

TONE at the TOP

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EXCLUSIVELY FOR SENIOR MANAGEMENT, BOARDS OF DIRECTORS, AND AUDIT COMMITTEES

We Need to Talk...

Talking sometimes gets a bad rap, especially when preceded by the statement, “We need to talk.” However, whether in personal relationships or situations regarding internal control and corporate governance, there is absolutely no substitution for communication — particularly in terms of clarifying expectations, maintaining understanding, and staying current on what’s happening. And in the world of business, few “talking partnerships” are more critical than that of members of a board of directors’ audit committee (AC) and the internal auditors — or more specifically, the chairman of the audit committee and the chief audit executive (CAE).

What makes communication between these two roles so essential, and why should executive management do everything possible to preserve it? Well, in general, it’s simply good business; and in specific, it supports effective governance. Because the internal audit activity is an organization’s best inside resource to provide assurance that things throughout the entity are working as intended, it must have direct access to and ongoing communication with the body responsible for organizational oversight. And that body — in many cases — is the audit committee.

The CAE should have what is referred to as “executive sessions” both during regularly scheduled AC meetings



for open discussion of management issues without the presence of other senior managers, and between scheduled meetings as needed to address issues as they occur. Although this clearly is appropriate and considered to be a best practice, it is not always the case. This is unfortunate, says The Institute of Internal Auditors’ (IIA) President Richard Chambers, CIA, CGAP, CCSA, as he points out abuses in the way some executive sessions are conducted: “The most alarming trend is the frequency that other executives sit in on the CAE’s executive sessions with the audit committee,” says Chambers. “And when there is a ‘session crasher,’ it is often the CFO, who would never consider attending an executive session between the external auditor and the audit committee.”

Official Definition of Internal Auditing

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

WHY EXECUTIVE SESSIONS SHOULD EXCLUDE EXECUTIVES

As the definition of internal auditing clearly states, independence and objectivity are critical to the internal auditors’ roles. Unfortunately, in some organizations, the internal auditors are not fully empowered by executive management to carry out their responsibilities in this way. They (the internal auditors) might be made to feel

threatened or pressured by management to reveal to the AC or other governance entity only part of the story in regard to the state of affairs within the organization. And yet, unless the AC has all the information it needs, it cannot be effective in helping safeguard the interests of all stakeholders.

Good CAEs require integrity and stamina, and must be courageous and politically savvy. But that's not enough. They must be positioned appropriately and empowered to carry out their duties, and this requires the buy-in of both executive management and the board of directors. In some organizations — such as those to which Chambers refers — executive management becomes (or attempts to be) a barrier between the internal auditors and the AC.

If the AC does not have direct access to the CAE, that, in itself, should be a red flag that something is amiss. A review of numerous corporate failures over recent years reveals company after company at which executive management was involved in fraudulent activity. Appropriately conducted executive sessions between the CAE and the AC can bring to light early signs of inappropriate activities and potential frauds, as well as opportunities to enhance the effectiveness and efficiency of operations, the accuracy of financial reporting, and the adequacy of risk management.

Of course, this is not news to those at the top of the best-run companies. CEOs and CFOs at such organizations are well

aware of the benefits and value their internal auditors bring to the table, as well as the safety net they provide to management itself. In fact, they welcome the scrutiny, and find it reassuring that internal auditing is a management function whose goal is to provide assurance and to help the organization meet its objectives.

GUIDELINES FOR UNENCUMBERED COMMUNICATION

If executive sessions are going to be effective and truly valuable to an organization's governance, all parties — the audit committee, executive management, and the internal auditors — should agree to and honor several rules of engagement, both in theory and in practice. Here are just a few for consideration:

