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GUIDELINES ON CORPORATE GOVERNANCE AND AUDITING: INTERNATIONAL STANDARDS

Textbook

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G 94 **Guidelines** on Corporate Governance and Auditing: International Standards : textbook / V. Shkola, M. Troian, V. Scherbachenko, T. Kasianenko. – Sumy : Sumy State University, 2021. – 158 p.

The textbook provides guidance to all types of organizations, regardless of their size or location, on: the core subjects and issues of corporate governance; to corporate governance; principles and practices relating to international auditing; integrating, implementing and promoting international standerts of corporate governance and auditing throughout countries worldwide and, through its policies and practices. It caters for the institutional, legal and regulatory frameworks for corporate governance and auditing across jurisdictions worldwide. It can be used by students, academicians, governments, regulators and the private sector to get information on practices in specific jurisdictions.

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INTRODUCTION

The aim of the international standards of corporate governance module is to equip students with the knowledge and key skills necessary to act as adviser to governing authorities across the private, public and voluntary sectors. The course will include all aspects of the governance obligations of organizations, covering not only legal duties, but also applicable and recommended standards of best practice.

The task of learning is to enable the development of a sound understanding of corporate governance law and practice in a national and international context. It will also enable students to support the development of good governance and stakeholder dialogue throughout the organization, irrespective of sector, being aware of legal obligations and best practice.

On successful completion of this module, students will be able to:

• appraise the frameworks underlying governance law and practice in a national and international context;

• distinguish between and compare the legal obligations for governance and recommended best practice;

• advise on governance issues across all sectors, ensuring that the pursuit of strategic objectives is in line with regulatory developments and developments in best practice;

• analyze and evaluate situations in which governance problems arise and provide recommendations for solutions;

• assess the relationship between governance and performance within organizations;

• compare the responsibilities of organizations to different stakeholder groups, and advise on issues of ethical conduct and the application of principles of corporate responsibility or corporate citizenship.

Part 1

INTERNATIONAL STANDARDS OF CORPORATE GOVERNANCE

- Corporate Governance: The Principles and Standards
- The Role of Stakeholders and Ethical Behavior in Corporate Governance
- Board of Directors: Functions and Responsibilities
- The Role of Audit and Regulation
- The Essence of Remuneration and Establishment of Remuneration Committee
- The Influence of Globalizationon Changes in Corporate Governance in Foreign Countries

CHAPTER 1

CORPORATE GOVERNANCE: THE PRINCIPLES AND STANDARDS

Henry Ford once said thata great business is really too big to be human. Indeed, that is the purpose of the corporate structure, to transcend the ability and lifespan of any individual. It is also the challenge of the corporation (Monks & Minow, 2011, p. 4).

The most significant forces governing the direction of corporations and trying to reduce agency costs and maximize sustainable value creation areinternal and structural ones, namely management, shareholders, boards of directors (Monks & Minow, 2011).

The concept of governance is not a new one but nowadays we hear words as corporate governance, organizationalgovernance or good governance frequently.

The term corporate governance first appeared in 1962 in a book by Richard Eells of Columbia University.

Actually corporate governance (or as defined in ISO 2600:2010 "organizational governance") is "the system of rules, practices and processes that directs and controls an organization" (European Commite for Standartization, 2010).

Note

ISO 26000 (Guidance on Social Responcibility) is the international standard intended to assist organizations in assessing effectively and addressing social responsibilities while respecting cultural, societal, environmental, and legal differences and economic development conditions.

In essence, corporate governance involves balancing the interests of an organization's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community (ASQ, n.d.). According to ISO 26000 organizational or corporate governance can include both formal governance arrangements and informal arrangements (European Commite for Standartization, 2010).

Note

Formal governance arrangements are based on established structures and processes.

Informal governance arrangements stem from the culture and values of the organization and are often influenced by the leaders of the organization.

Organizational governance is the main function of any kind of organization, as it is the basis for decision making within the organization (European Commite for Standartization, 2010).

Corporate governance can be regarded as a synergy-driven environment based on high moral values, ethics, and trust. It has gained tremendous importance in recent years. There is a considerable body of literature which considers the components of a good system of governance and a variety of frameworks exist or have been proposed.

Note

According to the UK Code 1992 published by the Cadbury Committee "*corporate governance* is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

"The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company" (Financial Reporting Council, 2016).

Supra-national authorities such as the Organization for Economic Cooperation and Development (OECD) and the World Bank designed their own principles of corpotate governance 'to assist governments in their efforts to evaluate and improve their frameworks for corporate governance, and provide guidance for regulators and, more broadly, participants in financial markets' (Kirkpatrick, 2004).

Note

"The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation.

The OECD is also at the forefront of efforts to understand and to help

governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies. The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members"(OECD, 2015, p.57).

This type of self-regulation was chosen above a set of legal standards.

Standards reflect agreement between governments on the best policies or practices in a specific field. Some OECD standards are legally binding, e.g. Decisions or international treaties, while others are not, e.g. Recommendations.

Note

OECD developed over 450 international standarts, including conventions, recommendations, decisions, and declarations over thw past 55 yers. Currentty, more than 250 legal instruments are in force, some relating to multiple sectoral areas (OECD, 2019c).

In the OECD, standards are developed at the request of Member countries, agreed on by consensus, and developed through a rigorous evidence-based process of negotiation led by expert committees, and involving a variety of stakeholders (OECD, 2019c).

Note

Principles of Corporate Governance (OECD, 2015) is one of the twelve Key Standards for Sound Financial Systems developed by international financial institutions to promote transparent and efficient capital markets and sound corporate governance practices. Besides the former they include:

1. Code of Good Practices on Transparency in Monetary and Financial Policies (IMF, 1999);

2. Code of Good Practices on Fiscal Transparency (IMF, 2007);
3. Special Data Dissemination Standard/General Data Dissemination System (IMF, 2021);
4. Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (Leroy,A.-M., &Grandolini,G.M., 2016);
5. Principles of Corporate Governance (OECD, 2015);
6. International Accounting Standards (IAS Plus, n.d.);
7. International Standards on Auditing(IAASB, n.d.);
8. Core Principles for Systemically Important Payment Systems (CPSS, 2001) and Recommendations for Securities Settlement Systems (CPSS-IOSCO, 2001);
9. International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation (FATF, 2012-2020);
10. Core Principles for Effective Banking Supervision (BCBS, 2012);
11. Objectives and Principles of Securities Regulation (IOSCO, 2017);
12. Insurance Core Principles (IAIS, 2018).

Given somemajor corporate scandals at the financial markets concerning investors, the issure of their protection became crucial to most companies. According to European Bank for Reconstruction and Development "successful implementation of international standards strengthens domestic financial systems and encourages sound regulation and supervision, greater transparency, efficient institutions, markets, and infrastructure" (EBRD, 2021).

Note

A corporate scandal can have a dramatic effect on a company's bottom line. The top 10 of the biggest corporate scandals of recent times ranked according to notoriety are:

1. Enron
2. Volkswagen
3. Lehman Brothers
4. BP
5. Uber
6. Apple
7. Facebook
8. Valeant Pharmaceuticals
9. Kobe Steel
10. Equifax

As defined in the G20/OECD Principles of Corpotate Governance, "the purposeof corporate governance is to help build an environment of trust,

transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies" (OECD, 2015).

In practice there are some basic principles of good corporate governance. "Companies that embrace the tenets of good governance, including accountability, transparency and sustainability, are more likely to engender investor confidence and achieve long-term sustainable business performance" (Monetary authority of Sinagapure, 2018). All these principles are related with the corporate social responsibility of company.

In accordance with the ISO 26000 there are seven key principles of social responsibility, such as:

- "Accountability
- Transparency
- Ethical behavior
- Respect for stakeholder interests
- Respect for the rule of law
- Respect for international norms of behavior
- Respect for human rights" (European Commite for Standartization, 2010).

According to the G20/OECD Principles of Corpotate Governance (OECD, 2015) "the corporate governance framework should promote transparent and fair markets, and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement. In order to achieve this task it is suggested that:

A.The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets;

B. The legal and regulatory requirements that affect corporate governance practices should be consistent with the rule of law, transparent and enforceable;

C. The division of responsibilities among different authorities should be clearly articulated and designed to serve the public interest.

D. Stock market regulation should support effective corporate governance;

E. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained;

F. Cross-border co-operation should be enhanced, including through bilateral and multilateral arrangements for exchange of information."

Moreover, "the corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders". "All shareholders should have the opportunity to obtain effective redress for violation of their rights. In order to achieve this task it is suggested that:

A. Basic shareholder rights should include the right to:

1) secure methods of ownership registration;

2) convey or transfer shares;

3) obtain relevant and material information on the corporation on a timely and regular basis;

4) participate and vote in general shareholder meetings;

5) elect and remove members of the board;

6) share in the profits of the corporation.

B. Shareholders should be sufficiently informed about, and have the right to approve or participate in, decisions concerning fundamental corporate changes such as:

1) amendments to the statutes, or articles of incorporation or similar governing documents of the company;

2) the authorisation of additional shares;

3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
2. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.
3. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
4. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known, including through votes at shareholder meetings, on the remuneration of board members and/or key executives, as applicable. The equity component of compensation schemes for board members

and employees should be subject to shareholder approval.

5. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.
6. Impediments to cross border voting should be eliminated.

D. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

E. All shareholders of the same series of a class should be treated equally. Capital structures and arrangements that enable certain shareholders to obtain a degree of influence or control disproportionate to their equity ownership should be disclosed, namely:

1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in economic or voting rights should be subject to approval by those classes of shares which are negatively affected.
2. The disclosure of capital structures and control arrangements should be required.

F. Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders, namely:

1. Conflicts of interest inherent in related-party transactions should be addressed.
2. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

F. Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders, namely:

1. Conflicts of interest inherent in related-party transactions should be addressed.
2. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

G. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited.

H. Markets for corporate control should be allowed to function in an

efficient and transparent manner, namely:

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.
2. Anti-take-over devices should not be used to shield management and the board from accountability."

Furthermore, according to the G20/OECD Principles of Corpotate Governance (OECD, 2015) "the corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance." In order to achieve this task it is suggested that:

"A. Institutional investors acting in a fiduciary capacity should disclose their corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

B. Votes should be cast by custodians or nominees in line with the directions of the beneficial owner of the shares.

C. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

D. The corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice.

E. Insider trading and market manipulation should be prohibited and the applicable rules enforced.

F. For companies who are listed in a jurisdiction other than their jurisdiction of incorporation, the applicable corporate governance laws and regulations should be clearly disclosed. In the case of cross listings, the criteria and procedure for recognising the listing requirements of the primary listing should be transparent and documented.

G. Stock markets should provide fair and efficient price discovery as a means to help promote effective corporate governance."

In addition the G20/OECD Principles of Corpotate Governance (OECD, 2015) assume that "the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in

creating wealth, jobs, and the sustainability of financially sound enterprises" (in more detale see chapter 3). In order to achieve this task it is suggested that:

"A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

C. Mechanisms for employee participation should be permitted to develop.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and to the competent public authorities and their rights should not be compromised for doing this.

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights."

Additionally,the G20/OECD Principles of Corpotate Governance (OECD, 2015) state that "the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company." In order to achieve this task it is suggested that:

"A. Disclosure should include, but not be limited to, material information on:

1) the financial and operating results of the company;
2) company objectives and non-financial information;
3) major share ownership, including beneficial owners, and voting rights
4) remuneration of members of the board and key executives;
5) information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board;
6) related party transactions;
7) foreseeable risk factors;
8) issues regarding employees and other stakeholders;
9) governance structures and policies, including the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high

quality standards of accounting and financial and non-financial reporting.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in accordance with high-quality auditing standards in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users."

Furthermore, according to the G20/OECD Principles of Corpotate Governance (OECD, 2015) "the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders" (see chapter 3). In order to achieve this task it is suggested that:

"A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfil certain key functions, including:

1) reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures;

2) monitoring the effectiveness of the company's governance practices and making changes as needed;

3) selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning;

4) aligning key executive and board remuneration with the longer term interests of the company and its shareholders;

5) ensuring a formal and transparent board nomination and election process;

6) monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions;

7) ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards;

8) overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs, namely:

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.
2. Boards should consider setting up specialised committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
3. Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information

G. When employee representation on the board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of board skills, information and independence."

The G20/OECD Principles of Corpotate Governance (OECD, 2015)"are intended to be concise, understandable and accessible to the international community. On the basis of the Principles, it is the role of government, semi-government or private sector initiatives to assess the quality of the corporate governance framework and develop more detailed mandatory or voluntary provisions that can take into account country-specific economic, legal, and cultural differences."

The G20/OECD Principles of Corpotate Governance (OECD, 2015) "focus on publicly traded companies, both financial and non-financial. To the extent they are deemed applicable, they might also be a useful tool to improve

corporate governance in companies whose shares are not publicly traded. While some of the Principles may be more appropriate for larger than for smaller companies, policymakers may wish to raise awareness of good corporate governance for all companies, including smaller and unlisted companies.

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders.

Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The Principles do not intend to prejudice or second-guess the business judgment of individual market participants, board members and company officials. What works in one company or for one group of investors may not necessarily be generally applicable to all of business or of systemic economic importance" (OECD, 2015).

"The Principles recognise the interests of employees and other stakeholders and their important role in contributing to the long-term success and performance of the company.

Other factors relevant to a company's decision-making processes, such as environmental, anti-corruption or ethical concerns, are considered in the Principles but are treated more explicitly in a number of other instruments including

1) the OECD Guidelines for Multinational Enterprises,
2) the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,
3) he UN Guiding Principles on Business and Human Rights,
4) and the ILO Declaration on Fundamental Principles and Rights at Work, which are referenced in the Principles" (OECD, 2015).

The G20/OECD Principles of Corpotate Governance (OECD, 2015)"are developed with an understanding that corporate governance policies have an important role to play in achieving broader economic objectives with respect to investor confidence, capital formation and allocation.

The quality of corporate governance affects the cost for corporations to access capital for growth and the confidence with which those that provide capital – directly or indirectly – can participate and share in their value-creation on fair and equitable terms. Together, the body of corporate governance rules and practices therefore provides a framework that helps to bridge the gap between household savings and investment in the real economy. As a consequence, good corporate governance will reassure shareholders and other stakeholders that their rights are protected and make it possible for corporations to decrease the cost of capital and to facilitate their

access to the capital market. This is of significant importance in today's globalised capital markets" (OECD, 2015).

"International flows of capital enable companies to access financing from a much larger pool of investors. If companies and countries are to reap the full benefits of the global capital market, and if they are to attract long-term "patient" capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles. Even if corporations do not rely primarily on foreign sources of capital, a credible corporate governance framework, supported by effective supervision and enforcement mechanisms, will help improve the confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing" (OECD, 2015).

It should be noted that another node of legislative corporate governance is the national corporate governance codes applied around the world (Appendix A).

Note

The UK Corporate Governance Code 2016 (published in April 2016) applies to accounting periods beginning on or after 17 June 2016 and applies "to all companies with a Premium listing of equity shares regardless of whether they are incorporated in the UK or elsewhere" (Financial Reporting Council, 2016).

The UK Corporate Governance Code 2018 (published in July 2018) applies to accounting periods beginning on or after 1 January 2019. At the heart of this Code is an updated set of Principles that emphasise the value of good corporate governance to long-term sustainable success (Financial Reporting Council, 2018). It places greater emphasis on relationships between companies, shareholders and stakeholders, as well as promotes the importance of establishing a corporate culture aligned with the company purpose, business strategy, promotes integrity and values diversity (Financial Reporting Council, 2020).

Rewiew questions

1. What is meant by corporate governance?
2. What are the reasons to implement corporate governance?
3. What is the relationship between corporate governance and corporate social responsibility?
4. What are the 4 principles of corporate governance?

5. What does the rule of law mean?
6. Explain transparency.
7. What is meant by stewardship?
8. Why will good governance mechanisms create competitive advantage?

Questions to discuss

1. Why it is management, shareholders, boards of directors that are the most significant forces of corporate governance?
2. What is the prominenceand importance of social responsibility?
3. Clarify the essence ofcorporate governance as an environment of trust, ethics, moral values and confidence.
4. Consider top 10 biggest corporate scandals and analizy how they affected share prices.

Problems

1.1. Consider and discuss Case "Suzano" (OECD, 2006, pp. 70-77).

Analyze according to the following scheme:

1) a brief description of the company (where, by whom, when founded; in which sector of the economy it operates; what market share it owns).

2) prerequisites, or what prompted the company to implement corporate governance standards.

3) what is the essence of the chosen model of corporate governance.

4) what results were achieved.

5) what are the prospects for the studied company.

1.2. Consider and discuss Case "Embraer" (OECD, 2006, pp. 30-37). Analyze according to the aforesaid scheme.

Case 1.1. Variations on comply-or-explain reporting on corporate governance codes

A few countries have developed unique systems for promoting implementation of national corporate governance codes that do not hew strictly to usual comply-or-explain systems. For example, in Costa Rica, the National Council of Supervision of the Financial System (CONASSIF) Corporate Governance Regulation is mandatory to implement but based on a "comply and explain" rule, unlike the more common model followed in other countries under which the company may choose not to comply but must explain the reason why. While complying with the code is considered

mandatory, it also suggests that companies may apply the principle of proportionality, meaning that in practice there remains some flexibility in how the code is applied. Listed companies are nevertheless mandated under the national code to establish and disclose their own codes and additional information consistent with the disclosure and transparency recommendations of the G20/OECD Principles of Corporate Governance. In Malaysia, the Malaysian Code on Corporate Governance follows an "apply or explain an alternative" approach, where companies that are not applying the practices prescribed by the Code must provide an explanation for the departure, and disclose an alternative practice that meets the intended outcome of the principles of the Code. In addition, large companies (as defined in the Code) departing from a recommended practice in the Code are required to disclose measures to be taken by the company to adopt the practice and the time frame for their adoption. The disclosure requirements are mandated in the Listing Requirements, which apply to all Code practices, and to all listed companies. Mexico provides an example of a mixed approach involving binding and voluntary code recommendations. In 2005, its securities market law incorporated a minimum framework of the practices and principles of sound corporate governance for listed companies contained in the Code of Principles and Best Practices in Corporate Governance. That is, while the Code itself is not binding, many of the practices previously recommended in it have become binding by Law. Moreover, Stock Exchange listing rules require listed companies to disclose their degree of adherence to the Code both to the Stock Exchange in which their stock is traded, and to investors. Stock Exchange listing rules also require issuing companies to be knowledgeable about the Code (OECD, 2019a)

CHAPTER 2

THE ROLE OF STAKEHOLDERS AND ETHICAL BEHAVIOR IN CORPORATE GOVERNANCE

In some European countries, the rights of stakeholdersare enshrined in company law or other related legislation, such as codetermination and employment-protection legislation. In Germany, for example, a 1976 lawmandated that worker representatives hold seats on theboards of all companies employing over 500 people.Proponents of codetermination argue that it leads toreductions in management-labor conflict by means ofimproving and systematizing communication channels.

By contrast, companies in other countries have a tradition of focusing more narrowly on the interests of shareholders. However, regardless of legal obligations, the governance framework should take into accountthe interests of stakeholders. The risks to the companyof insufficiently incorporating the stakeholder perspective into governance arrangements could be considerable. Consequently, well-governed companies in Europemake an effort to establish and maintain dialogue andconstructive engagement with relevant stakeholders (International Finance Corporation, World Bank Group, 2015).

Stakeholders are such groups or individuals without whose support the organization would cease to exist and who can affect or is affected by the achievement of the organization’s objectives.

We can see from these definitions that many people can be a stakeholder to an organization. The most common groups who we consider to be stakeholders include: managers, employees, customers, investors, shareholders, suppliers. There are some more generic groups who are often included: government, society, the local community.

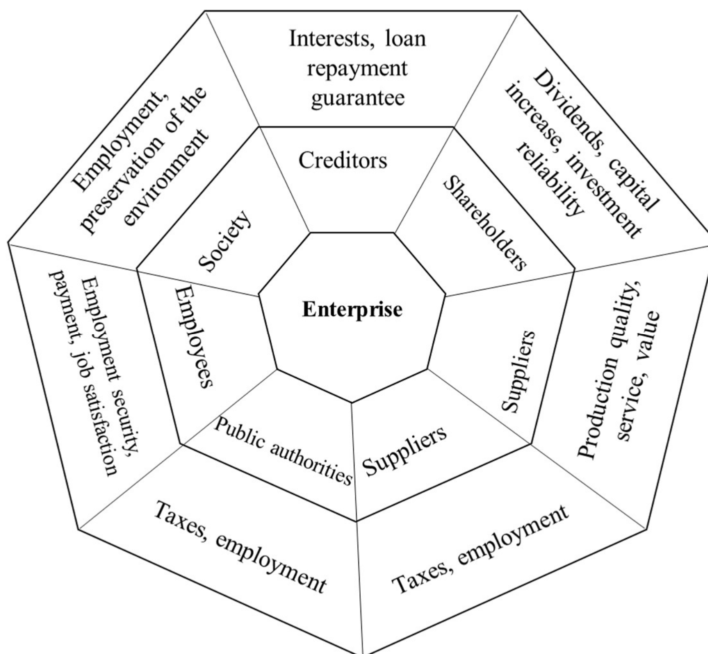
The G20/OECD Principles of Corpotate Governance (OECD, 2015) state that the corporate governance framework should recognise the rights ofstakeholders (see chapter 1).

A key aspect of corporate governance is “concerned with ensuring the flowof external capital to companies both in the form of equity and credit” (OECD, 2015). Corporategovernance is also “concerned with finding ways to encourage the variousstakeholders in the firm to undertake economically optimal levels of investmentin firm-specific human and physical capital”.

The competitiveness and ultimatesuccess of a corporation is the result of teamwork that embodies contributionsfrom a range of different resource providers including investors, employees, creditors, customers and suppliers, and other stakeholders. Corporations should recognise that the contributions of stakeholders constitute a valuable resource forbuilding competitive and profitable companies. It is, therefore, in the long-terminterest of corporations to foster wealth-creating co-operation amongstakeholders. The governance framework should recognise "the interests of stakeholders and their contribution to the long-term success of the corporation" (OECD, 2015).

Example

In the UK a regulator has regulated utility industries since privatization and thus the regulator is a stakeholder of these organizations. Similarly, certain industries are more environmentally, politically or socially sensitive than others and therefore attract more attention from these stakeholder groups, and again the water or nuclear industries provide examples here (Crowther & Seifi, 2011).



Firure 2.1.**Stakeholder groups and their expectations**

The rights of stakeholders are "often established by law (e.g. labour, business, commercial, environmental, and insolvency laws) or by contractualrelations that companies must respect. Nevertheless, even in areas wherestakeholder interests are not legislated, many firms make additionalcommitments to stakeholders, and concern over corporate reputation andcorporate performance often requires the recognition of broader interests. Formultinational enterprises, this may in some jurisdictions be achieved bycompanies using *the OECD Guidelines for Multinational Enterprises* for duediligence procedures that address the impact of such commitments" (OECD, 2015).

The legal framework and process should be transparent and not impede the ability of stakeholders to communicate and to obtain redress for the violation of rights.

The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

Creditors are a key stakeholder and the terms, volume and type of credit extended to firms will depend importantly on their rights and on their enforceability. Companies with a good corporate governance record are often able to borrow larger sums and on more favourable terms than those with poor records or which operate in less transparent markets. The framework for corporate insolvency varies widely across countries. In some countries, when companies are nearing insolvency; the legislative framework imposes a duty on directors to act in the interests of creditors, who might therefore play a prominent role in the governance of the company. Other countries have mechanisms which encourage the debtor to reveal timely information about the company's difficulties so that a consensual solution can be found between the debtor and its creditors.

Creditor rights also vary, ranging from secured bond holders to unsecured creditors. Insolvency procedures usually require efficient mechanisms for reconciling the interests of different classes of creditors. In many jurisdictions provision is made for special rights such as through "debtor in possession" financing which provides incentives/protection for new funds made available to the enterprise in bankruptcy (OECD, 2015).

Ethics shows a corporation how to behave properly in all its business and operations. However, business ethics is characterized by conflicts of interests. Businesses attempt to maximize profits as a primary goal on one hand while they face issues of social responsibility and social service on the other. Ethics is the set of rules prescribing what is good or evil, or what is right or wrong for people. In other words, ethics is the values that form the basis of human relations, and the quality and essence of being morally good or evil, or right

or wrong. Business Ethics means honesty, confidence, respect and fair acting in all circumstances. However, such values as honesty, respect and confidence are rather general concepts without definite boundaries. Ethics can also be defined as overall fundamental principles and practices for improving the level of wellbeing of humanity (Crowther & Seifi, 2011, p. 58).

Ethics is the natural and structural process of acting in line with moral judgments, standards and rules. Being a concrete and subjective concept, business ethics can be discussed with differing approaches and in varying degrees of importance in different fields. Indeed, it is highly difficult to define ethics and identify its limits and criteria. Accordingly, there are difficulties in discussing this concept in literature, as it is ubiquitous in business life, at the business level, and in human life. According to what, how, how much and for whom ethics is or should be are important questions. It is not always easy to find answers to these questions (Aras & Crowther, 2008a).

However, ethical behavior and ethical business has effects not only on stakeholders, and shareholders but also on the entire economy. We believe that when we act ethically in business decision-making process this will ensure more effective and productive utilization of economic resources (Crowther & Seifi, 2011).

