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Internal surveillance mechanisms in state owned companies

Internal surveillance mechanisms in corporate governance

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- ❑ Internal control systems
- ❑ Internal auditing
- ❑ Board of Directors (supervisory board) – Audit Committee
- ❑ Financial Statements Auditing

Audit committees in the corporate governance (1)

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- The Board as a mechanism of corporate governance
 - One-tier: the Board of Directors
 - Two-tier: Supervisory Board and Management Board

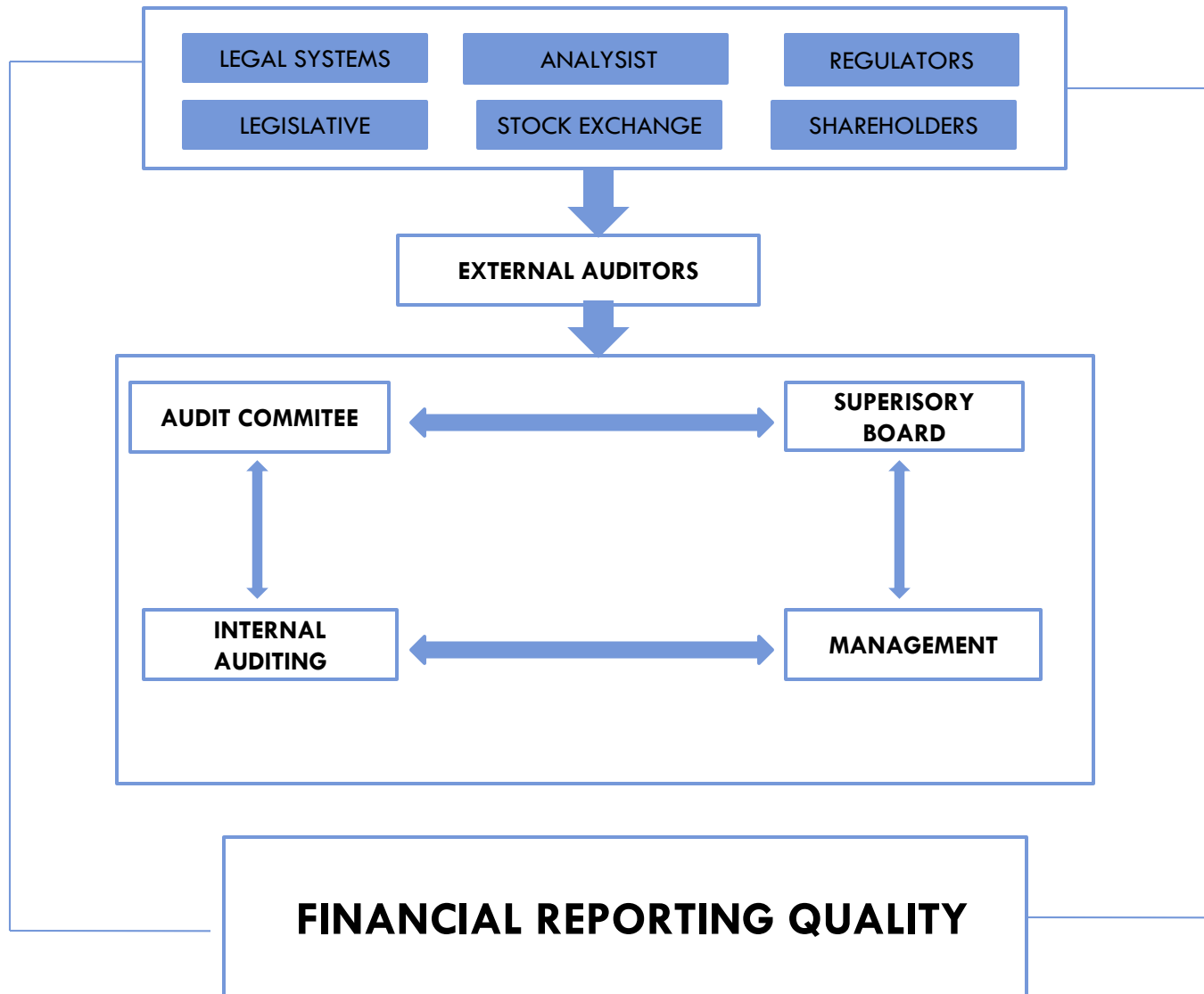
- Company Act

Audit committees in the corporate governance (2)

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- Audit committee:
 - 1) The Board of Directors
 - 2) If the audit committee is not founded then the whole Board is taking the responsibility for the audit committee functions

- Audit committee appoints the Board of Directors – advisory role
 - ▣ Audit committee can not make decisions
 - ▣ Audit committee has advisory role – the Board of directors decides whether the recommendation will be accepted or not.



