

CORPORATE GOVERNANCE PRACTICES: RISK IMPLICATIONS & BOARD-LEVEL SOLUTIONS

Summary of Research Results

The London Society of Chartered Accountants is interested in developing better management practice and reducing the risk of governance failures. As part of this effort, LSCA developed a research study that examined how the boards of 29 UK-listed companies review internal control and report on corporate governance (mandated by Listing Rule 12.43A) and how audit committees and internal audit functions are used in that process.

The evidence from this study suggests that some boards may not achieve the risk control intended by these practices because, over time, environmental change may reduce the effectiveness of their system of governance and management control, and few boards appear to have a clear role in ensuring that governance and control is appropriate.¹

Also, the level of risk control may be reduced if

1. The board relies on their external auditors for the mandated evaluation of internal control (n=16 companies that do so).

Limitation: External auditors focus on financial controls and current period financial statements. They rarely address operating risks unless these affect GAAP financial statements in the current period, or threaten business continuance. Also, since they are retrospective, GAAP statements have well known shortcomings.

2. Directors rely on information about governance, internal control and performance that is obtained *via* normal chains of managerial command (n=22).

Limitation: Information received *via* the normal chain of command can be manipulated as it moves upward because managers may be inclined, or incentivised, to downplay developing problems. Information received *via* the normal chain of command may be unreliable unless confirmed independently.

3. Internal Audit does not report directly to the board or to a director (n=18).

Limitation: Lack of director supervision of internal audit means that its work may not be relevant to board requirements, and managers will have opportunities to “vet” the information directors receive from internal auditors.

¹ Governance refers to the system that organises, co-ordinates and monitors organisational activities (Cadbury, 1992)

4. Internal Audit focuses on financial not operational controls (n=21).

Limitation: An evaluation of the governance system needs to address (a) how operational *and* financial activities are co-ordinated, controlled and monitored, (b) management's ability to detect operating risks and performance problems, and (c) the outcomes of material investment and/or change initiatives.

Some boards do conduct broader operational reviews and take a role in the evaluation of the overall governance system (n=5). Directors in these companies also use a more diverse set of routine governance processes. These include "hot lines" that by-pass the normal chain of command, internal audit reports received directly from the function, and a wider range of non-financial information. Some of this material comes directly from independent sources (*e.g.* data on customer satisfaction and market performance, employee "hot-lines").

Interestingly, one firm that does not have any internal audit *function*, has developed an audit and improvement *process* whereby cross-functional teams conduct sophisticated operational reviews and report the results of these directly to the board. In this company, the directors believe that this process gives them a significant competitive advantage.

Corporate governance mechanisms appear to be most effective when they are updated as market conditions, strategy and company operations change. If this conclusion is correct, a governance system needs to be capable of responding to changes in customer, employee and other relevant groups. When it does not respond to changing conditions, risk of governance failure may increase.

The implications: Directors need to assess their governance and management control processes. Regulators should consider how to encourage boards to improve governance and control practice. The accounting profession would create improvement by broadening the audit and reporting approaches. Better understanding of the management of governance and control mechanisms is also needed.

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