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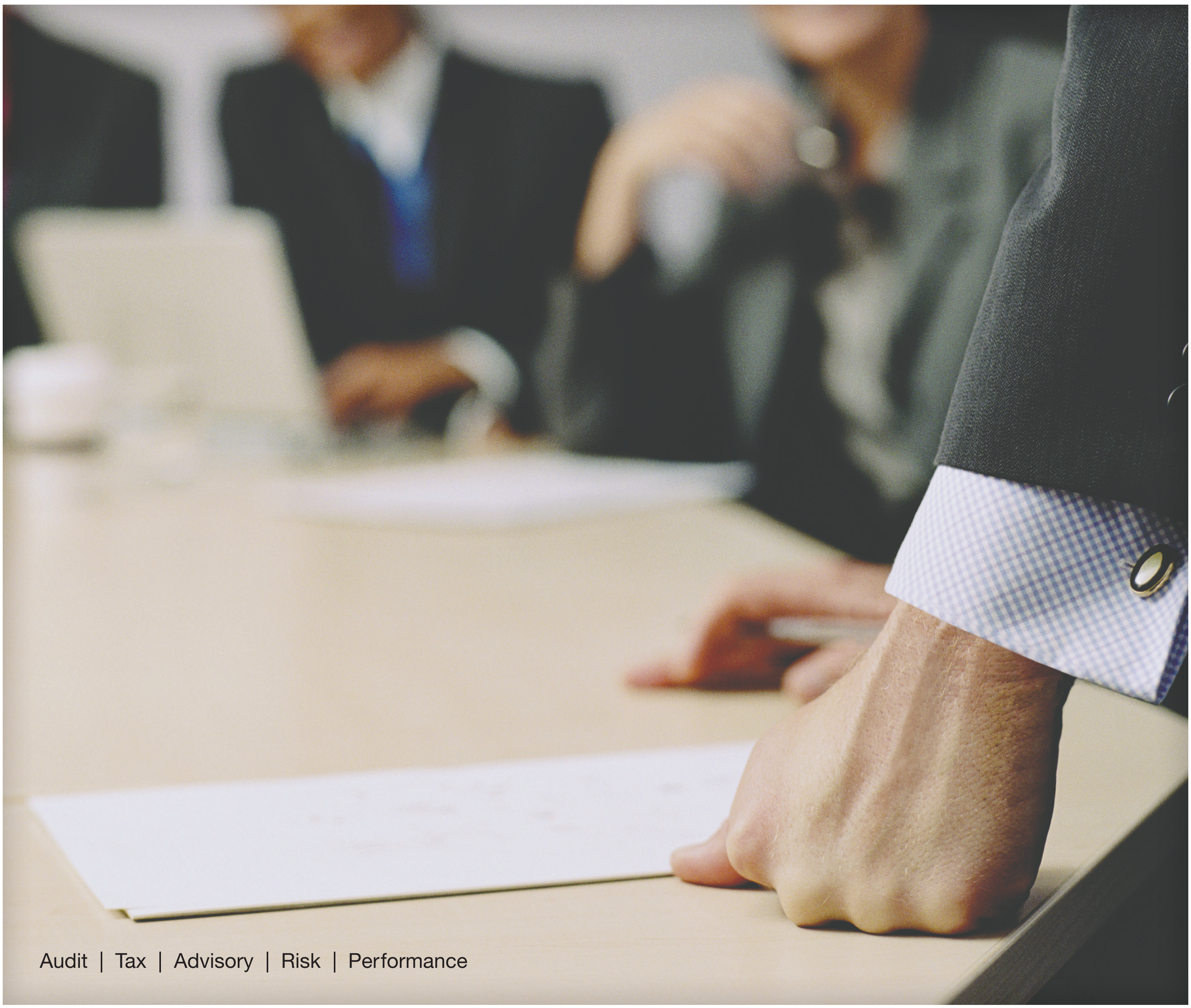
Strengthening Corporate Governance With Internal Audit

A Crowe White Paper by Rick Julien and Larry Rieger



A focus on corporate governance offers internal audit the opportunity to become a more active and strategic team player. Recent surveys have shown that management and boards of directors are looking for greater contributions from the chief audit executive (CAE) and internal auditors. Internal auditors can meet the heightened expectations by taking a more holistic view of corporate governance and aligning internal audit skills and activities to assess, improve, and monitor their organizations' corporate governance capabilities. The CAE must understand all of the components of corporate governance and how internal audit can support them.

