

The newsletter for Audit Committee members in Thailand

# On Board\*

Issue 4: September 2006

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Key findings from PWC's 2006 "State of the internal audit profession survey"



## Editor's comments

Welcome to our 4<sup>th</sup> edition of On Board\*, the newsletter for Audit Committee members in Thailand.

**Our first article** takes a look at how Audit Committees can take the initiative and tell the markets and other stakeholders about their effectiveness. The article provides suggestions on how to improve effectiveness in six key areas:

- Getting a grip on risk;
- Understanding the business;
- Injecting objectivity into the reporting process;
- Overseeing the "C" suite;
- Honing effectiveness; and
- Disclosing what matters.

With Audit Committees starting to think about year end reporting, now is a good time to consider where more valuable disclosure can be made in the annual report.

**In our second article** we look at reducing fraud risk. Understanding and managing fraud risk, and in particular fraudulent financial reporting, is high on the agenda of most Audit Committees. The article explores the ways in which the opportunity to perpetrate and conceal fraudulent activities can be reduced through the implementation of appropriate prevention, deterrence, and detection practices.

**Our final article** reveals the findings from PwC's 2006 "State of the internal audit profession survey". The issues it highlights will provide Audit Committees with an opportunity to further engage their Heads of Internal Audit. The four key themes cover:

- "Continuous auditing" and how the concept is gaining momentum;
- The varying commitment to quality expressed by Heads of Internal Audit;
- The continuing shortage of talent faced by the internal audit profession; and
- Best practices for audit report ratings.

We trust you will find this edition helpful, and we would also appreciate your feedback on how it might be improved or your suggestions for future articles.

**Varunee Pridanonda**  
Partner

### Recent events

#### **PwC and the Institute of Directors - "Developing a Code of Ethics"**

PwC sponsored the seminar on "**Developing a Code of Ethics**", organised by the Institute of Directors on 26 August 2006.

While the seminar touched on the key elements of a strong code, its focus was on the practical implementation of a successful code. In particular, the seminar reiterated the importance of board and senior management behaviour when it comes to influencing the actions of employees and developing a strong ethical culture.

We will explore this topic in more detail on our next edition of "**On Board**".

#### **PwC and the Institute of Internal Auditors – "Fraud prevention and detection"**

PwC presented on the topic of fraud at the annual conference of the Institute of Internal Auditors of Thailand on 25 August 2006. The presentation highlighted mounting evidence which indicates that fraud is on the increase. To combat this, senior management must change its mindset from the more traditional approach, that is investigating issues as they arise, to one which places far more emphasis on proactive fraud prevention and detection measures.

Our article on page five provides guidance on how organisations can improve their anti-fraud programs.

## Taking the initiative – how to present a full picture of Audit Committee effectiveness\*

### Audit committees in the spotlight

Now more than ever, the capital markets tend to punish unpredictability in corporate performance which has the potential to wreak havoc among corporate reputations and share price values.

In this environment, audit committees should consider taking the initiative – looking to go beyond compliance, and actively seeking to identify ways in which they can enhance the quality of governance that exists in their organisations.

Our view is that companies should not only be looking at ways in which they can build greater effectiveness into the way their audit committees work, but also taking into account the benefits of communicating these activities to the markets.

Communication to the markets of the audit committee's role in monitoring the integrity of financial reporting, exercising robust oversight of risk management and internal control processes, and ensuring the proper performance of external and internal auditors could provide the markets with greater assurance on the effectiveness of the audit committee.

### Getting to the heart of effectiveness

In many territories, audit committees are required to review their effectiveness. However, in some companies, the assessments are geared towards a 'checkboxlist' approach, with the emphasis on structure.

Companies could benefit from broadening their outlook. Audit committees must have the right structure and process in place, but without strong leadership and good group dynamics to promote a culture of challenge and engagement, they may be unable to fulfil their role effectively.



### Process

As things stand, some effectiveness reviews of audit committee processes are conducted with the primary aim of achieving compliance with codes and regulations.

In a more comprehensive process, audit committees should be asking themselves how they can become more effective, by enhancing their oversight of core issues, as well as by ensuring that they are getting the right information and holding the right discussions.

### Leadership

Strong leadership is essential. The chair plays a crucial role in driving the agenda for committee meetings, ensuring that all relevant issues are included – and that they all get discussed.

### Group dynamics

The dynamics of the committee – the way in which its members interact with each other, with the chair and with the board, management and auditors – is a vital, and often overlooked, factor for review and development.

