Editorial

Corporate Governance: Some Key Challenges and Opportunities for Accounting Researchers

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Introduction

The focus on corporate governance has grown exponentially over the last decade. As evidenced by the increasing number of codes of best practice developed by leading international bodies such as the OECD, the Commonwealth and CalPERS (refer Demirag et al. (2000) for a fuller list of publications), corporate governance reform has now become a key global issue. Not only do factors such as the increasing globalisation of financial markets, the growth in multinational corporations and regional economic developments motivate the need for good corporate governance, but the recent spate of large corporate collapses such as Enron and WorldCom in the United States and HIH Insurance in Australia clearly signal the urgency for significant improvements in corporate accountability and reporting.

In the Institute of Certified Management Accountant's (ICMA) December 2002 newsletter, the President of the ICMA, Mr. Leon Duval urged members to lobby the relevant stakeholders in their business environments to review their corporate governance and listing standards, including important issues of officer and director qualifications, codes of conduct of public companies, and to pull together a comprehensive rulemaking to address these issues.

In specific, the issues listed include the need for:

- stockholder approval of all stock option programs;
- majority of Directors be independent;
- audit, compensation and nominating committees be comprised entirely of independent directors;
- tightening "independence" requirements to reduce the ties between independent directors and the company or its executives;
- mutual funds and their advisers to disclose to shareholders and clients how they vote the proxies for the securities they hold; such greater transparency of proxy voting which should encourage mutual fund directors and investment advisers to exercise their fiduciary responsibilities in an appropriate manner, particularly since there are conflicts of interest associated with proxy voting, and
- the undertaking of both 'Strategic Audits" and 'Cost Audits' in addition to the "Financial Statement Audits' that are currently mandatory.

This editorial seeks to highlight some of the key challenges and opportunities within management accounting research to further contribute to the development of effective corporate governance systems. To date, much of the study of corporate governance by accounting researchers has been undertaken from a financial accounting perspective, particularly on issues as to how to secure or motivate efficient management of corporations by the use of incentive mechanisms (Sloan, 2003). However, for a corporate governance structure to be fully effective, the existence and support from a well-designed management accounting information system is essential. Management accounting information systems are a key source of control in making available accurate and timely

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information for organisational decision making. In this respect, management accounting researchers face a critical challenge in designing efficient and effective internal monitoring and control mechanisms that meet the strategic needs of senior management in discharging their corporate governance duties. Our focus in this paper is to highlight the increasing importance of the interrelationships among several key governance features within an organisation, specifically the link between audit committees, external auditors and internal auditors. In particular, we explore the potential for strategic management processes such as strategic audits to contribute to improved corporate governance.

A Strategic Audit involves an objective assessment of the growth and exit options available to shareholders and management when critical and often difficult decisions need to be made in order to maximise shareholder value. The result of a Strategic Audit is to ensure that there is a well defined and agreed path of development including a series of practical steps which when implemented will substantially enhance the value of a company. Internal auditors may be called upon to conduct a large selection of alternative Strategic Audits which in turn is likely to lead to higher quality corporate governance procedures by linking an organisation's strategic goals and performance with critical decisions undertaken by the Board of Directors including strategic changes, risk assurance procedures, and managerial compensation.

In the next section of this paper, a discussion of the definition of corporate governance is undertaken. This is followed by an identification of the inter-relationships between some of the key stakeholders in a corporate governance structure including the board of directors, audit committees, external auditors, and internal auditors and the strategic audit process.

Corporate Governance Defined

While the term corporate governance has been widely used, it has not been clearly defined. In general, corporate governance is viewed as a system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. In this paper, we define corporate governance as

> "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance", (OECD, 1999, p.11).

