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Audit Committees Oversight Approach in Audits Involving Virtual Assets

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ABSTRACT: *This article focuses on the audit committee's insight about the impact of on quality of the external audit process. The findings also imply that the Audit Committee can help enhance various aspects of audit quality, including the quality of the evidence gathered and the invaluable advice the audit committee provides to the external auditor. This article focuses on aspects of the audit in relation to virtual assets that allow the audit process to be made more successful. The communication between the audit committee and the external auditor can be directed toward various audit-related issues. This suggests that in order to improve the external audit process, the auditor has to be aware of how specific procedures are dynamically decided upon. The findings have consequences for regulators and practitioners who evaluate the audit committee's contribution to enhancing the dependability of the auditor's and financial reports. The results show that audit committees can affect many aspects of the audit quality. More significantly, the findings show that Georgia's audit practice has a new era in audits involving virtual assets. This study presents a novel idea to the audit committees on how to enhance it's effectiveness in order to attain audit quality.*

KEYWORDS - *Audit Committee Oversight, Auditor Communications, Virtual Assets, Audit Risk, Financial Reporting.*

I. INTRODUCTION

Today, it is agreed on a theoretical level that blockchain stands out as a transformative technology that will alter a variety of financial services activities and may have an impact on corporate governance. The most significant effect that blockchain will have on corporate governance is wide-reaching. Financial crises and corporate scandals may be significantly influenced by poor corporate governance. The current complexity of the investment chain may also be a factor in some corporate governance systems' inefficiency and ineffectiveness. The intricate web of middlemen has widened the gap between the investors and the firms. Better corporate governance is made possible by blockchain technology, whose main promise is the abolition of some intermediary practices. This theory of how blockchain technology could enhance company governance may be worth looking into further. As long as all transactions are finalized in real currencies (Euro, Dollar, etc.) or digital currencies, such as Apple Pay stated in terms of real currencies, it is currently quite simple to envision numerous blockchain uses in finance. In other words, thinking about blockchain is simple when conventional currency is there but the idea of a token can be more unclear.

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II. BLOCKCHAIN IN CORPORATE GOVERNANCE

MITCHELL Innes (1913) wrote a century ago about the concept of money: "The misunderstanding that has arisen on this subject is due to the difficulty of realizing that the use of money does not necessarily imply the physical presence of a metallic currency, nor even the existence of a metallic standard of value. We are so accustomed to a system in which the dollar or the sovereign of a definite weight of gold corresponds to a dollar or a pound of money that we cannot easily believe that there could exist a pound without a sovereign or a dollar without a gold or silver dollar of a definite known weight. But throughout the whole range of history, not only is there no evidence of the existence of a metallic standard of value to which the commercial monetary denomination, the "money of account" as it is usually called, corresponds, but there is overwhelming evidence that there never was a monetary unit which depended on the value of coin or on a weight of metal; that there never was, until quite modern days, any fixed relationship between the monetary unit and any metal."

Money has taken many forms through the ages, but money consistently has three basic functions: medium of exchange, unit of account, and storage of value. According to this logic, if a token on a blockchain can perform these tasks, the notion that it is money can be questioned. Of course, tokens are not produced by central banks and are not traded through banks. This could be the conundrum these new technologies create in terms of Innes' logic.

In the OECD Corporate Governance working papers No 21 we see the map of the basic purposes of corporate governance against the basic properties of blockchain technology:

Purpose of Corporate Governance	Properties of Blockchain
Transparency	Shared distributed ledgers
Accountability	Irreversibility of records
Responsibility	Peer-to-Peer communication
Fairness	Smart contracts

From a conceptual standpoint, the irreversibility of recorded information and the sharing of information by all necessary stakeholders are the two most effective strategies for ensuring transparency and accountability in business operations. On peer-to-peer network designs, clarity and accessibility in communication channels can aid in defining responsibility and ensuring its fulfillment. The most challenging aspect of corporate governance in reality is arguably fairness, which frequently requires human judgment and participation. Technology may not be very helpful in this area. It is still conceivable, though, that smart contracts may be created to monitor specific corporate actions (such related party transactions) that call for fairness for parties not involved in the decision-making process. In a similar vein, it is evident that the goals of corporate governance can serve as a valuable framework for rethinking financial regulation and updating public laws to take into account cutting-edge innovations like blockchain.

III. REGULATORY REGIME FOR VIRTUAL ASSET INDUSTRY IN GEORGIA

The structure of a new regulatory regime for virtual assets and related services that took effect in 1 January 2023 was unveiled by the Georgian Parliament on September 9, 2022. The full implementation of the regulation is envisaged in several stages.

A virtual asset is defined as "a digital expression of value that is interchangeable and non-unique, can be transferred or traded in digital form, and is used to make investments and/or payments. A virtual asset does not include the digital representation of cash, securities or other financial instruments." Activities related to virtual asset, same as crypto asset, have been possible without special regulations until now. The Parliament of Georgia, together with the National Bank of Georgia, discussed the issue and adopted new legislation related to activities related to crypto assets.

