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AUDITING AND ITS ROLE IN CORPORATE GOVERNANCE

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Corporate Governance Defined

- **International Standard on Auditing (ISA) 260:** ***"Communications of Audit Matters with Those Charged with Governance"***
  - **Governance is the term used to describe the role of persons entrusted with the supervision, control, and direction of an entity.**
- **Depending on the jurisdiction, different bodies may have responsibility for corporate governance:**
  - **Board of Directors**
  - **Audit Committee**
  - **Other supervisory committees**
- **ISA 260 requires the auditor to determine those persons that are charged with governance**

Benefits of Good Corporate Governance

- Most direct benefit is to non-management shareholders.

- Ultimate benefit is the more efficient allocation of capital to its most productive uses.

Reasons for Corporate Governance Failures

- No governance system, no matter how well designed, will fully prevent greedy, dishonest people from putting their personal interests ahead of the interests of the companies they manage.

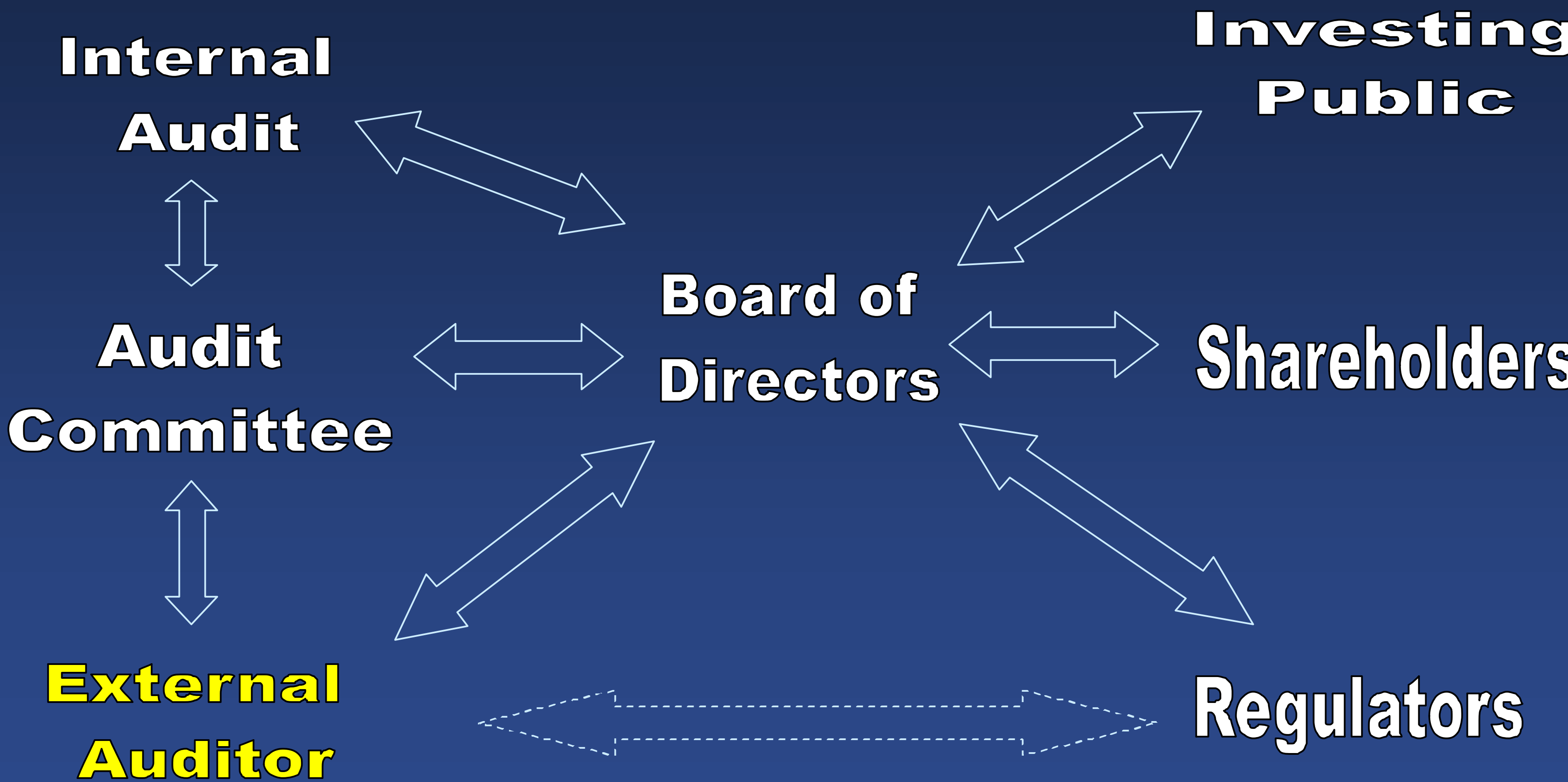
  - But many steps can be taken to improve corporate governance and thereby reduce opportunities for accounting fraud.

