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Paper
P1

PROFESSIONAL ACCOUNTANT

ACCA QUALIFICATION
COURSE NOTES
JUNE 2009 EXAMINATIONS

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Paper P1

CONTENTS

AIMS AND OBJECTIVES

Aim

- To apply relevant knowledge, skills and exercise professional judgement in carrying out the role of the accountant relating to governance, internal control, compliance and the management of risk within an organisation, in the context of an overall ethical framework.

Objectives

- On successful completion of this paper, candidates should be able to:

  - define governance and explain its function in the effective management and control of organisations and of the resources for which they are accountable
  - evaluate the professional accountant's role in internal control, review and compliance
  - explain the role of the accountant in identifying and assessing risk
  - explain and evaluate the role of the accountant in controlling and mitigating risk
  - demonstrate the application of professional values and judgement through an ethical framework that is in the best interests of society and the profession, in compliance with relevant professional codes, laws and regulations.

Position of the paper in the overall syllabus

- The syllabus for Paper P1 acts as the gateway syllabus into the Professional level. It sets the other Essentials and Options papers into a wider professional, organisational, and societal context.
- The syllabus assumes essential technical skills and knowledge acquired at the Fundamentals level where the core technical capabilities will have been acquired, and where ethics, corporate governance, internal audit, control, and risk will have been introduced in a subject-specific context.
- The Professional Accountant (PA) syllabus begins by examining the whole area of governance within organisations in the broad context of the agency relationship. This aspect of the syllabus focuses on the respective roles and responsibilities of directors and officers to organisational stakeholders and of accounting and auditing as support and control functions.
- The syllabus then explores internal review, control, and feedback to implement and support effective governance, including compliance issues related to decision-making and decision-support functions. The syllabus also examines the whole area of identifying, assessing, and controlling risk as a key aspect of responsible management.
- Finally, the syllabus covers personal and professional ethics, ethical frameworks – and professional values – as applied in the context of the accountant's duties and as a guide to appropriate professional behaviour and conduct in a variety of situations.

Detailed syllabus

A Governance and responsibility

1. the scope of governance
2. agency relationships and theories
3. the board of directors
4. board committees
5. directors' remuneration
6. different approaches to corporate governance
7. corporate governance and corporate social responsibility
8. governance: reporting and disclosure

B Internal control and review

1. management control systems in corporate governance
2. internal control, audit and compliance in corporate governance
3. internal control and reporting
4. management information in audit and internal control

C Identifying and assessing risk

1. risk and the risk management process
2. categories of risk
3. identification, assessment and measurement of risk

D Controlling risk

1. targeting and monitoring risk
2. methods of controlling and reducing risk
3. risk avoidance, retention and modelling

E Professional values and ethics

1. ethical theories
2. different approaches to ethics and social responsibility
3. professions and the public interest
4. professional practice and codes of ethics
5. conflicts of interest and the consequences of unethical behaviour
6. ethical characteristics of professionalism
7. social and environmental issues in the conduct of business and of ethical behaviour

Approach to examining the syllabus

- The syllabus will be assessed by a three-hour examination. The examination paper will be structured in two sections.
- Section A will be based on a case study style question comprising a compulsory 50 mark question, with requirements based on several parts with all parts relating to the same case information. The case study will usually assess a range of subject areas across the syllabus and will require the candidate to demonstrate high level capabilities to evaluate, relate and apply the information in the case study to several of the requirements.
- Section B comprises three questions of 25 marks each, of which candidates must answer two. These questions will be more likely to assess a range of discrete subject areas from the main syllabus section headings, but may require application, evaluation and the synthesis of information contained within short scenarios in which some requirements may need to be contextualised.

Section A: Compulsory question	50 marks
Section B: Choice of 2 from 3 questions (25 marks each)	50 marks
	100 marks

The examiner is David Campbell

Chapter 1

CORPORATE GOVERNANCE

- the system by which organisations are directed and controlled (Cadbury Report)

- corporate governance (cg) is a set of relationships between an entity's directors, shareholders and other stakeholders.

