Corporate Governance

Principles of Auditing: An Introduction to International Standards on Auditing - Ch 14

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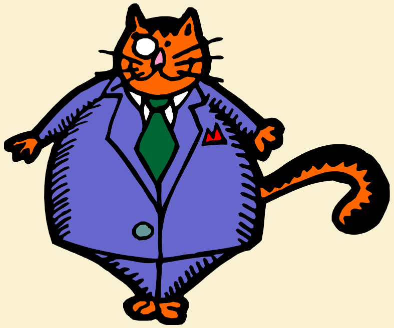
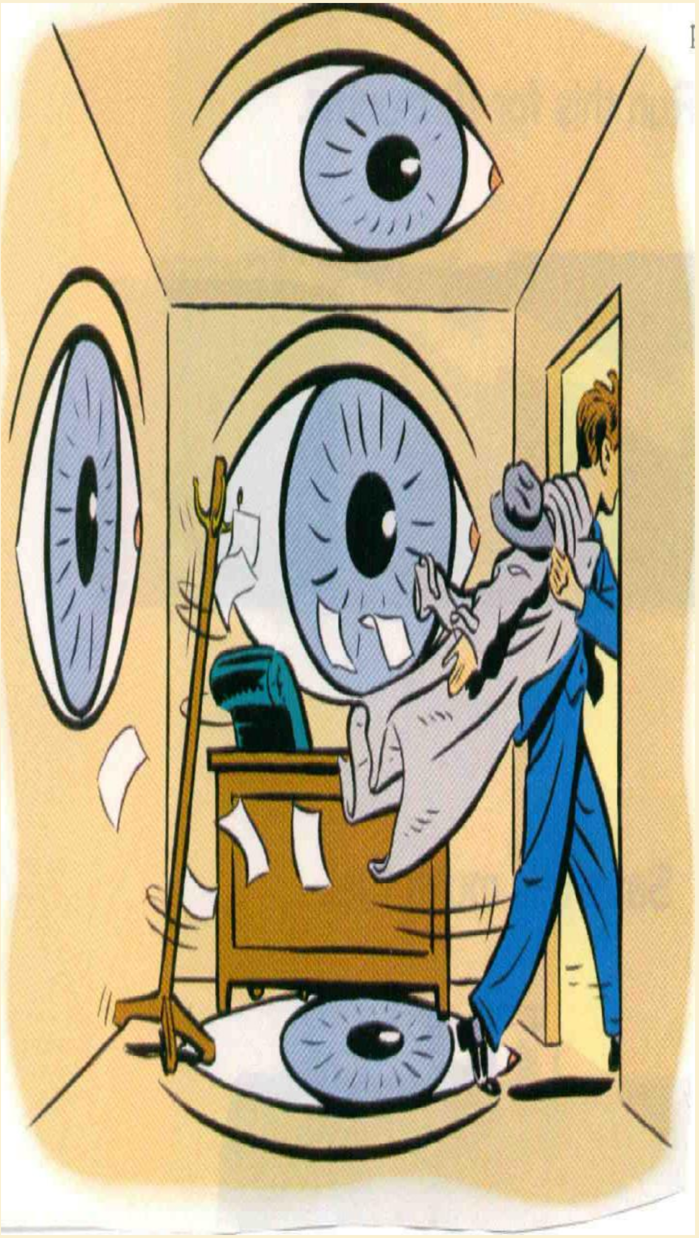
Corporate Governance Defined



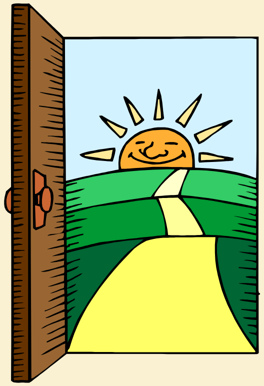
- Corporate Governance is the process and structure used to direct and manage the business and affairs of the corporations with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business.
  - The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board and management.
- Cadbury Committee: Corporate governance is the system by which companies are directed and controlled.

Stakeholders

- Corporate governance has the objective of enhancing shareholder value. But it also take into account the impact of decisions on other stakeholders.
  - Stakeholders are the community, the general public, consumer groups, etc.
- The stakeholder relationships include a relationship between the community and the firm, between governments and firms, and between community and governments.



Transparency



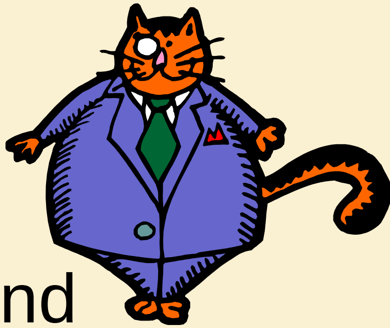
- Transparency forms the backbone of good corporate governance and requires a sophisticated system of accounting. Such a system should:
  - allow investors to assess the magnitude and timing of future cash flows to be generated by a business
  - encourage efficient operations and maximization of results;
  - provide an early warning of problems in meeting objectives of the firm;
  - lead to quick corrective action whenever things go bad.

