

WORKSHOP THE BOARD AUDIT COMMITTEE TRAINING

The Legal Framework of Audit Committee

A Synopsis of the Global Outlook

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Subject



PLENARY SESSION 1

The Legal Framework of Audit Committees A Synopsis of the Global Outlook

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Legislative and Regulatory Frameworks



- ❑ **The Public Finance Management Act, 2012 and Public Finance Management Regulation, 2015 requires that each public entity establish an Audit Committee**
- ❑ **Public Finance Management (County Government) Regulations 2015 require all public entities of sufficient complexity to establish an Audit Committee**

Legislative and Regulatory Frameworks



- ❑ **Smaller public entities, consider factors such as their complexity and whether the governing body can sufficiently consider audit issues accurately in deciding whether to establish an audit committee.**
- ❑ **Publicly quoted companies and many other large corporations (Capital Markets Act. Cap. 485A, Guidelines , etc.)**

Principles and Framework of Public Finance Management Act (Cap. 12)



- ❑ **There shall be openness and accountability, including public participation in financial matters;**
- ❑ **The public finance system shall promote an equitable society,**
- ❑ **The burdens and benefits of the use of resources and public borrowing shall be shared equitably between present and future generations**
- ❑ **Public money shall be used in a prudent and responsible way;**
- ❑ **Financial management shall be responsible, and fiscal reporting shall be clear**

Re-visiting “Why Audit Committees”



- a) **Acting as a forum for dialogue between the accounting officer or statutory body, executive management and the internal and external auditors. The communication helps facilitate a better awareness of each party's responsibilities and provides a more efficient and coordinated audit process.**
- b) **Promoting the integrity and quality of internal and external reports by providing a high level of assurance and check.**

Re-visiting “Why Audit Committees”



- c) Fostering and promoting a more effective and efficient audit process by providing an independent review of the internal audit annual work plan and reports.**
- d) Providing a ‘no surprises’ environment in an entity, particularly with regard to the prompt identification of risks and threats to the entity.**
- e) Providing a depth of knowledge that assists management discharge its responsibilities in the most effective and efficient manner**

CASE STUDY BRIEFS



***Fish rots from the head down
(Tragedies)***

» **Enron**

» **WorldCom**

» **Parmalat**

» **Merrill Lynch**

The Place of Audit Committee (Globally)



Key Events that informed the move to create / strengthen Audit Committees place in CGs:-

- ❑ The Sarbanes-Oxley Act of 2002 in the US;**
- ❑ The Report of the Australian Treasury of 2002;**
- ❑ The Recommendations of the Smith Committee of 2003 and the Higgs review of 2003 in the UK;**
- ❑ King Reports on corporate governance in South Africa- King I (1994), King II (2002) and King III (2009);**

CASE STUDY 1 – ENRON SCANDAL (2001) (Energy and Service Corporation - USA) - Quoted



What Happened?

Dubious accounting schemes caused shareholders to lose \$74 Billion

How did it happen?

- **Reduction of Enron's tax payments;**
- **Inflation of Enron's income and profits;**
- **Inflation of Enron's stock price and credit rating;**

CASE STUDY 1 – ENRON SCANDAL (2001) (Energy and Service Corporation - USA) - Quoted



How it happened

- **Hidden losses in off-balance-sheet subsidiaries;**
- **Engineered off-balance-sheet schemes to funnel money to CEOs themselves, friends, and family;**
- **Arthur Andersen (USA) the auditors could not verify the stock of gas accurately and instead inflated the stock revenue and stockholders equity in the balance sheet**

CASE STUDY 1 – ENRON SCANDAL (2001) (Energy and Service Corporation - USA) - Quoted



Key Players

Chief Financial Officer Jeff Skilling and Chief Executive Officer Kenneth Lay

How was it discovered?