- also provides the structure through which the objectives of the entity are set and determines the means of achieving those objectives and monitoring performance.

- cg is an issue for all entities, whether they be

  - large quoted entities

  - commercial entities

  - not–for–profit organisations including:

    - public sector
    - non–governmental organisations

Corporate governance - elements

- management, awareness, evaluation and mitigation of risk
    - includes the operation of an adequate and appropriate system of control.
- overall performance is improved by good supervision and management within set best practice guidelines
- framework for an organisation to pursue strategy in an ethical and effective way
- offers safeguards against misuse of resources – human, financial, physical and intellectual
- involves more than following externally established codes of good practice. Also requires a willingness to apply the spirit as well as the letter of the law
- can attract new investment into entities, particularly in developing nations
- accountability to shareholders and also other stakeholders
- underpins capital market confidence in entities, government, regulators and tax authorities

Corporate governance – concepts

- **honesty / probity** – not simply telling the truth but also not being guilty of issuing misleading statements or presenting information in a confusing or distorted way

- **accountability** – emphasis of the directors' accountability to shareholders, but opens the door for discussion about the extent of their accountability to other stakeholders

- **independence** – strong emphasis on the appointment of independent non–executive directors who are free from conflicts of interest and are thus able to monitor effectively the entity's and executive directors' activities, ideally working closely with the external auditors

- **responsibility** – a system of responsibility should exist whereby entity directors acknowledge their responsibilities to the stakeholders, and will take whatever corrective action is necessary in order to keep the entity focussed.

- **decision taking / judgement** – the skill with which management make decisions which will improve the wealth / prosperity of the organisation

- **reputation** – built by directors, often as a result of their ability to comply with other cg concepts

- **integrity** – straightforward dealing, honesty, and balance. For financial statements to have the characteristic of integrity, this depends upon the integrity of those people who prepare them. Integrity involves a person who demonstrates high moral character, is principled, professional, honest and trustworthy

- **fairness** – taking into account the interests, rights and views of everyone who has a legitimate interest in the entity

- **transparency / openness** – involves full disclosure of material matters which could influence the decisions of stakeholders. This means not simply openness in the reporting of information required by IFRS in the financial statements. It also involves other information such as cash and management forecasts, environmental reports and sustainability reports

Corporate governance and agency theory

- directors act as agents of the shareholders

- cg tries to ensure that agency responsibilities are fulfilled as agents by requiring disclosure and by suggesting performance-related rewards

- definition: an agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision–making authority to the agent

- fiduciary duties definition: a duty imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflicts of interest

- fiduciary duties are owed to the entity, not to individual shareholders

- directors must exercise their powers for the proper purpose

Duties of directors as agents

- performance – if paid, directors have a contractual obligation to perform as agreed (if unpaid, no such obligation)

- obedience – directors should act strictly in accordance with the principal's instructions

- skill and care – directors should act with such a degree of skill and care as may reasonably be expected from a person with such experience and qualifications

- personal performance – directors should only delegate their assignments where they have no reason to believe that the person to whom the work is delegated is not capable of proper performance

- avoid conflicts of interest – eg should not sell his own property to the entity, even though it may be at an independent, arm's length valuation

- confidence – agents should not disclose confidential matters about the principal, even after the agency agreement has ended

- accounting for benefits – agents must account to the principal for any undisclosed benefit which they receive as a result of their office as agent

- because ownership of an entity is necessarily separated from the management, problems may result

Corporate governance – Potential Problems

- directors may choose to pursue strategies more beneficial for their own interest rather than the entity's

- directors will almost certainly have a different attitude to risk, and risk management, since it is not their own investment which they are risking

- if management have only a small beneficial interest in the entity (or even none at all) then they may well pursue activities which improve short term results (therefore improving their current bonuses) to the exclusion of more far–sighted strategies which would be of greater benefit to the entity in the longer term

- ultimately, shareholders have the right to decide who shall (and who shall not) be directors of their entity. But this is, in practical terms, very much a theoretical power. Generally shareholders neither have the dynamism nor organisation to effect such a change in the composition of the board

Overcoming the problem - alignment of interests (goal congruence)

- incentives designed to align interests include:

    - profit related pay

    - share issue schemes, for instance on the occasion of a management buy–out

    - share option schemes

- but for all of these there is a natural tendency for management to adopt creative accounting to manipulate the profit figure upon which these incentives are based.