Every company should have a Code of Ethics that covers the owners, the Board of Directors, the Management the employees and representatives. The Code of Ethics should be developed by the Management and approved by the Board of Directors.

The code of ethics should cover (Brazilian Institute of Corporate Governance, 2016):

- true and complete accounting;
- correct invoice values;
- bribery and improper payments;
- loans to the controlling owner;
- use of assets by controlling owner;
- conflict of interest;
- security of proprietary information;
- receiving gifts;
- giving gifts;
- discrimination;
- environment;
- sexual harassment;
- workplace safety;
- political activities;

- community relations;
- employee privacy;
- substance abuse;
- nepotism;
- child labor.

There is a conflict of interest whenever a party is not independent in regard to a particular issue and the party in question might influence or make decisions in this regard. Similar criteria are valid for management or any other company employee or representative (Brazilian Institute of Corporate Governance, 2016).

The person in question should identify his/her conflict of interest. If he/she fails to do so, any other person should speak up.

As soon as a conflict of interest has been identified the person in question should leave the meeting room and only return once the discussions have finished and the decisions have been taken.

The temporary absence should be recorded in minutes (Brazilian Institute of Corporate Governance, 2016).

One of the most certain definitions found in ISO 26000 is that declared the importance of ethical behavior. This standard has defined ethical behavior as: behavior that is in accordance with accepted principles of right or good conduct in the context of a particular situation and is consistent with international norms of behavior.

We must remember however that international standards are a problematic concept as there are very few universally agreed upon standards and it is very easy therefore to assume that Western norms have international agreement.

Rewiew questions

1. Who are the stakeholders?
2. How can we classify stakeholders?
3. Name a multi-dimensional performance measurement framework.
4. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights?
5. Why does a company have to be ethical?
6. What is the relationship between CSR and corporate behaviour?

Questions to discuss

1. Consider thr concept of CSR on the example Tiffany & Co (2017). How such practice may influence companies' image (brand)?
2. Study and discuss the obgectives of ISO 26000. How do you think Ukrainian compamies should follow this standart to immrove their performance in corporate governance?
3.What do you know about stakeholder theory? Consider different stakeholders' group and their role in social and economic perfomance.

Problems

2.1. Watch educational video "Enron: The Smartest Guys In The Room". Discuss which actions of top management has caused the fatal consequence and led to corruption scandal? How companies may eliminate negative consecuences in future?

2.2. Consider and discuss Case "Marcopolo" (OECD, 2006, pp. 50-57). Analyze according to the following scheme:

1) a brief description of the company (where, by whom, when founded; in which sector of the economy it operates; what market share it owns).
2) prerequisites, or what prompted the company to implement corporate governance standards.
3) what is the essence of the chosen model of corporate governance.
4) what results were achieved.
5) what are the prospects for the studied company.

Case 2.1. **National provisions to facilitate effective minority shareholder participation in board selection**

Eight jurisdictions have special voting arrangements to facilitate effective participation by minority shareholders (Table 2.1). In Italy, at least one board member must be elected from the slate of candidates presented by shareholders owning a minimum threshold of the company's share capital. In Israel, it is recommended for initial appointment and required for re-election, that all outside directors be appointed by the majority of the minority shareholders. In the United Kingdom, the Financial Conduct Authority published a rule in 2014 that provides additional voting power to minority shareholders in the election of independent directors for a premium listed company where a controlling shareholder is present ("dual voting mechanism"). It requires independent directors to be separately approved

both by the shareholders as a whole and the independent shareholders as a separate class. Moreover, initial appointments must be approved by the majority of the minority shareholders. Brazil, India, Portugal, Spain and Turkey have also established special arrangements to facilitate the influence of minority shareholders in the process of board nomination and election (OECD, 2019a).

Table 2.1 Board representation of minority shareholders (OECD, 2019a)

Jurisdiction	Required for re-election	Requirement / recommendation
Brazil	Allowed	One or two members of the board may be elected separately by minority shareholders, pursuant to the following rules: Minority shareholders holding voting shares that represent 15% or more of the voting capital are entitled to appoint one member for the board; and Minority shareholders holding non-voting preferred shares or preferred shares with limited voting rights that represents 10% or more of the total capital stock are entitled to appoint one member to the board - if neither the holders of shares with voting rights nor the holders of preferred shares without voting rights or with restricted voting rights achieve the percentages mentioned above, they are allowed to aggregate their shares in order to jointly elect a member for the board of directors, as long as their shares represent at least 10% of share capital; and - in the case of state-owned enterprises, minority shareholders have the right to elect one representative for the Board with no minimum share capital requirement
India	Allowed	Companies Act, 2013 provides for nomination of one director by small shareholders. In this context, a small shareholder is someone holding shares of nominal value of not more than twenty thousand rupees.
Israel	• Recommended for initial appointment; • Required for re-election	All outside directors must be appointed by a majority of the minority.
Italy	Required	At least one board member must be elected from the slate of candidates presented by shareholders owning a minimum threshold of the company's share capital. His/her appointment is not a necessary condition for the valid composition of the board (i.e. the board composition is still valid if only one slate has been presented and the board is consequently made up of only directors elected from that slate).

Portugal	Required	The articles of association of public listed companies must provide that: i.) a maximum of one-third of board members are appointed within candidates proposed by a group of shareholders holding between 10 and 20% shareholding; or ii) that minority shareholders representing at least 10% of the share capital appoint at least one director.
Spain	Allowed	Shares that are voluntarily grouped to constitute share capital amounting to or exceeding the sum resulting from dividing the capital by the number of members of the board of directors, shall be entitled to designate the number of members deduced from the proportion of share capital so grouped, rounding any fractions. In other words, depending on the number of directors, shareholders can pool their shares in order to appoint a number of directors to the board in proportion to the share capital they hold in accordance with the proportional representation system For instance, if minority shareholders possess 100 shares and the board has 12 members, they may pool the 100 shares divided by 12 in order to designate a member of the board.
Turkey	Allowed	The minority shareholders (holding 5% of the equity capital for listed companies) may be given the right to be represented at the board (maximum half of the members of the board can be elected in this way, provided that the articles of association of the company allow.)
United Kingdom	Required for premium listed companies with controlling shareholders	Premium listed companies with controlling shareholders must ensure that their constitutions provide for the election of independent directors by a dual voting structure. This structure requires that independent directors must be separately approved both by the shareholders as a whole and the independent shareholders as a separate class.

CHAPTER 3

BOARD OF DIRECTORS: FUNCTIONS AND RESPONSIBILITIES

The G20/OECD Principles of Corpotate Governance (OECD, 2015) state that board structures and procedures vary both within and among countries.

Some countries have two-tier boards that separate the supervisory function and the management function into different bodies. Such systems typically have a "supervisory board" composed of non-executive board members and a "management board" composed entirely of executives.

Other countries have "unitary" boards, which bring together executive and non-executive board members. In some countries there is also an additional statutory body for audit purposes.

The G20/OECD Principles of Corpotate Governance (OECD, 2015) are "intended to apply to whatever board structure is charged with the functions of governing the enterprise and monitoring management. Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfil their responsibilities they must be able to exercise objective and independent judgement. Another important board responsibility is to oversee the risk management system and systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable" (OECD, 2015).

The board is not only "accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context"(OECD, 2015).

The *board of directors* is "the highest governing authority within the management structure at a corporation or publicly traded business. The board owes a company's shareholders the highest financial duty under American

law, known as a *fiduciary duty"*.

It's the board's duties to:

1. Select, evaluate, and approve appropriate compensation for the company's chief executive officer (CEO).
2. Evaluate the attractiveness of and pay dividends, recommend stock splits.
3. Oversee share repurchase programs.
4. Approve the company's financial statements.
5. Recommend or strongly discourage acquisitions and mergers.

A *stock split* is a decision by a company's board of directors to increase the number of shares that are outstanding by issuing more shares to current shareholders.

Example

In a 2-for-1 stock split, an additional share is given for each share held by a shareholder. So, if a company had 1 million shares outstanding before the split, it will have 2 million shares outstanding after a 2-for-1 split. A stock's price is also affected by a stock split. After a split, the stock price will be reduced since the number of shares outstanding has increased. In the example of a 2-for-1 split, the share price will be halved. Thus, although the number of outstanding shares and the price change, the market capitalization remains constant.

Stock buyback program is a process when a company choose to buy back shares of its stock. A company pays the market price for the shares, retains ownership, and increases the ownership stake of the remaining stockholders.

In some European countries, the sentiment is much different in that many directors there feel that it is their primary responsibility to protect the employees of a company first and the shareholders second. In these social and political climates, corporate profitability takes a back seat to the needs of workers.

The Structure and Makeup of the Board.

"Shareholders shall have the possibility to evaluate the performance of the board of directors and the directors on a regular basis. Good corporate governance requires that the entire board of directors is elected annually at the annual general meeting. Any provisions of the company's articles of association that depart from this recommendation shall be reported as departures" (Securities Market Association, 2020).

The board is made up of individuals (the "directors") whoare elected by the shareholders for multiple-year terms.Many companies operate on a rotating system so that only afraction of the directors is up for election each year.In most cases, directors have a vested interest in the company; work in

the upper management of the company (so-called "executive directors"); or are independent of the company but are known for their business abilities.The number of people on a board of directors can vary substantially between companies and can range anywhere from 3 to 30.

The composition of the company's board of directors shall reflect the requirements set by the company's operations and development stage. A person elected as a director must have the competence required by the position and the possibility to devote a sufficient amount of time to attending to the duties. The number of directors and the composition of the board of directors shall be such that they enable the board of directors to see to its duties efficiently. Both genders shall be represented in the board of directors (Securities Market Association, 2020).

The audit committee is responsible for ensuring that the company's financial statements and reports are accurate and use fair and reasonable estimates. The board members select, hire, and work with an outside auditing firm that does the auditing.

The compensation committee sets base compensation, stock option awards, and incentive bonuses for the company's executives, including the CEO. In recent years, many boards of directors have come under fire for allowing executive salaries to reach unjustifiably high levels. In exchange for providing their services, corporate directors are paid a yearly salary, additional compensation for each meeting they attend, stock options, and various other benefits. The total amount of directorship fees varies from company to company. The compensation directors receive, along with any otherbenefits, short biographical information, age, and level of existing ownership in the business is found in a special document known as the *proxy statement*.

A proxy statement is a document containing the information the Securities and Exchange Commission (SEC) requires companies to provide to shareholders so they can make informed decisions about matters that will be brought up at an annual or special stockholder meeting. Issues covered in a proxy statement can include proposals for new additions to the board of directors, information on directors' salaries, information on bonus and options plans for directors, and any declarations made by the company's management.

The annual meeting of a corporation is a gathering of shareholders of the corporation. An annual meeting may also be called*a general meeting*, an annual shareholder meeting, or an annual stockholder meeting. Every corporation is required to hold an annual meeting; usually, the meeting is heldjust after the end of the company's fiscal year, at a time and place designated in the bylaws.

The annual meeting usually includes the following activities (Securities

Market Association, 2020):

- election of directors whose terms are up for renewal or to fill vacancies on the board of directors;
- declaration of a dividend or changes in the dividend policy;
- review of the corporation's annual report;
- discussion of new projects and activities.

Before the annual meeting, each shareholder receives a proxy statement. This document (usually mailed) describes matters to be voted on at the meeting. Typically, the proxy is for voting on the board of directors' members and for votes on other matters the board wants shareholder opinion on. Shareholders who cannot attend can usually vote their proxy by mail.

Every corporation is required by the SEC to have an annual report and/or a more complex, detailed document called a 10-K, for shareholders. The annual report includes information on the company and its current financial position.

Most corporate annual reports include:

- a statement by the Chairman or CEO about the state of the business (kind of like the State of the Union address);
- a narrative review of the past year, with new products, new research,
- happenings, and other current information for shareholders;
- a discussion of changes in financial policies, dividends changes, and other matters of concern to shareholders;
- financial statements, including a balance sheet, income statement, and
- sources and uses of funds statements;
- for publicly traded companies, an auditor's report must also be included. The auditor certifies that the financial statements were compiled using generally accepted accounting principles.

When a corporation starts having shareholders, the shareholders elect the board members – one share, one vote. Usually, a nominating committee prepares a slate of possible boardmembers, who are voted on at the annual meeting. Board members usually are elected for a term of several years, with staggered terms, so some board members are coming off the board each year and need to be replaced. This keeps the board from being filled with just new members or with members who "retire in place."

Board work requires a considerable amount of work from the directors. In addition to attending the meetings, a significant part of board work consists of preparing for the meetings, committee work, familiarisation with the company's business operations and operating environment, and monitoring and assessing the operations of the company.

In order to ensure and improve the efficiency and continuity of its work, the board of directors shall make sure that its operations and working methods

are evaluated regularly. The evaluation may be carried out in the form of an internal self-evaluation. Using an external evaluator at intervals and to the extent deemed necessary by the company may provide new and more objective perspectives.

"The evaluation may focus on, for example, the composition of the board of directors, the organisation and effectiveness of the board of directors as a team, the meeting preparations, cooperation with the managing director, andthe competence, special expertise, and efficiency of each director and the board of directors as a whole. The evaluation may also include an assessment on how successfully the board of directors has operated in relation to the setobjectives. It may also be justified to conduct similar evaluations of thecommittees of the board of directors" (Securities Market Association, 2020).

Rewiew questions

1. What is the purpose of a Board of Directors?
2. What is meant under fiduciary duty?
3. When does company take decision to split a stock?
4. Which activities does annual meeting usually include?
5.Which elements do corporate annual reports consist of?

Questions to discuss

1.Has the board agreed on its role in formulating the company's strategic plan – and, does the board understand the strategic factors that shape the company's success?
2. What should be discussed in a board meeting?
3.What are the key responsibilities of the board of directors?

Problems

Case 3.1. Case study on the flexible framework for boards in the United Kingdom

A flexible and proportional approach to the composition, committees and qualifications of the board is well illustrated by the case study of the United

Kingdom where the Companies Act provides companies with a large degree of freedom to compose their boards in a manner that fits their business model. As a consequence, it does not contain any substantive provisions regarding the qualifications and composition of the board. Neither does the legislation address definitional issues, such as the distinction between executive and non-executive directors. Instead, the main guidance relating to the composition, workings and qualifications of the board is found in the UK Corporate Governance Code, which is a legislative requirement for companies with Premium listing of equity shares. The Code is considered to allow for both flexibility and proportionality as it expects companies to either comply with its recommendations or explain why they have chosen a different arrangement. With respect to the appointment of independent non-executive directors, the Code also has a special exemption with respect to company size, providing less extensive recommendations for smaller companies that are subject to the Code.

Companies with a Standard listing on the London Stock Exchange benefit from wider flexibility. The requirement is limited to producing a Corporate Governance Statement in the Annual Report and disclose whether and to which extent they comply with a specific code. Companies listed on the Alternative Investment Market (AIM) are also required to apply a recognised corporate governance code but are allowed the flexibility to choose between the UK Corporate Governance Code and the Quoted Companies Alliance (QCA) Corporate Governance Code (OECD, 2019a).)

Case 3.2. Case study on the flexible and functional approach to say on pay in Sweden

Sweden provides an example of how flexibility and proportionality is introduced with respect to say on pay in companies that are listed in a regulated market. The rules include a mix of statutory requirements, comply or explain code and ad-hoc rulings by the self-regulatory body, the Securities Council. The statutory provisions are mainly concerned with the decision making process, giving shareholders control of the cost. In the interest of flexibility the board may still deviate from the remuneration guidelines agreed by the shareholder’s meeting if there are particular reasons to do so. The Swedish comply or explain code expands beyond the cost and recommends an explanation of the link to performance criteria and the alignment with shareholder’s interests. But again, these provisions include flexibility in terms of comply or explain. The Securities Council has also established rulings with respect to the use of synthetic options, board

participation in equity schemes and information requirements to the general meeting. When formulating these rulings, the Securities Council applies a flexible and functional approach that allows criteria such as company size, international expanse and competition to be taken into account (OECD, 2019a).

Case3.3. Case study on flexible and proportional disclosure in the United States

In the United States, flexible and proportional disclosure is illustrated by the scaled disclosure provisions that facilitate access to the public capital market for emerging growth companies, with total annual gross revenues of less than USD 1.07 billion. The scaled requirements apply both to disclosure at the time of the initial public offering and for a defined period after the company's listing. The U.S. Securities and Exchange Commission (SEC) has also adopted scaled disclosure requirements for smaller reporting companies, that generally are companies that are below certain threshold with respect to the amount of public equity float or total annual revenues. The scaled disclosure requirements permit smaller reporting companies to include, for example, less extensive narrative disclosure than required of other publicly listed companies, particularly in the description of executive compensation. The US federal securities laws also provide a certain degree of flexibility and proportionality as they relate to certain foreign private issuers and companies that offer and sell securities based on exemptions from registration. As already mentioned, it is important to recall that these requirements are complemented by both public and private enforcement actions and the SEC staff's selective review of certain types of company filings (OECD, 2019a).

Case3.3. Case study on flexibility and proportionality mechanisms for related party transactions in Italy

The flexibility and proportionality mechanisms in the Italian regulatory framework for related party transactions are embedded in the design of a three-layer system: the Civil Code provides the legal framework and the general objectives, the Securities Regulator (Consob) establishes the principles for achieving the objectives of the Code and the companies define

their own steps to be followed when dealing with related parties. The disclosure requirements, for example, in the Consob principles are proportionate with respect to the materiality of the transactions in the sense that only transactions that exceed certain thresholds must be disclosed. With respect to approval procedures, a primary role has been given to independent directors. At the same time, the Italian regulatory framework provides a proportionate approach by also defining stricter rules with respect to, for example, the company's structure, such as different materiality thresholds for pyramidal group companies (2.5% instead of the general 5% rule) (OECD, 2019a).

CHAPTER 4

THE ROLE OF AUDIT AND REGULATION

A company shall establish an audit committee, if the extent of the company's business requires that the preparation of the matters pertaining to financial reporting and control be done by a body smaller than the entire board of directors.

The members of the audit committee must have sufficient expertise and experience with respect to the committee's area of responsibility and the mandatory tasks relating to auditing.

"The majority of the members of an audit committee must be independent of the company and at least one member shall be independent of the company's significant shareholders" (Securities Market Association, 2020).

In the UK, and most countries, audit is a statutory function which must be undertaken by someone appropriately qualified – either a qualified auditor or a qualified accountant with appropriate experience. Increasingly also other information – such as environmental impact assessments are subject to audit by appropriately qualified people. This kind of audit is growing in importance but is not yet subject to control such as for financial auditing.

Although auditors are supposedly impartial, they are appointed by the Board of Directors of the company and receive remuneration from the company. This has raised questions about their actual independence from the company and this is one important issue as far as governance is concerned. It should be noted also that an impartial assessment is not always arrived at. For example, the accounts of Enron were always audited and confirmed, although the auditors – Arthur Andersen – went out of business at the same time as Enron did. But more recently the accounts of Lehman Bros were also audited and confirmed.

Every company must have an audit committee. This is an operating committee of the Board of Directors charged with oversight of financial reporting and disclosure (Fottrell, 2014). Committee members are drawn from members of the company's board of directors. It should contain independent directors and at least one member must be qualified as a financial expert. The role of audit committees continues to evolve as a result of the passing of the Sarbanes-Oxley Act 2002 (2002).

The audit committee will handle the auditor's report and possible audit minutes as well as the supplementary report presented by the auditor to the audit committee. If necessary, the audit committee will discuss any key factors arising in the course of the aforementioned duties with the auditor.

The legislation is based on the idea that an audit committee is responsible for the aforementioned mandatory auditing duties. If the company has no audit committee, the company's entire board must see to these duties or assign them to another committee. If the mandatory auditing duties have been assigned to another committee, the composition of that committee must meet the requirement for independence and expertise set forth in this recommendation.

An independent audit is an important tool for owners of all types of companies, since the auditors' main role is to verify whether the financial statements adequately reflect the real situation of the company.

The Independent Auditors should give an opinion on thefinancial statements to be submitted to the owners and/orthe market, in accordance with professional standardsand, for that purpose, assess the company's internalcontrols and procedures.

The Board of Directors, assisted by its audit committee (if in place), should establish the audit plan together with the Independent Auditors and reach an agreement on the fees. During the first year, the auditors are getting familiar with the company and will naturally devote many more work hours than in subsequent years. This should be reflected in their remuneration.

The auditors should be contracted for a specific number of years in order to ensure the independence of their opinions. The contract may be renewed after evaluation of independence and performance.

Some independent auditors are offering both audit and consulting work. The Board of Directors, or the Audit Committee (if in place), should make sure that there is a clear separation between auditing and consulting. Otherwise, it should either contract different consultants, or different Independent Auditors.

The Independent Auditors are selected by the Board of Directors as representative of the owners. The Independent Auditors are therefore accountable directly or indirectly to the owners. The Independent Auditors' relations with the CEO, the Management and other company employees should be at arm's length and strictly professional.

The responsibilities of the Fiscal Council are established by Company Law. The Independent Auditors are obliged, on request, to give explanations and information to the Fiscal Council. In order to avoid conflicts of interest, the Independent Auditors should not be members of the Fiscal Council.

The Independent Auditors should annually submit a letter to the Board of

Directors/Audit Committee confirming their independence as per recommendations of the Independence Standards Board (Brazilian Institute of Corporate Governance, 2016).

In addition to the aforementioned duties, the duties of the company's audit committee may also comprise, for example, the following (Securities Market Association, 2020):

• monitoring of the financial position of the company;

• supervision of the financial reporting process and risk management process;

• evaluation of the use and presentation of alternative performance measures;

• approval of the operating instructions for internal audit;

• handling of the plans and report of the internal audit function;

• evaluation of the processes aimed at ensuring compliance with laws and regulations;

• establishment of principles concerning the monitoring and assessment of related party transactions;

• other communications with the auditor in addition to the duties required by regulations;

• monitoring of the company's funding and tax position;

• monitoring of the significant financial, funding, and tax risks;

• monitoring of the processes and risks relating to IT security;

• handling of the company's corporate governance statement and non-financial report; and

• resolution and monitoring of any special issues allocated by the board of directors and falling within the competence of the audit committee (such as issues relating to the company's procedures and/or specific risks).

The duties of the audit committee must be reported in the same manner as the duties of the other committees.

The range of duties of the audit committee is wide. The versatile and mutually complementary expertise, competence, and business administration experience of the audit committee members contribute to the audit committee's ability to support and challenge the company's operative management in matters falling within the audit committee's competence. The audit committee shall, as a whole – and taking into account the mutually complementary expertise, competence, and industry knowledge of its members – have sufficient expertise and experience in matters forming part of the audit committee's duties and of the company's operating environment.

The audit committee must have sufficient expertise and experience to be able to challenge and evaluate the company's internal accounting function and the company's internal and external audit function. Due to the mandatory

auditing duties, legislation also requires that at least one member of the audit committee must have expertise in accounting or auditing. Expertise means, for example, competence obtained through experience and often also through studies or research. For example, serving as a chief financial officer, in other demanding financial administrative positions, or as an auditor are typical ways to obtain the competence referred to. Other corporate management experience can also be assessed to provide sufficient expertise in accounting and auditing (Securities Market Association, 2020).

"Agency theory argues that managers merely act as custodians of the organisation and its operational activities and places upon them the burden of managing in the best interest of the owners of that business. According to agency theory all other stakeholders of the business are largely irrelevant and if they benefit from the business then this is coincidental to the activities of management in running the business to serve shareholders. This focus upon shareholders alone as the intended beneficiaries of a business has been questioned considerably from many perspectives, which argue that it is either not the way in which a business is actually run or that it is a view which does not meet the needs of society in general" (Crowther & Seifi, 2011).

Conversely, stakeholder theory argues that there is a whole variety of stakeholders involved in the organization and each deserves some return for their involvement. According to stakeholder theory, therefore benefit is maximized if the business is operated by its management on behalf of all stakeholders and returns are divided appropriately amongst those stakeholders, in some way which is acceptable to all. Unfortunately, a mechanism for dividing returns amongst all stakeholders which has universal acceptance does not exist, and stakeholder theory is significantly lacking in suggestions in this respect. Nevertheless, this theory has some acceptance and is based upon the premise that operating a business in this manner achieves as one of its outcomes the maximization of returns to shareholders, as part of the process of maximizing returns to all other stakeholders.

"Moral hazard arises where it is difficult or costly for owners to observe or infer the amount of effort exerted by managers. In such a situation, there is an inevitable temptation for managers to avoid working to the terms of the agreed employment contract, since owners are unable to assess the 'true picture'. Managers may also have the incentive as well as the means to conceal the 'true picture' by misrepresenting the actual outcomes reported to the owners. Accounting provides one such means for misrepresentation through its ability to represent outcomes from any course of action in more than one way" (Crowther & Seifi, 2011).

Rating Agencies

A rating agency is a company that devises credit rating – assessments of the risk involved – for various financial instruments and their issuers. In some cases, the servicers of the underlying debt are also given ratings. In most cases, the issuers of such securities are companies, state and local governments, not-for-profit organizations and NGOs or national governments issuing debt-like securities (e.g. bonds) that can be traded on a secondary market. A credit rating for an issuer takes into consideration the issuer's credit worthiness (i.e., its ability to pay back the loan), and affects the rate of interest applied to the particular security being issued. In theory the role of the rating agency is to provide an impartial assessment – based upon their expertise and research – to potential lenders in order to compensate for the inevitable information asymmetry between borrower and lender.

