How audit practices got muddled in the US and UK

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ABSTRACT

This paper considers how auditing practices became muddled in the US and the UK to create muddled corporate governance principles. The US 1933 law that required corporations to appoint an auditor was based on the prospectus provisions in the UK 1929 Companies Act to protect investors from fraud. However, this is not the purpose of UK statutory audits whose legal role is to protect the company and provide shareholders with intelligence for voting on the election and remuneration of directors whether or not the company issues shares or whether it has shares publicly traded. The UK statutory auditor only reports to the shareholders who approve his appointment and remuneration. The US auditor is appointed by the directors and reports to both directors and shareholders to subrogate the reason for having an auditor to identify conflicts between them.

The establishment of audit committees with independent directors cannot remove the conflicts. These are exacerbated by the Sarbanes-Oxley Act and the UK Combined Code that require audit committees to provide oversight of the auditor. Some European countries avoid these conflicts by the auditor being controlled by a shareholder committee or "watchdog board". Audit practices got muddled by corporations not establishing a shareholder audit committee as provided in the model constitution attached to the UK 1862 companies Act. Compelling arguments are presented to conclude that convergence of audit practices on those found in the US or UK is not in the best interest of directors or auditors in reducing their conflicts or safeguarding: investors, the proprietary rights of shareholders or self-governance.

Key words: Audit Committees, Auditing, Audit Standards, Corporate Governance, Conflicts, Cross border, Shareholder panel, Watchdog boards

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How audit practices got muddled in the US and UK

1.0 Introduction

The purpose of this paper is to explain how conflicts have arisen in auditing practices in the US and the UK and to analyze their governance implications. Different conflicts arise in each country because the purpose of US audits is an economic one to protect investors from fraud while the legal role of annual statutory audits in the UK is to carry out a governance role to make directors accountable. The paper concludes that UK audits can also protect investors when minority shareholders, rather than the directors, control the auditor.

The US audit was modeled on the UK 1929 prospectus audits commissioned by directors to inform prospective investors in public companies (O'Connor 2004: 51). Unlike a prospectus audit, a UK annual statutory audit is not directly concerned with share value. Audits are required for companies in the UK that do not issue shares. In the US, audits are only required for companies that have their shares publicly traded while UK audits are required for companies that do not have their shares traded.

The legal role of a UK audit is to counter any self-serving presentation in the accounts to provide a basis for shareholders, or members, to exercise their proprietary rights in determining the appointment, remuneration, retirement of directors and any other matters that requires their vote. It is through these rights that shareholders govern corporations. The ability of UK auditors to protect investors arises from their obligation to attest that the accounts are true and fair.

The Sarbanes-Oxley Act (SOX) requires US auditors to check the information provided by directors even though the auditor is appointed, controlled and remunerated by the directors. SOX requires directors, that are defined to be "independent", to manage this legally mandated conflict of interest. However, this in turn introduces a conflict of interest between executives and Non Executive Directors (NEDs) when a check on management is most required.

As pointed out by O'Connor (2004: 3), "Agents cannot successfully serve two principals with potentially adverse interests". The purpose of having an audit is because the possibility of the interest of directors being different from those of the shareholders. However, the OECD (2004: 22) Corporate Governance Principles perpetuates the conflict between directors and shareholders by stating that the auditor should report to both "the board and shareholders".

UK auditors in theory avoid the conflict of the Auditor being accountable to two different constituencies as they only report shareholders, not directors like US auditors. Unlike US auditors, shareholders approve the appointment and remuneration of UK auditors. However, in practice the directors and Auditors also have a conflict of interest because directors are required to manage the auditor on behalf of the shareholders. This conflict is ignored and exacerbated by the UK Combined Code on Corporate Governance (Code 2003).