Stakeholders

- anyone or any group
  - primary or secondary
  - internal or external
  - narrow or wide
  - known or unknown
  - legitimate or illegitimate
  - active or passive
  - voluntary or involuntary
  - recognised or unrecognised
- stakeholders may be sub-classified
  - an operational role within the entity
  - a role in corporate governance
  - a number of interests in the entity
- consider these elements in the context of:
  - directors
  - entity secretary
  - second tier management
  - employees
  - unions

- Each **external** stakeholder has:

  - a role to play in influencing the operations of the entity (**IO**)
  - their own interests and claims in the entity **(OI)**

- consider these in the context of:

  - auditors
  - regulators
  - government
  - stock exchange
  - small investors
  - institutional investors

- **Reference to David Campbell Student Accountant articles:**
  "Rules, principles and Sarbanes-Oxley" April 2008

Chapter 2

APPROACHES TO CORPORATE GOVERNANCE

Two distinct approaches to corporate governance

- rules based, and
- principles based

Characteristics of the rules based approach

- prescribed set of cg requirements
- quick way of ensuring compliance
- adopts a checklist approach
- clear distinction between compliance and non–compliance
- easy to see that entity is complying
- reduction of flexibility on the part of management and auditors
- difficult to set rules to cover all situations
- possible to misinterpret rules
- same rules apply to all, whatever their size

Characteristics of the principles based approach

- activities of entities must address major principles set out in codes of best practice
- not simply a box ticking exercise
- more difficult to avoid than a rules based approach
- easy to see that entity is complying
- directors required to work in the entity's best interests
- more flexible, and therefore better able to deal with "new" situations
- easier justification for apparent breach of principles
- but principles may be interpreted differently

- Arrival of corporate governance

    - headline hitting corporate failures in Europe , USA and UK led to recognition of the need for some sort of control in an attempt to prevent similar failures

- common elements identified as:

    - poor entity management by directors
    - single dominant individual
    - unreliable financial reporting
    - ineffective internal controls
    - incompetent directors
    - lack of close involvement of institutional shareholders
    - directors interested more in personal position rather than in the welfare of the entity

Development of the Combined Code (CC)

- 1992, the Cadbury Report
- followed by Greenbury report on directors' remuneration
- then Hampel report – a list of principles of "good corporate governance"
- 1998, these three merged into the Combined Code on Corporate Governance
- 2003, Higgs Report, effectiveness of non-executive directors (neds)
- 2005, Turnbull report, guidance on internal controls
- 2006, new Combined Code published
- CC applies to all UK quoted entities which must state:
  - how it has applied CC principles
  - whether or not it has complied with CC throughout the accounting period, and ….
  - …if not, why not

Rules based approach

- USA passed legislation - Sarbanes Oxley (SOX)

- applies to all US quoted entities

- but also to any entity, anywhere in the World, if it has an American quoted parent entity

- main provisions of SOX

    - all quoted entities must provide a certificate to the Securities Exchange Commission confirming the accuracy of their financial statements

    - where financial statements have to be restated following material non-compliance, CEO and CFO must repay any bonuses received in the previous twelve months

    - auditors restricted to audit work (and tax)

    - senior audit partner must rotate off the audit after no more than five years

    - Public Entity Oversight Board – responsible for enforcing professional standards in accounting and auditing

    - directors forbidden from dealing in entity shares during “sensitive” times

OECD and ICGN have both issued principles on corporate governance

- these principles serve multiple purposes:
  - assist governments in their efforts to introduce cg principles
  - provide guidance and advice to regulatory bodies such as stock exchanges, investor groups and institutions
  - although aimed directly at listed entities, recognised that all entities could benefit from adoption of principles
  - the principles have no legal status