Corporate Governance Discussion

Four causes of the current corporate governance discussion:

1) bankruptcies, fraud, and mismanagement
2) the influence of public, customers and media,
3) globalization of capital markets, and
4) developments in information technology (IT).

Corporate Governance Structures



Two types:

(1) Market corporate governance structure and

(2) Network corporate governance structure

- Market oriented countries are more aggressive and confrontation seeking, while network cultures seek consensus instead of conflict.
- In Market countries, shares are widely distributed among individuals. In network countries, banks, insurance companies and other institutions mainly hold shares. As a consequence, stock exchanges play a more important role in market-oriented countries.
- Another major difference is the two-tier separation between the board of management and the supervisory board in the network structure vs. one board in the market system.

Corporate Governance Committees and Reports

- US – COSO Report [1992], Sarbanes-Oxley [2002]
- UK – Cadbury [1992], Hampel [1998], Higgs [2003]
- Canada – Dey: "Where were the directors?" [1994]
- Germany – [1998] "Kontrag", Cromme Commission [2002]
- France – [1995, 1999] Viénot Rapport, Bouton [2002]
- Netherlands – Peters Committee [1997], Tabaksblat [2003]
- South Africa – [1994] "The King Report"
- Australia – [1994] "Bridging the Expectation Gap"
- OECD – [1999] "Improving Competitiveness and Access to Capital in Global Markets"

The Sarbanes Oxley Act consists of 11 Sections

I – Public Company Accounting Oversight Board

II – Auditor independence

III – Corporate Responsibility

IV – Enhanced Financial Disclosures

V – Analyst Conflicts of Interest

VI – Commission Resources and Authority

VII – Studies and Reports

VIII – Corporate and Criminal Fraud Accountability Act of 2002

IX – White-Collar Crime Penalty Enhancements

X – Corporate Tax Returns

XI – Corporate Fraud and Accountability

EU Laws

The EU Action Plan for Company Law, pays attention to the need for regulator response at the European level.

A 2001 comparative study concluded that the EU should not devote time and effort for the development of a European corporate governance code.

EU and Company Management

The EU is strengthening management of companies during the period 2003 - 2009 along the following lines:

- Modernizing the board of directors
- Board composition (independent non executives or supervisory directors and creation of specific committees)
- Director's remuneration (both ex ante and ex post)
- Directors' responsibilities (special investigation right, wrongful trading rule, directors' disqualification).

Best Practice from a Global Perspective

Four elements of governance:

I. Managing including board responsibility
II. Supervision
III. Internal control
IV. Transparency.

I. Managing Best Practice

An important element of governance is "managing" which includes the concepts of mission, strategy, objectives, and compatibility with societal objectives.

Board Responsibility

The board defines the company’s strategy, appoints the corporate officers responsible for managing the company and implementing this strategy, oversees management and ensures the quality of information provided to shareholders and to financial markets through the financial statements.

Certification of SEC reports by executives

- Chief executive and financial officers of US listed companies have to certify annual and quarterly reports filed with the SEC.
- Certification means that these executives reviewed the reports and based on their knowledge there are no untrue statement or omission of material fact, and the statements fairly present the Company's financial condition.
- Signing officers also certify that they evaluated the effectiveness of disclosure controls and procedures.
- By signing they also confirm that disclosures have been made to auditors and *audit committee* of all significant deficiencies in internal control or any fraud that involves employees with significant role in internal control.

II. Supervising Best Practice

- Good corporate governance requires a system of independent supervision and active oversight of management.
- A reduction on management influence over boards is generally achieved by rules that ensure the independence of non-executive members of the board or, in continental European countries, supervisory board members.
- According to Anglo-Saxon best practice, the board represents the shareholders – not other constituencies, although some countries hold that the board represents all stakeholders
- Appraisal of individual directors is a key element of corporate governance including designing and approving appropriate remuneration scheme.

Audit Committees

- Since 1978, the major American stock exchanges have required listed firms to have **audit committees** comprised of independent, outside, directors who own relatively little stock in a firm and who are not members of management.
  - They have responsibilities for monitoring management, corporate reporting, and relations with the independent auditor.
  - They meet with the internal and external auditors, reviewing financial statements before they are issued to the public, and, in certain circumstances, taking action to control management.
  - Audit committee members should not receive fees other than for board service and should not be an "affiliated person" of the company or any subsidiary.

Audit Committee

Independent Directors

Audit committee members should not receive fees other than for board service and should not be an “affiliated person” of the company.

Financial Expert

At least one member of its audit committee must be a "financial expert" (expertise in US GAAP).

Auditor Oversight

Responsible for oversight of external reporting, internal controls and auditing, and the appointment and compensation of the auditor.

Whistle-Blower Communications

Confidential and anonymous submissions by employees.

SOx: Auditor Reports to Audit Committee

All critical accounting policies and practices in use by the publicly listed company

GAAP alternatives discussed with management and any alternative preferred by the audit firm.

Other material written communications such as *management letters* and *unadjusted audit differences.*

III. Internal Control Best Practice

The US Treadway Commission

Recommended that internal controls could prevent and detect fraud and that guidelines be developed by COSO.