Internal whistle blowing by the Vice President Sherron Watkins after suspicion over high stock prices

Sanctions

- 1. Chief Accounting Officer, Richard Causey sentenced to five years and six months in prison on one count of securities fraud.**

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CASE STUDY 1 – ENRON SCANDAL (2001) (Energy and Service Corporation - USA) - Quoted



- 2. Jeffrey Skilling, Chief Financial Officer convicted and sentenced to 24 years and four months in prison. The sentence was later reduced by ten years.**
- 3. Kenneth Lay, Chief Executive Officer convicted of conspiracy and fraud. He died before appeal and his conviction was erased.**
- 4. The auditors, Arthur Andersen (USA) indicted and found guilty of obstruction of justice. Decision later overturned by Supreme Court.**
- 5. Andrew Fastow, Chief Financial Officer pleaded guilty to two counts of wire fraud and securities fraud and served a four year sentence.**

CASE STUDY 2- WORLDCOM SCANDAL (2002) (Telecommunications Company - UK) - Quoted



What happened?

Assets inflated by over \$11 Billion leading to \$180 losses in Billions to investors.

How did it happen?

- **Fake accounting entries**
- **Accounting department underreported line costs by capitalizing and not expensing**
- **Inflated revenues**

Person involved

Chief Executive Officer, Bernie Ebbers

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CASE STUDY 2- WORLDCOM SCANDAL (2002) (Telecommunications Company - UK) - Quoted



How was it discovered?

Whistle blowing - WorldCom's Internal Auditor discovered inappropriate accounting.

Sanctions

❑ Arthur Andersen LLP, (UK) the auditors breached professional duty to evaluate the internal controls of the organization and to design tests to detect material errors which can result in misstatement of financial statements.

❑ Kenneth M. Avery and Melvin Dick were the primary auditors representing their firm. Dick was barred from practicing accounting for 4 years and Avery was barred for 3 years.

CASE STUDY 2- WORLDCOM SCANDAL (2002) (Telecommunications Company - UK) - Quoted



Sanctions Cont...

- ❑ Bernie Ebbers - Chief Executive Officer sentenced to 25 years for fraud, conspiracy and filing false documents.**
- ❑ Scott Sullivan – Chief Financial Officer received 5 years in prison for improper accounting.**
- ❑ David Myers – Controller and Senior Vice President sentenced to 1 year and 1 day in prison for improper accounting**
- ❑ Buford Yates – Director of Accounting sentenced to 1 year and 1 day in prison for participating in the scandal.**

CASE STUDY 3– PARMALAT SCANDAL (2003) (Dairy Food Company - Italy) - Quoted



What happened?

Parmalat was unable to pay a debt of over \$185 Million

How did it happen?

- **Financial misreporting and manipulation of balance sheet**
- **Inflated revenues**
- **Bank confirmations were fake. Scanned copies “received”**
- **Auditors (Grant Thornton and Deloitte) “allowed” Parmalat to follow wrong / false accounting practices and helped them to cover fraud.**

CASE STUDY 3– PARMALAT SCANDAL (2003) (Dairy Food Company - Italy) - Quoted



Person involved

Chief Executive Officer Calisto Tanzi

How was it discovered?

Whistle blowing by Internal Auditors after scrutinizing Parmalat accounts

Sanctions

- i. Calisto Tanzi - Chief Executive Officer sentenced to 18 years imprisonment.**
- ii. Fausto Tonna - Chief Financial Officer sentenced to 30 months for faking accounts.**

CASE STUDY 4– THE MERRILL LYNCH CASE (2003)



Company Background

- ❑ Founded on January 6, 1914**
- ❑ Investment banking**
- ❑ 15,000 financial investors and trillions in client assets**

What happened?

- In July 2008, the company announced \$4.9 billion fourth quarter losses for the company from defaults and bad investments.**
- In one year between July 2007 and July 2008, Merrill Lynch lost \$19.2 billion.**

CASE STUDY 4– THE MERRILL LYNCH CASE (2003)



How did it happen?

- **Misrepresentation of the risk on mortgage-backed securities**
- **Merrill Lynch charged almost \$30 billion in losses to its subsidiary in the United Kingdom, exempting them from taxes in that country**
- **Lack of true disclosure by the Board to shareholders**
- **Fictitious reports by the Board to conceal the true position of the company's net worth**

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CASE STUDY 4– THE MERRILL LYNCH CASE (2003)



Effects?