  - The auditing profession has an important role to play.

Where does the auditor fit in?

- The auditor does not have direct corporate governance responsibility but rather provides a check on the information aspects of the governance system.

Where does the auditor fit in?



Auditor's Role in Corporate Governance

- Corporate governance involves decision making, accountability, and monitoring.
  - Decisions require relevant and reliable information.
  - Accountability involves measuring, reporting, and transparency.
  - Monitoring involves systems and feedback.
- Auditor's primary role is to check whether the financial information given to investors is reliable.

Objective of an Audit

- To express an *expert opinion* on the fairness with which financial statements present, in all material respects, a company's financial position, results of operations, and cash flows in conformity with GAAP.

- To be able to express such an opinion, the auditor must examine the financial statements and supporting records using sound auditing techniques.

Reliance on Financial Statements

- People rely on financial statements to make economic decisions.
  - Especially people outside the enterprise.

- Audit provides confidence.
- Audit reduces uncertainty and risk.
- Audit adds value.

“Present Fairly in Conformity with GAAP”

- Why might financial statements NOT present fairly? Two main reasons:
  - ERROR.
  - FRAUD.

- Auditor’s role is to look for misstatements caused by either reason.

Focus on Internal Controls

- One reaction to corporate governance failures has been to focus on public companies' internal controls:
  - Sarbanes-Oxley Act (SOX) requires separate report on effectiveness of internal controls
  - Recent changes to ISAs place a much higher focus on the auditor understanding internal controls as part of the audit
  - Both ISAs and EU 8th Directive require reporting of material internal control weaknesses to Audit Committee

Reforms to ISAs

- Another reaction to the audit and corporate governance failures is the expected changes to ISAs dealing with:

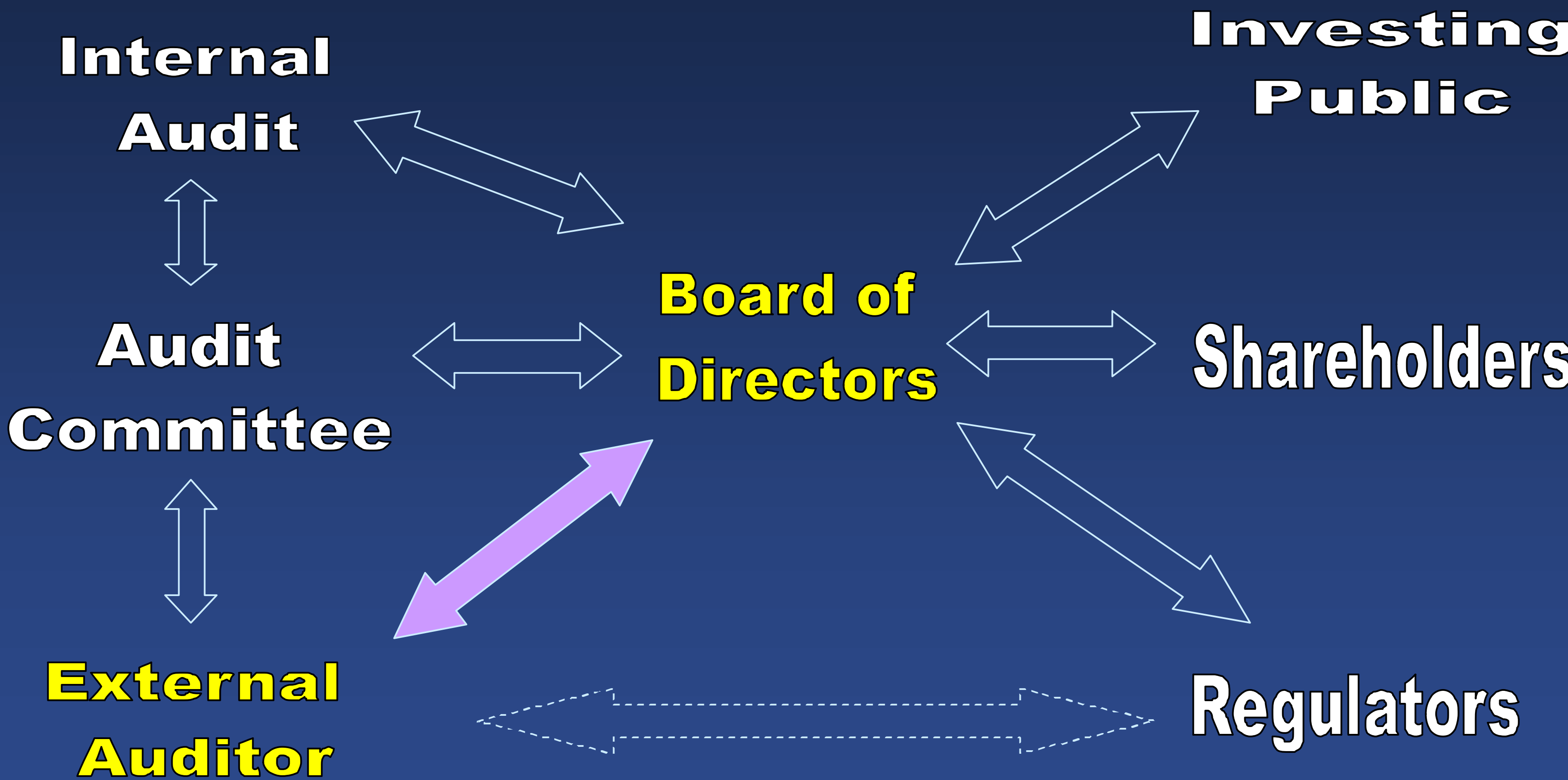
  - Group audits – requiring the group auditor to have a more intimate understanding of the entire group and its audit

