Chapter

6

# Corporate governance, ethics & internal audit



ACORN
PROFESSIONAL
TUTORS

## 6.1 Corporate governance

> "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals corporations and society"
>
> (Sir Adrian Cadbury in 'Global Corporate Governance Forum' World Bank 2000)

**The principal-agent problem**

Corporate governance addresses the principle-agent problem, found within large publicly quoted companies today. The 'principals' e.g. thousands of company shareholders, hire 'agents' e.g. a board of directors, to run the company and add value on their behalf e.g. maximise profit, dividends and their share price.

With publically quoted companies there exists a separation (or divorce) between ownership of the company e.g. shareholders/principles, and control e.g. stewardship of assets in the hands of directors/agents who run the company. The agent must promote the interests of the principle, which is normally that of profit maximisation; however the agent's personal interests may conflict with maximising returns to shareholders. This problem is not normally common in small companies, which are often private limited and owner-managed e.g. owner/shareholder, the same person(s) who run and control the company on a day to day basis, unlike shareholders of publically quoted companies.

**The role of directors (the agents)**

**Directors**

Someone who holds office or has been appointed by the company.

- **Accountability** e.g. board of directors must answer to a higher level authority, being the principle shareholders, who have the power to remove directors which have been appointed. They will be accountable for the stewardship of company assets.
- **Supervision and legal duties** e.g. board of directors must maintain adequate internal controls on behalf of the company.
- **Strategic direction** e.g. board of directors must formulate strategies and give strategic direction to the company.



ACORN PROFESSIONAL TUTORS

**Responsibilities of directors in making strategic decisions**

- **Fiduciary responsibilities** e.g. trust or in 'good faith' to act on behalf of the principle (shareholder) rather than in their own personal self interest.
- **Due diligence** e.g. to show reasonable competence or a duty of care to the company when managing it or making decisions, directors must have the skills, knowledge and experience required in order to carry out their duty of care.

Various mechanisms can be used to try to align the interests of an agent with that of the principal e.g. shareholders, in a profit seeking organisation.

- Profit sharing remuneration.
- Share ownership and/or share options.
- Regulations e.g. corporate governance, company legislation etc.

## 6.2 Some history of corporate governance scandals

**The Guinness share-trading fraud**

Ernest Saunders, the former Guinness chief executive, is famous for 'rubber stamping' a £2 million bonus e.g. approval of a bonus, by himself, for himself, without consulting the Guinness board. This raises a corporate governance matter of a dominant chairman or chief executive, being able to abuse their power for own self interest, the common principle-agent problem. Ernest Saunders was jailed for 5 years in December 2001, for false accounting, conspiracy, and theft. The Guinness share-trading fraud was a famous UK business scandal, Ernest Saunders and other board members, attempted to manipulate and overinflate the share price of Guinness, in order to assist a £2.7 billion take-over bid for Scottish drinks company Distillers.

**The collapse of Barings Bank**

The collapse of Britain's Barings Bank in February 1995 is a tale of financial risk management gone wrong e.g. inadequate internal controls. The failure of Barings was completely unexpected; Nick Leeson was the trader that managed to bring about this collapse. The main reason he was able to do this was because there was a fundamental weakness in the banks internal controls being a lack of segregation of duties. Leeson was responsible for the entire Singapore office (trading, back office and management) and was able to hide huge trading losses in the accounts whilst reporting healthy profits to his superiors in London. Other weaknesses in the controls lied with his superiors in London who did not properly interrogate and review the accounts and simply just accepted them for what they showed, and even gave Leeson bonuses for falsified profits in the accounts. In addition the auditors failed to bring to light these basic weaknesses in internal controls.



ACORN
PROFESSIONAL
TUTORS

**The collapse of the Mirror Group**

Robert Maxwell was a British media proprietor building an extensive publishing empire during the 1970s and 80s. The Mirror Group, collapsed after his death, due to discovered fraudulent transactions committed, which included the illegal use of the groups pension fund to support his business empire. This raises a corporate governance matter of a dominant chairman or chief executive, being able to abuse their power for own self interest, the common principle-agent problem.

**Investors misled by Shell Oil Company**

The more reserves an oil company has, the more valuable it is, therefore the share price will rise. Oil companies are required to list their reserves with the US financial markets regulator Securities and Exchange Commission (SEC) in the United States. The SEC regulates share trading to ensure that investors are not defrauded. The oil company Shell was telling the SEC that it had nearly 20 billion barrels of oil and gas reserves that were proven and commercially viable to exploit, when in fact the figure was nearer 16 billion. The chairman of Shell was Sir Philip Watts who resigned in disgrace.

**The Enron scandal**

The Enron scandal revealed in October 2001, involved the American energy company Enron and the accounting, auditing and consultancy firm Arthur Andersen, Arthur Andersen, was accused of applying lax standards in their audits because of a conflict of interest over the significant consulting fees generated by Enron. In 2000, Arthur Andersen earned $25 million in audit fees and $27 million in consulting fees. In December 2001, Enron filed for bankruptcy, this scandal caused the dissolution of Arthur Andersen, at the time, one of the five largest accounting firms in the world.

One consequence of these events was the Sarbanes-Oxley Act in 2002, raising criminal penalties for securities fraud, for destroying, altering or fabricating records to defraud shareholders. The company had been able to hide billions of dollars of debt by using off-balance-sheet financing through hundreds of partnerships. The hidden liabilities allowed Enron to maintain the appearance of a rapidly growing but financially stable company until the very end, when bankruptcy was imminent.

**The WorldCom scandal**

July 2002 US telecoms giant WorldCom shocked the business world by admitting a multi-billion dollar accounting fraud. The company directors used fraudulent accounting methods to mask WorldCom's declining earnings, painting a false picture of financial growth and profitability to prop up the price of WorldCom's stock. The fraud included under reporting of revenue costs by capitalising these costs on the balance sheet rather than properly expensing them through the income statement. Also directors were inflating revenues with bogus accounting entries.



ACORN
PROFESSIONAL TUTORS

**The credit crunch crisis**

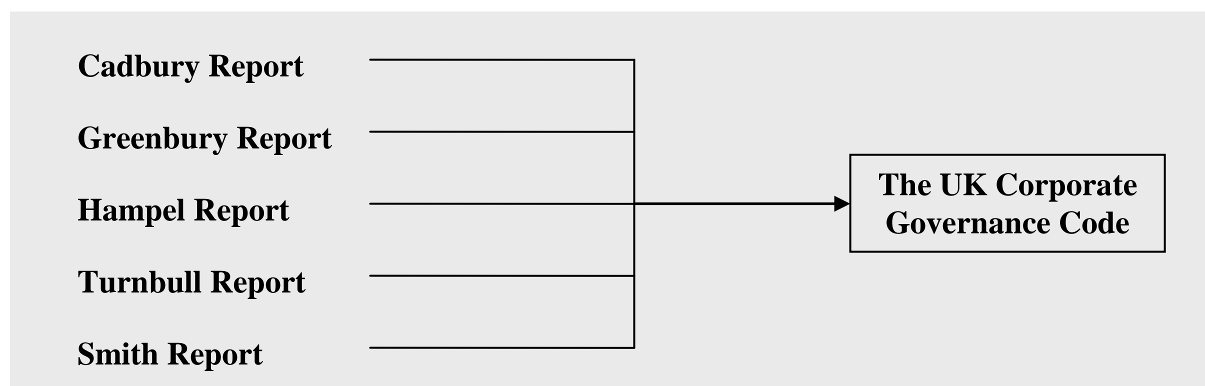
As seen in 2008, the collapse of Northern Rock, Bear Stearns and Lehman Brothers. Also the UK government's £37bn rescue package for Royal Bank of Scotland (RBS), Lloyds TSB and HBOS. Many UK banks bought bundles of the bad mortgage debt from US mortgage companies, directly or indirectly e.g. the so called sub prime market. When in the US, high mortgage defaults arose, banks lost money and had massive bad debt write offs. This caused interbank lending to freeze up e.g. credit crunch.

Northern Rock had lent many long-term mortgages by raising money on the short-term money markets, a very risky strategy. Most building societies borrow money on the open money market to service their mortgages e.g. 25 year mortgages advanced, and to finance it, borrow on a short term basis, perhaps 3 months or even overnight. The money markets froze up due to the credit crunch and Northern Rock run out of funding, off particular concern here is the failure of the risk management policies (internal controls) and therefore corporate governance policies by such organisations.

## 6.3 Corporate governance reporting and recommendations

In recent years, high profile frauds and poor business practice (Polly Peck, BCCI, Maxwell Group, Barings, WorldCom, Enron) has led to doubt being cast over the way directors manage companies. This has led to the stock exchange commissioning a series of reports to help management to achieve better practice.

The following are 'voluntary' codes of conduct for good corporate governance in the UK e.g. recommendations for the conduct of a companies board of directors. These recommendations are about promoting company fairness, transparency and accountability to shareholders. These recommendations only apply to publically quoted companies and are voluntary, however non-compliance, and a board must disclose with the financial statements how and why they have not complied with such recommendations.






ACORN PROFESSIONAL TUTORS

**Cadbury committee report**

Introduced three principles for the spirit of its recommendations e.g. openness, integrity and accountability of directors to shareholders. Formed (and chaired by Sir Adrian Cadbury) in 1991 from recommendation of the London Stock Exchange and Financial Reporting Council (FRC). Much critism existed about corporate governance matters at this time, press coverage of 'fat cat' directors 'milking' companies, as well as the lack of information being presented to shareholders, was being scrutinised heavily by the media.

A report was published in 1992 recommending changes to corporate governance in the UK. The Cadbury code recommended companies should raise their standards of internal controls, become more answerable to stakeholders not just shareholders and behave in a more ethical and responsible manner. Even though the code is voluntary, companies had to explain within their annual published accounts the extent to which they have complied with this code and give reasons for any non-compliance.

The Greenbury Report (published in 1995) followed after the Cadbury report, and was prompted by growing public concern about the growth of executive remuneration, especially to departing directors e.g. 'golden handshakes' such as large severance packages or lavish pensions and bonuses.

