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Essay Topic:

Assessing Governance – Internal audit’s role in reviewing the top of the organization.

- What happens when the structure or practices of governance are the problem?
- What ruler should internal audit be using to “assess” and “advise” governance, and can internal audit overstep its role?
- How does internal audit manage the delicate political balance in proposing, participating in, and reporting on a governance assessment where they are effectively reviewing their boss?

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About the Author

Raluca Alexandra Popescu was born in Romania and raised in Kuala Lumpur, Malaysia before moving to Buffalo, New York to obtain a bachelor’s degree in Accounting. Currently, she is a student in the Internal Audit and Risk Management track of the Masters of Science in Accountancy program at the University at Buffalo. She is expecting to graduate in May 2018 with a Bachelor and Master of Science (BS/MS) in Accounting with specialization in Internal Auditing. Later this year, Raluca will join EisnerAmper as a full-time staff accountant.
Executive Summary

To understand governance takes three steps. This paper aims to get to know what governance is all about. After it has been defined as a process, both internal and external parties must be identified. The third step is to then define the role the Internal Audit Function. Once established, governance may be separated into two broad areas. One area covers strategic direction and the second covers governance oversight\(^1\). Strategic direction concerns the responsibility of the board in establishing key business objectives that must single handedly remain consistent with their business model and must also align with stakeholder priorities. On the other hand, governance oversight is focused on how the board manages and monitors operations. Overall, the board is fully involved with the structure and the practices of governance. These areas are developed through the building blocks of governance.

However, when the structure or practices of governance as questioned to be problematic, the Internal Audit Function may be question if they are over stepping their role. Internal audit can provide independent assurance activities that provide an objective assessment of not only the effectiveness of governance but on risk management actives as well. This is an area that is important to Internal Audit Function as they are responsible in assessing, as well as recommending on, how to improve the current governance process of an organization. However, the Internal Audit Function needs to use specific rulers to “assess” and “advise” governance. This paper aims to address the delicate political balance that needs to be managed in terms of proposing, participating in and reporting on governance assessment as they are in a sense reviewing their boss.
Introduction

There are several reasons as to why governance is a critical component of an organization. It not only provides a comfort of confidence in its council, but also encourages faith in the elected members and officers in their decision-making process. Good governance paves a path that leads to better decisions and therefore must be assessed thoroughly as the organization is highly dependent on governance.

To be able to understand and identify good governance, the role of internal audit comes in to play a huge part. Internal audit has several roles but one of them is reviewing the top of the organization in terms of governance. However, it is important to address what happens when the structure or practices of governance may be the problem. In order to address this, it must be taken into consideration as to what internal audit should be using to “assess” and “advise” governance. This is important to evaluate as there may be a concern that internal audit may overstep its role. Therefore, internal audit needs to manage the delicate political balance in proposing, participating in, and reporting on a governance assessment where they are effectively reviewing their boss.
Getting to know “Governance”

Governance is a term defined by a lack of clarity. The lack of clarity associated with governance has thus become a challenge to the Internal Audit Function when trying to understand what it is and how to monitor or improve it. Various Internal Audit Functions must interpret the definition of governance through means such as developing supporting tools that may help them wade such grey territory. Before we can discuss Internal Audits’ role in governance, we must first identify how governance should be defined and viewed.

One way to define governance is as a “combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.” This is a high-level overview of what governance is entailed to focus on as it contains an extensive list of activities that must be coordinated and monitored. The extensive list of activities is partly why the issue in regards to a lack of clarity exists when identifying what good governance is required to do. This creates numerous interpretations of what makes effective governance due to such a grey territory of what the main focus of governance is. There is a broad array of activities required by governance in terms of informing, directing, managing and monitoring that can be further subdivided into smaller categories of activities. Another interpretation attempts to delve deeper in defining governance by assessing the characteristics of governance as being “efficient, allows a respectful conflict of ideas, is simple, is focused, is integrated and synergistic, has good outcomes, preserves community assets, and leads to enjoyment and personal reward for the individual board members.” This is an area that is important to the Internal Audit Function as they are responsible in assessing, as well as recommending on, how to improve the current governance process of an organization. Therefore, this is an inclination that internal auditing plays a significant role as they must understand what governance is and how their organization has implemented governance in order to be able to maintain and improve it. They bear the responsibility to decode and understand such an extensive element that an organization depends upon to achieve their objectives successfully in an effort to create value.