  - Related parties – placing more responsibilities on the auditor to identify related party relationships and transactions

Auditing is a Public Responsibility

- **Public accounting firms offer many services to clients.**
- **Auditing is *different*.**
- **It involves a *public* responsibility that is more important than the employment relationship with the client.**

Relationship between the Board and the Auditors



Relationship between the Board and the Auditors

- To meet its obligations to shareholders, the board must ensure that it receives relevant and reliable information.
  - Auditor assists the board in achieving that goal.
  - There must be open and frank dialogue between the auditors and the board.

Relationship between the Board and the Auditors

- Auditor must be open (candid) in communicating with the board and its audit committee.
  - May have to say things the client does not want to hear.
  - May have to stand up to the client.

Audit Matters of Governance Interest

- SOX, EU 8th Directive and ISAs all require the auditor to communicate to the audit committee and the board about:
  - Approach, scope, limitations of the audit.
  - Going concern uncertainties.
  - Selection of and changes in accounting policies and practices.
  - Significant risks and exposures, such as litigation, requiring disclosure.
  - Disagreements with management that could affect the financial statements or audit report.

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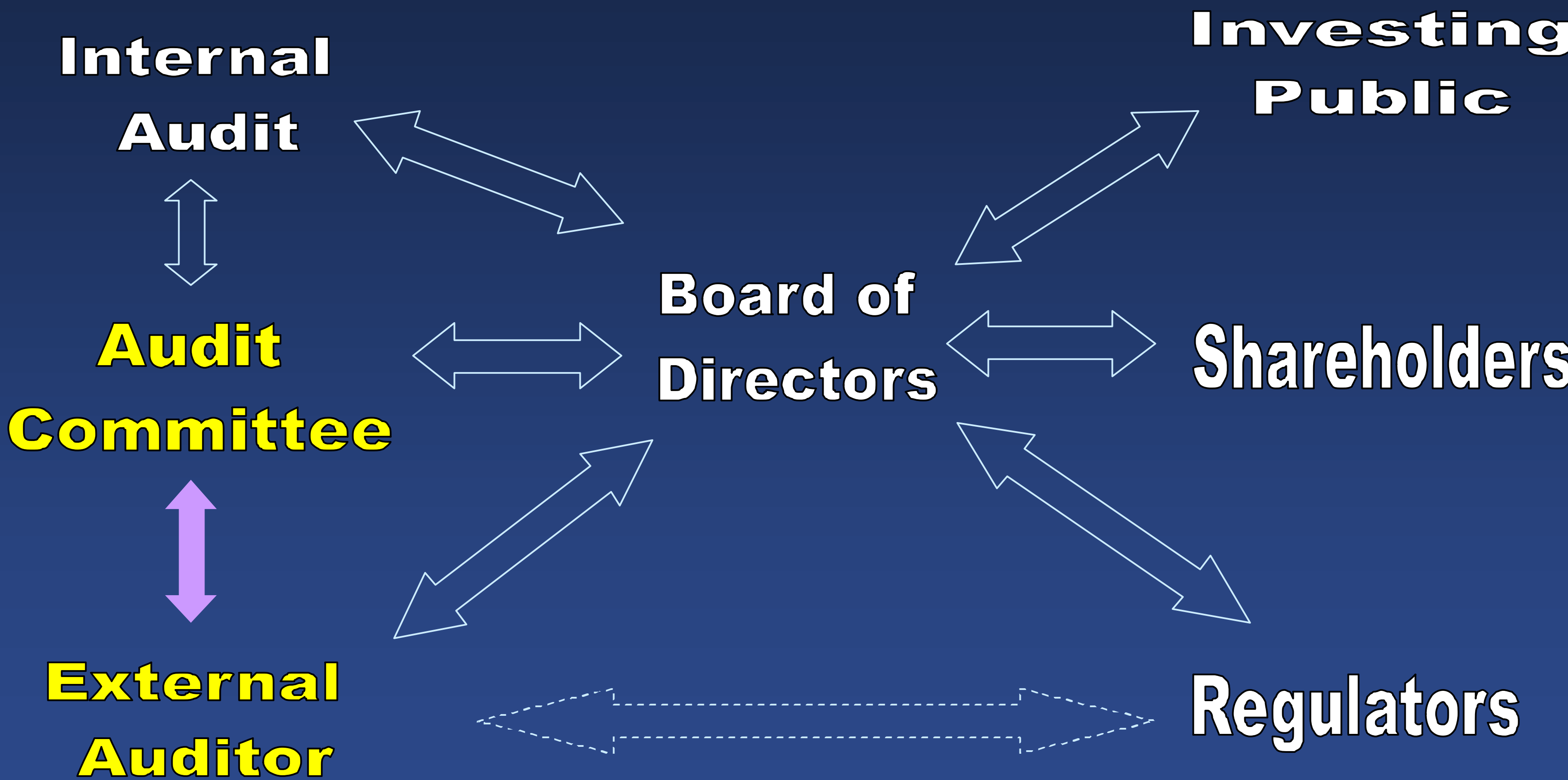
Audit Matters of Governance Interest

- **More communication items:**
  - Audit adjustments that could significantly affect the financial statements.
  - Weaknesses in accounting and internal control systems.
  - Expected modifications to the auditor's report.
  - Irregularities, fraud, non-compliance with law and regulations.
  - Other matters agreed in the terms of the audit engagement.

Relationship between the Board and the Auditors

- Auditors must express, to the board, their view on the *appropriateness* – not just the acceptability – of the accounting principles used or proposed to be used, and on the *transparency and completeness* of the disclosures.

Relationship between the Audit Committee and the Auditors



Relationship between the Audit Committee and the Auditors

- **An effective audit committee is a vital component of an effective corporate governance system:**
  - **The Audit Committee and the Auditors need to maintain an ongoing dialogue independent of management and the rest of the board**