**Summary of Cadbury and Greenbury report**

- Split the chairman and chief executive roles for greater 'dual authority'. This helps 'dilute' power that often rests with dominant and key board members.
- Regular and more formal meetings to improve effectiveness of the board.
- Director's contracts limited to one year. Director's remuneration clearly shown within the published accounts for greater transparency.
- Pay awards to be decided by a remuneration committee assisted by non-executive directors only e.g. not employed full-time by the company and present in an advisory role, not executive directors. For greater independence when determining director remuneration.
- Establish an audit committee to be assisted by non-executive directors only. To create 'Chinese walls' and prevent accounting, auditing and consultancy firms applying lax standards in their audits, because of a conflict of interest over the significant consulting fees often generated. This enables greater independence of auditors when reporting to shareholders.
- Every company should have at least 3 non-executive directors as members of the company board, who can bring their experience and judgement from outside the company. This would enable more 'dilution' of control and influence from the executive directors.

**Summary of Hampel report (1996)**

- Directors to obtain the 'right balance' of non-executive directors, receive timely information, are formally appointed and be re-elected at least once every 3 years.
- Formal procedure for director's remuneration and the disclosure of full remuneration of directors within the annual published accounts.
- More encouragement to communicate more effectively with shareholders namely institutional investors.

The Hampel report incorporated the recommendations from both the Cadbury and Greenbury Committees, as well as amendments from the London Stock Exchange; it was published as the Combined Code in June 1998.

**Stock exchange combined code report (1998)**

- Companies can combine the chairman and chief executive role but must justify with reasons.
- Promoted a strong and independent 'non-executive' element for a board of directors.
- Remuneration committee to consist entirely of 'non-executive' directors.

**The Turnbull report (1999)**

The Turnbull report recommended full compliance with the Combined Code and Listing Rule requirements. Those companies with accounting periods ending on or after 23rd December 1999 should have established procedures to implement the combined code.

It also focussed on the review of internal controls and importance of a risk management framework.

**Higgs report (2003)**

- Focuses on the role of the non-executive.
- Non-executives have the inconsistent role of both reviewer of executives and working with executives to consult on strategy for the company.
- Non-executives should have four roles:
  - **Strategist** – challenge, help and develop company strategy.
  - **Performance** – has mgt met agreed goals and objectives?
  - **Risk** – is the financial information accurate and are the financial controls and risk management systems adequate?
  - **People** – to determine remuneration of the executives and a main role in appointments, removals and successions of executives.
- Board performance evaluation should be devised by the chairman.
- Should improve effectiveness, promote strengths and address weaknesses.
- Overall board performance disclosed to board, but individual performances are confidential.



ACORN PROFESSIONAL TUTORS

**Smith report (2003)**

- Focuses on the audit committee.
- Chairman cannot be a member of the audit committee.
- At least one qualified member with relevant experience should be on the committee.
- Appointments should last for 3 years but extendable.
- Committee should be independent of management to protect interests of shareholders.
- Any disagreements should be resolved at board level.
- At least three meetings a year (audit plan review, interim statement review, full annual report review).
- At least once a year with the external and internal auditors without management present to discuss audit issues.
- Key roles are oversight, assessment and review, not preparing financial statements (mgt responsibility) or preparing the audit plan and carrying out the audit (auditor responsibility).
- The committee should review the company's internal financial controls.
- The committee should monitor and review the internal audit function.
- The committee is responsible for the oversight of the external auditors and have procedures to ensure their independence.
- Chairman of the committee should be present at AGM to answer audit related issues.
- Details of the committee's role, names and qualifications of members, how responsibilities were discharged, non-audit services provided by external auditors and how independence was safeguarded.

Corporate governance issues are still under reform considering whether aspects of the report should be made legal as company law. This has meant already a lot of time and money already spent by companies trying to comply with these codes. Quoted companies have to comply with the combined code or disclose non-compliance.

**UK Corporate Governance Code (2012)**

The UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. The latest edition published September 2012. The main principles of the code include:

**Section A: Leadership**

- Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.
- There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.
- The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.
- As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.



ACORN PROFESSIONAL TUTORS

**Section B: Effectiveness**

- The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.
- There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.
- All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.
- All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.
- The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

**Section C: Accountability**

- The board should present a fair, balanced and understandable assessment of the company's position and prospects.
- The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.
- The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting, risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors.

**Section D: Remuneration**

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose.
- A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.
- There should be 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 or her own remuneration.

**Section E: Relations with Shareholders**

- There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.
- The board should use the AGM to communicate with investors and to encourage their participation.

**Source:** The UK Corporate Governance Code (September 2012)



ACORN
PROFESSIONAL TUTORS

**Principles of good governance**

| Directors | Directors Remuneration | Relations with Shareholders | Accountability and Audit |
|---|---|---|---|
| • **The Board**<br>Effective to lead and control the company. | • **Level and make-up of remuneration**<br>Sufficient to attract and retain but not more than necessary.<br><br>A proportion linked to performance. | • **Dialogue with institutional shareholders**<br>Ready to enter into dialogue. | • **Financial reporting**<br>Present a balanced and understandable assessment of the company's position and prospects. |
| • **The Chairman & CEO**<br>Clear division of responsibilities to ensure balance of power and authority. | • **Procedure**<br>Formal and transparent for developing policy and fixing remuneration of each director. | • **Constructive use of the AGM**<br>To communicate with private investors and encourage their participation. | • **Internal control**<br>Maintain a sound system of internal control. |
| • **Board balance**<br>Executive and non-executive (including independent non-executive). | • **Disclosure**<br>Remuneration policy details of the remuneration of each director. | | • **Audit committee and auditors**<br>Formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the auditors. |
| • **Supply of information**<br>Timely and of appropriate quality. | | | |
| • **Appointments**<br>Formal and transparent procedures. | | | |
| • **Re-election**<br>All directors at regular intervals and at least every three years. | | | |

**Benefits of good corporate governance**

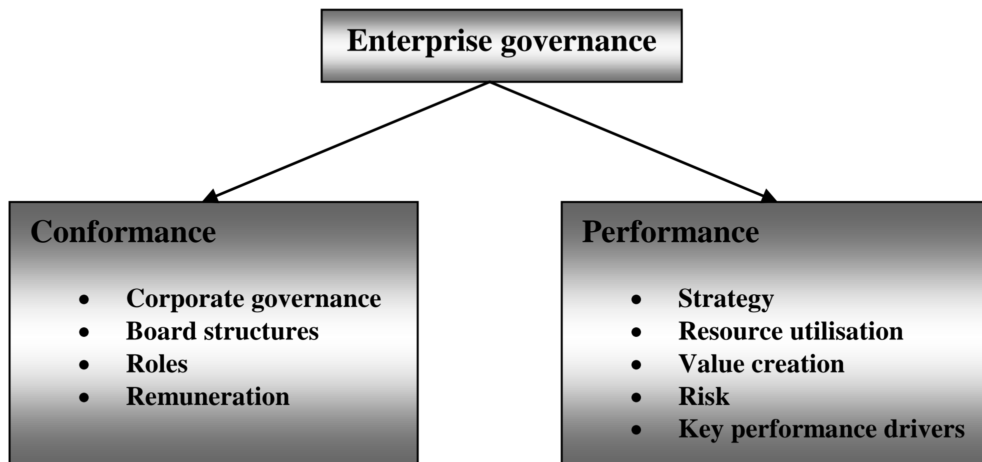
- Decreases the risk of companies failing as a proper analysis of risk has been conducted and mitigated through effective internal controls.
- Promotes performance in companies as rewards are given for genuine increases in wealth for the company.
- Transparency, openness, accountability and honesty to public.
- Better leadership through clarity of understanding what is expected of employees.
- Better access to capital markets as financial institutions are more willing to accept the financial information to be reliable and accurate.



ACORN PROFESSIONAL TUTORS

**Enterprise governance**

This a report published by CIMA and IFAC in 2004 *“Enterprise governance: Getting the balance right”*.




In the case studies conducted by CIMA and IFAC the main findings were:

- Successful companies had good corporate governance being intrinsic in the culture of the company driven throughout the company from the top being the CEO, board of directors and strong internal controls.

- Good corporate governance on its own cannot ensure the success of a company.

- Needed in addition:

  - Choice and clarity of strategy.
  - Strategy execution.
  - Fast response to changes in environment.
  - Successful mergers and acquisitions.

- Recommendation was to have a strategy committee to review the above and report to the board, just like the audit committee does for conformance areas.



ACORN PROFESSIONAL TUTORS

## 6.4 International perspective

### The OECD guidelines for multinational organisations

This is of paramount practical concern for policymakers, managers, accountants and others since they are affected by the regulatory regimes and changes of regulations on a daily basis in their working environment. The **organisation for economic co-operation and development (OECD)** carried out consultation with member countries to develop a set of principles that all members must work towards. These 'voluntary' recommendations to multinational enterprises were in all the major areas of business ethics, including employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, fair competition, and compliance to taxation regulations.

### Corporate governance aspects of OECD guidelines

- Rights of shareholders e.g. election of the board of directors, using one share equals one vote principle for all shareholders at General Meetings.
- Equitable treatment of shareholders e.g. the minority interests..
- Equitable treatment of all stakeholders e.g. addressed the role of creditors and employees.
- Disclosure of reliable and relevant information e.g. accurate and timely information for users of published information.

### Developments in the US

### Sarbanes-Oxley Act (2002)

- It is a legal requirement for all companies with a US listing.
- Attempts to address auditor independence and corporate governance issues.
- Places restrictions on the nature of non-audit services that can be performed by auditors.
- Audit committees approve any allowed additional services.
- Audit committee members should be independent, and are responsible for the appointment, remuneration and overseeing of external auditors.
- Audit committee must establish rules for the protection of whistleblowers.
- CEO and CFO must personally certify the accounts to be accurate.
- CEO and CFO must also certify quarterly accounts and annual accounts to be accurate and fair.
- CEO and CFO must also report on the effectiveness of internal controls.

- CEO and CFO lose their bonuses for the last year if the accounts have to be re-stated because of non-compliance with reporting standards.
- Off-balance sheet transactions must be disclosed and their material impact.