- The CAE to have a dual reporting role to executive management on administrative issues and directly to the AC.
- The CAE and the AC chair to build and maintain a relationship of mutual trust, sensitivity, and respect; and to engage in open dialogue and regular interaction.
- The CAE to educate both the AC and executive management about internal audit roles and responsibilities and the structure and value of executive sessions. (Practice Advisory (PA) 1110-1 is available at www.theiia.org)
- The CAE to maximize communication with the AC through executive sessions, without the presence of management.
- Executive management to support the executive session concept and parameters.
- The AC to not permit outsiders to sit in on executive sessions, and to excuse those parties prior to beginning such a session.
- Confidentiality and privacy to be inherent in executive session discussions.
- The AC to be open to the CAE's insights on risks, controls, policies, procedures, and the ethical environment, as well as regarding the behavior and practices of corporate executives.
- The CAE to discuss with the AC ways that internal auditing could assist the board in fulfilling its required oversight of risk management, including compliance with regulations such as those recently issued by the U.S. Securities and Exchange Commission (SEC) requiring public disclosure of information on governance activities.



ASKING THE RIGHT QUESTIONS

IIA Chairman of the Board Rod Winters, CIA, observes that “A significant part of any relationship based upon honest communication includes asking and answering questions. The AC should be comfortable with the answers the CAE provides to probing questions.” These include questions such as:

- Does the internal audit activity comply with The IIA’s *International Standards for the Professional Practice of Internal Auditing*?
- Is the activity sufficiently detached from functional areas to guarantee its independence? (NOTE: Although internal auditing is integral to the organization, it must be independent of the function it audits.)
- Do the internal auditors avoid activities that could undermine their objectivity?
- Is the internal audit plan based on the organization’s risk profile?
- How well is the internal audit activity completing its plan to date?
- Does internal auditing have a quality assurance program, and does it have a plan to undergo an external quality assessment every five years as required by the *International Standards*?
- What are the results of the most recent quality assessment?
- Does the internal audit activity have the resources it needs to live up to its charge to provide objective assurance on risk and control?

Likewise, the CAE should have a level of comfort with the AC’s answers to questions such as:

- Do all members of the AC fully understand the roles and responsibilities of the internal audit function?
- Does the AC charter include the internal auditors’ reporting relationship?
- Does the AC have all the education and information it needs to ensure its decisions are well-founded and reality-based?
- Do the AC members understand and acknowledge their responsibility to ask tough questions and elicit truthful



and comprehensive answers in order to stay abreast of what’s really going on within the organization?

- Is the AC familiar with the results of the internal auditors’ risk assessment and fully comfortable with the level of risk the organization is tolerating for growth?

COMMUNICATION: INTEGRAL TO INTERNAL CONTROL

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) included information and communication as one of the components of internal control in its highly acclaimed *Internal Control — Integrated Framework*. COSO also cited information and communication as one of the components of enterprise risk management in its *Enterprise Risk Management — Integrated Framework*, global guidance released in 2004. Both works have been embraced by organizations all around the world, as they attempt to build strong systems of internal control and risk management.

Clearly, those at the top (both executive management and the board of directors) need honest, straight-forward, and comprehensive communication in order to achieve sustainability. And the internal auditors’ role in providing this must be ongoing, as they gather information, analyze it, and report on it — all for the organization’s greater good.

Additional Resources at www.theiia.org

- New SEC Proxy Disclosure Rules (IIA alert)
- Adding Value Across the Board (brochure)
- The Audit Committee: A Holistic View of Risk
- The Audit Committee: Internal Audit Oversight
- The Audit Committee: Purpose, Process, Professionalism (brochure)



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Mission

To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and

responsibilities for, the internal audit activity.

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The Institute of Internal Auditors (www.theiia.org) is dedicated to the global promotion and development of internal auditing.

Established in 1941, The IIA is an international professional association with global headquarters in Altamonte Springs, Fla. The IIA has more than 170,000 members in internal auditing, risk management, governance, internal control, IT auditing, education, and security.

The IIA is the global voice, recognized authority, chief advocate, principal educator, and acknowledged leader in certification, research, and technological guidance for the internal audit profession worldwide. The IIA enhances the professionalism of internal auditors and is internationally recognized as a trustworthy guidance-setting body. It fosters professional development, certifies qualified audit professionals, provides benchmarking, and through The IIA Research Foundation, conducts research projects and produces educational products.