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Agenda Item
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Committee: IAASB Consultative Advisory Group

Meeting Location: New York

Meeting Date: March 8–9, 2011

CAG Corporate Governance Working Group—Matters for CAG Consideration

Background

The past decade of business around the world has highlighted the role that corporate governance practices play in maintaining viable entities and safeguarding investor and other stakeholder interests. Corporate governance failures at some large multi-national entities illustrate the risks posed by corporate governance breakdowns. The global governance problems in the early part of the decade were characterized by a lack of transparency and controls.

Good corporate governance leads to better results for entities and shareowners. Corporate governance, therefore, is a factor that shareowners cannot ignore but should consider in seeking the best possible results for their investment decisions.

Corporate governance practices differ among countries, business cultures and through legislative action. However, despite these differences in practices, it is possible to identify a set of best practice.

Common Principles and Best Practices of Corporate Governance

Generally speaking good corporate governance practices seek to ensure that:

- Board Directors (Board) act in the best interests of shareowners—Note that in some jurisdictions this is a broader group (labor groups, society at large);
- The entity acts in a manner that is lawful and ethical;
- Shareowners have a right to participate in the governance of the entity. They are entitled to receive fair treatment from the board and management and all rights of shareowners and other stakeholders are clearly delineated and communicated;
- The Board and its committees are structured to act independently from management and individuals or entities that have control over management and other non-shareowner groups;
- Appropriate controls and procedures are in place covering management's activities in running the day-to-day operations of the entity;

- The entity's governance activities, as well as its operating and financial activities, are consistently reported to shareowners in a fair, accurate, timely, reliable, relevant, complete, and verifiable manner.

The following are some commonly considered best practices:

- The shareowners select a nominating committee which is responsible for identifying candidates for the Board.
- The nominating committee prepares a list of candidates for the board of directors. (The shareowners might not have adequate knowledge of the different candidates and therefore sometimes turn to proxy advisors.)
- The shareowners elect directors in the annual general meeting.
- The board of directors chooses a Chief Executive Officer (CEO) who in turn builds the management team.
- The directors create committees for specific tasks (e.g., audit committee, the remuneration or compensation committee, the nominations committee, etc.). From a governance point of view the most critical one is the audit committee. The audit committee's primary objective is to ensure that the financial information reported by the company to shareowners is complete, accurate, reliable, relevant and timely. All members of the audit committee should be independent (especially related to management). If the independence of the audit committee members is compromised, there could be doubts about the integrity of the financial reporting process and about the credibility of the company's financial statements. This could have an adverse impact on the company' financial performance and a detrimental impact on the company's share valuation which would be harmful to shareowners.
- The audit committee selects the auditor for approval by the Annual General Meeting.
- The audit committee maintains dialogue with the auditors during the course of their engagement.
- The manager of internal audit reports to the chairman of the audit committee. The independent auditor should not perform any non-audit services for the company.

Examples of Differences in Best Practices Existing Today

In reality there are many departures in best practices of corporate governance throughout the world. These differences make it difficult for shareowners and other stakeholders to assess the adequacy of the practices among entities in different jurisdictions.

Germany

The board (Aufsichtsrat) of large companies (> 2000 employees) consists of 10 members elected by the shareowners and 10 members elected by the employees (or their unions). The management (Vorstand) runs the company. There is no overlap between the board and the management.

Sweden

Swedish companies often have strong owners. The shareowners create the nominating committee that selects board candidates and auditors for the approval by the Annual General Meeting. Two or three board members are elected by the employees. The CEO is normally not a board member but normally participates (without voting rights) in the board meetings except for the "executive session".

UK

The board of directors basically used to consist of management. In the beginning of the corporate governance movement there was a strong tendency to appoint NEDs (non-executive directors). Most UK boards of directors are now mixed.

USA

Shareowners have no or limited proxy access (e.g. to put proposals on the agenda of the Annual General Meeting) and can only vote yes, no or abstain on proposals from the board. The Chairman of the board is normally also CEO. Other executives might also be board members. Independent auditors are sometimes selected by the management subject to approval by the board.

Conflicts of Interest

One of the fundamental ideas of corporate governance is to eliminate situations of conflict of interests by clear and distinct responsibilities for the controlling shareowners, minority or non-controlling shareowners, board of directors, management and the independent auditors. Unfortunately, many jurisdictions are full of conflicts of interest, for example:

- Chairman of the Board and the CEO are sometimes the same person.
- Chairman of the Board, the CEO and serve on the nominating committee.
- Management selects the auditor and approves the fees.
- Independent Auditor also performs non-audit work for the same company.
- Labor representatives serve on the board of directors are not independent in labor conflict situations.

Scope of the Auditor's Report and Scope of the Audit

Scope of the Auditor's Report

The independent auditor shall consider the governance structure and the risk management of the entity. Both shall have an impact on the scope of the audit and the fees.

During the engagement the independent auditor observes and tests internal controls and upon completion of the audit writes a letter to the company (often called "management letter") about their observations.

From a shareowner point of view all these matters are of importance for decisions to buy, hold or sell shares in the company.

This raises the question whether the auditor's report should therefore also cover the following:

- Compliance with best practices of corporate governance.
- Observations with regard to risk management.
- A summary of observations with regard to internal controls.
- Observations with regard to internal audit including subordination and work program.
- Information with regard to contractual fees and number and value of additional audit hours charged.
- Number and value of hours charged for non-audit work.

If auditor reporting requirements are expanded this obviously requires more investment and work for IAASB.

Matters for CAG Consideration

Scope of the Audit

1. Are there good corporate governance criteria that may be (or should be) considered in an audit of financial statements or in an assurance engagement? Examples:

   Does the entity have a corporate governance program that meets the criteria of the Organisation for Economic Co-operation and Development (OECD) or similar set of criteria? Such as:

   - The existence or lack of existence of an audit committee (or equivalent) that hires or fires the auditor.
   - The separation of positions of Chairman of the Board of Directors and the Chief Executive Officer.
   - The existence or lack of existence of an internal audit program.

2. Does the existence of good corporate governance criteria affect the scope of an audit or assurance engagement? Examples:

   Does the existence of or lack of good governance criteria affect:

   - The overall scope of the audit.
   - The risk assessment process.
   - The consideration of internal controls.
   - The specific procedures to be employed in high risk areas.