The Cadbury Committee in the UK

Code of Best Practice deals with internal controls as defined by COSO.

Section 404 (SOX 404)

Requires the annual report of issuers to contain management reports which state management responsibility for internal control structure and procedures and give an assessment of effectiveness.

Internal Audit Department

COSO says internal control component "monitoring" includes the contribution of an internal audit department

SOx: Auditor Report on Management's Assertion About Internal Controls

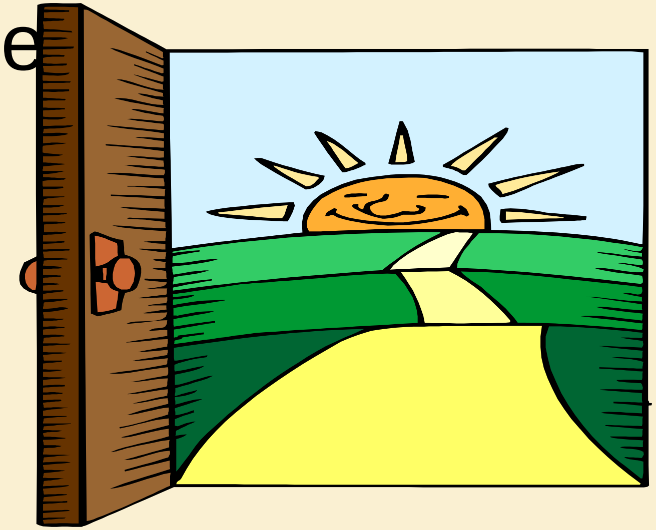
SOx 404 requires management reports on the effectiveness of internal controls and the auditors attest to management's assertions.

PCAOB Audit Standard #2: auditor should:

- ✓ Obtain understanding of internal control and management's evaluation
- ✓ Evaluate design effectiveness of controls
- ✓ Test and evaluate the operating effectiveness of controls
- ✓ Form an opinion

Best Practice: Transparency

- Elements of transparency include timely disclosure of reliable, adequate and relevant information for decision making.
- Investors want clear, reliable and internationally comparable information about enterprise



EU Corporate Governance Disclosure

The EU annual corporate governance statement should at least include the following items:

- The operation of the shareholder meeting and its key powers and the description of shareholder rights and how they can be exercised.
- The composition and operation of the board and its committees;
- The shareholders holding major holdings and their voting and control rights as well as key agreements;
- The other direct and indirect relationships between these major shareholders and the company;
- Any material transactions with other related parties;
- The existence and nature of risk management systems;

ILLUSTRATION 14.4

Current and Future Business Reporting Models

Current Reporting Model	*Future Reporting Model*
Shareholder focus	Stakeholder focus (Shell, Ben and Jerry, Body Shop)
Paper-based reporting	Web-based reporting (Microsoft financial forum)
Standardized information	Customised information (relevant information for decision making)
Periodic reporting	Continuous (online, real-time)
Distribution of information	Dialogue (i.e. a two-way communication)
Financial information	Broader indicator range (such as environment, health and safety)

Illustration 14.4

Corporate Governance And The Role Of The Auditor

The external auditor plays a central role in good corporate governance. Their core role is to

- audit financial statements and other (financial) reporting
- attest internal control statements, and
- review or attest of corporate governance statements.

Combined Code provisions are as follows:

- The Board should have a formal schedule of matters specifically reserved to it for decision.
- The Board takes independent professional advice if necessary, at the company's expense.
- Non-executive directors should be appointed for specified terms subject to re-election
- All directors should be subject to election by shareholders.
- There should be a statement by the auditors about Board reporting responsibilities.
- The directors should conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so.
- The board should establish an audit committee of at least three directors, all non-executive.

Duties of the PCAOB are:

Public Company Accounting Oversight Board

- Register public accounting firms that prepare audit reports for issuers.
- Establish or adopt rules: Auditing, Quality control, Ethics, Independence, as related to preparation of audit reports
- Conduct investigations of and disciplinary proceedings involving registered public accounting firms.
- Establish auditing standards
- Establish quality control standards. Quality control standards could include rules to require monitoring professional ethics and independence

EU Eighth Company Law Directive on Statutory Audits

- 2004 the Commission of the European Union proposed a major revision of the 8th Company Law Directive.
- It addresses:
  - the duties of statutory auditors, their independence and ethics
  - external quality assurance
- It creates an audit regulatory committee to ensure public oversight over the audit profession.
- It mandates regulators in the country where an audit firm is established take full responsibility for supervising the audit process.

EU Eighth Directive: Other Provisions

- The ownership and the management of audit firms will be opened to statutory auditors of all Member States
- Auditors and audit firms in all Member States will be registered with the EU
- Basic principles of professional ethics and auditor independence are described and are very closely related to IFAC's.
- Member States will set rules for audit fees that ensure audit quality and prevent "low-balling"
- Auditors must use ISAs for all EU statutory audits. Member States can only impose additional requirements in certain defined circumstances.

Thank You for Your Attention

Any Questions?