Regulation

The company must regularly control and monitor its activities to ensure the efficiency and results of its business operations. The board of directors shall ensure that the company has defined the operating principles for internal control and that the company monitors the functioning of the internal control.

The purpose of the operating principles for internal control is to ensure that the company's objectives relating to matters such as the company's strategy, operations, practices, and especially financial reporting, are achieved. The operating principles for internal control also help to ensure that the company complies with all applicable laws and regulations.

"Each company shall define its methods and operating principles for internal control on the basis of its own circumstances taking into account, inter alia, the size of the company, its line of business, the geographical scope of its operations, and its group structure" (Securities Market Association, 2020).

Rewiew questions

1. What is information asymmetry?
2. What is the main purpose of audit and how does the Audit Committee help this purpose?
3. How do rating agencies help to solve information asymmetry?
4. Why the role of regulation is important in corporate governance?
5. What is the difference between moral hazard and adverse selection?

Questions to discuss

1. Consider the examples of information asymmetry on different markets. How can this problem be solved?
2. What does agency theory assume?
3. Discuss the duties of Audit Committee.
4. Discuss the the statement: "…Each company shall define its methods and operating principles for internal control on the basis of its own circumstances taking into account, inter alia, the size of the company, its line of business, the geographical scope of its operations, and its group structure" (Securities Market Association, 2020).

Problems

Case 4.2. Case study on the disclosure of major share ownership in Japan

Japan provides a number of examples of flexibility and proportionality with respect to share ownership. The most important criterion for exception relates to changes in ownership by certain financial institutions for which the rules are relaxed in terms of the frequency of reporting and the deadlines for filings. The rationale is that strict adherence to the default rules would result in excess paperwork and impede smooth transactions of listed stocks. There are two important qualifications for using this exemption; the institution is not allowed to use its ownership to influence the company's business in any important way and the ownership cannot exceed 10% of the company shares. Other exemptions from the general reporting requirements include the disclosure of treasury shares held by listed companies, since they do not carry any voting rights.

Case 4.3. Case study on flexible and proportional provisions for takeovers in Portugal

As the case study of Portugal illustrates, even within a national statutory framework, several provisions for flexibility and proportionality are typically applied. Some of them are of principal interest. First is the fact that the Portuguese Securities Commission has discretionary power to make an independent assessment of whether a change in control actually has occurred when an owner reaches the formal threshold for a mandatory bid, which is

one-third of the voting rights. Circumstances that may influence the judgment on actual control include the specific shareholder structure (including the presence of shareholder agreements) and the target company's free float. Other examples include instances where someone gains control as a consequence of a voluntary bid, a merger or as the result of a financial recovery plan (OECD, 2019a).

CHAPTER 5

THE ESSENCE OF REMUNERATION AND ESTABLISHMENT OF REMUNERATION COMMITTEE

According to Corporate Governance Principles and Recommendations (ASX Corporate Governance Council, 2019) a "listed company should pay director remuneration sufficient to attract and retain high quality directors and design its executive remuneration to attract, retain and motivate high quality senior executives and to align their interests with the creation of value for security holders and with the entity's values and risk appetite".

"The board of a listed entity should have a *remuneration committee*. It has at least three members, a majority of whom are independent directors; and is chaired by an independent directos. The board of a listed entity shoulddisclosethe charter of the committee; the members of the committee; and as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings. If it does not have a remuneration committee, disclose that fact and the processes it employs for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive" (ASX Corporate Governance Council, 2019).

Remuneration is a key driver of culture and a key focus for investors. Remuneration of senior management increasingly requires shareholder approval at a general meeting on the policy and various components of compensation of executives. The European Commission's recommendation on remuneration of directors in listed companies (Commission Recommendation 2004/913/EC) introduced the concept of say on pay into the European Union corporate governance agenda.

The Shareholder Rights Directive (Directive 2007/36/EC) improves transparency on remuneration policies and individual remuneration of directors, as well as granting shareholders the right to vote on remuneration policy and the remuneration report. As part of a broader agenda to encourage shareholder engagement in their investee companies, the EU Commission has published proposals concerning say on pay relating to a revised Shareholder Rights Directive (Directive (EU) 2017/828).

According to the Commission, companies should benefit from remuneration policies that stimulate longer-term value creation, and executive pay should be linked to performance. Poor remuneration policies and/or incentive structures lead to unjustified transfers of value from companies, their shareholders, and other stakeholders to executives. The Commission's goal is to enhance transparency on remuneration policies and individual remuneration of directors by granting shareholders the mandatory right to vote on remuneration policy and the remuneration report.

The remuneration committee can focus on the development of the remuneration schemes of the managing director and the other management team, as well as on the remuneration principles observed by the company, more efficiently than the entire board of directors. The establishment of the remuneration committee promotes the transparency and systematic functioning of the company's remuneration schemes and the development of the company's intellectual capital and the organisation's competence, as well as successor planning (Securities Market Association, 2020).

The duties of the remuneration committee are established in the charter to be adopted for the committee. In addition to the preparation of the remuneration policy and report, the remuneration committee's duties can include:

• the presentation of the remuneration policy and report in the general meeting and responding to questions related there to;

• the preparation of the appointment of the managing director and the rest of the management team as well as successor planning;

• the preparation and assessment of the remuneration of the managing director and the rest of the management team; and

• planning of matters pertaining to the remuneration of other personnel and the development of the organisation.

The duties of the remuneration committee shall be published in the same manner as the duties of other committees.

The majority of the members of the committee shall be independent of the company. Neither the company's managing director nor other board members in the management team may be members of the committee.

When carrying out its duties, the remuneration committee shall act independently with relation to the operative management of the company. If the remuneration committee uses an external advisor to assist in carrying out its duties, the committee shall ensure that the advisor is not also an advisor to the operative management in a manner that can result in a conflict of interest (Securities Market Association, 2020).

Rewiew questions

1. What is a remuneration?
2. Define the essense if the remuneration committee.
3. Name the duties of remuneration committee.

Questions to discuss

1. Consider and discuss remuneration policy in famous listed companies.
2. Do the remuneration committee understand all the reward structures in operation, how they operate and how they interact with each other? How do these structures broadly operate, how were they determined and what isthe range of likely outcomes?
3. Has remuneration committee appropriately considered what is and what is not disclosed in terms of remuneration?

CHAPTER 6

THE INFLUENCE OF GLOBALIZATION ON CHANGES IN CORPORATE GOVERNANCEIN FOREIGN COUNTRIES

The Concept of Global Governance

"All systems of governance are concerned primarily with managing the governing of associations and therefore with political authority, institutions, and, ultimately, control. Governance in this particular sense denotes formal political institutions that aim to coordinate and control interdependent social relations and that have the ability to enforce decisions. Increasingly however, in a globalized world, the concept of governance is being used to describe the regulation of interdependent relations in the absence of overarching political authority, such as in the international system" (Crowther,& Seifi, 2011).

"Thus, global governance can be considered as the management of global processes in the absence of any form of global government. There are some international bodies which seek to address these issues and prominent among these are the United Nations and the World Trade Organization. Each of these has met with mixed success in instituting some form of governance in international relations but is part of a recognition of the problem and an attempt to address worldwide problems that go beyond the capacity of individual states to solve" (Rosenau, 1999).

To use the term global governance is not of course to imply that such a system actually exists, let alone to consider the effectiveness of its operations. It is merely to recognize that in this increasingly globalized world there is a need for some form of governance to deal with multinational and global issues. The term global governance therefore is a descriptive term, recognizing the issue and referring to concrete cooperative problem-solving arrangements. These may be formal, taking the shape of laws or formally constituted institutions to manage collective affairs by a variety of actors – including states, intergovernmental organizations, non-governmental organizations (NGOs), other civil society actors, private sector organizations, pressure groups and individuals. The system also includes of course informal (as in the case of practices or guidelines) or temporary units (as in the case of coalitions).

Thus, global governance can be considered to be the complex of formal

and informal institutions, mechanisms, relationships, and processes between and among states, markets, citizens and organizations, both inter- and non-governmental, through which collective interests on the global plane are articulated, rights and obligations are established, and differences are mediated.

How Globalization Affects Governance

The question might be how globalization affects governance. But the answer to this question is not only related to the last quarter of the 20th century but also related to previous centuries. John Maynard Keynes calculated that the standard of living had increased 100 percent over four thousand years. Adam Smith had a seminal idea about the wealth of communities and in 1776 he described conditions which would lead to increasing income and prosperity. Similarly, there is much evidence from economic history to demonstrate the benefit of moral behavior; for example, Robert Owen in New Lanark, and Jedediah Strutt in Derbyshire – both in the UK – showed the economic benefits of caring for stakeholders. More recently Friedman has paid attention to the moral impact of the economic growth and development of society (Friedman, 1962).

According to international norms, (practice) and expectations, companies have to take into account social, ethical and environmental issues more than during the last two decades. One of the reasons is more competition and not always more profit; another reason is consumer expectation is not only related to the cost of products but also related to quality, proper production process and environmental sensitivity.

Moreover, shareholders are more interested in long term benefit and profit from the company. The key word of this concept is long termism which represents also a sustainable company. Shareholders want to get long term benefit with a sustainable company instead of only short-term profit. This is not only related to the company profit but also related to the social and environmental performance of the company. Thus, managers have to make strategic plans for the company concerning all stakeholder expectations which are sustainable and provide long term benefit for the companies with their investments. However, Sustainability can be seen as including the requirement that whatever justice is about – fair distribution of goods, fair procedures, respect for rights and social justice – and is capable of being sustained into the future indefinitely.

“Enron, WorldCom, Parmalat, and various other failures of global corporations bring out some governance issues and have increased attention to the role of business ethics. Managers and CEOs of these companies must be considered responsible for all of these failures and these are cases of corporate irresponsibility. Many people have the opinion that if corporations

were to behave responsibly, most probably corporate scandals would stop" (Crowther & Seifi, 2011).

Corporate governance protects firms against some long-term loss. When corporations have social responsibilities, they calculate their risk and the cost of failure. Firstly, a company has to have responsibility to shareholders and also all stakeholders which means that it has responsibility to all society. Corporate failures have an important impact on all society also. In particular, big scandals such as Enron have sharply affected the market and the economy. Various stakeholders (e.g. employee, customer, consumer, suppliers etc.) as well as shareholders and regulators of the firm have a responsibility to ensure good performance. Therefore, corporate governance is not only related to firms but also related to all society.

Concentrated ownership structures are a common feature in Asian economies while dispersed structures are less typical, though there are noteworthy differences between jurisdictions. While the People's Republic of China (hereafter China) and Viet Nam, for example, are characterised by substantial state ownership, India and Korea maintain significant family ownership structures. Understanding ownership structures in Asia is critical to ensuring the development of effective corporate governance standards (OECD, 2017).

China. Listed companies in China are characterised by concentrated ownership. Only a small portion of shares of listed companies are held by individual or foreign investors, with average ownership equaling 2.38% and 2.66%, respectively (OECD, 2017). Government and institutional investors hold large portions of shares, with 31.27% and 19.86%, respectively.3 The Shanghai Stock Exchange and the Shenzhen Stock Exchange have 2 887 listed companies (1 781 and 1 106 respectively) with a total market capitalisation of USD 6.966 trillion (WFE, 2017). Regulators/Custodians of the codes and principles in China are Ministry of Finance, China Securities Regulatory Commission, Stated-owned Assets Supervision and Administration Commission. There are Non-profit institutions that promote better CG practices in China: Shanghai Stock Exchange, Shenzhen Stock Exchange, China Association for Public Companies. Key national corporate governance code and principles consist of The Code of Corporate Governance for Listed Companies in China.

Italy. Italian companies are in most cases incorporated and operating as corporations, i.e. limited liability company (società a responsabilità limitata) or joint stock company (società per azioni) (Legal 500).

On the one hand, private companies are usually incorporated as limited liability companies – small and medium-sized enterprises (SMEs) or closely-held – or joint stock companies. On the other hand, public companies, i.e.

companies with shares admitted to trading on a regulated market, are typically incorporated as joint stock companies or cooperative companies limited by shares (as limited liability companies cannot be listed).

It is worth noting that, while limited liability companies issue "quotas" – which are not securities from a legal standpoint, therefore investors are called "quotaholders" – joint stock companies issue shares. Shareholder activism and engagement have kept growing and gaining strength in the past years. Following the national implementation of Shareholder Rights Directive II (BNY Mellon, 2020), we expect such trend to increase even more in the Italian financial markets, also in light of the publishing of the new CG Code occurred in January 2020 (Italian Corporate Governance Committee, 2020).

On a different note, strengthening corporate governance will be of pivotal importance for Italian companies (listed and non-listed), with a specific focus on internal control systems and procedures, as well as regulatory/compliance schemes, such as those related to the liability of legal entities for crimes committed in their interest or to their advantage (under Legislative Decree 231/2001), data protection (under the General Data Protection Regulation and its national implementing and supplementing measures), whistleblowing, IT and cyber risks, AML (FIDH, HRIC, & ECCJ, 2019).

Finally, it is expected companies and regulators to focus on the interactions between innovation and corporate governance (e.g. crypto-assets, FinTech, AI and technology within the corporation, etc.) (Legal 500).

France. French companies may take any of the following limited-liability corporate forms:

- the société anonyme ('SA') is the most common corporate form for the largest companies (whether listed or not). An SA shall have at least seven shareholders (if it is listed) or two shareholders (if it is not listed), and a share capital of at least €37,000 represented by negotiable shares. Most French listed companies are SA. The legal regime applicable to the SA is governed by detailed rules with respect to corporate governance and shareholders' rights;
- the société par actions simplifiée ('SAS') is a very common corporate form for small and large non-listed companies (an SAS may not be listed). An SAS shall have at least one shareholder, its share capital is represented by negotiable shares (but there is no minimum share capital requirement). The main advantage of the SAS, as compared to that of an SA, is that its legal regime is very flexible in terms of corporate governance and shareholders' rights. Most newly incorporated French companies, or French companies changing their corporate form, take the form of an SAS;
- the société en commandite par actions ('SCA') is a much less common corporate form. An SCA may be listed, and part of its legal regime refers to

that of the SA. An SCA shall have at least four partners (whether it is listed or not), and a share capital of at least €37,000 represented by negotiable shares. The main characteristic, and difference from the SA, of an SCA is that certain of its partners are unlimited-liability partners (e.g., founders and heirs) while the other partners are limited-liability shareholders, with the unlimited-liability partners often managing and controlling the SCA. The SCA has proved to be an efficient defence against unsolicited takeovers;

- the société à responsabilité limitée (‘SARL’) is a traditional corporate form for closely held companies (e.g., family businesses). An SARL shall have at least one and no more than 100 limited-liability partners. There is no minimum share capital requirement. The share capital of an SARL is represented by non-negotiable shares (‘parts sociales’), meaning that any transfer of SARL shares is subject to legal formalities and, under most circumstances, restrictions such as a prior approval by the other partners; or
- the European company or societas europaea (‘SE’) is governed by European regulations and, for SE having their registered office in France, the legal regime applicable to the SA. Certain technicalities for the constitution, organization and functioning of an SE and the fact that one of its main advantages is the possibility to transfer its registered office within the European Union makes it appropriate for large companies having European or worldwide activities. Ten of the SBF 120 listed companies (i.e., the 120 largest companies listed on Euronext Paris) are SE.

New trends in Freanch corporate governance are:

1. The legal developments and new campaigns relating to shareholder activism.
2. The steady increase of the role and participation of significant shareholders in the review and determination of the compensation of the board members and executive officers of listed companies.
3. The recent reforms of the legal regime applicable to preferred shares issued by non-listed companies, which are intended to significantly increase the use of such instruments.

Japan. The most common corporate entity form in Japan is a stock company (kabushiki kaisha or KK), and its organisational structure typically consists of (i) shareholders, (ii) a board of directors, (iii) representative directors and (iv) statutory auditors, with some notable exceptions (see question 2).

Stock companies may generally be divided into two groups according to the restrictions on the transfer of shares by their articles of incorporation (Legal 500):

1. Closed KKs. Closed KKs require the company’s approval for any acquisition or transfer of the company’s shares. In numbers, most existing

KKs are closed KKs. Closed KKs may simplify the organisational structure, and some organs, like board of directors, representative directors, or statutory auditors may not be mandatory.

2. Open KKs. Open KKs are companies without articles of incorporation requiring the approval of the company for acquisition or transfer of all or part of their shares. Generally, only securities issued by open KKs can be listed on a securities exchange in Japan. The Tokyo Stock Exchange (TSE) is the most well-known securities exchange in Japan and is one of the largest equity markets in the world, listing over 3,700 companies (as of January 31, 2020), including major Japanese companies.

The applicable requirements and practice thereunder regarding corporate governance may significantly differ depending on whether a company is closed KK or open KK, and whether the company is listed or not. In order to simplify the discussion, however, we assume that the corporate entities mainly discussed herein are listed companies on the TSE, unless otherwise noted.

The three most significant issues influencing corporate governance trends over the next two years are (Legal 500):

First, the 2019 CA Amendment will come into effect by June 11, 2021. Not only the amended provisions themselves, but we also anticipate seeing significant updates on the corporate governance environment in connection with the 2019 CA Amendment, such as the requirement that there be at least one independent officer for a listed company (see question 7), and discussions regarding potential future revisions of the CGC, and the like.

Second, the role of independent directors will become more important. Based on recent discussions on corporate governance in Japan, it will be indispensable for them to be actively involved in discussions regarding appointment and dismissal of top management such as CEOs, and remuneration for members of the governing body.

Third, it is still very important for listed companies to improve the contents of their disclosures. While the form and requirements regarding disclosure have been expanded or modified year to year, each listed company should keep in mind what information shareholders and investors really want. At the same time, the role of shareholders is becoming more important, encouraging them to review company disclosure material more carefully and to engage in fruitful dialogue with the company for the sustainable growth and the creation of mid- to long-term corporate value.

Rewiew questions

1. How does globalization affect corporate governance?
2. Why is global governance an issue and what form might it take?
3. Is irresponsible management the reason for the big corporate scandals?

Questions to discuss

1. Consider and discuss the future trends in corporate governance.
2. How has corporate covernance changed in China?
3. How has corporate covernance changed in France?
4. How has corporate covernance changed in Japan?

Part2.

INTERNATIONAL AUDITING

- International Auditing and Corporate Governance
- International Diversity in External Auditing
- International Harmonization of Auditing Standards
- Ethics and International Auditing
- Additional International Auditing Issues
- Internal Auditing
- Future Directions

CHAPTER 7

INTERNATIONAL AUDITING AND CORPORATE GOVERNANCE

Numerous reports have been produced in recent years in many countries focusing on corporate governance. In 1999, the Organization for Economic Cooperation and Development (OECD) developed a set of principles, Principles of Corporate Governance (OECD, 1999), to assist member and nonmember governments in their efforts to "evaluate and improve the legal, institutional and regulatory framework for corporate governance" and to "provide guidance and suggestions" for various stakeholders in corporate governance.

Corporate governance deals with the way corporations are managed and governed. As a new term, corporate governance suffers from a lack of definition and can mean many different things to different people.

According to the OECD (1999), "Corporate governance . . . involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring" (OECD, 1999, p. 1)

The OECD principles deal with, among other issues, the rights and fair treatment of various groups of shareholders, the role of various stakeholders, the importance of disclosure and transparency of information, and the responsibility of the board. They clarify the notion that the board of directors has the ultimate responsibility for governing (not operating on a day-to-day basis) a company. The OECD principles formed the basis of the corporate governance component of the World Bank/International Monetary Fund's Reports on the Observance of Standards and Codes (ROSC).

In April 2004, the member governments of the OECD ratified a revised Code of Corporate Governance that would give shareholders stronger rights in most of the member countries. The revised principles emphasize, among other things, that auditors should be accountable to shareholders, not

management, and that boards of directors should effectively oversee the financial reporting function, ensuring that appropriate systems of control are in place. The principles are designed to strengthen corporate governance practices in companies around the world. The International Federation of Accountants (IFAC) has its own task force on Rebuilding Credibility in Financial Reporting.

Note

IFAC comprises more than 160 professional accounting bodies from throughout the world, representing more than 2.5 million accountants in public practice, education, the public sector, industry, and commerce.

In March 2003, to support this task force, IFAC introduced a new Internet resource center entitled “Viewpoints: Governance, Accountability and the Public Trust.” In a report published in early 2008, based on a survey conducted in 2007, titled Financial Reporting Supply Chain – Current Perspectives and Directions, IFAC identifies positive areas, areas of concern, and areas for further improvements. With regard to the positive, the report states that there is increased awareness that good corporate governance counts; there are new codes and standard improvements in board structure, risk management, and internal control; and more disclosure and transparency in business and financial reporting. The report identifies five areas of concern: governance in name but not in spirit; overregulation; the development of a checklist mentality; personal risk and liability for company directors and senior management; and cost-benefit concerns. IFAC makes improvements in the areas of behavioral and cultural aspects of governance; review of existing rules, since many have been introduced as a response to crises; quality of directors; the relationship of remuneration to performance; expanding the view from compliance governance to business governance. IFAC guidance on corporate governance addresses risks and organizational accountability. The Professional Accountants in Business (PAIB) Committee of IFAC has released a new International Good Practice Guidance document entitled “Evaluating and Improving Governance in Organizations” (PAIB Committee, 2009). The new guidance to professional accountants in business includes a framework, a series of fundamental principles, supporting guidance, and references on how they can contribute to evaluating and improving governance in organizations. In February 2008, the FRC in the United Kingdom published The Audit Quality Framework (Financial Reporting Council, 2008). The FRC states that it will assist companies (in evaluating audit proposals), audit committees (in undertaking annual assessments of the effectiveness of external audits), all stakeholders (in

evaluating the policies and actions taken by audit firms to ensure that high-quality audits are performed, whether in the United Kingdom or overseas), and regulators (when undertaking and reporting on their monitoring of the audit profession). The Framework identifies the following key drivers of audit quality:

1. The culture within an audit firm.
2. The skills and personal qualities of audit partners and staff.
3. The effectiveness of the audit process.
4. The reliability and usefulness of audit reporting.
5. Factors outside the control of auditors affecting audit quality.

In the United States, proposals of the Sarbanes-Oxley Act (2002) for better corporate governance include the following:

- A new oversight board for the accountancy profession: the Public Company Accounting Oversight Board.
- Certification by chief executive officers (CEOs) and chief financial officers (CFOs) regarding financial statements and internal controls.
- A tightened definition of "independent" audit committee members.
- A requirement for external auditors to report directly to audit committee.
- Prohibitions on certain nonaudit services by external auditors.
- Tougher penalties for financial statement fraud.
- Following the Sarbanes-Oxley Act 2002 (2002), the New York Stock Exchange (NYSE) introduced several new listing requirements:
- Corporate boards must have a majority of independent directors.
- Listed companies must have audit, compensation, and monitoring committees composed entirely of independent directors.
- Nonmanagement directors must meet at regularly scheduled executive sessions without management.
- For a director to be deemed independent, the board must affirmatively determine that the director has no material relationship with the listed company.
- Listed companies must have an internal audit function.
- Companies must adopt and disclose governance guidelines, codes of business conduct, and charters for their audit, compensation, and nominating committees.

In December 2007, the Public Company Accounting Oversight Board (PCAOB) published a Staff Audit Practice Alert (Public Company Accounting Oversight Board, 2007b) on the audit of fair value measurements in financial statements. The alert provides auditors with additional information related to auditing fair value measurements and disclosures.

The results of a survey of senior executives at U.S.-based MNCs,

published in July 2004, show that a majority of the companies (over 60 percent) had made compliance with the Sarbanes-Oxley Act (2002) part of their regular corporate governance approach and had integrated it with other regulatory activities.

The common issues concerning corporate governance include the quality of published information, internal controls, independent directors, auditor independence, audit committees, ethical conduct, and treatment of financial statement fraud.

The measures that have been taken around the world by governments, worldwide regulators, IFAC, accountancy organizations, and others to strengthen and improve corporate governance rules, regulations, and audit standards have had an impact on the operations of MNCs to the extent that some MNCs now include a separate section in their annual reports explaining corporate governance issues.

Example

The following excerpt from the 2009 annual report of the Volkswagen Group in Germany is an example.

Sustainable economic success can only be generated in our company if we comply with national and international rules and standards, because that is the only way to strengthen the trust of our customers and investors. Transparent and responsible corporate governance takes the highest priority in our daily work. That's why the Board of Management and the Supervisory Board of Volkswagen AG comply with the recommendations of the current German Corporate Governance Code (Government Commission, 2009) as issued on June 18, 2009, with only a few exceptions.

Auditing issues, concerning both external and internal auditing, are directly linked to corporate governance. External auditing provides assurance to financial statement users that the information contained in those statements is of high quality. Monitoring risks and providing assurance regarding controls are two main internal auditing functions. Monitoring risks involves identifying risks, assessing their potential effect on the organization, determining the strategy to minimize them, and monitoring the possibility for new risks. As a result of recent credit market conditions, the risks to confidence in corporate reporting and governance are higher than they have been for some years. Companies may find that their precise circumstances are not expressly provided for in the standards. In fact this is one of the strengths of principles-based standards. In a multinational context, the linkages between auditing and corporate governance can be explained in terms of a set of relationships as depicted in Figure 7.1.