**Developments in the UK and other countries**

Announced by the UK government:

- Senior external auditors allowed max of 5 years to work on a single company's books.
- New voluntary rules that will stop partners and senior employees of external audit firms moving to jobs within the companies they have audited for two years.
- Single regulator for accounting and auditing standards will be created.
- Corporate Governance - 50% of the board members and chairman should be independent.
- Separation of chairman and chief executive roles to be reinforced.
- FSA to get new powers to identify and investigate companies with "high risk" accounting standards.

France announced rules on restricting non-audit services being performed.

In South Africa there was the **King Report (2002)**

- Broader stakeholder approach to governance.
- Considers social, environmental, economic aspects of company activities (HIV/AIDS impact, black economic empowerment, equal opportunities and human capital development)
- Accountability and independence of the board emphasised more.
- Delegation did not diminish ultimate responsibly of the board.
- Board is responsible for risk management process, which includes internal audit.
- Openness and substance over form.

Despite these measures many believe we are still along way from preventing financial scandals like Enron occurring. Corporate governance if followed would not stop companies getting into problems or collapsing; however a company not following good corporate governance is more likely to fail.

> "No regulatory system, however stringent, can provide against the consequences of human greed, folly or corruption"
>
> Tim Yeo (Shadow Trade and Industry Secretary)

**Corporate governance in less developed countries**

Very few studies have been published on corporate governance, accounting and auditing practices and economic development in less developed countries. Recent studies on accounting in less developed countries argued that developing accounting infrastructure including corporate governance would promote economic development e.g. investors seeking to invest will have more confidence. Some less developed, emerging and transitional economies, have been induced by the World Bank and IMF, and have embarked upon structural adjustment programmes, including capital market reforms and improvements to corporate governance mechanisms.



ACORN PROFESSIONAL TUTORS

A fuller understanding and implementation of corporate governance can help contribute to economic reform and prevent unexpected and unsought consequences of imposed corporate governance frameworks from the West.

Despite these measures many believe we are still a long way from preventing financial scandals like Enron occurring. Corporate governance if followed would not stop companies getting into problems or collapsing; however a company not following good corporate governance is more likely to fail. No regulatory system, however stringent, can provide against the consequences of human greed, folly or corruption.

**Example 6.1**

**Why should good corporate governance exist within organisations?**

**Example 6.2 – (CIMA past exam question)**

**Explain the role and responsibilities of the Board of Directors with respect to corporate governance in the UK.**

**Explain the role and responsibility of the audit committee with respect to corporate governance in the UK.**

**Example 6.3 – (CIMA past exam question)**

**Identify the key reasons for the emergence of corporate governance regulations around the world.**

**Disclosure of corporate governance arrangements**

The main disclosure requirements within the annual published accounts are as follows:

- A statement on how UK corporate governance was followed and principles applied so that the readers of the accounts can draw their on conclusions.
- A statement which explains the extent to which UK corporate governance was followed by the directors and explanations for any non-compliance of the requirements.
- Although UK corporate governance is a voluntary code of compliance and not a legal requirement unlike in the USA, most listed companies do comply with it as the City and the public at large do not favour companies that do not comply.



ACORN PROFESSIONAL TUTORS

- An explanation of the directors responsibilities in preparing the accounts and that they have performed the necessary work to conclude that the business is a going concern.

- A statement explaining that the internal controls have been reviewed and have been effective for the period of account in mitigating all risks.

- Details of the members of the board of directors and their responsibilities and attendance to board meetings.

- The names of the senior non-executive, chairman and chief executive.

- The independence of the non-executives and meetings they have attended.
- Information about additional services provided by the external auditors and measures taken to ensure that there is no infringement of their independence.

- Explanation of the board's regular acknowledgement of the shareholders views and the state of relation.

- Performance evaluation techniques used and explained to assess the board and committees.

## 6.5 Ethics and social responsibility

**Ethics** means rules or morals about the right behaviour and way of conduct e.g. ideas about what is right and wrong.

**Corporate social responsibility (CSR)** means being aware of the impact of actions on others, and to act in the best interests of society e.g. third parties not directly involved in any economic transaction.

Ethics is concerned with rules or morals about the right behaviour and the way an organisation conducts itself e.g. ideas of what is right and wrong. Ethics within organisations can be about free flow of information to stakeholders, owing a duty of care to them. Many organisations have implemented integrity-based programmes to encourage ethical behaviour.

1. Promoting ethical behaviour to staff
2. Ethics committees to monitor and control ethical practices
3. Written codes of behaviour
4. Protection for whistle blowers

Ethics is the code of moral principles about what is right and wrong in an organisation or society and culture plays a big part. Law does not necessarily enforce it or government organisations. Many national cultures will contrast enormously when it comes down to what is acceptable and unacceptable conduct or action.



ACORN PROFESSIONAL TUTORS

Unethical behaviour is about dishonesty, hypocrisy, aggression or exploitation.

- Fraud, corruption or deception
- Dishonesty when advertising
- Abuse of the responsibility given to directors

**Corporate Social Responsibility (CSR)**

The corporate social responsibility (CSR) definition is very diverse. Although Corporate Social Responsibility (CSR) does not have a generally agreed definition, it is about being sensitive to the needs and wants of all organisational stakeholders, not just shareholders. CSR is about corporate philanthropy e.g. charitable giving, community relations and community development. CSR is about organisation's 'corporate conscience' or good 'corporate citizenship', using sustainable practices and a general sense of social responsibility. CSR attempts to maximise the positive and minimise the negative in terms of the impact that its decisions will have upon its stakeholders.

**The four dimensions (nature) of CSR**

The four dimensions of CSR evolved as a framework to group sustainable practices into a set of logical categories. It can be remembered using the acronym **'PEEL'**, standing for **P**hilanthropic, **E**conomic, **E**thical and **L**egal.

- **Philanthropic.** Meaning "the love of humanity" such as charitable giving and partnerships with charities. McDonalds over recent decades has created a number of different charities aimed at improving the health and well-being of children directly.

- **Economic.** How the organisation contributes to the development of the local economy in which it operates. This responsibility can include 'paying' not 'avoiding' taxes, recruiting staff primarily from the local area the organisation operates and funding local community projects.

- **Ethics.** Ethics is about integrity, to always do the right thing e.g. truthfulness and honesty. Business ethics comprises principles that govern behaviour in the world of business e.g. the CIMA code of ethics. Ethics underpins the concept of Corporate Social Responsibility (CSR). This dimension could include the way the organisation treats its staff, customers or suppliers, for example 'fair' pay and 'safe' working conditions for staff, zero tolerance for use of child labour in the supply chain and 'Fair Trade' schemes to support suppliers in poverty. Opinions about what is morally "right" and what is morally "wrong" when analysing ethics is a subjective concept, it can vary between different national and organisational cultures.

- **Legal.** How the organisation complies with laws and regulations. The 2010 US environmental catastrophe involving the BP Oil Company, was allegedly caused by BP minimising its US health and safety regulations, the explosion resulting in 10 staff losing their lives. News Corp, the media company, faces hundreds of civil claims by phone-hacking victims due to illegal voice-mail interception by the now-closed News of the World tabloid. The legal dimension is not just about compliance to laws, organisations with high integrity should be more proactive, supermarkets could



ACORN
PROFESSIONAL TUTORS

abolish free disposable plastic carrier bags even though legal in the UK, to minimise carbon footprint and could discourage excessive purchasing of alcohol by its shoppers for social good ‘without’ waiting for laws to be passed such as minimum pricing.

**Examples of ethical or social responsibility issues**

- Fair competition within industries e.g. controlled by watchdogs like the office of fair trading (OFT) or the Competition Commission within the UK.
- Fair claims within advertising e.g. controlled by watchdogs like the advertising standards authority (ASA) within the UK.
- Socially undesirable goods being produced e.g. tobacco, alcohol, hazardous ingredients etc.
- Duties or responsibilities towards the wider community or society that organisations have e.g. to reduce ‘carbon footprint’ by lowering carbon emissions and recycling.
- Poor treatment of staff or customers.

Press coverage in the past has included poor treatment of asbestos victims, poor working conditions, employment law breaches or environmentally unfriendly waste or pollution not being properly disposed of. The concept of ethics and social responsibility is very far reaching. It can also be socially enforced by the expectations of society not just by legislation or government policy e.g. the poor corporate image of McDonalds when promoting unhealthy foods to young children, led to more healthy eating options for young children.

**A case history of ethics**

In the 1980s Perrier received adverse media and public attention about the scare that Perrier bottled water was contaminated and withdrew their product off the shelf immediately. They suffered lost business in the short-term but their reputation and face with the public remained untarnished, improving the brand and profits of the company in the long-term.

In 2004 ‘Dasani’ a bottled water brand trademarked by Coca-Cola was labelled by the press as ‘Peckham Spring Water’ with Media attention focused on the marketing of the brand as "one of the purest waters around" however it was being manufactured and bottled by using ‘treated’ south-east London tap water. Dasani sold for 95p per 500ml, Thames Water, which supplies homes in the area where the product was sourced and bottled, sold the water at the equivalent of 0.03p per 500ml.

**Advice on how to be more ethical and socially responsible**

- Good public relations.
- Protection of the ecological environment from pollution e.g. materials and components bio-degradable or recyclable.
- Control energy consumption, waste and emissions
- Recycle all packaging material used
- Support charities and the local community
- Good conditions of work provided for employees e.g. health and safety, minimum wage, maintain adequate controls over disease, accidents or fatalities at work.



ACORN PROFESSIONAL TUTORS

- Be proactive about ethics e.g. 'Fair Trade', the Body Shop marketed its whole persona on ethical practices.
- Embody ethical culture through a mission statement and training.
- Set and publish aims and objectives to achieve greater CSR.

**Bennett and James 'areas of environmental responsibility'**

- **Production** e.g. minimising waste.
- **Environmental auditing** e.g. to comply with legislation and take a more proactive ethical stance.
- **Ecological approach** e.g. minimising waste throughout the entire value chain.
- **Quality** e.g. targets to reduce environment waste and emissions.
- **Accounting** e.g. accounting for the social costs to third parties within investment appraisal decisions.
- **Economic** e.g. economic charges for any social cost created by a division within a group to encourage minimisation.

