Rethinking accountability and corporate reporting in South Africa

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The high profile corporate failures and accounting scandals have led many to believe that there is a widespread lack of accountability, and a decline in the ethical values of those involved in the management of economic institutions. To overcome the problem, governments have responded in various ways; from providing emergency funding to major banks and insurance companies to the promulgation of tougher regulations. In the United States, the Sarbanes Oxley Act of 2002 was a response to the Enron and Arthur Anderson accounting scandal. The September 2008 banking crisis was sparked by the collapse of Lehman Brothers. The extent to which the bank's auditor, Ernst and Young, is a party to the alleged hiding of debt from the balance sheet of the bank is yet to be determined. The response of the regulator to the latest crisis was the promulgation of the Dodd-Frank Act of 2010.

Accounting therefore has an important role in the economy. As one of the specialisation areas of economics, accounting supplies decision-useful, reliable, relevant and timely information about the allocation, distribution and control of resources. For this, it uses evolving scientific recognition, measurement and reporting methods. Hence, accounting is at the heart of the governance of modern and post modern institutions. It formalises and quantifies expectations, evaluates performance, and if properly used, enhances the enforcement of ordinary, commercial and broader social contracts. The literature uses the term accountability and responsibility interchangeably. For Olov Olson, Christopher Humphrey and James Guthrie, accounts are the control features of life, and accountability is the process of giving accounts. For the late Anthony Hopwood, the founding editor of the *Journal of Accounting, Organisations and Society,* accountability is related to the universality of human action. Therefore, an individual faces political accountability, workplace accountability, social-cultural-religious accountability, family accountability and personal accountability. Hence, the formal definition of the term accountability would have to be context driven. Interestingly, when the concept of accountability is examined through the lenses of the separation of powers doctrine, useful insights can be made about the link between accountancy and the governance of economic and public sector institutions.

A number of theories attempt to explain how economic institutions should be governed. Agency, managerial hegemony, stewardship, external pressure and stakeholders are the dominant theories in the literature. Almost all of the theories underscore the critical role played by accounting. Notwithstanding this, there is a gap between top management and accountants. The accountant's interest may or may not be in line with the interests of top management. There is a gap between what external auditors actually do and what investors think auditors are doing. There is a gap between what rating agencies do and what actually happens in the financial institutions. These findings suggest that the conventional wisdom and the established theory of uncertainty reduction, which states that more and credible information leads to risk reduction, may not be achieved under existing institutional arrangements. Hence, the frequent corporate failures will affect the reputation of individuals and groups that are entrusted to be the custodians of public savings (investments).

Fraudulent financial reporting, financial statement reinstatement, earnings management and debt understatement are intricately connected with managerial behavior. Dysfunctional executive behavior leads to what economists describe as adverse selection and moral hazard problems. In other words, dysfunctional behavior leads to inaccurate asset prices, produces "paper profits" and allocates resources to inappropriate projects. It is clear that nowadays the role of accounting is not just to produce financial statements. Behind the financial statements there are human beings. Accounting, therefore, is an instrument for enforcing the accountability of human beings. It is an instrument of good corporate and public governance. In this short article, I attempt to examine the issues of accountability and corporate reporting in the context of South Africa. To make the article readable, I have kept the technical jargon to a minimum, and avoided the quantitative analysis that usually accompanies a discourse on accountability and financial reporting.

Corporate reporting: Some theoretical and practical issues

The link between accountability and financial statements depends on the type of economy one is examining. Any relationship outside the fable of the Robinson Crusoe economy requires some degree of accountability. In a primitive economy, where wealth is stored in sheep and goats, the shepherd is accountable for the herd, and periodically reports about the wellbeing of the assets with which he is entrusted. In communist economies, where separation of powers is not practiced, the purpose of accounting is to provide information to the central planner. In contrast to communist economies, to a greater extent, capitalism is guided by the market. Hence, with the collapse of the Berlin Wall in 1989 and the success of the Deng revolution in China, there is now a global consensus about the importance of markets. Within the capitalist economies, the difference between bank dominated financial systems and equity dominated financial systems is also narrowing. Common law and code law countries are integrating through various forms of economic union. Financial integration and increased human migration are key features of globalisation. While the gulf between value systems and culture continues unabated, the Anglo-American financial reporting tradition of fair representation is dominating the new conceptual framework for International Financial Reporting Standards (IFRS). By the end of 2007, over one hundred countries had adopted IFRS, and in April 2009, the G20 leaders reaffirmed the need for global accounting standards.

