5.2.6

INTERNAL AND EXTERNAL AUDIT

The Board (with the support of the audit committee) is responsible for the proper oversight of the company's control system. In this regard, the best friends of the Board and the audit committee are a well-functioning internal audit function and an independent, professional external auditor.

Responsibility for the development and operation of sound risk management and internal control systems lies with management. The Board (with the support of the audit committee) is responsible for the oversight of these processes.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. The internal auditor is appointed by the Board, not by the CEO or Management Board, is not part of the management team and, unlike other employees, does not hold an operational role.

External (statutory or financial) auditing is the obligatory annual examination of a company's financial statements and records by an independent external auditor. The external auditor is approved by the shareholders on the recommendation of the Board.

Differences between the internal and external audit functions

ASPECT	INTERNAL AUDIT	EXTERNAL AUDIT
Who performs it?	Employees of the company or outsourced internal auditors	Independent third-party firm
Purpose	Improve internal operations, risk management, and controls; help the company achieve its goals	Provide an independent opinion on the fairness and accuracy of financial statements
Audience	Management and the Board and audit committee	Shareholders and other stakeholders (investors, creditors, regulators, public)
Scope	Broad; covers various aspects of the business (operations, compliance, IT, HR, cyber and other areas)	Primarily focused on financial statements and internal controls over financial reporting

ASPECT	INTERNAL AUDIT	EXTERNAL AUDIT
Reporting	Internal reports for the audit committee and the Board, with recommendations for improvement	Formal audit report, expressing an opinion on financial statements and presented to the audit committee, Board and shareholders
Independence	Organisational independence; not subordinate to the company's CEO or Management Board	Strict independence from the company being audited (no material ties, no provision of other services)
Mandatory?	Generally, not, but highly recommended for good governance	Usually legally mandatory
Frequency	Ongoing throughout the year	Typically, annual

Internal audit

Internal audit is a function within a company that is tasked with providing unbiased, independent reviews of systems and processes. That is why the internal auditor is the only non-operational function in the company. The role of internal audit is to provide the Board and top management with an objective source of information regarding the company's risks, control environment, operational effectiveness and compliance with applicable laws and regulations.

The reviews performed by Internal Audit are called internal audits. The aim of internal audits is to identify weaknesses within the organisation's processes and control environment internally so that they can be fixed as quickly as possible to prevent harm to the company or its stakeholders.[19]

Internal audit reports to the Board (and its audit committee), providing recommendations for the necessary improvements in systems and processes as well as reports on the implementation of those recommendations. It is important to emphasise that, where the Board has an audit committee, the Board should still maintain a regular relationship with the internal auditor and not delegate this important duty entirely to its audit committee, which supports the Board by examining internal audit activities in greater depth and providing opinions and suggestions for Board decisions.

It is important to emphasise that internal audit not only performs internal audits, but also advises the responsible company employees to help them achieve the set goals. Internal audit is the eyes and ears of the Board.

19 See also Linford & Co, Internal control environment, https://linfordco.com/blog/internal-control-environment/.

Internal audit should comply with the Global Internal Audit Standards of the IIA.[20]

The audit committee proposes, and the Board approves:

- the internal audit regulations;
- the strategic internal audit plan;
- the risk-based internal audit plan (three-year and annual);
- the internal audit budget (annually);
- the appointment, dismissal, evaluation and remuneration of the head of internal audit.

The head of internal audit must have functional accountability to the audit committee and the Board, and only administrative accountability to the CEO. It is the Board, not the CEO, that appoints the internal auditor, sets their remuneration and assesses their performance.

External audit

The responsibilities of the Board and its audit committee in relation to the external audit include:

1. ***Recommending the external auditor.*** The audit committee assesses potential audit firms (and the particular auditor) for independence, objectivity and expertise, and then recommends a firm (and the particular auditor) to the Board for appointment or reappointment by the shareholders.
2. ***Negotiating fees.*** The audit committee negotiates the auditor's fees to ensure that they are reasonable and will not compromise audit quality.
3. ***Reviewing the audit plan.*** The audit committee reviews and approves the external auditor's audit plan, including the scope of the work, the key risks identified and the planned resources.
4. The entire Board (including the audit committee) should ***meet the auditor twice*** during the annual audit cycle: before the audit, to share its insights into the situation in the company that could be relevant to the auditor and to learn about the audit plan, and after the audit, to discuss the findings and the auditor's report. ***In addition***, the audit committee should meet the auditor during the audit to discuss emerging findings.
5. The audit committee should ***assess the quality of the external auditor's work***.

20 The IIA (2024), Global Internal Audit Standards, https://www.theiia.org/en/standards/2024-standards/global-internal-audit-standards/.