- **Trading partners' loss of confidence in Merrill Lynch's solvency and ability to refinance money market obligations ultimately led to its sale**
- **Merrill Lynch was later sold to Bank of America to save it from undergoing bankruptcy process**
- **In February 2019, Bank of America announced Merrill Lynch was to be rebranded from "Merrill Lynch" to "Merrill"**

CASE STUDY 4– THE MERRILL LYNCH CASE (2003)



Sanctions

- **Merrill Lynch made to pay a fine of \$100 million for publishing misleading research and as part of the settlement agreement, Merrill Lynch agreed to increase research disclosure and work to decouple research from investment banking**
- **Merrill Lynch charged with misleading brokerage customers about trading venues and agreed to pay a \$42 million penalty**

A Glimpse at Leading Practices around the World: Highlight of South Africa King III Reports



Recommendations in regard to Audit Committees:

- I. That the audit committee should be comprised by a majority of independent Non Executive Directors;**
- II. The majority of the members of the Audit Committee should have a good financial background;**
- III. The chairperson should be an independent non-executive director and not the chairman of the board;**

A Glimpse at Leading Practices around the World: Highlight of South Africa King III Reports



Recommendations in regard to Audit Committees cont....:

- I. Audit Committee to have written terms of reference to deal with its membership, authority and duties.**
- II. Companies to disclose in the annual reports whether or not the audit committee has satisfied its responsibilities in accordance with terms of reference.**
- III. Membership of audit committee to be outlined in the annual report**

A Glimpse at Leading Practices around the World : United Kingdom (UK)



Financial Reporting Council (FRC) Audit Committees are required to:

- a) To describe in their reports the steps taken when undertaking tender processes**
- b) Give a key criteria used to assess firms taking part in a tender**
- c) Describe how they assess effectiveness of the auditor and the audit process**

A Glimpse at Leading Practices around the World: United States of America (USA)



Securities and Exchange Commission (SEC)

Disclosure requirements:-

- a) Whether audit committee has reviewed and discussed the audited financial statements with management**
- b) Audit committee to hold discussions and reviews with the independent auditors**
- c) Give a report of the independence of the audit committee**

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A Glimpse at Leading Practices around the World: United States of America (USA)



Securities and Exchange Commission (SEC)

Disclosure requirements cont...:-

- d) Disclosure of fees paid to auditors in four parts (audit, audit related, tax and other fees)**
- e) Disclosure about how the audit committee evaluates auditors compensation**

A Glimpse at Leading Practices around the World: Germany



Revised International Standard of Accounting 260'

Audit committee requirements:-

- a) Restriction on the maximum term an auditor can serve**
- b) Duty to publish a separate report to shareholders on how audit committee fulfilled their legal and statutory obligations**

A Glimpse at Leading Practices around the World: Canada



Audit Committee requirements:-

- a) Diversity – female representation in the audit committee**
- b) Appropriate expertise and engagement in financial reporting to manage the complex disclosure issues of cyber security risks and technology risks**
- c) Transparency - provides investors with information to evaluate audit committee performance and increase investor confidence**

Challenges facing Audit Committees



1. Legislative and regulatory requirements

Unique regulatory framework with a number of pieces of legislation and regulations, thus requirements of audit and roles and responsibilities to be undertaken may not be clearly understood.

Challenges facing Audit Committees



2. Lack of clarity in roles and reporting lines

The Appointing Authority is seen as the Board while the Minister may be involved in the appointment of the audit committee.

WHO REPORTS TO WHO THEN?

Challenges facing Audit Committee



3. Lack of independence

The independence of the audit committee may be impaired due to previous/current relationships of audit committee members or the political standing, among other factors.

4. Lack of knowledge, skills and experience

Members need to have sufficient understanding of financial reporting and controls, audit process, corporate law, risk management and IT among others.

Challenges facing Audit Committee



5. Lack of adequate dedication and commitment of audit committee members. No proper preparation, reading, processes and follow-up procedures during assignment. In some cases, plain corruption / compromise

6. Lack / poor cooperation by management

Audit committees are sometimes unable to evaluate situations and fulfil their responsibilities due to the absence of quality information made available by management (filtering danger).

References



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Questions / Comments

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