Function and responsibilities of audit committees (1/2)

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- Risk management process and internal control systems
- Financial reporting
- Financial statements auditing
- Internal Auditing
- Communication and reporting
- Compliance with law and legislative
- Assurance and efficiency

Risk management process and internal control systems

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- **Risk management process:**
 - Communicate with Board the attitudes towards the risk and ensure that management act within the agreed parameters
 - Understand the framework for risk assessment and the role of management in the risk management process,
 - Consider the exposure of the company towards the main financial risk and undertake the necessary steps for control and surveillance over the identified risks

- **Internal control systems:**
 - 1) assessment whether the management created a control environment - procedures for risk assessment and management,
 - 2) understanding the internal control systems implemented by management,
 - 3) review whether the management adopted the recommendation for internal control systems enhancement given by internal and external
 - 4) consider fraud appearance in financial statements.

Financial reporting

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- Consider **main accounting and reporting issues** (regulatory requests)
- Read the **letter of management representation** to the auditor's and consider the issues represented in that letter
- Consider financial statements and adopted **accounting policies**
- Consider **elements of annual report,**
- Consider **the results of external auditing**

Cooperation between audit committee and external auditor's (1)

- Cooperation in all phases of auditing process
- Basic features of audit service
 - Auditor competence
 - Independence
 - Conducting the audit
 - Audit quality assurance
- Risks and control (identified risks by auditor)
- Financial reporting (accounting policies, pronouncements, the quality of financial reporting process)
- Other matters of governance

Prohibition against Audit of Individual Legal Persons (1/2)

- **A certified auditor may not carry out audit of the legal person:**
 - ▣ In which he/she owns interest or shares,
 - ▣ In which he/she participated in keeping of business books or in preparation of financial statements for the year in which the audit is carried out,
 - ▣ In which he/she is a member of supervisory or management board, procurator, proxy or in which he/she is employed,
 - ▣ In which his/her spouse, a person related by blood in direct line up to the second degree, is a member of supervisory or management board, or a procurator, and
 - ▣ Where other circumstances exist, threatening his/her independence and objectivity.

Prohibition against Audit of Individual Legal Persons (2/2)

- **Audit firm and independent auditor may not carry out audit of the legal person:**
 - In which they own interest or shares,
 - Which owns interest or shares in the audit firm
 - In which they participated in keeping business books or in preparation of financial statements for the year in which the audit is carried out
 - With which they connected in such manner that doubts as to the independence and objectivity of audit arise, and
 - Where other circumstances exist, threatening their objectivity.

Cooperation between audit committee and external auditor's (2)

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- **Sarbanes Oxley Act 2002**
 - **Nonauditing services – audit committee (provision)**

Cooperation audit committee and internal auditors (1/2)

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- Organizational independence is effectively achieved when the chief audit executive reports functionally to the board.
- **Functional reporting to the board typically involves the board:**
 - Approving the internal audit activity's overall charter.
 - Approving the internal audit risk assessment and related audit plan.
 - Receiving communications from the CAE on the results of the internal audit activities or other matters that the CAE determines are necessary, including private meetings with the CAE without management present, as well as annual confirmation of the internal audit activity's organizational independence.
 - Approving all decisions regarding the performance evaluation, appointment, or removal of the CAE.
 - Approving the annual compensation and salary adjustment of the CAE.
 - Making appropriate inquiries of management and the CAE to determine whether there is audit scope or budgetary limitations that impede the ability of the internal audit activity to execute its

Cooperation audit committee and internal auditors (2/2)

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- **Administrative reporting** is the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit activity.
- **Administrative reporting typically includes:**
 - Budgeting and management accounting.
 - Human resource administration, including personnel evaluations and compensation.
 - Internal communications and information flows.
 - Administration of the internal audit activity's policies and procedures.