Corporate governance is seen largely as the province of boards of directors and legal compliance officers, and that narrow view can restrict improvements to the corporate governance process. Good governance is a journey that begins with a broad, organizational perspective. Making steady progress requires committed senior leadership, integrated planning, coordinated execution, and constant monitoring.

Internal audit's responsibilities are growing due to increased regulatory scrutiny as well as directives from executives to strengthen controls and improve risk management. Increasingly, business leaders expect internal audit to play a more strategic – rather than merely tactical – role in the governance process. In fact, that role is consistent with the definition of "internal audit" sanctioned by The Institute of Internal Auditors (IIA). However, the internal audit function continues to play only a minor role in many organizations.

At a high level, corporate governance can be thought to have seven interrelated components: board of directors and committees, legal and regulatory, disclosure and transparency, business practices and ethics, enterprise risk management, monitoring, and communication. Internal audit performs critical roles in all aspects of corporate governance by:

- Supporting the audit committee in fulfilling its heightened responsibilities;
- Participating in the organization's disclosure committee;
- Reviewing the effectiveness of the organization's code of conduct, ethics policies, and whistle-blower provisions;
- Helping assess risks and gauge performance across the organization;
- Monitoring corporate governance activities and compliance with the organization's policies;
- Facilitating and enhancing communications with the chief executive officer, general counsel, chief financial officer, chief information officer, and other oversight executives; and
- Evaluating the effectiveness of the corporate governance activities and recommending areas for enhancements.

The rewards of improved corporate governance encompass more than a greater sense of personal accomplishment or company pride. Researchers at the University of Michigan Business School, along with other business and academic studies, have found a strong correlation between effective governance and profitable investment opportunities. Internal audit plays a pivotal role in this process by fostering an integrated, well-planned, and progressive governance program.

A Changing Role

During the boom times of the 1990s, people's trust in business grew along with rising stock prices. Serious interest in risks, controls, and ethics on the part of the media and many investors was limited. Although internal audit began to allocate resources based on risks and the function's visibility increased, staffing levels were relatively constrained and audits often focused on performance improvement opportunities.

Recent regulations, including an emphasis on anti-fraud and whistle-blower provisions and the potential impact on stock prices, have compelled auditors to take a more active role in governance. In 2003, the U.S. Securities and Exchange Commission approved final versions of revised New York Stock Exchange (NYSE) and Nasdaq requirements. The NYSE now requires that listed companies have an internal audit function. The IIA has clarified roles and responsibilities by affirming the importance of risk management and corporate governance. Internal auditing, according to the institute, "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." The institute's revised International Professional Practices Framework calls upon internal auditors to evaluate and offer recommendations to improve governance processes.[1]

Internal auditing requires business knowledge, insight, good judgment, and effective communication. Consequently, CAEs with many years of business experience and insight are becoming highly valued.

Multifaceted Challenges

Internal audit will always have the challenge of remaining independent and objective while being part of the organization. In this age of intense scrutiny of business motives and ethics, the last thing a company needs is a passive internal audit function. But no organization wants an internal auditor group whose only response to risk is an attempt to eliminate it entirely. There are risks in any business venture, and closing off all risks also closes off any rewards.

Internal auditing requires business knowledge, insight, good judgment, and effective communication. Consequently, CAEs with many years of business experience and insight are becoming highly valued, and internal auditors must continue to increase their skill levels in order to contribute greater value, help strengthen governance, and improve company performance.

The biggest challenge facing companies and their internal auditors is the lack of a one-size-fits-all method to improve corporate governance. Each organization must tailor an individual solution that considers its industry, maturity, business strategy, capabilities, corporate culture, and competitive position. Since there is no quick solution for addressing this multifaceted challenge, keeping the focus on good governance over the long term is an important goal for most organizations.

