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ACCA Paper

P1

Governance, Risk & Ethics

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Chapter 1

CORPORATE GOVERNANCE

- the system by which organisations are directed and controlled (Cadbury Report)
- corporate governance (cg) is a set of relationships between an entity's directors, shareholders and other stakeholders
- also provides the structure through which the objectives of the entity are set and determines the means of achieving those objectives and monitoring performance
- cg is an issue for all entities, whether they be
  - large quoted entities
  - commercial entities
  - not–for–profit organisations including:
    - public sector
    - non–governmental organisations

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Corporate governance - elements

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

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Corporate governance – concepts

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

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

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

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

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

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

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

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

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

- **innovation** – the requirement that entities should continue in their efforts to be innovative. If not, and they stagnate, their long-term future is under major threat

- **scepticism** – the need for entities always to be sceptical in their estimation of the probability that good times lie around the next corner. The need therefore to adopt an attitude of prudence and caution

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Corporate governance and agency theory

- directors act as agents of the shareholders
- cg tries to ensure that agency responsibilities are fulfilled as agents by requiring disclosure and by suggesting performance-related rewards
- definition: an agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision–making authority to the agent
- fiduciary duties definition: a duty imposed upon certain persons because of the position of trust and confidence in which they stand in relation to another The duty is more onerous than generally arises under a contractual or tort relationship It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflicts of interest
- fiduciary duties are owed to the entity, not to individual shareholders
- directors must exercise their powers for the proper purpose

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Duties of directors as agents

- performance – if paid, directors have a contractual obligation to perform as agreed (if unpaid, no such obligation)
- obedience – directors should act strictly in accordance with the principal's instructions
- skill and care – directors should act with such a degree of skill and care as may reasonably be expected from a person with such experience and qualifications
- personal performance – directors should only delegate their assignments where they have no reason to believe that the person to whom the work is delegated is not capable of proper performance
- avoid conflicts of interest – eg should not sell his own property to the entity, even though it may be at an independent, arm's length valuation
- confidence – agents should not disclose confidential matters about the principal, even after the agency agreement has ended
- accounting for benefits – agents must account to the principal for any undisclosed benefit which they receive as a result of their office as agent
- because ownership of an entity is necessarily separated from the management, problems may result

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Corporate governance – Potential Problems

- directors may choose to pursue strategies more beneficial for their own interest rather than the entity's
- directors will almost certainly have a different attitude to risk, and risk management, since it is not their own investment which they are risking
- if management have only a small beneficial interest in the entity (or even none at all) then they may well pursue activities which improve short term results (therefore improving their current bonuses) to the exclusion of more far–sighted strategies which would be of greater benefit to the entity in the longer term
- ultimately, shareholders have the right to decide who shall (and who shall not) be directors of their entity But this is, in practical terms, very much a theoretical power Generally shareholders neither have the dynamism nor organisation to effect such a change in the composition of the board

Overcoming the problem – Alignment of interests (goal congruence)

- incentives designed to align interests include:
  - profit related pay
  - share issue schemes, for instance on the occasion of a management buy–out
  - share option schemes
- but for all of these there is a natural tendency for management to adopt creative accounting to manipulate the profit figure upon which these incentives are based

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Stakeholders

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

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- Each **external** stakeholder has:
  - a role to play in influencing the operations of the entity
  - their own interests and claims in the entity
- consider these in the context of the external interests:
  - auditors
  - regulators
  - government
  - stock exchange
  - small investors
  - institutional investors
- **Reference to David Campbell Student Accountant articles: "Rules, principles and Sarbanes-Oxley" April 2008**

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Chapter 2

APPROACHES TO CORPORATE GOVERNANCE

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Two distinct approaches to corporate governance

- rules based, and
- principles based

Characteristics of the rules based approach

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

Characteristics of the principles based approach

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

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- Arrival of corporate governance
  - headline hitting corporate failures in Europe , USA and UK led to recognition of the need for some sort of control in an attempt to prevent similar failures
- common elements identified as:
  - poor entity management by directors
  - single dominant individual
  - unreliable financial reporting
  - ineffective internal controls
  - incompetent directors
  - lack of close involvement of institutional shareholders
  - directors interested more in personal position rather than in the welfare of the entity

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Development of the UK Corporate Governance Code 2010 (CGC)

- 1992, the Cadbury Report
- followed by Greenbury report on directors' remuneration
- then Hampel report – a list of principles of "good corporate governance"
- 1998, these three merged into the Combined Code on Corporate Governance
- 2003, Higgs Report, effectiveness of non-executive directors (neds)
- 2005, Turnbull report, guidance on internal controls
- 2006, new CGC published
- 2010, revised and re-named – The UK Corporate Governance Code (CGC)
- CGC applies to all UK quoted entities which must state:
  - how it has applied CGC principles
  - whether or not it has complied with CGC throughout the accounting period, and …
  - …if not, why not

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Rules based approach

- USA passed legislation - Sarbanes Oxley (SOX)
- applies to all US quoted entities
- but also to any entity, anywhere in the World, if it has an American quoted parent entity
- main provisions of SOX
  - all quoted entities must provide a certificate to the Securities Exchange Commission confirming the accuracy of their financial statements
  - where financial statements have to be restated following material non-compliance, CEO and CFO must repay any bonuses received in the previous twelve months
  - auditors restricted to audit work (and tax)
  - senior audit partner must rotate off the audit after no more than five years
  - Public Entity Oversight Board – responsible for enforcing professional standards in accounting and auditing
  - directors forbidden from dealing in entity shares during "sensitive" times

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OECD and ICGN have both issued principles on corporate governance

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

Summary of OECD principles

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

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Summary of ICGN principles

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

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Chapter 3

THE BOARD OF DIRECTORS

Directors

- anyone who occupies the position of director
- shadow directors are 'anyone in accordance with whose instructions the directors are accustomed to act'
- cgc establishes roles and responsibilities:
  - provide leadership for the entity
  - represent the entity in its dealings, and to the public generally
  - set the agendas for board meetings
  - decide those matters which are to be determined by the board, and not therefore to be delegated
  - decide upon a strategy for the entity
  - select a director to be CEO, and…
  - …another one to be Chair

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- directors' roles and responsibilities continued
  - establish a corporate culture
  - ensure that those charged with taking operating decisions are doing their job properly
  - establish and implement an effective system of internal controls capable of risk assessment and management
  - ensure that aims and objectives of the entity are realistic and achievable
  - ensure that all employees are aware of the entity's responsibilities to its stakeholders
  - hold regular and frequent board meetings
  - assess own performance, and report annually to shareholders
  - submit themselves for re–election every three years (FTSE 350 entity? re-elect ALL directors every year)
  - for listed entities there are "additional requirements"

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Listed entity requirements and the Higgs report contents

- listed entities should:
- appoint appropriate and independent neds
  - establish sub-committees
    - audit
    - remuneration
    - risk
    - nomination
- Higgs identified four factors which affect the effectiveness of the board:
  - time available to devote to entity matters
  - personal competence
  - quality of information
  - boardroom culture
- other major points addressed by Higgs were:
  - the role of neds, and
  - performance measurement for the board as a whole and for individual directors

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Corporate Governance Code sub-divisions

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

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CGC sub-divisions - directors

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

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CGC sub-divisions – directors' remuneration

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

CGC sub-divisions – accounts and audit

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

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CGC sub-divisions – investor relations and potential problems with implementation of CGC

- directors should have regular dialogue with institutional investors
- directors should encourage active participation of all shareholders at the annual general meeting
- to adopt all the recommendations of the CGC sounds like an excellent idea, but there can be problems!
- potential problems
  - possible that executive board could lack skill or experience
  - when daily management team report to executive, their failings could mean that problems are not fully appreciated or opportunities could be overlooked
  - directors may meet infrequently and are not necessarily close acquaintances This could make it difficult for them effectively to question the daily management team
  - CEOs are often people with forceful personalities who sometimes exercise a dominant influence over the board
  - CEO's performance is judged by the same people who appointed him Could be very difficult for them to be unbiased in their evaluation of CEO's performance

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

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

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Structure of the board - two-tier structure

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

Directors - structure of the board

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

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Directors - sub-division of roles

- Executive directors
  - involved in day to day management
  - usually remunerated as full–time employees
  - dedicate their working lives to fulfilling their duties as director
  - take responsibility for the day to day running of the entity
- Non-executive directors
  - members of the board, but not involved in the day to day running of the entity
  - neither a full–time employee, nor connected in any other way with the entity
  - serve on the various board sub-committees:
    - audit
    - remuneration
    - risk
    - nominations
    - social and
    - ethical

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Functions of neds

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

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Statutory duties of all directors

- We have already come across some of the duties of directors, but the following list includes some new ones:
  - act in good faith, in the interests of the entity as a whole, by:
    - treating all shareholders equally
    - declaring any conflicts of interest
    - not making personal profits at the entity's expense
  - ensure that the entity maintains proper accounting records
  - produce proper financial statements and directors' report
  - file the financial statements with the Government department
  - obey other laws and regulations such as health and safety legislation
- Individually, each director must:
  - disclose any interest in an entity contract
  - disclose any interest in shares or debentures of the entity
  - disclose details of any options which are held
- In addition, directors have a common law duty to demonstrate such degree of skill and care as may reasonably be expected from a person of that age, experience and qualification. Failure to do so may result in the director being found liable for negligence with the consequence that a Court may hold the director personally liable for any loss which the entity has suffered as a result of that negligence.

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Directors - appointment and service contracts

- Appointment
  - The rules for the appointment and removal of directors are found in the constitution of an entity and typically provide the following:
    - the first directors are appointed at the time of formation of the entity
    - subsequent directors are normally appointed by the directors in the time between general meetings, but such appointees must seek to be re–elected by the shareholders at the next annual general meeting
    - directors are required to retire by rotation
    - directors should step down from office at least every three years, but may seek re–election
    - if the entity is an FTSE 350 entity, all directors must be re-elected every year
- Directors' service contracts
  - These are legal documents containing the terms of service for each director and will normally include:
    - key dates
    - duties
    - remuneration details
    - termination provisions
    - constraints
    - any other "normal" employment provisions
  - The contract should not be for a period in excess of one year

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Directors – removal and disqualification

- Directors may be removed from office at any time by the vote of the majority of members in general meeting In addition, the office of director shall be vacated according to the rules set out in the entity's constitution Typically this will provide that a director shall lose office if:
  - becomes disqualified by law
  - dies
  - is removed by shareholders
  - becomes personally bankrupt
  - resigns from office by notice in writing
  - is absent from board meetings without permission for a period in excess of six months
- Disqualification under the law can happen when a director is guilty of:
  - allowing the entity to continue to trade whilst it is insolvent
  - not keeping proper accounting records
  - failure to prepare financial statements
  - three defaults (within a five year period) of failing to file relevant documents with the Government department
  - failure to file tax returns (or pay tax)
  - taking actions which are deemed by the Court to be inappropriate for the management of the entity

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Directors – Insider dealing

- Insider – a person who has a business connection with an entity as a result of which they may acquire relevant information
- Dealing – buying or selling shares or securities in an entity
- Unpublished price – sensitive information is information about the entity which is not in the public domain
- is less than 6 months old, and…
- is, on publication, likely to have a material impact on the market price of the entity's shares
- An insider in possession of unpublished price – sensitive information should not deal
- An offence is also committed if the insider encourages another person to deal
- A person dealing as a result of that encouragement, and believing the source to be an insider, is also committing an offence
- Disclosure of inside information, other than in the proper course of employment to an authorised person, is also an offence
- Some defences are available to be claimed

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Directors - induction and education

- The CGC establishes principles for the education of a new director in the activities of the entity It is clearly important that the new director should become acquainted with the executive board as soon as possible after their appointment, so the entity's induction procedure should:
  - be comprehensive
  - be tailored to the needs of the entity and individual directors
  - contain written information plus presentations and appropriate activities (eg site visits)
  - give new appointees a balanced overview of the entity
  - not overload the director with an excess of information
  - at the end of the induction process, the new director should have:
    - an understanding of the nature of the entity, its business and the markets in which it operates
    - a link with the entity's employees
    - an understanding of the entity's main relationships including the relationship with the auditors

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Directors – performance evaluation

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

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Chapter 4

BOARD COMMITTEES

Audit committee

- audit committee is a sub–committee of the board and is comprised entirely of neds
- in a listed entity, there should be at least three neds on the audit committee, one of whom has had recent relevant financial experience
- key roles for the audit committee are:
  - **oversight**
  - **assessment**
  - **review** of the other functions and systems in the entity
- most of the board's objectives relating to internal control will probably be delegated to the audit committee
- the audit committee should:
  - review the entity's internal financial controls
  - review all the entity's ic and risk management systems
  - approve the wording in the financial statements relating to ic and risk management systems
  - receive reports from management about the effectiveness of the control systems
  - receive reports concerning the conclusion of any tests carried out on the controls by either internal or external auditors

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Internal control systems

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

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Internal controls -categorisation

- can be remembered by the mnemonic oap spasm

O	Organisational
A	Arithmetic and accounting
P	Personnel
S	Segregation of duties
P	Physical
A	Authorisation
S	Supervision
M	Management

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Internal controls - categorisation