### Six suggestions for improving effectiveness – and what to tell the markets

#### 1. Getting a grip on risk...

Developing and updating risk-orientated working agendas on a regular basis to reflect new developments and reflecting the company's current situation and strategic priorities are important.

...and telling the markets

- Whether the audit committee is overseeing the effectiveness of the risk identification and management process.
- Which specific risks are within the scope of the audit committee and how the oversight of business risks is apportioned.
- How the board deals with assigning oversight of new risks that arise.
- How assurance is obtained over the effectiveness of the risk management process, as well as over the integrity and appropriateness of the risk information being presented.
- How the audit or risk committee periodically assesses these various sources of assurance.

## 2. Understanding the business...

Among the many good practices already performed by the most effective audit committees, getting out and about to 'kick the tyres' of the business is one of the best.

...and telling the markets

- The existence of the site visits programme and how locations visited are determined.
- The programme's main focus.
- The functions of the people who have been met during this programme.
- Key developments resulting from the visit.

## 3. Injecting objectivity into the reporting process...

CEOs and CFOs make inherently subjective assessments and judgements every time a company produces external reports.

Audit committees have a valuable role to play in overseeing this process, helping to inject objectivity and independence into CEO/CFO decision-making.

...and telling the markets

By announcing the formation of a disclosure committee, together with details of its composition and schedule throughout the year, companies would be ensuring that their financial reporting has greater credibility among stakeholders in the capital markets.

## 4. Overseeing the C-suite...

Recent corporate collapses have consistently pointed to failings in the C-suite. Audit committees have a crucial role to play, restoring trust among shareholders by putting in place monitoring processes designed to pre-empt these types of failings.

...and telling the markets:

- How the committee gauges the candour, adequacy and timeliness of reporting on issues from business units and functional heads to the board.

- How the committee monitors the process through which the 'health' of the organisation's culture is assessed.
- The existence of an in-house whistle blowing process and the frequency with which issues are reported to the audit committee.

## 5. Honing effectiveness...

Keeping abreast of fast-changing commercial developments represents a major challenge. Audit committees can only be effective if they have the knowledge needed to evaluate the information on which they are basing their decisions.

In practice, most members of audit committees will sit on a number of boards and will therefore be receiving information and education from a wide range of sources which means they are probably already well supplied with the latest information regarding Governance rule changes, evolving regulatory requirements and accounting and reporting developments.

Focused education and development programmes can address specific learning needs.

...and telling the markets:

Companies might consider reporting audit committee targets for development, as well as how those targets will be met.

## 6. Disclosing what matters...

Regular reviews of audit committee effectiveness are already a core requirement in many territories. However, few companies provide the markets with any details of their approach to these assessments, or of the improvements that are being targeted as a result.

...and telling the markets

By communicating the requirements that are placed on the audit committee, as well as the ways in which ongoing, systematic performance assessments of the entire committee – and those of individual members, track performance against these requirements, companies would shed real light on audit committee effectiveness, in terms of current performance and future opportunities for improving operations and procedures.



# Fraud Risk – what should a strong antifraud program look like?

## Introduction

The opportunity to perpetrate fraud and conceal fraudulent activities can be reduced by the implementation of appropriate prevention, deterrence, and detection practices. Whilst fraud detection could be a challenge depending on the circumstances, strong emphasis on fraud prevention reduces the opportunity to perpetrate fraud whilst implementation of appropriate fraud deterrence measures sends a clear message of the consequences of engaging in fraudulent activities.

### Control Environment

#### *Tone at the Top*

The control environment not only refers to such intangibles as integrity, ethical values, competence of the organisation's people, management philosophy and operating style, but it also refers to more concrete expressions of these intangibles such as the way management assigns authority and responsibility, and organises and develops its people.

The control environment has a pervasive influence on the way business activities are structured, objectives are established, and risk assessed. It also influences risk assessment, control activities, information and communication systems, and monitoring activities. The control environment is influenced by the organisation's history and culture and in turn influences the "control consciousness" of its people in performing day-to-day activities.

#### *Code of Conduct*

The Code of Conduct is the vehicle through which the core values of the organisation are communicated across the organisation. For the Code of Conduct to be effective it is paramount that the contents are clearly understood and accepted by all employees.

#### *Ethics Hotline/Whistleblower Programme*

Employees should be encouraged to communicate concerns about possible violations of the organisation's Code of Conduct without any fear of retribution. To facilitate this process many organisations have implemented an "Ethics Hotline" which enables employees to communicate their concerns anonymously if preferred.