The auditing conflicts in both the US and the UK are avoided in some European countries where the auditor is appointed by shareholders, reports to shareholders and is controlled by a shareholder panel or "watchdog board". This arrangement was part of the UK Company law in 1845 and envisaged in the 1862 UK companies Act. At that time two auditors were required with at least one being a shareholder but neither needing to be an accountant (O'Connor 2004: 17).

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In the following Section the history of US auditing practices is considered and how the US diverged from the UK practice and most other places around the world. The third section considers the inconsistencies and conflicts in UK audit practices and how these were exacerbated through the way Audit Committees are used. The fourth section considers suggestions and arrangements to overcome the problems found in the US and the UK.

The paper concludes that international convergence of corporate governance practices based on either the US or UK approach to auditing would be counter productive in avoiding conflicts for directors and auditors or for furthering: investor protection, the proprietary rights of shareholders or self-governance.

2.0 Historical outline of US auditing practices

The US constitution reserved for the States the power to create and manage corporations. Such was the concern that corporations might be used by foreigners to control local economies after the war of independence that the constitutions of some States would not allow their legislature to grant a corporate charter without a citizen plebiscite (Grossman and Adams 1993: 8). Many States limited the life of corporate charters and would withdraw the charter earlier if the enterprise created harms or entered into activities for which it was not authorized. Up until the mid 19^{th} century, US corporations were in effect audited by the citizens and regulated directly by State legislatures.

The tight local democratic supervision and regulation of corporations was cast aside by the growth and influence of giant enterprises that emerged at the end of the 19^{th} century. States competed with each other to introduce more and more liberal conditions for corporations to obtain charters and to operate. This created a "Race to the Bottom" in corporate de-regulation (O'Connor 2004: 30). The result was that by the beginning of the 20^{th} century few States required corporations to present accounts and so there was nothing to audit. In addition, States competed with each other to minimize the power of diverse shareholders to make directors accountable.

Never-the-less, as reported by O'Connor (2004: 40) by the beginning of the 1925–1929 boom almost 70% of corporations quoted on the New Stock Exchange had agreements to provide annual or quarterly reports to stock holders with 25% of quoted firms providing both annual and quarterly reports. As a reaction to the Wall Street crash of 1929, competition for creditability significantly improved the situation. By 1933, "all of the 1157 listed firms provided annual reports, 60 percent also provided quarterly reports, and 85 percent underwent annual audits by CPAs with the results made publicly available" (O'Connor 2004: 40). The incentive to appoint Auditors may have also been encouraged by the need for directors to check on the operations of management.

At a time when many States did not require companies to publish accounts, or have auditors, audit committees were developed by directors to protect them rather than shareholders or investors. As reported by Guthrie and Turnbull (1995), financiers commonly requested directors to sign "negative pledges" when advancing funds to a US company early in the 20^{th} century. Like shareholder agreements with contemporary venture capitalists these pledges required that management did not spend funds on excessive remuneration, loans to officers, investments not approved by the financier and so on. The directors became personally liable for the loan only if the pledges were not honored. This provided a compelling incentive for NEDs to meet separately with the auditor to check on how corporate funds were applied.

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The incentive for establishing audit committees had nothing to do with how they are used to today to oversee how the financial statements are presented to shareholders or investors. The auditor simply had to follow the money trail to protect the directors who were his client. The auditor did not make judgments on the timing of recognizing income or expenses, or the value of liabilities and assets, or which accounting policies to adopt.

The Securities Act of 1933 introduced Federal regulation to prevent fraud from the *issue* of securities to interstate investors. The Federal government did not have power to make laws for securities issued within a State. Companies were required to lodge a registration statement with their accounts audited by an independent public or certified accountant. The 1933 Act was modeled on the prospectus provisions of the UK 1929 companies Act. These provisions did not require a balance sheet, only a "certified profit and loss statement" for the previous three years (O'Connor 2004: 51). UK prospectus information is concerned with reporting to investors, who are not shareholders, on the economic status and prospects of the company with the directors appointing the Auditor. This is different from UK annual statutory accounts where the auditor is appointed by shareholders and reports to shareholders.