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

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

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Audit committee and internal audit (ia)

- as part of their obligation to ensure adequate and effective controls audit committee is responsible for the activities of ia
- the audit committee should:
  - monitor and assess the role of the ia function within the entity's overall risk management system
  - check the efficiency of ia
  - approve the appointment (or removal) of the chief internal auditor
  - ensure that the ia function has direct access to the Chair and is accountable to the audit committee
  - review and assess the annual ia work plan
  - receive reports concerning the work of the ia function
  - review and monitor management's response to ia findings
  - ensure ia's recommendations are implemented
  - help to preserve the ia function from pressures which might otherwise impair their objectivity
- audit committee should meet with ia at least once each year to discuss audit–related matters
- possible that even a listed entity does not have an ia function
- if no audit committee, should review the situation annually and make any appropriate recommendation
- if there is no ia department, this fact must be disclosed in the financial statements

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Audit committee and the external auditors (ea)

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

Reporting on internal controls to shareholders

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

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Internal audit reporting

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

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Role and function of an audit committee

- create a climate of discipline and control leading to a reduction of opportunities for fraud
- lend an air of credibility and objectivity in the financial statements thereby increasing public confidence
- assist CFO by providing a forum
- review financial statements to improve the quality of reporting
- independent judgement
- strengthen position of the internal auditor
- strengthen position of the external auditor
- assist in the resolution of disputes between external auditor and executive board
- remember Clarissa

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Remuneration committee

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

Strategy of the remuneration committee may consider:

- greater benefits in kind to compensate for lower basic salaries
- offering non–cash motivation for some (or all) of the entity's employees. Non–cash motivators could include things like crèche facilities, cars and additional holidays
- availability of entity resources. For example, the entity may not have sufficient cash resource to pay an annual bonus, but may offer a share incentive scheme instead
- encouragement of long–term loyalty by offering share–purchase schemes

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Remuneration committee responsibilities

- determine, and regularly review, the framework, broad policy and specific terms for the remuneration, terms and conditions of employment of the Chair and of the executive directors
- recommend and monitor the level and structure of the remuneration of senior management
- set detailed remuneration for all executive directors and the Chair including pension rights and compensation payments
- ensure that executive directors and senior management are fairly rewarded for their individual contributions to the overall performance of the entity
- demonstrate to shareholders that the remuneration of executive directors and senior management is set by individuals with no personal interest in the outcome of the committee's decisions
- agree compensation for loss of office
- ensure that provisions for disclosure of remuneration, including pensions, as set out in law and in the CGC are followed

Nominations committee

- importance:
  - needs to be seen to be unbiased and impartial
  - needs to be objective in order to ensure that appointments are made in line with pre–agreed specifications
- role
  - identify appropriate people to be invited to join the board
  - the committee determines appropriate packages for the prospective executive directors, and the composition of those packages
- composition
  - executive directors and neds, but neds should be the majority
- accountability
  - makes recommendations to the main board, but
  - final decisions are made by the main board as a whole

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- overall responsibilities of the nominations committee are to:
  - review regularly the structure, size and composition of the board, and make recommendations to the board of new nominees
  - give full consideration to succession planning for directors
  - regularly evaluate the balance of skills, knowledge and experience of the board
  - prepare a description of the role and capabilities required for any particular board appointment
  - identify, and nominate for approval, candidates to fill board vacancies as they arise
  - recommend to the board concerning existing directors standing for re–appointment

Risk management committee

- board is responsible for risk identification and risk management, both of which involve the establishment of a sound system of internal control
- importance:
  - gives an objective view on the entity's risk profile
- role
  - assesses internal controls
  - performs risk assessments of the entity's key operations
  - often oversees the implementation and effective operation of risk strategy, policies and procedures
- composition
  - executive directors and neds, but neds should be the majority
- accountability
  - makes recommendations to the full board of internal control and risk strategy, or
  - to the audit committee, but they in turn will report to the full board
- main responsibilities and duties of the risk management committee are to:
  - advise the full board on risk management issues, strategy and policy

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- emphasise and demonstrate the benefits of a risk–based approach to internal controls
- set appropriate internal control policies
- regularly assure that the system is functioning
- review the effectiveness of internal controls
- provide relevant disclosures about internal controls in the financial statements
- review the system of internal controls paying particular attention to the control environment, risk assessment, information systems, control procedures and monitoring

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Chapter 5

CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY

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- entities are increasingly accepting that they have social and environmental responsibilities
- who are the people who are affected by an entity's actions?
  - there are, of course, many including:
    - employees
    - customers, suppliers and the local community
    - the environment may be affected as a result of our production processes
- CG vs CSR
  - cg is not the same as corporate social responsibility (csr)
  - csr is the principle that an entity will think about its impact on the wider environment and will take documented steps to minimise the damage and maximise the benefits of its actions
  - strategy of an organisation is shaped by many factors, including the demands of stakeholders
  - each different stakeholder, or class of stakeholder, will typically have different objectives as well as different levels of influence
  - expression stakeholder is applied to anyone who has anything to do with the business, whether directly or indirectly
  - cg framework of an entity should recognise the rights of stakeholders established by law or by separate agreement
  - because different stakeholders have different objectives, it is necessary for the board to balance these conflicting interests
  - an entity's strategy is often to manage, rather than satisfy, stakeholder objectives
  - inevitably, the more influential the stakeholder, the greater will be the attention directed to their interests

The most important group of stakeholders is (normally) the shareholders

- they are the legal owners of the entity, and control it through votes cast at the annual general meeting
- even though they own the entity, they do not own the property of the entity – this reinforces the legal concept of an entity being a separate legal person
- shareholders have a number of statutory rights:
  - the right to transfer their shares
  - the right to receive notice of meetings
  - the right to attend, speak and be heard at those meetings
  - the right to receive a dividend (when approved by the general meeting)
  - the right to a copy of the entity's financial statements
- once they have paid the full face value of the shares held by them, they (normally) will have no further obligation to contribute to a shortfall in an insolvent liquidation (but there are exceptions)
- they do NOT have to remain loyal to the entity and may sell their shares at any time
- nor do they have any duty to ensure that the entity operates in a socially responsible way

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Corporate social responsibility and disclosure

- is a successful business also a good corporate citizen?
- only if it pays attention to its environment and stakeholders
- for example:
  - as well as making products or supplying services, resulting in profitability, it should also try to maximise the benefits of, and minimise the harm caused by, its operating activities
  - it should achieve a balance between its legal responsibilities, its commercial responsibilities and its social responsibilities
  - it should constantly be reviewing its social responsibility position
  - as a consequence of acknowledging its social responsibility, and being seen to be acting in a responsible way, an entity could very well find that demand for its products increases
- disclosure
  - general principles
    - because shareholders are the owners of an entity, they are entitled to be given sufficient information to enable them to make investment decisions
    - the Annual General Meeting is seen as the most opportune time (often the ONLY time!) for directors to be able to communicate directly with the entity's shareholders
    - in addition, the financial statements are often the only printed information which shareholders receive from the entity
- common sense will tell us that:
  - more regular and constructive dialogue with our shareholders will lead to:
    - better understanding of shareholders' interests and concerns
    - better understanding by the shareholders' of what the entity is trying to achieve
    - increase in shareholder interest therefore encouraging checks on the managers of the entity
    - potential benefit resulting from the closer interest in the entity by the major shareholders

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CGC disclosure recommendations

- disclosure
  - it allows the entity's board to provide information on governance matters to shareholders and other stakeholders
  - disclosure demonstrates that good cg principles are being applied by the entity
  - also a means of communicating matters of interest and value
  - CGC contains policies and provisions with which listed entities are expected to comply
  - these policies and provisions represent "best practice" in terms of disclosure
- CGC requirements
  - a listed entity is required to state within the financial statements:
    - how it has applied the principles of the CGC, and
    - whether it has complied with the CGC throughout the accounting period
    - and if not, why not

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CGC – additional disclosures

- a statement by the board acknowledging their responsibility for the financial statements
- a statement by the board to confirm their view that the entity is a going concern
- details of each board member together with details of their responsibilities and their record of attendance at board meetings
- the identity of the Chair, the CEO and which directors sit on which of the sub–committees (audit, social responsibility, nominations, remuneration and risk management) as well as their attendance records at meetings of those committees
- reports on the activities of the committees
- if there is no internal audit function, the relevant section of the annual report should explain why not
- a statement that the directors have undertaken a review of the effectiveness of the internal control system
- a report on the methods used to evaluate performance of the board and its committees
- information about the measures taken by the board to ensure that it understands the views of its major shareholders
- information about the steps taken to ensure the continuing independence of the external auditors
- where the board does not accept a recommendation from the audit committee, there should be a statement by the audit committee explaining their recommendation and why the board has taken a different view

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Annual General Meetings

- every entity must hold an annual general meeting once in every calendar year (This is not technically correct – private entities may dispense with this requirement but, for our purposes, when dealing with corporate governance of public entities, the statement is true)

- some quick points about AGMs
  - they are a legal requirement
  - each issue must be approved by separate resolution
  - the meeting requires not less than 21 days' notice
  - the first meeting must be held within 18 months of the entity's incorporation date
  - each successive meeting shall be held no later than 15 months after the previous meeting
  - all shareholders who are entitled to attend must be given notice of the meeting
  - the board should use the AGM to communicate with shareholders, and should encourage their participation
  - the purpose of the meeting is to approve the "ordinary business" of the entity together with any other matters which require shareholder approval
  - "ordinary business" comprises:
    - the receiving of the annual financial statements
    - the reappointment of directors retiring by rotation
    - the reappointment of the auditors for another full year
    - the formal approval of the dividend which has been proposed by the directors
  - the board should arrange for the Chair of the sub–committees to be present at the AGM to answer any questions from the shareholders, and for all directors to be present

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Other general meetings and proxy votes

- entities may also find that they need to hold general meetings which are not AGMs These are Other General Meetings (OGMs)
- some quick points about OGMs
  - held irregularly, and only when something urgent arises which needs shareholder approval
  - separate resolutions should be passed for each different matter
  - length of notice of the meeting depends on what type of resolution is to be proposed
  - it is theoretically possible for an entity to go from birth to death without any need to hold an OGM
- proxy voting
  - a shareholder who is unable to attend a general meeting may appoint a person to attend the meeting on their behalf
  - such a person is called a “proxy” and the document which appoints them is a “proxy form”
  - where the shareholder is an entity, they will appoint a “representative” and not a proxy

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CGC and proxies

- CGC says about proxies:
  - for each resolution to be proposed, the proxy form shall provide the shareholder with the options of directing their proxy to vote in favour, against, or withhold their vote
  - a vote which is withheld is not counted as a vote – neither in favour nor against
  - the entity should ensure that all proxy forms received are properly recorded and counted
  - for each resolution, after a vote has been taken, the entity should publish on its website the details of the votes and, in particular:
    - the number of shares in respect of which valid proxies have been received
    - the number of votes for each resolution
    - the number of votes against the resolution
    - the number of shares in respect of which the vote was withheld

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Chapter 6

CORPORATE GOVERNANCE – CONTROL SYSTEMS

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- Internal control is a key process within an organisation concerned with the management of risk and the achievement of objectives
- by internal control is meant not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to
  - carry on the business of the entity in an orderly and efficient manner
  - ensure adherence to management policies
  - safeguard the assets
  - prevent and detect fraud and error
  - secure as far as possible the completeness and accuracy of the accounting records enabling
  - the timely preparation of reliable financial information
- Internal control and risk management in cg
  - both elements of internal control and risk management are fundamental parts of sound cg because:
    - cg has key links to risks and to internal controls
    - whilst it is not possible to prevent corporate failures, good cg can go a long way to minimise the risk, and well–run entities tend to achieve their objectives in a less risky way
    - so we can see that cg is a key to risk reduction
    - the CGC requires entities to operate appropriate systems of internal control, and to ensure that those systems are regularly reviewed and improved

Turnbull Report and internal controls

- requires that internal controls should be established using a risk–based approach
- specifically an entity should:
  - establish its business objectives
  - identify the associated key risks
  - design controls to address those risks
  - establish a system to implement the controls, including the provision of regular feedback
- objectives of internal control systems
  - manage the risks which have been identified within an entity including the risk that the entity fails to achieve its objectives
  - internal control systems should be designed so that they give reasonable assurance that:
    - operations are running efficiently and effectively
    - financial reporting is reliable
    - applicable laws and regulations are being adhered to
  - if there were no internal control system, management would be unable to monitor the effectiveness of their risk management strategy, and would certainly not be in any position to respond to new threats as they arose

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- Executive management roles in risk management

  - in any entity the board is ultimately responsible for all matters concerning the entity However, it is not unreasonable to expect the board to delegate duties down to individual executive director level

  - CEO (ultimately responsible for the entire system and operations of the entity) should be seen to be in control of risk management

  - CEO is the one individual more than any other who sets the standard for ethics and acceptance of responsibility

  - board of directors, as a whole, is responsible for ensuring the adequacy of the internal control system and they should therefore ensure that executive directors monitor the internal control system effectively

  - senior executive management is responsible for setting the internal control policies and for monitoring the adequacy and effectiveness of the internal control system They also report to the full board that this has been done

