P1 comprises of:

- Corporate Governance – 60%
- Risk Management and Internal Controls – 20%
  May include calculations for Sensitivity Analysis, Expected Value (probability x outcome), CAPM… although likelihood is extremely rare
- Business and Professional Ethics – 20%
  Business ethics applies to directors, while professional ethics applies to professional accountants

Section A: Mandatory – 50%

Section B: 2/3 Questions – 50%

Weaknesses

Any "weakness" mentioned in the questions refer to issues not in compliance with best practices. Essentially, identifying issues requires foreknowledge of what is being adopted as best practices / deemed as best practices by authoritative literature.

"To know what is bad, you have to know is the best"

P1 is a professional paper

The proverbial "gap" that leads to the professional-level papers is actually two words: "synthesis", and "evaluation".

Unlike the fundamental and skills modules, professional papers require candidates to ask themselves questions when applying concepts to a particular exam scenario, e.g. "why?", "so what?", "how?"… It is general questions like these which trigger content, leading to a more wholesome answer that is able to anticipate the varying, unstandardized expectations of the examiner.

"You cannot blah… You have to blah, blah, and blah!"

Board of Directors

The ‘Board’, as it is known eponymously, is in charge of delegating tasks to the executive management and its sub-Board committees, while reserving (for itself) exclusive powers to decide on matters of strategic importance, namely: the declaration of dividends, method of raising finance, capital expenditure and disposals.

Chairman
To chair meetings, oversee running of the Board, ensure fair and acceptable conduct by directors, resolve differences and disputes between directors, and to hold directors accountable.
The Chairman role is recommended to be played by an independent non-executive director, who is in the least likely position to practice favouritism, and as such, makes it easier for them to mediate, hold parties answerable, and effectively protect shareholders’ rights (and above all, those of the minority shareholders).
The Chairman is said to be the most powerful seat in the company as the chairperson can has veto power (i.e. final say), and is enabled to set/draft the agenda and resolutions, thus dictating the matters to be discussed in Board meetings – unless shareholders, with 10% voting rights or more, propose an agenda concerning their interests.

Executive Management
(Salaried, in charge of operational matters)

Non-Executive Management
(Must be of a balanced* proportion [at least half of the board], in charge of the organisation’s monitoring function)

↖ ↑ ↗

CEO / Managing Director

Executive Director(s)
(Assisting the CEO)

Company
← **Secretary** →

Senior Non-Executive Director

Non-Executive Director(s)

(UK Corporate Governance Code)

***Balance**

In the context of corporations, there is a valuable need for balance, which becomes a fundamental building block of independence, gradually liberating the organisation as a whole from abuses of dominant position / power.

Separation of Ownership and Control

To dispel the confusion that the Board of Directors both own and run the company… Quoted companies have one thing in common: the owners may or may not be the same individuals running the business. Instead, it is the norm for shareholders to appoint managers to assume stewardship of their invested companies. This situation is known as the “separation of ownership and control”.

Stakeholders

Individuals / groups with bi-directionality of influences – at the same time when one group or more can influence, others may conversely, be influenced by the company's decision. A fit dichotomous example would be major shareholders (who can influence) and minority shareholders (who could only be influenced).

The purpose of having Performance Targets

In a company that is delineated with a separation of ownership and control, agency problems (illustrated by a manager who fails to observe his/her fiduciary duties to the shareholders who entrusted them with the task of running the company in their best interests) can potentially emerge. To ensure that the managers are exercising their role with due loyalty and care, one of the measures widely-instituted in many corporations is performance targets. By measuring and benchmarking their performance, senior executives are held accountable to shareholders. Having a record of performance measures reflects the scorecard of the effectiveness and goal-orientations of a company's top management, and facilitates establishment of performance-related pay, making these senior managers answerable to their evaluators on the Remuneration and Nomination Committees – who are the parties responsible for determining their pay packages and incentives.

Independence

In corporate governance terminology, independence is an attribute that is used to describe a state being free of financial, personal, and family ties – normally used as a reference in evaluating the status of a director on the company Board. Being independent reduces the possibility of a director becoming involved in conflicts of interest, and thus, biasness in his/her judgment.

Timely communication

Timely communication is about reporting relevant information within proper timeframe to an individual, or a group of, party / parties. According to the Fama (1960), an efficient market is one where, at any given time and in a liquid market, security prices fully reflect all available information. That would be an ideal situation, though it is far from the truth in practice because much information has not been communicated to the stock market in a timely manner. After all, most company annual reports are released only around / before four months[1] following the financial year-end. Therefore, the stock markets we currently experience are only "semi-efficient" so to speak. It is believed that through effective and timely communication of key information, we are able to remove information asymmetry, i.e. the knowledge difference between insiders and outsiders. By doing so, we will reduce the incidence of insider trading, and pave the way for a clean, efficient market.

[1] *In Malaysia, Tan Sri H.P. Tay's companies – Public Bank Berhad, and Lonpac Insurance – maintain a model practice of releasing their financial results a mere 50 days after the closure of books.*

Shareholder activism

Shareholder activism refers to the aggressiveness of shareholders in monitoring the company and its managers, through avenues such as: participation at the Annual General Meeting, initiating dialogue with investee senior management (this approach is traditionally reserved for institutional investors).

It should be noted that, under this view, the activeness of the shareholders equates to the power exerted by them – which is also dependent on the significance of their shareholding.

Internal Control

Functional / Financial	Has the effect of preventing fraud and error, thereby ensuring truth and fairness of financial statements.
Operational	Ensuring the business is efficient and economical, allowing for goals / objectives to be achieved (effectiveness).
Risk Management	Allows the company to take (business) risks knowingly. 居安思危 • Identify: Knowing the risks • Assessing / Measuring: Calculating the risks • Manage: Controlling and mitigating the risks
Compliance	Ensure the company complies with internal policies and procedures, as well as external laws and regulations. This is especially important in regulated, tightly-monitored industries.

Approaches to Corporate Governance

Corporate governance is concerned with two cardinal objectives:

- safeguarding shareholders' investment; and
- maximising shareholders' returns.

Rules-based *'Hard' approach* *Outside-in*	Such an approach implies that compliance is compulsory, and deviations are punishable by fines and imprisonment. A rules-based environment is denounced by critics as one that "stifles creativity" – which is the driving force behind entrepreneurship that can be used to great advantage in procuring growth that benefits shareholders.
Principles-based *'Soft' approach* *Inside-out*	This 'softer' approach is characterised by a regulatory environment that encourages voluntarism in addressing compliance – compliance is selective and not mandatory by law. In the insistences of non-compliance, principles-based guidelines recommend that explanations be made.
Hybrid approach	A 'hybrid approach' is a blend of both rules and principle-based guidelines, the combination of soft and hard approaches is best illustrated with the Malaysian corporate governance context: Outside-in, the Capital Markets and Securities Act requires companies to prepare a "Statement of Corporate Governance and Internal Control", with explanations tying it to the Malaysian Code of Corporate Governance's (MCCG) requirement. Inside-out, compliance to the MCCG is voluntary, with departures requiring only explanation.

MINUTIAE

Are directors truly 'directors'?

Well, to be truly considered a director, a senior individual within the organisation has to have a place on the Board. In hospitality circles, many employees are in possession of position with an affixed title of 'director', for example: F&B Director, Marketing Director etc. Certainly, it can be concluded that most of these individuals are merely 'directors-in-name', if their presence is not required of at Board meetings.

In the corporate context, directorship entails that the person is both an employee in charge of operational affairs, and who has a seat in Board meetings. On another note, the issue of whether to reward director's fees to the chief executive remains a contentious one (requiring approval by shareholders), because meetings are usually being held during office hours – covered by basic pay.

Why do Boards need a company secretary (COSEC)?

A company secretary is an individual who ought to have studied, and possess considerable knowledge of corporate law. Their expertise is in ensuring that the Board remains compliant with listing rules as well as relevant sections of the law, which is particularly critical when the company is a quoted entity that has to meet regulatory requirements, for instance: releasing financial statements to shareholders approximately a fortnight before the Annual General Meeting (where director remuneration is approved – and this does not include salary, which is contractual) – which often requires the COSEC's coordination.

Yours Sincerely: one-to-one communication

≠

Yours Faithfully: communicated to a group of people

Formal Letter vs. Letter to the Shareholders

Sarbanes-Oxley Act and the Rules-Based Approach

U.S. entities are under the purview of a rules-based listing legislature. The Sarbanes-Oxley Act should be used as explicit reference for accounting-related practices concerning publicly-listed U.S. entities as well as their subsidiaries and partners overseas. A rules-based system is also known as a "box-ticking" approach (or sometimes called a "checklist" approach). Nevertheless, proponents of the principles-based approach (applicable to accounting, regulation etc.) argue that in order to be truly effective, compliance must be in terms of spirit and substance, and not just mere compliance to the letter (made up of rules and codes).

The *Vicks Vaporub* study method

According to Mr Goh, sleep more than a number of 5 hours is considered excessive[1]. To maintain energy levels for 19 hours throughout the day, one needs to invest in a bottle of *Vicks*[2] – the popular brand in mentholated ointments – while devoting time and effort to master the technique of applying it under his/her eye. As there is a guaranteed intense burning sensation (which leads to streams of tears seconds after application), disciples of this method are required to endure pain, which might lead to possible success of passing the ACCA examinations.

[1] *This is based on personal experience, which is indeed a more powerful testimony than if suggested by scientific research.*

[2] *Although there are many other balm and ointment formulations out there, Mr Goh endorses the use of this brand specifically.*

Did You Know?

Because the steel sector is deemed by most nations as an industry of "national strategic importance", Perwaja Steel is a front for Malaysia's national ego… with weak operational capabilities and poor corporate governance. The "politically conceived, commercially questionable" company was on the brink of collapse (an unthinkable aftermath that involves the firm being dissolved, leading to mass retrenchment and unemployment of workers with hardly much transferrable skill), necessitating billion-ringgit government and external injection of funds.

Leave Notices

Under most Employment Acts in general, employees are required to inform their employers in advance of their resignation from the company (and "serve the notice", i.e. they would have to work until the period is up). This is necessary as in practice, companies would need the "gap period" to assess and recruit candidates to fill up the vacancy left by the outbound personnel.

- Employees are required to provide a leave notice of around 1-3 months. The period is determined by their level of seniority within the organisation, as it is relative to the difficulty in finding their replacement.
- For directors, it is the norm for their leave notices to be as long as one year. Unless, of course, they are legally bound to serve the remainder of their contract period, or face punitive consequences. From the company's view, to require an employee to not serve a notice would necessitate the use of severance measures – this includes a "severance payment" (aka. 'golden handshakes', 'golden goodbyes', which are commonly associated with a reward for failure to perform – because most directors are "sacked" by their companies out of the reason that they failed to achieve the targets set for their performance).

Refresher: Related-Party Transactions are covered under which IAS standard?

IAS 24.

The definitions of Corporate Governance

Conceptually, corporate governance can be defined in the narrow and broad context:

Narrow definition *Restricted view*	Companies subscribing to this view of corporate governance restrict themselves to only serving the needs of the stakeholders under the remit of the Companies' Act. As recognised in the eyes of the law, a profit-centred organisation need only be answerable to its shareholders (as befits the 'Agency Theory'). **THIS IS THE PREFERRED VIEW FOR EXAMINATION PURPOSE**
Broad definition *'Web of relationship with other stakeholders'*	Under the broad definition, the company owes accountability not only to its shareholders, but extends this also to other stakeholders.

Cadbury Report (1992) *The view which most proponents of CG recognise and agree on. The report was prepared by a Committee led by Adrian Cadbury in 1991, during the wake of Polly Peck – a major UK company that went insolvent after years of falsifying financial reports.*

"Corporate governance is the way companies are directed and controlled."

Solomon & Solomon (2004)

"Corporate governance is a system of checks and balances, internal and external to a company, to ensure accountability to stakeholders."

What is the importance of Corporate Governance?

Construct the case for / Argue for the importance of CG:

- Safeguarding of shareholders' investments
- Maximisation of returns to shareholders – returns can take the form of dividends, as well as capital (short-term share price appreciation)
- Aligning the interest between the Board and the corporation's shareholders – through monitoring and incentives
- Provides ease of raising finance (debt/equity), and lowers cost of capital – good practices attract better credit ratings

Contents of the UK Code of Corporate Governance (-)

The UK Code of Corporate Governance dates back to the Hampel Report (published on January 1998), which was a "Combined Code" produced with the consolidation of the CG principles established by Cadbury as well as Greenbury (1995). The Hampel Report had pointed out the role of the Chairman as the "leader" of the non-executive directors, and suggested the publication of directors' remuneration (traditionally viewed as a sensitive topic, but one which is of great interest to shareholders), as well as setting the case for institutional investors to consider voting at the AGM.

- **Directors**
  A description of the composition of the Board, and its sub-Board Committees
- **Directors' remuneration**
  Determines the level of appropriateness of director pay
- **Relationship with shareholders**
- **Accountability**

Condensing the above points, listed companies are required to publish a *Statement of Corporate Governance*, as well as an *Internal Control Statement* that deals with the safeguards adopted by the company with regards to financial reporting, its operational activities, risk management, and compliance functions (same as above, "Accountability").

Corporate Governance concepts/principles (“CG CONCEPTS”)

This section could also be referred to for concepts (“mindset”, “mental attitude”) which make a good director.

Sound qualities which differentiate the good or bad scenarios we can observe that’s going down at companies. For any visible gaps between the concepts/principles highlighted in the Code and those lacking in the scenario, we have a CG issue in need of improvement.