A Focus on Corporate Governance

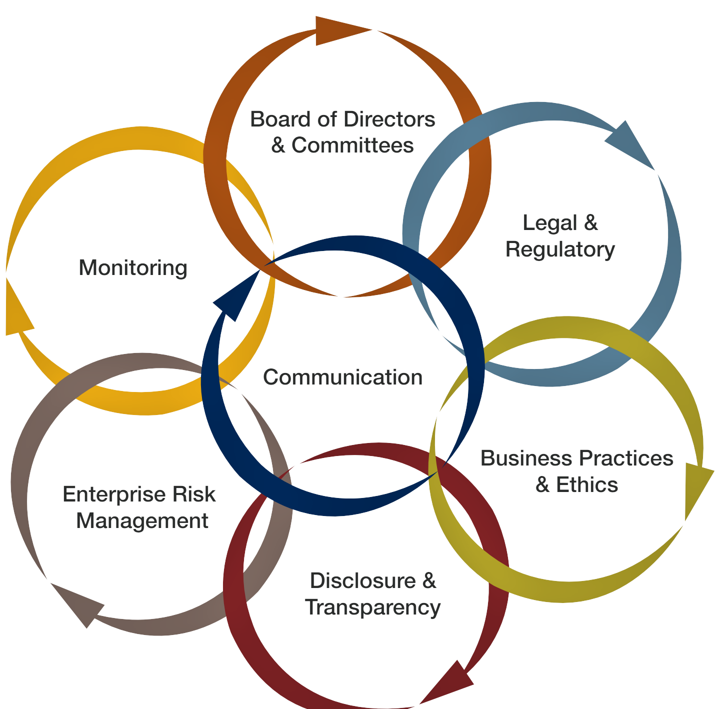
Investors and other stakeholders value companies that anticipate problems and show evidence of strong internal oversight. Internal audit should be a champion in assessing opportunities where corporate governance can be strengthened and suggesting corrective action as needed.

But, first, a definition to clarify the concept of governance:

> **Corporate governance is the systems and processes an organization has in place to protect and enhance the interests of its diverse stakeholder groups.**

The best governance addresses the needs of all of an organization's stakeholders – shareholders, employees, customers, lenders, vendors, and the community – because all of these groups share a common interest in perpetuating the business. Well-governed organizations recognize that balancing the interest of them all is critical for a sustainable organization.

Auditing the effectiveness of an organization's corporate governance systems, practices, and performance requires a reliable framework and methodology. The following is an analysis of the seven essential and interrelated components of the Crowe Corporate Governance Framework. These components emerged during extensive research and practical experience with governance issues.



The Crowe Corporate Governance Framework

These seven components give a comprehensive view of the complexity, interrelationships, and variables organizations must manage in order to strengthen their governance. When all components operate effectively and are efficiently coordinated, corporate governance provides a platform to help improve business performance and enhance stakeholder value. Each of the seven components discussed in the rest of this white paper is accompanied by examples of actions internal audit should take to meet stakeholders' expectations.

Board of Directors and Committees

The primary responsibility for effective corporate governance rests with the board of directors. The board establishes the direction and values of an organization, oversees performance, and protects shareholder interests.

Board responsibilities are formally defined in bylaws and charters. Listed corporations are required, by law, to include a minimum of three board committees, which are in charge of overseeing audits, regulating compensation, and managing nomination and corporate governance policies. The number of additional committees and members is up to the organization.

The committee of greatest interest to internal audit is the audit committee, which reports regularly to the full board and meets separately and periodically with management as well as internal and external auditors. At least one member of the audit committee should function as a "financial expert."

Ideally, a board of directors establishes benchmarks for its performance against peer boards and best practices to improve corporate governance. Section 301 of the *Sarbanes-Oxley Act* (SOX) states that all members of the audit committee panel must be independent.

Internal Audit

- Assists the board of directors and committees with their self-assessment and best practices;
- Assesses audit committee effectiveness and compliance with regulations;
- Reviews the audit committee charter with the help of legal counsel;
- Is interactive on the subject of governance, bringing best-practice ideas about internal controls and risk management processes to audit committee members;
- Establishes the accuracy of information used in decisions by the compensation committee; and
- Assists the board with its proxy reporting on oversight of risk management.

