. In research carried out in 2000 among UK institutional investors the definition which found the most favour was ‘the process of supervision and control intended to ensure that the company’s management acts in accordance with the interests of shareholders’ (Parkinson, 1994).

This, as you see, goes right to the heart of the problems of agency theory outlined above.

The principles of Cadbury and its successors have not been enforced by legislation on companies listed either on the London Stock Exchange or on any other. Instead listed companies are required to abide by what is known as the Combined Code on Corporate Governance, or to state in their accounts why they don’t comply, the so-called ‘comply or explain’ basis (see Table 1.2).

This leaves open the door to non-compliance by listed companies, which may only have to suffer a note in the auditors’ report and perhaps a stern word from the Stock Exchange for a first offence, and of course it has no effect at all, other than a persuasive one, on unlisted companies.

Interestingly the Companies Act 2006 does incorporate within it specific duties for directors. Among other things S172 of the Act lays down a specific duty on a company director to:

- act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and to have regard to
  - the interests of the company’s employees
  - the need to foster the company’s business relationships with suppliers, customers and others
  - the desirability of the company maintaining a reputation for high standards of business conduct.

(Note: UK legislation generally uses ‘he’ throughout although supposedly this has no gender implications and applies equally to women)

### Table 1.2 Corporate governance reports after Cadbury

<table>
<thead>
<tr>
<th>Report</th>
<th>Key feature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greenbury (1995)</td>
<td>Looked at the question of directors pay. This was partly in response to the ‘Cedric the Pig’ protest campaign at the 1994 AGM for newly privatised British Gas when the then chairman, Cedric Brown, was looking for a 75% pay rise for doing the same job as he was doing pre-privatisation</td>
</tr>
<tr>
<td>Hampel (1998)</td>
<td>Reinforced points made in the original Cadbury Report, in particular the separation of the roles of chairman and managing director and the balance of the composition of the board between executive and non-executive directors</td>
</tr>
<tr>
<td>Turnbull (1999)</td>
<td>The role of internal audit</td>
</tr>
<tr>
<td>Higgs (2003)</td>
<td>Reinforcing the role of non-executive directors</td>
</tr>
<tr>
<td>Tyson (2003)</td>
<td>Additional guidance on recruitment and training of non-executive directors</td>
</tr>
<tr>
<td>Smith (2003)</td>
<td>The relationship between the auditors and the audit committee and the role of the audit committee</td>
</tr>
</tbody>
</table>
For the first time there is a specific legal provision for a specified class of individuals to have regard for the interests, not only of those who have invested in the company over which they have day-to-day control, but also of those of the other stakeholders, employees, customers, suppliers and indeed – in its injunction to maintain a high standard of conduct – anyone the business comes into contact with in the course of its business.

It legislates for a moral code, something which companies appear to have seen, until recently, as a useful part of human relations policy, but not as a creed to live by.

### The Combined Code on Corporate Governance 2003

The Financial Reporting Council (FRC) drew up guidelines that were published in July 2003 as part of its Combined Code on Corporate Governance.

The Code incorporates the key good governance provisions of the Cadbury Report and the subsequent reports detailed above and is underpinned by a Financial Services Authority rule that requires companies listed on the London Stock Exchange to state, in their annual report, how they have complied with its provisions or to explain why they have not done so. This is known as the ‘comply or explain’ basis and differs from the purely regulatory approach adopted in other countries, particularly the USA.

Listed companies are supposed to abide by the Combined Code, but it is good practice for all companies to abide by as many of these principles as are practicable.

We will look at the main provisions of the Code, insofar as they are relevant to our subject. In this case we will concentrate on the role of the board of directors and the audit committee.

### The role of the board

As part of the background we need to consider the role played by the board of directors. They have many tasks but as this is not a book on management we will confine ourselves to a consideration of the role they have in maintaining good corporate governance and, in particular and most relevant to our purpose, their role in creating and maintaining good systems of control within the business.

There are two fundamental principles underlying good corporate governance practice:

- **Accountability** – directors and the organisation they control must be accountable to the various stakeholders involved in the business, which will include not only the shareholders but also employees, suppliers, customers and lenders.
- **Transparency** – not only being accountable but being seen to be accountable to those stakeholders.