Openness	Willingness to disclose timely information and accept constructive criticism. In a past sitting, the examiner introduced candidates to a director who hung up on the auditor after only having just given a half-hearted response to his/her question. From this behaviour, candidates were supposed to identify the lack of openness demonstrated by the character.
Integrity / Honesty	A quality of being straightforward and truthful. To determine if the company (or one of its directors) is being seen as truthful in the eyes of the public, we need only to pay attention to press comments on company announcements (or, in the case of an individual: his/her track record, and the reasonableness of their remuneration).
Transparency	An organisation is said to have achieved transparency when there is timely disclosure (which eliminates information asymmetry), and possesses a clear process / governing system that minimises the use of judgment – that often leads to abuse – e.g. enforcing the use of ‘open’, meritocratic tenders as opposed to ‘negotiated’ tenders (an opaque form of tendering, a distinguishing feature of cronyism). Having a transparent system (rather than making decisions behind “smoke-filled rooms”) can protect an organisation from probing by non-governmental organisations, and reduce the perceived risk of providers of finance towards the company – enabling more advantageous borrowing to be solicited, and a share premium to be enjoyed by subsequent share issues.
Judgment	Educated decision made based on the exploration of further information, and exercised with a duty of care.
Independence	Independence is the state of being free of relationships – financial, personal, family – and free of conflict of interest (which can cause a director to prioritise his/her own interest over that of other stakeholders). This attribute is particularly relevant for monitors, e.g. NED and external auditors, except for shareholders, whom are indirectly related to the company, financially. According to the UK CG Code,
Accountability	Also known as ‘answerability’. A director who observes the principle of accountability shall discharge responsibilities rightfully according to his/her position, and is willing to be held responsible for the outcome. In view that Board decisions are normally long-term, strategic decisions that have long gestation periods, shareholders (and others in the monitoring function) must be ready to assess its benefits on the scope of 5-10 years. As such, to properly evaluate the performance of a director (in terms of ‘narrow view’ criteria), the measures should be long-term so as to avoid short-termism on their part. With public sector organisations, the lack of a market mechanism of monitoring performance (as there is with listed companies, for example) means that accountability is gained in part by having a system or reporting and

	oversight of one body over others.
Responsibility	Responsibility goes hand in hand with accountability, as there is no accountability if the Board of Directors do not see their responsibility towards certain stakeholders (varies with the view taken).
Fairness	Fairness means 'to treat the same / equally'. The 'treatment' takes two forms: • Narrow View: The company's focus is on treating shareholders equally, and must allocate the time and resources to consider the interests of institutional investors (major shareholders) and private investors (usually minority shareholders), both local and foreign. • Broad View: Under this view, the company is required to pay attention to the stakeholder claims arising from the workplace, marketplace, community, and environmental context. An 'equivalent stance' is necessary in this case to keep all the stakeholders content.
Reputation	Societal standing is not only important for the company, and applies to directors as well, because they represent the voice of the corporation. Failure for designated individuals to maintain reputation in their capacity as directors could thwart to discredit the goodwill of the company, and cause a general deterioration of public perception towards the company and the products / services it supplies. Such a business risk will certainly reduce returns to the shareholders… so steps must be taken to preserve the image of the company and its directors, and if compromised, proper remedial action must be exercised to manage the situation.
Innovation	Failure to innovate implies weakness in competing against other industry players, and could result in a reduction of a company's returns to its shareholders.
Scepticism	Scepticism is an attitude that requires an individual to keep a questioning mind with the intention of uncovering fraud and error. Such a characteristic is relevant for monitors, who are advised to query and verify all matters brought to them, instead of relying on the indicators at face value.
Due Care	Directors decide on behalf of shareholders, so it is logical that the former must exercise carefulness by exploring as much information as possible so that the judgment made will be sound.

“Cadbury Report” (1992), Adrian Cadbury

The report advocates for transparency in reaching top-tier decisions, and recommends for the formation of three sub-Board committees, namely the following: Remuneration Committee, Audit Committee, and Nomination Committee.

Establishing these sub-committees (as with the presence of non-executive directors in monitoring internal controls for signs of abuse) will help the company in the following ways:

- Relieves the main Board of heavy responsibilities to allow for strategic decision-making;
- Introduces independence in the decision-making process;
- Ensure decisions reflect current practices and specialization of the directors involved;
- Bolsters investor confidence.

Remuneration Committee (‘Remco’)

In addition to the Cadbury recommendations, ex-Marks & Spencer CEO Greenbury’s report (1995) provides that, in light of the potential conflicts of interest (should the executive director be directly involved in deciding his/her pay) and shareholder’s inability to decide (as they are not in the position to suggest a realistic figure), a Remuneration Board should be set-up, and manned entirely by independent NEDs, so that no one senior executive will be involved in determining (or influencing) their own pay package.

The role of the committee is as follows:

- **Setting remuneration policy for the Chairman and Executive Director.** As the success of an organisation depends on the calibre of its directors, it is essential that the remuneration policy be capable of attracting, retaining, and motivating executive directors to achieve excellence (e.g. performance-related bonuses which are linked to established targets).
- **Approve and decide performance-related pay targets and claims.** Remco will have to work with the Nomination Committee in establishing the criteria which directors will be assessed on.
- **Recommend, monitor senior executive pay, i.e. for the Executive Director.** Remco shall benchmark senior executive pay against those of its competitors, and consult parties such as the Chairman, when deciding the sum to reward its top executives.
- **Determine if policy change is necessary.** When the remuneration packages of the company becomes no longer competitive, Remco has to redevelop the company’s remuneration policy – either internally, or through engaging remuneration consultants externally.
- **Design contractual terms which are fair to the terminated Executive Director.** Naming a figure for an executive director who has been let off due to a failure to achieve performance targets is a complex and sensitive matter. Having Remco step in as an independent evaluator will no doubt ensure that the outbound Executive Director is compensated adequately and justly.

Nomination Committee ('NC')

The Nomination Committee will be responsible for the recruitment of appropriate directors with business acumen, and directors with the skillsets to help the Board achieve balance. The oft-prescribed practice of an NC's composition is 'majority NED'.

The role of the committee is as follows:

- **Analyse the attributes and collective competitiveness of Board leadership.**
- **Evaluate the leadership needs of the Board.** Based on a review of Board size and composition, the NC will decide on factors such as diversity, mix of competencies and qualities to enhance the existing Board. If done correctly, a well-balanced Board will possess directors equipped with the skill, knowledge, and diversity of perspectives for quality judgment and reduction of the 'groupthink effect'.
- **Identify and recruit candidates for Board vacancy.** Ensuring suitable candidates are brought in to assume unfilled positions on the Board (without merely relying on personal and social contacts) is an important responsibility of the NC. To sufficiently maintain independence of the arrangement, the NC must also ensure that the proposed appointee discloses present and future business interests.
- **Prepare 'terms of reference'.** As a formality, the NC is required to make ready the 'terms of reference' (which is as laid out by *ICSA*, the Institute of Chartered Secretaries and Administrators), which is defined in other words as "the appointment letter for directors".
- **Consider succession planning with an emphasis on transfer of knowledge and experience.** As succession planning is a forbidden topic in most family-run businesses, having an NC formalizes the process of forming a succession structure, and thus eliminates the 'taboo' element.
- **Review directors' performance.** NC measures the Executive Director's performance in relation with the organisation's performance, as well as the value created for its shareholders.
- **Coordinate training programmes for directors.** To keep directors efficient and abreast of the current happenings and industry trends, the NC will have to orchestrate timely trainings and development modules for its directors.
- **Liaise with Remco.** Based on the matrices jointly developed with Remco, NC is presupposed to feedback to Remco on the outcome of the evaluation procedure. Also, together with Remco, the said evaluative outcome can be utilised for preparing future job descriptions which fit the designated roles.
- **Terminate with accountability.** In the spirit of exercising fairness and accountability, NC ensures that directors are answerable for their poor performance / fraud crimes / scandalous behaviour etc., by swiftly ejecting them from the company.

Risk Management Committee ('RMC')

A Risk Management Committee is not a mandatory sub-Board committee. However, it is still a quintessential feature for businesses on the grounds that no company in business is not exposed to risk – which begets rewards. With the notion in mind that risk-taking is a must to procure earnings, this committee identifies business risks, and establishes priority of controls in helping the company to first anticipate, and then overcome risks as they arise (rather than being ad-hoc, i.e. 'fire-fighting', seeking solutions at the final hour).

Put simply, an RMC ensures the company takes risks knowingly, thereby allowing the organisation as a whole to stand a better chance of surviving a crisis. The RMC is also the tone at the top for embedding a risk-aware culture within the organisation, which drives its personnel to unconsciously be mindful of prevailing risks and to be always equipped with the know-how (internal control and/or risk management practices) to manage risks on the spot.

The composition of an RMC is not specifically covered in most recommendations, although according to the *Walker Review*, RMC meetings should comprise mostly of NED, with an ED present to provide his/her voice as an implementer.

The other role(s) of the committee is/are as follows:

- **Review the company's 'risk register'.** Unless it is wholly prepared by the Committee, the risk register is normally a responsibility of a subordinate Risk Management department, which is subject to review by the RMC for assessing its relevance and efficacy.
- **Review 'Statement of Internal Control'.** Considering that the 'Statement of Internal Control' is a legally-required feature (thanks to listing rules, e.g. those of the likes of Malaysia's CMSA, and Bursa Malaysia's best practices guidelines) to be included in the company's annual report (alongside the 'Statement of Corporate Governance') that deals with accountability, the RMC provides an additional layer of review to ensure the substance of the document is proper.

Arguments for NED involvement

- Introduces independence in overseeing risks, and enlarges operational visibility / intensifies scrutiny of operations, deterring cover-ups.
- Diversified background and knowledge opens up avenues for addressing and managing risks.

Arguments against NED involvement

- EDs could become demotivated as opportunities are hard to be capitalised upon when NEDs are always scrutinising the risks which could arise from the EDs' area of responsibility.
- NEDs are part-time directors whom are not fully engaged in the business, which could lead them to being not knowledgeable of operational matters to respond quickly to sudden risks.

MINUTIAE

Audit Exemptions

An audit is an objective examination of a company's financial statements and systems of internal control. For limited liability companies, audits are typically required by law.

However, due to the implications of feasibility, lawmakers have realised that private companies of certain categories – that are dormant, or are classified as small / medium-sized enterprises – are of a scale or ownership structure (of concentrated shareholding, and consisting mainly of owner[s]) that makes audit unnecessary. Taking this into consideration, authorities have waived the audit requirement for the majority of these companies. Such a practice has occurred in the UK since as early as 1989.

- In the UK, private limited companies qualify for audit exemption if they possess at least 2 of the following conditions: an annual turnover of no more than £6.5 million, assets worth no more than £3.26 million, 50 or fewer employees on average.

Robert Smith (2003)

The Smith Report mainly discusses the guidelines relevant to Audit Committees. The most notable recommendation is that the Audit Committee should be membered only by Non-Executive Directors (NEDs).

How interests are aligned? Monitoring and incentives.

- **Monitoring:** There are basically three parties in the corporate monitoring function – auditors (internal and external), non-executive directors, and shareholders. Monitoring here means that the stewards of the corporation are subject to scrutiny, and this promotes accountability.
- **Incentives:** This refers to the combination of monetary and non-monetary (i.e. perquisites / benefits-in-kind) benefits rewarded to the director in achieving the purpose of motivating and retaining (after having attracting). A remuneration package is divided into short-term incentives (e.g. salaries, bonuses, perquisites) and long-term incentives (e.g. share options, company shares).

Insider Trading

'Insider trading' refers to the act of benefitting from a privileged position to achieve an unfair advantage in the stock markets – by buying ahead of good news, or selling before bad news is announced. In modern examples of insider trading, proxies (representatives) are the favoured mode of perpetrating the crime.

Stakeholder claims

Stakeholder claims are the demands of the stakeholders whose interests (e.g. welfare) are affected by the activities and decisions of the company, with a view that their claim should be observed and respected.

The argument against using stock prices as a performance measurement

It is normal for stock prices to react to news – in a bearish or bullish manner, depending on whether it counts as bad or good news. A director whose bonuses are linked to stock performance may seek to create exaggerated hype for the company and even falsify news to inject excitement to the stock markets, so as to rile investors up into a buying frenzy… causing stock prices to drive upwards.

The argument against using profitability measures as basis for evaluating director performance

Profitability measures are vulnerable to manipulation – either at the financial statement level or year round. An example of a profitability ratio that is prone to distortion would be the Earnings per Share (EPS), which the company could influence by buying shares from the open market for its treasury, or vice versa.

MAICSA *(The Malaysian Institute of Chartered Secretaries and Administrators)*

Earnings Management: From the meaning of the phrase, it is unlikely a company would be able to influence its earnings without any form of tampering (demand for a company's products and services is uncontrollable). To this effect, we say that the 'managing of earnings' is an act / series of acts which involve manipulation of the financial statements to achieve an intended outcome (profit).

Forthcoming: This word could possibly stand for 'candid', 'cooperative' or even 'approaching'.

Short-Termism

Decisions that benefit the shareholders (the company as well) in the short run, although not necessary in the long-term. Short-termistic decisions, such as terminating efforts to expand or enrich existing services, abandoning research and development (R&D) projects in lieu of short-term profitability, can cause company performance to deteriorate in the long-term, especially high-technology firms whose competitive advantages are heavily dependent on their ability to innovate and develop new products and solutions.

Sub-Board Committees in a Public Listed Company

- Audit Committee
- Remuneration Committee
- Nomination Committee
- Risk Management Committee **(Optional)**

Sub-Board Committees receive their duties as delegated, preserving only matters of critical attention for the main Board. The Board of Directors acts on the recommendations from the sub-Boards, and formulates decisions for the long-term strategic advantage of the company.

Advice from a retired EY Partner

"So, you would like some advice that'd help you in your career in auditing?"

Look out for the 3Cs. Auditees are always out to pull the 3Cs on auditors:

- **Convince.** Financial statements are management assertions. Basically, this first stage is where auditees test the waters of the auditor's understanding, and seek to invite the latter into agreeing with the accounting policies adopted by their company.
- **Confuse.** When explanation is no longer satisfactory, the frustrated auditee will seek to fabricate stories that he/she hopes the auditor will believe out of confusion. Usually, auditors (especially Big Four types who charge their clients top dollar), for fear of looking unprofessional (the word here is 'foolish'), will appear to be completely knowledgeable on the subject matter… even when it is gibberish.
- **Con.** It is the job of financial officers within certain unethical companies to resort to conning its auditors, if the first two steps did not work. Unless they are incentivized to do so (guess how else a junior finance staff can ascend to finance directorhood in a short span of 5 years), many in this situation are pressured to deceive their monitors on behalf of their superiors (especially finance directors who find it difficult to con the auditors because they often play by the book, much to their superiors' dismay).

Risk register

Conventionally prepared by the Risk Management department during the course of work, a 'risk register' (or 'risk profile') is a report on the details of the risks faced by the company, accompanied by:

- The likelihood (of individual occurrence) and significance (impact) of risks;
- What measures should be taken to address the said risks;
- Deadline of implementation; and
- Personnel assigned to manage the safety measures.

Enterprise-wide risk

A profitable way of calling ‘business risk’.

CG disclosures in the Annual Report

‘Comply or explain’ approaches have been taken by listing authorities to ensure that companies include CG disclosures in their annual report, these disclosures take the form of:

- the Statement of Corporate Governance (which encompasses a brief on the directors, their remuneration, and shareholder relations); and
- the Statement of Internal Control (that touches on accountability aspects and financial reporting).