**Example 6.4**

**What are the arguments for and against an organisation being more socially responsible?**

## 6.6 Ethics for members of CIMA

In March 1992 CIMA adopted an amended version of the International Federation of Accountants (IFAC) *"guidelines on ethics for professional accountants"* for professional ethics and behaviour code for members. Within other professions there are the same standards of behaviour. The conduct of your professional affairs (standard of behaviour and competence) – with sanctions if not met!

- **Integrity** – You should be honest and truthful about all issues and deal fairly in all your professional and business relationships. Integrity implies fair dealing and truthfulness. This principle for example would be in breach if you were to falsify or produce misleading information, or by your own deliberate omission of information mislead a user.

- **Objectivity** – Intellectual objectivity should be exercised when considering an issue in mind. Not allow bias, a conflict of interest or undue influence from others to override or compromise your professional or business judgment. Be sceptical and verify sources of information when presented to you and never 'subjectively' present information for anyone else's or your own personal or gain.

- **Confidentiality** – Not to disclose any information obtained by the client or employer to third parties without proper and specific authority, unless a legal or professional right or duty to disclose. Also not to use information for personal advantage e.g. insider dealing.

- **Professional behaviour** – You should always conduct yourself politely and courteously with everyone. To comply with relevant laws and regulations and avoid any action that discredits your profession and brings your profession into disrepute. Professional accountants when marketing and promoting themselves should be honest and truthful and not make 'exaggerated claims' they are unable to offer, the qualifications they possess, or experience they have gained. They should also refrain from making any disparaging references or unsubstantiated comparisons to the work of others.

- **Professional competence and due care** – Work should be undertaken with expedience and where your expertise or experience may shortfall support should be sought from experts to complete the work. Under no circumstances should you attempt to do work where you do not have the expertise or experience to complete it.

  To maintain professional knowledge and skill at the level required to ensure that the client or employer receives competent professional services and to act diligently and in accordance with applicable technical and professional standards.

  This principle also requires attainment and maintenance of professional competence, such as continuing professional development (CPD) in order to remain up-to-date with changes in the technical environment. A professional accountant should make their own limitations known to the client, employer or other users when information or advice is provided.

**Code of conduct ensures**

- A positive global image to CIMA e.g. 'high standard of conduct' promoting the integrity of the CIMA qualification.
- Protection for public interest.
- An untarnished image for CIMA or CIMA members e.g. prevention or limitation of adverse media attention from any malpractice.
- Repeat business in the long-term for CIMA and CIMA members e.g. enhances the employability of CIMA members. Higher salaries to CIMA members.

**Conflicts of interest**

- An overbearing manager compromising your integrity.
- Being asked to ignore some aspects of a technical standard.
- Divided loyalties between colleagues and professional standards.
- Employer publishes misleading information to benefit him and may benefit you.
- Not having adequate expertise or experience to carry out a piece of work or give advice.



ACORN
PROFESSIONAL
TUTORS

**Resolving conflicts of interest**

- Discuss the issue with your superior if it is to do with a colleague.
- Discuss the issue with the next level of management if it involves your superior or human resources if it involves your superior.
- Use the company's internal procedures for "whistle blowing" if available.
- Contact CIMA for advice on the issue and possible courses of action.
- If discussions with superiors do not lead to resolution then consider resignation as final solution, with written reasons to employer.
- Throughout the entire conflict ensure that tact and confidentiality is maintained unless legally obliged to divulge.

**Example 6.5**

**How can companies help to communicate an ethical code of conduct?**

**Approach to answering ethics questions**

- Establish the facts briefly.
- Consider options and courses of actions.
- Consider breached ethical guidelines.
- Decide on the best course of action.



ACORN PROFESSIONAL TUTORS

**Example 6.6 – (CIMA past exam question)**

As a CIMA member, you have recently been appointed as the Head of Internal Audit for SPQ, a multinational listed company that carries out a large volume of internet sales to customers who place their orders using their home or work computers. You report to the Chief Executive, although you work closely with the Finance Director. You have direct access to the Chair of the Audit Committee whenever you consider it necessary.

One of your internal audit teams has been conducting a review of IT security for a system which has been in operation for 18 months and which is integral to internet sales. The audit was included in the internal audit plan following a request by the Chief Accountant. Sample testing by the internal audit team has revealed several transactions over the last three months which have raised concerns about possible hacking or fraudulent access to the customer/order database. Each of these transactions has disappeared from the database after deliveries have been made, but without sales being recorded or funds collected from the customer. Each of the identified transactions was for a different customer and there seems to be no relationship between any of the transactions.

You have received the draft report from the Internal Audit Manager responsible for this audit which suggests serious weaknesses in the design of the system. You have discussed this informally with senior managers who have told you that such a report will be politically very unpopular with the Chief Executive as he was significantly involved in the design and approval of the new system and insisted it be implemented earlier than the IT department considered was advisable. No post-implementation review of the system has taken place.

You have been informally advised by several senior managers to lessen the criticism and work with the IT department to correct any deficiencies within the system and to produce a report to the Audit Committee that is less critical and merely identifies the need for some improvement. They suggest that these actions would avoid criticism of the Chief Executive by the Board of SPQ.

**Required:**

**Explain the ethical principles you should apply as the Head of Internal Audit for SPQ when reporting the results of this internal review and how any ethical conflicts should be resolved.**



ACORN
PROFESSIONAL
TUTORS

## 6.7 Comparison of external and internal audit

| Internal audit | External audit |
|---|---|
| Requirements are very far reaching<br>1. VFM audits<br>2. Post completion audits – How effective as a project been in achieving it's desired objective?<br>3. Management audits – How effective is mgt and corporate structure in achieving objectives and policies?<br>4. Quality audits – How is the company improving the final product to the customer?<br>5. Risk audits – How are high risk areas are determined and mitigated?<br>6. Improvement of internal controls<br>7. Substantive testing<br>8. Review of financial results<br>9. Fraud prevention<br>10. Improving financial accounting systems<br>11. Coordinating with external auditors<br>12. Social & environmental audit – e.g. pollution targets being met, employment, health & safety, contribution to the community?<br><br>They are employees of the company but must remain independent and objective<br><br>Appointed by management or an audit committee<br><br>**Their scope covers**<br>1. Accounting systems.<br>2. Internal control systems.<br>3. Compliance with the law.<br>4. Improving efficiency.<br>5. Protecting against fraud.<br>6. Cost reduction.<br>7. Risk assessment.<br>8. Safeguarding assets.<br><br>They help discharge the above legal responsibilities of senior management and improve the business efficiency and effectiveness.<br><br>They report to the management of the company. No formal qualifications required | Companies Act requirement for companies above a certain turnover level to appoint external auditors.<br><br>They go through the audit process and express an opinion on whether the financial statements are true and fair to the shareholders in an audit statement.<br><br>It is an independent examination by experts.<br><br>True and fair mean that the financial statements a materially free from error or omission.<br><br>Their responsibility is not to produce the accounts, not to spot fraud; this is the director's responsibility.<br><br>Appointed by the shareholders<br><br>They report to shareholders.<br><br>Qualified member of a RSB. Independent and external to company. |

**Example 6.7 – (CIMA past exam question)**

**Briefly explain the limits of the responsibility of external auditors to detect fraud.**



ACORN PROFESSIONAL TUTORS

**“Internal audit is the independent appraisal activity established within an organisation as a service to it. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls.” (CIMA)**

**CIMA: Internal audit – a guide to good practice for internal auditors and their customers**

- Internal audit aims agreed by the board.
- All areas of control are covered by internal audit not just financial controls.
- Unfettered access to people and documents.
- Head of internal audit has access to chairman, CEO and head of audit committee.
- Head of internal audit reports to senior director.
- Independent of executive management.
- Compliance with auditing standards and best practice.
- Consulted if major changes in business or controls are about to occur.
- No involvement in operations outside of internal audit areas.
- Results are clearly communicated and recommendations are acted upon by senior management.
- Performance of internal audit is regularly assessed.

**Head of internal audit is responsible for:**

- The creation of an annual audit plan based on the organisations risks that it is exposed to as identified by the assessment carried out by the Board.
- Sending the audit plan to the audit committee for approval.
- Carrying out the agreed audit plan.
- The creation and maintenance of an audit team capable of undertaking the audit plan who have the knowledge, expertise and experience to do so.

**Example 6.8 – Notorious B.I.G. Limited**

Notorious B.I.G. Limited is a successful alternative drug manufacturing company and has an existing internal audit department. Mr 2Pac Shaker is the head of internal audit.

**Required:**

**To whom will Mr Shaker report to and why?**



ACORN PROFESSIONAL TUTORS

**The advantages and disadvantages of external provision of internal audit services**

*Advantages*

- Increased independence of internal auditors.
- It frees up the time of staff.
- Services performed quicker and to a higher standard.
- Outsourcing is only means if company not large enough to afford an internal audit department.
- Investigation of sensitive areas easier.
- Relevant accounting and auditing skills.
- Increased reliability.
- Service can be flexed to time scale needs.
- External providers may have more access to specialist knowledge.

*Disadvantages*

- Cost to company can be expensive.
- Limited knowledge of specific entity.
- Independence issues if external auditor provides internal audit function.
- External staff may change frequently.
- Internal auditors therefore will know the system better, problems resolved faster.
- Internal auditors will be on the "inside track" of the business for casual indications of developments or problems.
- Commercially sensitive information may get into the wrong hands.
- There maybe opposition from employees if it means redundancies.

**Example 6.9 – (CIMA past exam question)**

"Effective internal control, internal audit, audit committee and corporate governance are all inter-related".

**Required:**

**Discuss this statement with reference to:**

**a) How internal audit should contribute to the effectiveness of internal control.**

**b) How an audit committee should contribute to the effectiveness of internal audit.**

**c) The role of an audit committee in promoting good corporate governance.**

## 6.8 Integrated and non-integrated audit functions

Traditionally companies have operated a non-integrated audit function where you have separate departments of audit for financial, IT and operational. The integrated approach audit function sees all three disciplines merged into one department and being led by someone from any one of these areas.

**Advantages of non-integrated audit function**

- Managers are directly responsible for their staff involved.
- No need to co-ordinate efforts with other disciplines and so scheduling more flexible.
- Chief auditor is focal point.

**Disadvantages of non-integrated audit function**

- Several audit reports generated as opposed to one combined comprehensive report.
- Overlapping of work.
- Key issues maybe overlooked if one team assumes that another will be covering that.
- Identified control weaknesses may have compensating controls which might be missed.