6. Ensure that the external auditor is invited to the annual general meeting of shareholders.
7. The Board, with the help of its audit committee, should ***follow up on the external auditor's recommendations***.
8. The Board should ***ensure the disclosure of the audit report*** (in the annual report and on the website).
9. Ensure that the auditor is rotated in line with the applicable rules: for public-interest entities, EU law requires rotation of the audit firm after no more than ten years and of the key audit partner after no more than seven years, unless national legislation sets other limits.
10. Pay close attention to the smoothness of the collaboration between the executives and the auditor.

KEY TAKEAWAYS

A. Management is responsible for sound risk management and internal control systems; the Board, with the support of the audit committee, is responsible for their oversight. Internal audit and the external auditor are the Board's principal sources of independent assurance.

B. Internal audit is an independent, objective assurance and consulting function that evaluates and improves risk management, control and governance. It is appointed by the Board, not the CEO, reports functionally to the Board and its audit committee, and is the only non-operational function in the company.

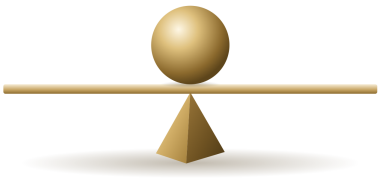
C. The audit committee proposes, and the Board approves, the internal audit regulations, the strategic and risk-based audit plans, the budget and the appointment, dismissal, evaluation and remuneration of the head of internal audit. Even with an audit committee, the full Board should maintain a direct relationship with the internal auditor.

D. External audit is the statutory annual examination of the financial statements by an independent auditor, approved by the shareholders on the Board's recommendation. The audit committee assesses the auditor's independence and quality, negotiates fees and reviews the audit plan.

E. The Board should meet the external auditor at least twice a year, follow up on the auditor's recommendations, ensure the audit report is disclosed and that rotation rules are observed, and watch the quality of the working relationship between executives and the auditor.

QUESTIONS FOR THE BOARD

1. *Does internal audit report functionally to the Board and its audit committee, and is it the Board, not the CEO, that appoints, evaluates and remunerates the head of internal audit?*
2. *Are the internal audit regulations, the strategic and annual risk-based audit plans and the budget approved by the Board, and do they cover the company's most significant risks?*
3. *How does the full Board, and not only the audit committee, engage with internal audit, and how are its recommendations followed up?*
4. *Has the audit committee assessed the external auditor's independence, expertise and quality of work, and are the fees adequate to secure a quality audit?*
5. *Did the Board meet the external auditor before and after the annual audit, and what did the auditor raise that management did not?*
6. *Are the auditor rotation requirements observed, is the auditor invited to the general meeting, and is the audit report disclosed in the annual report and on the website?*
7. *Does the relationship between executives and the auditor allow open and timely disclosure of issues, and would the Board know if it did not?*



CHAPTER

5.3

ETHICS AND INTEGRITY

How the Board sets and guards the company's ethical standard – from compliance and whistleblowing to conflicts of interest and related party transactions.

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5.3.1

ETHICS

Ethics is about doing what is right, not only what is required. The law and the corporate governance code set the minimum standards; ethics is the standard the company sets for itself, and the one by which its Board, management and people are judged when the rules are silent or inconvenient. Every company has an ethical standard in practice, whether or not it is written down. The question for the Board is whether that standard is chosen deliberately and upheld consistently, or left to emerge from habit and pressure.

This sub-chapter deals with the ethical standard itself and the Board's responsibility for it. Corporate culture and tone at the top are covered in sub-chapter 5.1.2; compliance, whistleblowing, conflicts of interest and related party transactions in sub-chapters 5.3.2 to 5.3.5; and the duty of loyalty of each Board member in sub-chapter 4.1.

Most corporate scandals begin not with an illegal act but with a series of lawful decisions that no one was willing to call wrong. Ethical failures destroy trust faster than financial ones. In the Baltic states, where markets are small and business and political networks overlap, the cost of an ethical lapse is high, and for state-owned and municipally owned enterprises public trust in the company is also public trust in its owner.

The role of the Board

The Board is the guardian of the company's ethical standard. It cannot delegate this role to a compliance function or a lawyer, because ethics is ultimately a matter of judgement, and the Board's judgement sets the ceiling for everyone else's. The Board's contribution has four parts. It defines the standard, by approving the code of ethics and the company's position on the dilemmas that matter in its business. It embodies the standard, by applying the same rules to itself and by the way it takes decisions. It tests the standard, by asking about the ethical dimension of what it approves and by refusing lawful but improper proposals. And it protects the standard, by ensuring that systems are in place to detect and correct breaches, and that consequences apply regardless of seniority.

Management runs the ethics programme: it drafts the code, designs training, handles day-to-day questions and investigates most incidents. The Board does not do this work, but it approves the framework, receives the evidence and holds management to account for the results. Where a Board committee exists, the audit committee or a dedicated ethics and compliance committee will usually prepare the