  - lower level management (not executive directors) will typically find that these responsibilities have been delegated to them! But executive directors remain the ones responsible for confirming adequacy and effectiveness

  - employees generally have the task of carrying out the directors' orders, and are therefore the ones who are charged with the responsibility of ensuring the correct application of the internal controls

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Chapter 7

AUDITORS AND INTERNAL CONTROLS

Function and importance of internal audit

- internal audit (ia) is an independent appraisal activity established within an organisation as a service to it
- it is a control which functions by examining and evaluating the adequacy and effectiveness of other controls
  - in a large organisation ia will be a separate department
  - in smaller entities, it could be that an individual is allocated to carry out specific tasks of an ia nature
  - it may be that the ia function is outsourced
  - if it is an in-house department, it is important that the function is structured in an appropriate way
- scope of internal audit
  - management will prescribe the scope and objectives of the ia department, but these will typically include:
    - review of the accounting and internal control systems
    - detailed testing of transactions and balances
    - review of the economy, efficiency and effectiveness of operations
    - review of the implementation of entity policies
    - special investigations
    - assisting the external auditors

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Independence of internal audit

- for an audit function to operate successfully, it is necessary that the auditor is independent
- applies equally well to internal auditors as to external auditors
- for internal audit to be effective, the reviews which they carry out must be conducted and reported on on an independent basis
- the equivalent of the confidence which is given by the external auditor being independent
- Comparison of internal and external auditors

	External	*Internal*
Required by	statute	management
Appointed by	shareholders	management
Reports to	shareholders, and management	management
Reports on	financial statements	internal controls
Opinion about	truth and fairness, proper presentation	adequacy of int conts, value for money
Scope	as necessary	prescribed by executive board

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Potential threats to independence

- in the syllabus for the earlier auditing paper,
- see how many you can remember!
- f
- f
- c
- l
- b
- g

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Chapter 8

MANAGEMENT INFORMATION SYSTEMS

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- information flows are vital if management are to be able to manage risk and monitor internal controls
- three elements which should be apparent:
  - both internal and external information is required in order that informed decisions can be made
  - the information should be provided on a regular basis in order that management can monitor performance of economy, efficiency and effectiveness
  - there needs to be clearly defined, effective channels of communication within the organisation so that management receive the information on a timely basis

Information characteristics

- a accessible
- a adequate
- c complete
- c concise
- c consistent
- i integrated
- o objective
- p provable
- r relevant
- r reliable
- t timely
- u unbiased
- u understandable

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Chapter 9

THE RISK MANAGEMENT PROCESS

Risk and corporate governance

- good cg involves effective risk management, and that effective risk management in turn involves a sound system of internal control (Turnbull Report)
- good corporate governance will eliminate or decrease many of the risks facing an entity
  - fair treatment of shareholders
  - rights of shareholders
  - the role of stakeholders
  - disclosure requirements and transparency arrangements
  - board responsibilities

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First three principles of good corporate governance

- Fair treatment of shareholders
  - preferential treatment should not be given to any one group of shareholders
  - other shareholders could resent this and it could result in bad publicity for the entity
- Rights of shareholders
  - the entity may not allow shareholders their rights
  - for example, if the entity fails to allow a shareholder to join in discussions at an AGM, or if the entity fails to communicate the details of the AGM
- The role of stakeholders
  - entities may ignore stakeholders
  - a stakeholder group could be treated inappropriately
  - for example, if an entity tries to make an employee redundant without following established legal procedure

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Final two principles of good corporate governance

- Disclosure requirements and transparency arrangements
  - directors possibly fail to provide appropriate reports
  - directors fail to report the true financial position of the entity
  - it is necessarily the case that, for proper disclosure and transparency, a sound system of internal control in the entity should exist
- Board responsibilities
  - the board possibly does not control the entity adequately
  - the board attempts to run the entity for their own benefit rather than for the benefit of shareholders and other stakeholders

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Management's responsibility for risk management

- Risk is defined as "the chance of exposure to the adverse consequences of uncertain future events"
- It can therefore be seen that:
  - risk can adversely affect the achievement of the entity's objectives
  - by reducing the likelihood of an event, or its potential impact, the risk is managed
  - the responsibility for managing the risk is management's and they do so by establishing a risk management system
- Process of risk management system establishment
  - identify – prepare list of potential risks
  - analyse – prioritise the potential risks
  - report to management about the risks identified
  - design risk management system – prepare avoidance and contingency plans
  - recommend designed system for implementation
  - implement – put in place the accepted system
  - evaluate – monitor and, if necessary, re-analyse

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Risk management

- necessary to manage risk:
  - identify new risks that may affect the entity so an appropriate management strategy can be designed
  - identify changes to existing or known risks so an amendment may be made to existing strategy
  - ensure that best use is made of changing opportunities
- managing the upside
  - risk applies equally to "good news"
  - this upside risk needs to be managed just as much as downside risk
- management of the upside risk is viewed in a different way than the downside because:
  - risks are seen as opportunities to be used to advantage
  - organisations are prepared to accept some uncertainty in order to gain greater benefits and higher rewards associated with higher risk
  - risk management is used to identify risks associated with new opportunities leading to an increase in probability of profitability and maximised returns
  - effective risk management is seen as a way of improving shareholder value by improving performance
- ALARP attitude to risk management
  - manage risk down to a level as low as reasonably possible
  - basically, a cost benefit analysis

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- strategic or operational?
  - **Strategic risks** are those which arise from the possible consequences of strategic decisions taken within the organisation
    - example would be where one entity pursues a strategy of growth by acquisition whereas another aims to grow organically
    - "acquisition" entity is exposed to a greater degree of risk, but the potential returns are likely to be greater
  - **Operational risks** are the risks of losses resulting from inadequate or failed internal processes, people and systems, or from external events
    - refers to the potential losses which might arise in business operations
    - includes risk of fraud or theft by employees
    - can be managed by internal control systems

Sources and impacts of business risks

- businesses face risk from a number of different sources:
  - market – risks associated with the sector or industry in which the entity operates
  - credit – relates to the credit rating of the business, and therefore its ability to raise finance
  - liquidity – the risk of being unable to meet debts as they fall due because of insufficient cash
  - technological – relates to the risks associated where a fast–changing technology affects the market or products
  - legal – risk associated with the need to comply with law and regulation
  - health and safety and environmental issues
  - reputation – the possibility of damage to the entity's image arising from poor performance or adverse publicity
  - business probity – relates to the governance and ethics of the entity
  - derivatives – risks due to the use of financial instruments

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Examples of risks faced by entities

Risk	Sources	Impact
Market	• Failure to provide goods customers require • Market sector overall declines.	• Entity ceases to trade.
Credit	• Entity's credit–rating is decreased (on, e.g. Standard and Poor's). • There are going concern problems so suppliers are paid late.	• Entity may not obtain materials needed for production.
Liquidity	• Customers are not paying quickly enough. • There is poor credit–rating (as above). • There is poor cash management.	• Entity may not obtain materials needed for production. • Entity cannot meet commitments which may lead to entity failure.
Technological	• There is lack of investment in research and development. • Competitors achieve technological advantage.	• Products appear to be out of date. • There is loss of market share.
Legal	• There is a breach of regulations, e.g. Companies Act. • Entity is sued by third party for breach of legislation.	• Adverse publicity • Fines and penalties payable by entity and/or officers.
Health, safety and environmental	• Breach of relevant legislation. • Entity trading in sector with adverse reputation (e.g. testing on animals).	• Adverse publicity • Fine payable by entity • Legal damages payable (accidents at work).
Reputation	• Production of poor quality • Product recalls/adverse publicity against entity.	• Loss of market share • In the extreme – entity closure.
Business probity	• Directors/officers receive high bonuses when entity is making losses. • Entity trading in sector with adverse reputation (e.g. arms trade with 'enemy' countries).	• Adverse publicity • Possible boycott of entity products.
Derivatives	• Losses made on forward exchange contracts. • Financial statements do not adequately disclose entity's transactions/exposure	• Financial loss to entity. • Adverse publicity. • Possible closure of business if losses large

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Sector specific risks

- business risks may be simply general risks facing any business
- but some risks will be specific to a particular entity, market, or industry
- generic risks include changes in interest rates, or non–compliance with law
- in addition, although a risk may be general, it can affect different businesses in different ways
- above example of a change in interest rates will clearly have opposite affects for one entity with a substantial deposit account at the bank and another with a large overdraft!
- sector specific risks relate to a particular sector, and potentially not to any other sector
- for example, sector specific risks facing a private hospital could be:
  -
  -
  -
  -

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Analysis of risk

- one way of analysing risk is to acknowledge that the probability of risk could be "high" or "low", and that consequences (impact) could also be "high" or "low"
- a matrix can be prepared showing the four possible combinations of "high" / "high", "high" / "low" etc
- when a risk is seen as "high" / "high", it needs urgent attention / immediate action in order to manage the risk
- if the risk is "high" probability, but "low" impact, then the position needs to be monitored, and the entity needs to prepare to meet the change
- a "low" probability, "high" impact combination needs action to be considered and, at the very least, a contingency plan
- "low" probability and "low" impact – keep an eye on the situation, and be prepared to adapt to any change

		IMPACT / CONSEQUENCE	
		HIGH	LOW
PROBABILITY	HIGH		
	LOW		

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Role of the board in risk analysis

- board has an important role to play in risk management, because they:
  - consider risk at the strategic level, and then define the entity's attitude and approach to risk
  - are responsible for implementing the risk management process, and therefore for ensuring that those charged with administering it have appropriate resources
  - are also responsible for ensuring that the risk management policies support the overall strategic objectives of the entity
  - determine the level of risk which the entity is prepared to accept in order to meet its strategic objectives
  - communicate the risk management strategy to the rest of the entity and will ensure that it is integrated with all other entity activities
  - review the risks, and then identify and monitor the progress of the risk management policies
  - determine the risks which will be accepted, but which cannot be managed, or where it is too expensive to manage. These are called residual risks

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External reporting

- Should reports be made to people other than management concerning the internal controls and risk management?

- Points to consider:

  - reporting may be required, or may be voluntary

  - in an extreme situation, it may be that third parties have to be reported to where management is unaware of reporting requirements or simply refuses to report voluntarily

  - many reports are intended for internal use only – for example, reports to the audit committee – but there can be situations where external reporting is required

  - such external reporting will normally only be done as a requirement of compliance with law or regulation, or compliance with ethical guidelines applicable either to the entity itself or to the external regulator

- Reporting methods

  - three obvious ways in which entity information can be reported externally:

    - annual financial statements
    - auditors
    - audit committee

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Reporting methods

- annual financial statements - internal controls
  - disclosure is required by the principles outlined in cg regulations for listed entities
  - detail to be given is a statement of the directors' assessment of the adequacy of the internal control system, and of how the directors maintain the system
- annual financial statements – risk
  - disclosure should be made explaining how the directors have addressed some of the risks facing the entity
  - disclosure would be made, for instance, in the Corporate and Social Responsibility Report
- auditors – internal controls
  - where the internal control system is weak, this could lead to the auditors issuing a modified audit report
  - this modified report may therefore include details of the particular areas of the control system which have given the auditors cause for major concern
- auditors – risk
  - the auditors would only report on risks facing the entity in the situation that the risk has given rise to a material error in the financial statements
- audit committee – internal controls
  - in the normal course of events, the audit committee will report its recommendations about control weaknesses to the board
  - only in an extreme situation (for instance, where the board ignores the recommendations and the situation is serious) will the audit committee report externally (called "whistle blowing")
- audit committee – risk
  - it would be unusual for an audit committee to report externally on matters concerning risk

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Chapter 10

CONTROLLING RISK

- **risk targeting**
  - risk manager
  - risk management committee
  - audit (internal and external)
- **risk reduction**
  - risk awareness
  - embedding risk in systems
  - embedding risk in culture
  - diversification
- **risk avoidance / retention / modelling**
  - risk avoidance and retention
  - risk attitude
  - need for risk
  - attitude to risk – does size matter?