The requirements for audited accounts for newly issues shares in the US 1933 Act was carried over into the US 1934 Act to regulate stock exchanges and *secondary* exchanges of corporate securities. This explains how the auditing of annual accounts in the US adopted UK prospectus audit practices that are not used in the UK for annual accounts.

O'Connor (2004: 61) reports that the US 1933 Act "left it open as to who would hire and set compensation for the auditors, this responsibility fell to management and/or the board of directors ─ the very parties whom the auditors were supposed to be checking upon!"

> Thus, the American accountant/auditor is placed in the untenable position of the agent serving many masters with conflicting interests. In such an imbroglio, is it any wonder that the group who hires, fires, and sets compensation for the auditor becomes the *de facto* client (O'Connor 2004: 62).

This problem was explained by Bazerman, Loewenstein and Moore (2002) with the topic also raised by Hayward (2003), Anand and Moloney (2004), Bush (2004), Cunningham (2004), Ramono (2004) and Shapiro (2004).

Rather than remove the conflicts of interest for auditors and directors, SOX has exacerbated the problem by enshrining them in Statute. As stated by Romano, (2004):

> The learning of the literature, which was available when Congress was legislating, is that SOX's corporate governance provisions were ill-conceived. The political environment explains why Congress would enact legislation with such mismatched means and ends.

The intrinsically flawed US auditing architecture is now being adopted by companies registered in other countries who are seeking to have their securities traded in the US.

There are a number of other reasons why other countries are being encouraged to enshrine the conflicted US audit practices in their own economies. First, the US is seen as the prime role model for other market economies to emulate. Second, as noted earlier, the OECD Corporate Governance Principles follow US practice. Third, corporate governance rating agencies typically base their metrics on OECD like principles and this creates market forces for corporations outside the US to adopt US practices. Fourth, the size and influence of US markets provides practical incentives to follow the US model. Fifth, the World Bank, IMF, international and bi-lateral finance and aid agencies proselytize and encourage so called "good governance" using the US and/or OECD[1] Principles. The sixth and most insidious influence is that of the big international accounting firms. The US remains their most important client base. It is understandable that they assume that the US approach represents the most creditable, relevant and advanced development of audit practices. Indeed, as noted by Hatherly (1995: 504) there is a belief that existing practices "represent the natural order of things" to provide a basis for insinuating US practices around the globe.

Notwithstanding the suggestion by O'Connor (2004) that the UK system has advantages over the US audit regime, governance practices in the UK create conflicts of interests for auditors and directors that are considered in the next Section.

3.0 UK auditing practices

This Section identifies how UK governance practices conflict with the legal purpose of a statutory annual audit. These conflicts are shared with other countries that follow UK law like Australia, Canada (except Quebec), Hong Kong, India, Ireland, Malaysia, and South Africa (Bush 2004: 4).

The legal role of the UK audit was articulated in 1990 by House of Lords in considering a case by Caparo Industries Plc (Caparo) against Dickman, the auditor of Fidelity Industries Plc (Fidelity). Caparo alleged that the audited accounts of Fidelity should have reported a loss rather than a profit. However, Caparo lost the case on appeal as the Law Lords considered that the audit carried out a governance role rather than an economic one.

The principles developed by the case were summarized in the Report of the Committee on *The Financial Aspects of Corporate Governance* (FACG) that became known as the Cadbury Committee. FACG (1992: 81) stated that:

> The case has established that in the absence of special features, auditors are not regarded as owing a duty of care to prevent loss to anyone relying on their report except (a) the company, and (b) the shareholders as a body. In the absence of special features, no duty of care is owed in particular to-individual shareholders, subscribers to new shares, purchasers or intended purchasers of shares from third parties including those conducting takeover bids, bankers or other lenders to the company, or persons doing business with the company.

