AUDITING FUNDAMENTALS

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Exhibit 5.6 Key areas requiring internal and external audit input

- Monitoring of the executive in its decision-making process in terms of sound governance for the benefit of wealth creation for the shareholder and the general well-being of stakeholders in terms of corporate social responsibility
- Mechanisms for ensuring that management is accountable to shareholders and stakeholders
- Ensuring that companies are run properly and taking into account internal control and risk management
- Audit to show a true and fair view of the financial statements in order to comply with legislation
- Recognition of the important role that both internal and external auditors play in corporate governance
- Advisory role to the board and Audit Committee

- becoming involved in matters relating to auditor appointment and remuneration;
- providing auditors with access to the Audit Committee to discuss issues that may be sensitive to certain members of management.
- acting as a channel of communication between the corporate board for both the auditors;
- acting as a communication link between both sets of auditors where there may be a failure to interact or communicate with certain members of the executive.

The main areas requiring input for both internal and external audit, and therefore requiring a good working relationship, are given in Exhibit 5.6.

US legislation on corporate governance – the Sarbanes-Oxley Act (2002)

The Sarbanes-Oxley Act became US law in July 2002 and was largely a response to a number of major corporate and accounting scandals, such as those of Enron and WorldCom. The US Congress passed the legislation in an attempt to curb the likelihood of similar corporate collapses as a consequence of poor corporate governance. At the time of its inception, Sarbanes-Oxley was regarded as the most important legislative document in relation to corporate governance, financial disclosure and the practice of public accounting in the USA since the securities laws of the early 1930s. The Act requires company executives, directors and auditors to comply with greater corporate accountability and transparency. It affects the way companies operate, manage and report on their organisation.

In terms of its jurisdiction, the Act only applies to companies listed on the New York Stock Exchange, non-listed companies with 300 or more shareholders, and non-US corporations who are part of any company or group in the US required to comply with the Act. The Act focuses on issues such as the presence of controls within an organisation, the processes by which the Act is applied and the way that the data used is subject to audit verification. A major impact on companies during the first year of implementation was the cost of compliance.

An important aspect of the Sarbanes-Oxley Act is that companies recognise that adherence to the legislation means that they are now monitored more closely and that company information is more public than it was before. This has forced companies to review and improve their corporate governance, thereby enhancing the potential efficiency of the organisation by focusing attention on areas of risk and weaknesses and allowing the opportunity for corrective action.

The main provisions of the Sarbanes-Oxley Act are as follows:

- The establishment of a new Public Companies Accounting Oversight Board (PCAOB) with authority over registered public accounting firms (both inside and outside the US). This PCAOB examines auditing and audit standards, audit quality control and auditor independence. Effectively this removes self-regulation from the auditing profession.
- Section 2 establishes and regulates the relationship between the auditor and its clients, including the prohibition of the provision of a wide range of non-audit services to clients and introduction of mandatory audit partner rotation.
- Section 302 requires officers to certify that the financial statements and the information given to the external auditors are complete and fair.
- Section 404 requires companies to review the effectiveness of internal control over their financial reporting and to express an opinion. Many companies have established a project comprising the following stages:
  - documentation of processes and internal controls over financial reporting;
  - evaluation of internal controls over financial reporting;
  - redesigning the control framework and internal controls over financial reporting to address any gaps or deficiencies identified;
  - ongoing monitoring and testing of internal controls over financial reporting.
- Section 406 requires that companies disclose whether they have a code of ethics for senior financial officers, and Section 407 requires the company to disclose the name of the financial expert on the Audit Committee.
- The Act also dramatically increases criminal and civil penalties and sanctions for acts of financial fraud.

Sarbanes-Oxley, internal auditing and corporate governance

The legal requirement to comply with the Sarbanes-Oxley Act 2002 can indirectly point to the need for internal audit of processes and budgets in order to meet the requirements of the Act and the International Financial Reporting Standards (IFRS). This is because of the existence of strict penalties for non-compliance, which means that many companies have set up 'heads of compliance' jobs in order to ensure that compliance issues do not adversely affect business activity. These 'heads of compliance' can be viewed as internal auditors in disguise, where establishing an internal monitoring process can make regulatory compliance a simpler task.

There are four steps to ensuring an appropriate level of compliance:

1. Evaluating which levels within the organisation have an insight into status and the budgetary issues as and when they arise.
2. Being prepared to lead the change – there will inevitably be cultural impacts on the workforce (e.g. meeting the requirements of new IFRSs) and making employees aware of the impact of their role in these changes is important.

3. Ensuring an appropriate level of efficiency by educating personnel as to the importance of security of information, having an awareness of the sensitivity of information, as well as the levels of responsibility attached to the information. The need to meet these SOX compliance requirements will require a unification of processes, technology and people.
4. Automation and consolidation, transparency and accessibility to management information are key factors in compliance achievement. In addition there is a need to ensure that the risk of inaccuracy in management information is kept to a minimum.

An internationally accepted format for corporate governance

Internationally, codes, reports and frameworks have been issued by organisations such as the Canadian Institute of Chartered Accountants, Criteria of Control Board (CoCo), the Treadway Commission, Committee of Sponsoring Organisations (COSO), and the Organisation for Economic Co-operation and Development (OECD).