**Advantages of integrated audit function**

- Eliminates redundancies and omissions as it is a co-ordinated effort for a single audit report.
- Automatic cross-training and knowledge share between audit disciplines.
- Audit procedures take place at the same time and therefore being time efficient.



ACORN PROFESSIONAL TUTORS

**Disadvantages of integrated audit function**

- Lack of technical skill and understanding for a manager of a different discipline when trying to review or advise his team of specialists.
- Some technical audits will still require experts in that area only.

## 6.9 Internal audit assignments

***Value for money (VFM)***

A VFM audit is defined by the three E's:

**Economy:** Attaining the appropriate quantity and quality of resources (physical, human and financial) at lowest cost.

**Efficiency:** Relationship between outputs (goods or services produced) and inputs (resources used). Efficient operations would maximise output for a given set of inputs.

**Effectiveness:** How well an activity has achieved its policy objectives or other intended effects.

VFM can only be judged by comparison. Present methods of operation and uses of resources compared to alternatives. Usually there will exist some alternative that gives better VFM.

**Example 6.10 – Duff Suds**

Duff Suds is a leading brand of washing up liquid. If we were to believe it's advertising, it washes twice as many plates as any other liquid. Bottle for bottle it may be more expensive but plate for plate it is cheaper. Not only this but Duff Suds gets plates "squeaky" clean.

**Required**

**You have been asked to carry out a VFM study on Duff Suds. Very briefly from the information given what would you write under the three E's?**

**Problems with VFM**

- **Measuring outputs** – difficult to find an objective yardstick. E.g. The fire service reviewing their call-outs comparing man stuck in lift, a small house on fire, road accident etc. Which one shows greater output?
- **Measuring effectiveness** – overcrowded hospitals & longer waiting lists v greater success in treating various illnesses and other conditions?
- **Measuring efficiency** – profit v more people treated?
- **Overemphasis on cost control** – VFM cost control for short-term gains (e.g. abandon capital expenditure plans) at the expense of long-term benefit and value.



ACORN PROFESSIONAL TUTORS

***Best value***

New performance framework for local government. Focusing on best value performance plans and review of all their functions over a five-year period.

Defined by the 4 C's:

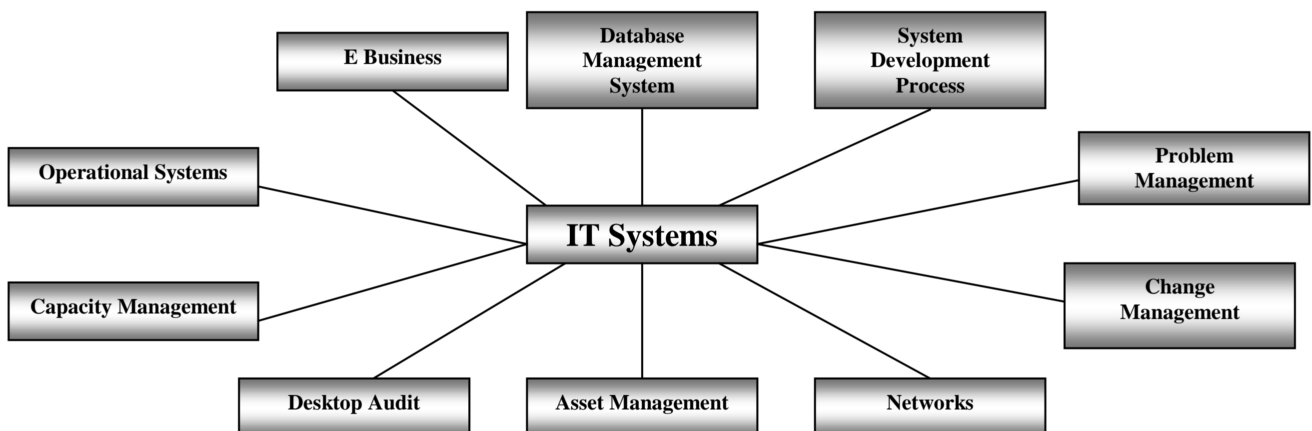
- **Challenge** – How and why is a service provided?
- **Compare** – Make comparisons with other local authorities and the private sector.
- **Consult** – Talk to local taxpayers and services users and the wider business community in setting performance targets.
- **Compete** – Embrace fair competition as a means of securing efficient and effective services.

***Information technology***

An IT audit is a test of control in a specific area of the business, the computer systems.

The controls over computers are some of the most important in today's modern business.

The internal audit team is likely to have an IT specialist to undertake this work as some of the controls will be programmed into the computer system.




***Financial***

The financial audit is internal audits traditional role, which involved reviewing all the available evidence (usually the company's records) to substantive information in management and financial reporting.

Increasingly it has become a minor part of internal audit, as it is largely carried out by the external auditors. No significant value would be added to the business by internal auditors carry out this role.


ACORN PROFESSIONAL TUTORS

## 6.10 Operational internal audit assignments

These are audits of the operational processes of the organisation. They are also known as "management" or "efficiency" audits. Their prime objective is the monitoring of management's performance, ensuring company policy is adhered to.

Assignments include:

- Procurement
- Marketing
- Treasury
- HR

**Approach**

Two aspects to consider:

- Ensure policies are **adequate**
- Ensure policies work **effectively**

**Reporting**

No formal rules on how to structure report and depends on the requirements asked of from the directors. Things to bear in mind when writing the report:

- The **purpose** of the report
- The **readers** of the report
- Using **layman's language** to explain technical issues.

The report should address the following matters more specifically:

- **Scope** and extent of the review.
- **Purpose** of the review.
- **Conclusions** of the assignment.
- The report will often include **recommendations** to management.
- The report may **request formal feedback** from management, which may be written or oral.
- Agreed upon **target dates** for feedback and recommendations.
- **Responsibility** for issuing the report should lie with the **Chief Auditor**.
- The report may be **confidential**, in which case this fact should be **clearly stated** on it.



ACORN PROFESSIONAL TUTORS

**Example 6.11 – (CIMA past exam question)**

HIJ is a new company that provides professional services to small businesses. Apart from the Principal, a qualified accountant who owns 100% of the business, there are four professionally qualified and two support staff. The business model adopted by HIJ is to charge an annually negotiated fixed monthly retainer to its clients in return for advice and assistance in relation to budgeting, costing, cash management, receivables and inventory control, and monthly and annual management reporting. The work involves weekly visits to each client by a member of staff and a monthly review between HIJ's Principal and the chief executive of the client company. In delivering its client services, HIJ makes extensive use of specialist accounting software.

The Principal continually carries out marketing activity to identify and win new clients. This involves advertising, production of brochures and attending conferences, exhibitions, and various business events where potential clients may be located.

The management of HIJ by its Principal is based on strict cost control, maximising the chargeable hours of staff and ensuring that the retainers charged are sufficient to cover the hours worked for each client over the financial year.

**Required:**

**Discuss the need for various types of audit that are appropriate for HIJ.**

## 6.11 Using the work of the internal auditor by external auditor

During the course of their planning, the external auditors should perform an assessment of the internal audit function if they consider that it may be possible and desirable to rely on certain internal audit work in specific audit areas for the purpose of the external audit of the financial statements.

When obtaining an understanding and performing an assessment of the internal audit function, the important criteria are:

- **Organisational status** – Internal audit's specific status in the organisation and the effect this has on its ability to be objective.

- **Scope of function** – The nature and extent of the assignments which internal audit performs.

- **Technical competence** – whether persons having adequate technical training and proficiency as internal auditors perform internal audit work.

- **Due professional care** – Whether internal audit work is properly planned, supervised, reviewed and documented.



ACORN PROFESSIONAL TUTORS

When the external auditors use specific internal audit work to reduce the extent of their audit procedures, they should evaluate that work to confirm its adequacy for their purposes.
**Factors:**

- Risk and materiality – External auditors involvement must be sufficient to form own conclusion.
- Work is properly supervised, reviewed and documented.
- Adequately trained staff.
- Exceptions are resolved.

**Example 6.12 – Slim Shady Limited**

You are in the process of planning the audit of Slim Shady Limited for the year ended 31 December 2002. In January 2002, the company set up an internal audit department, and this will be your first audit since the department was set up. From your initial discussions with the MD, you have established that Mr Busted Rhymes, the internal auditor, has undertaken a variety of assignments across the company and fed back his findings to the Board.

**Required**

**What steps should you take when considering whether you can rely on the work undertaken by Mr Rhymes and his team?**

## 6.12 Fraud

**'Distortion of results for individual benefit or theft by misappropriation of assets'**

- Ghost employees (Imaginary employees set up and wages paid to the fraudster).
- Payroll fraud (small amounts deducted from large numbers of employees and paid to the fraudster or the stealing of unclaimed wages).
- Collusion with third parties (overcharging on purchases or under charging on sales where the fraudster pockets the difference).
- Teeming and lading (misappropriate cheques by setting up a bank account name similar to the companies and returning the funds before an audit is made).
- Inflating expense claims.
- Misappropriation of assets (stealing).
- Failure to record a transaction (no sale recorded and when the money comes in, keep the cash, even if the sale is recorded you could issue a credit note (but do not send it to the customer) or write it off as bad.

**Example 6.13**

What controls or procedures would you recommend to either prevent or detect the above activities?



ACORN
PROFESSIONAL TUTORS

## 6.13 Investigation of fraud

When investigating a fraud the following should be considered:

- Establish the facts.
- Extent of loss.
- Who had access?
- Who maybe implicated?
- How did the fraud occur?
- Inadequate internal controls?
- Internal controls were adequate but not applied?
- Review all relevant material (e.g. documents, files, emails, telephone conversations etc…).
- Interview people (e.g. colleagues, supervisors etc…).
- Reach a conclusion on how it occurred and the strength and application of internal controls.