There are several advantages of having "a single set of high quality" global financial reporting standards. First, it narrows worldwide accounting diversity, and hence, comparability of financial statements becomes relatively easy. Second, it promotes international trade and the cross listing of securities. Third, it reduces uncertainty and, therefore, the cost of capital. Fourth, it enables the transfer of accounting and auditing technology. Shyam Sunder of Yale University, in an article entitled IFRS and the accounting consensus (Accounting Horizon Volume 23, Number 1, 2009) outlines the disadvantages of having a single set of global accounting standards. He argues that the system introduces global bureaucracy and rigidity, and discourages local innovation. It reduces university education to a vocational training and exacerbates rote learning. Analysis of the strengths and weaknesses of these arguments is beyond the scope of this article.

On the theoretical front, three factors are critical for accounting. First, accounting serves as an internal reporting and control mechanism. Second, it provides reliable and timely information for the price formation (valuation) process. Third, it signals the going-concern status (continuity) of the firm. Hence, accounting's main preoccupation has been, and continues to be, supplying useful information to managers, capital providers and other stakeholders. How accounting should cater for the other stakeholders continues to be an unresolved issue.

The association between corporate information disclosed through the annual report and price formation in the equity market (valuation) has been extensively researched. The papers that appear in the *Journal of Accounting Research, The Accounting Review*, *Journal of*

Accounting and Economics, Journal of Business Finance and Accounting, and Contemporary Accounting Research followed empirical research protocol, and reported that the value relevance of accounting information in the United States is limited. This finding, however, is not supported by research done in European and emerging markets. The microstructures of these markets are different. In these markets there is an association between the level of corporate information disclosure and the degree of uncertainty reduction. To summarise the finding in South Africa, there is some evidence which shows that after controlling for the effects of size and debt, the level of corporate disclosure through the annual report is associated with the information component of the buy-sell spread of stock prices. Hence, much of the debate, at least in the context of emerging markets, is whether the gains stemming from more corporate disclosure can be exogenously determined.

Another dimension of corporate information research is examining the economic consequences of fraudulent financial reporting practices. Paul Healy and James Wahlen defined earnings management as "an event that occurs when management uses judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers". The empirical evidence from New York Stock Exchange (NYSE) to Johannesburg Securities Exchange (JSE) reveals, except for some methodological controversies, that managers indeed manage earnings upwards or attempt not to report losses. In a related study, John Graham, Campbell Harvey and Shiva Rajgopal administered a survey of 401 executives in the United States and conducted in-depth interviews with some 20 senior executives to determine the key factors that drive decisions related to performance measurement and voluntary corporate information disclosure. The majority of their respondents view reported earnings as the key metric for an external audience. Furthermore, they reported that companies would avoid initiating a positive net present value project if it meant failing short of expected earnings. In addition, they reported that more than three-fourths of the respondents would give up economic value in exchange for smoothed earnings. In a follow-up work entitled "value destruction and financial reporting decisions", Graham *et al* asserted that the amount of value destroyed by firms striving to hit earnings targets exceeds the value lost in high profile fraud cases. Hence, today's external audit challenge is not just detecting whether ordinary fraud and irregularities have occurred in the organisation; it involves curbing dysfunctional behavior. Corporate reporting and auditing is about the accountability of executives.

With regard to the role of accounting in providing information about the going concern status of the firm, the issue is more sensitive. Even though audit standards have directly and indirectly indicated this critical role, standard audit reports have shied away from providing assurance. Auditors argued that assurance would require additional work, and therefore the audit "expectation gap" cannot be filled within the current audit fee structure. Notwithstanding this, investors and regulators have been continuously asking whether the audit process is dead or alive. There are four possibilities for an audit failure and corporate failure. The first scenario is that the company is a going concern and the auditor confirms the going concern status of the firm. The second scenario, which is more unlikely to occur, is where the company is a going concern but the auditor fails to detect that and issues an adverse or a qualified opinion. The third possibility is that the company is in distress and the auditor detects the distress. The fourth scenario is that the company is in distress but the auditor failed to detect the illness either because of his/her incompetence (detection error) or lack of independence. Scenarios two and four constitute an audit failure, while only scenario four leads to actual post audit corporate failure. Here the accountabilities of the auditor, the management, the board and the audit committee are in the spotlight. The failures of other external monitoring systems such as rating agencies and analysts do not get the attention of the media. Hence, the evidence suggests that there might be many zombie companies that are taking their time to fail. In other words, the art and science of going concern assurance and failure predication (stress tests) are insufficient for analysing today's complex institutions and financial products.