However, the lack of clarity in defining governance hints that there is no single way to achieve effective governance. This may be due to the fact that an effective approach of tackling governance varies greatly depending on how it is assumed to be defined as by the organizations’ leadership. The variation may stem from many variables, such as the cultural settings borne by different organizations and the tone at the top. Hence, this variation must be taken into consideration when examining governance. Nonetheless, the variability of how governance is enacted creates the issue concerning how to tackle such a broad definition held by governance.

Governance is a term that is not only defined by its’ process but also by identifying the parties included. The “umbrella of authority, direction and oversight” is the recipe for a sufficiently effective governance structure over the long term. The umbrella is composed of both internal and external parties involved:

- Executive of the company (CEO)
- Board of Directors (BOD)
- Management
- Sub-board audit committee
- Stakeholders
The first layer of authority in governance is the Chief Executive Officer (CEO) as they are directly accountable and have authority over the BOD. However, as Adam Smith, The Wealth of Nations, 1776 put it:

"The directors of companies, being the managers of other people's money rather than their own, cannot well be expected to watch over it with the same anxious vigilance with which (they) watch over their own."

Effective governance may not be managed by just the directors of a company as they can be blinded by certain aspects due to the fact that they may not be able to see certain things that others may. With such a big focus on solely managing governance without any outside input, it may easily mean that there is a limited view that may in turn limit growth. By adding more layers, there is more potential for growth and development to achieve effective governance. The second layer of authority is held by the BOD as a cohesive unit, not by the individual board members. Thus, the BOD are responsible for two areas of governance; strategic direction of the organization and governance oversight. Strategic direction concerns the responsibility of the board in establishing key business objectives that must single handedly remain consistent with their business model. The strategic direction implemented by the BOD must also align with stakeholder priorities. Furthermore, governance oversight is focused on how the board manages and monitors operations to advise management. The oversight role performed by the BOD allows the organization to form a strong structure coupled with strong practices to be formed that in turn allows for governance to be effectively implemented. The strong structure created by the organization leads us to management, which is the third layer of authority. Management is responsible for implementing policies and procedures through a strategic plan enacted by the CEO/BOD that enables governance activities to take place within the organization. Beyond the management level, the audit committee is the fourth layer of authority in effective governance as they are an accessory to the board. By being an accessory, it means that the BOD may delegate certain tasks to specific groups of individuals if needed. Tasks that may be delegated to the committee must tie to their specific duties such as

![Figure 1. Governance Structure Overview](image-url)
"assessing the board’s current composition and identifying missing qualities and characteristics drafting a recruitment plan and continuously cultivating new prospects developing job descriptions for board members orienting new board members and continuing to educate all members on their responsibilities." This ensures that board effectiveness is maintained and that they are fully supported.

In trying to understand how to navigate the gray areas of governance, after analyzing the process of governance and identifying the internal parties involved, the next is to identify the external parties. Common external parties include, but are not limited to, shareholders, regulators, governments and auditors. The Internal Audit Function, while may appear to be an external party, is considered an internal party to the organization as the role of internal audit is defined as:

"An objective assurance and consulting activity that is independently managed within an organization and guided by a philosophy of adding value to improve the operations of the organization. It assists an organization in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organization’s risk management and governance processes.” (Institute of Internal Auditors [IIA], 2000)

Both academic researchers as well as practitioner are in favor of the Internal Audit Function being an important component of corporate governance. As mentioned previously, there is a heavy reliance borne on them by both the board as well as by management to meet governance accountabilities. Internal audits’ regular duties in governance will be discussed in depth later, however, it is important to understand that the Internal Audit Function plays an extended value-added role due to the increased need to offer consulting and assurance services to the board. If the role created for the Internal Audit Function by the organization allows them to be effective in participating and monitoring governance, governance in turn will be effective.
Figure 2. High Level View of Major Components of Governance

(Created by:
https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-auditing-governance.pdf)

The Building Blocks of “Governance”