The Central Bank now requires businesses using cryptocurrencies in Georgia to obtain a license. The obliged entities under the National Bank of Georgia's supervision are required to put internal control policies, procedures, and mechanisms into place in line with Georgian law in order to prevent and repress money laundering and the funding of terrorism. Crypto companies are registered with the National Bank as virtual asset service providers.

Virtual asset regulation has a significant impact on some businesses in Georgia, depending on several factors. On the one hand, a number of businesses operate in Georgia, whose activities are related to crypto currency, and thus, the new regulations have a direct and immediate impact on them. In addition, the regulation of crypto-currency opens up new opportunities for businesses, as the regulation of the mentioned area and bringing it into a legal framework increases the credibility of crypto-currency.

Servicing of a virtual asset is defined as "exchange of a convertible virtual asset (including through a self-service kiosk) in national or foreign currency, another virtual asset or financial instrument, transfer and/or storage/administration of a convertible virtual asset or an instrument necessary for its use, which on the virtual asset allows control, management of a portfolio consisting of convertible virtual assets (except collective portfolio management) and/or administration of a trading platform of convertible virtual assets and/or lending of such virtual asset and/or initial offering and/or services related to the initial offering." to an entity that The provider of virtual asset services is called a virtual asset service provider (VASP). convertible virtual asset: "A virtual asset that has an equivalent value, either in a foreign currency, another virtual asset and/or instruments, may be exchanged." Defined by low of Georgia for commercial Banks.

A VASP in Georgia can engage in one or more of the following: Transfer and/or storage/administration of virtual assets; Trade platform administration; Exchange (including through a self-service kiosk): in national or foreign currency, in another virtual asset, in a financial instrument; Initial offerings; Services related to initial offerings; Portfolio management (except collective portfolio management); Virtual asset lending.

Role of Audit Committee

New Law of Georgia on Entrepreneurs for all PIEs requires establishing of the audit committees (AC) with the main purpose to oversight external audit and internal controls including internal audit function within the company.

Investors and other stakeholders look to audit committees of public companies to oversee the quality and sufficiency of the accounting and financial reporting processes, as well as the audits of public companies. As part of audit committees' audit oversight responsibilities, it is important that audit committees engage in effective two-way communication with auditors and ask relevant questions throughout the audit.

IV. QUESTIONS AUDIT COMMITTEES SHOULD CONSIDER ASKING THEIR AUDITORS IN RELATION TO VIRTUAL ASSETS

Given the current economic and geopolitical climate, this article offers questions that audit committee members may find interesting to discuss among themselves or with their external auditors. It emphasizes factors to take into account when addressing specific obligations under ISA rules for auditors of issuers who deal in or possess cryptoassets. This article also offers questions that audit committees should think about posing to their auditors in cases where ownership or transactions involving cryptoassets have a meaningful impact on an issuer's financial statements. The data might be especially useful to auditors and audit committee members of issuers that are just starting to deal in or possess cryptoassets.

It is important to maintain focus on sound accounting and financial reporting practices while engaging with digital assets. In this regard general question audit committees should consider and ask to auditors:

1. What is the experience of the engagement partner and other engagement team's senior mambers with virtual assets? Could the company, if needed, bolster the engagement the team's knowledge?
2. What is the auditor's understanding of the blockchain technology underlying the company's virtual asset-related activities?
3. Are specialized technology-based audit tools needed to identify, assess, and respond to risks of material misstatement?
4. How does the audit firm monitor auditor independence considerations associated with audit engagements involving cryptoassets (e.g., monitoring whether its staff invests in cryptoassets)?
5. What policies and procedures does the audit firm have regarding conducting and monitoring audit engagements involving cryptoassets, including considering the risks associated with performing such audits?
6. How does the auditor evaluate reliability of information obtained from blockchain that is used as audit evidence?

The virtual asset legal and regulatory environment is rapidly evolving with Georgian regulators prioritizing this topic. Questions Audit Committees should consider and ask to Auditors:

7. What is the auditor's understanding of the legal and regulatory framework in Georgia, what part is regulated and what's unregulated?
8. How can company act in unregulated areas? How does the auditor monitor emerging risks and developments in Georgia's virtual asset regulatory environment?

Utilizing virtual assets can expose businesses to increased fraud risk as well as new concerns. When it comes to successful risk management for company strategies including the utilization of virtual assets, audit committees play a significant monitoring role. Questions that audit committees might think about posing to auditors include:

9. Based on how the company has set up its virtual asset holdings and transactions, what risks effecting the financial statements has the auditor identified?
10. Has the auditor identified any deficiencies or lack of internal controls to mitigate against risks?
11. Has the auditor identified any fraud risks related to the company's virtual assets? What's auditor's response to such risks?