The Environment of Accountability

In order to examine accountability and corporate reporting practice in South Africa, I follow Sue Llewellyn's five levels of theory and theorising in social sciences and scan the accountability environment to find context for the discussion. Several writers have indicated that South Africa is a land of two extremes. Beautiful landscapes, extensive seacoasts and abundant natural resource endowments are available for its

50 million people. It has a complex financial and industrial infrastructure. The constitution is based on the principles of the separation of powers and term limits. Its Companies' Act (as amended) traces its roots to English common law and Roman Dutch law, and follows the "true and fair view" accounting model. Its Public Finance Management Act (PFMA) assigns direct responsibility to public officials. The country has liberalised its finance industry and some of its home grown companies are listed on foreign stock exchanges. Its stock exchange is about 100 years old, and over 600 securities are listed in the two boards. The pension fund, insurance and unit trust industry is better than many of its European competitors. The Rand is one of the most actively traded currencies in the world. Its banks, though few in number, are being acquired by major international banks. The major accounting firms are affiliated to global audit firms. The accounting profession traces its roots to the Scottish and English accounting societies, created around the turn of the 19th century. It also has a vibrant financial press. It is the collective strength of these institutions that make South African financial reports respectable. Indeed the World Economic Forum's Global Competitiveness Report continuously rates South Africa high on the strength of its auditing and reporting standards, the efficiency of corporate boards, the soundness of banks, and the accountability of private sector institutions.

On the other hand, one finds abject poverty, extreme inequality among and within population groups, rampant crime and corruption, worrying level of youth unemployment, poor law enforcement and a public service with dismal performance. These problems are exacerbated by the process of liberation from the legacies of apartheid and British colonialism. The transition has not been easy. There are also complex and disturbing indicators of abysmal performances in almost all directions. These social, political and economic factors affect the environment of accountability and the general way of life. The Global Competitiveness Report indicates that the business cost of crime and violence puts South Africa at 137th out of 139 countries. With regard to organised crime (including white collar crime) the country is ranked at 114th out of 139 countries. Quality of education, quality of mathematical and science education, health and primary education and higher education are respectively ranked at 130th, 137th, 129th and 75th. Thus, when one deals with issues of accountability in South Africa, one cannot feel comfortable and show laxity by the glowing report that the country is getting in published global reports that crucially depend on opinions that are based on accounting technicalities. Critical accounting attempts to use social theory and political economy to understand the dynamics inside and outside the board room and the accounting profession.

Widespread poverty, corruption, crime, ethnicity, racism, xenophobia and impunity affect the business environment. They exacerbate the migration of financial and human capital. They influence the decision-making system and affect the credibility of reports. One must ask simple questions. Can one trust the findings reported in the thesis of a graduating student? Could one rely on a professor's report about his/her colleague's performance? Are passports, death, birth, marriage and academic certificates authentic? Can the audit reports produced under such an environment be credible? The list of questions about trust becomes long when the environment of accountability is spoiled. Hence, the issue of accountability in South Africa might be better explained by social theories rather than financial reporting theories. Analysis of corporate accountability will leave a void if it does not take cognizance of the political, legal, ethical, cultural, and educational situations that prevail in the country.

Corporate reporting in South Africa

So far we have established that trust is the key feature of accountability. The problem of trust has been addressed in the seminal work of Adam Smith. Michael Jensen and William Meckling extended the theory to modern institutions. The trouble is that as institutions and financial products became complex, the problems of trust could not be explained by the conventional principal-agent (agency) relationship. *Ceteris paribus*, the discussion about the environment of accountability, the problem of trust is not uniquely a South African problem. The difference between countries is a matter of degree. Financial globalisation and culture, however, complicate the problem. The monitoring process needs to keep pace with global changes. In this respect, by most benchmarks, South Africa's listed companies' corporate reports and audits meet global standards. There are a number of reasons for this.