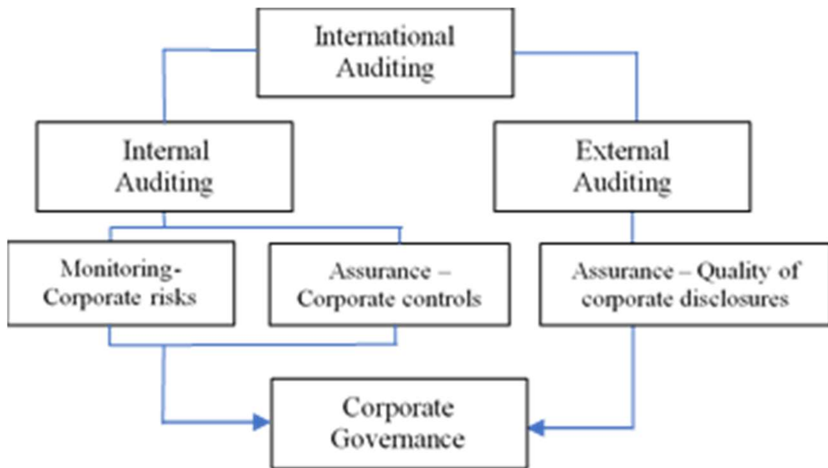


Figure 7.1 International Auditing and Corporate Governance

There are two main theories of corporate governance, namely, agency theory and stakeholder theory. According to agency theory, corporate governance emphasizes shareholder value, and board composition is determined by shareholder election (this view is predominant in the Anglo-American system). In contrast, the German system embraces a wider set of stakeholders with some stakeholder groups (such as employees) having a legal right to elect members of the supervisory board. However, the past decade has seen the emergence of several hybrid (or at least aligned) stakeholder–agency approaches, which recognize that if shareholders are to maximize their returns, they need to ensure they satisfy the company's various stakeholders.

Rewiew questions

1. What are the main differences between the OECD Principles of Corporate Governance issued in 1999 and the revised version issued in 2004?
2. What are the provisions in the Sarbanes-Oxley Act 2002 and the New York Stock Exchange listing requirements that are aimed at improving Corporate Governance and are directly related to audit committees?
3. What determines the primary role of external auditing in a particular

country?

4. What is audit quality? What determines audit quality in a given country?
5. What are two main theories of corporate governance? Describe them briefly.

CHAPTER 8

INTERNATIONAL DIVERSITY IN EXTERNAL AUDITING

External auditing is the first line of enforcement of legal and professional requirements concerning financial reporting. Given the prevalence of MNCs and the audit of nondomestic companies, issues related to international auditing are becoming increasingly important. However, there are major variations in many aspects of external auditing across different countries. These aspects include the purpose of external auditing, the audit environment, the regulation of auditing, and audit reports.

Purpose of Auditing

The external auditor's primary concern is whether the financial statements are free of material misstatement. In recent years, an increasing number of companies revealing "financial accounting irregularities" in their past financial statements and causing heavy financial losses to investors around the world has created considerable problems for the accounting profession, particularly in view of the fact that many of these companies had received clean audit reports from large international accounting firms. The investors raised doubts about the integrity of financial information disclosed by large corporations. The question often asked by investors and other interested parties is "Where was the auditor?" However, this is not new; the same question has been asked on many occasions in the past. For example, following the global financial market crisis that emerged from Asia in 1997 and 1998, the World Bank asked international accounting firms to refuse to give clean audit reports for financial statements that had not been prepared in accordance with internationally acceptable accounting standards. Later, commenting on the causes of the Asian financial crisis, an official of the U.S. Securities and Exchange Commission (SEC) pointed to the failures of (1) company accounts to show billions of dollars of debt, allowing companies to continue borrowing with no hope of repayment and (2) auditing to detect the vulnerabilities (Turner, 2001).

The role of the auditor can vary in different countries. For example, in Germany the role of the statutory auditor is much wider compared to that of his or her counterparts in the United Kingdom or the United States. The UK

Companies Act of 1989 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1989), which requires that audits of large and medium-sized companies must be performed by a registered auditor, specifies that the role of the auditor is to report to shareholders whether the financial statements give a true and fair view of the financial position and results of operations of the company and whether the financial reports have been properly prepared in accordance with the provisions of the act (Section 235). In Germany, Section 316 of the German Commercial Code (Germany. Federal Office of Justice, 1897) requires that in addition to financial statements, an auditor should examine management reports of large and medium-sized corporations. The role of the statutory auditor in Germany is legally defined by the Auditors' Regulation and the German Commercial Code. German auditors take a much broader view of the concept of "client" than their counterparts in the United Kingdom or the United States. It is less problematic for German auditors to view the state and thus society as in part constituting the client (Baker, 2001).

A country's corporate governance structure seems to be a major factor that determines the purpose of external auditing. In Anglo-Saxon traditions, auditors' primary reporting responsibilities are to the shareholders of companies. However, this is not the case in some other countries, which have different corporate structures. In some European countries, a two-tiered board of directors is required for a public company, in that in addition to the management board, a company is also required to have a supervisory board. In Germany, for example, limited liability companies (public companies and private companies with over 500 employees) are required to appoint a supervisory board (Aufsichtsrat) to oversee the management board (Vorstand). The management board is composed solely of insiders and is responsible for the company's daily business activity, whereas the supervisory board has general oversight functions and is responsible for safeguarding the company's overall welfare by reviewing management board activities.

Note

The supervisory board consists of directors who are representatives of employees, creditors, and shareholder groups. The duties of the supervisory board as set out in the German Commercial Code (Germany. Federal Office of Justice, 1897) are as follows: The supervisory board supervises the management of the corporation in all branches of its administration. For that purpose members of the supervisory board have the right to ask the management for information, to have access to the books of account, and to review the cash on hand. The supervisory board audits the income statement,

the balance sheet and the application of profits suggested by the management (Vorstand). The supervisory board is required to call a general assembly if it is deemed necessary and is in the interests of the corporation (Article 225a, 1870 Amendment to the German Commercial Code (Germany. Federal Office of Justice, 1897)).

The German Commercial Code (Germany. Federal Office of Justice, 1897) establishes a duty for the supervisory board to conduct audits of the financial statements presented by the management to the shareholders' general meeting. It was envisaged that the supervisory board would perform substantive corporate governance. As accounting valuation issues became increasingly complex, supervisory boards started to use external auditors to fulfill their audit and control duties. This was the beginning of the development of the profession of external auditors in Germany. Historically, the German auditor's primary reporting responsibility is to the supervisory board and not to shareholders, as in the Anglo-Saxon traditions. The basic function of the statutory auditor in Germany is to assist the supervisory board, and the audit report is normally addressed to the supervisory board, which engages the auditor.

In China, many former state-owned enterprises are being redefined to create new economic enterprises that will be looking to list their securities on domestic and foreign stock exchanges. However, these enterprises do not conform to the Anglo-Saxon concept of an accounting entity:

In China, the principal business of a geographical region or Province might have been historically designated as the reporting entity, and made responsible for the education and health care of its citizens as well as employment and production. The State is now "carving out" business enterprises from these former social and economic units so they can be established as independent businesses. These newly "carved-out" enterprises are just now encountering the Western concept of entity (Graham, 1996).

These enterprises will still have many related-party transactions with formerly related business units that are now outside the new entity. There will also be intercompany transactions involving these units. The auditor's role or responsibilities in defining the boundaries of these entities and reviewing their transactions becomes unclear.

Example

In China, some public companies have a supervisory committee, somewhat similar to the German supervisory board. The 2009 annual report of China Eastern Airlines Corporation Ltd., for example, includes a separate report of the supervisory committee, in addition to the auditors' report; this

report states, In 2009, the members of the Supervisory Committee, basing themselves on the powers bestowed upon them by the Company Law and the Articles of Association of the Company and their sense of responsibility toward all the shareholders, actively carried out their tasks, faithfully performed their supervisory duties, and protected the legitimate rights and interests of the Company and of all the shareholders.

Audit Environments

Cultural values in different countries can have an impact on the nature and quality of the audit work undertaken. For example, the perceptions of auditor's ethical conduct may be influenced by cultural norms. Similarly, the perceptions of auditor independence may vary as a result of underlying cultural and environmental differences across countries. Therefore, culture may be helpful in understanding the differences in auditor behavior patterns in different countries (Soeters & Schreuder, 1988). For example, the concept of an independent auditor is neither historically nor culturally appropriate in Japan, and legal liability suits against Japanese auditors are almost nonexistent (McKinnon, 1983). The exercise of legal rights in a court of law is not in accordance with the underlying Japanese beliefs in the maintenance of harmony in interpersonal and intergroup relationships and the avoidance of open confrontation (Mueller, 1985).

Chinese cultural values - including respect for seniors, the desire to avoid confrontation and look for agreeable compromises, and the concern for "saving face" - are likely to have implications in the audit judgment area. Further, history also plays a part in shaping the practice of auditing in China. As Graham explains:

Example

One culture shock for auditors steeped in the "risk-based audit" concepts of the 1980s, is the statutory limitation on allowances for doubtful accounts or the rule limiting the application of lower [sic] cost or market considerations for Chinese inventories. . . . This practice is steeped in the State enterprise system, where all products were perceived as useful for something, someday, thereby obviating the need for obsolescence reserves or written-downs. Foreign enterprises may now create an allowance for doubtful accounts of up to 3 percent of ending accounts receivable. Bad debt allowance accounts for Chinese enterprises are limited to between 1/3 to 1/2 percent of ending accounts receivable. . . . Since enterprises historically were, and most still are, State owned, State credit was always by definition "good," and bad debt provisions were/are generally unnecessary. There seems to be a "go-slow" attitude toward change that is reflected in the broadening of the

Chinese principles to accommodate the expectations of business partners from more advanced nations (Graham, 1996).

The various environmental factors affecting auditing issues can be identified in terms of a broad concept often referred to as the accounting infrastructure, which includes producers of information; final users of information; information intermediaries; laws and regulations that govern the production, transmission, and usage of information; and legal entities that monitor and implement the laws and regulations (Lee, 1987).

In less developed countries, in particular, creditors and investors play a minimal role in the accounting infrastructure and so a less developed auditing profession, compared to that in a developed country, would be expected. Further, the primary source of finance in a country may influence the degree to which the audit profession in that country has evolved. Countries in which the primary source of capital is absentee owners (stockholders) and creditors such as the United States, the United Kingdom, and Australia may have a much greater need for audit services and more sophisticated audit procedures compared to those countries in which state-controlled banks or commercial banks are the primary source of capital. In a debt-financing country such as Japan, for example, there may be a much reduced need for audited information or reliance on public financial information.

Different legal systems are also likely to influence auditing in different countries. For example, a codified Roman law system that exists in countries such as Germany and France may require more reliance on the stated legal objectives of the auditing profession. Countries with a common law system, such as the United Kingdom, Canada, or New Zealand, may allow audit characteristics to develop more freely or rely more on the auditing profession to set a general tone for the profession (Wood, 1996).

The differences in the environment in which auditing operates can have implications for the transfer of auditing technology among countries. The international diversity in accounting and securities market regulations and practices, economic and political systems, patterns of business ownership, size and complexity of business firms, and stages of economic development would affect the nature of the demand for audit services and the complexity of the audit task. Therefore, audit technologies which are cost-beneficial in one national setting can be ineffective, or even dysfunctional, in a different setting (Chow & Hwang, 1994).

Further, audit quality is also likely to vary across different audit environments. Audit quality can be defined as the probability that an error or irregularity is detected and reported (DeAngelo, 1981). The detection probability is affected by the actual work done by auditors to reach their

opinion. This in turn is influenced by the level of competence of the auditors (eligibility and qualifications), the requirements regarding the conduct of the audit (quality review and monitoring), and the reporting requirements. The reporting probability is affected by the auditor's independence. High independence implies a high probability of publicly reporting a detected material error or irregularity.

Audit quality is also affected by the nature of the legal liability regime that exists in a country (we also discuss auditor liability later in this chapter). A strong liability regime will provide incentives for auditors to be independent and produce high-quality audits. In some Asian countries, for example, this is an unlikely scenario, because (due to cultural and other reasons) the liability regimes may not be strong and violations of professional conduct may go unpunished. This creates audit markets of uneven quality. In some countries, such as Indonesia, Malaysia, and Thailand, fraud and irregularities are required to be reported to the board of directors, not in the audit report (Favere-Marchesi, 2000).

Regulation of Auditors and Audit Firms

The approaches taken to regulate auditing in different countries range from those that leave the task largely in the hands of the profession to those that rely heavily on the government. In Anglo-Saxon countries, mechanisms are put in place to regulate auditors within the framework of professional self-regulation. In the United States, PCAOB, composed of five independent members (not more than two of whom may be professional accountants), was established in 2002 by the U.S. Securities and Exchange Commission (SEC) pursuant to the Sarbanes-Oxley Act (2002). This act reaffirms the necessity for the auditor to be independent of management, in fact and appearance, and expands the auditor's reporting responsibility. Section 404 of the Sarbanes-Oxley Act (2002), "Management Assessment of Internal Controls," requires public companies to include in their annual report an assessment by management of the effectiveness of the internal control structure and procedures for financial reporting. The external auditor must attest to and report on that assessment. Accordingly, the PCAOB issued an audit standard, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements", which was approved by the SEC in June 2004 (Public Company Accounting Oversight Board, 2004a). The new standard requires two audit opinions: one on internal control over financial reporting and one on the financial statements.

Auditors of SEC-registered companies are required to be members of the PCAOB. This also includes non-U.S. audit firms that audit the accounts of a company or subsidiary (domestic or foreign) listed on a U.S. stock exchange. The PCAOB has the authority (1) to establish or adopt auditing standards,

quality control standards, and ethical rules in relation to the conduct of audits of public companies and (2) to inspect audit firms. It also has the power to require cooperation with quality control reviews and disciplinary proceedings, and it may impose a broad range of disciplinary sanctions against auditing firms and individual members. Large firms that undertake audits of more than 100 public companies will be inspected annually. The requirement for non-U.S. audit firms to become members of PCAOB has caused some concern among the large European audit firms. Although at first the PCAOB said it should regulate both U.S. and non-U.S. accounting firms, in July 2004 announced that, for some non-U.S. audit firms that audit companies registered with the SEC (e.g., audit firms in Canada, Japan, andmany European countries, including the United Kingdom), it would be willing to rely on the auditor's home-country regulators (Fisher, 2004).

In the United Kingdom, the word accountant is not defined in statute and there is no qualification requirement in order for someone to practice as an accountant. However, most accountants choose to qualify under the auspices of one of the professional bodies. The situation for auditor is different. The Companies Act of 1985 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1985) prescribes a statutory scheme for the regulation of auditors, under which the Department of Trade and Industries (DTI) recognizes certain accountancy bodies for the training and supervision of auditors. The Companies Act of 1985 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1985) states that every company shall appoint an auditor or auditors (except for most small companies or dormant companies). The Companies Act of 1989 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1989), which implemented the European Union's Eighth Directive, introduced stronger statutory arrangements for the regulation of auditors. It restricts qualifications for appointment as a statutory auditor to those who hold a recognized professional qualification and are subject to the requirements of a recognized supervisory body. It makes specific provision for the independence of company auditors. An officer or employee of a company being audited, for example, may not act as auditor for that company.

Under the regulatory structure for the accounting profession introduced in 1998, an independent body, the Accountancy Foundation, with a non-accountant board of trustees, was established in 2000. With the establishment of the Foundation, a strong lay and independent element was introduced into the regulatory framework. This element involved oversight arrangements concerning the regulatory activities undertaken by the principal professional accountancy bodies. The Foundation was funded by the Consultative Committee of Accountancy Bodies (CCAB).

The Foundation (Accountancy Foundation, www.frc.org.uk) and its related bodies (The structure of the Foundation comprises five limited companies: the Accountancy Foundation Ltd.; The Review Board Ltd. (to monitor the operation of the regulatory system to ensure that it serves the public interest); The Auditing Practices Board Ltd. (to establish and develop auditing standards): The Ethics Standards Board Ltd. (to secure the development of ethical standards for all accountants); and the Investigation and Discipline Board Ltd. (to investigate disciplinary cases of public interest)) were responsible for the nonstatutory independent regulation of the six chartered accountancy bodies of the CCAB. This framework was developed in light of a growing recognition in the profession of the need for the regulatory arrangements to reflect the wider public interest. The regulatory functions of the Foundation included monitoring the work of accountants and auditors, handling complaints and disciplinary violations, and conducting investigations. The regulatory structure under the foundation provided an increased level of public oversight regarding statutory auditors, while essentially retaining the self-regulatory nature of the profession (Departmentof Trade and Industry, 1998). Accordingly, the responsibility for determining who might be recognized as a statutory auditor has been delegated primarily to four CCAB members: the Association of Chartered Corporate Accountants (ACCA), the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants in Ireland (ICAI), and the Institute of Chartered Accountants in Scotland (ICAS). Each of the four recognized professional bodies has its own examinations to assess thetechnical competence of the entry-level registered auditor (the term used in the United Kingdom for statutory auditor). In order to become a registered auditor in the United Kingdom, the professional accountant must be listed in a register maintained for that purpose by a recognized professional body.

The Auditing Practices Board (APB) was responsible for setting and developing auditing standards in the United Kingdom. The APB, as constituted under the Accountancy Foundation arrangements, continued the work of its predecessor body, which was established in 1991 under the auspices of the CCAB. Failure to abide by the professional standards issued by the APB might be grounds for disciplinary action. According to a report on audit regulation in the United Kingdom made public by the Department of Trade and Industry in July 2004, the ICAEW, ICAS, and ICAI undertook 1,030 monitoring visits during 2003. Of the firms visited, 88 percent required no action at all or, by the conclusion of the visit, had suitable plans in place to improve their audit work, and 14 firms had their registration as auditors withdrawn following a monitoring visit, compared with 11 in 2002 (Details

are available at link).

The Companies (Audit, Investigation and Community Enterprises) Act of 2004 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 2004) provided the Financial Reporting Review Panel with statutory power to require companies, directors, and auditors to provide documents, information and explanations if it appears that accounts do not comply with relevant reporting requirements.

Under the new regime the Financial Reporting Council (FRC) is the United Kingdom's unified, independent regulator for corporate reporting and governance. Its functions, which are relevant to auditing, include the following:

- Setting, monitoring, and enforcing auditing standards, statutory oversight, and regulation of auditors.
- Operating an independent investigation and discipline scheme for public interest cases involving professional accountants.
- Overseeing the regulatory activities of the professional accountancy bodies.

The FRC is also responsible for the Combined Code of Corporate Governance and its associated guidance on internal control (the Turnbull Guidance) and audit committees (the Smith Guidance). Similar bodies have been established in Canada, Australia, Japan, France, Germany, and several other countries in the European Union.

The requirements for becoming an auditor may vary in different countries. For example, unlike in the United States, there is no uniform system of examination in the United Kingdom where four professional bodies conduct their own examinations. On the other hand, in Germany, the examinations for the prospective auditors are set by the Ministry of Economics, and self-regulation of the auditing profession takes place within the strict boundaries of the law (Baker et al., 2001). Unlike in the United Kingdom, instead of the professional bodies, quasi-governmental agencies play a major role in the regulatory functions in Germany. The Auditors' Regulation specifies the admission requirements to become a statutory auditor and defines, among other things, the rights and duties of the auditor, the organization of the Chamber of Auditors, or Wirtschaftsprüferkammer (WPK), and the disciplinary measures for breeches of professional duties. The WPK is supervised by the Ministry of Justice. Statutory auditors, including audit corporations, must bemembers of the WPK, a public law body created in 1961. The WPK also participates in disciplining auditors who violate standards.

In China, the government is heavily involved in the regulation of the auditing profession. China's accounting and auditing profession is sanctioned

and regulated by the state. All certified public accounting (CPA) firms, both state owned and privately owned, are under the supervision of the local Audit Bureau, which is itself supervised by the state. The CPA firms must be approved by the state in order to be able to audit foreign owned or joint venture companies or Chinese companies listed on the stock exchange, as required by law. The state may also intervene in the allocation of audit assignments among CPA firms.

Audit Reports

There are significant differences in the audit reports across different countries and sometimes across different companies within the same country. In this section we describe some of these differences. The appendix to this chapter provides examples of audit reports from MNCs located in Japan, Germany, the Netherlands, United Kingdom, and China.

Audit reports on company annual reports for 2009 show a variety of applicable audit standards and formats.

- China Southern Airline's audit report states that an audit has been conducted in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants.
- China Eastern Airline's audit report is in both English and Chinese. It states that the audit has been conducted in accordance with International Standards on Auditing.
- The audit report of Bayer states that the audit has been conducted in accordance with German Commercial Code requirements and German generally accepted standards for the audit of financial statements promulgated by the Institute of Public Auditors in Germany.
- The audit report of Sumitomo Metal Industries states that audit has been conducted in accordance with auditing standards generally accepted in Japan.
- Toshiba's audit report has been prepared in accordance with auditing standards generally accepted in the United States. However, the report states that "The Company's consolidated financial statements do not disclose segment information required by Statement of Financial Accounting Standards No.131 (Financial Accounting Standards Board, 1997), disclosures about Segments of an Enterprise and Related Information. Therefore, the audit opinion is that financial statements present fairly, in all material respects, except for the omission of segment information."
- The audit report of Unilever PLC has been prepared in accordance with Chapter 3 of Part 16 of the Companies Act of 2006 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 2006). It also states that "Our responsibility is to audit the consolidated financial statements in accordance with applicable law and International Standards on

Auditing (UK and Ireland). There are three sets of opinion, namely, Opinion on financial statements, separate opinion in relation to IFRS, and Opinion on other matter prescribed by the Companies Act 2006."

- The audit report of Unilever N.V. states that the audit has been conducted in accordance with Dutch law.
- The audit report of Kubota states that the audit has been conducted in accordance with the standards of the Public Company Accounting Oversight Board and that financial statements as of March 31, 2010, and 2009, are in conformity with U.S. GAAP. The report further states that the auditors expressed a qualified opinion in the audit report for 2009 because there was no segment information, but in the current financial statements this has been corrected.
- The audit report on Cadbury PLC's financial statements of 2008 states that the audit was conducted in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board (UK). The audit opinion states that

(a) the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the EU, of the state of the Group's affairs as of December 31, 2008, and profit for the year then ended;

(b) the parent company financial statements give a true and fair view, in accordance with IFRS as adopted by the EU as applied in accordance with the provisions of the Companies Act of 1985, of the state of the parent company's affairs as of December 31, 2008;

(c) the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act of 1985 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1985) and as regards the Group financial statements, Article 4 of the IAS Regulation (Commission of the European Communities, 2003);

(d) the information given in the Directors' Report is consistent with the financial statements. The audit report also includes a separate opinion in relation to IFRS, which states that the Group, in addition to complying with its legal obligation to comply with IFRS as adopted by the EU, has also complied with the IFRS as issued by the International Accounting Standards Board (IASB).

Some audit reports, for example, those of China Southern Airline, China Eastern Airline, Unilever PLC, and Unilever N.V., specifically mention that the auditors need to comply with ethical requirements.

As mentioned earlier, a special feature in the corporate structure in some European countries, including Germany, is the two-tiered structure with a management board and a supervisory board.

Example

The report of the supervisory board of Volkswagen AG, in the annual report 2009, states: 'During the past fiscal year, the Supervisory Board addressed the situation and the development of the Volkswagen Group regularly and in detail. In compliance with the legal requirements and the German Corporate Governance Code, we provide advice and support to the Board of Management in issues relating to the management of the Company. The Supervisory Board was consulted directly with regard to all decisions of fundamental importance to the Group. In addition, current strategic considerations were discussed with the Board of Management at regular intervals.'

The Board of Management provided the Supervisory Board with regular, prompt, and comprehensive verbal and written reports on the development of business, the planning and the position of the Company, including the risk situation and risk management. These included all key aspects relating to the creation of an integrated automative group with Porsche. The Board of Management also informed us continuously about other current issues and the topic of compliance. We always received documents relevant to our decisions in good time prior to the Supervisory Board meetings. Furthermore, the Board of Management provided the Supervisory Board with detailed monthly reports on the current business position and the forecast for the year as a whole. The Board of Managementexplained any variations from the defined plans and targets in a comprehensive verbal or written report. The Board of Management and the Supervisory Board discussed and analyzed the reasons for the variations in detail to allow appropriate measures to be initiated.

Rewiew questions

1. What is the PCAOB? What is its role in audit regulation?
2. What does the audit environment include?
3. What was the impact of the European Union's Eighth Directive on the regulation of auditing in the United Kingdom?
4. In what ways do company audit reports vary in different countries?

CHAPTER 9

INTERNATIONAL HARMONIZATION OF AUDITING STANDARDS

The audit report is the primary tool auditors use to communicate with financial statement users about the results of the audit function. The globalization of capital markets and the growth of international capital flows have heightened the significance of cross-national understanding of corporate financial reports and the associated audit reports (Gangolly et al., 2002). For MNCs the ideal situation would be for both the parent company and its foreign subsidiaries to adopt one set of accounting standards, and for the auditors in both cases to use one set of auditing standards in providing their opinion on the financial statements. However, as explained in the previous sections, the audit environments and the mechanisms for audit regulation can vary significantly among different countries, and this could affect the form, content, and quality of the audit report.