This requires the directors to ensure that they report regularly and efficiently to the various stakeholders they have identified. This task is now seen as somewhat wider than a grudging acceptance that they have to prepare and circulate a set of annual accounts with a minimal level of disclosure. Modern corporate governance best practice requires a regular and accessible flow of information using all modern means, including the Internet.

The board of directors is also responsible for the company’s system of internal control. This is the system of checks and balances within the organisation designed
to ensure that the financial information it produces is free from significant error or misstatement. We will return to the principles of internal control later in Part 3.

The board’s role in internal control is to create a suitable internal control environment. This involves:

- setting appropriate policies
- communicating these to staff, and
- seeking regular assurance that will enable it to satisfy itself that the system is functioning effectively.

It does this through its own efforts in understanding and monitoring risks and the control systems designed to deal with those risks through engagement with staff and senior managers on a regular basis. Ideally the directors will institute a system of internal audit, if the organisation is of sufficient size, perhaps reporting to an audit committee of non-executive directors (see later) and of course through the external audit process.

What the board must not be is passive, simply trusting that all is well in the absence of information to the contrary, or trusting solely to the annual audit to expose any defects in their control systems. It must, instead, be proactive in ensuring that the system of internal control is effective in managing business risks in the manner it has approved. Note that, according to best practice, there is no budgetary limitation to managing risk; using budgets as an excuse for poor risk management is dangerous short termism and is likely to lead to problems in the future.

It is the role of line management, below director level, to implement board policies on risk and control. In fulfilling its responsibilities, line management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board. We will look at this in more detail in Chapter 8.

Earlier in this chapter we looked at the broad concept of agency theory, the idea that agents (managers) will tend to make decisions in their own interests rather than in the interests of principals (shareholders).

In Britain the development of a strong code of corporate governance, following on from the Cadbury Report, has possibly sheltered the UK corporate world from the worst kind of corporate scandals epitomised in America by Enron and WorldCom.

The application of framework-based UK codes, reinforced perhaps by the new directors’ provisions in S172 of the Companies Act, 2006 have, commentators state smugly, prevented directors indulging in the same kind of blatant manipulations and frauds that rocked corporate America.

Other countries which imposed strong corporate governance regimes have also been largely unaffected by Enron-style shenanigans. This is not to say there has not been some poor practice, evidenced by the collapse of Barings Bank in 1995 and the activities of a lone SocGen trader which caused the major French bank some heartache in 2007. Arguably these cases are somewhat different, being perpetrated by single individuals, not motivated by the desire to steal but by a desire to make a name for themselves, aggravated by corporate systems failure. They were not, after all, corporate frauds designed and led by some or all of the board of directors.

Detractors from this view will, of course, point to such cases as Parmalat in Italy where some of the directors, who also had shares in the business, indulged in large-scale fraud but this case, again, was one which appears to involve theft motivated by simple greed on the part of a few senior individuals rather than institutionalised dysfunctional behaviour as happened at Enron. There will always be corrupt managers and opportunists and these make both entertaining headlines and money for the legal profession when the plots are revealed. They also, at some level, cause personal tragedies.
It should not be forgotten that institutionalised corruption strikes at the very heart of the confidence the financial world needs if it is to function. Loss of investor confidence in the audit profession, in the probity of directors and in the soundness of banks can and, as we have seen, does wreak havoc not only in the financial world but in the economies of those countries which support those corrupt institutions.

The standards of personal morality and the ethical climate established and maintained in an organisation by those who govern it are crucial to successful corporate governance and consequently to reliable financial information and to the security of the organisation’s assets. The newest corporate scandals in the USA and the old ones in the UK showed that, when senior management goes bad, the organisation, as the proverb puts it, like fish, rots from the head. The influence of a corrupt senior manager can have a hugely deleterious effect on their subordinates who are forced into an invidious position. They either have to:

- comply – go along with the deception by either turning a blind eye to it if they are able or actively assisting it, or
- deny – by leaving the organisation, getting transferred or blowing the whistle.

This applies irrespective of the level of management involved, whether it be a canteen supervisor stealing food or a managing director falsifying profits to improve a share price. They cannot and do not act alone. Only the lone fraudster covertly siphoning value out of the business acts in this way – all other forms of corporate malpractice are, at some level, team efforts.