First, almost all of the listed companies are audited by the big four and two second tier audit firms. These firms are predominantly the local affiliates of the global audit firms. According to the Independent Regulatory Board of Auditors (IRBA), by the end of

2009 there were 1400 audit firms in South Africa. The number of individuals who could provide the attest (audit) function was 2800. This figure is about 11% of the 31230 chartered accountants. That is, about 89% of the members of the South African Institute of Chartered Accountants (SAICA) do jobs other than the attest (external audit) function. In other words, chartered accountants are both the preparers and the auditors of financial statements.

Secondly, accounting higher education is geared towards vocational training. The system is designed to feed the audit industry. The big audit firms have significant influence not only on SAICA but also on the universities. The influence is both direct and indirect. The direct interactions are through the recruitment of graduates, extensive branding, salary subvention (which is approximately about 7% of the payroll of accounting departments in accredited universities) and social interactions. The indirect influence is through SAICA and IRBA. Audit partners and audit executives dominate SAICA's boards. SAICA in turn, determines the kind of accounting education that is taught in the higher education sector. There are 14 accredited chartered accounting programs in the nation's 25 universities. Hence, the main preoccupation of the country's main universities is producing chartered accountants. SAICA produces annually the pass rates by university. High pass rates in the qualifying examination brings respect to the university, while at the same time it introduces gamesmanship into the system. Almost all of the Heads of Accounting Departments and the professors are chartered accountants. All other qualifications and educational programs are subordinate to the chartered accountancy qualification/program. There are two salary structures in most of the accounting departments. SAICA's discriminatory allocation of subvention exacerbates the disparity, and creates tension within the accounting faculty. It increases the commoditisation of accounting higher education. The CA certification (four year degree plus three years training at the audit firms) is the entry level qualification for a career in academia. In many universities the CA qualification earns the rank of a senior lecturer. Promotions to the rank of an Associate Professor and Professor are less stringent than they could have been. Less than 10% of the accounting faculty in South Africa has a PhD level qualification. In terms of the American Association of Collegiate Schools of Business (AACBS International) criteria, South African universities appear to be predominantly staffed by individuals who are professionally qualified (PQ) and to a lesser extent by those who are academically qualified (AQ). The effects of this structure on innovation, scholarship, international parity of the quality of accounting academics, and the governance of accounting schools are many. There is a need for national conversation.

A political economy view of the accounting profession and the higher education sector reveals that the existing structure has not transformed itself. With the exception of the newly accredited program at Fort Hare University, the 13 SAICA accredited programs are found in the formerly "whites only" universities. These universities are the nation's finest institutions and some of them are within the top 500 of world universities. The universities are, however, struggling with the problems of transition, political pressure, increased enrolment, resource inadequacy and, at times, poor leadership. Sixteen years after the abolition of apartheid, SAICA's African (black) members constitute only 5.58% of the total membership. Despite the much publicised Thuthuka Program, 94.42% of the members of SAICA are not black Africans. At the universities, the situation is the same. For instance, there is not a single black person with a rank of full professor who holds a full time position in any of the 14 SAICA accredited universities. The pass rates of African, Asian and White students are different. Hence, critical social theory not only describes the nature of the institutions of accounting but points to the change that the country and the profession have yet to undergo.

Hence, one of the challenges that universities are facing is their inability to redefine the structure of accounting higher education in post apartheid South Africa. The relationship between academia and the professional organisations need to be redefined. Notwithstanding this, it is also important to note that SAICA's monitoring visits to academic institutions has documented several weaknesses in a number of universities. The accreditation process involves extensive documentation, consultation, interactions with faculty and students, and physical inspection. Most of the accreditation criteria are taken from higher education quality control standards. It focuses on issues that relate to teaching quality, staff adequacy, staff competency (CAs), graduate competency, currency of the teaching material, examination standards, teaching infrastructure, and whether there are adequate financial resources for the program.

The accreditation visits have had ripple effects on other undergraduate accounting programs. The accreditation visits have also provided wake-up calls in many universities. The November 2008 media frenzy between SAICA and the University of the Witwatersrand is an example of this.