The arguments put forward by the Law Lords would have little relevance for corporations registered in jurisdictions that did not make it practical for shareholders to hold directors accountable for their stewardship such as found in the State of Delaware. This highlights how fundamentally different the role of an audit is between the UK and the US.

Lord Justice Oliver (Caparo 1990: 16) in his judgment asked the rhetorical question as to what is the purpose of holding an annual meeting and what is the purpose of the directors presenting accounts and having them audited. He answered these questions by pointing out that:

> This is the only occasion in each year upon which the general body of shareholders is given the opportunity to consider, to criticise and to comment upon the conduct by the board of the company's affairs, to vote upon the directors' recommendation as to dividends, to approve or disapprove the directors' remuneration and, if thought desirable, to remove and replace all or any of the directors. It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

To counter the argument that the purpose of the audit was to inform investors of the economic value of the company Lord Oliver (Caparo 1990: 17) went on to say:

> I find it difficult to believe, however, that the legislature, in enacting provisions clearly aimed primarily at the protection of the company and its informed control by the body of its proprietors, can have been inspired also by consideration for the public at large and investors in the market in particular.

The views of Lord Oliver in providing shareholders with "reliable intelligence for the purpose of enabling them to scrutinize the conduct of the company's affairs" were supported by Lord Bridge who quotes a 1896 judgment as to the role of the auditor by noting that: "No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them" (Caparo 1990: 11).

As the auditor in the UK is appointed by shareholders to report to shareholders, conflicts of interests are introduced when the auditor is controlled by the directors and remunerated by the company. The facts of the situation described in the Caparo case are quite different from those that applied to the UK Company Clauses Act of 1846 referred to earlier when an auditor was required to be a shareholder and was paid by the "Commissioners of the Treasury" (O'Connor 2004: 14). The cost of the audit was reimbursed by the company.

UK audit practices got muddled because companies did not appoint a *shareholder* audit committee as envisaged in a model constitution attached to the Act. In regards to the present situation, Lord Bridge noted that "In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client" (Caparo 1990: 12).

The architecture of how power is delegated to directors by the constitutions of Publicly Traded Corporations (PTCs) in the US and UK creates conflicts of interests for both the directors and the auditors. This need not be so as corporate constitutions can be changed without the need to change company law. An audit committee can exacerbate the problems rather than removing them as discussed below.

In the context of UK and US companies that are governed by single or "unitary" board, it is impractical for diverse shareholders to manage and pay the auditor so directors are forced to act as the agents for shareholders in this regard. As a result, the most ethical and conscientious director is placed in the position of exerting power over the auditor and so perceived to be in a conflict of interest situation that corporate constitutions and the law generally require directors to avoid. As the role of the auditor is to act "antagonistically" this also creates a fundamental conflict of interest for the auditor.

The conflict is exacerbated by audit committees that increase the frequency and intimacy of the contact between directors and auditors as recommended by FACG and now included in the UK Combined Code on Corporate Governance (Code 2003). FACG (1992: 27) stated that "The external auditor should normally attend audit committee meetings, as should the finance director". How such interactions can result in the best intentioned and ethical auditors into misleading themselves as well as investors is described by Bazerman, Morgan, and Loewenstein, (1997). They identified five reasons why audits fail that were later confirmed by experiments reported by Bazerman, Loewenstein, and Moore, (2002).

As shown by Bazerman and his colleagues, auditors unconsciously and so unwittingly become agents of the directors. If this occurs, then the auditor becomes in turn an agent of management when dispersed shareholders allow managers to form "power coalitions" with directors as described by Dallas (1988: 28). It is thus questionable if Audit committees made of independent directors could significantly mitigate the conflicts in the US where auditors are appointed by and report to the directors.

In the UK, the independence of directors becomes irrelevant to the legal purpose of an audit which is to inform shareholders on how *all* the directors make themselves accountable. This is because purpose of UK audits was to provide shareholders with the "intelligence" on how to vote for the re-election, remuneration and dismissal of the directors or any other matter that requires their participation.