It is the responsibility of the board, as part of strong corporate governance, to use their best endeavours to create the climate where fraud and malpractice not only cannot flourish but where any green shoots of fraud are rooted out and dealt with appropriately.

**Directors**

The rules which derive from the Combined Code insofar as they affect the directors are, broadly, as follows. Suitably adapted these can, of course, be applied to any organisation whether it be a public sector body or charity – the principles are what matter. We will, however, refer to companies and directors throughout for convenience.

- Every company should be headed by an effective board, which is collectively responsible for the success of the company.
- There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business. No one individual should have unfettered powers of decision. What this means, in practice, is that the chairman of the board should not be the same individual as the managing director or chief executive officer.
- The chairman is basically responsible for running the board and ensuring that it functions as a board and that its members are suitably qualified and competent. This includes taking responsibility for non-executive directors. The chief executive is responsible for the business activities and the actions of executive directors.
- The board should include a balance of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board’s decision taking.
Chapter 1  The development of corporate governance

- There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.
- The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. This is a requirement to produce good-quality management information, both financial and non-financial, in a form the directors can understand and in a timely manner.
- All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance. The board should ensure planned and progressive refreshing of the board.

Director’s report on internal controls

We will look at internal controls in more detail later; at this stage it is only necessary to know that this relates to the internal accounting and financial procedures within the organisation which are designed to detect errors and misstatements, and of course frauds, which it is the responsibility of the directors to maintain.

Listed companies have to include, in their financial statements, a narrative report from the directors which:
- identifies the organisation’s business objectives
- identifies and assesses risks which threaten achievement of those objectives
- reports on the design and operation of controls to manage those risks, and
- reports on the process of monitoring and reviewing those controls to ensure they are operating correctly.

Directors’ remuneration

This is relevant for the purposes of forensic accountancy because the remuneration of directors is often a very political issue in companies. In addition there have been several cases where directors have sought excessive remuneration by falsifying results or distorting performance. An understanding of the principles is therefore appropriate.

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully.
- A company should avoid paying more than is necessary for this purpose.
- A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance, i.e. incentive-based pay such as bonuses.
- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No directors should be involved in deciding their own remuneration. In practice this usually takes the form of a Remuneration Committee of non-executive directors as recommended by Greenbury (see above).

Accountability and audit

- The board should present a balanced and understandable assessment of the company’s position and prospects.
Part 1 Corporate governance, the role of the auditors and the legal context

- The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.
- The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company’s auditors. This is should be carried out by an audit committee, comprising at least three non-executive directors.

The key point about good corporate governance is that its requirements should be met in the spirit of good governance and not just by observing the letter of the Code. ‘Box ticking’ should not be a substitute for clear thought and fair exposition.

It is the responsibility of the directors to produce financial statements which truly and fairly reflect the financial position of the organisation and which make them accountable for the results of the financial period. Figure 1.1 illustrates the process.

Figure 1.1 The financial audit process
The audit committee

The Combined Code requires that all listed companies set up an audit committee as a subcommittee of the main board.

Ideally:

- it should comprise at least three non-executive directors who are independent of management
- the members should have a wide range of business and professional skills
- the members should have a good understanding of the business yet should have had no recent involvement with direct management of the business, and
- the committee should have clear written terms of reference setting out its authority and its duties.

Clearly this can sometimes be difficult to achieve. However, the object is to create a committee which is competent to carry out its role, is independent and is free from bias.

The key objectives associated with the setting up of audit committees, from the point of view of Corporate Governance generally, are:

- to increase public confidence in the credibility and objectivity of published financial information
- to assist the directors in carrying out their responsibilities for financial reporting, and
- to strengthen the position of the external auditors by providing a channel of communication at board level without the constraint of any executive bias.

There are advantages to having an audit committee. These are:

- It can improve the quality of management accounting as they are able to criticise internal reporting, which is not necessarily the responsibility of the external auditors.
- It can facilitate communication between the directors, internal and external auditors and management.
- It can help minimise any conflicts between management and the auditors.
- It can facilitate the independence of the internal audit role if the internal auditors report to the audit committee directly.