As mentioned previously, the layers of authority are the sole owners of governance and internal audit is there to assist management in identifying improvements to governance as well as new governance activities to be implemented. Such improvements are in regards to the audits they provide and the testing procedures completed to evaluate an organization’s activities, as well as their solutions to remedy the issues that an organization is presented with. The improvements they provide also come through providing consulting services to ensure effectiveness is evolving. However, before internal audit may come in to perform governance audits or consulting activities, as mentioned before, the organization
must create a strong structure with strong practices and procedures. A strong structure allows for governance to be implemented. This structure is alike to building blocks, as the right pieces in the right places enables a foundation to be strong and stable. If the right pieces are obtained and if they are carefully aligned, there is a beneficial long-term gain. However, if the structure or practices of governance are the problem it will mean that the role of an internal auditor will be ineffective as no structure is stable without a good foundation.

These building blocks, in terms of governance, may be identified as four different controls that need to be systematically approached in a precise way in order to be able to build a strong foundation for effective governance. The four controls or “building blocks” are as follows:

1. **Identify key stakeholders of an organization**

   A stakeholder may be directly or indirectly involved in the organization. When there is indirect involvement, a stakeholder may be interested in the organization and in turn still be affected by any outcome. A possible outcome, for example, would be success. To illustrate this idea in terms of a real-life example, you may look at a stock market investor. A possible success outcome for a stock market investor would be an increase in stock value. However, some stakeholders may lack both direct or indirect involvement and still have an influence on some aspects of the organization. This is a concept that mirrors the agency theory\(^\text{13}\). It explores the concept of how both company insiders and the degree of concentration of the holdings of the outside shareholders matter to an ownership structure. The larger shareholders have more control of monitoring costs and also have the sufficient voting power that can influence governance, which makes them seem more powerful than the smaller shareholders. However, the agency theory provides that both insiders and outsiders must be identified and recognized. Furthermore, the stakeholder theory\(^\text{14}\) establishes a framework that helps examine if there is such a connection between a stakeholder and the organization achieving various corporate performance goals.

2. **Understand the needs and expectations of key stakeholders**

   The needs and expectations of key stakeholders may be self-evident or may require research and analysis to be understood clearly. Needs and expectations may be determined through the use of internal discussions with the board or by direct discussions with the key stakeholders themselves. Like any good relationship you have outside of the office, you need to apply the same basic concepts to your relationships within the office. Your listening skills are key to figuring out exactly what the stakeholders need from you and for you to let them know you are interested as well as devoted to making a difference. If there is no clarity in regards as to what their needs are, how are you supposed to make them happy? Without this mastered, you may not effectively move on to develop the next step in the foundation.
3. **Identify potential outcomes that would be unacceptable to key stakeholders**

An undesirable outcome does not necessarily equate to an unacceptable outcome. An outcome may be disappointing to a key stakeholder but still be considered as acceptable. Therefore, it is vital to consider if the outcome causes harm to the organization and/or it represents a failure to effectively exploit opportunities. To be able to consider such outcomes, controls must be in place to manage the identified needs of a wide stakeholder base through governance. The dependency theory\textsuperscript{15} suggests that the different sets of skills required by board members is linked to firm performance. Their role of enhancing organizational reputation as well as establishing relationships is highly important when managing the needs of a wide stakeholder base.

4. **Establish tolerance levels based on unacceptable outcomes**

Tolerance levels need to be established in regards to unacceptable outcomes. In developing and implementing appropriate governance processes, governance accountabilities must be accounted for. An example of such an accountability is providing assurance processes that enables the BOD as well as the senior management to receive feedback. This feedback is essential to monitor the effectiveness of control mechanisms and processes put in place so that if a problem does occur it can be acted on efficiently. The
stewardship theory\textsuperscript{16} suggests that governance through an influence of trust and professionalism requires control and continuous monitoring, which ties in to the need for feedback. Intrinsic reward type of controls, such as feedback, help to provide a pat on the back and stimulates a desire for growth.

These four different controls need to be systematically approached in a precise way to be able to build a strong foundation for effective governance. Ineffective governance does not necessarily mean that the building blocks of governance is not at fault entirely, but neither is internal audit. They should both be tasked with striving for improvement as well as adapting their roles to enable a fluid path to efficiency and effectiveness.