FACG (1992: 11) stated that the Caparo case exposed two widely held misconceptions:

> (a) that the audit report is a guarantee as to the accuracy of the accounts, and perhaps even as to the soundness of the company; (b) that anyone (including investors and creditors) can rely on the audit, not only in a general sense but also very specifically by being able to sue the auditors if they are negligent.

But FACG ignored the point that the purpose of appointing an external auditor is because of the potential conflict of interest between directors and shareholders. Also ignored was the point of Justice Lord Bridge that role of the Auditor is to act "antagonistically" to the directors. The denial of the existence of conflicts by FACG is supported by the fact that the word "conflict" is used only three times in the report on pages 19, 20, & 46. Even then the word is not used in relation to either NEDs or the relationship of the auditor to the Directors. In regards to executive directors, the report only recognized "potential conflicts" on page 20.

By ignoring what Monks & Sykes (2002: 12) describe as the "inappropriate powers" of a unitary board and their manifold intrinsic conflicts of interest identified by Turnbull (2000c), FACG (1992: 11) was able to state that "The basic system of corporate governance in Britain is Sound". This view was consistent with the stated aim of the report to "strengthen the unitary board system and increase its effectiveness, not replace it" (FACG 1992: 11). However, this objective was in conflict with a proposal at that time by the UK Auditing Practices Board for auditors to be controlled by a shareholder panel (Hatherly 1995: 538).

The conflict created by directors controlling the auditor is analogous to a university (shareholders) allowing students (directors) to nominate, manage and remunerate the examiner appointed by the university/shareholders to examine the student/directors! Such a situation would be completely unacceptable in academe but astoundingly it is mostly accepted as the natural order of things in the world of business.

The ability of directors to control the auditor is an "inappropriate power" in furthering the ability of an auditor to be independent of directors in either the US or the UK. Board Audit Committees do not change the power relationship and exacerbate the independence of auditors as noted above when they are used to control the external auditor. On the other hand, Audit Committees that are used to control the internal auditor provide a way to mediate the conflicts that are inherent in an employee of management reporting on the integrity of management. It is with internal auditing that Audit

Committees can add value in reducing risk in financial communications, especially if the directors are supervised by a dominant shareholder.

FACG (1992: 58) recommended the adoption of audit committees as "Best Practice" in the UK. The recommendation was supported by pointing out that the New York Stock Exchange had mandated them in 1978 and the belief of the American Treadway Commission in 1987 that they increased the integrity of financial reports (FACG 1992: 26). Audit Committees that follow the US role of controlling the auditor are now specified in Sections C.3.2 and C.3.6 of the UK Combined Code (2003: 20/21).

This explains how UK auditing practices become muddled. It only makes sense for audit committees to appoint, remunerate and control internal auditors. Audit committees who also manage the external auditor exacerbate conflicts and muddle the role of external auditors. Bush (2004: 34) notes that NEDs may use external auditors to check on management when their is role is to act for the shareholders to check on the directors. In any event, as noted by Hatherly (1995: 541) "Non-executive directors cannot be impartial towards accounting outcomes".

Hatherly (1995: 541), a former member of the UK/Ireland Auditing Practices Board states: "As a means of facilitating the current statutory role whereby the auditor is accountable to members, the audit committee is both conceptually unsound and practically difficult".

A former Audit Partner of one of the big four audit firms in the UK confirms this view by stating that:

> There are two fundamental problems with independent audit. The first is that it isn't independent at all. It is in reality – and, as things stand, inevitably –closely aligned with the company management. The second problem is that it is an uncompetitive market, dominated by four large firms" (Hayward 2003).

However, auditors can become independent of a unitary board when there is a dominant shareholder to select, appoint, remunerate and supervise the directors and how they control the auditor. The dominant shareholder becomes an informal supervisory board as found in a number of European jurisdictions. The presence of a dominant investor is the typically situation for most PTCs around the world as noted by Porta, Lopez-de-Silanes and Schleifer (1999).