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Risk targeting – risk manager

- leader of the risk management committee
- reports directly to the board
- role is primarily to oversee implementation of the board's risk management policies
- supported by risk management committee
- not normally involved in determining strategy
- more of an operational role
- policies to be implemented are decided by board and risk management committee

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Risk targeting – risk management committee and audit

- risk management committee
  - established by the board
  - reports to the board
  - if no committee, functions pass to audit committee
  - three main objectives
    - raising risk awareness within the entity
    - ensuring reporting and monitoring procedures are in place and effective
    - keeping the risk profile up to date, reporting to the board, and making recommendations about risk attitude
- audit
  - provides independent review of risks and controls
  - provides a fresh outlook on the situation
  - Sox requires some audit work
  - auditor will report any recommendations arising from the audit work

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Risk reduction – risk awareness

- to be totally effective, risk awareness needs to be apparent at **strategic, tactical** and **operational** levels
- a lack of awareness automatically indicates that an entity has an inappropriate risk management strategy
- if an entity is not aware of risks at all levels, it could mean that there are risks affecting the entity which have remained unidentified and that automatically means that the risk is not being controlled
- even if there is awareness a risk could occur but, because of poor monitoring, the risk is not controlled
- continuous monitoring is clearly necessary, and management strategy should be reviewed and updated as appropriate
- risks at the strategic level include new competition, new technology…
- risks at the tactical level include loss of key customer, supplier, product, licence, employee…
- risks at the operational level include failure to recognise changes in market tastes, failure to apply effective quality control procedures, repetitive stock–outs…

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Risk reduction – embedding risk in systems

- it is important that risk management should be included within an entity's control systems and not treated as a separate exercise
- this point is included as a principle in the UK CGC and in law in the US
- it is essential that the board gives approval to the principle of embedding risk management

Risk reduction – embedding risk in culture

- even though risk management may be included as integral to the control systems, it can only be effective if everyone within the organisation recognises its importance
- in that way, all personnel will view the processes as part of the normal "life" of the entity
- a number of matters need to be considered in the decision to embed risk management into the control systems including the general attitude to internal controls, the commitment of all personnel to risk management, governance…
- similarly, there are a number of ways of introducing risk management awareness into an entity such as performance targets, employee rewards, corporate magazines, website, job descriptions, in–house courses…

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Risk reduction – diversification

- one way of reducing risk is to spread the entity's activities over a greater range, whether geographical, product, target market…
- in this way, poor performance in one sector could well be counterbalanced by a good performance in another
- to be effective, the diverse businesses should not be closely or similarly affected by external factors – as the factor affects adversely one area, we don't wish it to affect adversely the diverse area too!

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Risk avoidance and retention

- the expression "risk avoidance" means a strategy by which an entity, quite literally, avoids a risk, whereas…
- "risk retention" is the risk strategy by which an entity chooses to retain the risk within the entity
- both expressions are indicators of the entity's risk appetite
- for example, an entity may choose to accept the risk of exchange rate movements of the Euro, believing them to be probably insignificant, whereas…
- the same entity could well avoid the risk of entering contracts quoted in the Uzbekistan currency (the soum) believing such exchange rate movements could well be significant

Risk avoidance – risk attitude

- attitude is determined by a combination of strategy, capacity and appetite
- the overall strategy determines the overall approach
- the capacity indicates how much risk the entity can accept
- the appetite determines the way in which risks will be managed

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Risk avoidance – need for risk

- accepting risk can give an entity a competitive advantage
- equally, an entity which is not prepared to accept risk will lose a competitive advantage to another which is
- the greater the risk, the greater the rewards – returns tend to be higher on riskier projects
- and the benefits don't need to be financial – they could also involve better quality information

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Risk avoidance – attitude to risk – does size matter?

- the matter of an entity's size and its attitude to risk is not a relationship which is necessarily closely correlated It is possible to make some generalisations, but individual entities in their own situation could very well disprove the generalisation

- for example, a **small entity** would normally face higher risks, managed at board level It will not, typically, have resources available to cover the risk of new product development

- it is probable that a smaller entity will have a smaller product range If one product fails then the impact on the entity could be substantial. The launch of a new product can involve a major investment, and there's no guarantee that it will be popular / viable

- but, if it is to survive, a small entity will need to continue to take the gamble / accept the risk

- as a generalisation, it should be "easy" to see that a small entity will need to accept a certain degree of risk

- on the other hand, a **large entity** will normally face fewer risks – the sub–divided structure of a larger organisation allows such entities / groups to enjoy much greater diversification, thus spreading the risk

- a more extensive product range, a diversification of markets and geographical areas of operation all contribute to a reduction in risk

- the appetite for risk will depend upon the existing portfolio of investments / activities. A diverse portfolio could mean that the entity may be prepared to accept greater risks in new ventures, whereas a higher–risk portfolio might suggest an aversion to taking any more risks

- it is sometimes the case that, because of its size and established reputation, larger entities / groups will wish to protect their image and reputation, and then become positively risk averse

- in addition, theory also suggests that, as entities grow, they increasingly face the problems of making incorrect decisions at critical times (Grainger's Model). Naturally, entities will seek to minimise this risk by taking action as soon as possible. Either that, or, by recognising the risk, plan to manage it

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Chapter 11

ETHICS AND SOCIAL RESPONSIBILITY

Chapter sub–divides into three:

- ethical theories
- different approaches to ethics and to corporate social responsibility
- the role of the accountant in the context of values and ethics

Ethical theories

- With reference to ethical theories, there is a clear distinction between those based on **absolute** values and those based on **relative** values
- Absolute value theorists
  - they assumed that there was only one set of moral rules, and they were always true
  - but truth in one culture must be different from the truth in another Consider the different truths behind Christianity and Islam!
  - so the "absolute school" now accepts that each separate culture has its own truths
  - but, even then, some truths are international – for example, murder by one person of another must surely be a basic unacceptable anti–social act, whatever the culture, religion, geographical location …

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- In contrast, relative value theorists:
  - accept that there are many moral / ethical codes each of which evolves over time and each could be different from every other
  - as a result of this more open acceptance of differing codes of ethics, the relative theorists do not believe in the "one moral truth"
  - accept the need for evolution of moral codes
  - accept also the idea of different races, religions, sects… having their own codes of ethics
  - auditors in one country may well accept as normal an activity by a client which would be seen as abnormal by auditors in other countries
  - these different attitudes, and associated morality, have been developed into a theory explaining how morals and ethics change over time
- Lawrence Kohlberg six stages
  - Level 1 Pre–conventional Morality
    - Obedience and Punishment Orientation
    - Individualism and Exchange
  - Level II Conventional Morality
    - Good Interpersonal Relationships
    - Maintaining the Social Order
  - Level III Post–conventional Morality
    - Social Contract and Individual Rights
    - Universal Principles

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Kohlberg's Six Stages

- Level 1 stage 1 pre-conventional
  - in any action, the individual thinks only of themselves
  - actions are seen as being right or wrong and consequences as being the reward or punishment
  - individuals focus on the consequences which are likely to arise from their actions and how those consequences will affect them personally
  - the morality of an action can be measured by considering the consequences
  - the greater the punishment, the greater the lack of morality
- Level 1 stage 2 pre-conventional
  - at this stage, individuals think of the affect of their actions on others - but only to a very limited extent
  - whilst still looking at morality from an individualistic point of view, individuals at this stage are more concerned with how they will benefit personally from a particular course of action
  - actions are therefore taken from a "what's in it for me" thought process
  - "if you scratch my back, I'll scratch yours"
  - thinking about the affect of actions on other people is incidental to how the action can generate personal benefit
- Level 2 stage 3 conventional
  - stage 3 sees the beginning of the recognition of society beyond the individualistic attitude of the pre-conventional level
  - actions taken are seen to affect society, and society may approve or disapprove of those actions
  - the moral decision is one where society approves
  - this leads to the individual being liked by society
  - "I want to be liked and well-thought of; I can achieve this by not being naughty"
  - but recognition of society extends only to the individual's desire to be liked

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- Level 2 stage 4 conventional
  - at this point, the individual recognises the importance of maintaining a structured and functioning society
  - this automatically leads on to the acceptance of the need for laws and regulations
  - and to the acceptance that those laws and regulations should be obeyed if society is to be able to function
  - if one person breaks a law, this could lead to everyone also breaking that law
  - and that in turn will lead to anarchy and the break-down of society
  - stage 4 (the place reached by most adults) involves the obeying of laws purely because they are laws
  - and in doing that, the best interests of society are protected (but not always!)
- Level 3 stage 5 post-conventional
  - level 3 is known as the principled level
  - recognition that people are individuals separate from society
  - the morality of actions is viewed from an individual's own perspective
  - laws are seen as social contracts
  - any law which does not operate to the general benefit of society needs to be changed
  - but that change is effected by majority decision and, inevitably, compromise
  - "for the greater good of the greater number"
  - generally, the democratic process

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- Level 3 stage 6 post-conventional
  - moral reasoning based on abstract principles using universal ethical principles
  - laws are only valid if they are grounded in justice
  - just as it is important that society should obey laws, it is argued to be of equal importance that "bad" laws should be broken
  - but also acknowledged by the stage 6 thinker that, in breaking the "bad" law, society's rules have been violated and should result in punishment
  - Gandhi, Mandela, Martin Luther King, Christ
  - deontological morality - follow a particular course of action not because of your own self-interest but because it's "the right thing to do"
  - so social contracts (laws and regulations) should be unnecessary - they are not essential for deontic moral decisions and resultant actions
  - decision making is not some theoretical, hypothetical, conditional exercise
  - it's categorical and absolute
  - John Rawl described the thinking as using a "veil of ignorance" - imagining what you would wish to happen if you viewed the situation from the point of view of others affected
  - the resulting concensus is the action which should then be taken
  - in this way, any action is not a means to an end - it is an end in itself
  - an action is taken "because it's the right thing to do" not because it is expected, required by law or has been previously agreed

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Chapter 12

DEONTOLOGY AND TELEOLOGY

Deontological approach

- "deontic" defined as "of such ethical concepts as obligation and permissibility" and "designating the branch of logic that deals with the formalisation of these concepts"
- approach is based on the theory proposed by Immanuel Kant
- sometimes referred to as a "non-consequentialist" approach
- suggests that whether an action is right or wrong is **not** dependent upon the outcome of the decision
- instead, what is important is the motivation or principle
- it is therefore an approach based on ethics / morality
- the "right or wrong" of an action is determined by looking at the moral attitude behind that action
- can only be morally correct if it satisfies three tests:
  - consistency - motivation for an action should be one which would be good to be seen applied throughout the World (consistency) (eg lying is immoral because it destroys the concept of truth and leads to the deterioration of society)
  - human dignity – actions taken should bear in mind the whole of society (eg the concept of slavery cannot be considered acceptable)
  - universality – actions should be taken which are of net benefit to society (eg have you ever taken an action which, if publicised, would make you feel uncomfortable? If so, it's probably of doubtful moral status)

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Deontology and teleology

- teleology defined as "the belief that certain phenomena are best explained in terms of purpose rather than in terms of cause"
- also referred to as a "consequentialist approach"
- motivation for the action is not important
- instead, if the action results in benefit, then it must be good
- but "benefit" for who?
  - egoist view
  - utilitarian view
- egoist asks "is it good for me?"
- utilitarian asks "is it good for society / the majority?"
- these views are not mutually exclusive – consider the position of a tuition provider
- in a general sense, the utilitarian view looks at the consequences of a proposed action and tries to measure "good" effects against "bad" effects
- if "good" outweighs "bad" effects, the action is pursued
- but measurement of these effects is imprecise and subjective – effectively it's a cost/benefit exercise

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Chapter 13

SOCIAL RESPONSIBILITY

Gray, Owen and Adams

- book by **Gray, Owen and Adams** on ACCA's reading list looks closely at the social responsibility of entities
- proposed that entities should accept some degree of social responsibility and
- as an extension to that, some degree also of social accountability
- also accept that this may mean that the World needs to change in that as it is now could be different than as they believe it should be
- identifies **seven positions on social responsibility**
- seven identified categories / groups of people who see social responsibility from their own perspective:
  - capitalists
  - opportunists
  - social contractors
  - social ecologists
  - socialists
  - feminists
  - committed ecologists

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- Capitalists
  - their position is that they believe that the way the World works now is a good approximation to how it should work
  - in addition, they accept the principle of the liberal democratic economy
  - by way of explanation, this group accepts that the needs of shareholders are most important, and that shareholders themselves also believe that to be true
  - it is only one small step to understand that this group has little or no concept of corporate social responsibility (csr)!
- Opportunists
  - their position is that they believe that for entities to be successful, they need to seize opportunities as they arise In that situation, it can easily be seen that the concept of csr is secondary / minimal to the interest of the opportunistic entity's objectives
  - but also realise that, in order for an entity to grow and be successful, it is necessary for it to accept some degree of csr
  - people realise that there should be at least a minimum acceptance of csr, whether it be imposed upon them by legislation or regulation, or whether they have voluntarily realised this in their own self–interests
  - impact on society of the entity's actions is beginning to be recognised as important, and entities are accepting that their use of resource does in fact have an impact on society
- Social contractors
  - believe that entities exist only because society wants them to exist and therefore the entity should operate to serve the needs of society
  - the proposition is that the existence of an entity is justified if it serves the public interest
- Social ecologists
  - express concern that large organisations have damaged the environment and caused social problems
  - believe that the way to repair this damage is in the power of those same large organisations
  - believe that entities should amend their operating and production practices, and
  - become more aware of matters such as pollution, waste disposal and sustainability of resource
  - only in this way can the quality of human life be improved

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- Socialists
  - believe that capital is dominant in social, economic and political life
  - this needs to change in order to reduce the extent of this dominance
  - considers the production of goods should be a secondary consideration, social responsibility should be number one
  - distrusts accounting systems and csr systems but does not necessarily have a clear idea of how to achieve their objectives
- Feminists
  - believe that our society is male dominated – socially, economically, politically and in business
  - this dominance is reflected by the masculine concepts of strength, power, aggression, achievement and conflict
  - see that the business world is lacking in the softer feminine traits of compassion, co–operation, tenderness and love
  - see that csr systems are inherently flawed in that they omit feminine views and
  - to follow the male dominated characteristics is not the best way of organising a group of compassionate (essentially) human beings
- Committed ecologists
  - believe that the human race has no greater claim to the right to exist than any other group of living organisms
  - feel that our existing thinking is totally flawed
  - we should not be destroying natural habitats to build roads or new airport terminals
  - in addition, the farming of such natural resource as fish or timber should, at the very least, be sustainable
  - we should be trying to leave more on this planet for future generations than we ourselves inherited

