

Ethics and Governance: Evolving responsibilities for audit committees resulting from the credit crunch

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Abstract

The economies of countries and the business world at large have been shocked over the years by corporate scandals and business failures that had in common poor corporate governance practices, fraudulent financial reporting, creative accounting, auditor inefficiency and a lack of ethical conduct. The events that led to the credit crunch and that resulted in a worldwide financial crisis again displayed a lack of ethical conduct. It can be expected that these events will have a wider effect on society, and will bring fundamental changes in the way the world does business.

In this paper it is argued that the credit crunch and the challenging economic environment that it brings will increase the risk of unethical behaviour and the potential for fraud. It is further argued that this state of events will result in company boards looking towards their audit committees to provide them with assurance that these risks are adequately addressed and managed, resulting in the modern audit committee taking responsibility for areas not traditionally within their remit, such as the monitoring of the company's ethical compliance and overseeing stakeholder reporting. Empirical evidence is also provided that audit committees at the largest listed companies in South Africa are already taking on responsibilities in this regard.

Keywords: Ethics, business ethics, corporate citizen, sustainability reporting, corporate governance, King II, King III (draft)

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1. Introduction

The economies of countries and the business world at large have been shocked over the years by corporate collapses, fraudulent financial reporting and business failures. The start of the twenty-first century saw a new spate of corporate collapses, of which the Enron and WorldCom sagas were probably the most significant. It was reported that Enron, which filed for bankruptcy in December 2001, was the largest bankruptcy case in American history (Terry, 2007:33). It resulted in huge financial losses for shareholders and significant hardship for employees who not only lost their jobs, but also their life savings and pensions. These corporate scandals had in common poor corporate governance practices, fraudulent financial reporting, creative accounting, auditor inefficiency and a lack of ethical conduct (Marx, 2008: 10; 323).

In February 2007 the real estate market in the United States (hereafter US) started to show signs of a slowdown, real-estate prices started to decrease, and borrowers began having difficulty making their monthly mortgage payments (Institute of Internal Auditors (hereafter IIA), 2007:12). This was the beginning of the credit crunch, which was the result of a sustained period of careless and inappropriate lending that resulted in losses for lending institutions and investor debt when the loans turned sour and the full extent of the bad debts became known (Wikipedia, 2009). Again, a lack of ethical conduct was evident in the events that led to the credit crunch and resulted in a worldwide financial crisis. It is argued that these events will have a wider effect on society, and will bring fundamental changes in the way the world does business (Blaine, 2009).

The credit crunch and the consequent challenging economic environment will bring an increased risk of unethical behaviour and the potential for fraud. This state of events has resulted in company boards increasingly looking to their audit committees to provide them with the assurance that these risks are adequately addressed and managed (Ernst & Young, 2009a:3). Accordingly, the role of the modern audit committee is evolving and has resulted in audit committees taking responsibility for areas not traditionally within their remit, such as the monitoring of the company's ethical compliance and overseeing stakeholder reporting.

In this paper the evolving role that an effective functioning audit committee can play in strengthening business ethics and providing accurate stakeholder and sustainability reporting is analysed and discussed. Empirical evidence is also provided on current audit committee practices at the largest listed companies in South Africa in this regard.

2. The growing importance of business ethics and the evolving role of the audit committee

Most of the well-known corporate collapses and business failures involved some form of unethical conduct and unscrupulous practices by those responsible for the management of such entities (Marx, 2008:323). This has resulted in an increased focus on the importance of ethics in business, and accordingly the concept of business ethics evolved. Many definitions have been applied to the term “business ethics” over the years but for the purposes of the paper the definition by Rossouw, Prozesky, Van Heerden and Van Zyl (2007:6) is used: “while ethics in general deals with what is good or right in human interaction (and interaction between humans and animals and the environment) business ethics focuses on what is good and right in economic activity specifically. It therefore focuses on morally evaluating economic practices and activities.” From this explanation of business ethics (and those of others – see Marx, 2008:324-325), it can be concluded that business ethics is essentially about doing business in an ethical manner (own deduction).