For businesses that retain and deal in virtual assets, custody procedures are of utmost importance. Effective asset protection depends on knowing how management chose a suitable custody based on the unique facts and conditions of the organization. The majority of virtual assets can be controlled by anyone has access to their private key. Private key management and custody are therefore crucial components of protecting virtual assets. There are 2 methods: self-custody and third party custody. Digital asset owners can decide to self-custody their digital assets, in which case they are in charge of protecting their private keys in a noncustodial wallet, or they can use a third party custodian to look after their digital assets on their behalf, depending on their particular facts, circumstances, and risk profile. Each custody model has different risk factors to take into account. Questions that audit committees might think about posing to auditors include:

12. What risks has the auditor identified in management chosen custody model?
13. If the company uses self-custody for their virtual assets, has the auditor identified any risks related to management's skills and technological resources?
14. In case of self-custodies, does the auditor think that management has implemented the efficient controls and processes to address the risks?
15. If a third-party custody service is used, does the auditor have any issues regarding management's monitoring of the third-party custodian or its due diligence performed by management?
16. During the third-party custody it's important the understanding whether a company has ownership over digital assets. This can necessitate that the business conduct a legal examination of the custody agreement. It's important topic for audit committees to discuss with auditors.

Knowing the dangers associated with interacting with third parties in the virtual asset ecosystem is crucial, in addition to knowing the blockchain itself. Depending on the nature and complexity of the transactions it engages in, a corporation may have relationships with a variety of distinct third parties. The following query regarding third parties may be helpful for audit committees to discuss with the auditor:

17. Has the auditor identified any financial reporting risks related to the interactions with third parties related to its virtual asset transactions?

The exchange where they trade virtual assets or the place where they are stored may provide management with information. However, it's crucial to take the validity of the data into account while getting it from outside sources. It is crucial to confirm that the business has the necessary infrastructure to support the financial reporting process as it relates to transactions involving digital assets. When using typical accounting software to record transactions involving virtual assets, there may be a number of difficulties. The following queries from the audit committee may prove helpful to the auditor:

18. Has the auditor identified any risks related to the systems and controls recording virtual asset transactions?
19. Has the auditor identified any risks related to the reliability of internal or external data used to record virtual asset transactions?

The risk of misidentified related party transactions or the ability to disguise specific related party transactions may arise from the pseudo-anonymous nature of blockchain transactions. When management or service providers (such exchanges) don't carry out KYC or other procedures that help identify counterparties, it may be difficult for management and the external auditor to discover related party transactions. It is crucial for management to establish the right procedures and controls to identify the counterparties in transactions from the standpoint of financial reporting. Audit committees may find the following questions useful to discuss with the auditor:

20. Has the auditor identified any risks to the financial statements related to related party transactions?
21. Is the auditor able to obtain sufficient audit evidence about related party transactions?

Audit committees should be aware that the audit procedures over such accounts may involve particularly difficult, subjective, or complex auditor judgment and may be deemed to be a critical audit matter (CAM) depending on the nature, complexity, magnitude, and materiality of digital asset transactions and account balances. Depending on the type of business or transaction, a CAM may or may not be a particular account and disclosure. Engaging with the auditor to learn about any CAM and how it was addressed throughout the audit is a good practice for audit committees. We frequently observe CAMs pertaining to the existence (including private key ownership) of digital assets as well as issues pertaining to rights and obligations.

22. Was it identified CAMs related to virtual assets? If yes, how has the auditor addressed them?

V. CONCLUSION

Audit committees can more efficiently carry out their oversight duties if they are aware of the major virtual assets subjects and know what questions to pose to the external auditor. AC members need to have access to the best practices within the country and worldwide, agree on certain policies and influence legislative improvements. Georgian ACs may build even more trust in the financial reporting process, which is their traditional and core job, by accepting the need to expand into new areas of responsibility. Most significantly, they can help the company be better prepared for the dangers that will unavoidably arise in the future. For this purpose would be beneficial to have in Georgia Audit Committees' Association. Also it could enhance audit committees performance through implementation of the best practices.

An auditor's responsibility to compile data supporting relevant to management's accretions about the fair presentation of the financial statements stays the same, but the techniques used and the evidence gathered are very different from traditional audits (Boillet J. EY's Global Accounts Committee Assurance Lead). Due to these and other digital changes expecting, the biggest issue now facing Georgian Audit Committees is striking an appropriate balance between today's operational and reporting challenges and tomorrow's unforeseeable hazards. For these purposes AC should: recognize the need for new abilities in relation to digital tools, systems, and procedures that affect company operations and the function of internal and external audit; take into account modifying the tenure of board committees to hasten the adoption of those new skills by the AC and work more with policymakers and regulators to reduce any unfavorable effects of regulatory change.

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