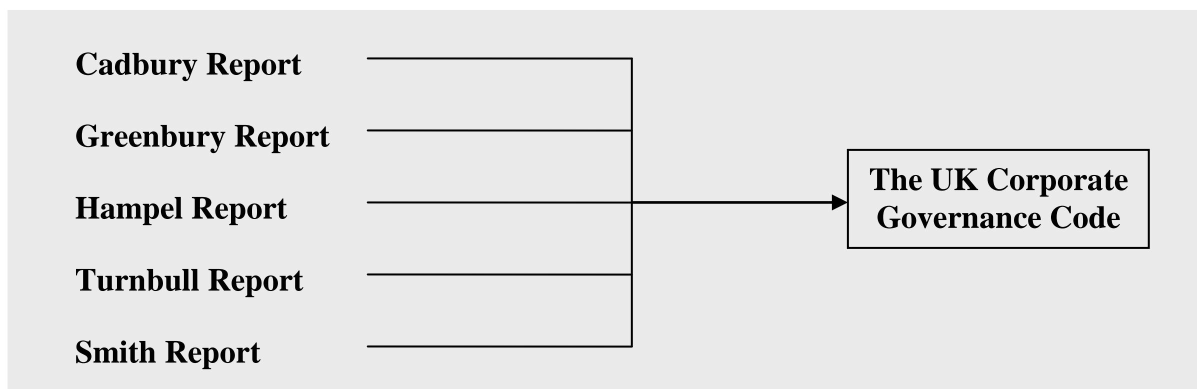
ACORN PROFESSIONAL TUTORS

**Key summary of chapter**

**Corporate Governance**

"The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals corporations and society"
(Sir Adrian Cadbury in 'Global Corporate Governance Forum' World Bank 2000)

**UK corporate governance reporting and recommendations**




**Cadbury and Greenbury report recommendations**

- Split chairman and chief executive role.
- Regular and more formal meetings.
- Directors remuneration clearly shown within the published accounts.
- Pay awards to be decided by a remuneration committee using non-executive directors only.
- Establish an audit committee using non-executive directors only.
- Every company should have at least 3 non-executives directors.

The Hampel report incorporated the recommendations from both the Cadbury and Greenbury Committees as well as amendments from the London Stock Exchange; it was published as the Combined Code in June 1998.

**Benefits of good corporate governance**

✓ Greater fairness and openness of directors.
✓ Greater public confidence in companies.
✓ Reduced risk for investors and other stakeholders.
✓ Lower risk of strong CEO domination.
✓ Transparency, timely and clearer communication of information.
✓ Improves performance and leadership by the board.



ACORN PROFESSIONAL TUTORS

**Higgs report (2003)**

- Focuses on the role of the non-executive.
- Non-executives have the inconsistent role of both reviewer of executives and working with executives to consult on strategy for the company.
- Non-executives should have four roles:
    - **Strategist** – challenge, help and develop company strategy.
    - **Performance** – has mgt met agreed goals and objectives?
    - **Risk** – is the financial information accurate and are the financial controls and risk management systems adequate?
    - **People** – to determine remuneration of the executives and a main role in appointments, removals and successions of executives.
- Board performance evaluation should be devised by the chairman.
- Should improve effectiveness, promote strengths and address weaknesses.
- Overall board performance disclosed to board, but individual performances are confidential.

**Smith report (2003)**

- Focuses on the audit committee.
- Chairman cannot be a member of the audit committee.
- At least one qualified member with relevant experience should be on the committee.
- Appointments should last for 3 years but extendable.
- Committee should be independent of management to protect interests of shareholders.
- Any disagreements should be resolved at board level.
- At least three meetings a year (audit plan review, interim statement review, full annual report review).
- At least once a year with the external and internal auditors without management present to discuss audit issues.
- Key roles are oversight, assessment and review, not preparing financial statements (mgt responsibility) or preparing the audit plan and carrying out the audit (auditor responsibility).
- The committee should review the company's internal financial controls.
- The committee should monitor and review the internal audit function.
- The committee is responsible for the oversight of the external auditors and have procedures to ensure their independence.
- Chairman of the committee should be present at AGM to answer audit related issues.
- Details of the committee's role, names and qualifications of members, how responsibilities were discharged, non-audit services provided by external auditors and how independence was safeguarded.



ACORN PROFESSIONAL TUTORS

**The UK Corporate Governance Code (2012)**

**Section A: Leadership**

- Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.

**Section B: Effectiveness**

- The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

**Section C: Accountability**

- The board should present a fair, balanced and understandable assessment of the company's position and prospects.

**Section D: Remuneration**

- Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose.

**Section E: Relations with Shareholders**

- There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

**Source:** The UK Corporate Governance Code (September 2012)



ACORN PROFESSIONAL TUTORS

**Summary of the principles for good governance**

**Directors responsibilities**

- The Board should be effective to lead and control the company.
- Clear division of responsibilities between Chairman and CEO to ensure balance of power and authority.
- Board balance e.g. executive and non-executive roles.
- Supply of 'transparent' information.
- Timely and of appropriate quality of information.

**Appointment of directors**

- Formal and transparent procedures.
- Re-election e.g. all directors at regular intervals and at least every three years.

**Directors remuneration**

- Level and make-up of remuneration should be sufficient to attract and retain but not more than necessary.
- A proportion linked to performance.
- Formal and transparent procedure fixing remuneration of each director.
- Disclosure e.g. details of the remuneration of each director.

**Relations with shareholders**

- Dialogue with institutional shareholders.
- Constructive use of the Annual General Meeting (AGM).
- To communicate with private investors and encourage their participation.

**Accountability and audit**

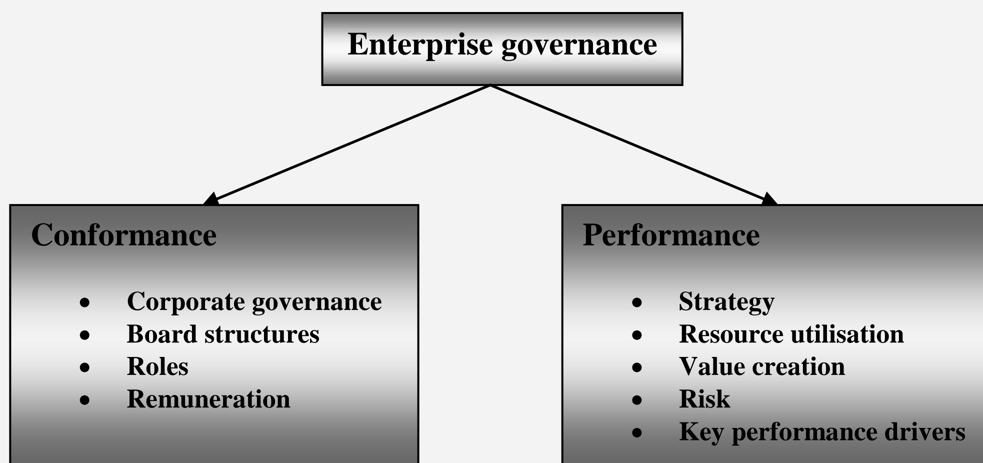
- Financial reporting e.g. balanced and understandable assessment of the company's position, performance and prospects.
- Maintain effective internal controls.
- Audit committee for maintaining an appropriate relationship with the auditors.



ACORN PROFESSIONAL TUTORS

**Enterprise governance**

This a report published by CIMA and IFAC in 2004 *"Enterprise governance: Getting the balance right"*.




**International perspective on corporate governance**

This is of paramount practical concern for policymakers, managers, accountants and others since they are affected by the regulatory regimes and changes of regulations on a daily basis in their working environment.

**Organisation for economic co-operation and development (OECD)**

- Rights of shareholders e.g. one share equals one vote for all shareholders.
- Equitable treatment of shareholders e.g. protection of minority interests.
- Equitable treatment of all stakeholders.
- Accurate and timely information for users of published information.

**US, the Sarbanes-Oxley Act (2002)**

- Legal requirement for all companies with a US listing.
- Attempts to address auditor independence and corporate governance issues.
- Places restrictions on the nature of non-audit services that can be performed by auditors. Audit committees must approve any allowed additional services.
- Audit committee members should be independent, and are responsible for the appointment, remuneration and overseeing of external auditors.
- Audit committee must establish rules for the protection of whistleblowers.

**South Africa, the King Report (2002)**

- Broader stakeholder approach to governance.
- Considers social, environmental, economic aspects of company activities (HIV/AIDS impact, black economic empowerment, equal opportunities and human capital development)
- Accountability and independence of the board emphasised more.
- Delegation did not diminish ultimate responsibility of the board.
- Board is responsible for risk management processes including internal audit.
- Openness to all stakeholders

**Ethics and social responsibility**

**Corporate social responsibility (CSR)** is concerned with being aware of the impact of actions on others, and to act in the best interests of society.

**Ethics** is concerned with rules or morals about the right behaviour and conduct, it is one part of CSR

**Advice on how to be more ethical and socially responsible**

- Good public relations.
- Protection of the ecological environment.
- Control energy consumption, waste and emissions.
- Recycle all packaging material.
- Support charities and the local community.
- Good conditions of work provided for employees.
- Embody ethical culture through a mission statement and training.
- Set and publish aims and objectives to achieve greater CSR.



ACORN PROFESSIONAL TUTORS

**Ethics for members of CIMA**

The CIMA Code of Ethics for Professional Accountants sets out the fundamental principles of professional behaviour that members and students are required to follow. Other accountancy bodies and professions such as the ACCA, ICAEW and AAT, have similar standards of behaviour and conduct.

