

CASE ANALYSIS: Hue Incorporated

Hue Incorporated designs and manufactures personalized shirts and jackets. The company employs 2,500 staff, and its shares are held by 15 individuals, most of them from the same family. The maximum shareholding is 15% of the share capital.

The executive directors are drawn mainly from the shareholders. There are no executive directors primarily drawn from the shareholders. There are no non-executive directors because the company legislation in Hue Incorporated's jurisdiction does not require any. The executive directors are very successful in running Hue Incorporated, partly from their training in production and management techniques, and partly from their 'hands-on' approach motivating employees.

The Board is considering a significant expansion of the company. However, the company's bankers are concerned with the standard of financial reporting as the financial director (FD) has recently left Hue Incorporated. The Board is delaying the provision of additional financial information until a new FD is appointed. Hue Incorporated does have an internal audit department. However, the chief internal auditor frequently comments that the Board of Hue Incorporated does not understand his reports or provide sufficient support for his department or the internal control systems within Hue Incorporated.

The Board of Hue Incorporated concurs with this view. Rivera & Co, the external auditors, have also expressed concern in this area and the fact that the internal audit department focuses work on control systems, not financial reporting. Rivera & Co are appointed by and report to the Board of Hue Incorporated. The Board of Hue Incorporated is considering a proposal from the chief internal auditor to establish an audit committee. The committee would consist of one executive director, the chief internal auditor as well as three (3) new appointees. One (1) appointee would have a non-executive seat on the Board of directors.

Required:

Answer the following **(3 items x 5 points)**:

- a. What do you think is the main cause why Hue Incorporated's Board does not understand the report given by the Chief Internal Auditor?

The main reason the Board of Hue Incorporated might not understand the Chief Internal Auditor's reports is likely due to their lack of expertise in financial reporting and internal controls. Since the executive directors mainly come from a production and management background, they might not have the necessary financial knowledge to interpret complex audit reports.

- b. How can you solve the problem identified in letter (a)?

To address this issue, the company can take several steps. First, they can provide training and education to the board members, especially the executive directors, on financial reporting and internal control systems. Second, fostering open communication between the Chief Internal Auditor and the Board, allowing them to ask questions and seek clarifications, can help bridge the knowledge gap. Lastly, appointing a board member with a financial or auditing background could provide valuable insights and enhance the board's understanding of audit reports.

- c. How can you ensure the independence of the external auditor?

To ensure the independence of the external auditor, it's essential that the auditor reports directly to an independent audit committee within the board rather than reporting to company management. This separation of reporting lines helps maintain objectivity and prevents any potential conflicts of interest. This would also help ensure that audit findings are reported without any undue influence from company management.

Rubric for grading:

CRITERIA	PERFORMANCE INDICATORS	POINTS
Content	Applicable ideas were presented	3
Organization of Ideas	Details were discussed with no grammatical error	2
TOTAL		5