Audit, Business Processes and Digitalization [BL 5]

Business Level II | CA Sri Lanka

Study Text

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Contents of the Curriculum

PART A: INTRODUCTION TO CORPORATE GOVERNANCE, RISKS AND CONTROLS

A.1: Corporate Governance

Corporate governance is the system by which companies are directed and controlled. Good corporate governance is important because the owners of a company and the people who manage the company are not always the same

Notes:

The importance of corporate governance

Corporate governance mainly assure best interest of owners/shareholders by maximizing the benefits of them. In addition, some of other benefits of practicing good corporate governance

- Provide better access to capital
- Aid economic growth
- Have a positive impact on stock prices
- Have a positive impact on performance
- Ensure that the business is fair and transparent
- Ensure that companies can be held accountable
- Lead to sustainability

Shareholder theory:

Stakeholder theory:

Agency theory:

Accountability:

Stewardship:

Conformance & performance:

OECD Principles of Corporate Governance

The OECD Principles of Corporate Governance set out the rights of shareholders, the importance of disclosure and transparency and the responsibilities of the board of directors

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined

OECD Principles of Corporate Governance

(a) To promote transparency, fair markets and efficient allocation of resources.

(b) To protect shareholders' rights and ensure all shareholders are treated fairly.

(c) To provide incentives relating to investment and to allow stock markets to function in a way that supports corporate governance.

(d) To recognize the rights of stakeholders and to encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of enterprises.

(e) To allow timely and accurate disclosure of material matters.

(f) To ensure companies are effectively guided and monitored.

Principles of the Code of Best Practice on Corporate Governance

A: DIRECTORS

The Board

A.1 Every public company should be headed by an effective board, which should direct, lead and control the Company.

Chairman and Chief Executive Officer (CEO)

A.2 There are two key tasks at the top of every public company – conducting of the business of the board and facilitating executive responsibility for management of the company's business. There should be a clear division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

Chairman's role

A.3 The chairman's role in preserving good corporate governance is crucial. As the person responsible for running the board, the chairman should preserve order and facilitate the effective discharge of board functions.

Financial acumen

A.4 The board should ensure the availability within it of those with sufficient financial acumen and knowledge to offer guidance on matters of finance.

Board balance

A.5 It is preferable for the board to have a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the board's decision taking.

Supply of information

A.6 The board should be provided with timely information in a form and of a quality to enable it to discharge its duties.

Appointments to the board

A.7 There should be a formal and transparent procedure for the appointment of new directors to the board.

Re-election

A.8 All directors should be required to submit themselves for re-election at regular intervals and at least once in every three years.

Appraisal of board performance

A.9 Boards should periodically appraise their own performance in order to ensure that board responsibilities are satisfactorily discharged.

Disclosure of information in respect of directors

A.10 Shareholders should be kept advised of relevant details in respect of directors.

Appraisal of CEO

A.11 The board should be required, at least annually, to assess the performance

B: DIRECTORS REMUNERATION

Remuneration procedure

B.1 Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his/her remuneration.

The level and make up of remuneration

B.2 Levels of remuneration of both executive and non-executive directors should be sufficient to attract and retain directors needed to run the company successfully. A proportion of executive directors' remuneration should be structured to link rewards to corporate and individual performance.

Disclosure of remuneration

B.3 The Company's Annual Report should contain a statement of remuneration policy and details of remuneration of the board as a whole

C: RELATIONS WITH SHAREHOLDERS

Constructive use of the AGM and conduct of the general meetings

C.1 Boards should use the AGM to communicate with shareholders and should encourage their participation.

Communication with shareholders

C.2 The board should implement effective communication with shareholders.

Major and material transactions

C.3 Further to complying with the requirements under the Companies Act, Securities and Exchange Commission law and Colombo Stock Exchange Regulations, as applicable, directors should disclose to shareholders all proposed material transactions which, if entered into, would materially alter/vary the company's net assets base or, in the case of a company with subsidiaries, the consolidated net asset base.

ACCOUNTABILITY AND AUDIT

Financial and business reporting (the annual report)

D.1 The board should present a balanced and understandable assessment of the company's financial position, performance, business model, governance structure, risk management, internal controls and challenges, opportunities and prospects.

Risk management and internal control

D.2 The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should have a process of risk management and a sound system of internal control to safeguard shareholders' investments and the company assets. Broadly, risk management and internal control is a process, affected by a company's board of directors and management, designed to provide reasonable assurance regarding the achievement of the company's objectives.

Audit Committee

D.3 The board should establish formal and transparent arrangements for considering how they should; select and apply accounting policies for financial reporting, determine the structure and content of corporate reporting, implement internal control and risk management principles and maintain an appropriate relationship with the company's auditors.