Business ethics is not only important for preventing unethical conduct and fraud, but is also essential for a company’s reputation as a responsible corporate citizen and the long-term sustainability and survival of the business. This argument is supported by Ernst & Young in their *Business Risk Report* for 2009, in which they identified the *reputation risk* resulting from the credit crunch as one of the major risks facing companies and businesses alike (Ernst & Young 2009b:6). The importance of building an ethical culture for a company’s long-term survival is explained by Dobie (2006:54) in the following way: “building a responsible ethical culture is embedded in the growing evidence that financial sustainability in the medium to long term is dependent on ethics”. The concept of corporate citizenship and ethics also received increased prominence in the draft Third Report on Corporate Governance (King III)

issued on 25 February 2009 in South Africa, as a whole chapter (chapter 2) is devoted thereto (IoD, 2009:Chapter 2).

With the increasing importance being assigned to business ethics and corporate citizenship, the role of the modern audit committee has also evolved accordingly. This includes the monitoring of ethics compliance within the company and taking oversight responsibility for the company's compliance with its code of conduct and overseeing the company's ethics programmes and ethics audits (Bromilow & Berlin, 2005:36; Ernst & Young, 2005:35; Jackson, 2006:42). This view is supported by the IIA (2006:3), who state in their 2006 guideline document on audit committees that the audit committee has "an oversight responsibility regarding the company's code of conduct and overseeing compliance with the company's ethics programmes". They also state the following: "Some detailed audit committee responsibilities include: ... ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic; reviewing corporate policies relative to compliance with laws and regulations, ethics, conflicts of interest and the investigation of misconduct and fraud" (IIA, 2006:2). A further responsibility that has evolved for the modern audit committee is that of taking oversight responsibility on the board's behalf for ensuring that the company provides accurate, reliable and credible financial and non-financial information to the various stakeholder groups to ensure not only the short-term profitability of the company, but also its long-term sustainability. An effectively functioning audit committee can fulfil a critical role in this regard. The King III draft report now also tasks the audit committee with taking responsibility for the entity's integrated sustainability reporting (IoD, 2009: Code, para. 3.4.4).

From the above discussions it is evident that business ethics and its related aspects of corporate citizenship and sustainability are becoming critical for the success of entities and their long-term survival. In this regard, an effectively functioning audit committee can play a pivotal role in taking oversight responsibility for these aspects on the board's behalf.

3. Justification for audit committees taking oversight responsibility on their boards' behalf in order to ensure companies' ethics compliance and sustainability

An overview of the literature indicates that the term 'audit committee' is not always formally defined, but is quite often informally described as part of corporate governance reports and legislative requirements. From the various audit committee definitions and descriptions, ranging from the earliest to the most recent, Marx (2008:41) concluded that: "the audit committee should function as a subcommittee of the board of directors of which the majority of members should be independent non-executive directors. Although the audit committee is tasked with many and diverse responsibilities, the most important task of the committee remains its oversight role to ensure accurate and reliable financial reporting. Accordingly, it is imperative that the members are financially literate and have the necessary financial experience and expertise to perform this oversight function effectively".

From the above description it is obvious that the modern audit committee, consisting of independent non-executive directors who are financially literate and who have the necessary financial expertise amongst themselves, is ideally suited to oversee and strengthen the company's ethical compliance and related business practices. This is mainly attributed to the fact that the status and seniority of the audit committee, and the fact that it is generally regarded as being the most important subcommittee of the board, will further strengthen the importance of business ethics if the oversight responsibility therefore falls under its remit. Various corporate governance codes also task the audit committee with oversight responsibility for the company's compliance with laws and regulations and the company's code of conduct. As such the audit committee already has oversight responsibilities for part of the company's ethical and legal aspects, and it makes sense to extend this responsibility to include the full coverage of business ethics compliance (Marx, 2008:326-327). This view is supported by PricewaterhouseCoopers (2005:23), who even before the emergence of the credit crunch stated that "audit committees increasingly have responsibility for monitoring ethics and compliance with laws and regulations and for establishing and overseeing 'whistleblower' hotlines."