International harmonization of auditing standards is important in view of the drive toward international convergence of financial reporting standards. It ensures the international capital markets that the audit process has been consistent across companies, and in particular that one set of high quality standards has been applied in auditing both the parent and its subsidiary companies. This enhances the credibility of the information in corporate financial reports. This would lead to a more efficient and effective allocation of resources in international capital markets. In addition, harmonization of auditing standards would enable audit firms to increase the efficiency and effectiveness of the audit process globally. However, efforts to harmonize auditing standards internationally have met with limited success.

The responsibility for developing international auditing standards rests mainly with IFAC through its International Auditing and Assurance Standards Board (IAASB). The IAASB was formerly known as the International Auditing Practices Committee (IAPC). As a condition of IFAC membership, a professional accountancy body is obliged to support the work of IFAC by informing its members of every pronouncement developed by IFAC; to work toward implementation, to the extent possible under local circumstances, of those pronouncements; and specifically to incorporate

IFAC's International Standards on Auditing (ISAs) into national auditing pronouncements (Preface to International Standards on Auditing and Related Services).

The IAASB develops ISAs and International Auditing Practice Statements (IAPSs). These standards and statements outline basic principles and essential procedures for auditors, and serve as the benchmark for high-quality auditing standards and statements worldwide. The IAASB also develops quality control standards for firms and engagement teams in the practice areas of audit, assurance, and related services. Table 9.1 provides a list of ISAs and International Standards on Quality Control (ISQC) issued by IFAC (International Standards on Auditing are available at www.ifac.org). The complete listing of the ISAs and ISQC 1 is set in Table 9.1 along with the Basis for Conclusions for each project. These staff-prepared documents provide background information, main comments received on the exposure drafts, and the IAASB's conclusions regarding these comments in developing the final standard.

Table 9.1 –International Standards on Auditing and International Standards on Quality Control

ISA Number	Title
200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
210	Agreeing the Terms of Audit Engagements
220	Quality Control for an Audit of Financial Statements
230	Audit Documentation
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with Those Charged with Governance
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
320	Materiality in Planning and Performing an Audit
330	The Auditor's Responses to Assessed Risks
402	Audit Considerations Relating to an Entity Using a Service Organization
450	Evaluation of Misstatements Identified during the Audit
500	Audit Evidence
501	Audit Evidence-Specific Considerations for Selected Items

Table 9.1

ISA Number	Title
505	External Confirmations
510	Initial Audit Engagements-Opening Balances
520	Analytical Procedures
530	Audit Sampling
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
550	Related Parties
560	Subsequent Events
570	Going Concern
580	Written Representations
600	Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)
610	Using the Work of Internal Auditors
620	Using the Work of an Auditor's Expert
700	Forming an Opinion and Reporting on Financial Statements
705	Modifications to the Opinion in the Independent Auditor's Report
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
710	Comparative Information-Corresponding Figures and Comparative Financial Statements
720	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
810	Engagements to Report on Summary Financial Statements

IFAC's international regulatory and compliance regime consists of the Forum of Firms (FoF) and the Compliance Committee, with participation from outside the accounting profession. Firms that carry out transnational audit work are eligible for membership in the FoF. Membership obligations include compliance with ISAs and the IFAC Code of Ethics for Professional Accountants, and submission to periodic quality control review. The Compliance Committee monitors and encourages compliance with international standards and other measures designed to enhance the reliability of financial information and professional standards around the world.

The International Organization of Securities Commissions (IOSCO) supports IFAC's efforts in this area. IOSCO's Technical and Emerging Markets Committees participate in the discussions that take place between

the IFAC and the international regulatory community regarding processes for the development of international auditing standards. In October 1992, IOSCO recommended that its members endorse ISAs and accept audits of financial statements from other countries audited in accordance with ISAs.

The issuance of ISA 13 in October 1983 by the International Auditing Practices Committee (IAPC) was an important landmark in international efforts to harmonize the audit report. The purpose of ISA 13 was to "provide guidance to auditors on the form and content of the auditor's report issued in connection with the independent audit of the financial statements of any entity" (paragraph 2). ISA 13 has been revised several times since 1983 (International Auditing and Assurance Standards Board, 2007). ISA 700, The Auditor's Report on Financial Statements (The International Federation of Accountants, 2015b), establishes standards and provides guidance on the form and content of the auditor's report. It requires the auditor to express an opinion about whether the financial statements "give a true and fair view" or "present fairly," which in turn requires the auditor to conduct the necessary auditing procedures to support his or her expressed opinion. The requirement also helps ensure that the information satisfies the need of the international users of financial statements.

ISA 700 (The International Federation of Accountants, 2015b) describes four types of audit opinion that can be expressed by the auditor: unqualified, qualified, adverse, and disclaimer of opinion. It also discusses circumstances that may result in other than an unqualified opinion, which includelimitation of scope, disagreement with management, and uncertainty. The appendixes to the standard include suggested expressions for the different types of opinion. For example, Table 9.2 provides an illustration of an unqualified opinion that incorporates the basic requirements.

Table 9.2 – ISA 700 Illustrative Audit Report (The International Federation of Accountants, 2015b)

AUDITOR'S REPORT (Appropriate Address) We have audited the accompanying (the reference can be by page numbers) balance sheet of the ABC Company as of December 31, 20x1, and the related statements on income, and cash flows for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

> We conducted our audit in accordance with International Standards on Auditing (or refer to relevant national standards or practices). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.
>
> In our opinion, the financial statements give a true and fair view of (or "present fairly" in all material respects) the financial position of the company as of December 31, 20x1, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards (IAS Plus) (or [title of financial reporting framework with reference to the country of origin] *In some circumstances it also may be necessary to refer to a particular jurisdiction within the country of origin to identify clearly the financial reporting framework used.*) (and comply with. . . . *Refer to relevant statutes or law*)

ISA 700 points out that although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the entity or the efficiency or effectiveness with which management has conducted the affairs of the entity.

ISA 200, Objectives and General Principles Governing an Audit of Financial Statements, states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects in accordance with an identified financial reporting framework. However, this could be a problem in some cases; for example, the European Union has endorsed a modified version of IAS 39 (International Accounting Standards Board, 1998), and selecting an appropriate text for such identification may not be easy.

Auditors are expected to comply with IFAC's Code of Ethics for Professional Accountants (International Federation of Accountants, 2005a) and to consider the activities of internal auditing and their effect, if any, on external audit procedures (ISA 610, Considering the Work of Internal Auditing (The International Federation of Accountants, 2015a)). In a paper published in December 2005, entitled The Role and Domain of the Professional Accountants in Business, IFAC's Professional Accountants in

Business (PAIB) Committee states that while there is certainly high awareness of the work of accountants in audit practice and tax preparation, there is a less understood, but equally important role that professional accountants in business play in designing and maintaining mechanisms to assure effective, ethical, and responsible corporate governance and control in organizations. To provide resources for professional accountants, IFAC launched the International Center for Professional Accountants in Business in July 2007.

In June 2003, IFAC issued an IAPS providing guidance on expressing an audit opinion when the financial statements are asserted by management to have beenprepared (1) solely in accordance with IFRS, (2) in accordance with IFRS and a national financial reporting framework, or (3) in accordance with a national financial reporting framework with disclosure of the extent of compliance with IFRS (The International Auditing and Assurance Standards Board, 2003).

In accordance with IAS 1, the IAPC specifies that financial statements should not be described as complying with IFRSs unless they comply with all the requirements of each applicable standard and each applicable interpretation of the International Financial Reporting Interpretations Committee (IFRIC). An unqualified opinion may be expressed only when the auditor is able to conclude that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the identified financial reporting framework. In all other circumstances, the auditor is required to disclaim an opinion or to issue a qualified or adverse opinion depending on the circumstances. An opinion paragraph that indicates that "the financial statements give a true and fair view and are in substantial compliance with International Financial Reporting Standards" does not meet the requirements of ISA 700 (The International Federation of Accountants, 2015b). Further, financial statements claimed to have complied with more than one financial reporting framework must comply with each of the indicated frameworks individually.

There have been efforts at harmonizing auditing standards at the regional level, particularly within the European Union. For example, the Fourth Directive of the European Commission requires that the auditor's report include whether the financial statements present a "true and fair view." The Eighth Directive aimed at harmonizing the educational and training prerequisites necessary to become a statutory auditor. Many EU member countries, including the United Kingdom, modified their company laws and regulations to comply with the provisions of the Eighth Directive. As a result, the UK professional bodies amended their entry requirements to include a rule that new members must have a university degree in any area. In addition,

a prospective candidate for membership of one of the professional bodies would also be required to undergo a three-year training period under the supervision of a practicing member of that professional body. A few years ago, the representative body for the accountancy profession in Europe, the Federation des Experts Comptables Europeens (FEE), conducted a survey and found that fundamental requirements to be recognized as a professional accountant and auditor largely have converged across Europe (Federation des Experts Comptables Europeens, 2007).

The UK Auditing Practices Board, one of the FRC's operating bodies, taking a big-bang approach, has recently issued a revised suite of auditing standards that very closely reflect the ISAs.

The IAASB has issued a series of key questions and answers in a publication titled "First-time Adoption of IFRSs, Guidance for Auditors on Reporting Issues" as well as a glossary incorporating terms used in ISAs issued as of October 31, 2004 (International Federation of Accountants, 2004). Further, in April 2005 the IFAC Education Committee issued an exposure draft on educational requirements for audit professionals proposing an International Education Standard (IES) titled "Competence Requirements for Audit Professionals" (International Federation of Accountants, 2005b).

There seems to be international cooperation in regulating auditors and audit firms. For example, the PCAOB has entered into a Statement of Protocol with Australian Securities and Investment Commission (ASIC) to enhance cooperation in the supervisory oversight of auditors and public accounting firms that practice in the United States and Australia. The PCAOB is expected to enter into similar arrangements in other non-U.S. jurisdictions. In December 2007, the PCAOB issued for comment proposed guidance regarding the implementation of PCAOB Rule 4012, Inspection of Foreign Registered Public Accounting Firms (Public Company Accounting Oversight Board, 2004). Accordingly, if the essential criteria as mentioned in the policy statement are met, the board may place full reliance on the inspection program of qualified non-U.S. auditor oversight entities. Rule 4012 sets out five broad principles:

1. Adequacy and integrity of the oversight system.
2. Independent operation of the oversight system.
3. Independence of the system's source of funding.
4. Transparency of the system.
5. System's historical performance.

Rewiew questions

1. What are the main benefits of international harmonization of auditingstandards?
2. What determines whether or not to issue an unqualified audit opinion on thecompliance of a set of financial statements with IFRS?
3. What role the International Organization of Securities Commissions (IOSCO) play regarding processes for the development of international auditing standards?
4. What main five broad principles sets out Rule 4012?
5. Name the basic International Standards on Auditing and International Standards on Quality Control.

CHAPTER 10

ETHICS AND INTERNATIONAL AUDITING

A More Communitarian View of Professional Ethics

Globalization in business and the global nature of the accounting profession increase the importance of the new global profession of accountant and auditor, as well as the importance of consensus of international morality and values in the global profession of accountant.

Further, accounting does not operate in a static environment and is undergoing change in accordance with community and business values. What was local – including business and professional fundamentals and community values – is now global. These values are currently directed to corporate responsibility and social and environmental issues and are communicated in nonmonetary terms. These changes in community values form part of what accounting is. Further, the realm of the accounting profession's jurisdiction does not seem to remain within the boundaries of monetary symbols and financial reporting. These issues are important in judging professional credibility and integrity into the next generation. Moral standing of the accounting profession is based on trust, which is established by the ethical conduct of its members. This is as important as an asset such as plant and equipment. At an international level, the profession has been directed to ethics education by international organizations such as IFAC. For example, IFAC membership obligations include compliance with ISAs and the IFAC Code of Ethics for Professional Accountants. The importance of consistency of ethical codes for the various professional bodies operating within individual geographical locations has also been emphasized. At the international level, the Public Interest Oversight Board (PIOB) was formed in early 2005 to oversee the work of IFAC committees, including n ethics standard-setting committee. Following the consideration and approval by the PIOB, the revised Code of Ethics for Professional Accountants (International Federation of Accountants, 2005a). was issued by the Auditing Practices Board. The revised code clarifies requirements for all professional accountants and significantly strengthens the independence requirements of auditors. Accountability over how banks are run is emphasized in the Walker

Review into Corporate Governance of UK banks.

However, ethical codes may also offer opportunities for “creative accounting.” Further, a focus on individual benefits has resulted in recent corporate failures. As a consequence, the accounting profession – as stewards of corporate behavior – was admonished in terms of public trust. When ethical values are falling, people often turn to government for help, as reflected during the recent global financial crisis.

The response to crises of the accounting profession in the United States has been to form committees and commissions whose recommendations end up changing little of substance. Those recommendations generally focused on rules of behavior. However, the shift from social norms to rules of behavior may not be the right path, as the focus on norms and culture are important to society.

A More Communitarian View of Professional Ethics

Professionals face their careers constrained by local laws and a set of values that appear to be universally held. Ethical standards are important in professional accounting work, and professional ethics reside in the form of a contract between a professional group and the community within which that professional group operates. Therefore, ethical issues can be local and contextual. Consequently, the notion of a universal or global set of ethical norms that is embedded in IFRS can be challenged, as the notion of an “international community” reflects the aspirations of Anglo-American culture. For example, some of the accepted methods of relationship building generally accepted in Chinese society may be considered bribery and corruption in an Anglo-American culture. Is a more communitarian view of professional ethics needed?

Rewiew questions

1. What is the moral position of the accounting profession based on?
2. The role of international organizations in the formation of ethics of accountants. Give examples.
3. Which international organizations care about the ethics of auditors?
4. The value of ethical norms and rules of conduct for the profession of auditor and accountant. Common and different between norms and rules.
5. Restrictions on the application of a global set of ethical norms in the international community.

CHAPTER 11

ADDITIONAL INTERNATIONAL AUDITING ISSUES

As a result of the renewed interest in restoring investor confidence internationally, the issues of auditor's liability, auditor independence, and the role of audit committees have figured prominently in discussion and debate. The fact that there is no international agreement on how to deal with any of these issues is of particular interest to MNCs, because they have to operate under different regulatory regimes in different countries.

Auditor's Liability

In general, auditors can be subject to three kinds of liability, namelycivil liability, criminal liability, and professional sanctions. Civil liability arises when auditors break contractual or civil obligations or both, and criminal liability arises when they engage in criminal acts, such as intentionally providing misleading information. Professional sanctions (warnings and exclusions by professional bodies) are imposed when auditors violate the rules of the professional bodies to which they belong (Favere-Marchesi, 2000). In terms of civil liability, the auditor may be exposed to litigation initiated by (1) the client company (the other party to the engagement contract) or (2) a third party (a party not involved in the original contract, such as a shareholder). In certain national jurisdictions, auditors are not liable to third parties. This was the case in Germany prior to 1998, but the situation changed as a consequence of a court decision in that year. Statutory auditors in Germany currently are liable to third parties in cases of negligent behavior. In the United Kingdom, under the Companies Act, the auditor reports to the members of the company but enters intoa contract with the company as a corporate entity. Accordingly, the auditor's primary duty of care is to the company and its shareholders as a group, not necessarily to individual shareholders. To be liable in negligence, the auditor must owe a "duty of care" to a third-party claimant. It is relatively difficult for individual shareholders to successfully assert claims against statutory auditors under British law (Baker et al., 2001).

In China, the concept of legal liability extending beyond the firm to its owners does not appear to exist. This is due to the flexibility in the ownership

structure of CPA firms, and the lack of a developed legal environment. A unique feature in the ownership structure of the Chinese CPA firms is that other entities, such as universities, may also have ownership interests in them. For example, Shanghai University has an ownership interest in Da Hua CPAs, one of the larger CPA firms in China (Graham, 1996).

Limiting Auditor's Liability

Prompted by the collapse of Arthur Andersen, the UK government conducted a public consultation on whether it should initiate legislation to limit auditors' liability. In its response, one of the Big Four firms pointed out that the risks involved in auditing are uninsurable, unquantifiable, unmanageable, and could at any time destroy the firm or any of its competitors (Parker, 2004). This should be of concern to MNCs, given that further reduction in the number of global accounting firms could seriously affect MNCs' ability to obtain the necessary professional services at reasonable prices. The remainder of this section describes some of the alternatives available for limiting auditor's liability.

Change the Ownership Structure

Audit firms, particularly in the UK tradition, are often organized as partnerships in which the principle of "joint and several liability" applies. Under this principle, each audit partner of the firm against whom a claim is made for negligence may be held liable for the whole amount of the claim. However, the joint and several liability feature is seen as a weakness of the partnership form of ownership. An effective way to limit auditor's liability would be to change the ownership structure of audit firms. Under the U.S. model of limited liability partnerships, "innocent" partners are able to protect their personal wealth from legal action. The Big Four firms are using limited liability partnerships, where permitted by law, to reduce their exposure to litigation. For example, Deloitte & Touche LLP became a limited liability partnership in August 2003.

Under UK law, limited partnerships are effective only if the limited partners are simply passive investors and take no role in the firm's professional work. Consequently, for many audit firms in the United Kingdom, the principle of joint and several liability applies to audit partners, as the firms are organized as partnerships. However, it is possible in the United Kingdom for audits to be carried out by limited liability companies. Among the ASEAN countries, in Thailand and Vietnam, auditing firms may be organized as limited liability companies (Favere-Marchesi, 2000). It was reported recently that of the United Kingdom's top 60 accountancy firms, the majority had turned to limited liability (Fisher, 2004a). In 1995, KPMG announced the formation of a new company, KPMG Audit PLC, to audit its top 700 clients worldwide (Accountancy Age, October 5, 1995, p. 1.). In

Germany also, statutory audits can be performed by audit corporations with limited liability. However, in other countries, such as New Zealand, an audit firm cannot be incorporated.

Proportionate Liability

Another approach that has been suggested to limit auditor's liability is to apply the concept of proportionate liability, by which the claim against each auditor would be restricted to the proportion of the loss for which he or she was responsible. However, this is not a widely adopted approach. For example, in September 1998, the New Zealand Law Commission declined a proposal by the then Institute of Chartered Accountants of New Zealand (ICANZ) [now, Chartered Accountants Australia and New Zealand (CA ANZ)] for changing auditors' liability from "joint and several liability" to "proportionate liability." In doing so the Law Commission stated that fairness among defendants was not relevant to fairness to the injured party. German regulators seem to have taken a different view on this issue. Although German law specifies the disciplinary procedures against auditors, they are not always strictly implemented due to an overall tendency to focus on damage to the reputation of the profession rather than on the extent of the individual culpability of the auditor. Australia and Canada have recently introduced systems that recognize proportionate liability for auditors. The Companies Act of 2006 in the United Kingdom removed the longstanding bar on auditors limiting their liability to the companies they audit, which was contained in section 310 of the Companies Act of 1985 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1985). Accordingly, limits for auditor liability could be agreed upon between the company and the auditor. From an international perspective, although the current UK regime is less favourable to auditors compared to those in Australia and Germany, a reasonable degree of protection is possible.

Statutory Cap

The use of a statutory cap is yet another approach that has been suggested to limit auditor's liability. The purpose of statutory cap is to reduce the amount of money that an audit firm would have to pay if found liable for negligence. In Germany, this has been the practice for many decades. In 1931, an explicit limit on auditors' maximum exposure to legal liability damages was introduced to relieve the auditor of an overwhelming worry of unlimited liability, and to limit the premiums for liability insurance (Baker et al., 2001). In the United Kingdom, the auditors are legally prevented from limiting their liability to their client company arising from negligence, default, breach of duty, and breach of trust (Napier, 1998). As an example of the extent to which auditors may be expected to pay, damages of £65 million were awarded against the accounting firm Binder Hamlyn in 1995. The case involved a

careless acknowledgement of responsibility for a set of audited accounts made to a takeover bidder by the firm's senior partner as reported in the Financial Times of December 7, 1995 (Doupnik, T. S., & Perera, H., 2012).

Disclaimer

UK auditors often include disclaimers of liability in their audit opinions to protect themselves from unintended liability. In March 2003, in response to a proposal put forward by the ICAEW to promote the capping of unintended auditor liability by changing the wording in audit opinions to illustrate to whom an opinion is given, the U.S. SEC clearly stated that this would not be acceptable in theUnited States and that disclaimers of liability placed in audit opinions by UK auditors would have no validity if placed on U.S. financial reports.

Auditor Independence

One of the main principles governing auditors' professional responsibilities is independence, in particular independence from management. However, reports of independence rule violations by major international accounting firms have appeared with increasing frequency. As an example, in January 2000, the SEC made public the report by an independent consultant who reviewed possible independence rule violations by one of the Big Four firms arising from ownership of client-issued securities. The report revealed significant violations of the firm's, the profession's, and the SEC's auditor independence rules (the full report is available at www.sec.gov/pdf/pwclaw.pdf). Following the corporate collapses at the beginning of this century in many countries, a series of such reports appeared and auditor independence became the subject of much debate at the international level.

IFAC Code of Ethics for Professional Accountants (International Federation of Accountants, 2005a) identifies two different categories of independence: independence in mind and independence in appearance. Independence of mind requires auditors to be in a state of mind that allows them to express opinions about the auditee without feeling that they are under pressure due to independence issues and to feel that they are allowed to act with integrity, conducting their audits objectively and with professional skepticism. Independence of mind is also referred to as "independence in fact." Independence in appearance relates to a third party's perception regarding the auditor's independence. If the third party doesn't think that the auditor appears to be independent, even though the auditor is independent in his or her mind, the third party doesn't trust the auditor due to certain circumstances or relationships that are incompatible with independence and the promise of the assurance that the auditor is supposed to provide is lost.

The NYSE Euronext Corporate Governance Guidelines (The New York

Stock Exchange, 2014) require, among other things, that the board will have four committees: an Audit Committee, a Human Resources and Compensation Committee, a Nominating and Governance Committee, and an Information Technology Committee. The guidelines also require that all of the members of these committees, except for information Technology Committee, should be independent directors.

The PCAOB requires public accountancy firms to communicate to an audit client's audit committee about any relationship between the firm and the client that may reasonably be thought to bear on the firm's independence. The communication would be required both before the firm accepts a new engagement pursuant to the standards of the PCAOB and annually for continuing engagements. The remainder of this section reviews various attempts to strengthen auditors' independence.

Auditor Appointment

Having stockholders involved in the auditor appointment process is expected to strengthen the independence of auditors from management and to improve audit quality. Generally, the law, for example the UK Companies Act of 1989 (Section 384), requires that the registered (or statutory) auditor be appointed by the shareholders in an annual general meeting (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1989). However, in practice, it is the company's managers who actually select the auditor, after negotiating fees and other arrangements. The auditor often considers the managing directors of the company as theclient, and hence the auditor's contractual arrangement is with the management of the company, not with the individual shareholders.

Restricted or Prohibited Activities

Another issue related to auditor independence is restricted or prohibited activities, including relationships with client companies. Mandated activities such as communication between auditors could also strengthen auditor independence. On the issue of the auditor's relationship with client companies, the Sarbanes-Oxley Act (2002) has specific provisions prohibiting certain nonaudit services provided by external auditors. However, the large audit firms point out that certain consulting work in fact helps improve audit quality. For example, they argue that consulting on information systems and e-commerce puts them on the cutting edge of business, and as a result, they can (1) start to measure items, such as a company's customer service quality, that are not on balance sheets even though investors consider them to be crucial assets; (2) develop continuous financial statements that provide real-time information instead of historical snapshots; and (3) explore ways to audit other measures of value that investors use, such as Web site traffic and market share locked up by being first with a new technology.

Regulatory Oversight

In many countries, the regulation and oversight of auditors have expanded to incorporate external monitoring and oversight of auditor competence and independence. The PCAOB in the United States and the Professional Oversight Board for Accountancy (POBA) in the United Kingdom are two examples. In October 2002, IOSCO issued a document titled Statement of Principles for Auditor Oversight (International Organization of Securities Regulators, 2020), which requires that "within a jurisdiction auditors should be subject to oversight by a body that acts and is seen to act in the public interest." In its Statement of Principles of Corporate Governance and Financial Reporting, IOSCO recommends the following:

- Auditors should be independent, in line with international best practice.
- Auditors should make a statement to the board concerning their independence at the time the audit report is issued.
- The audit committee should monitor the auditor's appointment, remuneration and scope of services, and any retention of the auditor to provide nonaudit services.
- The board should disclose the scope of the audit, the nature of any nonaudit services provided by the auditors, and the remuneration for these.
- The board should disclose how auditor independence has been maintained where the auditor has been approved to provide any nonaudit services.
- An independent oversight body should monitor issues of audit quality and auditor independence.

Mandatory Rotation

Mandatory rotation of audit firms often has been advocated as a means of strengthening auditor independence, ensuring that potential conflicts of interest are avoided. A recent government inquiry into auditor independence in theUnited Kingdom resulted in a recommendation for mandatory auditor rotation as a way to restore investor confidence in the market in response to investor and public concerns in the wake of corporate scandals like the one involving Enron. However, the United Kingdom's largest audit firms have overwhelmingly rejected the notion that auditors should face mandatory rotation (Details are available at link). They argue that such a change would only serve to bring down the quality of the audit and that there is no evidence that rotation will prevent corporate collapse. By contrast, in Singapore, the law requires the rotation of audit partners for publicly listed companies.

In revising its code of ethics for professional accountants, IFAC has specified that, for audits of listed entities, the lead engagement partner should be rotated after a predefined period, normally no more than seven years, and

that a partner rotating after a predefined period should not participate in the audit engagement until a further period of time, normally two years, has elapsed (IFAC, 2004). This requirement may be of particular concern in countries where there may be few partners with a sufficient understanding of the particular industry involved or a particular set of accounting rules (such as U.S. GAAP or SEC regulations).