Surprisingly this situation is also significant with the largest US corporations as reported by *The Economist* (2003) who stated: "Even in the United States, the founding family is an influential investor in more than one third of the Standard & Poor's 500 companies". While dominant shareholders can provide effective oversight of executives and protect the independence of the auditor from management it also means that a dominant investor can enter into related party transactions that disadvantage the company. Coffee (2005) reports a number of corporate failures arising from such activities.

Coffee (2005) notes that the presence of a dominant shareholder makes NEDs powerless and/or unwilling to prevent a dominant shareholder and/or dominant management expropriating value from the company. This is just the situation when investor protection is most required. A point not considered in the report by Higgs (2003) to the UK government on "The role and effectiveness of independent directors". In any event as pointed out above the Caparo case makes the appointment of Independent directors irrelevant to audit quality.

The UK Combined Code like SOX entrenches the conflicts of interests for auditors and directors. It requires companies to have an audit committee to make recommendations on the "appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor". It also requires the audit committee to both "develop and implement policy on the engagement of the external auditor to supply non-audit services". Imagine the public outrage if students had this power over their examiners? The charters of some audit committees even give them the power to negotiate "the scope" of the examination!

There is considerable difficulty in introducing reforms to the flawed US laws and the flawed codes, practices and habits of thinking in the UK and other jurisdictions that follow the practices of either.

The problem is reinforced by accounting and legal scholars who ignore the conflicts of interest inherent in audit committees of companies governed by a unitary board[2]. Another problem in promoting reform is that the large international audit firms and many boutique governance advisers obtain significant consulting fees from promoting the current practices. This could make it difficult to charge fees for alternative/contrary advice.

An additional problem is the resistance in the US and the UK to move away from a unitary board. The irony is that the majority of publicly traded companies in the US and a substantial number in the UK are governed by what is in effect a two tiered board from the presence of a dominant shareholder or by a financier who has obtained governance powers through their loan agreement. Financiers typically obtain governance powers in a leverage buyout (LBO). The organising LBO Association that procures the funding acts like a supervisory board. Jensen (1993: 869) states that this represents "a proven model of governance structure". Strategic decisions and monitoring are carried out by the LBO Association with their decisions endorsed by the statutory board that becomes responsible for day to day operations.

Not-with-standing the institutional inertia to entertain a different approach to corporate governance reform, the fundamental problems in the existing system and its recent reforms is gaining wider recognition by scholars as noted above and more importantly by some influential investors. The National Association of Pension Funds (NAPF) who collectively own the majority of shares in UK PTCs, made a submission to the UK government in December 2004. *AccountancyAge* (2004) reported that: "In a letter to minister Jacqui Smith, NAPF recommends alternative arrangements be introduced for the appointment and oversight of auditors, such as using a shareholder panel or a regulator". This consistent with the proposals of a number of scholars and commentators discussed in the next Section.

The fundamental conflict of interest in the Anglophone unitary board system of corporate governance requires removing from directors their "inappropriate powers" that Monks and Sykes (2002) stated "is thus the litmus test for any worthwhile reform of shareholder capitalism". This result can be achieved in a number of ways as is next considered.

4.0 Alternative Auditing practices

This section provides a brief review of some alternative audit arrangements for consideration. The literature on this topic is rapidly increasing with new approaches being proposed.

Six alternative arrangements were analyzed by Professor Hatherly (1995: 541). Three alternatives were dependent upon external agencies that he described as "Macro options" and three involved changes in the constitutional architecture of corporations that he described as "Micro options".