Returning to the corporate report itself, as indicated earlier, by most standards the financial statements of South African listed companies meet international benchmarks. The listing requirements of the JSE are on par with international standards and a Generally Accepted Accounting Practices (GAAP) monitoring panel is active. Studies that compared the disclosure practices of firms in South Africa over time have used disclosure scoring sheets that were used elsewhere, and results were comparable. More recently, the JSE rates companies for their Socially Responsible Investments. A number of South Africans have served as board members of the IASB and IASC. Hence, it is the cumulative strength of the institutions that put South African financial statements on par with the international trend. This, however, does not mean that there is no fraudulent financial reporting. It does not mean there were no audit failures. In fact, almost every audit firm has had its share of audit failure; but few of the failures have had the attention of the financial press. There is also some empirical evidence which shows that the JSE is unable to detect on time firms that manage their earnings.

Improvement Areas

Looking forward, critical social theory not only explains existing institutions but also attempts to suggest policy guides. Given that South Africa already enjoys the legal-technical foundations and the true and fair view paradigm, the interesting question is what South Africa can do to further improve the degree of corporate accountability. Another area of enquiry is the role of government in enhancing the environment of accountability. In other words, accountability requires a shared responsibility. Table 1 contains issues that require attention.

Table 1: Policy issues

1. Government can initiate a national conversation on the future of accounting higher education. Changes in technology, changes in business, globalisation, sustainability, ownership structures, institutional investors, and complex financial contracts affect the type of accounting education. It helps to decouple the audit education from broader accountancy higher education.
2. With regard to the regulation of the accounting profession and auditors, the present Acts need to be reformed. Both Acts were promulgated after the Enron-Arthur Anderson scandal and the Sarbanes Oxley Act, that is, the laws were enacted at a time when the accounting profession was going through crisis and bad publicity.
3. Interlocking directorship, ownership concentration, pyramids, executive compensation, disclosure of the identity of nominee companies, the merits and demerits of BEE and BBBEE financing, and the general democratisation of corporate boards require attention.
4. The monitoring capacities of IRBA and the GAAP monitoring panel of the JSE need to be strengthened and linked to the financial surveillance systems to minimise systemic failures. In the public sector the reluctance of politicians to enforce the PFMA needs to be resisted.
5. Most corporate reports do not provide for the liabilities that are arising from the past activities of environmentally sensitive enterprises. Since South Africa is a natural resource rich country, IFRS 6, IFRIC 5, IAS 37 and similar standards need to be carefully enforced. Environmentally sensitive firms must be required to set aside funds that are ring fenced. The funds need to be controlled by trustees that have an arms-length distance.

6 Investment in innovation, research and postgraduate education is another area that requires attention. There is a need to build a public-private partnership to enhance post graduate accounting education.
7 Standard setters need not confuse accounting for an event and disclosing an event in footnotes.
8 Transformation and equity require a new thinking. It is clear that the current system is not working.
9 The globalisation and commoditisation of accounting education needs to be understood by government and administrators of universities.
10 Without sounding like an advocate of social engineering, a philosophical-interdenominational civic and ethics education that is embedded on the fusion of culture and values system can be introduced at elementary schools to create, so to speak, "the new South African" that is ready to tackle the emerging issues of accountability, governance and globalisation. This initiative opens the opportunity to introduce the concept of accountability at an early stage in the life of the child.

Concluding Remarks

Financial globalisation and information technology have accelerated the speed at which assets are transferred from one center to the other. In the meantime, organisations and financial products have become complex. Institutional investors dominate the finance industry. The size of financial capital has grown. Globalisation is also manifested through increased human migration/immigration. According to some statistics, about 4% of the peoples of the world are living outside their country of birth. The same statistics also indicate that about 11% of the residents in the United States are foreign born. This trend is observed in many parts of the world, bringing in both fusion and gulf. Accounting thoughts, procedures, and institutions have also become either global or affected by the globalisation of knowledge production and dissemination. Whether this globalisation is going to end up with a repeat of previous globalisations, where Africa was at the receiving end, remains to be seen. The accountability of corporations must be seen from this ontological reality. Since accounting has the comparative advantage of enhancing the institutions of accountability, it can serve for monitoring local and transnational companies, public sector governance, environmental degradations, social justice and the financial markets.

The policy issues that are outlined in the table are meant to spark debate. There are many directions for future research on corporate reporting and accountability. Dysfunctional managerial behavior, misleading and faulty audit reports, and incorrect credit ratings will not be totally eliminated. The financial crisis and audit scandals of the last 30 years have produced new standards, procedures and laws. However, volatilities, scandals, crises and contagions appear to have become inherent in business. We must not just learn how to survive them but we also need to know how to manage them.