Splitting Operations

To address the independence issue, the large accounting firms have taken more drastic action, splitting into separate entities, each dealing with a specific operational area. This allows auditing and consulting arms to deal with the same customer. In 2000, Ernst & Young announced the sale of its management-consulting business to CAP Gemini Group SA for around $11 billion. One reason was to reduce SEC concerns about lack of independence. Also in 2000, PricewaterhouseCoopers decided to separate its audit and business advisory services from its other businesses (e.g., e-commerce consulting) in a decision that was "encouraged" by the SEC. In February 2000, KPMG announced the incorporation of KPMG Consulting, to be owned by KPMG LLP and its partners (80.1 percent), and Cisco Systems Inc. (19.9 percent), which in August 1999 agreed to invest $1 billion in the new company.

Stringent Admission Criteria

In the United Kingdom, the Companies Act of 1989 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1989), which implemented the EU Eighth Directive (The Council of the European Union, 2008), introduced stronger statutory arrangements for the regulation of auditors. It restricts qualifications for appointment as a statutory auditor to those who hold a recognized professional qualification and are subject to the requirements of a recognized supervisory body. It makes specific provision for the independence of company auditors; for example, an officer or employee of the company being audited may not act as auditor.

A Principles-Based Approach to Auditor

Independence In a recent auditor independence standard, the Canadian Institute of Chartered Accountants (2003) (CICA) makes a shift to a more rigorous "principles-based" approach. The standard reflects features of the relevant requirements included in IFAC, the U.S. Sarbanes-Oxley Act (2002), and the SEC for public companies. Its applicability goes beyond any specific situation and mandates a proactive approach based on clearly articulated principles. The core principle of the CICA standardis that every effort must be made to eliminate all real or perceived threats to the auditor's independence. It requires auditors to ensure that their independence is not impaired in any way. In a set of specific rules for auditors of listed entities,

the standard

- Prohibits certain nonaudit services (bookkeeping, valuations, actuarial, internal audit outsourcing, information technology system design or implementation, human resource functions, corporate finance activities, legal services, and certain expert services).
- Requires rotation of audit partners (lead and concurring partners after five years with a five-year time-out period, partners who provide more than 10 hours of audit services to the client and lead partners on significant subsidiaries after seven years with a two-year time-out period).
- Prohibits members of engagement team from working for the client in a senior accounting capacity until one year has passed from the time when they were on the engagement team.
- Prohibits compensation of audit partners for cross-selling nonaudit services to their audit clients.
- Requires audit committee prior approval for any service provided by the auditor.
- Stipulates that the rules for listed entities apply only to those listed entities with market capitalization or total assets in excess of $10 million.

A Conceptual Approach to Auditor Independence

In Europe, the Federation des Experts Comptables Europeens (Federation des Experts Comptables Europeens, 2000) describes its approach to auditor independence as a conceptual approach. By focusing on the underlying aim rather than detailed prohibitions, it combines flexibility with rigor in a way that is unavailable with a rule-based approach. It is argued that this approach

- Allows for the almost infinite variations in circumstances that arise in practice.
- Can cope with the rapid changes of the modern business environment.
- Prevents the use of legalistic devices to avoid compliance.
- Requires auditors to consider actively and to be ready to demonstrate the efficiency of arrangements for safeguarding independence.

An example of this approach would be the two-tiered corporate governance structure that exists in many continental European countries, such as Germany, France, and the Netherlands, and its perceived impact on auditor independence. Under that structure, because the supervisory board monitors the activities of the management board, and the auditors report to the supervisory board, the auditors may be more independent compared to their counterparts in the United Kingdom or the United States.

The main difference between the last two approaches is that, whereas the former uses a list of specific prohibitions, the latter avoids making such a list.

Audit Committees

An audit committee is a committee of the board of directors that oversees

the financial reporting process including auditing. The subject of audit committeeshas drawn increased attention in recent years (each of the Big Four firms has issued audit committee guidance, see, for example (AmericanInstitute of Certified Public Accountants, 2000; Blue Ribbon Committee, 1999; PricewaterhouseCoopers, 2000). In a 1999 report, the U.S. Blue Ribbon Committee (1999), which made recommendations on improving the effectiveness of audit committees, describes the role of the audit committee as first among equals in supporting responsible financial disclosure and active and participatory oversight (Blue Ribbon Committee, 1999). It defines the oversight role as "ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks, and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders."(BlueRibbon Committee, 1999, p.20).

In general, the audit committee responsibilities are to

- Monitor the financial reporting process.
- Oversee the internal control systems.
- Oversee the internal audit and independent public accounting function.

The Sarbanes-Oxley Act (2002) contains specific provisions dealing with issues related to audit committees, expanding their role and responsibilities. It requires the audit committee to be responsible for the outside auditor relationship, including the responsibility for the appointment, compensation, and oversight of a company's outside auditor. It also requires that members of the audit committee be independent from company management. Further, the requirements cover audit committee's authority to engage advisors, funding for the audit committee to pay the independent auditor, and any outside advisers it engages, and procedures for handling complaints about accounting, internal control, and auditing matters (whistleblower communication).

In January 2003, responding to Section 301 of the Sarbanes-Oxley Act (2002), the SEC proposed new rules for audit committees to prohibit the listing of companies that fail to comply with the requirements of Sarbanes-Oxley Act (2002) and SEC (Securitiesand Exchange Commission, 2003). The SEC's requirements relate to the independence of audit committee members, the audit committee's responsibility to select and oversee the issuer's independent accountant, procedures for handling complaints regarding the issuer's accounting practices, the authority of the audit committee to engage advisers, and funding for the independent auditor and any outside advisers engaged by the audit committee.

One of the key responsibilities of an audit committee is oversight of the external auditor. It is now widely accepted that the external auditor works for and is accountable to the audit committee and board of directors (in some cases, the supervisory board). The regulatory bodies in many countries now require listed companies to establish audit committees. For example, under the ASX Corporate Governance Guidelines (ASX Corporate Governance Council, 2019, February), listed companies in Australia are required to set up an independent audit committee made up completely of non-executive directors. All of the audit committee members are required to be financially literate, and at leastone must have financial expertise. Among the ASEAN countries, audit committees for publicly listed companies are required in Malaysia and Singapore (Favere-Marchesi, 2000, p.142).

Understanding how the accountability relationship through audit committees is supposed to work effectively is very important for all parties interested in corporate reporting in an international context. One of the potential problems, at least in some countries, would be the unavailability of individuals with the desired skills to be independent directors. Another concern is that as a result of the expanded responsibilities given to audit committees, suitable individuals may now be reluctant to take on the position of audit committee member. KPMG reported that 65 percent of a sample of UK audit committee members in 2003 believed the enhanced role and responsibilities would discourage individuals from taking on such positions (This research was carried out among 118 members of FTSE 350 audit committees at the recent Audit Committee Institute Round Table. (The UK Audit Committee Institute is wholly sponsored by KPMG.) Details available at http://acountingeducation.com.news/news3892.html.).

Rewiew questions

1. What are some of the strategies adopted internationally to limit the auditor’sliability?
2. What are the main factors that complicate the issue of auditor independence?
3. What is the oversight role of an audit committee?
4. What is a Conceptual Approach to Auditor Independence?
5. What is a Principles-Based Approach to Auditor?

CHAPTER 12

INTERNAL AUDITING

Internal auditing is a segment of accounting that uses the basic techniques and methods of auditing, and functions as an appraisal activity established within an entity. The Institute of Internal Auditors (2004) (IIA) founded in the United States in 1941(for more details, see (Ramamoorti, 2003)) defines internal auditing as *'an independent, objective assurance and consulting activity designed to add value and improve an organization's operations'*. The internal auditor is a person within the organization and is expected to have a vital interest in a wide range of company operations. The Sarbanes-Oxley Act (2002) specifically recognizes the importance of internal auditing in restoring credibility to the systems of business reporting, internal control, and ethical behavior. The SEC requires listed companies to have an internal audit function. The IIA is a main source of feedback to the SEC regarding implementation of the internal control provisions of the SarbanesOxley Act.

The role of internal auditing is determined by management, and its scope and objectives vary depending on the size and structure of the firm and the requirements of its management. In general, the objectives of internal auditing differ from those of external auditing. As stated in ISA 610 (International Federation of Accountants, 2015a), internal auditing activities include the following:

- Review of the accounting and internal control systems. The establishment of adequate accounting and internal control systems is a responsibility of management that continuously demands proper attention. Internal auditing is an ordinarily assigned specific responsibility by management for reviewing these systems, monitoring their operations, and recommending improvements thereto.
- Examination of financial and operating information. This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
- Review of the economy, efficiency, and effectiveness of operations. These operations include nonfinancial controls of an entity.
- Review of compliance with laws, regulations, and other external

requirements, as well as with management policies and directives and other internal requirements.

Risk management is directly related to corporate governance and is an area in which internal auditing can make a significant contribution. Monitoring risks and providing assurance regarding controls are among the main internal audit functions (Figure 12.1).

IFAC defines an internal control system as follows: '*An internal control system consists of all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal control system extends beyond these matters which relate directly to the fairness of the accounting system*'(IFAC, 2004).

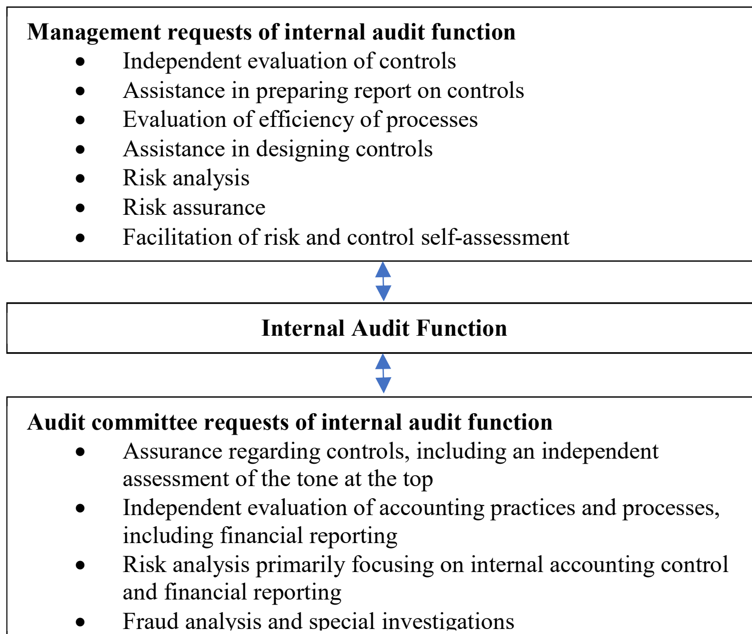


Figure 12.1. Competing Demands on Internal Audit Function (Bailey et al., 2003)

Recently, the IIA published a paper on internal auditing's role in enterprise risk management (ERM) (This is available at www.theiia.org). As shown in Figure 12.1, there are competing demands on internal audits from corporate management and audit committees. On the one hand, corporate management requests, among other things, assistance in designing controls, self-assessment of risk and control, and preparing reports on controls. On the other hand, audit committee requests assurance regarding controls and independent evaluation of accounting practices and processes.

The PCAOB's Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting, which is integrated with An Audit of Financial Statements (approved by the SEC), requires registered audit firms to use the new standard for all audits of internal control no later than for fiscal years ending on or after November 15, 2007 (Public Company Accounting Oversight Board, 2007). Adopted in May 2007, this standard implements Sections 103 and 404 of the Sarbanes-Oxley Act (2002). The new standard reflects a principles-based approach, and allows auditors to apply professional judgment in determining the extent to which they will use the work of others. It is less prescriptive and easier to read. It directs auditors to focus on what matters most, and eliminates unnecessary procedures from the audit.

In August 2007, in a paper focused on internal control from a risk-based perspective, IFAC states that one of the best defenses against business failures and an important driver of business performance is strong internal control. In June 2008, a pplying the extensive expertise and experience of its members and IFAC member bodies to draw out a set of globally applicable statements of principles. These principles should (1) guide the thought processes of professional accountants in business when they tackle the relevant topic, and (2) underpin the exercise of the professional judgment that is important in their roles. They provide professional accountants in business (and those served by them) with a common frame of reference when deciding how to address issues encountered within a range of individual organizational situations.

The Demand for Internal Auditing in MNCs

In a global competitive environment, internal auditing has become an integral part of managing MNCs. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has issued its Guidance on Monitoring Internal Control Systems. The guidance is designed to help organizations better monitor the effectiveness of their internal control systems and to take timely corrective actions if needed. In China, the Ministry of Finance has provided guidance on internal control. In April 2010, five government departments jointly issued "Guidance on Internal Control." This

guidance, together with the previously issued ”Framework on Internal Control,” is regarded as the basis for requirements on Chinese companies' internal control systems.

There is a growing demand for risk management skills as MNCs face an increasing array of risks due to the fact that their control landscape is more extensive and complicated compared to purely domestic enterprises. The demand for internal auditing has been growing internationally during the past three decades, particularly due to regulatory and legislative requirements in many countries, for example, the U.S. Foreign Corrupt Practices Act.

U.S. Legislation against Foreign Corrupt Practices

The Foreign Corrupt Practices Act (FCPA), which became law in December 1977 (U.S. Department of Justice, 1977), requires companies to establish and maintain appropriate internal control systems so that corporate funds are not improperly used for illegal purposes. Following the FCPA internal control requirement, the SEC Act of 1934 (United States Congress, 1934) was amended and, as a result, all the registrants of the SEC are required to install internal control systems to prevent or detect the use of firm assets for illegal activities.

The FCPA makes it illegal for U.S. companies to pay bribes to foreign government officials or political parties in order to secure or maintain business transactions or secure another type of improper advantage. Violation of the FCPA could result in large fines being levied against the corporation, and the executives, employees, and other individuals involved could also be fined or jailed or both. U.S. companies may be subject to liability for FCPA violations by their foreign subsidiaries or joint venture partners.

The FCPA grew out of the revelations of widespread bribery of senior officials of foreign governments by American companies. In particular, the Lockheed and Watergate scandals in the mid-1970s triggered the enactment of the FCPA. The Lockheed scandal involved kickbacks and political donations paid by Lockheed, the American aircraft manufacturer, to Japanese politicians in return for aid in selling planes to All-Nippon Airlines. The scandal forced Tanaka Kakuei to resign as prime minister and as member of the ruling Liberal Democratic Party. Lockheed had paid a total of $22 million to Japanese and other government officials.

In an investigation launched by the Securities and Exchange Commission following the Watergate scandal in the 1970s, it was discovered that American companies were engaged in large-scale bribery overseas. According to the report from that investigation, by 1976 more than 450 American companies had paid bribes to foreign government officials, made contributions to political parties, or made other questionable payments. A considerable amount of “slush funds” were generated for this purpose by

falsifying their accounting records. Thus, the original intention behind the enactment of the FCPA was to improve corporate accountability and transparency.

The FCPA has two main components – accounting provisions and antibribery provisions. The SEC plays the main role in enforcing the accounting provisions, which require a company to maintain books, records, and accounts fairly reflecting the transactions and dispositions of the assets. In addition, a company must devise and maintain an appropriate internal accounting controls system, execute transactions in accordance with the management's authorization, prepare financial statements in conformity with accounting principles, and record transactions to maintain accountability for assets. These requirements apply to SEC-regulated public companies – both U.S. and foreign companies – including their overseas branches.

The FCPA's accounting provisions require that a company holding a majority of a subsidiary's voting securities must cause that entity to comply with the FCPA accounting requirements. With regard to cases in which the parent holds less than a majority interest, the act requires a parent entity to "proceed in good faith to use its influence, to the extent reasonable under the circumstances" to cause compliance.

The Report of the National Commission on Fraudulent Financial Reporting in the U.S. (Treadway Commission Report, 1987), and the Report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, 1992, also placed particular emphasis on internal controls. The 1987 Treadway Report made several recommendations designed to reduce financial statement fraud by improving control and governance. The report made it clear that the responsibility for reliable financial reporting "resides first and foremost at the corporate level, in particular at the top management level." Top management "sets the tone and establishes the financial reporting environment." The idea is that good record keeping and internal control would make it more difficult to conceal illegal activities.

The International Anti-Bribery and Fair Competition Act of 1998 expanded the scope of the FCPA for application to foreign companies (other than those regulated by the SEC) and foreign nationals, if their corrupt activity occurs within the United States. A U.S. company can be prosecuted not only when it directly authorizes an illegal payment by its foreign affiliate but also when it provides funds to that affiliate while knowing or having reason to know that the affiliate will use those funds to make a corrupt payment.

The Sarbanes-Oxley Act (2002), Section 404(a), and the SEC's related implementing rules require the management of a public company to assess the effectiveness of the company's internal control over financial reporting,

and include in the company's annual report management's conclusion about whether the company's internal control is effective, as of the end of the company's most recent fiscal year. Following these requirements, the PCAOB issued an audit standard, and in June 2004 the SEC approved the PCAOB Release No.2004-003: "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." Accordingly, the integrated audit results in two audit opinions: one on internal control over financial reporting and one on the financial statements (Securities and Exchange Commission, 2004a).

Legislation in Other Jurisdictions

In December 1997, 33 countries signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and are required to make offshore bribery a crime under domestic law (OECD, 1997).

In the United Kingdom, the Cadbury Committee, which was set up by the FRC, the London Stock Exchange, and the accounting profession to address the financial aspects of corporate governance, presented Internal Control Frameworks in its report published in December 1992 (Report, 1992). The sponsors were concerned at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards, which the users of corporate reports sought and expected. These concerns were heightened by some unexpected failures of major companies such as Polly Peck (Gwilliam, & Russell, 1991). The report developed recommendations for the control and reporting functions of the board, and on the role of auditors. The main output of the committee was a Code of Best Practice for companies. It emphasized openness, integrity, and accountability, and was implemented by the London Stock Exchange. Similar proposals were made by the Criteria of Control Committee of Canada (CoCo Report) and by the OECD Convention. A detailed comparison is given by Professional Accountants in Business Committee in August 2006 in the Information Paper "Internal Controls – A Review of Current Developments" (Professional Accountants in Business Committee, 2006).

In July 2007, in response to the FRC's review of impact of the Combined Code, which became effective to reporting years beginning on or after November 1, 2006, following a review by FRC, the ICAS raised the question whether the *comply or explain* approach was working. It stated that the bodies who oversee its application must ensure that it does not become an exercise in mindless compliance for the increasing number of companies who adhere to the principles of the code. Too often the comply or explain principle in relation to applying the code was being interpreted as *comply* meaning good and *explain* meaning bad. The ICAS suggests that the code should explicitly

state that it is a good thing for a company to explain its policies and practices in support of compliance or noncompliance. It is also important that independence of directors should not be interpreted as more important than experience.

A study that examined whether the style and form of corporate governance has an effect in deterring financial fraud in China found that firms that had a high proportion of nonexecutive directors on the board were less likely to engage in fraud (Chen et al., 2006). Both internal and external corporate governance mechanisms are weak or nonexistent in China. Externally the market for corporate control and managerial labor market are seriously underdeveloped, and internally it was not until 2002 that independent directors and audit committees appeared in listed companies. Chinese auditors have enjoyed an almost litigation-free environment because of a lack of sophisticated users and providers of accounting information.

For an MNC, an important task of monitoring risks is to develop a plan to systematically assess risk across multinational activities within the organization. In addition, the MNC needs to assess existing risk of audited area and reporting of that assessment to management or the audit committee, or both; lead the risk management activities when a void has occurred within the organization; facilitate the use of risk self-assessment techniques; evaluate risks associated with the use of new technology; and assist management in implementing a risk model across the organization covering operations in different countries. Table 12.1 shows several evaluative frameworks that have been proposed for internal control.

Table 12.1 – Evaluative Frameworks for Internal Control (Deloitte& Touche, 2003)

Evaluative Framework for Internal Control	**Detail about Frameworks**
COSO–Internal Control–Integrated Framework	Developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission and sponsored by the AICPA, the FEI, the IIA and others, COSO is the dominant framework in the United States. The guidelines were first published in 1991, with anticipated revisions and updates forthcoming. This is believed to be the framework chosen by the vast majority of the U.S.-based public companies
CoCo–The Control Model	Developed by the Criteria of Control Committee (CoCo) of the CICA. The CoCo focuses on behavioral values rather than control structure and procedures as the fundamental basis for internal control in a company

Turnbull Report–Internal Control	Developed by the ICAEW, in conjunction with the London Stock Exchange, the guide was published in 1999. Turnbull requires companies to identify, evaluate, and manage their significant risks and to assess the effectiveness of the related internal control systems
Australian Criteria of Control (ACC)	Issued in 1998 by the Institute of Internal Auditors—Australia, the ACC emphasizes the competency of management and employees to develop and operate the internal control framework. Self-committed control, which includes such attributes as attitudes, behaviors, and competency, is promoted as the most cost-effective approach to internal control
The King Report	The King Report, released by the King Committee on Corporate Governance in 1994, promotes high standards of corporate governance in South Africa. The King Report goes beyond the usual financial and regulatory aspects of corporate governance by addressing social, ethical, and environmental concerns

However, in regard to internal controls a question remains: What if the top management was involved in the illegal transaction? After all, the top management is responsible for internal control and has discretionary power to override or restructure the internal control system. Managers can commit fraud by overriding internal controls, and audits conducted in accordance with auditing standards do not always distinguish between errors and fraud (Capalan, 1999, p.101). Evidence suggests that, although better internal controls would prevent or discourage fraudulent conduct on the part of employees, it would be more difficult to prevent fraud at the top level:

- In 1992, General Electric (GE) allegedly misappropriated $26.5 million from the U.S. government by falsifying accounting records in conjunction with a sale of weapons to Israel. GE was accused of violating not only the FCPA but also the Money Laundering Control Act, among other laws, and was ordered to pay $69 million in fines.
- In 1995, Lockheed was prosecuted for violating the FCPA based on its alleged payment of a bribe of $1 million to a member of the Egyptian parliament in order to sell its military jets to Egypt's armed forces. The company paid a $24.8 million fine. In this case, a fine of $20,000 was also imposed on the responsible manager, and the vice president of Middle East and North Africa marketing was fined $125,000 and sentenced to 18 months in prison.
- In 1998, a large U.S. oil company, Saybolt, was prosecuted for violating the FCPA when it allegedly paid $50,000 to a Panamanian

government official to obtain a lease for a site near the Panama canal, and paid a fine of $4.9 million.

- In 1996, Montedison, a major Italian company listed on the New York Stock Exchange, allegedly concealed hundreds of millions of dollars in losses by falsifying its books, and paid bribes to Italian politicians and others. The SEC filed a civil suit alleging violations of FCPA accounting standards. In response, the company reformed its internal controls and settled the case with the SEC for $300,000.

According to the results of the Management Barometer Survey 2004 79 percent of senior executives of U.S. MNCs stated that their company needed improvements in order to comply with Section 404 of Sarbanes- Oxley Act, which requires companies to file a management assertion and auditor attestation on the effectiveness of internal controls over financial reporting. They also mentioned the areas needing remedies (Table 12.2).

For effective governance, the ultimate responsibility for internal control should be vested in the board, which represents shareholders. The board is responsible for achieving corporate objectives by providing guidance for corporate strategy and monitoring management. The board is effective only if it is reasonably independent from management. Board independence usually requires a sufficient number of outsiders; an adequate time devoted by the members; and access to accurate, relevant, and timely information.

Table 12.2 – The areas needing remedies, according to the Management Barometer Survey 2004

The areas	**%**
Financial processes	55%
Computer controls	48
Internal audit effectiveness	37
Security controls	35
Audit committee oversight	26
Fraud programs	24

Because the board is usually not engaged in its work on a full-time basis, it needs to rely on experts for necessary information, such as the internal auditor and the external auditor. Being employees of the company, internal auditors are faced with a built-in conflict in regard to their allegiance. This makes the role of the external auditor crucial. External auditors are normally required to make an assessment of the internal control. If the external auditors are to attest to the “fair representation” or “true and fair view” of the financial position of the firm, they need to be able to form their opinion independent of the board and management. However, the issue of auditor independence is complicated by the facts that auditors are paid by the auditee company – more

specifically, its management – and often the auditors provide consultancy services to the auditee company.

Rewiew questions

1. What are the main differences between internal auditing and external auditing within an MNC?
2. What norms does the internal auditing activities include, as stated in ISA 610?
3. What Competing Demands on Internal Audit Function canyou name?
4. Which areas needed improvement to meet the requirements of the Section 404 of Sarbanes- Oxley Act?
5. How does the IFAC defines the concept of an internal control system?

CHAPTER 13

FUTURE DIRECTIONS

So far in this chapter we have discussed the current status with regard to various auditing issues that are important to MNCs. In this section, we provide some thoughts on the likely future developments. We identify them in terms of consumer demand for auditing, increased competition in the audit market, Big Four firms' continued high interest in the audit market, increased exposure of Big Four firms, a tendency toward a checklist approach, and the possibility that audit may not be the external auditor's exclusive domain.

Building robust corporate governance systems and processes, managing risk on a global scale, and complying with an increasingly vast web of regulatory requirements is difficult, costly, and time-consuming for MNCs.