Membership and organization of the audit committee

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- Financial literacy
- Members of the audit committee – accounting and auditing knowledge
- Number of members of the audit committee
- Mandate of the members of the audit committee
- Activity of the audit committee members
- Audit Committee Act

Charter (regulation) of audit committees

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- Purpose and aims
- Authority (responsibility)
- Organization, membership, necessary qualification, number of members, mandate of members
- Audit committee meetings, frequency, participation and documentation
- Role and responsibilities
- Communication with management and external auditors
- Reporting responsibilities
- Assessment of the efficiency of audit committees

Audit legislative in Republic of Croatia

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- Auditing Act (145/05)
- Auditing Act - amendments and updates of Auditing Act (139/08)

Auditing act - Audit committee (1)

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- Public interest entities shall be obliged to set up the audit committee.
- Public interest entities are:
 - Companies whose securities are quoted on the stock exchange in the first quotation or in the public companies quotation
 - Banks and other financial institution*
 - Companies of the special state interest, the registered capital of which exceeds HRK 300,000,000.00 in the accordance with the decision of the Government of the Republic of Croatia on the listing of companies of the special state
- The audit committee shall consist of the members of supervisory board and members appointed by the supervisory board
- At least one member of the audit committees shall be competent in the area of accountancy and/or audit.

- *Large enterprise pursuant to the Accounting Act (shall come into force on the day of accession of the Republic of Croatia to the European Union)

Auditing Act – Audit committee (2)

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- Monitor the **financial reporting procedure**
- Monitor the efficiency of the **internal control system**, internal audit and **risk management systems**
- Supervise the carrying out of **audit of annual financial and consolidates statements**
- Monitor **independence of independent auditors** or audit firms carrying out audit, and contracts on ancillary services, in particular,
- Give **recommendation to the Assembly** on the appointment of an independent auditor or audit firm
- Discuss **the plans and annual report** of the internal audit, and on important issues related to this field

Auditing Act - Audit committee (3)

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- An independent auditor or audit firm shall report to the audit committee
 - On the **key issues** arising from audit,
 - And on a **significant weaknesses of internal control** concerning the financial reporting process
- The independent auditor and audit firm that carry out the audit of a public-interest entity shall confirm annually
 - In writing to the audit committee of the entity **their independence** from the audited public-interest entity and
 - Shall inform the audit committee of any **additional services** provided to the audited entity
 - And discuss with the audit committee the **possible threats to their independence and the safeguards against those threats.**

Special state interest companies

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- Companies of the special state interest, the registered capital of which exceeds HRK 300,000,000.00 in the accordance with the decision of the Government of the Republic of Croatia on the listing of companies of the special state
- 69 companies
- The determination of Croatian Parliament (NN 132/2009, 56/2010).
- The state is majority owner in 21/69 companies.
- Approximately 110.000 employees

Companies of the special state interest, the registered capital of which exceeds HRK 300,000,000.00 in the accordance with the decision of the Government of the Republic of Croatia on the listing of companies of the special state