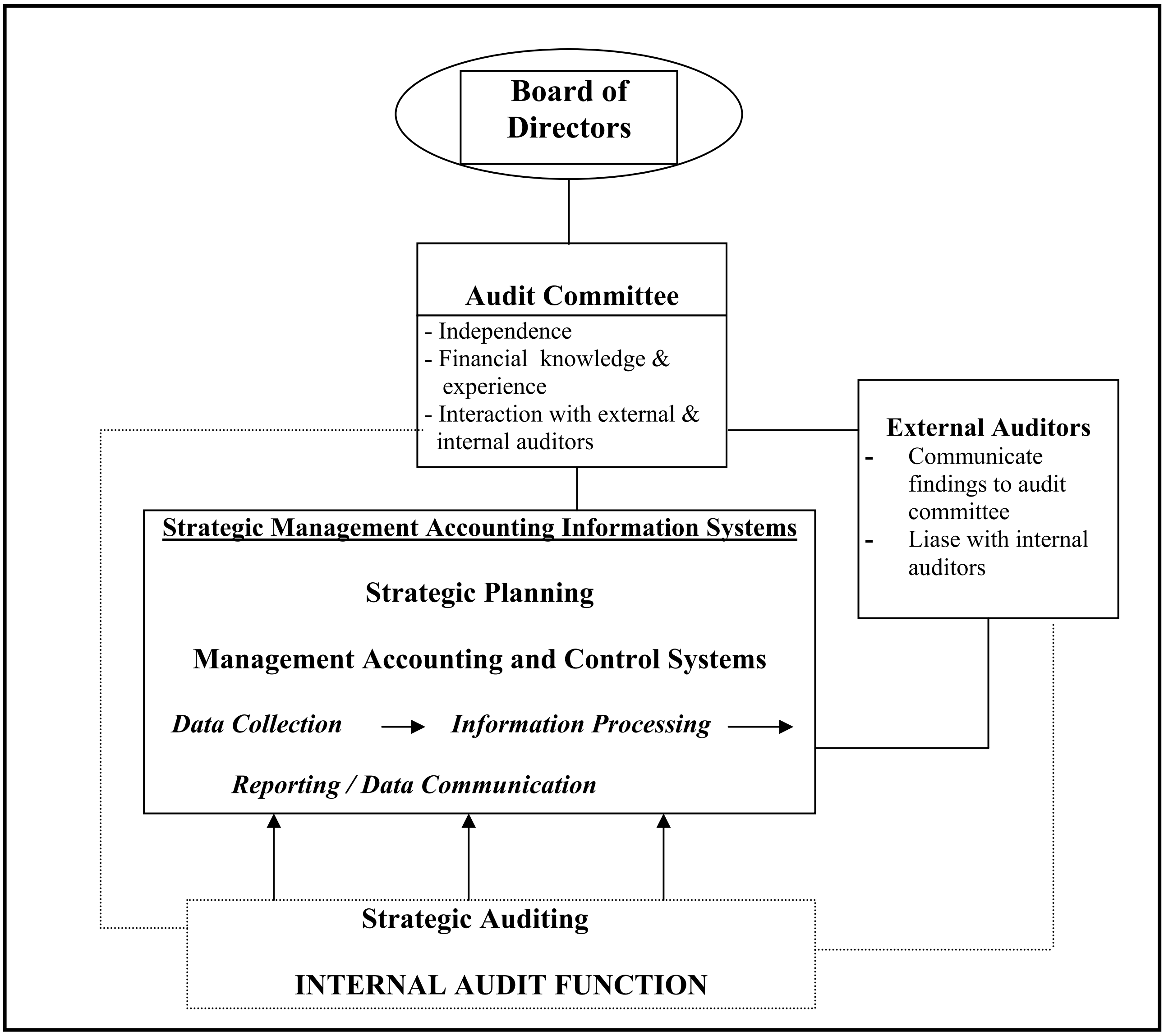
This definition is consistent with the one presented by Cadbury (1992), and is most appropriate for the purposes of this paper as it highlights the inextricable link between corporate governance structure and the strategic planning and management processes within an organisation. In particular, a good corporate governance structure is seen to assist the development and management of an organisation's strategic directions and goals through the existence of a clear and well-communicated set of duties and responsibilities between the different stakeholder and monitoring parties. While a multiplicity of factors affect the governance and organizational decision making, the principle focus on governance issues is seen to be a result from the separation of ownership and control. In the next section, as shown in Figure 1, we provide an overview of the key constituents from a corporate governance framework.