Related Party Transactions Review Committee

D.4 The board should establish a procedure to ensure that the company does not engage in transactions with 'related parties' in a manner that would grant such parties 'more favorable treatment' than that accorded to third parties in the normal course of business.

Code of Business Conduct and Ethics

D.5 Companies must adopt a code of business conduct and ethics for directors. Key management personnel and all other employees.

Corporate Governance Disclosures

D.6 Directors should be required to disclose the extent to which the company adheres to established principles and practices of good corporate governance.

E: INSTITUTIONAL INVESTORS

Shareholder Voting

E.1 Institutional shareholders have a responsibility to make considered use of their votes and should be encouraged to ensure their voting intentions are translated into practice.

Evaluation of Governance Disclosures

E.2 When evaluating Companies' governance arrangements, particularly those relating to Board structure and composition, institutional investors should be encouraged to give due weight to all relevant factors drawn to their attention.

F: OTHER INVESTORS

Investing/Divesting Decision

F.1 Individual shareholders, investing directly in shares of companies should be encouraged to carry out adequate analysis or seek independent advice in investing or divesting decisions.

Shareholder voting

F.2 Individual shareholders should be encouraged to participate in General Meetings of companies and exercise their voting rights

G: INTERNET OF THINGS AND CYBERSECURITY

G.1 The Board should have a process to identify how in the organization's business model, IT devices within and outside the organization can connect to the organization's network to send and receive information and the consequent cybersecurity risks that may affect the business. Internal and external parties could have computing devices embedded in everyday objects which may enable them to interconnect with the company's network to send and receive data. Such access could be authorized or unauthorized.

G.2 The Board should appoint a Chief Information Security Officer (CISO) with sufficient expertise, authority and budgetary allocation to introduce and implement a cybersecurity risk management policy which should be approved by the Board. The policy should include a robust cybersecurity risk management process, incident response system, vendor management system, disaster recovery plan and a governance structure to monitor effective implementation, reporting and the need for cybersecurity insurance.

G.3 The Board should allocate regular and adequate time on the board meeting agenda for discussions about cyber-risk management.

G.4 The Board should ensure the effectiveness of the cybersecurity risk management through independent periodic review and assurance. The scope and frequency of the independent periodic reviews could be determined based on the industry, vulnerability, company's business model and incident findings.

G.5 The Board should disclose in the annual report, the process to identify and manage cyber risks.

H: ENVIRONMENT, SOCIETY AND GOVERNANCE (ESG) ESG

Reporting

H.1 The Company's annual report should contain sufficient information to enable investors and other stakeholders to assess how ESG risks and opportunities are recognized, managed, measured and reported. Environmental, social and governance considerations can affect a company's ability to execute its business strategy and create value. While many ESG factors are 'non-financial', their management and likely impact have financial consequences. Hence they are important factors to be built into a company's business model, strategy, governance and risk management framework

Types of directors

Executive Directors

Involved in the daily management of the company, employed full time and receive a salary. Due to the close involvement in the running of the company they have a detailed knowledge of company operations and have a responsibility to present accurate information to the Board and stakeholders.

Non-Executive Directors

Not involved in the management of the company and should provide objective judgement on the issues faced by the company. They are independent of management in relation to strategy, performance and other management issues. They review the competence and performance of executive management.

Independent Non-Executive Directors

These are non-executive directors that do not have their independence compromised by the threats to independence we discussed earlier as defined in the code under A5.5 (such as serving for a long period or having material business relationships with the company).

Committees

The Code sets out four committees that should be established to assist the entity in acting in the best interests of the stakeholders. These are as follows:

- The Audit Committee
- The Remuneration Committee
- The Nomination Committee, in order to make recommendations to the board on all new board appointments
- The Related Party Transactions Review Committee, consisting of only non-executive directors. The committee should ensure that any related party transactions are captured and properly disclosed

Audit Committees

An audit committee can help a company maintain objectivity with regard to financial reporting and the audit of financial statements

Role and function of audit committees

An audit committee is a sub-committee of the board of directors, usually containing a number of independent NEDs. The role and function of the audit committee should be set out in written terms of reference and the extract from the Code that follows details what the roles and responsibilities of the audit committee should include

We will consider the advantages of having an audit committee. An audit committee can:

(a) Improve the quality of financial reporting, by reviewing the financial statements on behalf of the board

(b) Create a climate of discipline and control which will reduce the opportunity for fraud

(c) Enable the non-executive directors to contribute an independent judgement and play a positive role

(d) Help the finance director, by providing a forum in which they can raise issues of concern and which they can use to get things done which might otherwise be difficult

(e) Strengthen the position of the external auditor by providing a channel of communication and forum for issues of concern

(f) Provide a framework within which the external auditor can assert their independence in the event of a dispute with management

(g) Strengthen the position of the internal audit function, by providing a greater degree of independence from management

(h) Increase public confidence in the credibility and objectivity of financial statements

The board should establish an audit committee exclusively of non-executive directors with a minimum of three non-executive directors of whom at least two should be independent. If there are more non-executive directors the majority should be independent.