****Turnbull Report (1999) – elements of a sound internal control system:**

- Embedded in culture
- Responding quickly to risks to the business – requires monitoring to be in place in order for this objective to be fulfilled
- Procedure for reporting immediately – requires communication procedure to be put in place, otherwise there will be a delay in responding to weaknesses in control of fraud

****Sound system of internal control**

Control environment	'Tone of the top'. How the Board behaves will affect those working under it.
Control activities They must be adequate in the context of the situations faced in a company.	Financial Operation Risk Management Operational
Communication	<u>Timely / regular reporting</u> Information of 'high-quality' must be reported to the Board in a timely manner so that prompt, corrective action can be taken to allow sound strategic decision to be made. (*As the Board is not involved in day-to-day operations, they rely on financial statements / risk reports etc.*) <u>Whistle-blowing arrangement</u> Establishment of a whistle-blowing mechanism within the company encourages confidential reporting of malpractices ('white-collar crime') involving senior management, in a manner that will protect the identity of the whistle-blower. (*Overseen by the Audit Committee*)
Monitoring	In the absence of the internal audit function, the Board is responsible for undertaking the monitoring to ensure that the controls are effective and being applied as prescribed.

Sound system of internal controls cannot provide protection against fraud and error (which causes the company to suffer losses, or breach laws or regulations, or failure to meet business objectives) with certainty – due to the presence of **control risk**.

Control risk is the risk that internal control has failed to prevent and detect fraud and error, this can be due to:

- Collaboration (which causes the collapse of the segregation of duty) among several staff with a third party, resulting in the expected check and balance not taking place.
- Control overridden by management (especially when more resources than needed are used to accomplish a task, e.g. senior authorisation when in fact, junior authorisation will suffice).
- Staff responsible for exercising the controls are incompetent or have overlooked the presence of fraud and errors (human factor).
- Loopholes in the internal control system which were unknown to management / occurrence of unforeseen circumstances.

Categories of Internal Controls (*Financial*)

To ensure truth and fairness of financial reporting, and minimizes the occurrence of fraud and accounting errors – relevant to the external auditor.

Personnel	Focuses on ensuring that the personnel performing the work are of high competence – achieved through having: stringent recruitment policy for new employee, ongoing training for existing employees etc.
Authorisation, approval	Objective of this control is to ensure that payment is not made for fictitious purchases, and the signing of contracts and agreements is restricted to only senior personnel. e.g. *For payments, the "three-way matching" method is used. This refers to the collective presence of: 1)* ***purchase order****, 2)* ***goods received note*** *(raised by the warehouse staff), 3)* ***original purchase invoice****, before a particular transaction is approved and paid.*
Physical	Applicable for those goods / assets that are portable, valuable, and exchangeable, in which the chances of pilferage / theft / being stolen are high. e.g. *Passwords, lock and key, security personnel.*
Arithmetic & accounting (*also known as 'recording control')*	Objective is to ensure the completeness, accuracy, and validity of the transaction recorded, examples include: pre-numbering of documents / control totals (completeness), reconciliation of record and documents (accuracy) – cash book balance will be transferred to financial statements.
Management	Exercised by the highest authority within a company, usually on an ad-hoc (irregular) basis. e.g. *Monitoring of actual performance by benchmarking against budgetary system, review of financial statements / management accounts (P&L, SOFP, Cash flow statement – prepared monthly for the purpose of updating the company).*
Organisation	Control aims to ensure that staff within an organisation know their respective responsibilities, and to whom they are reporting to. This can be achieved by using: 1) job description, 2) organisation chart with clear reporting lines being shown, etc.
Supervision	Unlike management controls, this is exercised by the staff's immediate superior, usually on a day-to-day basis ('close monitoring').
Segregation of duties	Requires different tasks to be undertaken by different personnel to avoid cover-up of fraud and error, thereby introducing check and balance.

<u>Risk Management and Corporate Governance</u>

<u>Objective:</u> CG emphasizes on two things: 1) safeguarding of shareholders' investments ('looking after assets' and 'protect the value of shareholders' investment'), 2) maximisation of returns to shareholder – both of which can be achieved through risk management (by taking risks knowingly). Therefore, risk management is indeed good CG.

<u>Nature of Risk:</u> Risk is unexpected. The objective of risk management is to convert uncertainty into something that the Board can foresee so that appropriate measures can be put in place to prevent their occurrence. Therefore, by anticipating risks ahead, the company is in a better position to survive crises, subsequently preventing a 'knee-jerk' response from shareholders – by selling shares.

- **Downside risk** – a risk with negative effect. Although it may not be the case for other industries / businesses…
- **Upside risk** – not all risks are bad, as they are commonly linked to gains, so what is more important is that businesses should take calculated risks, i.e. those that are within the Board's overall risk appetite (the degree of tolerance of business risks; similar to the concept of 'materiality' used by external auditors for ascertaining audit risk).

Working around risks? Adjust organisational and capital structure.

Risk management reviews should be reported to shareholders, via **Statement of Internal Control** (which deals with accountability).

In risk management, risks are being studied regularly with measures being put in place to overcome them ('prevention'). This should reduce fraud and improve productivity, which helps maximize returns to shareholders.

<u>Roles of the Board in internal control</u>

Establish	Form appropriate policies on internal control for implementation by operating management – identify, evaluate risks faced by the company; for the design, and subsequent operation and monitoring of internal control system.
Review	Conduct a review of systems of internal control and report to shareholders, at least once annually (especially in the absence of an internal control function) – based on which they make sound decisions. If there is an internal audit function, it will be them instead whom evaluates the system of internal control, and report to the Board. **Risk report** is a document prepared by management where risks are highlighted, together with measures taken in addressing these risks.
Hiring	Consider the need to introduce an internal audit function for the purpose of monitoring the effectiveness of internal control (although it is not compulsory in the UK).
Committee	Establish audit committee that comprises of all independent NEDs to oversee financial reporting and internal controls.
Environment	In 'walking the talk' ('the tone at the top'), the Board must create a conducive control environment for the successful implementation of internal control systems.

Definition of Internal Audit as per IIA

"An independent appraisal activity"

Independent and objective assurance and consulting activity designed to add operational value to the business. (revised in 2007 to achieve win-win, consultative relationship)

"Lonely life"? "Backstabbers"? "Dog"?

Perception is that internal audits are to find fault in others, and therefore confrontational. Internal audit used to be confrontational (win-lose), today, the role is more consultative – clients seek consultants.

Generalists involved in evaluating and improving risk management process, acting independently of executive managers, report to the Board, Audit Committee, and/or CEO.

- Functionally (anything pertaining to work), IA report to the Audit Committee.
- Administratively (for administrative matters, e.g. necessitates company spending), IA report to CEO.

Work performed is not prescribed by regulations, but rather determined by the company ('toothless tiger' position). In the absence of law (a shortcoming), IA must seek power from the Board by preparing the **Audit Charter** which details the following information:

- Rights and responsibility of IA;
- Reporting line of IA;
- Audit methodology used by IA;
  techniques used by IA?
  Will knowledge empower management to seek loopholes?
- Frequency of IA reporting to the Board. *How often it is being carried out?*

External auditors derive their rights and power from the Companies' Act – access documents, right to demand information and explanation from client – staff – management, identical rights as a shareholder, qualify – insufficient appropriate audit evidence. Through use of the Audit Charter – its function akin to a warrant – the Internal Auditor is empowered to perform their work without interference.

Review internal controls encompasses four areas – financial, operational, risk management, and compliance, hence their possible tasks include:

- Reviewing internal control system (monitoring), e.g. review of financial controls jointly with external auditors;
- Special investigations (internal audit that is unplanned, usually in response to allegations of fraud by whistle-blowers) on operational details.
- Assess financial statements. Audit on audit-exempted subsidiaries (prevents overlap), and deducing conclusions based on the timeliness and accuracy of report information.
- Assess operational controls for VFM criteria: competitive pricing (economy), increased production (efficiency), achieve objective (effective);

- **Risk audit / assessment. Monitor and report risk management review – checking on, but not preparing (otherwise it's self-review) the three main stages in risk management systems: Identification (looking for the risk), Assessment (measure impact on organisation – to determine which risk is more critical than others), Control (introducing measures to overcome risk)... Internal auditors do not manage risk – which is done by a separate department: the risk management department – but auditing the work of the risk manager in the above.
- Conducting compliance audit – using a checklist approach.

****Work carried out by the auditor with regards to the Risk Management System ('Risk Audit')**

IDENTIFICATION → ASSESSMENT → MEASURES

A Risk Management System is merely based on assumptions on risks which haven't occurred. If a risk is being omitted from the identification stage, it will not be assessed and managed. Assessing risks is not about the good and bad about the risk, but about the 'likelihood and impact'. An internal auditor does not perform the below functions, but merely checks and provides recommendations on the comprehensiveness, reasonableness, and appropriateness of the process.

Identification of risks **(*Is it comprehensive?*)**	Involves internal auditor *reviewing the risks that have been identified* by both the Board and operating management to ensure that they are *comprehensive*. Any risk that is omitted from this process will be totally excluded from the system.
Assessment of risks **(*Are the assumptions reasonable?*)**	Involves the internal auditor *reviewing the likelihood and impact* that have been assigned to the respective risks to ensure that they are reasonable as this would have an implication on the type of measures taken to address the risks.
Managing / Control of risks **(*Is it appropriate?*)**	Involves internal auditor *reviewing the measures* taken to tackle / address the respective risks to ensure that they are *appropriate*. Otherwise, it will not be capable of managing them.

<u>Factors which affect the decision of having an IA function</u>

UK CG Code requires listed companies to review the benefits of having an IA function from time to time. **Turnbull (1999)** identifies the following factors to consider:

- **Scale** (refers to *size* of the organisation – the larger the company, the higher the volume of transactions, and therefore, the higher the quantity of processing errors) – the presence of IA would help review these transactions, and possibly, introduce control to minimize processing errors;
- **Diversity & Complexity** (related) – the more diversified a company's operations are, the more complex would be its web of operations. Therefore, an IA function is required to advise / suggest measures to improve on the company's operations.
- **Number of employees** – the greater the number of employees in an organisation, the higher the chance of having fraudsters among them. The presence of an IA function can serve as a *policing* (which originates from the word 'police') / *deterrent effect*, thus minimizing the potential occurrence of fraud.
- **Cost/benefit consideration** – *Cost* is expressed quantitatively (e.g. salaries / bonuses paid to IA, rental, utility charges incurred by the IA function), and qualitatively (e.g. the morale of operating management may be affected by the presence of the IA, because they perceive the Board / management to be no longer trusting). *Benefit* is also expressed quantitatively (i.e. the losses to the company prevented by detection of fraud, or even the cost efficiencies / savings brought about through recommendations), as well as qualitatively (i.e. deters fraud from happening due to the prospect of being caught by the IA – '*policing effect'* instils fear).

Importance of Auditor Independence

Something is important because of the benefits it brings / because if you had it otherwise it would have been unthinkable – i.e. negative consequences. (*what-if*)

Independence is not a fundamental principle (as it is a natural product of integrity and objectivity) – Integrity, Objectivity, Confidentiality, Professional Behaviour, Professional Competence and Due Care.

External Auditor	• Promotes transparency for a company as disclosures are more credible. • Contract monitoring (with respect to debt holders). • A wish to maintain good relations is a familiarity threat – applicable when both parties concerned are of seniority in position (at the firm and at the client's establishment), e.g. financial controller and audit partner. • Self-interest threats will only arise from fee dependency (undue dependence, a situation when a single audit client is responsible for over 15 per cent of the practicing firm's gross income over 2 years) provided that its services rendered are recurring in nature, e.g. taxation and audit. Consultancy services are solicited on an ad-hoc basis, and hence, not recurring.
Internal Auditor	• IA must report to the *highest authority*, i.e. the Board, or the designated Audit Committee, in order to command the co-operation of the auditees, as the highest authority is also their superior. The highest authority is not involved in executive management of the company, and so will remain independent in dealing with issues highlighted by the IA – the Board is unlikely to compromise. • Their work requires IA to perform with an honest belief that no significant quality compromises are made. Unfortunately, attributes such as personality, mental attitude cannot be seen. IA can only be reasonably judged from their appearance as well as services carried out by the IA. • Internal auditors do not determine the scope of their work (their powers are not governed by statute as external auditors), and their pay and promotion prospects are sourced from management. • IA should not assume operation function, as the activity for which they had authority or responsibility might invoke a conflict of interest / cause a 'self-review' threat to arise. • For prospective IA, cooling-off period must be observed – and must be sufficiently long so that the IA concerned will not be auditing his/her own work completed before the transfer, OR affected by the close relationships with ex-colleagues. • IA must not be involved in designing, installing, and operating systems. However, recommendation of standards of control for systems is acceptable in a way that is seen not to adversely affect their objectivity.

Threats to independence

- Fee dependency, self-interest;
- Familiarity between seniors;
- Should not take up management positions, making managerial decisions – therefore seen as a member of the client's management, as accountability is a liability which auditors should not assume;
- Self-review threat will occur if the outcome of non-audit services provided result in their work being recorded in the financial statements subjected to audit.

Safeguards

- **Erection of Chinese Walls:** Refers to having separate teams of professional accountants perform audit and non-audit services that avoid the self-review threat.
- **Avoid low-balling.** Although quoting a low audit fee does not necessarily constitute this, provided the client is not misled over: the level of services that the audit will cover (content), the fee chargeable on non-audit services. Independence may be lost to low-balling attitudes, in favour of marketing and business approaches.
- **Obtain clearance from superior.**

<u>Roles of the Audit Committee</u>

<u>Robert Smith Report (2003), *published post-Enron*</u>

- Review scope and outcome of audit;
- Approve the hiring and termination of the head of IA;
- Review whistle-blowing arrangements;
- Oversee appointment of internal and external auditors;
- To review according to remit (lettered in the 'Audit Charter');
- IA department should be adequately staffed with people of the right experience;
- Review and access the *Internal Audit Workplan:* suggestions made by IA for the audit to be carried out over the whole year.
- Receive report on internal auditors' work: 1) 'weaknesses in control' file, and 2) consequences of the said weaknesses, 3) recommendation for improvement.
- Review and monitor management's responsiveness to findings and recommendations of the IA. Should management not be responsive, this is indicative of a weak control environment in need of AC intervention.
- Meet with the head of IA in the absence of management, at least once a year;
- Monitor and assess the *role and effectiveness* (was whatever designated achieved? was the role effective?) of the IA function – in the context of risk management.

<u>AC and External Auditors</u>

By law, shareholders appoint EA. In practice, such an appointment is merely a formality, as they are clueless about EA competence, and so it is the Chairman, who, upon consulting with the Audit Committee, determines which EA to hire. If the Board is at odds with AC's recommendations, AC must explain recommendation and why the Board took a different position (disagreement).