Summary of OECD principles

- Contents of the OECD Principles:
  - identification of the basis for an effective cg framework
  - fair treatment for all shareholders
  - identifies the rights of shareholders
  - and the role of stakeholders
  - details disclosure requirements
  - and transparency arrangements
  - establishes key ownership functions
  - and board responsibilities

Summary of ICGN principles

- identifies corporate objective of providing returns to shareholders on their investments
  - disclosure and transparency matters
  - independent audit
  - details shareholders' ownership, responsibilities, rights and remedies
  - details provisions relating to boards of directors
  - prescribes board remuneration policies
  - provides guidance on cg implementation
  - prescribes social awareness
  - recommends entity / stakeholder relationship
  - establishes need for business ethics

ACCA FORUMS

Chapter 3

THE BOARD OF DIRECTORS

Directors

- anyone who occupies the position of director

- shadow directors are 'anyone in accordance with whose instructions the directors are accustomed to act'

- combined code establishes roles and responsibilities:

    - provide leadership for the entity
    - represent the entity in its dealings, and to the public generally
    - set the agendas for board meetings
    - decide those matters which are to be determined by the board, and not therefore to be delegated
    - decide upon a strategy for the entity
    - select a director to be CEO, and…
    - …another one to be chair

- directors' roles and responsibilities continued

  - establish a corporate culture
  - ensure that those charged with taking operating decisions are doing their job properly
  - establish and implement an effective system of internal controls capable of risk assessment and management
  - ensure that aims and objectives of the entity are realistic and achievable
  - ensure that all employees are aware of the entity's responsibilities to its stakeholders
  - hold regular and frequent board meetings
  - assess own performance, and report annually to shareholders
  - submit themselves for re–election every three years
  - for listed entities there are "additional requirements"

Listed entity requirements and the Higgs report contents

- listed entities should:

- appoint appropriate and independent neds

  - establish sub-committees

    - audit
    - remuneration
    - risk
    - nomination

- Higgs identified four factors which affect the effectiveness of the board:

  - time available to devote to entity matters
  - personal competence
  - quality of information
  - boardroom culture

- other major points addressed by Higgs were:

  - the role of neds, and
  - performance measurement for the board as a whole and for individual directors

Combined Code sub-divisions

- CC breaks down neatly into four sub-divisions:
  - directors
  - directors' remuneration
  - accounts and audit
  - investor relations

Combined code sub-divisions - directors

- every listed entity should have an effective board
- positions of Chair and CEO should be held by different individuals
- board should comprise both executive and non–executive directors
- there should be at least as many neds as executive directors
- appointment to the board should be formal and transparent
- information should be provided to the board
- there should be a formal assessment of the board’s performance annually
- should submit themselves for re–election on a regular basis...
- ...with intervals not greater than three years

Combined code sub-divisions – directors' renumeration and accountability and audit

- directors' remuneration

  - should be sufficient to attract, retain and motivate
  - a proportion should be performance related
  - no director should be involved in determining their own remuneration
  - remuneration committee should publish a report of their activities in the annual financial statements

- Accountability and audit:

  - board should present a balanced assessment of the entity's position
  - the board should maintain a sound system of internal control in order to safeguard shareholders' investments
  - formal arrangements should be in place for considering how to apply financial reporting and internal control principles
  - the board should make arrangements for maintaining an appropriate relationship with the auditors
  - this will involve establishing an audit committee

Combined Code subdivisions – investor relations and potential problems with implementation of cc

- directors should have regular dialogue with institutional investors

- directors should encourage active participation of all shareholders at the annual general meeting

- to adopt all the recommendations of the Combined Code sounds like an excellent idea, but there can be problems!

- potential problems

    - possible that executive board could lack skill or experience

    - when daily management team report to executive, their failings could mean that problems are not fully appreciated or opportunities could be overlooked

    - directors may meet infrequently and are not necessarily close acquaintances. This could make it difficult for them effectively to question the daily management team

    - CEOs are often people with forceful personalities who sometimes exercise a dominant influence over the board

    - CEO's performance is judged by the same people who appointed him. Could be very difficult for them to be unbiased in their evaluation of CEO's performance.