Corporate Governance Framework

Board of Directors: The Board of Directors of an entity holds the responsibility for the entity to be operated in the best interest of the members. At the same time, they also tend to delegate much of the oversight function to the audit committee.

Audit committees: This committee is a sub-set of the board of directors and assumes the important responsibility of representing boards of director on oversight matters related to financial reporting, auditing and overall corporate governance. As a governance mechanism, audit committees can increase the credibility of financial reporting process by monitoring and facilitating communication between the management, external auditors and internal auditors (DeZoort, 1997).

Figure 1: Corporate Governance Framework linking Board of Directors, Audit committees, External Auditors, and Management Accounting Systems



Oversight duties of audit committees, as prescribed by the Blue Ribbon Committee (BRC) on Improving the Effectiveness of Corporate Audit Committee (BRC, 1999) include reviewing the financial statement audit plan with the external auditor; reviewing the audit report; ensuring the adequacy of the scope, the functions and resources of the internal audit functions; and reviewing the internal audit programme, processes or investigation undertaken and whether or not the appropriate actions are taken on the recommendations of the internal audit function. In general, the members i.e. directors on the audit committee are seen to be more effective if they are independent, and if they have financial knowledge and experience. The BRC (1999) states that directors should not be considered independent if (1) the director of a member of his/her immediate family is an employee of the company of its affiliates within the past five years; (2) the director receives compensation for work other than board service; or (3) the director serves a partner or controlling shareholders or executive of a business with which the company has significant business.

The effectiveness of audit committees is also dependent on their relationship with two critical sources of information: the external auditors, and the internal audit/management accounting function.

External Auditors: The role of external auditors is to express an opinion on financial statements. External auditors are viewed to provide an independent assessment of the fairness of the financial statement and that such statements are free of material errors. No doubt, for external auditors the audit committee becomes a critical vehicle for providing an avenue for dialogue with the company's management as well as the management accountants.

At the same time, the internal audit function is also seen to provide important assistance to external auditors. In fact, the professional standards require external auditors to "obtain an understanding of internal auditing to make a preliminary assessment of its effect, if any, on control risk, and in determining external audit procedures' (AUS 604, para. 9). For example, AUS 604 encourages the external auditor to utilise internal auditor's work where it is assessed as reliable. In specific, the reliability of the internal audit function is assessed based on the following features:

1) having objectivity (as reflected by its organisational status),
2) scope of audit work conducted be appropriate and sufficient,
3) having adequate technical competence, and
4) exercising due professional care.

Internal Audit Function: While much of the extant literature has focused on the relationship between audit committees and external auditor, more recently, the roles of internal auditors have gained much interest among academics and practitioners. Internal audit function is a key governance structure for assisting management keep proper accounting records and internal controls. In meeting their responsibilities, internal auditors undertake analyses and appraisals of the various activities within an organisation, liase with external auditors, and make appropriate recommendations for improving internal controls and promoting overall efficiency. An audit plan is generally formulated on an annual basis and the Head of the internal audit or chief internal auditor is responsible for periodically reporting their findings and for making recommendations to the audit committee. Internal auditors therefore play an important role in overseeing the financial control and reporting environment.

At the same time, an audit committee also assumes important responsibilities such as reviewing the internal audit program and ensuring the adequacy of the scope and the function of internal audit. Thus, the roles, responsibilities and goals of the audit committee and the internal audit function are closely aligned. For example, the Audit Committees: Best Practice Guide (IIA, 2001) notes that "a cohesive, well orchestrated, cooperative relationship with internal audit is vital for the audit committee's fulfilment of its responsibility for overseeing corporate governance activities and ultimately for the well-being of the company" (sec. 3.3). Internal auditors are also required to report periodically to the audit committee on their activities, audit plan and findings (IIA, 2001, sec.3.3). Clearly, the quality of the interaction between internal auditors and the audit committee potentially impacts the strength of corporate governance within an organisation.