In terms of auditor role in corporate governance the OECD believes that the auditor should assess corporate governance regimes under five key areas:

- the rights of shareholders
- the equitable treatment of shareholders
- the role of stakeholders
- disclosure and transparency
- the responsibility of the board.

These issues do not necessarily mean that there should be a 'one size fits all' approach to corporate governance. Whilst establishing a standardised approach may in theory seem feasible when there are numerous multinational companies operating on a global scale, in reality a one-size-fits-all approach is not practical. Emerging economies wishing to play catch-up in the global market may find themselves in a situation where they have to introduce new corporate governance frameworks. These will inevitably test the robustness of any existing governance requirements. Companies dealing with different environments may find that embedded governance that is acceptable in one county may not be acceptable in another.

The world-leading corporate governance codes and rules of the UK and the US have distinct features, but they both represent fundamental frameworks that guide the way towards sound corporate governance. The main difference between the two is that the UK code is voluntary while the US is a mandatory code. There are arguments, however, in terms of developing an international code along the lines that the international accounting and auditing standards were developed.

In dealing with acceptability and robustness of a standardised code on governance, there are two distinct cultural aspects that can influence the development of an international corporate governance code. They are commonly referred to as the ideological structure and the socioeconomic structure. The *'ideological structure'* refers to societal norms and values such as collectivism, attitude towards time, professionalism, innovation, flexibility as well as the dominance of religion, sentiments, ethical principles, world views and ethos in society's everyday life. The 'socioeconomic structure' includes factors such as the political and legal systems, the power of the profession, the tax system, the education system and professional audit and accountancy training. Similarly, the extent of shared values and the degree of co-operation are determined by organisational co-ordinating activities and formality in the various socioeconomic systems. It is important, therefore, to recognise that norms and values can differ between groups even within a nation.

Limitations to the international acceptance of global corporate governance

There are a number of limitations to introducing a one-size-fits-all code for corporate governance. Specific measures can be introduced through legislation but there is no guarantee that they will work because very often there is a lack of funding available to allow the monitoring and enforcement of the codes that have been introduced. Appropriately skilled and qualified staff may be in short supply, as may resources to purchase equipment such as computers. The timeliness of audit review of financial statement audit reports cannot be assured to comply with specified time-frames which mean that any findings and possible remedial action may not be possible. The existence of legislation or a code of practice does not mean that citizens will behave morally. In circumstances where there are very few reinforcement agencies or a lack of penalties for non-compliance, the reality is that it may not operate as expected.

A network or circle of 'powerful' people can be very small and they are inevitably intricately knitted across political, business and social life. These factors will impact on the operation of sound governance in terms of expected independence, ethical behaviour and objectivity because friendships are important to 'get ahead'. Auditors will back-pedal on issues or decide to remain silent when controversial issues come to light. Even when changes in attitudes do occur, there will still be some key players in regulatory agencies that will have remained in place, making the implementation of expected codes of conduct impractical or unworkable.

A lack of transparency or a low rating on transparency in operations may exist because of traditional attitudes that exist. The accountability of public officers, including politicians and ministers of government, can be questionable due to personal greed and egotism. An attitude accepting insider trading and own stock trading by company executives as acceptable practice will not boost investor confidence or give a sense of fair play to stakeholders.

Cultural and economic factors will play a key influencing factor in how corporate governance frameworks are actually applied in practice. In countries with high unemployment, low savings and investment, and low salaries, the driving force may be survival and the exploitation of workers and stakeholders may become an acceptable practice. A few inter-linked families may own most of the businesses, and they may use their own version of a code of governance which they consider is a workable practice.

Boards of directors are charged with the role of ensuring the practice of good governance, but this may not be as straightforward as it seems because directors may be ignorant of their role and responsibility. Directors may never have received any training in governance or business. Their appointment may be dubious as they were appointed because of a 'favour' or friendship connections, and loyalties will undermine their objectivity. Often the 'uncomfortable' questions are not asked during board meetings which can undermine boardroom diligence. Very often there isn't a pool of competent directors (both executive and non-executive) available to choose from when vacancies arise on the board. The same individuals often sit on numerous boards, making it difficult for them to serve effectively as board members. It is difficult to ensure that there is a visionary chairperson on the board who can energetically promote their recommendations. It can often be difficult to have a board that reflects the main concerns and expectations of the stakeholders.

On the political horizon, governments are always looking for businesses to increase the economic prosperity of their countries, which will lead to a situation where governments will require businesses to comply with regulations and standards that can benefit both the company and the country as a whole. Very often governments will respond to the public demand for better control features, as happened with the initial corporate governance review in 1991 in the UK. Inevitably this will require better information and communication along with appropriate monitoring and review. This is key to corporate governance development which all takes time and often requires a change in attitudes and culture.

Summary

Corporate governance relates to the way a company is directed and controlled. Audit has a role to play in corporate governance by working effectively with the board, the Audit Committee and the executive. The provision of audit assurance in terms of reviewing the existence of internal control and the mechanisms for risk management contributes to the overall process of corporate governance.

? PRACTICE QUESTION

Is the UK system of corporate governance more effective than the Sarbanes-Oxley Act in preventing company fraud?

Chapter 6

Different approaches to investigation

Contents

Objectives

After studying this chapter you should be able to:

- understand and undertake a value-for-money review;
- discuss the auditor's possible role in undertaking a fraud investigation;
- discuss the role and importance of a statutory audit;
- describe voluntary audits;
- discuss the importance of social audits.