**Internal Audit & Governance**

As mentioned previously, authority coupled with direction and oversight are the required components for an effective governance structure that can be sustained in the long term. For internal audit to be effective, they must understand what “good” governance is. This will help them understand what they should be using to “assess” and “advise” governance with both credibility as well as with confidence. An approach to achieve this would be to set priorities and ensure a complete coverage of understanding. By identifying and understanding the priorities that are critical to effective governance, internal audit can efficiently tackle monitoring governance as well as encouraging growth and development. However, this in turn may create the possibility of internal audit overstepping its role.

Internal audit can provide independent assurance activities that provide an objective assessment of not only the effectiveness of governance but on risk management actives as well. The IIA Standard 2110 states the Internal Audit Function’s role in regards to assessing and making appropriate recommendations in regards to improving governance processes for\textsuperscript{17}:

1. Making strategic and operational decisions.
2. Overseeing risk management and control.
3. Promoting appropriate ethics and values within the organization.
5. Communicating risk and control information to appropriate areas of the organization.
6. Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management.

It is important to take note that internal audit should use as a ruler the fact that they are not there to make management decisions but only to advise. Apart from the practical bounds of a ruler for internal auditors, there is a moral side that must not be overstepped. As there is a certain point at which an internal auditor may lose independence. The consulting and auditing activities that Internal Audit Function performs, aims to not only achieve the goals of the organization but to also successfully implement the standard. These activities must evaluate the design, implementation as well as the effectiveness of the organization. More specifically the evaluation is concerned with the organizations ethics related objectives and activities. After having evaluated the objectives mentioned, the information technology governance of the organization must be assessed to ensure that it supports the organizations strategies and objectives. By having completed the previous consulting and auditing activities, the standard will have been successfully implemented.
When assessing how to implement governance audits into an existing plan, it may be beneficial to focus on three specific factors; the complexity of the organizational structure, the existing audit types and the size and structure of the Internal Audit Function. Even though it’s a grey territory, governance is necessary and the Internal Audit Function needs to be able to help governance maintain efficiency and pave a path of success. However, those involved in the process of governance also need to be able to create an environment where more effective rules can be managed.

Internal audit has limited contact with members of the BOD through various committees as they are more often than not only needed to present their report. As of now, the audit committee is the main governance entity that the Internal Audit Function reports their findings to. The lack of ongoing dialogue is thus a problem in regards to the BOD, audit committee chair and Chief Audit Executive (CAE). This creates a need for a two way means of communication between those involved in governance and internal audit as they must meet halfway to be able to produce results. The lack of fluidity in communication is something than can be improved on. For example, by the CAEs scheduling ample time with the Internal Audit Function on enables effective relationship building. Internal audit will develop a higher understanding of the board as well as the structure of governance that in turn can improve feedback, which is an element that currently doesn’t exist very often.

The entire body of Commonsense Principles provides some improvement over existing governance regulation. It leads down a path to more understanding in regards to what good governance is and also provides a starting point for a business that is unsure how to implement it. Therefore, it may be used as a measuring tool to help the Internal Audit Function “assess” and “advise”. The organization’s governance should have the ability to support the internal auditor’s needs as well as the values of the organizational culture. It may have a positive influence on the Internal Audit Function n as it can reinforce the tone at the top as well as ethical commitment. The principle of Board of Directors- Composition & Internal Governance, outlined in the body of the Commonsense Principles, would be most impactful to an internal auditor. It may have a positive influence if followed, as loyalty and integrity of the directors leads to a good tone at the top. This then allows for a more open and trustworthy relationship with the Internal Audit Function. Furthermore, the internal audit mission is based on concepts surrounding risk management, governance and control. The principle of “Board of Directors’ Responsibilities” ensures good communication and that critical activities are being implemented to improve risk management. On the other hand, negative influence may arise from this principle not being met. If the BOD aren’t up to speed on their responsibilities, there may be weaknesses in the control environment.

There are numerous ways to scope areas for a governance audit. There is an ability to customize the amount of coverage assessed in order for internal audit to address what ruler to be used to “assess” and “advise” governance. A few ways they can address what rulers to use is through identifying people and culture, examining the board and committees and assessing management information.