The Sarbanes-Oxley Act (2002) has had a noticeable effect on corporate behavior, particularly in regard to disclosure of information. For example, a recent survey of 2,588 global companies found that 95 percent of U.S. companies (versus 65 percent in 2002) now report having a qualified financial expert on the audit committee (More details about rating of companies from different countries can be obtained at www.Gmiratings.com). However, in November 2004, a study of audit firm performance, based on interviews with 1,007 audit committee chairs and 944 CFOs, indicated that there was a significant angst among them. Top management was concerned about the costs, in terms of money and time, of implementing the extensive requirements of Sarbanes-Oxley Act (2002). Audit committee chairs were feeling the pressure of increased accountability of the required financial reporting process. Further, a survey conducted by Financial Executives International (FEI) found that the cost of complying with Sarbanes-Oxley Section 404 requirements was much more than companies expected. The Year 1 cost averaged $4.36 million, up 39 percent from the $3.14 million they expected to pay based on FEI's July 2004 cost survey.

Consumer Demand

Historically, the assurance opinion of the statutory auditor has been led by legislation rather than by consumer demand. In the future, however, there will be increasing demand to meet the needs of consumers at a global level (Percy, 1999). For example, with the disclosure of corporate information on

the Internet, auditors will be expected to find new ways of giving assurance on that information, which would not be limited to financial information, and on a real-time basis. A report published by the IASC in November 1999 concluded that there was a need for a generic code of conduct for Internet-based business reporting (Lymer et al., 1999). The report suggested that such a code should include conditions clearly setting out the information that is consistent with the printed annual report, which contains the audited financial statements. It also pointed out that the users of Internet-based reports are likely to be confused as to which part of the Web site relates to the audit report, signed off by an auditor. From the auditor's point of view, there is a risk involved when the financial report issued by the entity (on which the auditor provides an audit report) is materially misstated due to unauthorized tampering. This could put auditors at risk of legal action.

Attempts are being made to find solutions to some of these problems on a national basis. For example, according to recent legislation in Australia, stockholders are allowed to put questions in writing to auditors in advance of the annual general meeting. However, it appears that governments have now realized the importance of collective action at the international level in this area.

Reporting on the Internet

The AICPA and the CICA have developed a set of principles and criteria to provide assurance services in the area of electronic business. Accordingly, public accounting firms and practitioners, who have a Web Trust business license from an authorized professional accounting body, can provide assurance services to evaluate and test whether a particular Web site meets these principles and criteria. The AICPA/CICA initiative has received international recognition as a major development (For example, the third version of CICA/AICPA Web Trust principles is available at www.accounting education.com/news/news497.html).

Increased Competition in the Audit Market

In the current global environment, auditor independence in the traditional sense is becoming increasingly problematic as both the audit firms and their clients grow in size and complexity. While the Sarbanes-Oxley Act (2002) has proposed more stringent independence standards, including some restrictions on the delivery of audit and nonaudit services to the same client, the Big Four international auditing firms need to ensure that they are independent both in fact and in perception. This is critical because the perception of a lack of independence will reduce the quality premium the Big Four firms are able to charge their clients and will open the audit market to more competition.

The whole area of systems, particularly technological systems, demands

an assurance of their effectiveness. In addition, there is an increasing demand for assurance on the effectiveness and quality of management arrangements and corporate governance. These new demands will require new skills. This will also encourage those not trained in accountancy, but trained in investigative matters in other areas, such as the environment and technology, to develop into a competitive force. In other words, nonaccounting groups may enter the audit market, which traditionally has been the domain of the accounting profession, protected by statutory franchise.

Continued High Interest in the Audit Market

Because they have a virtual monopoly of the large-firm audit market, the Big Four have been able to use this market to build their brands. They audit the world's largest 100 companies, with market capitalization ranging from US$31 billion to $273 billion (see www.iasc.org.uk/frame/cen1_9.htm). The audit market will remain central to the Big Four firms' operations because it helps them to maintain their brands. This will continue to be the case in the future, as it will be more difficult for the large firms to develop a reputation for perceived quality and build brands in the nonaudit market given that they are competing against recognized competitors with their own brands, such as McKinsey and Boston Consulting Group. Thus, even though the audit market is not extremely profitable, it will be in the interest of the Big Four to protect this market from the encroachment of competitors.

Increased Exposure of the International Auditing Firms

Becoming more global also means becoming more visible. The Big Four international auditing firms audit MNCs listed in numerous jurisdictions, and as these companies grow and become more globalized, the Big Four are increasingly coming under the watchful eye of global financiers and regulatory institutions.

The Big Four accounting firms, which together audit more than 90 percent of the world's largest businesses, can expect a more intense focus on their activities than at any time since the aftermath of the scandals at Enron, WorldCom, and Parmalat. There will be renewed interest in what users can expect from an audit. The audit firms need to recognize that the nature of business has changed. It is quicker, more connected, more global, and very different to the nature of business in the last century. Questions such as these will be the subjects of discussion and debate:

Have auditors kept pace with changes in the nature of business?

Do auditors, like rating agencies, suffer from a potential conflict of interest because they are paid by those they judge?

Particularly, with such big fees available, it is likely that politicians and regulators will be considering whether auditors face a temptation to sign off on practices that meet the rules but may present a misleading picture.

Tendency toward a Checklist Approach

The advent of litigation and the need for efficiency and effectiveness has driven the audit in some cases to be led more by process than by judgment. Given the various codes of corporate governance, regulations, and auditing standards and guidelines, there is a tendency for auditors to use a checklist approach in order to protect themselves from litigation (Percy, 1999).

Auditing No Longer Only the Domain of the External Auditor

Given the increased attention on corporate governance and the resulting changes to corporate structures in recent years, no longer is auditing only the domain of the external auditor. The audit function is increasingly becoming a process that involves a partnership between the audit committee, internal auditors, and external auditors.

Different Corporate Governance Models

Currently, the UK model of splitting the roles of chairperson and chief executive is taking hold globally. As recently as 2002, more than half of incoming chief executives at North American and European companies also chaired their company's board. In 2009, that number fell to less than 17 percent in North America and 7 percent in Europe. UK good governance guidelines have long advocated splitting the job to strengthen the board's oversight role. This can be described as the *globalization of governance.* There is also growing use of the Japanese "apprenticeship" model, in which the outgoing chief executive is promoted to chairperson to oversee his or her replacement. In Japan, this happens in 75 percent of companies. This happened in more than 40 percent of North American companies in the 2005–2009 period, up from 30 percent in the prior five years.

Summary

1. Recent corporate disasters have prompted regulatory measures that emphasize the importance of assurance services as essential ingredient in establishing and maintaining investor confidence in markets through corporate governance.
2. Over the years, the international aspects of auditing have received relatively less attention among policymakers and researchers, compared to the international accounting standards.
3. MNCs are realizing the need to pay attention to corporate governance issues in their efforts to succeed in increasingly competitive global markets.
4. The role of the external auditor can vary in different countries. For example, the role of the statutory auditors in Germany is much broader

than that of their counterparts in the United Kingdom or the United States.

5. Corporate structure is an important factor that determines the purpose of external audit. For example, some European countries have a two-tiered corporate structure, with a supervisory board and a management board. The supervisory board has general oversight function over the performance of the management board and the basic function of the statutory auditor is to assist the supervisory board. This is different from the situation that exists in Anglo-Saxon countries.
6. Audit quality is likely to vary in different audit environments, and the audit environments in different countries are determined by cultural, legal, financing, and infrastructural factors.
7. The approaches taken to regulate the audit function in different countries range from heavy reliance on the profession, for example, in the United Kingdom, to heavy reliance on the government, for example, in China.
8. The nature of the audit report varies depending largely on the legal requirements in a particular country and the listing status of the company concerned.
9. The responsibility for harmonizing auditing standards internationally rests mainly with the International Federation of Accountants (IFAC).
10. Auditors are subject to civil liability, criminal liability, and professional sanctions.
11. Different approaches have been taken in different countries to deal with the issues concerning the auditor’s liability to third parties, and the principle of joint and several liability.
12. Recently many countries have turned increased attention to audit committees as an important instrument of corporate governance.
13. Currently, regulators in the United Kingdom, the United States, and some other countries have placed emphasis on public oversight bodies to monitor issues of auditor independence.
14. Large auditing firms have adopted a policy of splitting the auditing and non-auditing work into separate entities as a way of demonstrating independence.
15. Internal auditing is an integral part of multinational business management, as it helps restore/maintain credibility of the business reporting system. The demand for internal auditing has grown during the past three decades, particularly due to regulatory and legislative requirements in many countries.

Rewiew questions

1. What are the current trends in consumer demand for international auditing?
2. What increase competition in the Audit Market?
3. What contributes to the continuation high interest in the Audit Market?
4. Why is the influence of international audit firms increasing?
5. What is the role of online reporting for the development of international audit?

Problems

1. Refer to the Report of Independent Auditors of Unilever NV and Unilever PLC, signed on 1 March 2005 (see the appendix to this chapter). Required: Identify the features in the above audit report that are unique to an MNC.
2. ISA 700 describes three types of audit opinions that can be expressed by the auditor when an unqualified opinion is not appropriate: qualified, adverse, and disclaimer of opinion. Required: What are the circumstances under which each of the above three opinions should be expressed? ISA700 is accessible from the IFAC Web site (www.ifac.org).
3. Internationally, legislators and professional bodies have focused on corporategovernance issues in making recommendations for restoring investor confidence, and auditing is an essential part of corporate governance.Required:Explain the link between auditing and corporate governance.
4. Some commentators argue that the two-tiered corporate structure, with a management board and a supervisory board, prevalent in many Continental European countries, is better suited for addressing corporate governance issues,including the issue of auditor independence, compared to that with one boardof directors prevalent in Anglo-Saxon countries. Required: Evaluate the merits of the above argument.
5. There is a unique ownership structure of many former stateowned enterprises in China, which have been redefined to create new economic entities. Required: Describe the uniqueness of the ownership structure of the entities mentioned above, and explain its implications for auditing.
6. There is the concept of accounting infrastructure, which encompasses the various environmental factors affecting the issues concerning auditing in a particular country. Required: Explain the environmental

factors that affect the issues concerning auditing in your own country.

7. The establishment of the Public Company Accounting Oversight Board (PCAOB) in 2002 was a major step toward strengthening the auditing function in the United States. Required: What can the PCAOB do to strengthen the auditing function in the United States? Provide examples of two key steps it has taken so far to achieve this.
8. In Anglo-Saxon countries, mechanisms are put in place to regulate auditors within the framework of professional self-regulation, whereas in many Continental European countries, quasi-governmental agencies play a major role in this area. Required: (a) Briefly describe the main differences between the audit regulation mechanisms in the United States and Germany, (b) Compare the audit regulation mechanisms in the United States and the United Kingdom.
9. The responsibility for harmonizing auditing standards across countries rests with IFAC. Required: Comment on some of the problems faced by IFAC in achieving the above goal.
10. There is no agreement internationally on how to address the issue of auditor liability. Required: Describe the approach taken in your own country in addressing the issue of auditor liability, and explain the rationale behind that approach.
11. The UK Corporate Governance Code takes the "comply or explain" approach. Required: (a) Describe the main features of the comply or explain approach to corporate governance, (b) Why do think this approach seems to be popular internationally?

Case 13.1. Director's dilemma: chairman's conflict of interest

The scenario

David is a long-standing expert in the airline business. He has been non-executive chairman of a large listed low-cost airline, RA plc, for 16 years. A recent Sunday newspaper has revealed that David's own multi-million dollar investment company, which he co-founded some years ago, is a bidder for an airport that is up for sale. RA plc is the airport's biggest customer and has, until recently, also been interested in buying the airport.

Question: Should the chairman, through his investment company, bid for the airport that is up for sale?

Analysis – issues to consider/debate:

1. Is David a suitable chairman of RA plc?
2. Does David have a conflict of interest?
3. If David has a conflict of interest, how should it be handled at the

RA plc board?
4. If David has a conflict of interest, how should it be handled at his investment company board?
5. What are the issues concerning this matter from the managing director of RA plc's point of view?
6. What are the issues concerning this matter from the board of RA plc's point of view?

Formulating a course of action

This dilemma is in that the conflict of interest relates to the chairman. The chairman does not currently have a conflict of interest. There is no evidence that the chairman influenced RA plc in dropping its interest in buying the airport. However, the proposed transaction through his company could potentially result in a conflict of interest, arising from RA plc being the biggest customer of the airport the chairman's company is contemplating buying. This conflict of interest is not directly between the chairman and the company, RA plc. Rather, it potentially arises indirectly because of the chairman's potential ownership (through his investment company) of a supplier to RA plc.

Identification of key parties to the dilemma.

There are four key parties to this dilemma:

Chairman David: It appears that the chairman of the board may be contemplating a transaction which, if it proceeds, could introduce a significant conflict of interest for him.

It is not clear that buying another company that has a relationship with RA plc involves an insurmountable conflict of interest for the chairman. Inevitably, from time to time, directors may have a conflict of interest with their company. However, in this case, pricing of the airport services to RA plc is at the heart of the conflict of interest and is fundamental. Thus, it appears that the conflict of interest for David if his company purchases the airport could be so systematic as to suggest his continuing position on the RA plc board would be inappropriate.

If David's company decides to go ahead with the tender, should David remain on the board of RA plc at that stage?

The wording of the dilemma ('A recent Sunday newspaper has revealed') implies that information on the proposed transaction may not have been known to the board prior to the newspaper article. Such information asymmetry between the chairman and his board may undermine trust on the board.

Board terms of reference documents usually set out how such occasional conflicts of interest are to be handled. They are usually handled by conflicted directors not receiving board papers relating to the issue of conflict, not

receiving minutes of meetings recording how the issue was dealt with by the board and absenting themselves from parts of the meeting where the issue of conflict is being discussed.

Senior independent director (see below): This non-executive director should act as mediator between the views of the chairman and the views of other directors on the board.

Other directors: Other directors will have to make their views known on the proposed transaction, possibly through the senior independent director. If the transaction takes place, other directors should require full transparency to the shareholders of the event.

External auditors: If the transaction goes ahead, it may have to be disclosed in the annual report as a related party transaction and be subject to questioning at the next annual general meeting. Obtaining the advice of the finance director, supported possibly by advice from/briefing by the external auditors to the board as part of their audit, on the disclosures required by law and by accounting standards would ensure directors have clarity on the consequences of the transaction proceeding.

Legal regulations to be considered and any pertinent associated case law

IAS 24 Related Party Disclosures requires the disclosure of related party transactions. In defining related parties, a distinction is made between persons and entities who are related parties. A person (e.g., David, the chairman) who is a director is a related party of the company. An entity is a related party of the company where the entity is controlled or jointly controlled by a director of the company. It would appear, therefore, that David's company is a related party to RA plc. The entity is David's own, which he co-founded, and therefore is probably controlled by him. The consequences of RA plc and David's entity being related parties is that the transactions between the two will have to be disclosed in the annual financial statements. This could cause proprietary information (i.e., valuable private commercial information) to be revealed publicly

Guidance from codes of best practice such as The UK Corporate Governance Code

Supporting principle A.1 of The UK Corporate Governance Code states that 'All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties', which are set out in the Companies Act 2006 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 2006).

Code provision A.4.1 of The UK Corporate Governance Code requires (on a comply-or-explain basis) the appointment of one of the independent non-executive directors as senior independent director. The role of the senior

independent director is inter alia to act as a sounding board for the chairman, as an intermediary for the other directors and as an extra channel of communication for shareholders (in addition to the managing director and chairman) for unresolved concerns.

David has been serving as chairman for 16 years. Code provision A.3.1 of The UK Corporate Governance Code requires (on a comply-or-explain basis) the chairman on appointment to meet the seven independence criteria under Code provision B.1.1. One of these is service on the board of more than nine years. Given the chairman's tenure, should the board be considering succession planning for this role?

Application of ethical principles

It is not clear from this dilemma that there is an insurmountable conflict of interest in this case. If David's company purchases the airport, this will result in a conflict of interest, which of itself is not unethical. It is a question of how the conflict of interest is handled. David will be privy to detailed financial information concerning RA plc. A supplier (such as David's company) to RA plc with such detailed financial information could use the information to its advantage. For example, there is a risk that the detailed financial information could be used during pricing negotiations with RA plc. This suggests that the conflict of interest in this dilemma is systematic. All board meetings of RA plc would consider detailed financial information of RA plc. It would be inconceivable for the chairman to have to leave every meeting of RA plc. It would be unworkable for the chairman not to receive financial information on RA plc.

Case 13.2. Director's dilemma: trade-offs between conflicting objectives

The scenario

You are a non-executive director of a railway company charged with running trains and managing the railway track infrastructure. Passenger safety is a regular topic on the board agenda. Passengers have persistently complained about the high price of train fares, and this has also attracted adverse newspaper coverage.

The company's chief transport officer has tabled a significant and very material capital expenditure project for the forthcoming board agenda. The proposal is to install a very expensive cutting-edge, state-of-the-art signalling system. The railway company will have the best and safest system in the world if the project goes ahead. The effect of the plan will be to significantly increase journey cost.

Included in the board papers is a survey of passengers who, asked their

views on a more expensive transport system and a safer signalling system, have overwhelmingly chosen the less expensive option. Passengers have indicated that if prices go up they will move to a cheaper supplier, which has experienced a number of accidents resulting in serious injuries of its passengers.

Question: Would you approve more expensive but much safer equipment which would result in loss of business because of higher prices?

Analysis – issues to consider/debate:

1. What are the commercial issues at play in this dilemma?
2. What are the trade-offs at play in this dilemma?
3. What are the risks and rewards of approving/not approving the capital expenditure proposal?
4. As a non-executive director, what are your responsibilities and how would you prioritise these?
5. Would you approve the capital expenditure proposal, and why/why not?

Formulating a course of action

This dilemma entails cost-benefit trade-offs which involve issues of company performance, governance, reputation and ethics. In a nutshell, the trade-offs involve profitability versus customer/passenger safety. Resolving the trade-offs is a matter of judgement for the board of directors. As the network railway infrastructure and train companies are separated in the UK, this dilemma would not arise in that jurisdiction. Identification of key parties to the dilemma

There are two key parties to this dilemma:

Board of directors: The board is presented with a decision trading off significantly increased costs and likely reduced profitability in favour of passenger safety which passengers have indicated in a survey they will not pay for. The board needs to exercise scepticism and challenge the results of the survey. The results of such a survey are likely to be influenced by how the survey questions have been framed. Were the questions asked in a different manner would the results have been the same? Were the railway company itself to experience a significant railway accident in the future, and it were to come to light the board had not approved an expenditure on passenger safety, judgement of the board's decision is likely to be adversely affected by subsequent events not existing at the time of the decision. If the board chooses to invest in the safer signalling system, it might make this a unique selling point of the company and promote the company's services as safer than the competition.

Customers/passengers: In addition, passengers might answer the questions differently were there to be a significant railway accident in the

future. What people say in a questionnaire survey cannot be relied upon, as passenger views may change, and would certainly change in the event of an accident.

Legal regulations to be considered and any pertinent associated case law

It is beyond the scope of this report to discuss the detailed laws and regulations on health and safety. Under Section 37 of the Health and Safety at Work etc. Act 1974, in the event a company is found to have committed an offence under the Act, with the consent, connivance or neglect of a director, manager or secretary those parties are guilty of an offence. Obtaining convictions against individuals under this legislation can be difficult. The Corporate Manslaughter and Corporate Homicide Act 2007 introduced the offence of Corporate Manslaughter but only companies not directors can be found liable under the legislation.

In the recent case of Lion Steel where an employee fell through a roof, the managing director, finance director and one other director were charged with health and safety offences and with gross negligence manslaughter. Following a hastily convened board meeting, the directors instructed the company to plead guilty to the charge of corporate manslaughter. The company was fined £480,000.

Guidance from codes of best practice such as The UK Corporate Governance Code

The UK Corporate Governance Code (Financial Reporting Council, 2018) advocates a long-term perspective for board decisions, referencing the phrase ‘long-term success’ a number of times.

The FRC’s Guidelines on Board Effectiveness (Financial Reporting Council, 2011) warns against boards paying insufficient attention to risk in making decisions.

Application of ethical principles

This dilemma deals with the trade-off between monetary rewards versus human safety. Which is more important: profit or human life? It also involves consideration of short-term versus long-term interests. Monetary rewards are current and measurable. The risk of an accident is in the future and contingent. It could be argued that in the long term, safer railways may attract more passengers.

Case 13.3. Director’s dilemma: gifts

The scenario

You are a non-executive director in an engineering company that prides itself on having impeccable ethical standards. In December, you hear from a

staff member in the organisation that around Christmas time employees receive gifts from clients. This is a norm in the industry. The gifts range from boxes of chocolates/bottles of wine, to cases of wine and other drinks, to gift certificates and cash. As the company operates in countries all over the world, such gifts are a feature of doing business in those parts of the world. Further, to refuse such gifts would cause extreme offence to clients, as a result of which the engineering company would lose business.

Question: As a non-executive director, what is your view of employees receiving gifts at Christmas?

Analysis – issues to consider/debate

1. How should boards/board members handle hearsay?
2. What high level principles would you apply in this dilemma?
3. What policies, processes and procedures of the company would you consult in this matter?
4. What policies, processes and procedures of the company would you expect to be in place in this matter?
5. What are the arguments for and against the company's staff receiving gifts at Christmas?
6. How should the gifts received this coming Christmas be handled?

Formulating a course of action

The giving and receiving of gifts are common in business – more common in some countries than in others. While the monetary amounts involved may be quite small, it is important to treat gifts properly, given their influence on the culture and ethics in the business. There are legal and reputational risks to companies as a consequence of inappropriate treatment of gifts. Staff also need to be protected from allegations of inappropriate behaviour. Identification of key parties to the dilemma

There are three key parties to this dilemma:

Board of directors: A key role of the board is to set the tone at the top. Although the amounts involved may not be material, gifts and hospitality are particularly important for the board to handle properly in setting the tone at the top. Does the company have a policy on gifts, hospitality, favours, sponsorship and entertainment? The policy should cover gifts offered, given, provided or accepted by employees and their family members. The policy should cover cash and non-cash items. The board has to consider whether a blanket prohibition on gifts is appropriate or whether gifts up to a certain value are acceptable. The policy should ensure that no gift could be construed as a bribe or payoff, and that any gifts do not violate laws or regulations. Gifts might be pooled within the organisation such that no individual could be accused of being influenced by a gift. Alternatively, gifts could be auctioned at the Christmas Party for charity.

Management: If there is a policy on gifts, favours and entertainment, management must ensure that the policy is robustly implemented. Implementation may involve a carrot-and-stick approach. In particular, for employees found to have breached the policy, sanctions may be appropriate. Management may also have to introduce training for employees to ensure that they understand the policy in practice.

Employees: In an industry where gifts are the norm, and where offence may be taken if employees do not accept a gift, the employer has a duty to protect employees through implementing an appropriate policy and guidelines for employees. This may entail keeping a register of gifts received/offered/accepted.

Legal regulations to be considered and any pertinent associated case law

The Bribery Act 2010 (OECD, 1997) applies to UK companies and includes their operations outside the UK. Lavish gifts and hospitality could be caught under this legislation. In 2012, ICAS and the Serious Fraud Office provided guidance on gifts and hospitality under the Act. While recognising that bona fide hospitality or promotional or other legitimate business expenditure is an established and important part of doing business, the guidance warns that bribes are sometimes disguised as legitimate business expenses.

Guidance from codes of best practice such as The UK Corporate Governance Code

The introduction to The UK Corporate Governance Code (Financial Reporting Council, 2018) observes that the board's actions are subject to laws, regulations and shareholders in general meetings. Thus, the board should ensure that the company's policies on gifts and hospitality meets legal requirements. A requirement of The UK Corporate Governance Code is for the board to set the values of the company. These values should be reflected in a company policy on gifts and hospitality. A strong policy on gifts and hospitality is also likely to protect the company's reputation.

Application of ethical principles

Part C of ICAS's Code of Ethics addresses the issue of inducements for professional accountants. Inducements include gifts, hospitality, preferential treatment, and inappropriate appeals to friendship or loyalty. Offers of inducements may create threats to compliance with the Codes' five fundamental principles. The existence and significance of any threats will depend on the nature, value and intent behind the offer. If a reasonable and informed third party, weighing all the specific facts and circumstances, would consider the inducement insignificant and not intended to encourage unethical behaviour, then a professional accountant in business may conclude

that the offer is made in the normal course of business and may generally conclude that there is no significant threat to compliance with the fundamental principles. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in business shall not accept the inducement. A professional accountant in business is advised under the Code to evaluate any threats created by such offers and determine whether to take one or more of the following actions:

- inform higher levels of management or those charged with governance;
- inform third parties of the offer – for example, ICAS or the employer of the individual who made the offer – which may involve seeking legal advice before taking such a step;
- advise immediate or close family members of relevant threats; and
- inform higher levels of management or those charged with governance of the employing organisation of immediate or close family members.

