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Leveraging Internal Audit from the Very Top

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Boards and audit committees should be leveraging their internal audit function in helping to fulfill their duties. Boards often utilize an audit committee to ensure oversight of their financial reporting process and internal controls, including oversight of the CEO. Ideally the governance structure contains adequate checks and balances to help ensure shareholder interests. Still, failures and weaknesses in corporate governance arrangements are commonly cited behind business catastrophes, including the September 2008 financial crisis that nearly brought the world to the brink of economic chaos. The Organization for Economic Co-operation and Development (OECD) concluded in 2009 that; "*when they were put to a test, corporate governance routines did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies*."[1]

It is not just financial service companies under the microscope as history proves that every type of organization and industry is prone to fraud, poor decisions, excessive risk taking, materially inaccurate financial statements and a barrage of other ills. Business failures are a favorite target of the media thus wrecking havoc on board members' reputation, the organization as a whole, and investors who are harmed and thus left to rationalize legal actions. Hence, it is understandable why people are increasingly reluctant to serve on boards, especially audit committees. Accounting complexities, legal exposures, time commitments, and operating risks are on the rise. Yet, how many boards and audit committees can truly conclude that they leverage their internal audit function in an effective manner? Ideally, the internal audit function should serve as an independent set of eyes and ears for the audit committee. This article identifies concepts, risks, and recommended actions to help audit committee members best leverage their internal audit function. It is inspired by several chapters I co-authored in a book entitled "The Board of Directors and Audit Committee Guide to Fiduciary Responsibilities: Ten Critical Steps to Protecting Yourself and Your Organization" published by AMACOM in July, 2013.

Independence is the Most Important Concept for the Board and its Committees

Independence is arguably the most important single word for effective boards and audit committees since objective judgment is illusive when personal relationships are also honored in the execution of one's duties. A well-recruited audit committee provides a brain trust of backgrounds, experience, perceptions, intellect, and specific skills that facilitate cross-fertilization and exposure to new ideas. The audit committee is typically responsible for monitoring all internal and external audit functions of a company, overseeing the financial reporting process, and ensuring regulatory compliance. However, this effort can be stifled and conflicted when independence is missing on the audit committee.

[1] Page 2, Corporate Governance Lessons from the Financial Crisis, February, 2009, authored by Grant Kirkpatrick for the Steering Group under the supervision of Mats Isaksson, published by the Organization for Economic Co-operation and Development.

There has been a slew of definitions from regulators in an attempt to promote the independence of audit committees thus mitigating the risks of conflict of interests with management. However, director independence is a vastly deeper, wider, and more complex topic than can be conveyed by the mapping of interlocking directorships. Regulators have been challenged to articulate independence beyond direct relationships and interlocking directorships. Indeed, personal connections formed through neighborhoods, schools, fraternities, social clubs, gyms, industry associations, former board members, political action committees, think tanks, charities, former work associations, and common friends can be just as important. A board and their committees must go beyond formal definitions of independence to understand and accept the spirit of independence as unbiased actions rather than simply looking at it on paper from a legal standpoint. A purist definition of an independent director or committee member is someone whose directorship constitutes his or her only connection to the organization. The independent director brings no biases from executive management and owes no favors to the CEO or their team.

Only after you have true independence on your audit committee, and the Chief Audit Executive (CAE) functionally reports to the audit committee (and only the audit committee), can you reasonably ensure strong internal audit activity as defined by the Institute of Internal Auditors (IIA):

"A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes."[2]

Craft a Culture of Action between the Audit Committee and the Internal Auditor

An audit committee is only as good as the quality of perspectives and actions of the individual directors comprising the committee. Collectively, the directors assigned to the audit committee must interact for the good of shareholders. This means injecting the audit committee culture with heavy doses of "constructive skepticism," as it is critical to nominate directors to the audit committee who will be vocal in dealing with difficult and controversial matters. These matters should be freely discussed with the CAE as the leader of the internal audit function reporting to the audit committee. There should be no "sacred cows" that are considered untouchable at audit committee meetings, but again to accomplish this both audit committee members and the internal audit function must be independent of executive management.

An effective audit committee must also bring critical thinking to the table. Members need to be able to freely ask difficult questions. Committee members must work together to complement each other's strengths and weaknesses to maintain a healthy degree of oversight and inquiry of officers. A culture of transparency, diversity, and accountability should rule not only among audit committee members, but also regarding their interactions with the CAE.