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Corporate and personal ethical stances

- refers to the positions adopted by entities and individual stakeholders within those entities
- need to consider the entity's position together with the position of the separate groups
- there are four groups to consider:
  - short–term shareholders
  - long–term shareholders
  - multiple stakeholder organisations
  - shapers of society
- short–term shareholders
  - from the entity's point of view, it needs to provide an adequate return to the group
  - from the group's point of view, the small shareholders require a suitable return on their investment (Larger shareholders will likely have very little short–term interest in the entity)
- long–term shareholders
  - from the entity's point of view, it is necessary for the entity to remain in existence!
  - the group itself will be concerned about the security of their investment, and will require capital growth
- multiple stakeholder organisations
  - the entity will identify the multiple stakeholders – those who hold great power and influence over the entity – and will consciously try to satisfy their requirements
  - the group itself expects the entity to recognise their interest, and expects the entity to respect them and act upon that recognition in the interest of the group
- shapers of society
  - the entity will try to change society (hopefully for the better!) by applying its power This change will be for the entity's benefit but also, hopefully, for the benefit of society at large
  - as an individual, little can be achieved to change society but, acting as a group, these individuals can accumulate power and effect change in the way that they exercise that power

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Variables determining the cultural context of ethics and csr

- four variables are identified and each has a different focus:
  - economic — focuses on profitability
  - legal — focuses on compliance with law
  - ethical — focuses on what is "right"
  - philanthropic — focuses on what is "desirable"
- different cultures view these matters in different ways An easy way to illustrate that point is to consider the European attitude in parallel with the attitude of the North Americans
- Economic
  - Europe
    - major focus on the actions of the entity Decisions take into account public image and social acceptability
  - USA
    - focus almost entirely on profitability and interests of shareholders
- Legal
  - Europe
    - government is seen as a necessity, and laws as necessary for the purposes of regulation of entities' activities
    - government seen as a law enforcer and accepted as being in the position of "interference" in an entity's actions
    - for example, Health and Safety legislation may mean slower production times, but is nevertheless followed (by most!)
  - USA
    - government is seen as an interference – an infringement of personal liberties
    - the role of Government is therefore often minimal

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- Ethical
  - Europe
    - ethical responsibility is at the forefront of European consciousness and European businesses are continually aware of the ethics and ethical consequences of their actions
    - this even extends to the point of making their ethical attitudes the subject of positive advertising – confirming in the minds of the public that their entity is a socially aware organisation
  - USA
    - as a result of the greater trust by the American public in the ethics of the US corporations, it is generally accepted that US corporations will be ethical, so no great issue is made of this
- Philanthropic
  - Europe
    - major focus on regulatory systems to provide educational, recreational and cultural opportunities
    - for example, the opening and sponsorship of art galleries, theatres and museums
  - USA
    - a great focus on the philanthropic acts of individuals (the Hearst Collection, the Getty Museum and Bill Gates) rather than on the regulatory framework
    - in summary, Europe concentrates on the ethical and philanthropic actions which are legally enforced whereas the USA concentrates its attention on the discretionary acts of individuals and corporations

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- American Accounting Association approach to ethical issues
  - Facts
  - Ethical issues
    - Independence
    - Obedience
    - Confidentiality
  - Norms, principles and values
    - Objectives
    - Governance
    - Independence
    - Transparency
  - Alternative courses of action
  - Best course of action
  - Consequences of each action
  - Decision
- Remember - Fen ABCD

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- Tucker's model for ethical decision making
  - Profitable – what would be the affect on "profits" of alternative courses of action
  - Legal – what legal limitations are there on alternative courses of action
  - Fair – are stakeholders' claims fair
  - Right – what are the right / ethical issues involved concerning different stakeholder groups
  - Sustainable – whatever course of action is chosen, it should be a course which is sustainable
- Remember – Professional lecturers find responsible students

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Chapter 14

PROFESSIONS AND THE PUBLIC INTEREST

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The topic sub–divides into:

- the nature of a "profession" and "professionalism"
- public interest
- the influence of accounting as a profession in the context of an organisation
- the role of accountancy in society
- the role of accountancy as a value–laden profession capable of influencing the distribution of wealth and power in society
- issues surrounding accounting and acting against the public interest

"Profession" and "professionalism"

- Definition

  - "profession" is defined as "an occupation requiring special training in the liberal arts or science, or the body of people in such an organisation"

  - easily extended to include accountants (liberal art? or science ?)

  - "professionalism" defined as "taking action to support the public interest"

  - Gray identified that a profession has two essential and defining characteristics:

    - a body of theory
    - and knowledge which guides its practice and commitment to the public interest

  - is the accounting profession really a profession?

  - applying Gray's thinking, does accountancy have

    - a body of theory and
    - knowledge which…

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- Body of theory?
  - ethical standards
  - auditing standards establishing quality of audit work
  - examination system to ensure that only people with appropriate professional skills should be accepted into membership
- Knowledge which…?
  - guidance notes on how to apply ethical standards
  - experience, accumulated over longer than a century, of the acceptability of accountants' actions, and the application of ethics to specific situations
  - the need to remain as a profession in which the public can safely put its trust and therefore be seen to be acting in the public interest
  - so, yes, the accounting profession seems to satisfy the Gray criteria and is rightly classed as a "profession"
  - does the profession demonstrate the attributes of professionalism?
  - remember – professionalism can be defined as "taking action to support the public interest"
  - within any profession, the members of that body are normally expected to take actions which contribute to the public interest and these same members should be seen to be acting professionally
  - "independence is an attitude of mind"
  - so too is "professionalism"
  - ACCA sets out the rules for us to follow in our daily professional lives but, really, it is our own individual code of personal conduct which establishes us as professional people
  - historically, the profession responded to crises as they arose – a reactive response to each new situation needing to be addressed
  - more recently, the profession has been taking a proactive role – seeking to prevent crises arising and trying to anticipate problems before they become a reality

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Public interest aspect of professionalism

- What exactly is the public interest?
  - no definition!
  - but it's safe to say that acts in the public interest should benefit society as a whole
  - this extends to the principle that the interests of society should outweigh the interests of any individual within society (where there is conflict between the two)
  - not only should accountants act in the public interest generally
  - but also, where a client entity is acting **against** the public interest, the actions of the accountant should be dictated by loyalty to society and not loyalty to the client
  - potential clashes between the interests of the public and the basic human rights of an individual
  - where a person commits a crime and is sent to prison, that surely is a breach of that person's human right of freedom
  - but for the greater good of society, the public interest is best served by keeping that criminal in prison and away from society
  - similarly, an entity may, acting through its majority, harm the rights of a minority shareholder English entity law includes provisions for the protection of minority rights The law will intervene where it is necessary to prevent those in control of the entity from leading it into a situation where it is about to breach its own constitution but, otherwise, the general principle of majority rule will apply
  - Government may also find itself in a position to regulate the affairs of an entity in the interests of the public, for example, where the entity is guilty of creating excessive pollution
  - in the UK the Government has given power to the National Rivers Authority to take action against entities which are guilty of causing pollution to the river system

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The influence of accounting as a profession in the context of an organisation

- accountancy firms are closely involved with their clients either through the role as auditors or in the provision of "other" services

- an auditor's independence could be threatened and could result in the auditor expressing an inappropriate opinion on the truth and fairness of the view shown by the client's financial statements

- but the auditor / accountant faces other dilemmas in addition to the problems posed by the traditional threats to independence

  - where the client is in financial difficulties

    - in this situation the dilemma facing the auditor is whether to modify the audit report or not
    - a modification in the form of a qualification could well hasten the client's progress to insolvency – is the bank likely to want to continue supporting the client?
    - equally, not to modify / qualify could well give the wrong message to stakeholders and, when subsequently the entity does fail, the auditors could face severe criticism at best and legal action for negligence at worst
    - precise wording of an audit report is therefore clearly a matter for great care and requires professional skill, expertise and experience, but the auditor should consider carefully the "public interest"

  - should the auditor provide other services?

    - why not? The audit firm already has a wealth of knowledge about the client and, almost by definition, probably has the professional skills necessary
    - however, there remains the danger of the audit / accounting firm becoming too dependent on the client because of the aggregate fees received from the client in respect of the combined services rendered
    - from society's point of view, it must be beneficial for the auditor to provide these additional services – less expensive and quicker – so the client avoids the unnecessary larger costs of the service which they would otherwise have passed on in the costs of their products
    - but society may be better served if these other services were provided by a second accountancy firm, thereby protecting both accountancy firms against the threats to their independence

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- Client relationships

  - it is in the interests of both the client and the auditor that the audit firm should not be changed on a frequent basis
  - with each change, the new auditor must go through an education process, learning all about the client, the systems, the history, products, risk…
  - from the client's point of view, it automatically restricts the number of people who have detailed knowledge about the entity, and thus confidentiality is protected
  - however, there is a danger that the relationship becomes too familiar and that the auditors are then in a position where they see only what they expect to see
  - such a situation is not in the public interest!
  - in the USA, Sox requires a rotation of reporting partner for the client every five years
  - the equivalent guidance in the UK is seven years
- Should the size of an audit / accountancy firm be restricted?

  - it is in the public interest that an audit firm should be large enough to be able to enjoy the benefits of economy of scale, and the larger they are, the greater the potential savings
  - this will keep the audit / accountancy fees to a sensible level, and the public should benefit
  - it is really only a large firm that is in a position to undertake multi–national group audits
  - but with growth comes increasing impersonality
  - in turn, this could lead to a fall in the quality of service caused by those in control losing sight of the detail
  - so, maybe it is not in the public interest for audit firms to be allowed to grow without some limitation being imposed
- The big 4

  - only a few years ago, the "big 4" were the "big 6" Then Price Waterhouse (2) merged with Coopers and Lybrand (5) and the "big 6" became the "big 5"
  - at this point, the accounting profession, under pressure from the Monopolies Commission in London, agreed that there should be no more mergers of super–large accounting firms, so the "big 5" should never become the "big 4"!
  - too few super–firms is clearly not in the public interest because of the reduction in choice available for clients
  - but the "big 4" are in a highly competitive market, they are profit orientated, and they need to keep winning new clients
  - this competition may be seen to be a temptation to reduce fees to an artificially low level
  - could be argued as a threat to the quality of the services rendered
  - but increasing awareness in the minds of clients of the possibility of taking a successful action against the auditors for negligence is a good deterrent for the auditor thinking of cutting corners

Accountancy in society

- The role of accountancy in society

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- there is a doubt in the minds of the public about the competencies and integrity of accountants which is fuelled by each successive high–profile corporate failure…

- …but accountants themselves believe that they have a role to play in society and as being able to serve the public interest They clearly have the skills and knowledge to perform the tasks which are expected of them

- generally, accountants see their role as well–established, the profession having developed over a period in excess of one hundred years

- the profession is, however, slow to change There is not normally a lot of time for accountants to consider innovation, and those working for others in an entity are pretty much restricted by the expectations of those who employ them

- So how do accountants become involved in "change"?

  - changes in the design and management of information systems often require the involvement of accountants because they are skilled in the processes of collecting and verifying data

  - change involving some financial aspect again presents the accountant with an opportunity to use specialist skills

  - Any new entity initiative will likely be profit related, and once again the accountant will be heavily involved

  - working in the public interest means that accountants need to design rules (IFRS!) for dealing with the doubtful practices which entities indulge in Examples would include "Contingencies and Provisions", "Financial Instruments" and "Share Based Payment Schemes" to name but three

  - one other area in which the accountant could well be involved is in the preparation or review of the Corporate and Social Responsibility Report

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The role of accountancy as a value laden profession capable of influencing the distribution of wealth and power in society

- we saw, at the start of this chapter, the sub–heading "The role of accountancy"
- the question is "How can accountancy?"
- This may be achieved in a number of ways including:
  - giving advice to Government about the content and wording of successive Acts of Parliament which could have an affect on the interests of creditors, employees and minorities
  - advising the Government on ways of making more fair the tax burden on individuals
  - ensuring that clients comply with legislation such as the full disclosure of directors' remuneration In this way, directors may be less inclined to pay themselves outrageous bonuses in order to avoid the criticism which may otherwise be directed at them
  - whistle–blowing on the illegal actions of entity officials

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Accountancy and acting against the public interest

- it is (almost) inconceivable that an accountant would knowingly act against the public interest
- but there are situations where, if they did nothing, it would be the equivalent of assisting a client to operate against that public interest
- the following section provides some examples where disclosure, or lack of disclosure, of information could be seen as acting against the public interest.