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revie.pdf

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Appendix A
CORPORATE GOVERNANCE CODES AROUND THE WORLD

Africa

Ghana
https://thelawreviews.co.uk/edition/the-corporate-governance-review-edition-8/1168924/Ghana

Kenya
www.ecgi.org/codes/documents/principles_2.pdf

Malawi
www.ecgi.org/codes/documents/malawi_codeii_1jun2010_en.pdf

Nigeria
www.ecgi.org/codes/documents/cg_code_nigeria_oct2003_en.pdf

South Africa
www.ecgi.org/codes/documents/king3.pdf

Tunisia
www.ecgi.org/codes/documents/guide_tunisia_2008_en.pdf

Asia and Australia

Australia
www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

China (PRC)
www.ecgi.org/codes/documents/code_en.pdf

Hong Kong (Special Administrative Region (SAR) of China)
www.hkex.com.hk/-/media/hkex-market/listing/rulesand-guidance/listing-rules-contingency/main-boardlisting-rules/appendices/appendix_14

India
www.ecgi.org/codes/documents/final_code_english.pdf

Indonesia
www.ifc.org/wps/wcm/connect/topics_ext_contentifc_external_corporate_site/ifc+cg/resources/toolkits+and+manuals/indonesia+corporate+governance+manual%2C+2nd+edition

Japan
https://www.jpx.co.jp/english/listing/cg-search/

Malaysia
https://home.kpmg/content/dam/kpmg/my/pdf/External/mccg2017.pdf

New Zealand
https://fma.govt.nz/assets/Reports/141201-FMA-Corporate-Governance-Handbook-Principles-and-Guidelines2014.pdf

Pakistan
www.secp.gov.pk/corporate-governance/listed-companies
Philippines
www.chanrobles.com/secmemorandumcircularno022002.html#.XEQ64dL7SM8
(Take care if you Google for the official governmentcode: it has had a Trojan problem.)
Singapore
www.mas.gov.sg/Regulations-and-Financial-Stability/Regulatory-and-Supervisory-Framework/Corporate-Governance/Corporate-Governance-of-Listed-Companies/Code-of-Corporate-Governance.aspx
South Korea
www.ecgi.org/codes/documents/cbp_korea_2003_en.pdf
Sri Lanka
http://www.sec.gov.lk/wp-content/uploads/code%20of%20best%20practice%20-%202013.pdf
Taiwan
www.carrotsandsticks.net/regulation/corporate-governance-best-practice-principles-for-tsecgtsm-listedcompanies
Thailand
https://ecgi.global/node/6197

Europe

Austria
https://www.omv.com/en/about-us/corporate-governance/corporate-governance-code
Baltic States
https://ecgi.global/code/governance-state-owned-enterprises-baltic-states-2012Customer
Belgium
www.corporategovernancecommittee.be/en/about-2009-code/2009-belgian-code-corporate-governance
Bosnia Herzegovina
http://documents.worldbank.org/curated/en/675461468202759670/Bosnia-and-Herzegovina-Report-on-the-Observance-of-Standards-and-Codes-ROSC-corporate-governance-country-assessment
Croatia
https://www.ebrd.com/news/2017/croatia-pushes-for-better-corporate-governance-standards.html
Cyprus
www.cse.com.cy/en-GB/regulated-market/listing/corporate-governance
Czech Republic

www.ecgi.org/codes/documents/czech_code_2004_en.pdf
Denmark
www.ecgi.org/codes/documents/haa_kap05-01uk.pdf
Estonia
http://www.oecd.org/corporate/ca/corporategovernanceprinciples/1931752.pdf
European Union
https://ec.europa.eu/info/business-economy-euro/doing-business-eu/company-law-and-corporate-governance_en
Finland
https://cgfinland.fi/wp-content/uploads/sites/6/2012/01/finnish-cg-code-2010.pdf
France
https://rubis.fr/en/group/corporate-governance/french-corporate-governance-code
Georgia
www.ecgi.org/codes/documents/cg_code_commercial_banks_georgia_sep2009_en.pdf
Germany
https://dcgk.de//files/dcgk/usercontent/en/download/code/170214_Code.pdf
Greece
www.ecgi.org/codes/documents/hellenic_cg_code_oct2013_en.pdf
Hungary
https://iclg.com/practice-areas/corporate-governancelaws-and-regulations/hungary
Iceland
www.ecgi.org/codes/documents/iceland_corporate_governance_guidelines_5th_edition_2015.pdf
Ireland
www.centralbank.ie/regulation/how-we-regulate/codes
Kazakhstan
www.ecgi.rg/codes/documents/cg_code_kazakhstan_21feb2005_en.pdf
Latvia
http://www.oecd.org/latvia/corporate-governance-in-latvia-9789264268180-en.htm
Lithuania
www.ecgi.org/codes/documents/code_lithuania.pdf
Luxembourg
www.bourse.lu/corporate-governance
Malta
https://www.mfsa.mt/publications/corporate-publications/corporate-

governance/
Montenegro
www.ecgi.org/codes/documents/montenegro_may2009.pdf
The Netherlands
www.mccg.nl/?page=3779
Norway
https://www.oslobors.no/ob_eng/Oslo-Boers/Listing/Shares-equity-certificates-and-rights-to-shares/Oslo-Boers-and-Oslo-Axess/Corporate-governance-CG/The-Norwegian-Code-of-Practice-for-Corporate-Governance
Poland
https://iclg.com/practice-areas/corporate-governancelaws-and-regulations/poland
Portugal
https://thelawreviews.co.uk/edition/the-corporate-governance-review-edition-7/1140926/portugal
Romania
https://bvb.ro/info/Rapoarte/Diverse/ENG_Corporate%20Governance%20Code_WEB_revised.pdf
Russia
www.ebrd.com/downloads/legal/corporate/russia_code.pdf
Serbia
www.ecgi.org/codes/documents/cg_code_serbia_jul2008_en.pdf
Slovakia
www.ecgi.org/codes/documents/cega_code_slovakia_jan2008_en.pdf
Slovenia
https://www.sdh.si/Data/Documents/asset-management/Slovenian_CG_Code_listed_companies_2016.pdf
Spain
www.cnmv.es/DocPortal/Publicaciones/CodigoGov/Good_Governanceen.pdf
Sweden
www.corporategovernanceboard.se/UserFiles/Archive/496/The_Swedish_Corporate_Governance_Code_1_December_2016.pdf
Switzerland
https://ecgi.global/code/swiss-code-best-practice-corporate-governance-0
Turkey
https://iclg.com/practice-areas/corporate-governancelaws-and-regulations/turkey
Ukraine
www.oecd.org/daf/ca/corporategovernanceprinciples/1930958.pdf

United Kingdom
https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf

Middle East

Bahrain
http://cbb.complinet.com/cbb/display/display.html?rbid=3274&element_id=1
Israel
www.isa.gov.il/Download/IsaFile_1124.pdf
Lebanon
www.ecgi.org/codes/documents/lebanon_cgcode_2010_en.pdf
Qatar
www.ecgi.org/codes/documents/cgcode_listed_companies_qatar_27jan2009_en.pdf
Saudi Arabia
https://ecgi.global/code/corporate-governance-regulations-kingdom-saudi-arabia-1
United Arab Emirates
http://www.rna-cs.com/corporate-governance-code-for-small-and-medium-enterprises-smes-of-united-arab-emirates-uae/

North America

Canada
https://tsx.com/listings/tsx-and-tsxv-issuer-resources/tsx-issuer-resources/corporate-governance
Mexico
www.ecgi.org/codes/documents/mexico_code_en.pdf
United States
https://iclg.com/practice-areas/corporate-governance-laws-and-regulations/usa

South America and the West Indies

Argentina
www.oecd.org/corporate/ca/corporategovernanceprinciples/37329786.pdf
Brazil
www.ibri.com.br/Upload/Arquivos/novidades/3877_GT_Interagentes_Brazilian_Corporate_Governance_Code_Listed_Companies.pdf
Colombia
http://www.oecd.org/countries/colombia/corporate-governance-in-colombia-9789264281134-en.htm
www.oecd.org/corporate/ca/corporategovernanceprinciples/39741294.pdf

Jamaica
http://ocg.gov.jm/ocg/sites/default/files/Revised%20Corporate%20Governance%20Framework%20%28Oct%202012%29_0.pdf
Peru
https://www.oecd-ilibrary.org/governance/corporate-governance-of-company-groups-in-latin-america/peru_9789264241725-9-en

Appendix B
COCA-COLA COMPANY AND SUBSIDIARIES

Extract from Form 10-K Report for the fiscal year ended December 31, 2008

Report of Management on Internal Control over Financial Reporting

Management of the Company is responsible for the preparation and integrity of the consolidated financial statements appearing in our annual report on Form 10-K. The financial statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances and, accordingly, include certain amounts based on our best judgments and estimates. Financial information in this annual report on Form 10-K is consistent with that in the financial statements.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934 ("Exchange Act"). The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the consolidated financial statements. Our internal control over financial reporting is supported by a program of internal audits and appropriate reviews by management, written policies and guidelines, careful selection and training of qualified personnel and a written Code of Business Conduct adopted by our Company's Board of Directors, applicable to all officers and employees of our Company and subsidiaries. In addition, our Company's Board of Directors adopted a written Code of Business Conduct for Non- Employee Directors which reflects the same principles and values as our Code of Business Conduct for officers and employees but focuses on matters of most relevance to non-employee Directors.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and, even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Audit Committee of our Company's Board of Directors, composed solely of Directors who are independent in accordance with the

requirements of the New York Stock Exchange listing standards, the Exchange Act and the Company's Corporate Governance Guidelines, meets with the independent auditors, management and internal auditors periodically to discuss internal control over financial reporting and auditing and financial reporting matters. The Audit Committee reviews with the independent auditors the scope and results of the audit effort. The Audit Committee also meets periodically with the independent auditors and the chief internal auditor without management present to ensure that the independent auditors and the chief internal auditor have free access to the Audit Committee. Our Audit Committee's Report can be found in the Company's 2009 Proxy Statement.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2008. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Based on our assessment, management believes that the Company maintained effective internal control over financial reporting as of December 31, 2008.

The Company's independent auditors, Ernst & Young LLP, a registered public accounting firm, are appointed by the Audit Committee of the Company's Board of Directors, subject to ratification by our Company's shareowners. Ernst & Young LLP has audited and reported on the consolidated financial statements of The Coca-Cola Company and subsidiaries and the Company's internal control over financial reporting. The reports of the independent auditors are contained in this annual report.

Muhtar Kent
President and Chief Executive Officer
February 26, 2009
Gary P. Fayard
Executive Vice President and Chief Financial Officer
February 26, 2009
Harry L. Anderson
Vice President and Controller
February 26, 2009

Appendix C
COCA-COLA COMPANY AND SUBSIDIARIES

Extract from Form 10-K Report for the fiscal year ended December 31, 2008

Report of Independent Registered Public Accounting Firm On Internal Control over Financial Reporting

Board of Directors and Shareowners
The Coca-Cola Company

We have audited The Coca-Cola Company's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Coca-Cola Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Report of Management on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the

assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, The Coca-Cola Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of The Coca-Cola Company and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, shareowners' equity, and cash flows for each of the three years in the period ended December 31, 2008, and our report dated February 26, 2009 expressed an unqualified opinion thereon.

Ernst & Young LLP
Atlanta, Georgia
February 26, 2009

Appendix D
EXAMPLES OF 2009 AUDIT REPORTS FROM MULTINATIONAL CORPORATIONS

The following audits were prepared in accordance with the requirements in the United States, Japan, Germany, the United Kingdom, the Netherlands and China.

INDEPENDENT AUDITORS' REPORT
China Southern Airline Co. Ltd
KPMG

Independent auditor's report to the shareholders of China Southern Airlines Company Limited

(Incorporated in the People's Republic of China with limited liability)

We have audited the consolidated financial statements of China Southern Airlines Company Limited (the "Company") and its subsidiaries (the "Group") set out on pages 46 to 138, which comprise the consolidated and company balance sheets as at 31 December 2009, and the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

The directors of the Company are responsible for the preparation and the true and fair presentation of these financial statements in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and the disclosure requirements of the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, selecting and applying appropriate accounting policies, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept

liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Company and of the Group as at 31 December 2009 and of the Group's financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the disclosure requirements of the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
The People's Republic of China
12 April 2010

INDEPENDENT AUDITORS' REPORT
China Eastern Airline Corp. Ltd

To the Shareholders of China Eastern Airlines Corporation Limited(incorporated in the People's Republic of China with limited liability)

We have audited the financial statements of China Eastern Airlines Corporation Limited (the "Company") and its subsidiaries (together, the "Group") set out on pages 66 to 164, which comprise the consolidated and Company balance sheets as at 31 December 2009, and the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

The Directors of the Company are responsible for the preparation and the true and fair presentation of these financial statements in accordance with International Financial Reporting Standards and the disclosure requirements of the Hong Kong Companies Ordinance. This responsibility include: designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and

appropriate to provide a basis for our opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the Company and the Group as at 31 December 2009, and of the Group's financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards and have been properly prepared in accordance with the disclosure requirements of the Hong Kong Companies Ordinance.

Other Matters

This report, including the opinion, has been prepared for and only for you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

PricewaterhouseCoopers
Certified Public Accountants
Hong Kong, 19 April 2010

INDEPENDENT AUDITORS' REPORT
Bayer Aktiengesellschaft, Leverkusen

Auditor's Report

We have audited the consolidated financial statements prepared by Bayer Aktiengesellschaft, Leverkusen, comprising the income statement and statement of comprehensive income, statement of financial position, statement of cash flows, statement of changes in equity and the notes to the consolidated financial statements, together with the group management report for the business year from January 1, 2009 to December 31, 2009, which is combined with the management report of the company. The preparation of the consolidated financial statements and the combined management report in accordance with the IFRS, as adopted by the E.U., and the additional requirements of German commercial law pursuant to § (Article) 315a Abs. (paragraph) 1 HGB ("Handeisgesetzbuch":

German Commercial Code (Germany. Federal Office of Justice, 1897) are the responsibility of the parent Company's Board of Management. Our responsibility is to express an opinion on the consolidated financial statements and on the combined management report based on our audit.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprьfer (Institute of Public Auditors in Germany) (IDW) and

additionally observed the International Standards on Auditing (ISA). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the combined management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the combined management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of the entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by the Company's Board of Management, as well as evaluating the overall presentation of the consolidated financial statements and the combined management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion based on the findings of our audit the consolidated financial statements comply with the IFRS as adopted by the E.U., the additional requirements of German commercial law pursuant to § 315a Abs. 1 HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The combined management report is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Essen, February 24, 2010
PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprьfungsgesellschaft
Armin Slotta
WirtschaftsprьferAnne Bцcker
Wirtschaftsprьferin

INDEPENDENT AUDITORS' REPORT
Sumitomo Metal Industries Ltd

Independent Auditors' Report

To the Board of Directors of Sumitomo Metal Industries, Ltd.:

We have audited the accompanying consolidated balance sheets of Sumitomo Metal Industries, Ltd. ("Sumitomo Metals") and consolidated subsidiaries as of March 31, 2009 and 2008, and the related consolidated statements of income, changes in equity, and cash flows for the years then ended, all expressed in Japanese yen. These consolidated financial statements are the responsibility of Sumitomo Metals' management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sumitomo Metals and consolidated subsidiaries as of March 31, 2009 and 2008, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in Japan.

Our audits also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 1. Such U.S. dollar amounts are presented solely for the convenience of readers outside Japan.

Deloitte Touche Tohaten
June 19, 2009

INDEPENDENT AUDITORS' REPORT
Toshiba Corporation

Report of Independent Auditors

The Board of Directors and Shareholders of Toshiba Corporation

We have audited the accompanying consolidated balance sheets of Toshiba Corporation and subsidiaries (the "Company") as of March 31, 2009 and 2008, and the related consolidated statements of income, shareholders' equity, and cash flows for the years then ended, all expressed in Japanese yen. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company's consoidated financial statements do not disclose segment information required by Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information." In our opinion, disclosure of segment information is required by U.S. generally accepted accounting principles.

In our opinion, except for the omission of segment information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Toshiba Corporation and subsidiaries at March 31, 2009 and 2008, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

We also have reviewed the translation of the consolidated financial statements mentioned above into United States dollars on the basis described in Note 3. In our opinion, such statements have been translated on such basis.

June 24, 2009
Ernst & Young Shinnikon LLC

INDEPENDENT AUDITORS' REPORT
Unilever PLC

Auditor's report United Kingdom
Independent auditors' report to the members of Unilever PLC on the consolidated financial stetements

We have audited the consolidated financial statements of the Unilever Group for the year ended 31 December 2009 which comprise the consolidated income statement, consolidated balance sheet, consolidated cash flow statement, consolidated statement of comprehensive income, consolidated statement of changes in equity, the related notes on pages 79 to 128, and principal group companies and non-current investments on pages 131 and 132. These consolidated financial statements have been prepared under the accounting policies set out in note 1 on pages 83 to 86. The financial reporting framework that has been applied in their preparation is applicable law and international Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of Directors and auditors

As explained more fully in the Statement of Directors' responsibilities set out on page 76, the directors are responsible for the preparation of the group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the consolidated financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the shareholders of Unilever PLC as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 2006). We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall

presentation of the financial statements.

Opinion on financial statements

In our opinion the Group financial statements:

• give a true and fair view of the state of the Group's affairs as at 31 December 2009 and of its profit and cash flows for the year then ended;

• have been properly prepared in accordance with IFRSs as adopted by the European Union; and

• have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Separate opinion in relation to IFRS as issued by the IASB. As explained in note 1 to the consolidated financial statements, the Group in addition to complying with its legal obligation to apply IFRSs as adopted by the European Union, has also applied IFRSs as issued by the IASB.

In our opinion the Group financial statements comply with IFRSs as issued by the IASB.

Opinion on other matter prescribed by the CompaniesAct 2006

In our opinion the information given in the Report of the Directors for the financial year for which the Group financial statements are prepared is consistent with the Group financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 2006) we are required to report to you if, in our opinion:

- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the Directors' statement, set out on page 76, in relation to going concern; and
- the part of the Corporate Governance statement relating to the company's compliance with the nine provisions of the 2008 Combined Code specified for our review.

Other matter

We have reported separately on the parent company accounts of Unilever PLC for the year ended 31 December 2009 and on the information in the Directors' Remuneration Report that is described as having been audited.

Richard Sexton
(Senior Statutory Auditor)
For and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London, United Kingdom
2 March 2010

INDEPENDENT AUDITORS' REPORT
Unilever N.V.

Auditor's report Netherlands
Independent auditor's report to the shareholders of Unilever N.V.
Report on the consolidated financial statements

We have audited the consolidated financial statements which are part of the Annual Report 2009 of the Unilever Group for the year ended 31 December 2009 which comprise the consolidated income statement, consolidated balance sheet, consolidated cash flow statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and the related notes on pages 79 to 128 and 131 to 132.

We have reported separately on the company accounts of Unilever N.V. for the year ended 31 December 2009.

Director's responsibility

The Directors are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union and as issued by the IASB and with Part 9 of Book 2 of the Netherlands Civil Code (DCL), and for the preparation of the Report of the Directors in accordance with Part 9 of Book 2 of the Netherlands Civil Code(DCL, 1992). This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audit. We conducted our audit in accordance with Dutch law. This law requires that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial

statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Unilever Group as at 31 December 2009, and of its result and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union and as issued by the IASB and with Part 9 of Book 2 of the Netherlands Civil Code(DCL, 1992).

Report on other legal and regulatory requirements

Pursuant to the legal requirement under 2:393 sub 5 part f of the Netherlands Civil Code(DCL, 1992), we report, to the extent of our competence, that the Report of the Directors is consistent with the consolidated financial statements as required by 2:391 sub 4 of the Netherlands Civil Code(DCL, 1992).

Rotterdam, The Netherlands, 2 March 2010
PricewaterhouseCoopers Accountants N.V.
R A J Swaak RA

INDEPENDENT AUDITORS' REPORT
Kubota Corporation

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Kubota Corporation:

We have audited the accompanying consolidated balance sheets of Kubota Corporation and subsidiaries (the "Company") as of March 31, 2010 and 2009, and the related consolidated statements of income, comprehensive

income (loss), changes in equity, and cash flows for each of the three years in the period ended March 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated June 19, 2009, we expressed a qualified opinion, because certain information required by Accounting Standards Codification ("ASC") 280, "Segment Reporting" was not presented in the consolidated financial statements for the years ended March 31, 2009 and 2008. As discussed in Note 1 to the consolidated financial statements, the Company has now presented the segment information required by ASC 280 for the years ended March 31, 2009 and 2008. Accordingly, our present opinion on the consolidated financial statements for the years ended March 31, 2009 and 2008, as expressed herein, is different from that expressed in our prior report on the previously issued consolidated financial statements for the years ended March 31, 2009 and 2008.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Kubota Corporation and subsidiaries as of March 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted a new accounting standard for noncontrolling interests during the year ended March 31, 2010.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of March 31, 2010, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 18, 2010 expressed an unqualified opinion on the Company's internal control over financial reporting.

Deloitte Touche Tohmatsu LLC
June 18, 2010

INDEPENDENT AUDITORS' REPORT
Cadbury PLC

We have audited the Group and Parent Company financial statements (the "financial statements") of Cadbury plc for the year ended 31 December 2008 which comprise the Group Income Statement, the Group Statement of Recognised Income and Expense, the Group and Parent Company Balance Sheets, the Group and Parent Company Cash Flow Statement, Group Segmental reporting (a) to (d) and the related notes 1 to 40.

These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with section 235 of the Companies Act 1985 (The United Kingdom of Great Britain and Northern Ireland. The Parliament, 1985).

Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The Directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and international Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements. Article 4 of the IAS Regulation. We also report

to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented elsewhere in the document that is cross referred from the Business Review section of the Directors' Report.

In addition we report to you if; in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the other information contained in the Annual Report as described in the contents section and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any further information outside the Annual Report.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

• the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended;

• the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2008;

• the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements. Article 4 of the IAS Regulation; and

• the information given in the Directors' Report is consistent with the financial statements.

Separate opinion in relation to IFRSs

As explained in Note 1(b) to the financial statements, the Group in addition to complying with its legal obligation to comply with IFRSs as adopted by the European Union, has also complied with the IFRSs as issued by the IASB.

In our opinion the Group financial statements give a true and fair view, in accordance with IFRSs, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended.

Deloitte LLP
Chartered Accountants and Registered Auditors
London, United Kingdom
24 February 2009

GLOSSARY

Agency theory argues that managers merely act as custodians of the organisation and its operational activities and places upon them the burden of managing in the best interest of the owners of that business. (p. 40)

Annual meeting of a corporation is a gathering of shareholders of the corporation. (p. 31)

Audit committee is responsible for ensuring that the company's financial statements and reports are accurate and use fair and reasonable estimates. (p. 31)

Board of directors is the highest governing authority within the management structure at a corporation or publicly traded business. (p. 29)

Corporate governance is the system by which companies are directed and controlled. (p. 7)

Creditors are a key stakeholder and the terms, volume and type of credit extended to firms will depend importantly on their rights and on their enforceability. (p. 231)

Ethics is the natural and structural process of acting in line with moral judgments, standards and rules. (p. 24)

European company or societas europaea (SE) is governed by European regulations and, for SE having their registered office in France, the legal regime applicable to the SA. (p. 51)

Fiduciary duty is the highest financial duty under American law. (p. 30)

Formal governance arrangements are based on established structures and processes. (p. 7)

Independent audit is an important tool for owners of all types of companies, since the auditors' main role is to verify whether the financial statements adequately reflect the real situation of the company. (p. 38)

Informal governance arrangements stem from the culture and values of the organization and are often influenced by the leaders of the organization. (p. 7)

ISO 26000 (Guidance on Social Responcibility) is the international standard intended to assist organizations in assessing effectively and addressing social responsibilities while respecting cultural, societal, environmental, and legal differences and economic development conditions. (p. 6)

Kabushiki kaisha (KK) is a stock company, the most common corporate entity form in Japan. (p. 51)

Moral hazard arises where it is difficult or costly for owners to observe or infer the amount of effort exerted by managers. (p. 40)

Proxy statement is a document containing the information the Securities and Exchange Commission (SEC) requires companies to provide to shareholders so they can make informed decisions about matters that will be brought up at an annual or special stockholder meeting. (p. 31)

Rating agency is a company that devises credit rating – assessments of the risk involved – for various financial instruments and their issuers. (p. 41)

Société à responsabilité limitée (SARL) is a traditional corporate form for closely held companies in France (e.g., familybusinesses). (p. 51)

Société anonyme (SA) is the most common corporate form for the largest companies (whether listed or not) in France. (p. 50)

Société en commandite par actions (SCA) is a much less common corporate form. (p. 50)

Société par actions simplifiée (SAS) is a very common corporate form for small and large non-listed companies (an SAS may not be listed) in France. (p. 50)

Stakeholders are such groups or individuals without whose support the organization would cease to exist and who can affect or is affected by the achievement of the organization’s objectives. (p. 21)

Stock buyback program is a process when a company choose to buy back shares of its stock. (p. 30)

Stock split is a decision by a company's board of directors to increase the number of shares that are outstanding by issuing more shares to current shareholders. (p. 30)

Електронне навчальне видання

Школа Вікторія Юріївна,
Троян Марія Юріївна,
Щербаченко Вікторія Олексіївна,
Касьяненко Тетяна Вячеславівна

КЕРІВНИЦТВО З КОРПОРАТИВНОГО УПРАВЛІННЯ ТА АУДИТУ: МІЖНАРОДНІ СТАНДАРТИ

Підручник
(Англійською мовою)

Редактор В. Ю. Школа
Комп'ютерне верстання М. Ю. Троян, В. О. Щербаченко

Стиль та офографія авторів збережені.

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Видавець і виготовлювач
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вул. Римського-Корсакова, 2, м. Суми, 40007
Свідоцтво суб'єкта видавничої справи ДК № 3062 від 17.12.2007.