- Integrity
- Objectivity
- Confidentiality
- Professional behaviour
- Professional competence and due care

**Code of conduct ensures**

- A positive global image to CIMA
- Protection for public interest.
- Prevention and limitation of malpractice.
- Repeat business in the long-term for CIMA and CIMA members

## Comparison of external and internal audit

| Internal audit | External audit |
|---|---|
| Requirements are very far reaching:<br><br>1) VFM audits.<br>2) Post completion audits – How effective as a project been in achieving it's desired objective?<br>3) Management audits – How effective is mgt and corporate structure in achieving objectives and policies?<br>4) Quality audits – How is the company improving the final product to the customer?<br>5) Risk audits – How are high risk areas are determined and mitigated?<br>6) Improvement of internal controls.<br>7) Substantive testing.<br>8) Review of financial results.<br>9) Fraud prevention.<br>10) Improving financial accounting systems.<br>11) Coordinating with external auditors.<br>12) Social & environmental audit – e.g. pollution targets being met, employment, health & safety, contribution to the community?<br><br>They are employees of the company but must remain independent and objective.<br><br>Appointed by management or an audit committee.<br><br>**Their scope covers**<br><br>Accounting systems.<br>Internal control systems.<br>Compliance with the law.<br>Improving efficiency.<br>Protecting against fraud.<br>Cost reduction.<br>Risk assessment.<br>Safeguarding assets.<br><br>They help discharge the above legal responsibilities of senior management and improve the business efficiency and effectiveness.<br><br>They report to the management of the company.<br><br>No formal qualifications required. | Companies Act requirement for companies above a certain turnover level to appoint external auditors.<br><br>They go through the audit process and express an opinion on whether the financial statements are true and fair to the shareholders in an audit statement.<br><br>It is an independent examination by experts.<br><br>True and fair mean that the financial statements a materially free from error or omission.<br><br>Their responsibility is not to produce the accounts, not to spot fraud; this is the director's responsibility.<br><br>Appointed by the shareholders.<br><br>They report to shareholders.<br><br>Qualified member of a RSB. Independent and external to company. |



ACORN PROFESSIONAL TUTORS

**Using the work of the internal auditor by external auditor**

When obtaining an understanding and performing an assessment of the internal audit function, the important criteria are:

- **Organisational status** – Internal audit's specific status in the organisation and the effect this has on its ability to be objective.

- **Scope of function** – The nature and extent of the assignments which internal audit performs.

- **Technical competence** – whether persons having adequate technical training and proficiency as internal auditors perform internal audit work.

- **Due professional care** – Whether internal audit work is properly planned, supervised, reviewed and documented.

**Fraud**

**'Distortion of results for individual benefit or theft by misappropriation of assets'**

- Ghost employees.
- Payroll fraud.
- Collusion with third parties.
- Teeming and lading.
- Inflating expense claims.
- Misappropriation of assets.
- Failure to record a transaction.



ACORN PROFESSIONAL TUTORS

# Solutions to lecture examples



ACORN
PROFESSIONAL
TUTORS

## Chapter 6

**Example 6.1**

Why should good corporate governance exist within organisations?

- ✓ To ensure personal objectives of the board and strategic objectives are in line with stakeholder views e.g. distortion of the truth about the size of Shell Plc oil reserves within the published accounts by the directors
- ✓ Public confidence is increased in the organisation
- ✓ Lower risk of strong CE domination or directors awarding lavish pay rises to themselves
- ✓ Transparency and clear communication improves relations with investors in the longer-term
- ✓ Protects shareholders

**Example 6.2 – (CIMA past exam question))**

**Role and responsibilities of the board of directors**

The main areas of responsibility of the board of directors:

- **Accountability** e.g. board of directors must answer to a higher level authority, being the principle shareholders, who have the power to remove directors which have been appointed. They will be accountable for the stewardship of company assets.
- **Supervision and legal duties** e.g. board of directors must maintain adequate internal controls on behalf of the company.
- **Strategic direction** e.g. board of directors must formulate strategies and give strategic direction to the company.
- **Fiduciary responsibilities** e.g. trust or in 'good faith' to act on behalf of the principle (shareholder) rather than in their own personal self interest.
- **Due diligence** e.g. to show reasonable competence or a duty of care to the company when managing it or making decisions, directors must have the skills, knowledge and experience required in order to carry out their duty of care.

The board must present a balanced and understandable assessment of the company's position and prospects and this is done through the regular production of financial accounts.

The board are responsible for the review and maintenance of internal controls. They must maintain a sound system of internal controls. They are also responsible for the devising and implementing of these controls. They are allowed to delegate these to experts like internal auditors but ultimate responsibility lies with the board.



ACORN PROFESSIONAL TUTORS

The board should have formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the auditors.

The board must be made up of individuals who are effective to lead and control the company, and the board should also include non-executives as well as a clear division of power and responsibilities between the Chairman and CEO.

Appointments to the board should be both formal and transparent in procedures and all directors at regular intervals or at least every three years are subject to re-appointment by the shareholders.

The board must identify the key risk areas and key performance indicators of the business and continually monitor and compare these to improve the business processes and help safeguard against any impact by competitors.

The board should set clear lines of accountability and assignment of responsibility to the appropriate managers through the company.

The board should encourage a strong control culture. Manager's bonus should not only be linked to company profits but also linked to internal control procedures being adhered to. There should be a specific manager who is responsible and accountable for internal control procedures for each division and who understands the details of that division.

**Role and responsibilities of the audit committee**

The overall objective of the audit committee is to assist in the development of controls within the business, provide independent judgement and discharge some of the duties of the directors.

- Committee should be independent of management to protect interests of shareholders.
- Any disagreements should be resolved at board level.
- At least three meetings a year (audit plan review, interim statement review, full annual report review).
- At least once a year hold meetings with the external and internal auditors without management being present to discuss audit issues.
- Key roles are oversight, assessment and review, not preparing financial statements (mgt responsibility) or preparing the audit plan and carrying out the audit (auditor responsibility).
- Liaising with external auditors, and consult and resolve any problems they may have.
- The committee should review the company's internal financial controls.
- The committee should monitor and review the internal audit function.
- The committee is responsible for the oversight of the external auditors and have procedures to ensure their independence.



ACORN PROFESSIONAL TUTORS

- Chairman of the committee should be present at AGM to answer audit related issues.
- Details of the committee's role, names and qualifications of members, how responsibilities were discharged, non-audit services provided by external auditors and how independence was safeguarded.
- Review the reporting judgement reached by internal and external auditors on the business to be acceptable and reasonable.
- Review of the internal audit department to ensure that they are being effective and delivering value for money service.
- They should appoint the head of internal audit.
- Review internal audit standards, their scope, resources, reports to be comprehensive but user friendly, and review the work produced to see if it is valuable.
- The appointment, removal, and remuneration of directors
- Review the effectiveness of the external audit process and if satisfactory whether to obtain non-audit services from them.
- Disclosure requirement should be addressed by the audit committee and should comply with corporate governance and the main principles should be applied.

**Example 6.3 – (CIMA past exam question))**

The key reasons for the emergence of corporate governance regulations around the world are:

**Abuses by directors of an organisation** - for example taking decisions in their interests and not in the interest of the organisation as a whole. This is due to the fact that there is divorce between owners and controllers of the company. The owners are the shareholders and the controllers are a different group of people being the directors of the company.

**Accounting irregularities** – Different ways of accounting for items have developed around the world and in addition fraudulent ways of accounting for items have also been devised and so it has become difficult to make any kind of meaningful comparison between companies.

**Poor risk identification and controls** – An increased number of companies failing due to the fact that management have not properly identified critical risks that will impact on the business and also have sufficient controls in place to mitigate them. Management have also not reviewed the risk regularly for changes in risk profile and also not reviewed the adequacy of current controls to mitigate the new risks.

**Globalisation** – Businesses today trade in different countries therefore will encounter different rules and regulations. Some countries have better rules surrounding the running of a business than others and those countries with less developed rules have seen an increase on corporate fraud.



ACORN PROFESSIONAL TUTORS

**Information and transparency –** Companies making poor decisions has a dramatic impact on their survival. Poor decisions have invariably been made because of poor information being produced by the company. In addition the public at large have felt there is a lack of transparency and trust of companies in the information.

**Example 6.4**

**Arguments for social responsible decisions**

Starbucks offers its customers certified organic coffee as well as fair trade, customers often paying premium prices because of this. Costa also offers customers a fair trade coffee option on all its coffees. Fair trade coffee guaranteeing the grower a better deal through fairer prices and better working conditions. Even the Body shop markets its whole organisations persona on social responsibility, by its ethically sourced products.

Such examples above reinforce the fact that sustainable competitive performance can be achieved by the organisation by differentiating itself relative to competition. Many other organisations as an example which purchase organic or fair trade often attract more socially responsible customers, often willing to pay premium prices, this all leading to greater sales revenue and profits for the organisation.

So called ‘green investments’ in certain companies e.g. recycling companies, or those companies which act in a more socially responsible manner, can also bolster up there share price due to there shares being more marketable and highly demanded, leading towards greater shareholder value as a benefit in the longer-term.

A new approach to strategic management was developed in the early 1990's by Kaplan and Norton by the development of the balanced scorecard. Traditionally most profit making organisations viewed the satisfaction of shareholder wealth as the primary objective, above all else. The balance scorecard is the creation for an organisation of a range of performance indicators (both financial and non-financial), concentrating on four different perspectives in order to satisfy all stakeholders not just shareholders.

**Arguments against social responsible decisions**

The fundamental objective of a firm according to the theory of economics is the maximisation of profit. According to traditional theory of shareholder wealth maximisation, the present value of a share price is the net present value of future dividends. Any socially responsible decisions an organisation chooses to make often leads to increased costs or reduced sales revenue because of it, conflicting with this theory.



ACORN PROFESSIONAL TUTORS

There are additional costs for compliance and social audits by an organisation e.g. staff, administration and education, potential loss of dividends as funds are invested into social projects and such decisions can also reduce sales revenue e.g. cutting prices of pharmaceuticals by GSK in order to help third world treatments of HIV or other illnesses. The argument therefore is that being socially responsible does not maximise the value of shareholders in the longer-term, leading to less dividends and a lower share price because of it.

Such examples above promote the fact that managers should therefore concentrate on only those decisions that maximise the wealth of its shareholders not the wider interests of its stakeholders. Being socially responsible diverts funds, as well as management time away from what really matters according to economic theory.

In conclusion the maximisation of shareholders wealth is still the primary goal of most profit making organisations, however given the ever increasing pressure of media and civic society in the world today, those firms who do not act socially responsible, may not have a sustainable future due to the impact on profit that such actions may have. McDonalds increasing there range of healthier eating options, a prime example of an organisation reacting to the changing values and pressure of society today.

**Example 6.5**

How can companies help to communicate code of conduct?

1. Incorporate ethical behaviour through their mission statement
2. Formal rule books
3. Ethical training
4. Incorporate ethics as part of employee objectives
5. Code committees
6. Social audits
7. Encourage and protection of whistle blowers
8. Regular review of ethical procedures

**Example 6.6 – (CIMA past exam question)**

**Integrity**
Behave with integrity in all professional, business and personal financial relationships. Integrity implies not merely honesty but fair dealing and truthfulness. It seems you are being told not to bring to light the major deficiencies of the system as it would embarrass the CEO, this would conflict with integrity.