Situation	Example
Lack of disclosure would decrease accountability or limit decision making of the public.	▸ Not providing information on illegal actions of entities (e.g. Enron) allows actions to continue to the long–term detriment of stakeholders.
Lack of disclosure would lead to lack of enforcement of appropriate laws.	▸ It would be against the public interest not to disclose the information. ▸ Lack of disclosure would mean a criminal could continue a crime such as money laundering in breach of money laundering regulations.
Disclosure would adversely affect the economic interests of the jurisdiction in which the accountant is working.	▸ It would be against the public interest to disclose the information. ▸ Disclosing price sensitive information on an entity's share price or details of interest rate movements before they had been authorised could harm businesses in the jurisdiction or the jurisdiction as a whole (exchange rate movements). ▸ Disclosure would be inappropriate because the public interest would be harmed.
Lack of disclosure would impair the health and safety of public.	▸ Not disclosing information on potential contamination of land by an organisation. ▸ Non–disclosure of this information would not be in the public interest as health and safety could be compromised.

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Chapter 15

PROFESSIONAL PRACTICE AND CODES OF ETHICS

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Corporate ethics

- the topic relates to the attitude and behaviour of an entity in its application of ethical values
- in earlier chapters we have come across the Corporate and Social Responsibility Report (csr) It is within this csr report that we would expect to find disclosure of the entity's ethical approach to business
- disclosure extends beyond legal requirements and, in this respect, could be viewed as discretionary
- the entity should have developed policies in a number of areas in an effort to ensure the continued survival of the entity
- Key areas of corporate ethics include:
  - purpose of the business
  - workforce
  - customer relations
  - shareholders and other providers of finance
  - suppliers
  - society
  - implementation
- purpose of the business
  - the reason for the entity's existence
  - broad outline of the entity's products or services
  - entity's financial objectives
  - role of the business in society, as seen by the entity itself

- workforce – there should be disclosure of the entity's policies on:
  - working conditions
  - recruitment
  - training and development
  - rewards and bonuses
  - health and safety and security
  - equal opportunities
  - retirement
  - redundancy
  - discrimination
  - use of entity assets by employees
- customer relations
  - how can the entity maintain the quality of its product or service and, in that way, keep its customers loyal
  - how should the entity arrive at a fair price for its products so that the entity makes a profit, but the customer pays a reasonable price
  - how can the entity improve its after–sales service
- shareholders and other providers of finance
  - because the shareholders provide much of the finance for an entity, it is only right that they should want a return on their investment
  - in addition, they are entitled to expect a timely set of financial statements and other financial information
  - to a greater or lesser extent, under the principles of good corporate governance, shareholders will be involved in the decision making process of the entity
- suppliers
  - the providers of goods and services to the entity also need to be considered

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- the entity can expect goods and services of appropriate and acceptable quality to be delivered on a timely basis
- in turn, the entity should try to settle their debts to suppliers promptly
- try to arrange with suppliers for the more efficient delivery of goods
- and not use doubtful practices to secure contracts with suppliers – so no bribes or excessive hospitality!

- society
  - as a member of society, each entity should accept its role within that society and within the community at large
  - this acceptance can be communicated through the csr and, in particular, the entity should include within the report information about:
    - how the entity complies with relevant legislation
    - the steps taken by the entity to protect and improve the environment
    - how the entity is involved with the local community
    - the entity's policy with reference to sponsorship and charitable donations
- implementation
  - the entity should identify the CGC, and the process of the entity's implementation of the CGC's provisions
  - it should also include within its processes an annual review of the CGC, its provisions, and the way the entity is making efforts to comply

Professional ethics

- most professions issue their own code of ethics, and the accountancy profession in general, and ACCA in particular, is no exception
- main purpose of ethics guides is to ensure that members and students of the professions maintain proper, acceptable, professional standards of care
- there has to be, within each profession, a mechanism for the administering of disciplinary measures in the event that any member or student breaks the ethical guidance
- the profession can be seen to be acting in the public interest and therefore gives the public a basis for the placing of confidence in the activities of the profession and its members
- in any code of ethics of a profession, there will normally be:

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- introduction – providing a background to the code, identifying those to whom it shall apply, how it is to be enforced, and outlining disciplinary measures
- fundamental principles – key principles, either detailed or in summary, which must be followed by all those to whom the code applies
- conceptual framework – explanation of how the principles are applied, and also a recognition that the framework cannot cover all situations and should therefore be followed in spirit rather than following the actual words
- detailed application – examples of the application of the principles to specific situations

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- In the ACCA's code of ethics, the fundamental principles are:
  - **I** integrity
  - **O** objectivity
  - **C** competence
  - **C** confidentiality
  - **B** behaviour
- integrity
  - implies fair dealing and honesty
  - members should not become involved with any report or communication where the information is either:
    - materially false, or known to contain material misstatements
    - provided recklessly or carelessly
    - incomplete in such a way that the report becomes misleading
- objectivity
  - accountants should ensure that their professional judgement is not impaired by reason of any bias or conflict of interest

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- competence
  - accountants should have the necessary knowledge and skill to carry out work for their clients
  - accountants should follow applicable technical and professional standards when carrying out work for clients
  - accountants should not accept or continue work which lies beyond their professional competence unless they buy in those competencies
  - once an accountant has satisfactorily passed all the professional exams (acquired competence) it is then necessary to ensure that these competencies are maintained
  - hence the requirement of cpd
- confidentiality
  - information obtained in a business relationship shall not be disclosed outside the firm unless there is proper and specific authority to do so, or unless there is a professional right or duty to disclose
  - confidential information acquired in the course of employment shall not be used for personal gain
  - the main reasons for disclosure are when:
    - permitted to by law, and authorised by the client
    - required to by law
    - there is a professional duty or right to disclose, for example, when replying to the ACCA or when complying with ethical requirements

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- ethical considerations about disclosure
  - the accountant needs to consider the extent to which disclosure will adversely affect the interests of third parties
  - the extent of disclosure will be affected by any uncertainties in the matter The more uncertain, the less disclosure
  - the accountant should ensure that disclosure is made only to authorised persons
- professional behaviour
  - the accountant must comply with all relevant laws and regulations
  - should not get involved in any action which would bring discredit to the profession
  - should treat all people with whom they come into professional contact with courtesy and consideration
  - should not indulge in any marketing activity which would bring the profession into disrepute
- ethical threats connected with conflicts of interest
  - in the context of professional ethics, the ACCA guide identifies, within its framework, the problems associated with conflicts of interest
  - but the potential for numerous different examples of conflicts of interest is so great that the problems can only be solved on the basis of a generalised framework using the fundamental principles as guidance
  - this approach – applying generalised principles to particular situations as they arise – is seen to be preferable to a rules or legal based approach It involves the accountant in applying the spirit of the ethical guide rather than strictly adhering to a written set of rules which may well not cover the individual situation which the accountant is facing
  - safeguards can be adopted by different interest groups in an attempt to protect the accountant from the threats caused by conflicts of interest
  - these interest groups include the profession, the work environment and the individual

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Bribery

- Bribery Act 2010 targets both bribery and corruption
- 4 offences
  - bribing another person
  - receiving a bribe
  - bribing a foreign public official (FPO) (see next page)
  - commercial organisation failing to prevent bribery (see next)
- bribing = offering financial or other advantage to perform a relevant function or activity improperly
- relevant function or activity:
  - any function of a public nature
  - any activity connected with a business
  - any activity performed in the course of a person's employment
  - any activity performed by, or on behalf of, a group of persons
- these "relevant functions or activities" may be anywhere in the world

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Bribing an FPO

- offence to offer, directly or indirectly, a financial or other advantage to an FPO intending to influence them in gaining business or an advantage in connection with business
- an FPO holds an administrative, legislative or judicial position outside the UK
- commercial organisation failing...
  - a company or partnership is liable if an agent, employee or subsidiary bribes another person intending to gain a business advantage
- Defence - if a company can show that it had adequate procedures in place, appropriate to the level of risk
  - "adequate procedures" based on six guidance principles

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The Six principles

- proportionate procedures
  - proportionate to risks faced and size of company
- commitment by management
  - management should assess the nature and extent of risks faced and develop appropriate procedures to manage that risk
- due diligence
  - the company should apply due diligence procedures in respect of company personnel who are at greater risk of offering bribes
- communication
  - to ensure all employees / connected persons are aware of the company's culture and attitude
  - includes training and education procedures
- monitoring and review
  - procedures should be regularly reviewed and improved as necessary
- "adequacy of procedures" is a matter for a court to decide
- NB "hospitality" that is reasonable and proportionate is acceptable, ie is it not prohibited by the Act.

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Penalties

- an individual who is found guilty faces imprisonment up to 10 years
- a guilty company is liable to an unlimited fine
- but, in addition, there is reputation loss...
- ... and potentially, civil claims against the directors for failing to implement adequate procedures

First conviction

- Munir Patel found guilty of accepting £500 to suppress a driving conviction from court records. Serving a 3 year prison sentence

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Safeguards from within:

- the profession
  - education and training, including cpd requirements
  - setting corporate governance regulations and professional standards
  - monitoring of the quality of professional work, granting audit registration certificates and applying disciplinary proceedings when appropriate
- the work environment
  - internal control systems
  - review procedures
  - disciplinary procedures
  - entity's own code of ethics
  - separate review and reporting in key areas
- the individual
  - compliance with professional standards
  - maintenance of records of contentious issues
  - mentoring
  - contacting ACCA with professional queries

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- examples of threats and safeguards

Ethical threat	Safeguard
Conflict between requirements of the employer and the fundamental principles For example, acting contrary to laws or regulations or against professional or technical standards	▸ obtaining advice from the employer, professional organisation or professional advisor ▸ the employer providing a formal dispute resolution process ▸ legal advice
Preparation and reporting on information Accountants need to prepare/report on information fairly, objectively and honestly However, the accountant may be pressurised to provide misleading information	▸ consultation with superiors in the employing entity ▸ consultation with those charged with governance ▸ consultation with the relevant professional body
Having sufficient expertise Accountants need to be honest in stating their level of expertise – and not mislead employers by implying they have more expertise than they actually possess Threats that may result in lack of expertise include time pressure to carry out duties, being provided with inadequate information or having insufficient experience	▸ obtaining additional advice/training ▸ negotiating more time for duties ▸ obtaining assistance from someone with relevant expertise
Financial interests Situations where an accountant or close family member has financial interests in the employing entity Examples include the accountant being paid a bonus based on the financial statement results which he is preparing, or holding share options in the entity	▸ remuneration being determined by other members of management ▸ disclosure of relevant interests to those charged with governance ▸ consultation with superiors or relevant professional body

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Inducements – receiving offers Refers to incentives being offered to encourage unethical behaviour Inducements may include gifts, hospitality, preferential treatment or inappropriate appeals to loyalty Objectivity and/or confidentiality may be threatened by such inducements	‣ Do not accept the inducement! ‣ Inform relevant third parties such as senior management and professional association (normally after taking legal advice)
Inducements – giving offers Refers to accountants being pressurised to provide inducements to junior members of staff to influence a decision or obtain confidential information	‣ Do not offer the inducement! If necessary, follow the conflict resolution process outlined in the previous section
Confidential information Accountants should keep information about their employing entity confidential unless there is a right or obligation to disclose, or they have received authorisation from the client However, the accountant may be under pressure to disclose this information as a result of compliance with legal processes such as anti–money laundering / terrorism – in this situation there is a conflict between confidentiality and the need for disclosure	‣ Disclose information in compliance with relevant statutory requirements, eg money laundering regulations
Whistle-blowing Situations where the accountant needs to consider disclosing information although there is no obligation from statute or regulation Disclosure would therefore be in the public interest	‣ Follow the disclosure provisions of the employer, eg report to those responsible for governance ‣ Otherwise disclosure should be based on assessment of: • legal obligations • whether members of the public will be adversely affected • gravity of the matter • likelihood of repetition • reliability of the information • reasons why employer does not want to disclose

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Threats to independence

Threat to independence	Possible affect on ethical behaviour
Financial interests – an accountant holds shares in a client entity	Conflict between wanting a dividend from the shareholding and reporting the financial results of the entity correctly May want to hide liabilities or overstate assets to improve dividends
Financial interests – an auditor holds shares in a client entity	Conflict between wanting a dividend from the shareholding and providing an honest audit report on the entity May want to hide errors found in the financial statements to avoid qualifying the audit report and potentially decreasing the dividend payment
Close family member has an interest in the assurance client	Self–interest threat May decide not to qualify the audit report to ensure that the financial interests of the family member are not compromised May also be an intimidation threat – if an employee, the assurance client may threaten to sack the family member if a qualified audit report is produced
The assurance partner plays golf on a regular basis with the chairman of the board of the assurance client	Self–interest threat There may be a conflict between potential qualification of the entity financial statements and losing the friendship/golf with the chairman
Fee due from a client is old and the assurance firm is concerned about payment of that fee	Intimidation threat The client may threaten to default on the payment unless more work is carried out by the assurance firm The assurance firm may also be seen to be supporting the client financially, implying that any report will be biased because the firm wants the 'loan' to be repaid
A entity offers an assurance partner an expensive car at a considerable discount	Potential conflict because the partner may want the car, but also recognises the ethical threat of appearing to be bribed by the client The partner may accept the car and not report this
A close family member is a director of a client entity	Potential conflict because an assurance partner would not want to qualify the audit report and create bad feeling between the partner and the director The audit report may therefore not be qualified when it should be
An assurance partner serves as an officer on the board of an assurance client	Self–interest and self–review threats The partner would have a conflict between producing information for audit and then reporting on that information The partner may either miss errors or even decide to ignore errors identified to avoid having to admit to mistakes being made