- AC must also satisfy themselves that the level of fees that the company pays is appropriate and feasible;
- AC should perform assessment of threat to independence between the company and the audit firm;
- AC must observe company policy regarding employment of former employees of audit firms;
- Review representation letter for non-standard items (which auditors are able to determine for themselves, and would not require AC to describe);
- Review management's responsiveness to auditor's findings and recommendations (as highlighted in the management letter) to assess control environment;
- Consider 'robustness' of auditors in handling key audit adjustments.

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Conventions:

PwC: Investigations

Deloitte: Taxation

BDO, Receivership.

Mother of all controls: Segregation of duty prevents cover-ups

Awareness of importance = satisfactory control environment

Under instructions of the Board, the financial statements are prepared for the Board by the Finance Director.

Audit exemption (<RM100,000 turnover, <SGD5.5 million, as of 2016).

Internal audit is not compulsory in the UK, unlike in Malaysia.

Low-balling is a situation where the firm intentionally quotes a lower audit fee (during a tender) – leading to a low profit margins, resulting in corners being cut – in hopes of winning a bid for non-audit services (which is contrarily over-charged).

Unlike non-audit services, audit has no product differentiation, as ISA is standardised, so cost is the main area of competition.

Focus on VFM Audit – paid to learn.

SOXA stipulates that auditors should 'cool-off' for a year before joining the client.

SOXA does not disallow taxation services from being solicited in coincidence of an audit – as it is subject to Inland Revenue scrutiny.

Ability to force EA to resign? Shareholders, rightfully. It would be false for executive management to force. Following an 'exit meeting', this normally warrants AC investigation.

A qualified audit report exists because management, though aware of the misstatements, are reluctant to adjust their financial statements.

Audit representation letter: A document for confirmation on matters pertaining to judgement which cannot be verified in the audit – these *non-standard issues* do not include going concern issues, but inventory valuation, which can usually be appropriated by the auditor through various audit techniques.

Public relations build company image, suppress publication of negative news ('covering up'). PR is, because of this, a form of risk management – a form of CG as well.

P1: explain -> relate: e.g. accountability -> role of Chairman and CEO

Statement of Internal Control

A report produced by the Board which discloses the process of identifying, evaluating, and managing the risks faced by the company, which has been prepared and reviewed in accordance (‘with guidance’) to the Turnbull Report (2005).

Content: The disclosures should include:

- Acknowledgement of responsibility for internal control and effectiveness review;
- Summary of process applied by the AC & IA function – that plays an instrumental role in the reviewing of internal control;
- Changes in internal control, and responsiveness to changes in business environment;
- Scope and quality of monitoring;
- Extent and frequency of communication to the Board (e.g. Internal Audit report, Risk report);
- Weaknesses in internal control (‘control failings’) and consequences (impact on financial performance or condition);
- Remedies for weaknesses.

Qualities of an exemplary Internal Control information for Board use / Statement of Internal Control

Relevance	Information communicated to the Board must meet their objectives, i.e. the purpose in which the information is needed and must be material, as irrelevant information will have the effect of causing the Board to lose focus and suffer from an 'information overload'.
Understandable	Considering the Board is diversified, directors may not come from the same background, and so technical jargon should be avoided to ensure common understanding of the issues being discussed.
Timeliness	Any delay in communicating the information can cause a loss in the value of the information delivered, and defeat the purpose of communication.
Consistency	Refers to the basis upon which the information is being prepared. Without consistency, information will not be comparable.
Comparability	Ideally, comparative figures ought to be shown in the information reported, just as previous year results, industry averages… which will aid the Board in assessing the performance of the company.
Reliability	Depends on the competency of the individual providing the information, as well as their independence. Information will be more reliable if they are in written form, as opposed to an oral presentation – more so when they are the latest, most current information which reflects the situation.
Conciseness	In view that the Board has no time to read detailed reports, information furnished to them should be straight to the point and in summary form.
Cost	The cost in gathering information for the purpose of communicating to the Board must not outweigh the benefits derived.

Factors used to evaluate the soundness of the existing internal control system

COMPONENTS	***FACTORS***
Control environment	• Are there policies and procedures in support of risk management and internal control systems? • Does senior management foster a climate of integrity and competence?
Control activities (*'Risk assessment'*)	• Are there clear strategies for dealing with significant risks? • Are responsibilities clearly communicated? Scope of freedom to act? • Do people have the knowledge, skills, and tools to support achievement of objectives? (*Personnel control*) • How are controls adjusted in response to changes in the environment? • Have the objectives been communicated to provide direction on risk assessment and control issues? (*Refers to whether the company has in place the 'risk management policy'*) • Are significant FORC risks identified and assessed on an ongoing basis? (*Should a risk assessment department exist within a company, the identification, assessment, and management of the risk would on an ongoing basis*) • Is there a clear understanding by management and others within the

	company of ‘what risks are acceptable to the Board’? (*Refers to the establishment of risk appetite which measures the degree of tolerance by the Board, collectively*)
Communication	• Do management receive *quality* reports? • ~~Is information communicated objective (‘free of biasness’)?~~ Are information needs reassessed when risks, objectives change, or when deficiencies in reporting are identified? • Are reports balanced and understandable (not window-dressed, and free of jargon)? • Is there a whistle-blowing mechanism?
Monitoring	• Are there ongoing processes embedded? (*Refers to the existence of the IA function in charge of the monitoring role*) • Do the processes monitor company’s ability to re-evaluate risks and adjust controls (*Determines whether the scope of the IA includes evaluation of the company’s promptness in responding to changes in the environment – that necessitates a change in the existing internal control system*) • Are there effective follow-up procedures to ensure action? (*Without following-up, issues previously highlighted may not have been fully addressed*) • Is there appropriate communication so that prompt action (‘timely’) may be taken? (*Refers in communication to the Board in the form of Internal Audit and Risk reports, which facilitates the latter in the monitoring of internal controls and risk*) • Does the company have a policy of immediate reporting without delay so that prompt action can be taken by the Board? Such as with regards to the occurrence of fraud, which can cost the company more as time goes by.

Risk Management

Article: 'Tanjong has a lot more convincing to do'

In 2003, Tanjong ventured to Germany to build a 'tropical island' – similar to Gardens by the Bay, Singapore. Naysayers worry of the business risks:

- fear that project will involve huge capital outlay;
- long gestation / payback period – depletes cash pile and hurt earnings;
- inexperience in leisure industry – Tanjong is an independent power producer, and Damacai franchisor – particularly in a country where English is not the main language;
- Germany is not a tourism hotspot;
- does not have 'sparkling' track record in overseas expansion.

Article: 'A concept…'

Risk management is akin to the brakes of a car – avoiding collisions when used correctly, or cause dangers when used incorrectly. Healthy bottomline

All risk management proponents advocate that risk management is 'to ensure that the business unit or non-business unit (*not profit-oriented*) do not expose themselves to unacceptable losses or negativity'.

Capital risk and reward is a vicious cycle (interrelated): In view of the risk-reward relationship, it is not appropriate for a company to eliminate all risks. Instead, they should manage the risk according to the "ALARP" principle.

ALARP Principle: As Low As Reasonably Practical – which reminds us that it is not possible for a company to eliminate all the risks. Because 'no risk' equates to 'no gain'.

Manage risk to maximize reward on capital: Risk management doesn't only focus on the negative – as there are upside risks too ('possible gain or reward, capital appreciation, shareholder value').

Unavoidable risk losses are a way to do business?

Avoid asking shareholders to inject more money / lose original investment – when share prices drop.

Challenge for risk practitioners: How much risk to take without influence of negative effects?

Risk treatment and control: Are measures capable of addressing general and residual risks? Can the impact of risk be mitigated?

Residual risk: A risk that existing internal controls fail to address.

Preventive Control: Most cost-effective

Detective Control: Reconciliation

Corrective Control: Improvements

Article: 'Managing not avoiding'

Risk management is not supposed to be on inculcating pessimism. The fundamental objective of risk management is to 'anticipate' and 'prepare' (face the risk), a proactive and optimistic perspective that does not embrace avoidance (a pessimistic approach), but instead seeks to influence the outcome.

According to Deloitte, corporations need to develop a holistic approach to risk management, as companies fail to see interlinks between risks (see "*Risk interdependencies*").

Unforeseen interdependent risks can spiral into a company / industry-wide threat.

Create culture ('tone at the top', i.e. the way top management carries themselves) where there is a demonstrable commitment to conducting business according to policy and procedure – a standard / checklist approach has to be developed. Needless to say, it should also not be a climate of fear and pessmism – as no risk equates to no gain – as risk reduction is not the same as risk refusal.

Businessmen won't have to 'de-risk' the company as investors they would select only investees congruent to their risk appetite and investment horizon. Management therefore has to run the company in line with its own risk appetite.

Holistic Approach	**Fragmented Approach** **(*Fire-fighting*)**
Refers to an approach that is structured and wholesome (enterprise-wide), i.e. covers every possible aspect. *"Knowing a risk isn't good enough, you have to know the likelihood and impact of those risks, and how it is managed."* *"Imagined risks are also unlikely to occur… Rare events can sometimes be unpreventable, so therefore management has to 'work around it'."*	An approach that is ad-hoc, inconsistent, and lacks structure.

Risk interdependencies

Reputation damage (*reputation risk*)

↓

Company experiences difficulty to sell its product (*product risk*)

↓

As a result of low sales, the company's cash flow is affected (*liquidity risk*)

↓

If the situation prolongs, the company's going concern status will be threatened (*going concern risk*)

Correlations of Risk / Forms of related Risk

Risk A ↓ *(e.g. R&D risk is reduced when research expenditure is increased)*	Risk B ↑ *(e.g. Liquidity risk is increased as the cash flow of the company has worsened as a result of increased R&D activity)*
Negatively Correlated – deemed so if the risks 'move in opposite direction'	

Risk A ↓ *(e.g. Reputation risk is reduced when a company's goodwill is enhanced)*	Risk B ↑ *(e.g. Product risk has decreased as a result of better sales arising from enhanced reputation)*
Positively Correlated – deemed so if the risks 'move in the same direction'	

Simplistic approach to risk management	*ACCA Examiner's approach to risk management*
• Risk assessment • Risk information • Risk controlling	***Processes in Risk Management System ("I AM MC")*** • *Identification of risks* Undertaken by both the Board and operating management, depending on the severity / significance of the risks. The Board is responsible for identifying strategic risks, whereas the latter focuses on only the operational risks. Because this is the first step in the Risk Management System, any risk that is being excluded or overlooked will be excluded totally from the system, and hence completeness ('comprehensiveness') is an important factor to consider. Whether or not risks are under the control of the organisation is not important at this stage. This is to ensure that no risk will be omitted from being unidentified. Methods: Checklists, judgment based on experience and records, flowcharts (which requires study of the flowchart in detail for flaws and shortcoming), brainstorming, system (looking at gathered information) and scenario analysis (involves asking 'what-if' questions). Purpose: Identifying causes in identification of a risk is to facilitate subsequent determination of control to overcome the risk. • *Assessment of risks* Following their identification, risks will be assessed ('measured') according to their likelihood of occurrence and impact ('severity') on the organisation ('prioritisation of critical risks') which would directly affect the course of action to be taken to address them. Since the assessment is based on assumptions made, it is important that they are reasonable. Methods: Focus groups, questionnaires, computer simulations. Analytical Methods: Quantitative and qualitative. • *Managing the risks / Tackling the risks* Depending on their severity, risks are managed using the **TARA** Framework (Transfer, Accept, Reduce, Avoid). It is essential that the measures taken are appropriate in order to achieve the desired results. • *Monitoring the risks* Since risks hardly remain static – especially in turbulent / fast-changing environments – it is important that periodic review be undertaken to determine whether any new risks have emerged, changes in the likelihood and impact of a particular risk as well as whether the measures implemented had achieved the desired result. Enterprise-wide Risk Management is not a one-time exercise, it is ongoing. • *Reporting (Communicating) the risk status* On a periodic basis (usually quarterly), the risk manager (the overseer) will compile the status of the risks the company faces to the Risk Management Committee (composed of ED + NED), who will in turn, report the significant risks to the Board together with the measures taken to address them.

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Risk assessment: Measure of likelihood and impact – not about pros and cons.

Related risks: Refers to risk that exist at the same time.

Shareholder and stakeholder conflict: Risk and reward relationship of a stakeholder has no duality – “profits are shared in the good times, but losses are not shared during the bad times”.

Internal Control: FORC ≠ *Internal Control System / System of Internal Control*: Control environment, activity, communication, monitoring.

Risk Management: I AM MC ≠ *‘Managing the Risk’ / ‘Management of Risk’* : A particular component of I AM MC. Managing risks involves frameworks such as TARA – transfer, avoid, reduce, accept.

Risk Management Committee: Oversees risk management department, comprised of all types of directors (independent, non-independent, executive, non-exec etc.) ≠ *Risk Management Department*: A department which aim is to ensure that the organisation / a business / non-business unit do not expose themselves to unacceptable losses or negativity (“take risks knowingly”)

Risk Appetite

The level of tolerance ('amount') of risk by the Board as a whole ('broad level'), which can range from being risk-averse to risk-taker.

Risk-seekers favour higher risks and higher returns, while the converse is true for risk-averse entities.

Risk-takers tend to focus on the best case scenarios and ask themselves whether the returns are high enough to meet Board expectations ('*MAXIMAX*'). The risk-averse approach will focus on the worst case scenarios and ask that when such situations happen, whether it is within the Board's tolerance level ('*MINIMAX*'), choosing strategies such as sharing, reducing, or avoiding risks which are associated with acceptance of a lower rate of return.

**Risk Categories
Identify (from case study) and classify types of risk

Risk is classified to identify the best way of allocating responsibilities (‘resources’) more effectively with regards to addressing them. In practice, there are many methods of classifying risks, e.g. as a measure of likelihood and impact, risk-grouping according to departments within the organisation etc.

Risks fundamental to the organisation’s continued existence: Refers to risks which threaten an organisation’s going concern.

Day-to-day risks: ‘Not too serious’ risks.

Categorisation of Risk

Methods of classifying risk

Severity

Risks are grouped in accordance to their damage caused to the organisation.

- Strategic
- Tactical
- Operational

Nature

Risks are grouped based on their nature which can be operational, financial, and compliance-related.

Sources

Risks are grouped based on where they originate from.

E.g. If a risk originates from reputation damage, it will be thus termed ‘reputation risk’. On the other hand, if it relates to difficulties in selling the product, this will be called ‘product risk’.