Structure of the board - single tier (unified) or two-tier?

- single tier structure characteristics:
  - both control and management are in the hands of a single group of directors
  - common in the US and the UK
  - the combined code recommends that at least half the board should be neds
  - another recommendation concerns the split of the roles of CEO and Chair
  - the effect is to split the management (CEO) from control (a non–executive Chair)
  - in practice, the neds not only monitor management but also contribute to strategy development
  - in larger entities, management is often devolved to sub–committees
  - all directors, whether management or neds, have equal legal and executive status. All are therefore accountable and responsible for board decisions
  - neds may also take the initiative in management decisions and are not restricted to post–decision approval
  - all directors owe the same fiduciary duties to the entity

Structure of the board - two-tier structure

- two tier structure characteristics:

  - consists of a supervisory board and a management board
  - entities in France, Germany and other parts of Europe often have a two–tier board
  - management is responsible for the general running of the business
  - management board is led by CEO
  - supervisory board is responsible for the appointment, supervision and removal of members from the management board
  - also responsible for overseeing the activities of the management board, and its compliance with law, regulation and the entity's constitution
  - also, a general overseeing of the entity and its business strategies
  - supervisory board is led by the Chair

Directors - structure of the board

- the structure should take account of the following factors:
    - an effective board is essential for good corporate governance
    - a balance between executive and neds so that no single group can dominate
    - the board should not be dominated neither by any individual...
    - ...nor by any group / section
    - there needs to be a split of power between CEO and Chair
    - executive directors should each be an expert in their own field

Directors - sub-division of roles

- Executive directors

    - involved in day to day management
    - usually remunerated as full–time employees
    - dedicate their working lives to fulfilling their duties as director
    - take responsibility for the day to day running of the entity

- Non-executive directors

    - members of the board, but not involved in the day to day running of the entity
    - neither a full–time employee, nor connected in any other way with the entity
    - serve on the various board sub-committees:
        - audit
        - remuneration
        - risk
        - nominations
        - social and
        - ethical

Functions of neds

- constructively challenge and contribute to development of strategy
- oversee and evaluate management's performance in meeting agreed objectives
- satisfy themselves that financial information is accurate
- satisfy themselves that financial controls and systems of risk management are strong and appropriate
- role on remuneration committee
- constantly seek to establish and maintain confidence in the conduct of the entity
- be independent in judgement, and inquisitive
- try to understand the views of the major investors
- be offered the opportunity to attend meetings with major shareholders

Statutory duties of all directors

- We have already come across some of the duties of directors, but the following list includes some new ones:

    - act in good faith, in the interests of the entity as a whole, by:
        - treating all shareholders equally
        - declaring any conflicts of interest
        - not making personal profits at the entity's expense
    - ensure that the entity maintains proper accounting records
    - produce proper financial statements and directors' report
    - file the financial statements with the Government department
    - obey other laws and regulations such as health and safety legislation

- Individually, each director must:

    - disclose any interest in an entity contract
    - disclose any interest in shares or debentures of the entity
    - disclose details of any options which are held

- In addition, directors have a common law duty to demonstrate such degree of skill and care as may reasonably be expected from a person of that age and experience. Failure to do so may result in the director being found liable for negligence with the consequence that a Court may hold the director personally liable for any loss which the entity has suffered as a result of that negligence.

Directors - appointment and service contracts

- Appointment

  - The rules for the appointment and removal of directors are found in the constitution of an entity and typically provide the following:

    - the first directors are appointed at the time of formation of the entity
    - subsequent directors are normally appointed by the directors in the time between general meetings, but such appointees must seek to be re–elected by the shareholders at the next annual general meeting
    - directors are required to retire by rotation
    - directors should step down from office at least every three years, but may seek re–election

- Directors' service contracts

  - These are legal documents containing the terms of service for each director and will normally include:

    - key dates
    - duties
    - remuneration details
    - termination provisions
    - constraints
    - any other "normal" employment provisions