Legal and Regulatory

This component speaks to the legal boundaries within which a company operates and the requirements set forth by current laws as well as international, federal, and state regulations. The issues are complex, especially for large corporations engaged in specialized and highly regulated businesses.

The elements in this component deserve special attention because the cost of compliance continues to increase. Leading organizations are striving to improve their compliance responses and manage the costs more effectively. Many look for opportunities to aggregate and leverage certain compliance activities and capabilities to achieve improved performance at a reduced cost.

Internal Audit

- Verifies – with legal guidance – that the organization has identified requirements, assigned responsibilities, and addressed all of the key legal and regulatory requirements; and
- Looks for opportunities to leverage compliance activities and capabilities to reduce long-term costs and improve performance.

Leadership must set the tone from the top. Good governance has the best chance of taking root when embedded in the culture and seen in executives' daily activities.

Business Practices and Ethics

Business practices are the operational tactics and measures a company uses to achieve its purpose and strategy. The overriding goal is to maintain consistency, predictability, and accountability in conduct, decision making, and performance.

Ethics are the moral boundaries an organization believes it should observe when pursuing competitive objectives. Ethics and a well-defined code of conduct are cornerstones for building a strong foundation for good corporate governance. Due to the SOX whistle-blower provisions, companies need systems to field complaints and investigate potentially illegal and unethical conduct.

The goals for rules of conduct are the fair treatment by the organization and its employees of the interests of all stakeholders and staying within applicable laws and societal expectations. The code of conduct encourages employees at all levels to pursue business in fair and honest ways and to comply with government rules and regulations.

The tone needs to be set from the top. Good governance has the best chance of taking root when based on sound principles embedded in the organization's culture and seen in executives' day-to-day actions.

Internal Audit

- Reviews the code of conduct and ethics policies, verifying that they are periodically updated and communicated to management and employees;
- Performs a behavioral sciences ethics review to assess the understanding and perception of compliance at all levels of the organization (geographic and departmental, for example);
- Helps management and the audit committee hold people at all levels accountable, listening to their words but also looking at their actions;
- Serves in an ethics oversight role or confers with the organization's ethics officer;
- Participates in whistle-blower and other ethics complaints investigation processes;
- Conducts annual audits of hotline and follow-up processes, reporting results (for example, compliance with policies and consistency of actions) to the audit committee; and
- Assesses the linkage of ethics to goal-setting and performance evaluation processes.

Disclosure and Transparency

This component refers to the nature and timing of information an organization provides to its stakeholders. SOX requires executives of publicly traded companies to certify financial statements. Financial reports must meet legal expectations for clarity, relevance, reliability, and comparability. The legislative intent is to provide shareholders with information that is complete, objective, and timely. In many cases, however, organizations need to think more broadly than they do about what is appropriate disclosure and transparency to all stakeholders, not just shareholders. In fact, most states mandate timely disclosures when lapses in customer information privacy occur.

Internal Audit

- Conducts testing of financial disclosures and confers with the CFO;
- Understands concern for disclosure and transparency, aligning risk assessment with stakeholder expectations;
- In the annual audit plan, addresses disclosure and transparency objectives;
- Understands the breadth and depth – that is, the spectrum – of disclosure and transparency possibilities and where the organization strives to be or should be on the spectrum;
- Actively participates in the disclosure committee, including evaluating its effectiveness; and
- Reviews the subcertification process.

Enterprise Risk Management

In many organizations, control activities are narrowly focused on compliance. Enterprise risk management (ERM) encourages organizations to take a broader view. The ERM framework of the Committee of Sponsoring Organizations of the Treadway Commission[2] (COSO) is an integrated approach to managing risk and reinforces the need for a comprehensive approach to mitigating risk and improving corporate governance.

SOX is having the effect of pushing ownership of controls to process owners throughout the business. Process owners are in the best position to monitor operational risks and benefit greatly from a better understanding of internal controls over financial reporting.