**Severity *‘The seriousness of the risk’*	
• Strategic [*risk*]	The most severe form of risk that a company could experience and has the effect of threatening the company’s **going concern status**. Arose from strategic decision made by the Board as well as from the external environment beyond the company’s control, such as competition, unfavourable exchange rate movements etc. In view of this severity, these risks are overseen by the Board.
• Tactical	Occurs within a particular **division** in the company, e.g. market department (departmental), or a business unit (subsidiary). Though serious, a tactical risk does not threaten the going concern of the company. *Example: Sudden resignation of the Marketing Director, which had caused the company’s advertising and promotional activities not being coordinated until a replacement is found.*
• Operational	Arises from the company’s **day-to-day operations** that have the effect of creating temporary ‘hiccups’ to the operation. *Example: Food poisoning that caused several workers to be out of work for a week.* The party overseeing these risks will be the operating management.

Nature *'By characteristic'*	
• Operational [*risk*]	Refers to events that could threaten the smooth running of a company's operations. *Examples:* • *Strike initiated by workers* • *High staff turnover* • *Raw material shortages ("Stock-outs")* • *Failure to invest in R&D* • *Poor quality of products, and etc.*
• Financial	Focuses on events that could threaten the cash flow of a company, and putting it at the risk of collapse or insolvency. *Examples:* • *Default in payment by credit customers* • *Unfavourable exchange rate movement* • *Hike in interest rate / 'Overnight Policy Rate'* • *'Overtrading' – transacting more business than the firm's working capital can normally sustain.*
• Compliance	Applicable to companies operating in regulated industries, such as banking and finance, insurance etc. Failure to comply with external laws and regulations in this case can cost the company's going concern, especially through withdrawal of licence to operate.

Sources	
• Market [*risk*]	<u>*Product*</u> Inability to sell the product to potential customers. <u>*Resource*</u> Disruption in supply of raw materials by suppliers. <u>*Financial*</u> Failure to raise the required finance from financiers.
• Credit	Credit risk only occurs when credit customers default on their payment to the company / obligations are unfulfilled as per contract, e.g. bad debts.
• Liquidity	A risk that threatens the cash flow of the company, such as those discussed under '*Financial Risk*' previously.
• Technological	A risk of the company failing to keep up with the pace of development within the industry, causing its goods and services to fall out of favour / be not in demand, i.e. obsolescence, and subsequently being forced out of business.
• Legal	Refers to a risk that the company faces litigation due to non-fulfilment of the covenants (T&Cs) stipulated in a contract.
• Environmental	<u>*'Green issues'*</u> Focus on the negative environmental footprint that a company's operations may bring to the environment:

<table>
<tr><td></td><td>

Utilization of natural resources that are not renewable, i.e. excessive usage can deprive future generations from having access to them.
Hazardous emissions (or disruption of peace, e.g. noise) and pollution to the water, air, land etc.

<u>‘Internal Business Environment’</u>
Changes brought about in the ‘internal environment’ that threatens the company’s operations.

High labour turnover
Production outtakes from broken-down machines

<u>‘External Business Environment’</u>
Changes in the external environment which could threaten the company’s operations.

Changes in law and regulations
Competition

</td></tr>
<tr><td>• Reputation</td><td>Refers to general deterioration of the public’s perception towards the company, or the products and/or services that it sells – leading to product / market risk.</td></tr>
<tr><td>• Probity</td><td>A risk that the company is not seen as an ethical or trustworthy organisation due to certain incidents which have occurred, such as leakage of customer’s confidential information, involvement in bribery, earnings management etc. – arising from unethical behaviour by one or more ‘participants’.</td></tr>
<tr><td>• Derivatives</td><td>The risk is that of a company failing to have a hedging arrangement, which caused It to be unfavourably exposed to market exchange rates. Alternatively, derivative risk also exists when the company is involved in speculative activities, such as trading in futures.</td></tr>
</table>

<u>Variability of Business Risks by Sector</u>

Environment

Regulated	>	Unregulated
High-tech	>	Low-tech
Competitive	>	Uncompetitive *Characterised by **evergreen** (forever in demand) industries.*

Different types of environment will have different types of risk, but it should be noted that businesses operating in volatile, unstable environments (with greater regulation, changing consumer patterns, higher technology) are definitely riskier than simpler and stabler environments.

Business Models

- *Cash vs credit sales*: Misappropriation vs. credit risk & fraud risk.
- *Wide networks*: In order to make their products accessible to customers, certain businesses, such as traders and retailers, would need to have many branches all over the country, which inevitably will increase **control risk**.
- Certain industries rely heavily on customer service, and customer experience can be ruined by even the slightest dissatisfaction of service by an employee, especially a customer-oriented business model such as that of a full-service restaurant.

Strategy and Financial Structure

- *Debt vs Equity finance*: Companies which depend on debt financing would have a higher risk than those relying on equity finance, due to the obligation to service the loan, regardless of the company's performance – unlike dividends, which are not an obligation.
- *Huge capital outlay*: Industries that require heavy capital expenditure would enjoy lower risk of competition from new entrants, because of the barriers to entry. But, due to the nature of their massive investments, companies in these sectors would assume insurmountable financial risks should their business fail.
- *Operational gearing*: Companies with higher fixed costs (compared to variable costs) are said to have 'riskier', more volatile returns than those with a lower cost base.

Risk management policy / guidelines

It is a duty of the Board to define and document the risk management policy / guidelines.

Relevant to company's vision and mission, and nature of business.

Policy ensures consistency in the way things are done, and serves as a reference point for implementation, and holding staff accountable for flouting the rules (i.e. basis for reprimand).

Having a policy and trained staff (whom are well-informed in its requirements) will help the Board in building an appropriate culture.

Article: TM 'Enterprise RISK Management Guidelines' (also known as a 'risk profile' or 'risk register')

Content:

- **Statement by 'high authority'**
  Which communicates the 'tone of the top') expressing the company's commitment towards managing risks within the enterprise;
- **Methodology used**
  Defining what is the framework used in which risk will be identified, assessed, and managed. Important as there is no 'one prescribed method' that every organisation is following.
- **Risk reporting**
  The frequency of reporting risks within the organisation to the Board so that prompt action can be taken to address the most critical risk.
- **Risk Awareness Training**
  Scheduled training for all levels of staff in the organisation aimed at creating awareness of risk and control in order to coagulate it as part of the organisation's culture.
- **Structure and Administration of Risk Management**
  Parties in charge of the success of risk management and the respective responsibilities discharged.

Sources of risk – refer to 'PESTEL'.

Risk assessment – "A separation of major and minor risks."

Measurement of likelihood and impact must be performed in relation to existing controls, which have the effect of reducing the likelihood of occurrence, as well as the resulting impact that the risk has on the company, and so must be taken into consideration.

Quantitative Analysis

$Expected\ Value = Probability\ (\%)\ x\ Possible\ Outcome\ (\$)$	
Expected Value	*Expected effect of risk on the company*
Probability	*Likelihood of a particular risk occurring*
Possible Outcome	*Possible impact on the company should the risk occur*

Unlike Qualitative Analysis, the assessment of both likelihood and impact is the result of detailed research and experimentation. Outcome of Quantitative Analyses is based on the accuracy and completeness of the numerical values used.

The costs of using this method can be high, and gathering the necessary information could be rather time-consuming.

Qualitative Analysis

Descriptive scales to describe magnitude of potential consequences when a risk is unquantifiable (e.g. from insignificant to catastrophic).

Benefit of using this technique? Qualitative analysis is easy to understand with no technical training required. However, different individuals may have differing interpretations of the description, resulting in inconsistency in the assessment of risk.

Semi-Quantitative Analysis

Qualitative matrices assigned with values – to both likelihood and impact – for the purpose of removing ambiguity in interpretation of the two variables. Nevertheless, the values used in definition are not the outcomes of thorough or detailed experiment / research.

Sensitivity Analysis

"How sensitive is a particular value to the changes in the variables?"

$Sensitivity = \frac{Cash\ flow\ under\ consideration}{Net\ Profit}$	
-	-

The more sensitive a particular variable is towards the changes in the environment, e.g. a small change in the unit selling price can cause a company's profit to turn into a sour loss – essentially, a sensitive unit selling price poses a higher risk to the company's profitability.

MINUTIAE

Strategic Risk: Refers to risks that threaten the going concern of a company when they <u>exist</u>. ≠ *Strategic Control*: Refers to controls that threaten the going concern of a company when <u>absent</u>, e.g. compliance controls in the case of a company operating in a regulated industry such as banking and finance – which could lead to a revocation of license, subsequently leading to a going concern issue.

Purpose of identifying causes in identification of a risk is to facilitate subsequent determination of control to overcome the risk.

Outsourced risk management entails: 1) identification of sources

EU (dominant soybean producers) boycott of oil palm due to environmental issues from the replanting of fronds – in September, companies can choose to deforest via logging, or, incineration.

Managing the risk

TARA *(could also be referred to as 'RARA' or 'SARA')*

Reduce

While we say that the impact is low, cumulatively, the impact can be high. Thus, it is advisable to reduce the 'likelihood' of the risk occurring.

Avoid

Depending on the risk appetite of the company, the Board may decide to shelve or go ahead with a particularly risky business venture (due to the opportunities presented to it):

- *A risk-averse Board may see that a high-likelihood, high-impact project may bring high failure / risk of elimination to the company.*
- *A risk-taking Board may see greater, supernormal profits in a high-risk project with few competitors.*

It is also a maxim that, during the course of its relationship with investors, companies "don't have to de-risk [or conversely], as investors know which companies to invest".

Accept

The company acknowledges the insignificance of the risk, and remains its status quo, accepting the risk and does not feel the need to provide additional controls.

Transfer / Reducing / Sharing

A risk is said to be of 'high impact' possibly due to: lack of skill, or low-quality products. Transferring risks can take the form of: outsourcing to more capable / efficient producers, sharing the liabilities of risk with other entities through joint ventures and partnerships, through purchasing insurance. The last two options are usually best for risk events which have a huge impact on cash-flow.

Likelihood

Impact

PAST YEAR QUESTION

The company uses an ingredient which is in short-supply (and that has ever-fluctuating availability) – this is a risk that is of a high likelihood (it is already happening) and may pose a low, but cumulatively high impact on the business.

Depending on whether it is renewable, or non-renewable, we may decide to **reduce** this risk by advising the following courses of action:

- Switch / look for alternative supplier;
- Look for substitute.

Avoid: When a risk has a high likelihood of occurrence, and high impact.

Reduce likelihood: High likelihood, low impact. Audit and compliance program (using a checklist so that the changes of omitting certain requirements, laws, and regulations). And use of contract conditions.

Reduce consequences / impact: Contingency planning (involves making arrangements with external parties to make use of their resources in the event that their own computerised system is corrupted). By doing so, downtime is minimised.

Transfer: Involves having another party bearing or sharing the risk.

Retain / Accept: There may still be residual risks (any risk omitted from identification would automatically be retained) – which could possess any likelihood characteristic, with a random range of impact.

Assessing: The adverse impact of risks should be made as low as reasonably practicable (ALARP).

Risk, though out of sight, is never out of mind. Methods for managing risks may not be comprehensive, and require additional measures for the following scenarios could arise:

- Outsource vendor / JV partner may be incompetent or financially incapable, affecting the ability of efficacy of the risk-sharing approach;
- With liability reduction in mind, the insurance company which shares the burden of the risk may instate a limit ("per claim" / "lifetime" etc.) on the compensation paid or imposition of restrictive clauses (e.g. the insurance adjuster has the right to deny the insured's claim if there are illegitimate causal factors) in the event of the risk.

Therefore, it is vital that a company is flexible with its approaches and performs periodic reviews of the way it handles the risks it faces, in sync with the shifting nature of these risks.

Factors to consider in selecting an appropriate option:

The selection of the most appropriate option involves balancing the cost of implementing each option against the benefits derived from it.

Decisions should take account of the need to carefully consider rare but severe risks.

Opportunities: to benefit from opportunities that the risks bring, company should not choose the option of avoiding the risks.

Consider whether one risk treatment option will be a complete solution for a particular problem.

Identify priority order in which risk treatments should be implemented when the cumulative costs of these solutions exceed the budget available.

Preparing treatment plans

Measures / resources to be utilised

Budget allocation to address risk

Timetable for implementation (Chapter 4: Deadline for implementing)

Preparing / developing a risk treatment plan	Determine the level of treatment plans required for each risk according to level of priority. Specify the treatment option agreed - avoid, reduce, share/transfer or accept. Document the treatment plan - outline the approach to be used to treat the risk. Any relationships or interdependencies with other risks should also be highlighted. Assign an appropriate owner - who is accountable for monitoring and reporting on progress of the treatment plan implementation. Where the treatment plan owner and the risk owner are different, the risk owner has ultimate accountability for ensuring the agreed treatment plan is implemented. Specify a target resolution date - where risk treatments have long lead times, consider the development of interim measures. For example, it is unlikely to be acceptable for a residual risk to be rated 'high' and to have a risk treatment with a resolution timeframe of two years.
Forecast risk analysis	Forecast risk analysis involves the assessment of risk after existing controls and treatment plans for new or reinforced controls are taken into account. Changes from residual to forecast ratings will be dependent on whether these controls are designed to address the likelihood of the risk, the consequence or the risk or both. For each risk identified in the risk assessment, detail the following: Assess forecast likelihood - What is the probability of the risk event occurring within the control environment? This should be determined after a review of the proposed changes to the design of the control and/or its operating effectiveness. Assess forecast consequence - What is the extent of the most probable impact

	of the risk event if it were to occur within the control environment? Assume that the future controls will be operating at their intended future strength rather than the maximum consequence if the controls were to fail. Determine overall inherent risk ranking - Apply the risk rating to determine the overall ranking. For each risk, there should be only one overall forecast risk rating based on consideration of the future effectiveness of the single control, or the multiple controls, in place to address the risk.
Implementing treatment plans	Responsibilities should be agreed between the parties at the earliest possible time. Normally, the party whom identifies the risk will also be the one to assess and manage the risk. Risk owner has the responsibility of implementing the plan; The treatment plan owner is responsible for coordinating activities that ensure risk treatments are implemented. The owner may not be directly responsible for implementing the risk treatment plans, however, they are responsible for ensuring that plans are completed within the expected timeframe. When implementing a treatment plan, consider how the initiatives will be supported: Firm structure - Does there need to be any change to structure or delegations to support the risk treatment plan? Financing - If the budget for control improvement is constrained, should there be a process to prioritise controls with the greatest need or cost benefit? Resource availability - Does the firm have sufficient physical, human or financial resources to implement the risk treatment plan? Communication with stakeholders - Does the firm need to commence briefing sessions to inform stakeholders as to what changes are required and why? For each risk identified in the risk assessment, detail the following: Monitoring mechanisms and review points - The treatment plan owner should specify the mechanisms by which implementation will be monitored. This may include indicators to determine if the risk is increasing or decreasing. Successful implementation will usually be linked to business planning activities and will be reviewed regularly at meetings. Status of the treatment plan - the status of the treatment plan is either ‘open' for in progress or ‘closed' when implementation has been completed. If the status is closed and the risk has been eliminated, it may be removed from the current risk register into a closed items register. Where a risk is not eliminated, it should be retained in the current register and if another treatment plan is required this should be agreed or, if no other action is possible, the treatment agreed could be to accept and monitor the risk.
	Details of the mechanism and frequency of review of compliance with the treatment plan: subsequent follow-up – changing environment will modify the risk

Monitoring and review

Regular review of the organisation's risk register (and documentation of actions or events that change the status of a risk) is essential, because risk seldom remains static (due to the dynamic environment in which the company operates), effort should be made on a periodic basis to determine:

- Whether any new risk has diminished a previously identified risk;
- Changes in the likelihood and impact of risks previously assessed;
- Effectiveness of previously established measures to tackle the risk.