The fact that it is recommended that all audit committee members should be financially literate, with sufficient financial expertise amongst them, would imply that they should normally be schooled in accounting and/or auditing. As part of the

curriculum of accounting studies, students take the subject of auditing, which covers the area of professional ethics. Furthermore, the International Federation of Accountants (hereafter IFAC), has placed increased emphasis on the teaching of business ethics at university level, with the result that business ethics now forms part of the accounting curriculum of most universities (Els, 2007:211-213; IFAC, 2002:2; Naude, 2008:10-14; Williams, 2007:12). Audit committees are also required as part of their financial reporting and control oversight responsibilities to review various forms of financial reporting, and work through various reports and information on internal control and risk management systems. Given their accounting and auditing backgrounds and training they would be well suited to identify possible fraudulent financial reporting practices, areas for possible collusion and fraud, and ensure that accurate, credible and reliable sustainability reporting is provided to stakeholders.

Given all of the above, it is evident that the audit committee is possibly the best suited to monitor business ethics compliance and sustainability reporting on the board's behalf.

4. The impact of corporate governance developments on business ethics and audit committees

Corporate governance issues became prominent in the nineteenth century when the first limited liability companies were formed in the US and the United Kingdom, and as such separated formally and legally the management and ownership of companies. This resulted in the directors being entrusted with management power, while still being accountable to the owners of the company. Consequently the shareholders needed to protect their investments against abuse of power by the directors, and as a result the agency concept was created and the concept of corporate governance was born (Pullinger, 1995:7; Reynecke, 1996:34; Rossouw, De Koker, Marx & Van der Watt, 2003:3).

As mentioned, the debate surrounding corporate governance has intensified since the 1990s as a result of business failures and corporate collapses. It is also interesting to note that corporate governance practices have evolved from initial structural arrangements aligning the management of companies with the interests of

their shareholders to corporate governance concerns subsequently being extended to the interests of other stakeholders and society at large. In this regard Jhaveri (1998) states that corporate governance covers three types of issues, namely “ethical issues, efficiency issues and accountability issues to its shareholders and other stakeholders”.

Sound corporate governance and business ethics practices may also contribute to self-regulation by the business world, which could mean that stringent government interventions such as the Sarbanes-Oxley legislation in the USA (Gregg, 2009) could be avoided. Ultimately the benefits of practising good corporate governance (of which business ethics and an effective audit committee forms an integral part) can also be financially rewarding. A survey conducted in 2000 by the international organisation McKinsey & Company found that international investors would be willing to pay a premium of between 22% and 27% to invest in well-governed companies in emerging markets or in markets perceived to have strong governance practices (as quoted by Thomas, 2005:76). King II also noted this by stating that “significant shareholder value can be added by companies developing and applying good governance practices and that the creation of a good governance climate can make countries, especially in the emerging markets, a magnet for global capital” (IoD, 2002:13). Lastly, it is interesting to note that, in its Working Paper 10 of 2006, entitled *Corporate Governance Codes and their Implementation*, the Financial Law Institute provided a different perspective on the value of good governance by stating that “the effect of good governance on price information is controversial in the sense that it is empirically difficult to prove that good governance has a positive impact on share price. It is much more evident however that ‘bad’ governance has a negative impact, undermining the market’s confidence in a company” (Financial Law Institute, 2006:6).

The various corporate governance codes issued over the years gave prominence to the need for business to behave in a responsible and ethical manner (for corporate governance codes issued internationally, see the website of the European Corporate Governance Institute at http://www.ecgi.org/codes_/all_co_des.php). There was also a shift from the single bottom line of profits only, to that of the triple bottom line, and the concepts of ‘corporate citizenship’ and ‘sustainability’. These principles have

been carried forward in the latest corporate governance report issued, namely the King III draft report, which was released for comment in South Africa on 25 February 2009. The Report and the Code contain the following principles regarding ethics, corporate citizenship and sustainability (IoD, 2009: Chapter 1 and Chapter 2):