The process and risk-assessment-related evaluation skills that internal audit must have to understand the best mix of controls provide the foundation for assessing governance processes. Thus, internal audit can provide recommendations that manage risk, enhance performance, and improve governance.

Internal Audit

- Proactively advocates and participates in an organization's ERM efforts, including establishing a practical ERM governance structure having a commitment to common methodologies and tools;
- Facilitates identification of important risk areas for the organization as well as its most important processes;
- Ensures the business strategy is linked to the ERM process;
- Assists process owners with understanding, assessing, designing, and documenting controls;
- Inventories organizational risk and compliance activities and strives to integrate them into a common methodology; and
- Evaluates business and process owners on taking responsibility for ERM.

Monitoring

Monitoring tactics vary by company, but methods share a common objective: to evaluate whether components of the governance framework are operating as intended and provide reporting to various levels of the organization. At the most fundamental level, monitoring systems look at "what is" versus "what should be."

To identify gaps, organizations employ a variety of monitoring functions, including internal auditors, regulatory or legal compliance officers, ethics officers, internal management reporting, and self-assessments.

Timely risk and performance monitoring has a positive impact on an organization and the sustainability of corporate governance. With better integration among monitoring functions, methodologies, and systems, company leaders receive more relevant reports, thereby enabling them to take corrective action promptly. Effective integration contributes to better-trained individuals and enhances reporting capabilities and operational efficiencies.

Internal Audit

- Understands what monitoring activity is taking place in the organization for each of the other components of the governance framework;
- Facilitates the implementation of a common risk monitoring methodology across all corporate governance functions, thus feeding an integrated reporting system;
- Performs a strategic-level corporate governance audit or sees that one is conducted;
- Incorporates tactical-level corporate governance aspects into audit plans; and
- Develops an assurance scorecard and reports on it quarterly.

Internal audit participates in ongoing conversations with the general counsel, CFO, and other senior management officers.

Communication

The increasing complexity of legal requirements, compliance activities, and governance best practices requires good communication. Communication holds together the various components of the governance framework and keeps the process improving over time. A single announcement in a routine memorandum is not enough to ensure that everyone is getting the message about good governance.

Because corporate governance permeates virtually every area of an organization, it is important to have a shared set of terms people can understand and use productively in discussions. In essence, a common language is needed to discuss governance issues. A common governance language facilitates productive dialogue so that everyone can work together to strengthen governance and company performance.

Maintaining the focus on good governance is one of the key elements for improving it over time. Internal audit plays a pivotal role in communicating that focus throughout the organization.

Internal Audit

- Participates in ongoing dialogues with the general counsel, chief financial officer, and other senior management officers;
- Maintains steady communication with audit committee members and oversight executives (for example, depending on the organization's size and internal oversight structure, the chief risk officer, chief compliance officer, and/or ethics officer);
- Includes information about corporate governance in audit reports; and
- Assists in establishing a corporate governance communications calendar and solicits input about needs across the organization.

Costs to improving governance can include enhancing internal audit staffing, adopting ERM, and further developing the financial expertise of audit committee members.

Looking Ahead

It is in an organization's best interest to evaluate and improve its governance policies now. Auditing the effectiveness of its governance systems, practices, and performance requires a rigorous methodology and comprehensive view of the organization. With the understanding that corporate governance provides a compass for the journey, the internal audit charter should be aligned with the organization's long-term interests. There are costs to improving governance, whether through enhancing internal audit staffing, adopting ERM, or further developing financial expertise among members of the audit committee.

The returns may not be immediately measurable, but the long-term results of a successful governance program include better brand and reputation management, enhanced market value, compliance with regulations, sound business practices, and a more solid foundation for growth. Strong governance is part of a successful business strategy, and good governance can enhance an organization's competitive position, assist in retaining superior employees, attract top-notch directors, and contribute to long-term improved financial performance. Anticipation of improved stakeholder returns, therefore, can help to justify the investment.

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[1] The Institute of Internal Auditors, International Professional Practices Framework (IPPF), 2011, http://www.theiia.org/guidance/standards-and-guidance/interactive-ippf/?search=IPPF

[2] COSO, Guidance on Risk Management, http://www.coso.org/ERM.htm

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