The committee should be chaired by an independent non-executive director. The board should satisfy itself that at least one member of the audit committee has recent and relevant experience in financial reporting and control.

The committee should have a written terms of reference dealing with its authority and duties which must address:

The committee's purpose – which at minimum must be to assist board oversight of the:

- preparation, presentation and adequacy of disclosures in the financial statements in accordance with LKAS
- compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements
- processes to ensure that the company's internal controls and risk management procedures are adequate to meet the requirements of the Sri Lanka Auditing Standards
- assessing the company's ability to continue as a going concern in the foreseeable future
- performance of the Company's internal audit function
- process to the identification, monitoring and management of significant risk
- independence and performance of the company's external audit

The duties and responsibilities of the audit committee which should be as a minimum:

- making recommendations to the board pertaining to appointment, re-appointment and removal of external auditors and to approve remuneration and terms of engagement of the external auditors
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken
- to review and monitor the external auditor's independence and objectivity and its effectiveness
- discussion of the audit plan, key audit issues and management responses
- review the Company's annual audited financial statements and quarterly financial statement with management and the auditor to ensure compliance with LKAS and other relevant laws and regulations
- to review significant financial reporting judgements
- review the company's earnings, press releases and financial information and earnings guidance provided to analysts and rating agencies
- discussion of policies and practices with respect to risk assessment and risk management
- to review the company's internal financial controls and review the company's internal control and risk management systems
- ensuring that a process of sound system of internal control is in place
- ensuring that once every three years a review of the board's risk management, internal controls, business continuity, planning and information systems are carried out, and appropriate remedial action recommended to the board
- ensuring that an effective internal audit function is in place and is monitored and reviewed
- meeting separately and periodically with management, auditors and internal auditors
- ensuring that there is a mechanism for the confidential receipt, retention and treatment of complaints alleging fraud, received from internal/external sources and pertaining to accounting, internal controls or other such matters

- ❑ assuring confidentiality to whistle-blowing employees
- ❑ setting clear hiring policies for employees or former employees of the auditors
- ❑ reporting regularly to the Board

Drawbacks of audit committees

Opponents of audit committees argue that:

(a) The executive directors may not understand the purpose of an audit committee and may perceive that it detracts from their authority.

(b) There may be difficulty selecting sufficient non-executive directors with the necessary competence in auditing matters for the committee to be really effective.

(c) The establishment of such a formalized reporting procedure may dissuade the auditors from raising matters of judgement and limit them to reporting only on matters of fact.

(d) Costs may be increased due to an increased need for staff and resources (for example in internal audit).

Internal control effectiveness

The directors of a company are responsible for ensuring that a company's risk management and internal controls systems are effective

Importance of internal control and risk management

Internal controls are essential to management, as they help to ensure:

- ❑ The reliability of the entity's financial reporting
- ❑ The effectiveness and efficiency of its operations
- ❑ Compliance with applicable laws and regulations

Good internal control helps the business to run efficiently. A control system reduces identified risks to the business. It also helps to ensure reliability of reporting and compliance with laws

Directors' responsibilities for internal control

The ultimate responsibility for a company's system of internal controls lies with the board of directors. It should set procedures of internal control and regularly monitor that the system operates as it should.

Setting up an internal control system will involve assessing the risks facing the business, so that the system can be designed to ensure those risks are avoided

Internal control systems will always have inherent limitations, the most important being that a system of internal control cannot eliminate the possibility of human error, or the chance that staff will collude in fraud.

Once the directors have set up a system of internal control, they are responsible for reviewing it regularly to ensure that it still meets its objectives.

Under the Code the board should employ an internal audit function to undertake this task.

External auditors' responsibilities for internal control

The auditors should review any statements made concerning internal control in the annual report to ensure that they appear true and are not in conflict with the audited financial statements. Under auditing standards the objective of the external auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement level and assertion levels through understanding the entity and its environment, including the entity's internal control

Chapter review questions

1. Briefly explain the meaning of the term 'corporate governance'.

2. Which of the following is not an OECD principle
   A. To ensure companies are effectively guided and monitored.
   B. To protect directors' rights and ensure all directors are treated fairly.
   C. To recognize the rights of stakeholders and to encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of enterprises.
   D. To allow timely and accurate disclosure of material matters.

3. Complete the blanks. An audit…………is a sub-committee of the…………. …… …………., usually containing a number of………….…………. directors.

4. When a company cannot easily find non-executive directors it should not have an audit committee. True or False

5. Why are internal controls important in a company?