Communication and consultation

This step involves the risk manager compiling risk information for reporting to the Risk Management Committee, who will in turn, report to the Board on key risks and measures (the action[s] taken to address them) for the convenience of reviews to continually improve the organisation's risk management capabilities.

Importance of EXTERNALLY reporting on internal control and risk

A requirement practiced by entities under the jurisdiction of the Sarbanes-Oxley Act (US).

- **Demonstrates accountability.** The Board is tasked with the responsibility of establishing sound internal controls to safeguard shareholder interests, and to maximize returns. Therefore, the Board should report what they have done in this area.
- **Enhance shareholders' confidence and satisfaction.** Without such reporting, shareholders would have no idea of the status of internal control within the company.
- **Avoidance of reporting.** If the said reporting is made compulsory, companies would find non-reporting (of control information) unavoidable.

****Why are external reporting of risks and control weaknesses not applicable to smaller-sized companies?**

There is absence of a separation of ownership and control in small companies. With the principals being fully aware of the situation, external reporting is not needed for attention to be called to them.

Small companies also tend to rely quite heavily on close supervision as a means of control. Compulsory reporting will only succeed in finding little or no details in this respect.

Small companies are usually in command of low profits. Because of this, they may lack the resources to house an internal audit function to facilitate the reporting of risks and controls.

Cost can be prohibitive for smaller-sized companies should reporting and subsequent review by external auditors (in the form of 'expressed opinion') be made compulsory.

Role of a risk manager

“Quite similar to an accountant preparing the financial statements, but not auditing them”.

Oversees and coordinates risk management.

With the Board’s agreement, the risk manager is involved in developing and implementing enterprise-wide strategy (policies for risk and assurance activity) which encompasses all aspects of organizational risk.

To create the awareness of risk and control throughout the organization, the risk manager ought to conduct internal training on this matter.

Liaise with other corporate functions, and facilitate an improvement in the quality of discussion on risk and assurance issues at the senior corporate level – to enable a truly enterprise-wide appreciation of risk across all operations and functions.

Risk manager will oversee the respective processes in risk management by coordinating their efforts

Ensure compliance with industry regulations

Risk, likelihood and impact, deadline = outcome

Sort, standardise and merge risk management information into a ‘risk register’ / ‘risk profile’ – which practically contains descriptions of risks faced by the business along with its likelihood and impact.

Perform risk auditing and furnishing audit reports. After the audit, the risk manager submits a report is submitted to the principal (the Board that commissioned the audit), communicating key areas: extent of key risks, quality of existing assessment, effectiveness of controls.

Subject of urgent management attention.

Argue for and against risk audit being undertaken by external parties

As an internal function

- **Good understanding of the organisation.** Risk audit being performed by internal staff and personnel – whom are highly familiar with the organisation, its systems, procedures, regulatory environment, and culture. Due to their understanding of relevant technical matters (e.g. language specifically intended for a particular management within the organisation, and suits the background of the directors), legal frameworks, and control systems, they are able to carry out a highly context-specific risk audit, meeting specific company requirements.
- The audit carried out will be relevant to the situation of the company.
- **Lack of independence.** Nevertheless, being present in many internal audit situations will impair independence, developing overfamiliarity and biasness.

As an external function

- **Independent.** Reduces independence and familiarity threat.
- Identify issues that internal auditors may have overlooked due to familiarity.
- Because external parties are providing these services for a professional fee, they are more likely to update their knowledge on best practices and current developments for introduction to clients.

Risk awareness is a culture built on the knowledge of the nature, hazards, and probabilities of risk in given situations. So what is a 'culture'?

Attributes of a 'risk-aware' culture

- An inseparable part of organizational philosophy, practices, and business plans
- Collective action to be proactive in anticipating risks with ready solutions, not avoiding them or inculcating fear
- Unconsciousness in undertaking the action
- Taken for granted assumptions (not queried, unquestioned)
- Built into the reward system

A risk-aware employee is able to identify, assess, and manage risks, independently.

The non-existence of these factors will therefore hinder the creation of culture. Such a hindrance will cause to happen the following scenarios:

i) management's objectives not being aligned with that of the other members of the organisation;
ii) inadequacy of knowledge in risk and control;
iii) uprising of 'finger stabbing' / 'finger-pointing' culture, i.e. a disharmonious atmosphere of blaming between parties for risk or untoward incidents.

How to embed?

- **Behaviour of senior management:** Top managers should 'walk the talk' and lead by example, e.g. observing risk management practices.
- **Training:** To embed awareness, training of risk and control is required (usually performed by the risk manager).
- **Alignment of reward system with risk responsibilities ('reward compliance'):** To reprimand disobedience, while rewarding those who observe risk management, without which there would be difficulty in "encouraging" everyone to adhere to risk management policy.
- **Establish risk management department:** Provides an avenue of convenience where staff are able to consult a specialist to troubleshoot on matters occurring in their department.
- **Establishment of metrics and performance indicators ('clear criteria'):** Refers to criteria made available to determine the likelihood and impact of the risk so that consistency in their application can be expected. Without such criteria, inconsistency in the assessment can occur, and a culture will not be established.

15-18: PROFESSIONAL AND BUSINESS ETHICS

Professional Ethics

ACCA Fundamental Principles

- **Integrity:** Being straightforward and honest in all professional and business relationships.
- **Objectivity:** Not allowing bias, conflicts of interest or undue influence of others to override professional or business judgements.
- **Competence and Due Care:** To maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- **Confidentiality:** To respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- **Professional Behaviour:** To comply with relevant laws and regulations and avoid any action that discredits the profession.

Threats to independence, and associated safeguards (relating to within the firm, client company, or laws and regulations governing the profession)

- Familiarity
- Advocacy
- Self-interest
- Self-review
- Intimidation

Business Ethics / Normative Theories (ethical theories)

Ethical theories	**Ethical decision-making model**	**Corporate social responsibilities**
Relativism vs Absolutism	American Accounting Association (AAA)	Gray, Owen & Adam
Kohlberg's Moral Development: • Pre-conventional • Conventional • Post-conventional	Tucker's 5-Question Model	Johnson, Scholes & Whittington • Short-term shareholder interest • Longer-term shareholder interest • Multiple stakeholder obligation • Shaper of society
Teleological Approach… • Egoism • Utilitarianism		
…vs Deontological Approach • Ethic of duties • Ethic of rights and justice		

Ethical Relativism

An ethical assumption that takes the pragmatic approach (knowing how to handle situation) and respect differences.

According to Relativists, morality is situational (i.e. depending on a particular situation) and therefore will not be the same all the time. Just like the saying “when in Rome, do as the Romans do”, what is ethical is dependent on the majority of people in that society, and not one person’s say.

Under this view, there are no ethical standards that are absolutely true and that / should be applied to the companies and people of all societies.

Arguments against Relativism

- Moral standards are present
- Difference in belief doesn’t mean that there is no objective truth – regards all beliefs as right
- It becomes immoral, disrespectful to condemn societal standards
- Implies that whatever a society believes is correct, ethical, and beyond criticism

Conclusion

We should not dismiss the moral belief of other cultures when they do not match our own. However, it is often mistaken as a claim that all moral beliefs are right or wrong based on the moral standards prevalent in a given society.

Ethical Absolutism

Also known as ‘universalism’, a ‘dogmatic’ ethical assumption – believing what they are doing is right, while ignoring ethical and cultural differences.

Absolutists believe that there is an absolute truth – thus there is a ‘consistency’ in what they believe – which all entities should obey without exception. Unlike Relativists, Absolutists regard morality as not situational (i.e. does not depend on situation), and instead should be followed at all times.

Universalists and moral authoritarians see their own culture as superior to others, often failing to behave consistently with local tradition.

The moral minimum

“The middle ground.” – Donaldson (1996) and De George (1999)

In the context of an organisation, moral minimum represents the most basic expectation of management over its employees which normally is reflected in the company’s Code of Business Conduct – a reference point to consult whether an action should be regarded / disregarded, for purpose of benchmarking.

****Quote -> Relativist / Absolutist? How would they react?**

Identify characteristics.

****Kohlberg's Method**

Aims to measure ethical performance ('moral growth') – independent of age, education level, race – with a list of dilemmas, and in doing so reveals the motivation behind individual behaviour.

<table>
<tr><td rowspan="2">Level 1: Pre-conventional Morality

"In terms of rewards, and whether or not it be penalised, found out or rewarded – where right or wrong is always defined in 'self-centred' terms"

Self-centred behaviour will not be endorsed / approved by other personnel.</td><td><u>Stage I : Individual</u>
People at this stage will not undertake an immoral or illegal activity because of the fear of punishment. Without rules, "Stage I" individuals would "run wild". LAW-ABIDING</td></tr>
<tr><td><u>Stage II : Fair Deals Against the System</u>
People at this stage do not mind undertaking immoral or illegal activity provided that the act will not be found out or a fair deal exists, e.g. drug traffickers.</td></tr>
<tr><td rowspan="2">Level 2: Conventional Morality

"Right and wrong are justified by the norm of their social group, as well as the law of society"

Care for social group, and therefore is persuasive for them – as there is an interest for others, it is endorsed by the groups concerned. Exhibits 'Relativist' behaviour.</td><td><u>Stage III : Relatives</u>
People at this stage will not undertake activity that is against the wishes of their social group in order to be accepted by the latter.</td></tr>
<tr><td><u>Stage IV : Public</u>
People at this stage believe that an intangible social contract exists to bind them with the rest of society and therefore would not undertake activity that will create harm or inconvenience to others. As such, they will not undertake activities that are against the laws and regulations. LAW-ABIDING</td></tr>
<tr><td rowspan="2">Level 3: Post-Conventional Morality

"Frame morality in terms of the effects of action on oneself and others, critical to moral standards"

Demand change. Unlike Level 1 & 2, they are not law-abiding as they are not content and so condemn it. Exhibits 'Absolutist' behaviour.</td><td><u>Stage V : Change-makers</u>
People at this stage are not contented with the existing system, laws, or regulations, and want change to be made. However, they would do so via democratic means ('in line with democratic principles'), i.e. through elections, negotiation etc. in order to avoid causing chaos through their actions.</td></tr>
<tr><td><u>Stage VI : Anarchists</u>
People at this stage have such a strong urge for change that they do not mind creating chaos in society, seeing the "chaos" as merely a price to pay to effect change.</td></tr>
</table>

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Teleological

Based on Greek for ‘goal’.

Consequentialist – a focus on the outcome and that if desirable was the outcome, it is morally justified, rather similar to ‘relativism’.

The fact that outcome is considered, suggests that consequentialists are relativists, because they show interest in the situation.

Prone to misguidance – as though the outcome might be positive, the acts may be unethical.

Egoism

An action is deemed right if decision maker freely decides in order to pursue their desires (short-term) or interests (long-term).
Desires may not be incompatible with long-term interests (“what is good need not necessary generate long-term interest”).
Since egoists only care for him/herself, they are at Level 1 of Kohlberg’s Moral Development model.

Individual Egoism: One person is self-centred, and only would think of the benefit in helping others.
Universal Egoism: Everyone in society is self-centred, seeking only their best interests.

Argument Against:

- Renders different approaches to life as equivalent
- Appropriate if mechanism = law enforcement
- Universal egoism would be zero sum
- Desire might not bring long-term success

Utilitarianism

An action is morally right if it results in the greatest amount of good for the greatest amount of people affected by the action. (*similar to belonging to the Stage IV of Kohlberg’s Moral Development Model*)

Argument Against:

- Prone to subjectivity – perspectives of pleasure or pain is a matter of assumption, to the extent of sometimes equating two incomparable situations
- Difficult to quantify ‘greatest amount of good’ and ‘people’ without transactional / business element
- Distribution problem: Under this theory, the minority would have to sacrifice in order to allow the majority of stakeholders to benefit from a particular act.

←

Deontological ('CG Concepts', 'Corporate Governance Concepts')

Based on Greek for 'duty'.

Non-Consequentialist

Moral judgment is based on the underlying principles of the decision-maker's motivation.

Under this approach, what is regarded as 'moral' is dependent on the factors which motivate the decision maker to pursue a particular course of action… rather than the outcome itself. Hence, we say that this approach is not situational. Non-consequentialists is thus, an absolutist.

Stems from basic universal principles of right and wrong.

Applicable for directors.

Ethics of duties

There is a duty for us to behave ethically by observing certain conditions ("maxims").

Kantian Theory ("Categorical imperative framework" founded by German philosopher Immanuel Kant, 1724-1804)

Based on *priori moral laws*, which are unchangeable. An action is regarded as morally right if it survives all three tests:

Maxim 1: Do you expect your act to be followed by others? Will you expect the act to affect you the same?

Maxim 2: Do you treat your workers as individuals (humanely) with their own feelings and needs, instead of viewing them as tools for your own enrichment?

Maxim 3: When your act is known to others, will they endorse what you have done, or condemn it? ("Universally lawgiving" – is it forgiving?)

Arguments against…

- Based on the fundamentals, consequences are not looked at, hence we say this approach undervalues outcomes.
- Definition and evaluation of a decision can be complex.
- Kant optimistically views individuals as rational human beings, which loses its idealness in a business context ("business actors").

Ethics of rights and justice (*equality and fairness*)

A duty exists for all of us to respect the rights accorded to certain people and to ensure that our actions will not create any inconvenience or harm to other members of society ("fairness") – in terms of life, freedom, and property, which has been extended in the modern day to include other rights (*UN Declaration of Human Rights, 1948*).

The two underlying principles in application:

i) Ethics of rights: with reference to human rights;
ii) Ethics of justice: if parties involved possess the same basic liberties… would they have benefitted from the arrangement – as inequality asks if are the parties involved better or worse off with the arrangement.

Ethical Decision-making Model (EDM Model)

Process of identifying a problem, generating and choosing alternatives that maximize important ethical values while achieving an intended goal.