However, there are some disadvantages which the members of the audit committee have to avoid:

- It can be seen that their purpose is to criticise or ‘catch out’ executive management.
- It can result in the perception, if not the reality, of a two-tier board.
- The non-executives can become too embroiled in detail and start to act like executive directors, thus losing their independence.

In detail, the role of the audit committee can be summarised as:

- to review internal control procedures and processes
- to review the internal audit function and act as a channel of communication to executive management
- to review current accounting policies and the impact of any possible changes
- to review the usefulness and effectiveness of current management information
to review the financial information presented to shareholders and other information issued by the company such as profit forecasts etc.
• to liaise with external auditors, consider their reports to management and any issues arising from the audit and ensure any audit recommendations are dealt with by executive management
• to review the effectiveness and efficiency of the external audit
• to consider the independence of the auditors from executive management; this can be particularly important where the audit firm is supplying substantial additional services to the client in addition to their role as external auditors
• to recommend the nomination of external auditors and also to deal with their remuneration for carrying out the audit work, and
• to review compliance with the Combined Code on Corporate Governance.

In essence the audit committee is designed to act as an independent voice on the board of directors with regard to audit and corporate governance issues and can be a valuable asset, particularly with respect to maintaining the independence and integrity of the internal audit function which is relevant to any consideration by forensic accountants of the strength or otherwise of internal control systems.

The audit committee is also of practical value to the forensic accountant as it can be the conduit through which the results of any information are passed to the board. It may be that when an investigation is being conducted (Part 4) the link between the forensic investigator and the company is through the audit committee.

One of the reports which followed Cadbury, and built on its foundations, was the Turnbull Report which looked specifically at the issue of the internal controls that should be implemented within the financial management system of an organisation, to minimise the risk of errors or serious misstatements occurring in the processing and recording of financial information.

The Turnbull Report

In October 2005 the Institute of Chartered Accountants in England and Wales (ICAEW) published what has become known as the Turnbull Report (see Exhibit 1.2). The document forms the guiding principles whereby UK-listed companies can meet their responsibility to implement the internal controls required by the Combined Code on Corporate Governance. We will examine precisely what controls should be implemented in Chapter 8, but for now we will simply look at the principles underlying their implementation.

According to the Turnbull Report the company’s internal control system should:

• be embedded within its operations and not be treated as a separate exercise
• be able to respond to changing risks within and outside the organisation, and
• enable each organisation to apply it in an appropriate manner related to its key risks.

We will look at the main provisions of the Combined Code, which form the context for the more detailed consideration of the practical implementation of internal controls described in Chapter 8.
Chapter 1 The development of corporate governance

According to Turnbull the main principles of a sound system in internal control are:

- that the governing body acknowledges responsibility for the system of internal control
- that a process is in place for identifying, evaluating and managing significant business risks
- that the effectiveness of the system of internal control is reviewed at least annually by the directors or senior managers and that procedures are in place for this, and
- that there is a process to deal with the internal control aspects of any significant problems arising from the audit of the financial statements reported by the auditors.

In assessing what constitutes a sound system of internal control the directors should consider:

- the nature and extent of the risks facing the organisation
- the extent and categories of risk that are regarded as acceptable
- the probability of the identified risks materialising, and
- the ability of the organisation to mitigate the impact of identified risks should they materialise.

We will look in detail at the principles and processes behind this sort of risk management activity in Chapter 7.

With regard to the system of internal control, it should:

- be embedded in the operations of the organisation and form part of its culture
- be capable of responding quickly to evolving risks, and
- include procedures for reporting any significant control failings immediately to appropriate levels of management.

These principles, which form a part of good governance practice, involve all aspects of internal control from systems design to internal audit, and this forms the backdrop against which we will be reviewing both defensive procedures and active investigation techniques later in this book.

Exhibit 1.2 Internal control – the Turnbull Report

A company’s system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives. A sound system of internal control contributes to safeguarding the shareholders’ investment and the company’s assets.

Internal control facilitates the effectiveness and efficiency of operations, helps ensure the reliability of internal and external reporting and assists compliance with laws and regulations.