Strategic Management Accounting Information Systems

Strategic management accounting information systems involve linking long-term or strategic goals of an organisation with performance evaluation outcomes. An organisation through strategic planning makes decisions on the types of business and the markets it operates in. This process also involves the financing aspects of the activities. The management accounting and control systems in turn, processes information on the various activities through the data collection, information processing and communicates such information to higher management through internal reports. Given that audit committees are ultimately responsible for the internal controls that affect the adequacy and appropriateness of such reports, we contend that the adoption of appropriate audit techniques by the internal audit function is likely to improve the oversight duties of audit committees.

The Scope of Strategic Auditing

A Strategic Audit is far different from the common perception of financial audits. It is a continuous evaluation of all the strategic functions of any success-seeking firm. Numerous components as outlined below make up the totality of the Strategic Audit, although the scope of each component audit will vary depending on the organisation.

Stakeholder Audit: This audit is to assess the organisation through the eyes of the stakeholders. Stakeholders usually fall into four groups: shareholders, customers, employees and suppliers. In fact, anyone interested in the success of the organisation is a potential stakeholder who have various incentives to help it, thus it pays to know them well. Each group has a different reason why they want the organisation to be successful. Shareholders want a return on their investment, customers benefit from the organisation's products or services, employees earn income and suppliers want to sell the organisation more. When the organisation prospers, they prosper. The organisation's stability and growth is their stability and growth, thus this is a key audit area for corporate governance.

Marketing Audit: This is a comprehensive examination of the company's marketing environment, objectives, strategies, and activities with a view to determining problem areas and opportunities and recommending a plan of action to improve the company's marketing performance.

Productivity Audit: This audit explains the complexity of the productivity concept, and discusses the evaluation of productivity in a strategic context. This increases the chances of increasing productivity in real terms, rather than improving efficiency at the expense of strategic goals.

Logistics Audit: This audit includes the best practices of companies with world-class logistics systems, and suggests tools for measuring a company's performance in comparison to logistics leaders.

Service Management Audit: This audit provides information about using service resources effectively, measuring the quality of service management, and assessing a company's ability to recover in the face of service failure.

Customer Satisfaction Audit: This audit outlines the critical aspects of system-wide customer satisfaction, and provides tools for measuring performance along those lines.

Cost of Quality Audit: The term “cost of quality” actually refers to the cost of not ensuring high quality. This audit provides a way of understanding the amount of income that is lost as a result of poor quality, along with suggestions for reducing that cost and improving quality.

Environmental Audit: This audit describes how managers can determine which environmental standards should be targeted for a given organization, and provides a model for auditing performance in terms of those standards.

Leadership Audit: This is a method of determining which competencies are required for leadership success in a given organization, and presents tools for measuring the performance of the company’s employees in terms of those competencies. It stresses the need to develop leadership at all organizational levels, and suggests an outline for developing personal improvement plans.

Culture Audit: This audit provides a tool to uncover a company’s culture, and provides tips on using that understanding to implement change more effectively.

Corporate Identity Audit: This audit provides insight into determining the effectiveness of a current identity, and outlines a way of assessing whether an identity should be changed, and what is the direction of those changes.

Corporate Longevity Audit: This audit is undertaken to ensure that an organisation not only maximizes the value of the existing products and services, but also simultaneously develops their replacements that will earn future income. Many companies rest on their current successes, today’s breadwinners, without realizing it is only a matter of time until their current products and services are obsolete.

Corporate Flexibility Audit: This audit considers the processes in place to hire the right people the first time and get them up-to-speed as fast as possible. The checks on the systems created to bring people together (e.g. work presentations to non-related staff, office layout) and encourage good working relationships.

Information Security Audit: This audit provides a framework for systematically evaluating an information system’s security.

Strategic Alliance Audit: This audit suggests ways of determining whether or not a particular alliance option is suitable for a given company, and provides ideas for rejuvenating alliances that may be functioning at sub-optimal levels for both manufacturing and service firms.

Technology Audit: This audit provides insight into determining which technologies should be priorities for a company given its strategy. It also provides tools for determining what aspects of the company can be called technologies, and a system for breaking technologies down into component parts.