  - The contract should not be for a period in excess of one year

Directors – removal and disqualification

- Directors may be removed from office at any time by the vote of the majority of members in general meeting. In addition, the office of director shall be vacated according to the rules set out in the entity's constitution. Typically this will provide that a director shall lose office if:
  - becomes disqualified by law
  - dies
  - is removed by shareholders
  - becomes personally bankrupt
  - resigns from office by notice in writing
  - is absent from board meetings without permission for a period in excess of six months

- Disqualification under the law can happen when a director is guilty of:
  - allowing the entity to continue to trade whilst it is insolvent
  - not keeping proper accounting records
  - failure to prepare financial statements
  - three defaults (within a five year period) of failing to file relevant documents with the Government department
  - failure to file tax returns (or pay tax)
  - taking actions which are deemed by the Court to be inappropriate for the management of the entity

Directors – Insider dealing

- Insider – a person who has a business connection with an entity as a result of which they may acquire relevant information

- Dealing – buying or selling shares or securities in an entity

- Unpublished price – sensitive information is information about the entity which is not in the public domain...

- ...is less than 6 months old, and…

- ...is, on publication, likely to have a material impact on the market price of the entity's shares

- An insider in possession of unpublished price – sensitive information should not deal

- An offence is also committed if the insider encourages another person to deal

- A person dealing as a result of that encouragement, and believing the source to be an insider, is also committing an offence

- Disclosure of inside information, other than in the proper course of employment to an authorised person, is also an offence

- Some defences are available to be claimed

Directors - induction and education

- The Combined Code establishes principles for the education of a new director in the activities of the entity. It is clearly important that the new director should become acquainted with the executive board as soon as possible after their appointment, so the entity's induction procedure should:

  - be comprehensive
  - be tailored to the needs of the entity and individual directors
  - contain written information plus presentations and appropriate activities (eg site visits)
  - give new appointees a balanced overview of the entity
  - not overload the director with an excess of information
  - at the end of the induction process, the new director should have:
    - an understanding of the nature of the entity, its business and the markets in which it operates
    - a link with the entity's employees
    - an understanding of the entity's main relationships including the relationship with the auditors

Directors – performance evaluation

- The Combined Code contains a framework for assessing the performance of individual directors as well as of the board as a whole:

  - there should be an annual evaluation of the performance of the board as a whole and of each member of the board
  - the evaluation exercise should be tailored to suit the entity's needs
  - entities should publish in the financial statements whether such an evaluation exercise has been carried out
  - the Chair is responsible for the selection of an effective process, and for taking appropriate action on completion
  - the use of an independent third party would bring additional objectivity to the exercise
  - the evaluation exercise should consist of a number of questions and answers, designed to assess performance and identify how performance could be improved
  - the whole process should be used constructively as a means to improve board effectiveness, maximise strengths and minimise weaknesses
  - the results of the board evaluation should be shared with the whole board, but...
  - ...the results of individual evaluations should remain confidential between the Chair and the individual director

Chapter 4

BOARD COMMITTEES – AUDIT COMMITTEE

- board is responsible for risk identification and risk management, both of which involve the establishment of a sound system of internal control.

- audit committee is a sub–committee of the board and is comprised entirely of neds.

- in a listed entity, there should be at least three neds on the audit committee, one of whom has had recent relevant financial experience.

- key roles for the audit committee are:
  - **oversight**
  - **assessment**
  - **review** of the other functions and systems in the entity

- most of the board's objectives relating to internal control will probably be delegated to the audit committee

- the audit committee should:
  - review the entity's internal financial controls
  - review all the entity's ic and risk management systems
  - approve the wording in the financial statements relating to ic and risk management systems
  - receive reports from management about the effectiveness of the control systems
  - receive reports concerning the conclusion of any tests carried out on the controls by either internal or external auditors

- Internal control systems

  - for an ic system to be effective it needs to minimise successfully the business risks identified by management:

    - plays an important role in managing those risks which most threaten the attainment of the entity's business objectives
    - contributes significantly to protecting shareholders' investment, safeguarding the assets and ensuring compliance with law and regulation
    - should also seek to prevent and to detect fraud. In a poor control environment fraud could more easily develop
    - should be reviewed continually and improved as appropriate
    - the costs of implementing a control should not exceed the benefit to be gained from the reduced risk
    - suitability of a control will vary from entity to entity
    - should be an integral part of any entity's risk management strategy – it should not be an after–thought
    - effective financial controls (including maintenance of proper accounting records) are an important element of a system of ic

Internal controls -categorisation

- can be remembered by the mnemonic oap spasm

O	**O**rganisational
A	**A**rithmetic and accounting
P	**P**ersonnel
S	**S**egregation of duties
P	**P**hysical
A	**A**uthorisation
S	**S**upervision
M	**M**anagement

Internal controls - categorisation

- these eight controls can now be categorised into three headings –

Structure	Transactions	Staff
Organisational • control over the organisation structure including managers having specific responsibilities and delegation tasks.	**Physical** • protection of assets against theft, unauthorised access or use.	**Personnel** • controls that: - suitable people are recruited for each job, and - appropriate training is provided for that job.
Segregation of duties • for each transaction different people: - authorise it - record it - maintain physical custody of any assets - pay for it.	**Arithmetic and accounting** • checking accounting transactions for accuracy. • includes use of control accounts and reconciliations (e.g. bank reconciliation).	**Supervision** • oversight of work of other individuals to ensure tasks are carried out correctly.
	Authorisation and approval • controls to ensure that transactions do not proceed until an appropriate individual has given approval (normally in writing).	**Management** • control action taken by management depending on the contents of reports received.

Audit committee and internal audit (ia)

- as part of their obligation to ensure adequate and effective controls audit committee is responsible for the activities of ia.

- the audit committee should:

  - monitor and assess the role of the ia function within the entity's overall risk management system
  - check the efficiency of ia
  - approve the appointment (or removal) of the chief internal auditor
  - ensure that the ia function has direct access to the Chair and is accountable to the audit committee
  - review and assess the annual ia work plan
  - receive reports concerning the work of the ia function
  - review and monitor management's response to ia findings
  - ensure ia's recommendations are implemented
  - help to preserve the ia function from pressures which might otherwise impair their objectivity

- audit committee should meet with ia at least once each year to discuss audit–related matters

- possible that even a listed entity does not have an ia function.

- if no audit committee, should review the situation annually and make any appropriate recommendation

- if there is no ia department, this fact must be disclosed in the financial statements.

Audit committee and the external auditors (ea)

- audit committee is responsible for overseeing the entity's relationship with the ea.

- responsibility is given by the Combined Code which also states that the audit committee should:

  - have the primary responsibility for recommending eas for appointment, re–appointment or even removal
  - oversee the selection process when replacement auditors are being considered
  - approve the terms (not necessarily negotiate) of the ea's engagement, and their remuneration
  - develop procedures whereby they can annually ensure the ea's continuing independence and objectivity
  - review the scope of the audit with ea, and satisfy themselves that the scope is sufficient
  - ensure that appropriate plans are in place for the audit at the commencement of the audit
  - carry out a post audit review

Reporting on internal controls to shareholders

- Combined Code requires that an entity's board should maintain a sound system of internal controls to safeguard the entity's assets and to protect shareholders' investments.

- issue is how much the entity should tell its shareholders about the internal control system.

    - as owners of the entity, shareholders are entitled to know whether the internal control system is sufficiently strong to safeguard the entity's assets
    - board should, at least once each year, review the effectiveness of the internal control system, and report to the shareholders the results of that review
    - review should cover all material controls including financial, operational and compliance controls as well as the risk management system
    - in addition, the shareholders should be told, through the financial statements, about the work of the audit committee
    - at the annual general meeting the Chair of the audit committee should be available to answer any shareholder questions

Internal audit reporting

Report section	*Reason*	*Example*
Objectives of audit work	• Sets the scene for report audience by describing purpose of review.	• For a payroll audit 'check whether: - wages are paid to the correct individuals - deductions from gross pay are properly calculated'.
Summary of process undertaken by auditor	• Describes how the evidence to support the opinion and recommendations was gathered.	• 'Recalculation of deductions was performed for a sample of 50 monthly and 50 weekly wages payments.'
Audit opinion (if required)	• Summary of whether the control reviewed is working or not.	• 'In our opinion, the control is working as intended.'
Recommendations	• Highlight areas of control weakness and suggest course of remedial action.	• 'We recommend that new employees are only added to the payroll system on receipt of an appropriately authorised Form 1a.'