Effective financial controls, including the maintenance of proper accounting records, are an important element of internal control. They help ensure that the company is not unnecessarily exposed to avoidable financial risks and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.

Source: The Turnbull Report
The question of the effectiveness of the then approaches to corporate governance was brought sharply into focus by the financial scandals of the early part of the twenty-first century in the USA surrounding, in particular, Enron and the lesser but no less shocking events involving WorldCom, Tyco International, Global Crossing and many others. All of the major accounting firms had clients who were caught up in these scandals, the apotheosis being the destruction of the worldwide accounting firm of Arthur Andersen.

In 2002 this resulted in the USA passing the legislation known as the Sarbanes–Oxley Act (often shortened to ‘Sarbox’), which does not affect UK companies unless they are subsidiaries of US firms or are listed on any US stock exchanges.

The Act is designed to enforce corporate accountability through new requirements, backed by stiff penalties. Under the Act, chief executives and chief financial officers must personally certify the accuracy of financial statements, with a maximum penalty of 20 years in jail and a $5m fine for false statements. In addition, and of great significance to auditors, under Section 404 of the Act, executives have to certify and demonstrate that they have established and are maintaining an adequate internal control structure and procedures for financial reporting. This requires them to ensure that all the financial reporting systems, including ancillary systems such as procurement and HR, are functioning in such a way as to prevent material misstatements appearing in the financial accounts. It is a personal liability.

This legislation, which was passed in haste, is slowly being reassessed in the current climate as being too prescriptive and too inhibiting for US business freedoms. There may be further changes to come!

Summary

- The development of the joint stock company separated ownership from control.
- Agency theory holds that agents (managers) will tend to make decisions in their own best interests at the expense of their principals (shareholders).
- Research by Berle and Means (1932) demonstrated the increasing power of directors of large corporations.
- Auditors are required to evaluate the financial statements produced by agents to account for their activities and report to the shareholders on their truth and fairness.
- Full disclosure of financial results is a relatively recent phenomenon but has grown rapidly since the Companies Act 1948.
- The Companies Act 2006 is the current legislation for the running of companies and the rights and duties of directors and external auditors.
- The UK has a framework approach to corporate governance.
- The Cadbury Report established standards of corporate governance following a series of financial scandals in the UK.
Chapter 1 The development of corporate governance

- This was reinforced by the Combined Code and later reports.
- Standards have been established for the conduct and activities of directors and the running of corporate boards.
- The board has specific responsibilities with regard to internal control and the preparation of financial statements.
- This has encouraged greater involvement of non-executive directors in companies.
- An audit committee forms a link between the audit function and the board.
- The Turnbull Report defined the role of the internal audit function and helped strengthen its influence.
- The USA passed the Sarbanes-Oxley Act to enforce standards of behaviour by directors and auditors.

Case study

You are the audit manager of Tickitt and Run, a medium-sized firm of accountants. You have recently taken on a new client, Megablast Limited, a privately owned company which is now seeking a listing on the Stock Exchange.

The company has asked for your advice regarding any changes necessary in Megablast to achieve appropriate compliance with corporate governance codes.

This extract is from the company’s financial statement regarding corporate governance:

Megablast is a family company owned by the Blast family but has expanded rapidly in recent years: the expansion has been funded by loans and other forms of finance. They are looking for a flotation to refinance the business. The business is profitable and cash positive.

Mr Blast is the chief executive officer and board chairman of Megablast. He appoints and maintains a board of five executive directors, none of whom is a family member, and one non-executive director, his father, who is a major shareholder but who is no longer active in the company.

While the board sets performance targets for the senior managers in the company, no formal targets or review of board policies is carried out. Board salaries are therefore set by Mr Blast based on his assessment of all the board members, including himself, and not their actual performance. Mr Blast sets his own remuneration following discussion with the non-executive director.

Internal controls in the company are monitored by the senior accountant, although a detailed review is assumed to be carried out by the external auditors. Megablast does not have an internal audit department.

Annual financial statements are produced providing detailed information on historical performance, but no other information is provided to investors.

Required

- Does Megablast fulfil the principles of good corporate governance? If not, why not?
- What would Megablast need to do to comply with good practice?
- In what way might Megablast be affected by continuing non-compliance?
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