A decision is ethical if it is:

- Legal [1] (which may lead to ethical behaviour, provided that laws are not outdated and reflect current societal values);
- Linked to professional obligation and duties (espoused in Code of Conduct [2]) – not legally binding, based on commitment instead;
- Defined sense of right and wrong, and philosophical reasoning – identifies and provides answers to alternatives based on models that consider many aspects, e.g. AAA.

1 Lawful decisions are placed at the lowest level of an EDM Model as there is no element of "volunteerism in doing better than what the law and regulations prescribe".

2 Decisions in line with the Code of Conduct are placed at a higher level because the decision maker voluntarily adhered to their set of Codes, such as those found in the accountancy profession.

American Accounting Association (AAA) Model – Langenderfer and Rockness (1989)

Seven-step decision making model for *ethical dilemmas / tensions*.

Can be used to assist decision-makers who are both professional accountants as well as directors, i.e. those in business.

1. **Facts of the case.** Explain the dilemma faced by the unsure decision maker as seen in the scenario given.
2. **Ethical issues.** Identify stakeholders present and explain how they would be affected by your decision.
3. **Fundamental Principles.**
    - For Professional Accountants, it is the 5 principles. For Directors, the norm principle value can be: CG concept, ethics of duties, ethics of rights and justice, or utilitarianism. (*Egoism is not promoted in the interest of political correctness*)
    - For Professional Accountants, the duties include: follow instructions, define what you've been asked to do, seek authorisation from a higher authority, resign.
    - For Directors, the actions would depend on the scenario given.
    - Not necessary to adopt only one Framework, e.g. ACCA Fundamental Principles.
4. **The alternative courses of action.** Are there other appropriate measures / options which could be sought to address the ethical dilemma?
5. **Best course of action consistent with values.** Benchmark 4 against 3 to assess whether the norms, principle and values has been met.
6. **Consequences?** Consequential consideration: "Can the decision-maker 'live with himself'?"
7. **Decision?** Should there be more than two options, you may choose a combination instead of just one.

Advantages of AAA

- Allows the decision maker to better defend their decisions, which are made in accordance to ethical principles.
- AAA Model combines both teleological and deontological approaches in decision-making, which gives it the "best of two worlds".

Tucker's 5-Question Model

Is it profitable? From shareholder's perspective, decisions that have the effect of maximizing profits represent the discharging of director's duties towards them. Hence, to them, it's ethical.

Is it legal? Decisions in line with law and regulations are deemed ethical.

Is it fair? A decision should not create be disadvantageous for other stakeholders.

Is it right? A decision that is supported by an ethical principle.

Is it sustainable / environmentally sound? A decision that causes minimal footprint (impact) on the environment, e.g. by causing pollution and results in the consumption of depletable natural resources (is usage cut?).

CASE STUDY 3

1. **Identify the parties who will be affected by the decision made ('Characters')**

Product Manager (You)	Egoism. Short-term desire fulfilled, "healthy bonus". Feels guilty in the long-term as child labour is unthinkable in his culture Pain of not proceeding: no bonus Pleasure of not proceeding: clear conscience
Thai manufacturer (The Prospective Supplier)	Egoism: Short-term and long-term interests are aligned, for both are morally acceptable. Relativist – follows majority in saying that the well-established practice of home manufacturing is very common. Pain of not proceeding: loss of customer Pleasure of not proceeding: none
Portuguese supplier	
The Workers – men, women, and children	Parents: Short-term: income; Long-term: children's pursuit of education is affected. Pain of not proceeding: no income to send children to school Pleasure of not proceeding: none Children: Short-term: freedom; Pleasure Long-term: mechanical work guarantees no future; Limited future prospects is a pain Pain of not proceeding: none Pleasure of not proceeding: none Grandmother: *Same situation as parents, but may differ if answer requires pain / pleasure, identification of.* ***(Utilitarianism)***
The Nieces	

2. **Identify courses of action – *go ahead* or *abort* – available.** ***(Utilitarianism)***
3. **Determine whether each course of action would bring pain or pleasure to each and every party highlighted in (1).** ***(Utilitarianism)***
4. **Select course of action where pleasure exceeds pain by the most.** ***(Utilitarianism)***

Deontological Approach:

Kantian Theory / Categorical Imperative Theory

Ethics of duties		
MAXIM 1: Would you wish the same?	**MAXIM 2: Are you being humane?**	**MAXIM 3: Will others endorse or condemn?**
No	No	Condemn

Ethics of rights and justice

Right to living wage. In the scenario, the Thai supplier can be accused of rewarding the parents with a low wage rate to the extent that children have to be involved in helping to assemble the toy – in order to make ends meet.

Justice: Do the children possess the same rights? No.

CASE STUDY 4

Characters ('Stakeholders')

Plastics Division, Large Multinational Conglomerate

Susan, management accountant	
Harry, divisional manager	

Dilemmas

- Manipulation or division closed down – retrenchment of 35 people.

<u>AAA</u>

1. Facts of the case: Susan is torn between the fundamental principles (that she is required to observe as a professional accountant) and following the instructions of her superior. Susan was concerned that her failure to cooperate could jeopardize her relationship with the superiors and thus ruining her career in the company.
2. Stakeholders: Divisional manager, employees, Board, shareholders.
   Ethical issues: Should Susan proceed with the amendments, this would result in an "earnings management" situation causing the Board to be misled of the division's performance, despite the benefit of retaining (instead of retrenching) its 35 employees.
   On the other hand, the returns to shareholders will not be maximised due to the retention of a division that is performing poorly, instead of transferring the sources to other, more profitable ventures.
   The manipulation may cause the Board to be implicated as they have the overall responsibility of preparing the financial statements which present a "true and fair" picture of the company's financial situation.
3. Norms, principles, and values: Integrity, Objectivity, Independence, Technical & Professional Standards, disrepute from action will infringe "Professional Behaviour".
4. Alternative courses of action: doing nothing, whistleblow, resign, explain with consultative tone, compromise.
5. Which of the actions complies with the above?
6. Consequences?
7. Decision: lay out a plan in light of the analysis – Choose one? Link the decisions?

CASE STUDY 5

Second-class poor community on land where new factory investment will take place.

Profitable?	Cheaper land and labour cost
Legal?	Legal compliance aided by government Unless law (concerning displacement) accords rights to original inhabitants
Fair?	Unfair treatment by local government towards the poor community Poor community to surrender homes to make way for employment
Right?	From a Utilitarian point of view, it is morally right for shareholders and local suppliers
Sustainable?	Cleaner than previous ‘brownfield’ land

Corporate Governance ➔ Human Governance

The ethicality of decision making is not only affected by decision-making models (no guarantees here too), but also by the thinking of individuals and the environment.

CSR

Social accountability only arises if an organization has a social responsibility.

"Seven Ethical Positions" **– Gray, Owen & Adam (1996)**

Believes the world to be: Level 1 & 2 (*Kohlberg's Moral Development Theory*)

Would like the world to be: Level 3

Pristine Capitalist Level 1: Stage I	The world is a liberal economic democracy – a capitalist society. CSR exists in this environment – dominated by the need to make money for shareholders / whole-heartedly benefitting the shareholders. Not calling for change.
Expedient Level 1: Stage II	Long-term economic welfare can only be achieved by wider social responsibilities. (Minimal) CSR motivated by economic benefit ("reciprocity") – limited view of corporate citizenship.
Social Contractarian *"Proponents of social contract"* Level 2: Stage IV	*Equivalent view*
Social Ecologist Level 3: Stage V & VI	Not content, believes current environment to be fundamentally wrong, and that quality of human life is affected (and condemns) by the "over-expansion" of the economy. Wants balance in: social, economic, environmental performance.
Socialist Level 3: Stage VI	Believe that capitalist domination is unfavourable. Wishes to promote equality among members of society, e.g. through equitable pay.
Radical Feminist Level 3: Stage V & VI	Believes 'masculine' constructs ("traditional success") are evidence of a world that denies 'feminist' concepts ("of the fairer sex") – meticulousness, concern for shareholders etc.
Deep Ecologist *'Deep Green'* Level 3: Stage V & VI	Promotes equality among all living beings – "no one living being has rights or importance over another".

Extremes of the Gray, Owen & Adam Continuum

Narrow, e.g. Pristine Capitalist

Wide, e.g. Deep Ecologist

***Corporate & Personal Ethical Stance* – Johnson, Scholes & Whittington (2005)**

Ethical Stance = Ethical Viewpoint = Extent to which a corporation will exceed its minimum obligation to stakeholders.

Short-term shareholder interests	*Pristine Capitalist*

Only concerned about how regulatory environment impacts shareholder wealth, by doing the minimum. To this group, any form of CSR would have an immediate effect on the funds available for distribution to shareholders, and therefore, sees such activity as betrayal of shareholder trust.

Longer-term shareholder interests	*"Enlightened self-interest" (looking at a broader perspective)*

Justifies CSR as important to long-term financial success. This group is able to appreciate the business cases that come by being seen as an ethical company – similar to *Expedient*.

Multiple stakeholder obligations	*Social Contractarian*

This ethical stance focuses on going past the minimum, and adopts an "equivalent" view towards issues like CSR.

Shaper of society	*Social Ecologist, Socialist, Radical Feminist, Deep Ecologist*

** **Factors that influence a company’s approach to CSR**

- **National and regional culture**
- **Organisational field (industry / profession)**
  Such as the accountancy profession where all are required to adhere to the principles prescribed by The Code of Ethics for Professional Accountants, which shapes their behaviour.
- **Organisational culture**
  The basic assumptions and beliefs collectively shared by members of an organisation, unconsciously.
  Values (ideals management wishes to promote), Beliefs (accepted way of thinking, although this may not be reflected in action), Behaviour (conscious), Taken-for-granted assumptions (embedded customs).
  - *Schein (1997), “The Four Layers of Culture”*

MINUTIAE

Teleology: study of purpose or design of natural occurrences

Deontology: ethics based on rules and obligations

CSR SCHOOL OF THOUGHT

CORP CITIZENSHIP = Views – MATTER CRANE CHAPPLE (2003)

JOHNSON SCHOLE & WHITTINGTON = Stances

GRAY OWEN & ADAM = 7 positions

Consequential: Moral judgment is based on the outcome of a certain action.

Invisible Hand (Adam Smith, 1793): a market of free competition and good information distributes rewards and punishment accordingly.

Backdating is a common practice among auditors, to reduce liability of negligence.

PROFESSIONALISM

How professional behaviour can be demonstrated?

- Observe law and regulation
- Avoid actions which might discredit profession, or bring disrepute
- Not to make exaggerated claims in services offered – "most professional", "best", "most experienced" – as these are not accredited, only self-proclamation
- Not to use "Specialist" – as this is making a disparaging (belittling) reference in comparison to others / Make comparisons with other firms – if unsubstantiated, e.g. audit fees (based on time cost and seniority, related to risk)

PUBLIC INTEREST

Rational balance between public opinion and rational expectations

Professional accountant's (PA's) ability to meet the interests of the public is restricted by the fundamental principles of confidentiality – which requires the PA to obtain consent from the client / employer before making the said disclosures (guidelines, regulations), unless they are legally obligated to do so.

Scenario: ***Someone defames the profession with regards to public interest responsibilities and how accountants are "slaves to capitalism"*. Evaluate.**

SLAVES

- Management Accounting: Costing to maximize shareholder profit;
- Financial Accounting: For reporting to shareholder;
- Auditing: To verify quality of information to shareholder.

NOT SLAVES

- Financial information are critical in distribution of resources (financial and human resources – e.g. prospective FD candidate doing background check on company), which generate a positive impact to the company, and the spillover effects (from tax paid) will flow from the government to the public.

Role in influencing distribution of power and wealth in society

Liberal economic democracy: The environment in which Professional Accountants work in.

Accounting issues against public interest

Accounting departments have begun a transition into being "profit centres" – referring to Professional Accountants' involvement in manipulating financial statements which cause artificial profits to be generated, through use of accounting standards.

An example would be “income smoothing” – referring to structuring deals which do not have business value, but spinning off either profits or losses than can be *reversed* in the future to “manage earnings”.

IAS 37 deals with Big Bath Accounting. Upon realizing that companies are deliberately reducing profits (and not just being interested in overstating them), IASB attempts to subvert such practices using IAS 37, which dictates that provisions must be: present obligation, determined with reasonable certainty and accuracy, probable outflows of economic benefit.

By recognizing a provision when companies are doing well so that during (the following year perhaps), so that the expenses incurred will be debited to the provision, instead of being charged to the Statement of Profit or Loss, causing no effect on the reporting profit, especially when the company’s performance is poor.

This is because the preparation of financial statements involves judgment and estimation – the prerogative of client management – which auditors often find difficult to challenge. Also, the profession embraces “[commercial] substance over form”, which once again, requires the exercise of judgment.

Code of Ethics for Business Conduct ("Moral Minimum")

An authoritative statement (initiated by the highest authority in the company) of values (company values, what the company promotes to its employees) designed to set a minimum standard of acceptable behaviour.

Such a statement is not a legal requirement for limited liability companies, voluntarily prepared.

****Content of "Code of Business Ethics"**

- Senior Executive's message / statement – expresses commitment by senior management in upholding business ethics
- Values (which management wants employees to observe and practice)
- Responsibility of members
- Policies for (all) stakeholders

****How would having a Code of Conduct solve the issue / Advantages of having a Code**

- The Code serves as a moral minimum which is especially relevant for those companies that are multinational with businesses in foreign countries that have cultures and practices vastly different from the home country – thus it provides decentralized divisions with a value system reference
- Enhance board and management focus on ethical risk
- Provide guidance to personnel to help recognize and deal with ethical issues
- Provides mechanism for reporting unethical conduct – benchmarking
- A company is perceived to be more ethical, allowing it to win more contracts
- Promotes consistency in the reaction to common situations, and gradually becomes instrumental in creating a positive company culture
- The Code provides an excellent medium / platform for CSC to communicate its expectations to its personnel
- Attracts individuals with similar values to join the company

Limitations of the Code

- NYSE points out that the Code is only as good as management's commitment to the Code ("walking the talk") – which will help employees learn ethical behaviour from senior management, and not just plain window dressing (i.e. public relations effort which aims to impress the public, with no real effect on the employee). To make ethics a company culture, there must be management action against unethical behaviour – linked to reward and punishment / built into the reward system.

Conceptual Framework to Auditors' Independence ("REI")

- Identify threats to independence – Familiarity, Advocacy, Self-Interest, Self-Review, Intimidation;
- Evaluate the significance of the threats;
- Respond to the threats by applying safeguards (e.g. laws / regulations within client / firm).