Strategic Audit Issues

Due to such a wide scope, strategic audit issues are pertinent to management accountants, business analysts, audit directors, senior managers and executive-level management, as well as those aspiring to become someone who oversees audit, security, compliance and control functions. Similarly, Strategic Audits could not only dwell on highly technical matters, but also provide management and other stakeholders a perspective on information systems and technology issues at the strategic level. This will in turn promote good corporate governance by enabling managers to make well-informed planning and resource decisions that will ultimately enhance the value of the organisation.

Future Research

In light of the increasing recognition of the role of internal auditors and audit committees in promoting corporate governance, there is a clear need for better understanding of the relationship between the two critical governance mechanisms as well. In particular, there is a greater need for audit committee members to be fully aware of the strategic directions and commitments of an organisation and how these may inturn affect their reporting oversight responsibilities. While strategic audits may assist audit committee members identify the results of an organisation's strategic plan, further research is required in terms of the incidence, costs and benefits of such audits.

Further, a more detailed understanding of the communications and interactions between the internal auditor and the audit committee (e.g. frequency of meeting, management's presence at meetings, etc.), and its impact on internal auditors' perceptions of the functions and effectiveness of the audit committee is also warranted. One argument is that with the existence of a code of corporate governance, companies may tend to focus more on the 'form' i.e. meeting prescribed guidelines, rather than the 'substance' in terms of exercising their judgement on what may be more appropriate corporate governance practices for a given company or firm (Krishnamoorthy et al., 2002). In fact, the functioning of audit committees has attracted significant criticisms in various countries including the United Kingdom, United States and Australia (e.g. Treadway Commission (NCFFR, 1987), Cadbury Committee (1995), and the Australian Accounting Standards Board (AuASB), (2001)). More recently, the Blue Ribbon Committee (BRC) report on Improving the Effectiveness of Corporate Audit Committees (BRC, 1999) provides revised guidelines on best practice standards of governance structures and processes.[1] Previous empirical studies reveal the audit committee's composition and interaction with internal auditors as critical factors affecting audit committee effectiveness (e.g. Raghunandan et al., 2001). For example, Raghunandan et al. (2001) argue that when audit committees comprise sole independent directors, there are information asymmetries between the independent directors and management, and in turn internal auditing assumes a valuable resource for audit committees to gain appropriate information.

At the same time, prior studies also (Allison, 1994; Raghunandan et al., 2001) argue that for internal auditors to meet their responsibilities, not only is technical competency important, but that they should also be objective, and independent including having the ability to withstand management pressure or interference. Likewise, the BRC (1999) advocates that the internal audit activity should be independent of the activities they audit, and be performed with impartiality, proficiency and due professional care. The Guidelines also specify that an audit committee serves to reinforce the objectivity of the internal audit department, and that internal auditors ought to report directly to the audit committee. It further notes that if the internal auditors report primarily to management with little or no access to audit committees or the Board of Directors, they may encounter resistance to recommendations that do not meet with the management's approval. Empirical evidence on the interaction between audit committees and the internal audit function, nevertheless, remains unclear. No doubt, how internal auditors perceive the role played by audit committees in attending to problems identified by the internal audit function and the influence of top management and the external auditors in such circumstances have implications for internal auditors' work quality.

[1] The *Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee was* formed by New York Stock Exchange (NYSE) (1999) and National Association of Securities Dealers (NASD)(1999).

Conclusion

In sum, management accountants and internal auditors play a key role in the corporate governance process. Various strategic planning and control processes have evolved to facilitate management planning and reporting to organisational stakeholders. These processes have an important input to enhancing governance structure. In this paper, we have focused on highlighting the importance of strategic auditing and how the various types of strategic audits have implications for managers' ability to meet their corporate governance duties. Despite the inextricable link between management accounting systems, internal auditing and corporate governance, research in this area remains sparse and limited. Accounting researchers need to move beyond and expand the research agenda to identify the synergistic effects of aligning the organisation's strategic plans and the various feedback mechanisms within an organisation. To this end, the research opportunities call for a multidimensional, multi-theory and multi-method approaches to develop effective and efficiency corporate governance. For accounting researchers, this is a critical and exciting time as the accounting profession needs to evaluate and demonstrate its value not only to organisations but to society itself.

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