People & Culture

Tone from the top is important when trying to implement the right behavior. An example of a right behavior to implement may be to encourage the use of data to understand culture and behaviors. This will have a positive influence on the organization as the more you understand it, the more effectively you can manage it. However, it is not said often enough that tone at the top means nothing if it is not absorbed by those with tone in the middle. A trickle-down effect of good behavior is useless if there is no accessible path to let the good behavior “trickle” down.

Board & Committees
An issue that may affect governance may stem from the Board. For example, a dysfunctional Board or a domineering CEO are not key to effective governance. They may exert insufficient involvement, lack of personal accountability or/and insufficient technical competence. The skills and experience of the Board committee members play a big role.

**Management Information**

Once the Board is determined to be efficient and to have sufficient capabilities, they may still not be able to manage governance effectively if they do not have quality management information. Without complete and robust information, the right decisions may not be made.

**Figure 4. Scoping Areas for a Governance Audit**

**Internal Audit: Delicate Situations**

“Internal auditors need to sharpen their focus on risk management and governance processes, which are projected to become the cornerstone of the internal audit profession and conduct a more responsive and flexible risk based audit plan.” IIA’s Global Internal Audit Survey

Internal audit may face the danger of coming across as trying to over step their role. They may be seen as possibly over stepping their role, as mentioned previously, due to the fact that they have such limited contact with the BOD, audit committee and CAE that creates a lack of dialogue. Internal audit needs to evaluate the design, implementation as well as the effectiveness of the organization and through the eyes of the board committee it may seem like they are crossing sensitive boundaries. Therefore, by crossing these sensitive boundaries it affects the delicate political balance in proposing, participating in and reporting on a governance assessment.

The board committee may feel less threatened and would be encouraged to be more responsive by changing the way how they view the Internal Audit Function. If it becomes clear that their assessment is not personal in nature but rather for the good of the organization they may be more comfortable to become more responsive. Internal audit is not just simply an employee of the organization, but they are a partner of the organization. They are invested more deeply than just in keeping the organization afloat but to aid in developing it and nurturing it. In a discussion led by a representative of the internal audit team at M&T Bank, they suggested that there is a possibility to overcome the problems they may face with the BOD. By earning the trust of the BOD they are able to form a relationship that lets them comfortably communicate. The trust of the BOD not only enables communication in regards to present matters but also creates a bridge that enables collaboration with the BOD in terms of consulting on future issues. Furthermore, it helps both the client as well as the Internal Audit Function as they can work together on how to approach future issues, which creates less of a guessing game on how to tackle those future issues. This helps avoid the delicate political balance effectively with a big advantage that both parties are fully satisfied. The political imbalance stems from a lack of clarity of “governance” and the more we are comfortable with raising this subject without wincing, the more we are able to tackle the problems we are currently faced with.

The traditional rule of policing must be adapted to fit current needs. Traditionally, as mentioned previously, most Internal Audit Functions don’t see the entire BOD and only have minimal contact with the audit committee. An important question that internal audit ponders is if they are allowed to report inefficiencies to the audit committee. If the audit committee isn’t performing as they should be required to, there’s no reason that internal audit is not able to point it out. The feeling alike to stepping on eggshells, should not occur for both the audit committee or the Internal Audit Function. Thus, there must be a higher level of comfort to be embraced by both parties.

However, this does not mean the issue of over-stepping is a current existential problem. If you are a chair of the audit committee and aren’t satisfying the responsibilities that must be met, the Internal Audit Function should be able to talk to the chairman of the BOD. This opens up more communication paths and reduces any existing tension between the parties to the organization and the Internal Audit Function. However, clear-cut guidelines should be implemented on a global standard to achieve a more comfortable and welcoming environment where the idea of over stepping is no longer an issue. If it becomes a requirement to open up a line of communication between the Internal Audit Function and the chairman of the BOD, it would become more of a norm to be comfortable with increased communication.
By ensuring that these guidelines are created to adapt globally it gives it a stronger authority and would ease implementation as these guidelines would be standardized. The idea that these guidelines are standardized would mean that there is more fluidity and mutual understanding since it must be implemented worldwide. Furthermore, these guidelines should also be monitored to reflect the changing business environment. However, it should be seen as not just more restrictive rules that are added on but as an encouragement to enable increased communication and openness that may in turn enhance good governance. It may even be taken a step further gradually by tailoring guidelines to specific environments due to the wide variety of businesses that exist. This will help reduce the grey areas of governance as with more communication being encouraged there will be more clarity on what good governance is.