#### *Human Resources Practices*

The Human Resources function has a significant role to play in developing and maintaining the core values of the organisation. Human Resources practices governing recruitment, compensation, performance appraisals, recognition programmes, career development, and training have a bearing on the working environment of an organisation and therefore on employee morale. Poor employee morale may increase the incidence of fraudulent activities.

#### *Investigation/Remediation*

One of the critical aspects of an antifraud programme is the way an organisation responds to any significant deficiencies and material weaknesses that are identified, and the way they respond to incidents of suspected, alleged or actual fraud.

A standardised investigation process that clearly articulates that all allegations or suspicions of fraud, would be investigated robustly and appropriate disciplinary actions taken if substantiated would send a strong deterrent message throughout the organisation.

### Fraud Risk Assessment

Organisations should consider the potential for fraud as part of their enterprise-wide risk management process. Fraud risk assessment expands upon traditional risk assessment. It is scheme and scenario based rather than based on control risk or inherent risk. The assessment considers the various ways that fraud and misconduct can occur by, and against, the organisation.

Fraud risk assessment should also consider vulnerability to management override and potential schemes to circumvent existing control activities, which may require additional compensating controls.

Management should perform fraud risk assessments on a comprehensive and recurring basis rather than in an informal or haphazard manner if it is to be effective. Management must also assess fraud risk at the company-wide, business unit and significant account levels.

The audit committee and the board, in performing their fiduciary duties, are responsible for considering their own knowledge of the company's underlying performance, the types of fraud prevalent in the sector, and the risk of financial fraud by management, and ensuring that appropriate mitigating controls are in place to prevent and detect fraud.

### Control Activities

In the context of an antifraud programme, control activities are those actions taken by management to identify, prevent, and mitigate fraudulent financial reporting or misuse of an organisation's assets. Antifraud control activities should occur throughout the organisation, at all levels and in all functions. They include a range of activities as diverse as approvals, authorisations, verifications, reconciliations, segregation of duties, reviews of operating performance and security of assets.

Management should evaluate whether appropriate internal controls have been implemented in all areas where the risk of fraudulent activities is considered to be high as well as controls over the entity's financial reporting process and the potential for management override. Management must also implement and maintain appropriate controls over computer generated information given the importance of information technology in supporting business operations.

### Information and Communication

Effective communication is critical in ensuring the success of antifraud policies and programmes. In order to be effective, communication regarding the company's antifraud policies and programmes must flow down, up, and across an organisation.

Each employee must understand all relevant aspects of the organisation's antifraud programmes and his or her role and responsibilities as they relate to following and enforcing the organisation's antifraud programmes. Every employee needs to know what behaviour is expected or acceptable, and what is unacceptable. Employees must also have an effective channel for communicating significant information relating to fraud upstream. Information systems and technology are important tools in enabling an organisation to collect and share information regarding identified fraud risks, strengths and weaknesses of antifraud control activities, suspicions, and allegations about fraud remediation efforts.

### Monitoring

An organisation's antifraud programmes and controls must be subjected to ongoing and periodic performance assessments. The frequency of such evaluations should be determined by the nature and degree of changes that are occurring in the organisation and their associated risks, the competence and experience of the individuals implementing the controls, and the results of the ongoing monitoring.

### Conclusion

The elements discussed above must all work together to form an effective antifraud programme and this should be considered in the aggregate as an integrated system. Any deficiencies should also be evaluated in the aggregate in order to determine whether they combine in a way that creates an unacceptable exposure.

## Key findings from PwC's 2006 "State of the Internal Audit profession survey"

PricewaterhouseCoopers recently issued its second annual survey on the state of the internal audit profession in the US. The survey seeks to capture a current view of the internal audit profession.

The survey is based on responses from 444 audit managers from different sized companies and different sized internal audit departments in the US. Current views of the internal audit profession were identified.

In this article, we highlight the areas we believe will be of interest to Audit Committee members as they seek to engage their Heads of Internal Audit on topical issues.



### 1. "Continuous" auditing gains momentum

***Accelerating the audit cycle through the use of technology-enabled continuous auditing holds promise to deliver more timely assurance at a higher quality.***

The compressed timeframes of today's business cycles are fuelling increased demands from internal audit's key stakeholders for faster and better assurance. Senior executives and corporate directors are being asked to accept risks and make business decisions more quickly. To do so, they need more real-time assurance over risk management and related controls.

These are familiar challenges for chief audit executives, who know that cycle acceleration is the key to providing faster and higher-quality real-time assurance to their primary stakeholders.

#### ***So what is "continuous" auditing?***

Continuous auditing enables auditors to update all or portions of a risk assessment on a daily, monthly, or quarterly basis; automate periodic audit testing and improve audit cycle times; and compare and recalculate entire populations of data.

