AUDITING AND ITS ROLE IN CORPORATE GOVERNANCE

Bank for International Settlements
FSI Seminar on Corporate Governance for Banks
20 June 2006

Derek Broadley
Deloitte Touche Tohmatsu, Hong Kong
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?

- Internal Audit
- Audit Committee
- External Auditor
- Board of Directors
- Shareholders
- Investing Public
- Regulators
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

- 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.

continued…,
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

Internal Audit

Audit Committee

External Auditor

Board of Directors

Investing Public

Shareholders

Regulators
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

- **Internal Audit**
- **Audit Committee**
- **External Auditor**
- **Board of Directors**
- **Shareholders**
- **Investing Public**
- **Regulators**
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.