- 1. BOROVO GRUPA
- 2. GRUPACIJA DURO DAKOVIC
- 3. HRVATSKA POŠTANSKA BANKA – HPB GRUPA
- 4. JADROPLOV d.d.
- 5. KONCAR-ELEKTROINDUSTRIJA GRUPA
- 6. LUKA PLOCE d.d.
- 7. LUKA RIJEKA GRUPA
- 8. GRUPA PETROKEMIJA
- 9. PODRAVKA GRUPA
- 10. VUPIK d.d.
- 11. BRIJUNI RIVIJERA
- 12. KAPITALNI FOND
- 13. SREDIŠNJE KLIRIŃSKO DEPOZITARNO DRUŠTVO
- 14. INA MATICA d.d. .
- 15. BRODARSKI INSTITUT d.o.o.
- 16. BRODOGRADEVNA INDUSTRIJA 3 MAJ d.d. - GRUPA
- 17. BRODOGRADILIŠTE KRALJEVICA d.d.
- 18. GRUPA VIKTOR LENAC
- 19. GRUPA BRODOSPLIT
- 20. GRUPA BRODOTROGIR
- 21. GRUPA ULJANIK
- 22. BIZOVACKE TOPLICE d.d.
- 23. HOTEL MEDENA d.d.
- 24. HOTELI MAESTRAL d.d.
- 25. HOTELI MAKARSKA d.d.
- 26. HOTELI PLAT d.d.
- 27. HOTELI PODGORA d.d.
- 28. HOTELI ŽIVOGOŠĆE d.d.
- 29. HTP KORCULA d.d.
- 30. HTP OREBIC d.d.
- 31. IMUNOLOŠKI ZAVOD d.d.
- 32. JADRAN d.d.
- 33. LIBURNIA RIVIERA HOTELI d.d.
- 34. ZRC LIPIK d.d.
- 35. IMPERIAL d.d.
- 36. VRANJICA BELVEDERE d.d.
- 37. CLUB ADRIATIC d.o.o.
- 38. PARK PREVLAKA d.o.o.
- 39. CROATIA BANKA d.d.
- 40. ZRACNA LUKA ZAGREB – GRUPA
- 41. ZRACNA LUKA OSIJEK d.o.o.
- 42. ZRACNA LUKA PULA d.o.o.
- 43. ZRACNA LUKA RIJEKA d.o.o.
- 44. ZRACNA LUKA ZADAR d.o.o.
- 45. ZRACNA LUKA SPLIT d.o.o.
- 45. ZRACNA LUKA SPLIT d.o.o
- 46. ZRACNA LUKA DUBROVNIK
- 47. IPK OSIJEK GRUPA
- 48. LUKA VUKOVAR d.o.o.
- 49. ACI d.d.
- 50. CROATIA AIRLINES d.d.
- 51. CROATIA OSIGURANJE d.d.
- 52. JANAF d.d.
- 53. VJESNIK d.d.
- 54. AUTOCESTA RIJEKA – ZAGREB d.d.
- 55. HRVATSKA LUTRIJA d.o.o.
- 56. HRVATSKE AUTOCESTE d.o.o.
- 57. HRVATSKE CESTE d.o.o.
- 58. NARODNE NOVINE d.d.
- 59. ODAŠILJACI I VEZE
- 60. PLINACRO d.o.o.
- 61. PLOVPUT d.o.o.
- 62. HRVATSKA ELEKTROPRIVREDA - GRUPA
- 63. HRVATSKA POŠTA d.d.
- 64. HRVATSKE ŠUME d.o.o.
- 65. HRVATSKE ŹELJEZNICE
- 66. JADROLINIJA
- 67. FINANCIJSKA AGENCIJA - FINA
- 68. HRVATSKA RADIOTELEVIZIJA
- 69. HRVATSKE VODE

Comparative analysis

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CRITERIA	Agency Theory	Institutional Theory
Selection of Board members	Primarily by stockholders	Primarily by management
Primary Board Member Attributes	Independence, and expertise in monitoring and control	Perceived knowledge and independence. Frequent meetings.
Primary Focus of the Board	Monitoring management's actions	To provide assurance to outsiders that information provided by management is legitimate
Other Board Focus	Corporate Performance Global Risk Management CEO & Management Compensation Monitoring and Control	Ritualization of activities Impression Management Enhancing legitimacy of management Enhancing legitimacy of financial reporting process
Role of the auditor	Independent party working with other governance parties to ensure sound financial reporting	With the AC and board symbolic, the auditor is heavily responsible for sound financial reporting

(Non) Efficacy of audit committees

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- ❑ **Form vs substance** in organization and performance of auditing committees
- ❑ **Management has significant influence** on the quality of communication between the audit committee and internal auditing
- ❑ **Problems in organization and performing of audit committees** - noncompetence of its members
- ❑ The results of empirical research in Republic of Croatia (the role of audit committee in financial statements auditor engagements)

The results of empirical research

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- **Weakness in internal surveillance mechanisms:**
 - Weaknesses in organizational and performance of internal control systems and internal auditing
 - Weaknesses of audit committees
- 60% respondents answer that their audit committees meet 2-3 times a year
- Most frequently only one member of audit committee have the financial /accounting knowledge – mandatory (in accordance with law)
- Auditing committees didn't take the assigned roles and responsibilities – opinions of internal and external auditors do not differ statistically
- 84% respondents – appointment of the external auditor is primary on management

Conclusion

- Internal surveillance mechanisms: internal control systems; internal auditing and audit committee - synergy
- The quality of financial reporting in the interest of stakeholders on capital markets
- Legislative rules
- further significant improvement in organizing and functioning internal surveillance mechanisms, especially in state owned companies, in order to improve the process of corporate governance.

Thank you for Your attention!

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