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Chapter 16

ETHICAL CHARACTERISTICS OF PROFESSIONALISM

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- **Ethical decision making** is a four–stage process which is influenced both by the particular situation and by the individual making the decision

- The four stages of ethical decision making:
  - recognising the moral issue
  - making a moral judgement
  - establishing moral intent
  - behaving in a moral way

- A hypothetical example:
  - A customer has accidentally overpaid one of your invoices by $2,000. What is the process of the decision which you make?
  - Recognise the moral issue – if you keep quiet, then you will be richer by $2,000
  - Make a moral judgement – it is wrong to steal from your customers
  - Establish moral intent – decide upon a course of honesty
  - Behave in a moral way – notify the customer of his mistake, and repay the $2,000
  - (Kohlberg's theory of six stages – we came across him in chapter 11 – fits comfortably with the ethical decision making process)
  - But the decision taken will depend upon the individual making that decision (age, sex, experience etc) as well as on the situation (financial stability of the individual, demands on his resources, culture etc)

- **Ethical behaviour** of accountants is generally expected by the public However, that behaviour can be shown to be dependent upon the nature of the issue and the context in which the issue takes place

- with reference to issue–related matters, we shall see that the greater the intensity of a decision, the more likely it is that an ethical decision will be taken Thus:

  - where a decision will affect a lot of people, but only slightly, then an unethical decision could well result whereas if only a few people are likely to be affected, but to a great extent, the decision will probably tend to be ethical

  - similarly, if the identity of the affected people is unknown to the decision maker, then an unethical decision is more likely, but if the decision maker knows the people who will be affected, the decision will more likely be ethical

  - a third determining factor is the time frame within which the consequencies will become apparent If the time frame is long, the decision could well be unethical If the time frame is short, then an ethical decision is more likely

- with reference to context–related matters we shall see that the actions of others can easily affect the ethics of decisions For example, where colleagues are rewarded for actions demanded by superiors, even though those actions may be of doubtful ethics, then a "new" colleague is likely to want the reward too

- similarly, if everyone within an entity carries out their work in an unethical way, then all individuals are likely to conform with that established standard

- Key contextual factors

  - reward system

  - authority

  - bureaucracy

  - work roles

  - entity culture

  - national culture

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Factor	Effect on ethical decision making
Reward system	Where rewards are based on achievement (eg number of sales made) then ethical decision making may be affected Unethical decision making may also increase where unethical behaviour is unpunished or even supported by the organisation
Authority	Junior managers tend to follow instructions from senior managers Where senior managers make unethical decisions these are likely to be followed by juniors Senior management may also provoke a climate where unethical decision making is accepted
Bureaucracy	Bureaucracies tend to make employees follow rules rather than think about the ethics of decisions being made More bureaucracy may therefore mean a lower level of ethical decision making – although this depends on authority – see above
Work roles	Managers tend to follow the 'work role' expected – hence an ethical role such as an accountant will normally find managers behaving ethically – because that is expected In other roles where ethics are believed to be compromised regularly, managers will usually also behave less ethically
Entity culture	Managers tend to share the norms of the group they are in, so what may be described as unethical behaviour overall may be 'ethical' for the group A group may decide that copying work–related software at home is 'ethical' and therefore all members of the group participate in this behaviour
National culture	Different countries or cultures will have different ethics Whether a decision is ethically correct or not may therefore depend on the specific culture

- **Ethical dilemmas:** the approach of accountants and other professions to ethical dilemmas is based on a code of principles as discussed earlier in these notes. A rules–based approach is the obvious alternative

- Each approach has its own characteristics, advantages and disadvantages

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Rules-based approach		Principles-based approach	
1	Establish ethical rules that members must follow	1	Establish fundamental ethical principles that members must follow
2	Ensure members are aware of the rules	2	Ensure members are aware of the principles
3	Ensure members comply with those rules	3	Require members to identify and address threats to compliance with the principles and make an appropriate response to mitigate each threat

Advantages	
▸ Easy to check compliance as based on fact ▸ Easy to amend rule set as required	▸ Recognises that every threat cannot simply be 'listed' ▸ Allows for subjective judgement, so the member can apply the principles in accordance with their specific situation and nature of the threat

Disadvantages	
▸ The list of rules may not be complete ▸ There is no room for individual decision making	▸ In some situations it may be difficult to confirm that the compliance action was appropriate as two people may make different and valid decisions based on the same threat and circumstances

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Chapter 17

SOCIAL AND ENVIRONMENTAL AND ETHICAL BEHAVIOUR

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Economic activity

- **economic activity** is only capable of being sustained where the impact on society and the environment can also be sustained
- the social footprint looks at sustainability in terms of three aspects of capital – social, human and constructed, and entities need to ensure that their economic activities are sustainable in all three areas
- the environmental footprint is the aspect of ensuring that an entity's use of scarce resource is replenished That is, we should leave more natural resource to the next generation than we ourselves inherited from the previous generation

Sustainability

- **sustainability** can be measured objectively or subjectively
- the objective approach measures sustainability in terms of actual resource used compared with the amount of resource available
- subjective approach accepts the inability to measure resource and concentrates instead on the intentions of the entity in their attempts to achieve sustainability goals

Environmental footprint

- **environmental footprint** – the effect on the environment of today's society and how it will affect the next generations

- as an example, consider the sealing of food packages The traditional way of sealing these food containers has been to use glue to stick the see–through cover to the basic container A UK entity has recently designed and patented a method of sealing which uses radio–waves to effect that seal

- the overall effect of this is multiple!
  - it uses less glue and therefore fewer whales need to be killed (from which the glue is made)
  - it is more efficient in terms of fewer broken food packages, so less wastage and therefore fewer animals killed because of less wastage
  - the entire package is now bio–degradable whereas previously it wasn't
  - the equipment necessary for radio–wave sealing can be bought and used in all the separate food packaging entities, so there is no increase in the use of fuel to transport the food to the supermarkets

Social footprint

- **social footprint** looks at the use of capital in terms of social, human and constructed capital

- social – involves the use of services provided centrally (health, education, hospitals, pensions etc) If these services are not maintained (if money raised by central Government is not sufficient to maintain the services) then tax rates will need to increase

- human – involves the requirement that people should be able to continue working effectively This in turn involves the entity taking steps to help these people look after their personal health, and improve their knowledge and skills

- constructed – involves maintaining the physical structures (roads, buildings etc) that society has built

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Environmental accounting systems

- relates to the need to establish and maintain systems for assessing the impact of the entity on the environment
- Eco–Management and Audit Scheme (EMAS) and ISO 14000 were both developed in the 1990s, and both relate to the establishment and maintenance of environmental accounting systems
- whereas the ISO focuses on internal systems, EMAS focuses on the standard of good reporting and auditing
- many entities refer to their compliance within their csr report
- EMAS
  - is a voluntary initiative designed to improve entities' environmental performance
  - aim is to recognise and reward those entities which consistently go beyond compliance with minimum standards in their efforts to improve their environmental performance
  - requires entities to produce regular reports about their environmental performance
  - to become a member of the EMAS participators, entities must adopt an Eco–Management System (EMS) which meets the requirements of ISO 14001
  - participating entities must show that they understand and can implement all relevant legislation
  - the entities must recognise and meet the information needs of the shareholders
  - participators are required to improve their environmental performance over time
  - employees of the entities must be involved at all levels

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- ISO 14000
  - is a series of standards dealing with environmental management together with a supporting audit programme
  - it designs the specifications for an EMS, gives guidance for its use and establishes the standard against which it can be audited
  - to be registered as ISO 14000 compliant an entity must
    - implement, maintain and improve an EMS
    - assure itself of its own conformance with its own stated environmental policy
    - demonstrate conformance
    - ensure compliance with environmental laws and regulations
    - have its EMS externally certified
- an entity should identify elements of its operations which have an impact on the environment
- produce plans for its improvement and a management system to monitor the improvements

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- Advantages of compliance
  - compliance with either standard will reduce the cost of waste disposal
  - there will be savings in terms of consumption of energy
  - improved corporate image
  - the entity will have a framework to work to in trying to improve its environmental performance
- Social auditing
  - process by which an entity can assess and demonstrate its social, economic and environmental benefits
  - it also measures the extent to which an entity achieves its objectives as set out in its mission statement
  - in addition, it establishes the process for environmental auditing
- Environmental auditing
  - aims to assess the impact of the entity on the environment
  - it normally involves the implementation of EMAS or ISO 14000 (see next chapter)
  - it provides the data for the environmental audit
- Environmental accounting
  - the development of an environmental accounting system to support the integration of environmental performance measures
  - it provides evidence of the achievements of social and environmental objectives
  - without social and environmental auditing, environmental accounting would not be possible

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Chapter 18

INTERNAL MANAGEMENT SYSTEMS SUCH AS EMAS AND ISO 14000

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Brief history of environmental management systems

- first recognised as an issue in 1992 by the British Standards Institute
- 1996 International Standards Organisation adopted the BSI initiative in the ISO 14000
- 2010 ISO 14001 used by approximately 250,000 organisations around the World

Development of the ISO 14000 series

- ISO 14000 represents the core set of standards used by entities for designing and implementing an effective environmental management system (EMS)
- the major objective of the ISO 14000 series of norms is "to promote more effective and efficient environmental management and to provide useful and usable tools that are:
  - cost-effective
  - system-based
  - flexible, and
  - reflect the best entities and the best organisational practices available for gathering, interpreting, and communicating environmentally relevant information"
- ISO 14000 acts both as an internal management tool and as a way of demonstrating a company's environmental commitment to its customers and clients
- prior to the development of the ISO 14000 series, entities voluntarily constructed their own EMSs, but this made comparisons of environmental effects between companies difficult
- therefore, the universal ISO 14000 series was developed
- an EMS is defined by ISO as: "part of the overall management system, that includes organisational structure, planning activities, responsibilities, practices, procedures, processes, and resources for developing, implementing, achieving, and maintaining the environmental policy'

ISO 14001 standard

- ISO 14001 sets out the criteria for an EMS
- it does not state requirements for environmental performance
- instead, it maps out a framework that an entity can follow to set up an effective EMS
- it can be used by any entity that wants to improve resource efficiency, reduce waste, and drive down costs
- using ISO 14001 can provide assurance to entity management, employees and external stakeholders that environmental impact is being measured and improved
- it can also be integrated with other management functions and assists entities in meeting their environmental and economic goals
- ISO 14001 is voluntary
- its main aim is to assist entities in continually improving their environmental performance, while complying with any applicable legislation.
- entities are responsible for setting their own targets and performance measures, with the standard serving to assist them in meeting objectives and goals and in the subsequent monitoring and measurement of these
- the standard can be applied throughout an entity's structure and operations
- instead of focusing on exact measures and goals of environmental performance, the standard highlights what an entity needs to do to meet these goals
- ISO 14001 is a generic management system standard
  - it is relevant to any entity seeking to improve and manage resources more effectively
  - this includes:
    - single-site to large multi-national organisations
    - high-risk entities up the complete scale to low-risk service organisations
    - manufacturing, process, and the service industries, including local governments
    - all industry sectors including public and private sectors
    - original equipment manufacturers and their suppliers

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Basic principles and methodology

- PLAN, DO, CHECK, ACT

  - **Plan – establish objectives and processes required**

    - initial review to assist in identifying all elements of the current operation and, if possible, future operations, that may interact with the environment, termed "environmental aspects"
    - environmental aspects can include both direct, such as those used during manufacturing, and indirect, such as raw materials
    - this review assists the entity in establishing environmental objectives, goals, and targets, all of which should ideally be measurable
    - it helps with the development of control and management procedures and processes
    - it serves to highlight any relevant legal requirements, which can then be built into the policy

  - **Do – implement the processes**

    - the entity identifies the resources required and identifies those members of the entity responsible for the EMS implementation and control
    - this includes establishing procedures and processes
    - other procedures are required to foster better management control over elements such as documentation control, emergency preparedness and response, and the education of employees, to ensure that they can competently implement the necessary processes and record results
    - communication and participation across all levels of the entity, but especially top management, is a vital part of the implementation phase, with the effectiveness of the EMS being dependent on active involvement from all employees

  - **Check--measure and monitor the processes and report results**

    - performance is monitored and periodically measured to ensure that the entity's environmental targets and objectives are being met
    - internal audits are conducted at planned intervals to ascertain whether the EMS meets the user's expectations and whether the processes and procedures are being adequately maintained and monitored

  - **Act--take action to improve performance of EMS based on results**

    - a management review is conducted to ensure that the objectives of the EMS are being met, the extent to which they are being met, and that communications are being appropriately managed
    - also to evaluate changing circumstances, such as legal requirements, in order to make recommendations for further improvement of the system
    - these recommendations are incorporated through continual improvement
    - plans are renewed or new plans are made, and the EMS moves forward

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Continual Improvement Process (CIP)

- the core requirement of a CIP is different from the one known from quality management systems. CIP in ISO 14001 has three dimensions:
  - expansion: more business areas get covered by the implemented EMS
  - enrichment: more activities, products, processes, emissions, resources get managed by the implemented EMS
  - upgrading: an improvement of the structural and organisational framework of the EMS, as well as an accumulation of know-how in dealing with business-environmental issues
- overall, the CIP concept expects the entity gradually to move away from merely operational environmental measures towards a strategic approach on how to deal with environmental challenges

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Benefits

- better management control
- resulting in reducing their environmental impacts
- in addition to improvements in performance, entities can enjoy a number of economic benefits including higher conformance with legislation and regulatory requirements
- by minimising the risk of regulatory and environmental liability fines and improving an entity's efficiency benefits can include a reduction in waste, use of resources, and operating costs
- as an internationally recognised standard, businesses operating in multiple locations across the globe can use their compliance with ISO 14001, eliminating the need for multiple registrations or certifications
- satisfies the growing expectation of consumers for entities to adopt better internal controls, making the incorporation of ISO 14001 a commercially sensible approach for the long-term viability of businesses
- provides a competitive advantage compared with entities that do not adopt the standard
- in turn this can have a positive impact on an entity's asset value
- it can lead to improved public perceptions of the business, placing them in a better position to operate in the international marketplace
- the use of ISO 14001 can demonstrate an innovative and forward-thinking approach to customers and prospective employees
- it can improve employee morale
- increase a business's access to new customers and business partners
- in some markets it can potentially reduce public liability insurance costs
- it can assist in the reduction or complete removal of trade barriers between registered businesses
- there is growing interest in including certification to ISO 14001 in tenders for public-private partnerships for infrastructure renewal
- has been shown to improve environmental quality and therefore also benefit to the taxpayer

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Conformity Assessment

- ISO 14001 can be used in whole or in part to help an entity (for-profit or not-for-profit) better manage its relationship with the environment.