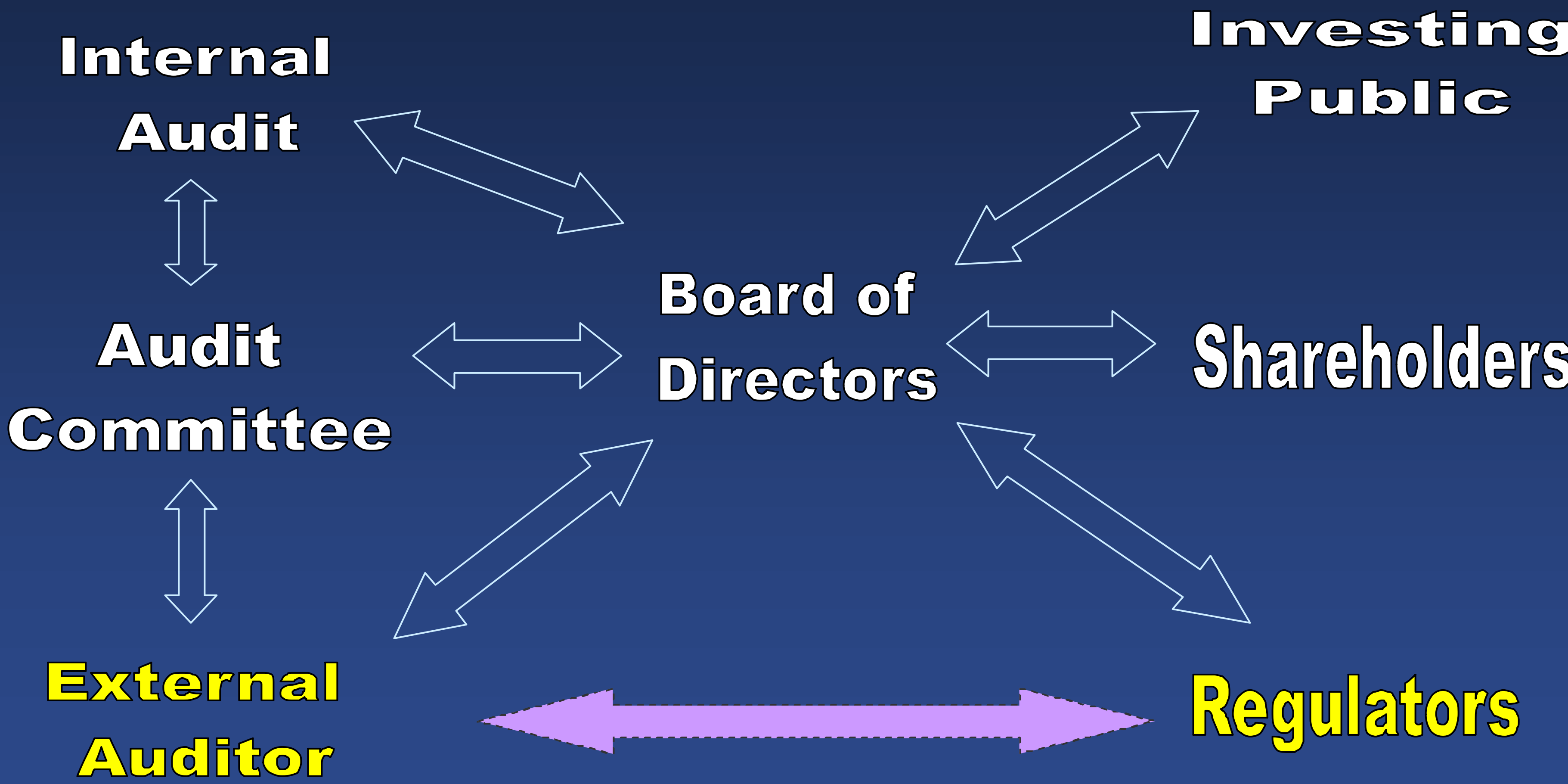
Audit Committees

- **Audit committees should:**
  - Include mainly non-executive directors.
  - Approve the appointment of the auditors.
  - Establish the audit fees.
  - Approve all non-audit services provided by the auditors (SOX).
  - Meet with the auditor independently of the rest of the board.
  - Review earnings releases and management's presentations to analysts.

Audit Committees

- Audit committee members must have "financial competence":
  - Minimum – a financial background.
  - Even better – qualified accountants.
- Better audit committee training is needed.
  - 1993 study by the Institute of Internal Auditors said this is the single most important key to audit committee effectiveness.

Regulation of Auditors



Regulation of Auditors

- Regulators are increasingly taking an interest in the activities of auditors evidenced by:
  - Regulation of the relationship between the auditors and the company (independence and freedom from conflicts)
  - Public inspections of audit firms (quality control systems within the firm and appropriateness of audit work)

Regulation of Auditors

- It is imperative that the auditor is perceived to be independent of the client
  - SOX adopts a rules-driven approach setting out prohibited services and requiring pre-approval by audit committee of non-audit services
  - International Federation of Accountants (and EU 8th Directive) apply a "threats and safeguards" approach
  - Rotation of audit partners every 5 years (SOX) or 7 years (IFAC)

Regulation of Auditors

- **Inspection of audit firms is important to enhance public confidence in audits**
  - **PCAOB expected to begin inspections in Asia next year**
  - **Most jurisdictions currently enhancing systems of oversight and inspection**

In Conclusion

- **The cost of accounting and audit failures is immense:**
  - **Immense in terms of skepticism about the auditors and the companies.**
  - **Immense in terms of litigation against the auditors and the companies.**
  - **Immense in terms of the survival of the auditors and the companies.**

In Conclusion

- The cost of accounting and audit failures is immense:
  - Immense in terms of misallocation of capital to companies that don't deserve it or that should be paying more for it.
  - And immense in terms of the investors and society.

Thank you for your attention.