- Principle 1.1: The board should act as the focal point for corporate governance.
- Principle 1.2: The board should ensure that the company acts as and is seen to be a responsible corporate citizen.
- Principle 1.3: The board should cultivate and promote an ethical corporate culture.
- Principle 1.4: The board should appreciate that strategy, risk, performance and sustainability are inseparable.
- Principle 1.5: The board should consider sustainability as a business opportunity.
- Principle 1.15: The board should ensure that the company implements an effective compliance framework and effective processes.
- Principle 2.1 The board should ensure that the company acts as and is seen to be a responsible corporate citizen.
- Principle 2.2: Companies should develop strategies and policies to guide their activities in becoming and remaining good corporate citizens.
- Principle 2.3: Corporate governance requires effective and responsible leadership to ensure that the company is run ethically, in a transparent and accountable manner.
- Principle 2.4: The board should actively manage the company's ethics program.
- Principle 3.4: The audit committee should oversee stakeholder reporting.

From the above principles in the draft King III, the focus on ethics (and accordingly business ethics) and corporate citizenship is obvious. From a practical viewpoint it is realistic to assume that the board as a whole will provide direction on these aspects, but that oversight responsibility for the actual enforcement and compliance therewith should be delegated to a well-structured and suitable committee of the board. Following from the discussions in section 3, it is clear that the audit committee is best placed to undertake this.

5. Empirical evidence regarding audit committee practices and ethical and sustainability aspects

In this section empirical evidence is provided on current audit committee practices regarding ethics and sustainability practices at the largest listed companies in South Africa.

The empirical study focused on audit committees at large listed companies in South Africa and accordingly the population for the empirical study was selected as the largest 40 companies ranked by market capitalisation in the JSE's All-Share Index. Questionnaires were sent in the first week of April 2008 to the audit committee chairs of these companies for completion. A response rate of 85% was achieved, as 34 out of 40 questionnaires were received back from the audit committee chairs. The response rate of 85% achieved for this study is deemed to be very high and should contribute to the reliability and usefulness of the information therein.

■ *Audit committee chairs' view regarding business ethics aspects*

The audit committee chairs were asked to consider how effective their committees are in dealing with business ethics aspects. 82.4% of the respondents were of the opinion that their committees are to a large extent effective in this regard, while 17.6% were of the opinion that their committees are effective to a lesser extent, while none were of the opinion that their committees are ineffective in this regard.

64.7% of the respondents indicated that their audit committee reviews the company's compliance with their code of ethics, while 88.2% indicated that the audit committee provides a channel for safe reporting.

■ *Audit committee chairs' view regarding corporate governance responsibilities*

85.3% of the respondents indicated that their audit committee reviews the company's compliance with laws and regulations, while 88.2% indicated that the audit committee reviews the company's compliance with corporate governance codes. An alarming aspect, however, is that only 47.1% of the respondents indicated that their committee review the fair presentation of sustainability reports.

■ *Summative assessment*

The above findings indicate that audit committees are already dealing with ethical and sustainability issues on their boards' behalf, a practice that is recommended in sections 3 and 4. The fact that these aspects received increased prominence in the King III draft report should further strengthen the application thereof in practice.

6. Conclusion

In this paper the effect of the credit crunch on the evolving responsibilities of the modern audit committee was discussed. Evidence was provided that the credit crunch has resulted in an increased risk of unethical behaviour and fraud, as well as a growing need for entities to be responsible corporate citizens. Against this background, it was argued that the modern audit committee, given its status and seniority as a subcommittee of the board, as well as the qualification and experience of its members, is well placed to deal with ethics and sustainability issues on the board's behalf. Empirical evidence was also provided that audit committees are already dealing with ethical and sustainability issues on their boards' behalf, although only 47.2% of the respondents are currently reviewing their company's sustainability reports – an aspect that is expected to change drastically, given the recommendation of the King III draft report that audit committees should oversee their companies' stakeholder reporting.

Further areas of research should include a study of the effect of the credit crunch on current and evolving business ethics and corporate governance practices. Such research should also take cognisance of the recommendations of the King III draft report.

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