- if all the elements of ISO 14001 were incorporated into the management process, the entity could choose anyone of four ways to prove that it has achieved full alignment or conformity with the international standard
  - make a self-determination and self-declaration
  - seek confirmation of its conformance by parties having an interest in the entity, such as customers
  - seek confirmation of its self-declaration by a party external to the entity
  - seek certification / registration of its EMS by an external entity

- ISO does not control conformity assessment; its mandate is to develop and maintain standards

- ISO has a neutral policy on conformity assessment

- no individual option is better than the next

- each option serves different market needs

- the adopting entity decides which option is best for them, in conjunction with their market needs
  - option 1 is sometimes incorrectly referred to as "self-certify" or "self-certification
    - the user is responsible for making their own determination, not the entity itself
  - option 2 is often referred to as a customer or 2nd-party audit
  - option 3 is an independent third-party process by an entity, based on an engagement activity and delivered by specially trained practitioners
    - this option was based on an accounting procedure branded as the EnviroReady Report, which was created to help small- and medium-sized entities
    - its development was originally based on the Canadian Handbook for Accountants but is now based on an international accounting standard
  - option 4 certification, is another independent third-party process that has been widely implemented by all types of entities
  - certification is also known in some countries as registration
  - service providers of certification or registration are accredited by national accreditation services such as UKAS in the UK

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ISO 14001 and EMAS

- EMAS III is now globally applicable and includes key performance indicators and a range of further guidance.

- **Similarities and Differences**
  - ISO 14001's environmental management system requirements are very similar to those of EMAS
  - additional requirements for EMAS include:
  - stricter requirements on the measurement and evaluation of environmental performance against objectives and targets
  - government supervision of the environmental verifiers
  - strong employee involvement - EMAS entities acknowledge that active employee involvement is a driving force and necessary for continuous and successful environmental improvements
  - environmental core indicators creating multi-annual comparability within and between entities
  - mandatory provision of information to the general public
  - registration by a public authority

- **Changing from ISO 14001 to EMAS**
  - ISO 14001 registered entities changing to EMAS registered is quite straightforward
  - two main differences are:
  - an environmental review to identify significant environmental aspects, and
  - publishing an environmental statement
  - there are some further insignificant matters to comply with

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- **ISO 14001 Use in Supply Chains**

  - many reasons why ISO registration should be a potentially attractive choice to managers involved in supply chains:

    - the use of the voluntary standard to guide the development of integrated systems
    - it's a requirement for supply chain members in industries such as automotive and aerospace
    - the potential for pollution prevention leading to reduced costs of production and higher profits
    - the alignment with the increasingly important aspect of corporate social responsibility
    - the real possibility that an ISO-registered system may provide firms with a unique environmental resource, capabilities, and benefits that lead to competitive advantage

- **Recent research into ISO 14001 effects**

  - recent research suggests that ISO 14001 registration can be leveraged across the supply chain for competitive advantage
  - several research propositions and an simple framework have proposed a number of positive effects of ISO 14001 registration on supply chain design including:
  - more proactive environmental management including processes and performance measurement related to sustainability across a supply chain
  - more effective levels of communication with major suppliers where the ISO registered plant has formal environmental management systems
  - reduced levels of waste and greater cost efficiency than non-registered plants
  - sustainable practices and projects with better return on investment than non-registered firms
  - higher levels of customer relationship management
  - positive association with greater expansion opportunities and image than non-registered plants
  - fewer issues with employee health and safety than non-registered plants
  - a strong positive relationship between formal communication, training, monitoring / control systems, and firm performance
  - higher levels of involvement and communication, which will be positively related to more internal and external integration with supply chain members

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Chapter 19

INTEGRATED REPORTING

An Overview Summary of Principles-Based Requirements of Integrated Reporting

- The overview discusses:
  - the objectives and audience of Integrated Reporting (IR)
  - the objectives of the International IR Framework (the Framework), and
  - how the Framework should be applied.
- It also discusses how IR is guided by the concept of integrated thinking and how it interacts with other reports and communications, including how the International Integrated Reporting Council (IIRC) aims to complement material developed by others with respect to specific indicators and measurement methods.
- The overview sets out the conditions that need to be fulfilled for an integrated report to be in accordance with the Framework.
- Unless unable to do so because of the unavailability of reliable data, specific legal prohibitions or competitive harm, an integrated report should comply with the principles-based requirements identified throughout the Framework
- Those requirements are to be applied taking account of the content of the Framework as a whole, including the fundamental concepts.
- Each of those requirements is included in this summary
- The Framework also includes the definition of IR and of an integrated report and requires that an integrated report should be prepared:

  (i) in accordance with the Framework, and

  (ii) primarily for providers of financial capital

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- The fundamental concepts of IR are discussed. These underpin and reinforce the principles-based requirements and guidance
- The fundamental concepts centre on:
  - the various capitals (financial, manufactured, intellectual, human, social and relationship, and natural) that an organisation uses and affects
  - the organisation's business model
  - the creation of value over time
- An organisation's business model is the vehicle through which it creates value.
- That value is embodied in the capitals that it uses and affects.
- The assessment of an organisation's ability to create value in the short, medium and long term depends on an understanding of the connectivity between its business model and a wide range of internal and external factors.
- Those factors are disclosed in an integrated report prepared in accordance with the Framework.

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Guiding Principles

- The Guiding Principles inform the content of an integrated report and how information is presented.

- An integrated report should include the following principles-based requirements:

  - strategic focus and future orientation: an integrated report should provide insight into the organisation's strategy, and how that relates to its ability to create value in the short, medium and long term and its use of and effects on the capitals

  - connectivity of information: an integrated report should show, as a comprehensive value creation story, the combination, inter-relatedness and dependencies between the components that are material to the organisation's ability to create value over time

  - stakeholder responsiveness: an integrated report should provide insight into the quality of the organisation's relationships with its key stakeholders and how and to what extent the organisation understands, takes into account and responds to their legitimate needs, interests and expectations

  - materiality and conciseness: an integrated report should provide concise information that is material to assessing the organisation's ability to create value in the short, medium and long term

  - reliability and completeness: an integrated report should include all material matters, both positive and negative, in a balanced way and without material error

  - consistency and comparability: the information in an integrated report should be presented on a basis that is consistent over time and in a way that enables comparison with other organisations to the extent it is material to the organisation's own value creation story

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Content Elements

- The Content Elements to be included in an integrated report are detailed
- An integrated report should stand alone as a concise communication, linked to other reports and communications for those stakeholders who want additional information
- The requirements with respect to the Content Elements are expressed as questions that should be answered in an integrated report in a way that best expresses the organisation's unique value creation story and makes the connections between the Content Elements apparent.
- They are not intended to appear in a set sequence or as isolated, standalone sections
- An integrated report should answer the following questions:
  - Organisational overview and external environment: What does the organisation do and what are the circumstances under which it operates?
  - Governance: How does the organisation's governance structure support its ability to create value in the short, medium and long term?
  - Opportunities and risks: What are the specific opportunities and risks that affect the organisation's ability to create value over the short, medium and long term and how is the organisation dealing with them?
  - Strategy and resource allocation: Where does the organisation want to go and how does it intend to get there?
  - Business model: What is the organisation's business model and to what extent is it resilient?
  - Performance: To what extent has the organisation achieved its strategic objectives and what are its outcomes in terms of effects on the capital?
  - Future outlook: What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and its future performance?
- further required disclosures are identified
  - the organisation's materiality determination process
  - the reporting boundary and how it has been determined
  - the governance body with oversight responsibilities for IR
  - the nature and magnitude of the material trade-offs that influence value creation over time

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- the reason why the organisation considers any of the capitals identified in the Framework to be immaterial given its particular circumstances, if that is the case.

Preparation and presentation

- Guidance on the preparation and presentation of an integrated report is given in the Framework
- Topics include:
  - the materiality determination process,
  - the disclosure of material matters,
  - involvement of those charged with governance,
  - frequency of reporting,
  - reporting boundary, and
  - the use of technology.

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OVERVIEW

- Integrated Reporting (IR) defined
  - IR is a process that results in communication by an organisation, most visibly a periodic integrated report, about value creation over time
  - an integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term
  - an integrated report should be prepared in accordance with the Framework

Objectives of IR

- IR aims to:
  - actively encourage a more cohesive and efficient approach to corporate reporting that communicates the full range of factors that materially affect the ability of an organisation to create value over time, and draws together other reporting strands
  - inform the allocation of financial capital that supports value creation over the short, medium and long term
  - enhance accountability and stewardship with respect to the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of the interdependencies between them
  - support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

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Audience for IR

- an integrated report should be prepared primarily for providers of financial capital in order to support their financial capital allocation assessments

- although providers of financial capital are the primary intended report users, an Integrated report and other communications resulting from IR will be of benefit to all stakeholders interested in an organisation's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators, and policy-makers

- enhance those providers of financial capital who take a long term view of an organisation's continuation and performance are particularly likely to benefit from IR. Their interests are likely to align over time with the interests of other stakeholders because both are focused on the creation of value in the short, medium and long term

Objective of the framework

- the purpose of the Framework is to assist organisations with the process of IR. In particular, the Framework establishes Guiding Principles and Content Elements that govern the overall content of an integrated report, helping organisations determine how best to express their unique value creation story in a meaningful and transparent way.

- the Framework does not, however, set benchmarks for such things as the quality of an organisation's strategy or the level of its performance. Assessing these things is the role of the intended users of the report based on the information in an organisation's integrated report

- the Framework is intended primarily for application by private sector, for-profit companies of any size but it can also be applied, adapted as necessary, by public sector and not-for-profit organisations

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Application of the framework

- any communication purporting to be prepared in accordance with the Framework should apply all the principles-based requirements identified within the Framework as requirements unless and to the extent of the unavailability of reliable data, specific legal prohibitions or competitive harm results in an inability to disclose information that is material

- where the unavailability of reliable data, specific legal prohibitions or competitive harm result in an inability to disclose information that is material, an integrated report should:
  - Indicate what information has been omitted
  - explain the reason why the information has been omitted
  - in the case of the unavailability of data, identify the steps being taken to obtain the data and the expected time frame for doing so

A principles-based approach

- the requirements of the Framework are principles-based and do not focus on rules for measurement or disclosure of individual matters or the identification of specific key performance indicators (KPIs)

- senior management and those charged with governance therefore need to collectively exercise judgement to determine which matters are material

- they also need to ensure material matters are appropriately disclosed given the specific circumstances of the organisation, including the application of generally accepted measurement and disclosure methods as appropriate

- the intent of the principles-based approach is to strike an appropriate balance between flexibility and prescription that recognises the wide variation in individual circumstances of different organisations but enables a sufficient degree of comparability across organisations to meet relevant information needs

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Integrated thinking

- IR is guided by the Framework and by integrated thinking
- integrated thinking is the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation uses and affects
- integrated thinking leads to integrated decision-making and actions that consider the creation of value over the short, medium and long term
- integrated thinking can be contrasted with traditional "silo thinking". It takes into account the connectivity and interdependencies between the range of factors that have a material effect on an organisation's ability to create value over time, including:
  - the capitals the organisation uses and affects, and the critical interdependencies, including trade-offs, between them
  - the capacity of the organisation's governance structure to assess resilience against short term disruptions and to respond to stakeholders' legitimate needs, interests and expectations
  - how the organisation tailors its business model and strategy to respond to the opportunities and risks it faces, as well as major changes in its external environment
  - the organisation's value drivers, activities, performance (financial and other), and outcomes in terms of the capitals – past, present and future

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