ACORN PROFESSIONAL TUTORS

**Objectivity**
Strive for objectivity in all professional and business judgements. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other. It presupposes intellectual honesty. It seems that you are being asked to change your opinions so as not to appear to be overly criticising the system, this would conflict with being objective, and would lead to the Board making wrong decisions.

**Professional competence and due care**
Not accept or perform work which they are not competent to undertake unless they obtain such advice and assistance as will enable them competently to carry out the work. It seems that if you adhere to pressures from the senior mangers in SPQ you would bring into question your competence in doing your job, and so there is conflict here as well.

**Resolving conflicts of interest**

Discuss the weaknesses with your superior being the CEO; however it may not be possible to do this as he has been involved in the design of the system and so he will have a self interest to suppress this negative report.

Discuss the weaknesses with the audit committee and in particular with the chairman confidentially. The chairman would then discuss with the CEO and persuade him that these weaknesses should be addressed properly and brought to light. This would help to resolve the conflict of competence as the audit committee would now be aware of the political manoeuvres in SPQ and internal audit will be able to preserve its competence.

Discusses the weaknesses with the financial director however he may have allegiances with the CEO and tell him of our conversation.

Use the company's internal procedures for "whistle blowing" if available.

Contact CIMA for advice on the issue and possible courses of action.

If discussions with superiors do not lead to resolution then consider resignation as final solution, with written reasons to employer.

Throughout the entire conflict ensure that tact and confidentiality is maintained unless you are legally obliged to divulge.



ACORN PROFESSIONAL TUTORS

**Example 6.7 – (CIMA past exam question)**

The main objective of external auditors is not to find fraud or all fraud in the company but to carry out their tests to meet the objective that the accounts are materially true and fair. Any omissions or frauds in the accounts will not change the overall opinion on the accounts, because they have taken reasonable steps in trying to find any material misstatements or fraud. However if by doing their tests they come across fraudulent activities then they must notify the directors and shareholders and investigate the fraud fully.

It is the internal controls in a business which are designed to stop fraud and other errors in the company; these of course have been devised by the directors of the company or assistance from specialists to help them devise them. Directors are ultimately responsible for safeguarding the assets of the business.

**Example 6.8 – Notorious B.I.G. Limited**

**Internal auditors will report to the following:**

- Internal auditors must have a reporting line which is independent of the function on which they are reporting.
- This is essential to maintain their independence and objectivity.
- The internal auditor will report directly to:
    1. Highest levels of management in the area they are auditing.
    2. The Board of Directors.
    3. And / or the audit committee (if there is one).

**Example 6.9 – (CIMA past exam question)**

**(a) How internal audit should contribute to the effectiveness of internal control.**

Internal audit is an appraisal or monitoring activity established by the board for the review of the accounting and internal control systems as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management.

Internal audit are seen as independent from management who are devising and implementing the internal controls, should be able to provide advice on internal controls both to management and the board.



ACORN PROFESSIONAL TUTORS

Internal audit can contribute to the effectiveness of internal controls by carrying out some of the tasks below:

- Value for money audits which focus on the efficiency, effectiveness and economy of the area concerned.
- Post completion audits – How effective as a project been in achieving its desired objective?
- Management audits – How effective is mgt and corporate structure in achieving objectives and policies?
- Quality audits – How is the company improving the final product to the customer?
- Risk audits – How are high risk areas are determined and mitigated?
- Improvement of internal controls.
- Substantive testing.
- Review of financial results.
- Fraud prevention.
- Improving financial accounting systems.
- Coordinating with external auditors.
- Social & environmental audit – e.g. pollution targets being met, employment, health & safety, contribution to the community?

**(b) How an audit committee should contribute to the effectiveness of internal audit.**

The overall objective of the audit committee is to assist in the development of controls within the business, provide independent judgement and discharge some of the duties of the directors.

The audit committee contribute to the effectiveness of internal audit in the following way:

- Assess whether the financial statements have been prepared with integrity.
- The committee should review the company's internal financial controls.
- The committee should monitor and review the internal audit function.
- Review the reporting judgement reached by internal auditors on the business to be acceptable and reasonable.
- Review of the internal audit department to ensure that they are being effective and delivering value for money service.
- Review the internal audit plans to be adequately based on risk assessments.
- They should appoint the head of internal audit.
- Review internal audit standards, their scope, resources, reports to be comprehensive but user friendly, and review the work produced to see if it is valuable.
- Ensure that the internal auditor has direct access to the Board of Directors, Chairman and Chief Executive Officer.



ACORN PROFESSIONAL TUTORS

**(c) The role of an audit committee in promoting good corporate governance.**

Corporate governance is the system by which companies are directed and controlled. It provides guidance for directors on how to be accountable to shareholders, supervise and comply with legal duties, formulate strategies and run the company ethically.

Corporate governance is important because some companies, particularly larger ones, are owned by one set of people and managed by another.

The role of the audit committee in promoting good corporate governance is mainly to provide oversight and review of all the main areas and processes of the company.

For example the audit committee will not prepare the financial statements which is the responsibility of management or preparing the audit plan and carrying out the audit which is the responsibility of the auditors, but reviewing these to be adequate in achieving the objectives in corporate governance.

Other areas that the audit committee is responsible for relating to the promotion of good corporate governance are as follows:

- The audit committee should be independent of management to protect interests of the shareholders.
- Any disagreements should be resolved at board level.
- At least three meetings a year (audit plan review, interim statement review, full annual report review).
- At least once a year with the external and internal auditors without management present to discuss audit issues.
- Liaising with external auditors, and consult and resolve any problems they may have.
- The committee should review the company's internal financial controls.
- The committee should monitor and review the internal audit function.
- The committee is responsible for the oversight of the external auditors and have procedures to ensure their independence.
- Chairman of the committee should be present at AGM to answer audit related issues.
- Details of the committee's role, names and qualifications of members, how responsibilities were discharged, non-audit services provided by external auditors and how independence was safeguarded.
- The appointment, removal and remuneration of directors.
- Review the effectiveness of the external audit process and if satisfactory whether to obtain non-audit services from them.
- Disclosure requirement should be addressed by the audit committee and should comply with corporate governance and the main principles should be applied.



ACORN PROFESSIONAL TUTORS

**Example 6.10 – Duff Suds**

- Economy – more clean plates per pound
- Efficiency – more clean plates per squirt
- Effectiveness – plates as clean as they should be, “squeaky” clean.

**Example 6.11 – (CIMA past exam question))**

Audit is an appraisal or monitoring activity established by the board for the review of the accounting and internal control systems as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management.

HIJ should have some basic internal audits carried out by the Principal or a separate internal auditor. It is arguable whether it is going to be cost effective to employ a full time auditor and maybe more effective to obtain external help when the work is needed.

The Principal needs to consider auditing the financial information to ensure that all revenues and costs are accounted for correctly, in tact, and are for business purposes. This will include a review of time spent on clients and as a result costs charged, to ensure that these are reasonable and recoverable.

The Principal being a qualified accountant should be able to do this effectively by himself through review of monthly accounts, budgets and cash flow projections.

The Principal needs to also consider whether customers are given value for money and are also satisfied with the service they receive. He can do this by periodically contacting and visiting the clients requesting feedback on service, also ensure that client feedback forms are completed after every job and reviewed by the Principal.

The Principal should also consider audits over the adequacy of non-financial areas such as IT, marketing and recruitment. The audits will focus on whether policies are adequate and whether policies have been followed. These are areas he may not have expertise over and may need to employ the help of specialists.

A recruitment audit would encompass the review of whether recruitment policies have been adhered to when employing staff such as interviews and assessment days. The audit should also cover areas of staff pay, sickness, dismissal and grievances procedures.

An IT audit would encompass the overall review of the IT strategy, system development procedures, database management procedures and disaster recovery plans. There should also be an audit of application controls such as controls over input, output, processing and standing data.



ACORN PROFESSIONAL TUTORS

A marketing audit would review the effectiveness of mediums used to generate business. Currently the Principal carries out the marketing of the business and uses mediums such as advertising, brochures, conferences and exhibitions. For a small business like HIJ most of their customers may be local and so it is important that they target the local business community. There maybe other ways of marketing that the Principal may not be aware of which maybe more effective such as websites, sponsoring local events and free business health checks. This kind of audit would greatly be enhanced with the help of a marketing specialist.

HIJ should also consider a management audit to review effectiveness of the strategy implanted by the Principal. This should be carried out by an external party and should be viewed as helping to improve management not attacking it.

**Example 6.5 – Slim Shady Limited**

- Organisational status of the internal audit department, including its ability to be objective and the levels of management to which it reports.
- Scope of function, including the nature of assignments and whether management acts on its reports.
- Technical competence of the persons performing the work.
- Application of due skill and care and whether the work is adequately planned, documented, supervised and reviewed.



ACORN PROFESSIONAL TUTORS

**Example 6.6**

What controls or procedures would you recommend to either prevent or detect the above activities?

**Ghost employees**
Head count reconciliation's
Sign in and out employees
Name badges
Supervision of clocking in
Separate authority of payroll and personnel records (regular cross checking)
Scrutinise account details of employees

**Payroll fraud**
Regular review of amounts paid to employees
Exception reports of small and large postings

**Collusion with third parties**
Passwords to authorise reductions in price
Authority given by senior supervision for invoices
Regular review of customer or supplier statements
Regular reconciliation's or circularisation to obtain third party evidence
Segregation of duties between invoice handling and cash

**Teeming and lading**
Surprise visits
Regular bank reconciliation's
Customer statements reviewed and agreed to the system
Segregation of duties between opening the post, recording and banking cash or cheques
Supervision of post

**Inflating expense claims**
Regular review of expense claims
Valid receipt or no reimbursement

**Misappropriation of assets**
Locks, passwords on doors, security guards or CCTV
Log in and out any assets taken away from premises
Regular agreement to fixed asset register

**Failure to record a transaction**
Segregation of duties between those that handle invoices and those that handle and record and bank cash
Regular debtors circs and agreement of third party statements to the system



ACORN PROFESSIONAL TUTORS