Furthermore, technology-enabled auditing can make the process even faster, cheaper, more efficient, and more effective - an internal audit group can improve assurance quality because of its ability to audit 100% of a transaction universe as opposed to just transaction samples.

Through continuous auditing, auditors can provide more timely analysis of risk factors and control assessments, and initiate more frequent discussions about emerging trends and the linkages between core financial and operational metrics.

### 2. Commitments to quality vary significantly

When the IIA unveiled its new Standards for the practice of internal audit in 2002, it mandated that internal audit groups conforming to the Standards adopt formal quality assurance and improvement programs that include an external quality assurance review (QAR) at least once every five years.

Although compliance with the IIA Standards is not generally mandated by statutes or regulations, its guidelines are often viewed as mandatory by internal audit executives.

***Only 52% of our respondents reported having a formal quality assurance and improvement program in place, while 48% said they lack a formal QAR and improvement program.***

To probe the QAR issue more deeply, we asked those respondents who are not pursuing a QAR to explain why. Their reasons varied: 14% said their internal audit groups cannot meet the deadline on time; 30% said they follow the IIA Standards but are not planning to conform to the QAR standards; 15% said the cost of a QAR is prohibitive; and 10% said their internal audit groups do not adhere to the IIA Standards at all.

### 3. Internal audit faces a continuing shortage of qualified talent

In today's operating environment, the demand for internal audit resources has increased much faster than internal audit capacity – a situation that raises serious concerns about the ability of internal audit groups to address higher-level risks facing their organisations.

#### *It is a major challenge to hire and keep qualified, capable internal audit staff.*

Legions of companies are looking for audit professionals with a sufficient breadth of capabilities to evaluate and test internal controls, audit complex areas, address enterprise-wide risk and governance issues, and provide insight into the adequacy of internal controls. Given such demands for specialised skill sets, it's no wonder there's a talent shortage.

### 4. Most internal audit groups now include overall ratings or conclusions in audit reports

With audit ratings, internal audit can determine the extent to which failure to identify risks or implement recommended controls, contributes to business units falling short of their objectives. Audit report ratings also can serve as the basis for follow-up attention from internal audit or the audit committee and, in rare instances, can serve as the basis for adverse actions against members of operating or executive management

#### *79% of our respondents routinely include an overall rating or conclusion in their reports to reflect their audit results.*

Although the formats of audit ratings reports will vary, a common approach is to rate the overall performance of the function, program, or activity subject to audit: strong, effective, adequate, requires attention, or weak.

Another approach is to feature a "heat map" that assigns colour designation derived from the number of action items stemming from an audit. For example, internal audit might assign:

- Red for an audit indicating weak controls and requiring multiple "red action items"
- Orange for an audit indicating the need for moderate levels of controls, and requiring a business unit to address one or two "red action items"
- Yellow to an audit indicating the need for moderate controls, and no "red action items", but one or two less serious "yellow action items"
- Green for an audit indicating the presence of strong controls, where a business unit is consistently managing risks to an acceptable level.

**In summary** – These issues can all feature on the agenda for discussions with Head of Internal Audit. Why?

**Continuous auditing** – The benefits are clear. By expanding the scope and frequency of the audit process, technology enabled continuous auditing provides the means for internal audit to strengthen reporting to, and communication with, senior management and the audit committee, and to deliver more effective independent assurance to these key stakeholders.

**Quality assurance** – Given that the trends indicate a low take up of quality assurance review, we suggest that Audit Committees should seek to find out, in the absence of a formal "QAR", how Heads of Internal Audit address the question of quality. Follow the dictum of "what gets measured gets improved".

**Talent** – To address shortfalls in resources and to strengthen skill sets, capabilities, and productivity, an internal audit function can leverage "capacity multipliers" ranging from strategic co-sourcing solutions to technology-enabled auditing. Further, with the capacity-multiplier approach, they can also leverage functional or subject-matter expertise from within the organisation to augment the function, set up a "guest auditor" system, or pursue a co-op or internship program with an educational institution.

**Audit report ratings** – Audit Committees can explore the advantages and disadvantages of including ratings within audit reports. On the plus side, audit ratings permit more rapid assessment of overall results by senior management and Audit Committees. They also help to facilitate the design and implementation of monitoring systems. Further, they can serve as a motivational tool to spur business units to strive for the top ratings possible. On the downside, audit report ratings can undermine good auditor/client relationships by creating friction between the parties. This can lead to less than open discussions between auditor and auditee. The need to agree on a "score" can also increase cycle time.



Your worlds



Our people\*