Board committees - remuneration committee

- importance:
    - executive directors should not be responsible for determining their own remuneration
    - remuneration decisions can be seen to be taken by those who will not benefit from those decisions
    - there is a need for formal, transparent procedures for developing policy and for individual packages
- role
    - the committee determines appropriate packages for the executive directors, and the composition of those packages
- composition
    - in listed entities the committee will typically comprise neds
- accountability
    - reports to the main board

Strategy of the remuneration committee may consider:

- greater benefits in kind to compensate for lower basic salaries

- offering non–cash motivation for some (or all) of the entity's employees. Non–cash motivators could include things like crèche facilities, cars and additional holidays

- availability of entity resources. For example, the entity may not have sufficient cash resource to pay an annual bonus, but may offer a share incentive scheme instead

- encouragement of long–term loyalty by offering share–purchase schemes

Remuneration committee responsibilities

- determine, and regularly review, the framework, broad policy and specific terms for the remuneration, terms and conditions of employment of the Chair and of the executive directors

- recommend and monitor the level and structure of the remuneration of senior management

- set detailed remuneration for all executive directors and the Chair including pension rights and compensation payments

- ensure that executive directors and senior management are fairly rewarded for their individual contributions to the overall performance of the entity

- demonstrate to shareholders that the remuneration of executive directors and senior management is set by individuals with no personal interest in the outcome of the committee's decisions

- agree compensation for loss of office

- ensure that provisions for disclosure of remuneration, including pensions, as set out in law and in the Combined Code are followed.

Board committees - nominations committee

- importance:
    - needs to be seen to be unbiased and impartial
    - needs to be objective in order to ensure that appointments are made in line with pre–agreed specifications
- role
    - identify appropriate people to be invited to join the board
    - the committee determines appropriate packages for the executive directors, and the composition of those packages
- composition
    - executive directors and neds, but neds should be the majority
- accountability
    - makes recommendations to the main board, but
    - final decisions are made by the main board as a whole
- overall responsibilities of the nominations committee are to:
    - review regularly the structure, size and composition of the board, and make recommendations to the board of new nominees
    - give full consideration to succession planning for directors
    - regularly evaluate the balance of skills, knowledge and experience of the board
    - prepare a description of the role and capabilities required for any particular board appointment
    - identify, and nominate for approval, candidates to fill board vacancies as they arise
    - recommend to the board concerning existing directors standing for re–appointment

Board committees - risk management committee

- importance:
  - gives an objective view on the entity's risk profile
- role
  - assesses internal controls
  - performs risk assessments of the entity's key operations
  - often oversees the implementation and effective operation of risk strategy, policies and procedures
- composition
  - executive directors and neds, but neds should be the majority
- accountability
  - makes recommendations to the full board of internal control and risk strategy, or
  - to the audit committee, but they in turn will report to the full board
- main responsibilities and duties of the risk management committee are to:
  - advise the full board on risk management issues, strategy and policy
  - emphasise and demonstrate the benefits of a risk–based approach to internal controls
  - set appropriate internal control policies
  - regularly assure that the system is functioning
  - review the effectiveness of internal controls
  - provide relevant disclosures about internal controls in the financial statements
  - review the system of internal controls paying particular attention to the control environment, risk assessment, information systems, control procedures and monitoring

Role and function of an audit committee

- create a climate of discipline and control leading to a reduction of opportunities for fraud.

- lend an air of credibility and objectivity in the financial statements thereby increasing public confidence

- assist CFO by providing a forum

- review financial statements to improve the quality of reporting independent judgement

- strengthen position of the internal auditor

- strengthen position of the external auditor

- assist in the resolution of disputed between external auditor and executive board

- remember Clarissa