Direct the External Audit

Overseeing the external audit relationship from contract award to termination is one of the most fundamental responsibilities of audit committees. Unfortunately, many companies go about this duty with little or no consideration of their internal audit function. This can be a wasted opportunity to help reduce potential audit fees by having discussions with the external auditor on their stance

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[2] Page 21, International Standards for the Professional Practice of Internal Auditing (Standards), October 2008, revised: October 2012, authored and published by The Institute of Internal Auditors.

for leveraging internal audit's work. Indeed Auditing Standard No. 5 from the Public Company Accounting Oversight Board states that; "*the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reportin*g."[3] The auditing standard goes on to also caution the external auditor from using the work of others who have a low degree of objectivity. Once again this points to the importance of independence and objectivity of the internal audit function.

The following additional actions will help ensure a healthy relationship between the audit committee and the accounting firm serving as the external auditor:

- **Ensure Auditor Independence**. Auditors possess a tremendous insight into organization vulnerabilities but they may shade the truth, all while complying with professional standards, to retain a client. Let your external auditors know that you demand the unvarnished truth.

- **Discuss Risks with the Auditor**. The external auditors can provide valuable insights into organizational and financial reporting risks. This should be a topic at every audit committee meeting for which the external auditor is also present. It is prudent for the audit committee to hold executive sessions with their external auditor. These sessions should be closed to the CFO and any other managers or non-independent directors. Be especially on the look-out for financial reporting risks pertaining to revenue recognition, fair value estimates, asset impairments, related party transactions, contingencies, and derivatives that could be the source for a restatement.

- **Don't Forget about Disclosures Outside of the Financial Statements:** While restatements pertain strictly to an organization's financial statements, most entities are subject to additional regulatory disclosures. These can range from tax returns to satisfying debt covenants to regulatory reporting; such as proxy statements, annual reports and real-time reports as required by the SEC. A public company's management and discussion analysis disclosures are especially important. Confirm the auditor's responsibilities for these disclosures and engage your internal auditors for important disclosures not covered by the external audit process.

Leverage Internal Audit and Outside Resources

The oversight of auditors, financial statements, controls, risks and other duties add up to be an incredibly daunting task for any audit committee. While there is a lot that audit committee members can do on their own, they realistically need to also rely to some degree on an independent source as their eyes and ears. They need someone to tell it like it is, not how management wants it told. This is the perfect role for a properly structured internal audit function. Some organizations have an internal audit function that provides directors with an independent and reliable stream of information while others may engage an outside assurance resource. Regardless of how the internal audit function is staffed, it is important for the audit committee,

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[3] Paragraph 17, Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, authored and published by the Public Company Accounting Oversight Board, PCAOB Release No. 2007-005A , June 12, 2007.

rather than management, to authorize the budget of internal audit activities, approve the audit plan, evaluate the performance of the CAE, and approve the internal audit charter.

An internal audit charter serves as the foundation for solid internal audit function. Audit committees should insist that the charter built upon principles like those outlined in the IIA's International Standards for the Professional Practice of Internal Auditing. The IIA standards include statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of its performance. The IIA standards address numerous topics related to internal auditing, including guidance on setting engagement objectives, scope, work programs, resource allocation, and supervision. Although these standards provide no absolute assurance against errors and poor judgments, they can go a long way toward mitigating associated risks.

Audit committees should also encourage internal audit's use of surprise audits since the "perception of detection" is a desired trait of strong anti-fraud business cultures. Ideally, the auditee should not be aware of the internal audit approach, testing thresholds, and precise sample of items to be tested until they are ready to be pulled for testing. Audit procedures and timing should also be changed from time to time. The audit committee should ensure that the CAE proposes and implements an audit program that meets the spirit of surprise audits. What's great about surprise audits is that unlike regular audits that often involve large sample sizes, surprise audits serve their purpose using very small sample sizes.

An audit committee should always keep in mind the need to bring in outside independent resources, including potentially outsourcing the entire internal audit function. This is a popular route for smaller organizations that cannot justify a full-time equivalent employee year-round for the internal audit function. Although no universal test exists for this threshold, organizations with less than $250 million in annual revenue typically fall in this category. Scale of the organization aside, the choice to staff internally or to outsource may be dictated by the complexity of the operations and other risk exposures. Even organizations large enough to have an in-house internal audit function may choose to outsource for access to certain specialized or sensitive matters. If the decision has been made to use outside resources, care must be taken in selecting an objective service provider. This is easier said than done since third-party contractors can be aligned with an internal sponsor, thus introducing a potential lack of independence. Mitigating this risk requires the audit committee to independently procure the right resources without input from management.

Finally, some people look for ways to avoid the most sensitive, controversial aspects of life. In the business world, this cuts at the heart of ethics, leadership lines, competency, and accountability. Thus, many organizations do not assess these areas head-on for fear of jeopardizing friendships, internal repercussions, retaliation, or other career setbacks. Yet these are the very areas that the board and the audit committee members need to understand and assess. Leveraging the internal audit function, as well as specialized independent outside resources, as the audit committee's independent assurance resource is a smart move to best fulfill director duties in protecting shareholder interests.

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