Contents of IFAC "Code of Ethics for Professional Accountants"

The Code establishes the fundamental principles which are applicable for both professional accountants in practice, and those who are in business. Principle-based does not define every situation but because of this, it prevents loopholes present in the rules-based system. The framework, being principle-based, allows the professional accountant to exercise his/her judgment and take ownership of his/her work. Besides this,

- Part A: Section of Code establishes the fundamental principles which are applicable for both professional accountants in *practice, and those who are in business*:
- Part B: Public practice;
- Part C: Business.

Threats to Independence

Familiarity Only applicable if the close relationship in the client's company and the firm respectively. Could possibly lead to a self-interest threat (when gifts and hospitality are extended). And if illegal, could lead to intimidation.	**e.g. Former partner (able to exert direct and significant influence)** The audit team assigned to audit a former partner's company may have previously worked for him/her before. As this is the case, a relationship already exists.
Advocacy Promoting client position to the extent it may compromise objectivity.	**e.g. Promoter of shares, acting as legal representative / mediator**
Self-interest Financial interest benefit, direct (e.g. shareholding in client that is so high that it is tantamount to control), indirectly (e.g. … no control). In cases where gifts and hospitality are extended by the client to the auditor in a non-arms-length manner, the very mental notion that the external auditor wishes for the offer to be recurring can constitute a self-interest threat.	**e.g. Shareholdings, loan and business relationship, potential employment, contingent fees…** **e.g. Undue dependence on total fees** In order for this to be valid, the total fees must be recurring. **e.g. Gifts and hospitality** Gifts and hospitality should be measured in terms of: value, nature, and amount (is it lower than market rate? Is it lower than staff rate?). Accepting these gifts/discounts/hospitality require clearance from senior.
Self-review Applicable when the outcome of non-audit services is included in the financial statements subject to audit ("Re-evaluation"), e.g. accounting.	**e.g. Auditor recently transferred from client company (where he/she was previous in a position to exert direct and significant influence over the subject matter of the assurance engagement)** The threat will be relevant if the firm fails to observe sufficiently long cooling-off period before assigning the said staff to audit his/her previous company.
Intimidation A form of pressure (exerted by client) which deters team from acting objectively and exercising professional scepticism.	**e.g. Threats of replacement over disagreement** **e.g. Pressure to reduce fees** This happens when the client puts assurance engagements out to tender. This threat will also happen when a junior auditor is asked to challenge client of a senior position.

****Suggest actions to be taken / Safeguards against threats (IFAC 'examples' – not able to include all aspects) p.222**

Profession, legislation, regulation	**1.** Quality control review **2.** Entry and continuing education requirements
Assurance client	**1.** Audit committee appoints assurance firms **2.** Competent employees can make managerial decisions – such the PA will not have to make decisions on behalf of the client and therefore avoid the self-review threat.

Firm-wide *Turnbull Report (1999) – Elements of a Sound System of Internal Control*	**1.** Policies for monitoring quality control of assurance **2.** Internal policies to monitor compliance with policies and procedures **3.** Policies that requires declaration of interests in the client's company, as well as relationships with senior management of the client. **4.** Define criteria for revenue capping **5.** Erection of 'Chinese Walls' (having different teams with separate partners and reporting lines) **6.** Firm policies which prohibit discussion of client affairs with non-team members in order to uphold the principle of confidentiality **7.** Timely communication of updates **8.** Whistle-blowing arrangement – *is it streetwise to whistle-blow on a senior?*
Engagement-specific	**1.** Hot (before issuance) review undertaken by an independent partner within the firm before the issuance of the audit report **2.** Rotation of senior personnel – e.g. engagement partner to cool-off for 5 years after 5-years of audit relationship **3.** Obtaining clearance from the Audit Committee on areas regarded as controversial, e.g. provision of non-audit services to the client **4.** Reperform assurance engagement involving another firm

Conflict of interest

Self-interest threat:

- Competes directly with client (especially if Managing Partner has business aside from the firm, he/she may use information obtained in the course of work to gain an unfair advantage); and

- Perform services for clients whose interests are in conflict with each other (such as when the same firm to audit two or more clients that are in competition.), despite 'Chinese Walls'.
- Financial, Personal, Family relationships between accountants and their clients or third parties.

Safeguard:

- Notify of conflicting interest, obtain consent that they may so act;
- Use of separate engagement teams with separate reporting lines;
- Physical prevention of access to data
- Policies – e.g. resignation

Fundamental principles

- **Integrity.** Straightforwardness and honesty in all professional and business relationships – also implies fair dealing and truthfulness. Avoid association with information that may be: false / misleading, erroneous (from reckless furnishing), obscured (therefore, misleading). Therefore, the professional accountant should also be quick to provide a modification to his/her report so as to serve the purpose of warning the reader.
- **Objectivity.** Free of prejudice, conflict of interest or undue influence of others to override professional or business judgment.
- **Professional Competence & Due Care.** Observing this fundamental principle would ensure the professional accountant will not be accused of negligence.
  -Maintenance of professional knowledge and skill requires the public accountant to attend continuing professional education programme.
  -To act diligently – exploring, exercising with due care – in accordance with technical and professional standards.
- **Confidentiality.** Proper and specific authority (consent of client / employer) must be obtained before disclosing any information to third parties without proper and specific authority, unless there is a legal / professional ("voluntary") right of duty to disclose ("obligations" – regulated industries where non-compliance with *existing laws and regulations* / malpractices should be disclosed; *subpoena* is served on the auditor which requires the latter to act as witness in a litigation / court proceeding against the client – failure to disclose by the professional accountant is seen as a collaborator / partner to client's malpractices, and constitutes an obstruction to justice offence, punishable by law). Even after the client/employer ties are severed, the principle must still be upheld, and shall not be used for personal advantage.
- **Professional Behaviour.** Observe law, not discrediting the profession.

INTEGRATED REPORTING

Demonstrates linkage between strategy, financial (for shareholders), governance (for share/stakeholders), and the social and environmental (for stakeholders) context. A brief on both the organisation's financial and non-financial information helps investors and other stakeholders understand how an organisation is *really performing*.

Without integrated reporting, decisions made tend to be focused on mainly financial grounds at the expense of other stakeholders, because other information is not available. This allows for a realization that our predecessors have all operated under the environment of insufficient information.

Unlike traditional reporting (which focuses on historical information which is short-term in nature), integrated reporting has the potential of sustaining value in the long and short term.

Integrated Thinking

To include consideration of other stakeholders as well.

Under Integrated Reporting, more information than usual is reported and made available to the investor, which enables them to make a more sound decision.

Objectives / Advantages of Integrated Reporting

- Improved quality of information (e.g. how the entity creates value over time) that is benefit for stakeholders, especially providers of finance – for a more efficient and productive allocation of capital;
- To enhance accountability, and promote understanding of their interdependencies (between types of capital – financial, manufactured, intellectual, human, social and relationship, and natural);
- Support decision-making for the short, medium, and long term.

Contents of an Integrated Report

Organisational overview and external environment	The circumstances under which it operates may create some issues with a particular type of capital, e.g. manufacturing companies always come faced with natural capital issues.
Governance	Refers to the Statement of Corporate Governance and Internal Control Statement, which provides details on: Directors, Directors' Remuneration, Relations with Shareholders, as well as Accountability.
Business Model	*Sensitive*
Risks and Opportunities	SWOT Analysis.
Strategy and Resource Allocation	*Sensitive*
Performance	To what extent has the organisation achieved its mission and vision?
Outlook	Prospects of the company.
Basis of preparation and presentation	Because the preparation of Integrated Reporting is voluntary, there is no one prescribed basis that's being used. To ensure comparability, the basis ought to be disclosed and used consistently.

Social Performance + Environmental Performance + Economic Performance

Benefits of Integrated Reporting

Greater clarity	Integrated reporting allows for more integrated thinking and management. This allows the Board to make decisions without losing sight of factors driving business performance, and the effect on other stakeholders.
Deeper engagement / connectivity with broad stakeholder community	Extensive reporting enables stakeholders to appreciate the limitations encountered by the company, and the company's duties towards each of them.
Lowers reputational risk	The company can enjoy the business case of a better reputation stemming from its clear and consistent communication.
Clarity of measuring performance	Strengthened reporting across most or all activities (IR focuses on six types of capital) directs the Board's attention to each one of them, which allows them to reassess their role in society.
Opens up clear view of risks	Exploit opportunity, manage risks.
Builds transparency	With integrated reporting that is reliable and complete, business cases, e.g. of better capital access, can be achieved.

Challenges of Integrated Reporting

Management will be diverted from its attention to shareholders, to stakeholders. The focus on other stakeholders can cause the company to be seen as not to be fulfilling its responsibilities under the Companies' Act.

Directors' duties	The duty of the director has been extended to include other stakeholders.
Directors' liability	By voluntarily disclosing its environmental footprint, the directors may attract criticism for their action – which otherwise will not be known to others.
Commercial confidentiality	Commercial sensitivity. As disclosure is not necessary, disclosure will help others gain the upper hand.
Capacity building	Much time and cost may have to be incurred to gather the information.

TYPES OF CAPITAL (6)

Stocks of value (not just company shares) that are transformed through the activity carried out by the organisation.

Financial	Pool of funds available for use by an organization in the production of goods and provision of services ("*POGAPOS*"). Company's sources of funds: government subsidies / grants, retained earnings, equity, debt. The larger the funds available, the more potent and enabled a company is in investing in other forms of capital, such as manufactured and intellectual capital.
Manufactured	Refers to property, plant, and equipment ("*PPE*") used in the POGAPOS, not the output. The information might be of interest to shareholders and NGOs as it provides indication of the company's future prospects, if the PPE used are advanced and modern, as well as the environmental impact of its machinery – the assumption is that older PPE would cause greater pollution.
Intellectual *Investment in R&D*	Information on patents and R&D are of interest to shareholders, for a purpose similar to manufactured capital. Important for companies in the high-tech industry, as a formidable intellectual capital can place them ahead of other competitors. Intellectual capital is dependent on the wealth of the Financial capital as well.
Human *Welfare of employees at the workplace*	Welfare provided by company to its employees, in the form of learning and development, fair employment opportunities / practices, offering a competitive wage rate.
Social & Relationship *With regards to the general public*	Activities the company is able to provide to the general public, e.g. public donations for the needy, construction of public facilities and infrastructure… in the locations in which they operate.
Natural	Similar to 'environmental footprint'.

Footprint

Positive: Negative attributes have been reduced; Negative: Negative attributes have increased.

Environmental Footprint – *part of "Social Footprint"*

Impact of business activities upon environment, such as:

Resource Environment: Refers to consumption of natural resources that are non-renewable.

Pollution Emissions: Air, water, land, or noise pollution.

Rising Temperature

Falling Water Tables

Shrinking cropland per person / forest: Especially when an agricultural-based country undergoes transformation

Loss of plant and animal species

Social Footprint

Similar to public interest, and hence the focus should be on:

Workplace: Retrenchment from corporate downsizing will displace workers and their families

Marketplace: Relationship with suppliers and customers.

Community: Mass tourism will erode local cultures and environments

Environment: (refer to above) Environmental pollution and waste disposal problems

Environmental Audit

ISO 14000: Available if company's operations meet certain environmental standards.

An assurance is an expression of an opinion. An audit engagement is an assurance engagement to verify the client's social and environmental statement issued. In preparing this, the Professional Accountant is responsible for expressing an opinion on the client's published social and environmental statement by benchmarking the company's performance as against the criteria.

Once an engagement has been concluded, the report is made on the opinion expressed by the Professional Accountant which vouches to the soundness of the said statement.

Shortcomings: Inconsistencies and lack of criteria as the process is voluntary.

Providers: External parties – competent and independent; Internal parties – familiar with the company's situation, and knowledge capacity of the directors on the Board.

The parties responsible for the social and environmental statement issued – responsible party

Make decision based on the opinion expressed by the PA on the said statement. Intended users

Social and Environmental Audit

Stages in environmental audit

Agreement of Metrics	Since environmental audits are voluntary, no standard exists to govern the auditing. As such, criteria would have to be established among the three parties: preparer ("responsible party"), professional accountant, and intended users for the purpose of benchmarking against the company's actual performance. Frameworks such as the ISO14000 and AA1000, Global Reporting Initiative exist, but none is singularly most dominating.
Measurement of Actual Performance against Metrics	Not every result reported by the client is capable of being measured because they are not quantifiable, e.g. the level of the employees' environmental awareness is immeasurable.
Level on Compliance / Variance *('Findings')*	Discuss the level of assurance that is offered to the readers. Under, there is no prescribed format as to how environmental audit is to be reported. And the opinion to be expressed, which can lead to inconsistency between company, making comparisons difficult.

Contents of an Environmental Report

The fact that environmental reporting is voluntary, having such a report would make the company seem to be an ethical company, and therefore enjoy business cases, e.g. better access to capital, lower reputation risk.

- Activities – the key driver which will create the footprints
- The company should disclose its entire environmental footprint associated with those activities disclosed
- A presentation of policy, programme and management – a In the light of the negative footprint, the measures initiated by the company to overcome
- Irregular. Disclosure of when is the publication of the next Statement / Report, can create some expectations among the readers
- Summary of footprint (quantitative measurement)
- Quantitative data and comparative figures
- Significant changes since the previous statement – refers to publication of comparative figures
- Name of accredited environmental verified (only if environmental audit is carried out)

MINUTIAE

Public Interest: workplace, marketplace, environment, community

US, 1978: Banning of professional services advertising is unconstitutional, thus it is allowed since that, Malaysia did the same only in 2000 – when accounting firms are also finding greater outreach through websites.

Dignity = advertising doesn't project image of being 'high and mighty'

Silence can be perceived as admission of guilt.

Gifts and hospitality from clients / employers: nature of the ***gift and hospitality, intention, value*** – could mean the difference between gesture of goodwill, and bribery (the gift could be illegal).

Contingent fees are fees (payable to the firm) dependent on the occurrence / non-occurrence of certain events, such as ~~increase in taxes~~ adjustments made by the Inland Revenue Board made to the tax returns prepared by the firm.

Tantamount = giving rise to.

Management decision = seen as part of organisation's team

- Immediate family: spouse & children
- Close family: others

Conciseness of Integrated Report: this quality is essential in order not to cause the reader to lose focus in the reviewing of the Integrated Report

Reliability: the personnel preparing the IR must be competent in preparing such reports

Materiality: only material information that deserves the attention of the stakeholder will warrant reporting.

Due Diligence: Undertaken before the acquisition of an investment to assess the relevant aspects of the acquired business asset. Internal auditors normally perform due diligence activities before the preliminary drafting of a Letter of Intent – after which a more extensively due diligence exercise will be carried out.

Auditor Independence is defined as when "auditor is able to express opinion freely based on evidence obtained without being influenced by relationships or other parties".

Confidentiality is a continuous commitment that goes beyond the bounds of employment.