When internal audit reports back on their findings and suggestions, they should take into consideration of the building blocks and layers that make up governance. The CEO shouldn’t be singled out as the assessment being reported is a comprehensive review of all levels, and specific engagements can be performed to specific layers if needed. Consulting would hence be a wise approach on helping each of the layers improve. The benefits should not just be reaped by one single block or layer as it may mean that it hinders the growth of other layers. Therefore, more of a balance needs to be implemented in the approach that internal audit uses to be able to create an environment that allows all components of governance to reap the benefits. This balance may be achieved if there is a fortified relationship between the layers of governance and the Internal Audit Function. It can be achieved by meeting each other in the middle, where both are exerting effort to make each other comfortable. Hence, to be able to manage this delicate political balance both governance and the Internal Audit Function on must both assess how they can do better individually.

**Conclusion**

Governance is a term defined by a lack of clarity and has become a challenge to the Internal Audit Function when trying to understand what it is and how to monitor or improve it. Areas that cover strategic direction and governance oversight are the two broad areas that make up governance. The variability of how governance is enacted creates the issue concerning how to tackle such a broad definition held by governance. Overall, the board is fully involved with the structure and the practices of governance, which are developed through the building blocks of governance. These building blocks, in terms of governance, may be identified as four different controls that need to be systematically approached in a precise way in order to be able to build a strong foundation for effective governance. However, ineffective governance does not necessarily mean that the building blocks of governance is not at fault entirely, but neither is internal audit. They should both be tasked with striving for improvement as well as adapting their roles to enable a fluid path to efficiency and effectiveness.

Internal audit has several roles but one of them is reviewing the top of the organization in terms of governance. An approach to achieve this would be to set priorities and ensure a complete coverage of understanding. By identifying and understanding the priorities that are critical to effective governance, internal audit can efficiently tackle monitoring governance as well as encouraging growth and development. When assessing how to implement governance audits into an existing plan, it may be beneficial to focus on three specific factors; the complexity of the organizational structure, the existing audit types and the size and structure of the Internal Audit Function. Even though it is a grey territory, governance is necessary and the Internal Audit Function needs to be able to help governance maintain
efficiency and pave a path of success. However, it is important to address what happens when the structure or practices of governance may be the problem. When the structure or practices of governance as questioned to be problematic, the Internal Audit Function may be questioned if they are over stepping their role. This may create an issue for internal audit as they must manage a delicate political balance in proposing, participating in, and reporting on a governance assessment.

The traditional rule of policing must be adapted to fit current needs. Traditionally, as mentioned previously, most Internal Audit Functions don’t see the entire BOD and only have minimal contact with the audit committee. Therefore, clear-cut guidelines should be implemented on a global standard to achieve a more comfortable and welcoming environment where the idea of over stepping is no longer an issue. If it becomes a requirement to open up a line of communication between the Internal Audit Function and the chairman of the BOD, it would become more of a norm to be comfortable with increased communication. However, it is important to take note that internal audit should use as a ruler the fact that they are not there to make management decisions but only to advise. Apart from the practical bounds of a ruler for internal auditors, there is a moral side that must not be overstepped.

In the end, it comes down to being comfortable with change and openness from all parties responsible with governance. Good governance is achieved by having the right building blocks in the right place and being comfortable with adapting to changes when they start to shift and lose their balance. A strong foundation and open mindset to develop an information flow based on a two-way street of communication between the BOD and upper governance bodies with the Internal Audit Function. This will enable a clearer understanding of the needs of governance, which will mean a clearer understanding of the grey areas we are faced with currently.
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5 https://www.ncbi.nlm.nih.gov/pmc/articles/PMC1276331/


12 http://eds.a.ebscohost.com/gate.lib.buffalo.edu/ehost/pdfviewer/pdfviewer?vid=12&sid=7f2fa55b-8d66-4123-a3e5-49c79d4d09c2%40sessionmgr4006


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