The Micro options were an Audit Committee accountable to directors, a Shareholder Panel accountable to shareholders and a Stakeholder Panel accountable to Stakeholders. The Macro options were a Stock Exchange Panel accountable to shareholders and an Audit Commission accountable to either stakeholders or the public interest. His recommendation was for a Shareholder Panel consistent with the proposals of Guthrie and Turnbull (1995), Murray (1998), Turnbull (2000a) and practices found in some European countries.

Dallas (1997), a US legal scholar recommended the reform of US corporate boards by establishing a dual board with a board ombudsperson to remove and manage board conflicts of interests. A comparison of this proposal with that of a "Corporate Governance Board" proposed by Murray (1998), a Shareholder Panel and a "Corporate Senate" is presented in Turnbull (2003).

Shapiro (2004) considered the US problem of "Dealing with two masters: The present dilemma of the 'independent auditor'" and analyzed three strategies for reform but did not consider a shareholder panel. The first strategy was to have the government appoint the auditor. In this regard a proposal to establish a Federal Bureau of Audits in the SEC was rejected by the US Congress in 2002. The second strategy was to improve the process of auditing, but Shapiro found that none of the four ideas considered were satisfactory. The third and preferred strategy was based on corporations purchasing Financial Statement Insurance (FSI).

Shareholders would be given the option having the financial accounts insured against misstatement (Ronen 2003, Cunningham 2004). The insurer would then hire the auditor rather than the directors and determine the scope and quality of the audit according to how much insurance was purchased. A crucial feature of this proposal was to make public both the cost of the insurance premium and the value of its cover to indicate the risk. Shapiro pointed out that there are many details to consider, including if it could be made to work without being mandated by the SEC.

The FSI proposal is based on the US concern for audits to carry out an economic role of avoiding fraud in the issuing or trading of shares. One question that needs to be considered for application in the UK is if it could also be used to carry out a governance role? This would seem questionable given the judgment made in the Federal Court of East Virginia on June 15, 2004 against a class action by shareholders of Cable & Wireless (C&W).

The judges threw out most of a the class action led by the Ontario Teachers Pension Plan against the auditors that went along with C&W executives releasing misleading and inaccurate information in the audited accounts that amounted to what the court described as "permissible business puffery" or "mismanagement" (Davis 2004). Because under US law, auditors are accountable to the directors they are not required to report incompetence that did not represent fraud[3]. This is not withstanding C&W is registered in the UK were the auditors are accountable only to the shareholders.

The FIS proposal needs to be compared and evaluated with European audit practices that avoid the inherent conflicts found in the US and UK. There are many different arrangements in Europe to consider. Many European countries have a two tiered board with the auditor appointed by shareholders like in the UK. Shareholders appoint a supervisory board and this board then appoints a management board. In some larger German companies employees appoint representatives to the supervisory board. No individual can be on both boards so conflicts of interest and loyalty between members of the two boards are minimized or eliminated. In this way, two tiered board enhances the independence requirements over that provided by audit committees in the US or the UK. However, the conflict remains of the auditor being managed by directors, on behalf of the shareholders.

Conflicts between directors and auditors are removed when shareholders appoint their own representatives, who are not directors, to control the auditor. This arrangement is found in some European countries such as France, Hungary, Italy, Russia and Spain. The arrangements may differ within a country. The corporate constitutions of French Insurance companies, Banks, finance companies establish a *Censeurs* to check on financial matters. State owned French companies have a *Cour des comptes* to check and investigate financial matters. Other arrangements are described in Hungary by Lempert (2003), in Italy by Melis (2004) and in Russia by Gitins (2002).

However, foreign corporations with a shareholder panel do not meet the requirement of SOX to have their shares traded in the US. This is because SOX specifies that an audit committee made up of directors must control the auditor. The problem is set out in a letter to the SEC requesting exemption from SOX for Russian companies seeking to trade their shares in the US (Gitin 2002). This illustrates how US practices are forcing a race to the bottom rather than to the top in audit quality.

The analysis of the inherent conflicts of interest in US and UK audit practices presented above should be of special concern to prudential regulators. Financial Statement Insurance (FSI) might well be a useful approach like private sector deposit insurance. However, the FSI approach may not be relevant to improving corporate governance or what the Caparo Law Lords described as the "proprietary" or ownership rights of shareholders to vote their shares to hold directors to account.

In researching material for this paper, one is overwhelmed with the plethora of accounting and auditing standards[4], corporate governance principles, and codes of conduct, ethics, and professional behavior and so called "best practices". They represent intrusive prescriptive complex band-aids that do not address the fundamental flaws of the dominant governance systems. What are required are some fundamental changes that introduce self-enforcing relationships as found in natural systems and in automated machinery and devices.

If the science of governance found in nature and used to design robotic machinery was applied to design the architecture of corporations, there would be little need for many of the laws, regulations and codes. Self-regulation cannot be reliable without the introduction of a division of power to create checks and balances and interdependency between those who govern and those who are governed. To minimize the role of government, corporations need to become more self-governing as demonstrated by sustainable employee owned enterprises.

The take home message is that every effort should be taken by countries around the world to resist the hegemony of the fundamentally flawed US audit practices. Yale legal scholar, Romano (2004) has recommended that SOX "corporate governance provisions should be stripped of their mandatory force and rendered optional. Other nations, such as the members of the European Union who have been revising their corporation codes, would be well advised to avoid Congress' policy blunder".

While the UK approach has less inconsistencies and conflicts than the US, it too does not provide a role model for the rest of the world. The science of governance explicates why unitary boards cannot reliably manage complexity or reduce the burden of intrusive, prescriptive and costly compliance rituals that are likely to be ineffectual if not counter productive.

Auditors managed by a shareholder panel controlled by minority investors by being elected on a democratic basis of one vote per investor represent such a self-enforcing approach. Coffee (2005) also concluded that minority shareholders need to control the auditor. How this might be implemented is described by Turnbull (2000a, c, 2003).

A major reassessment is required by governance opinion leaders and influential institutions like the OECD, World Bank and governance rating agencies. This paper raises compelling arguments to conclude that convergence of audit practices on those found in the US or UK is not in the best interest of directors or auditors in reducing their conflicts or safeguarding: investors, the proprietary rights of shareholders or self-governance.

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[1] A critique of the OECD Corporate Governance Principles prepared by the author is posted in The Corporate Library, at http://www.thecorporatelibrary.com/special/turnbull/Turnbull-OECDfailure.pdf The critique is based on a submission

published by the OECD at http://www.oecd.org/dataoecd/38/22/27211386.pdf Alternative "Self-enforcing Corporate Governance Principles" are posted for discussion by members of the European Corporate Governance Institute at http://f4.grp.yahoofs.com/v1/cOJ6QWcDM6yAen7T-jZjiWeIjbgUyivoWpWznrVC_QiVb-3HaXW71R1MVVdOsNXwwMcLxHhWJ1saPVSRC7hkiZqXw8rdErM_eLJK/Self-enforceing%20Principles/Draft%20Principals%20Sept%2013%2C%202004.doc

[2] The inherent conflict of interest of Directors controlling the Auditor was ignored in the 2001 report commissioned by the Australian Government on the 'Independence of Australian Company Auditors' by a University Law Professor. In Part 2, "Summary of recommendations", page 13 he states that "There can be no doubt that a well structured and well functioning audit committee can play a very important role in ensuring that the auditor is independent of the company" as reported at http://cclsr.law.unimelb.edu.au/research-papers/audit-ind-report/audit-ind.html The statement compounds confusion by suggesting that directors are independent of the company when they are the Principals of the company.

[3]UK auditors had no statutory duty to report fraud "or illegal activities except where these matters impact on the true and fair view given by the financial statement" as noted at the time by Hatherly (1995: 546).

[4] UK auditing standards exacerbate the quality of audits by accepting the misconceptions identified by FACG (1992: 11).