The Role of Internal Audit in Assessing Organisational Governance

Submitted by:

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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

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Anupam will be completing the Internal Auditing Education Partnership Program in May 2018, He was fortunate enough to get the Mark Salamasick IT Auditor Fellowship in January 2018. Anupam has passed the CISA (December 2017, awaiting certification) and he is sitting for CIA Part 1 in March and CIA Part 2 in May 2018.

Anupam always seek opportunities to volunteer for community services and events. He volunteered at the North Texas Food Bank to join the fight against hunger and The 6th Annual Dallas IIA Super Conference in 2017.

If granted, The Esther Sawyer Award is a dream, this will be a badge of honor, that will stay with Anupam for lifetime.
Executive Summary

Governance is an integral part of organisations in general, and good governance leads the organisation towards success. Well-governed organisations have effective communication, best industry practices and a well organised structure. Tone at the top plays a vital role in setting up these core competencies. The practices and structure within any organisation should be updated regularly and the Internal audit function should look into it. The Risk Owners should coordinate with management and the Internal audit function to mitigate the risks and optimize the operations. Otherwise, the organisation eventually start collapsing and may affect the market.

Internal audit should keep an eye on the governance to help them, by assessing and advising. There is no certain formula the Internal audit function can follow but it depends on the organisation and its requirements. It is desired to set some formal rulers to check the performance and provide feedback and training, if required. Continuous professional education (CPE) will not only help the individuals in their career path but also help succeeding the organisation as a whole. Effective communication and accurate information is another major key that the every organisation must integrate in their ecosystem.

Maintaining the top down approach in the organisation with delicate political balance in proposing, participating in, and reporting on a governance assessment is a key function of the Internal Audit. The audit committee should make sure that the board, top management, and other departments of the organisation should follow independence and competence. Self-assessment and involving key stake holder would help in achieving the strategic objectives of the organisation. Internal audit function should make sure that the recommendations are taken into consideration seriously and follow-up on the major engagements. The effective synchronisation between Governance and Internal Audit can help any organisation grow exponentially.
Introduction

Corporate governance has gained a lot of interest in recent years. “Successful organizations are seen to be governed well, whereas organizations about to collapse or those that have failed are seen to be ineffectively governed.” Corporate governance is an interesting topic because of its importance in the economic growth of organizations in general.

Governance is about the relationship between management, the board of Directors and the owners or shareholders. It specify responsibility and accountability for the organization as a whole in the exercise of its operations. Governance therefore is about how corporate governors manage their organizations, the relationship that exists between the governed and their governors, or leadership and systems of leading towards stated objectives.  

Corporate governance in an organization is about fair, efficient and transparent administration of the organization to meet well-defined objectives so as to satisfy stakeholders and comply with legal and regulatory requirements. Achieving good governance and ensuring results of such governance practices is one of the top priorities of stakeholders even today.

The board of directors is meant to oversee the development of the overall strategy of the organization and the decisions made by senior management in pursuit of those strategic objectives. In addition, the board should establish clear guidelines regarding the independence of its directors.

Senior management is meant to set the business strategy, oversee day-to-day decisions, and ensure that these decisions support the long-term objectives and policies as determined by the board. To ensure financial stability, execution of the overall objectives of the firm must be supported by rigorous internal controls and effective risk management. An effective internal control apparatus is critical to provide reasonable assurance that the information produced by the organization is timely and reliable and that errors and irregularities are discovered and corrected promptly.  

1. Ng’eno linner, Corporate governance practices and challenges (Department of Business Administration, School of Business, University of Nairobi, 2009)
2. Sreeti Raut, Corporate Governance – Concepts and Issues, Online Article, Accessed February 02, 2018
The internal audit function plays a unique role in the governance process; indeed it is a role that is being widely debated. Management often calls upon internal auditors to help provide them with assurance that (a) risks are effectively identified and monitored, (b) organizational processes are effectively controlled, and (c) organizational processes are efficient or effective. The early internal audit literature, e.g., Sawyer, often portrayed internal auditors as the “eyes and ears of management.” As the coordination between eyes and ears is very important for making decisions and working efficiently, the coordination between Internal audit, Management, Board and External Audit is required for effective governance, For a visual representation of this coordination see Figure 1-1.

![Figure 1-1: Corporate Governance Model](image)

For setting the tone at the top, internal audit has developed an extensive significance to incorporate the crucial role played by the board and management. Thus, Internal auditors may find themselves to be at odds in helping management to assess the effectiveness of their governance processes while reporting to the audit committee on the tone at the top.\(^4\,^5\)\(^6\) Besides the odds it is very important to assess and report, because when the structure or practices of governance are the problem, the organisation may face various consequences and it is not desirable and affects the organisational objectives.

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\(^4\) Dana R. Hermanson and Larry E. Rittenberg, *Internal Audit and Organizational Governance*

\(^5\) Sreeti Raut, *Corporate Governance – Concepts and Issues*, Online Article, Accessed February 02, 2018

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Problem with the structure or practices

Most people may argue that the CEO and other members of the C-Suite are the real risk owners of an organization. However, the individuals who conduct day-to-day activities such as identifying, monitoring, measuring and reporting risks to management or their heads are the real risk owners. They ensure that the risk management activities efficiently manage the risk to fit within the risk appetite of the organization. Some of the key responsibilities of the risk owners may include,

- Evaluation of the risk management activities
- Assessing the capabilities to execute risk management activities
- Determining the accuracy and consistency of the ongoing risk management activities
- Monitoring the daily reports to identify if there are any anomalies
- Ensuring the board and senior management have quick access to the accurate information

Risk owners can best execute the governance responsibilities by presenting recommendations to the risk committee. Any individual risk owner can prepare the recommendation of a risk that was not previously subject to the formal risk management activities, including the inherent risk, source, impact and tolerance levels. Risk owners are on the front line of the risk management activities. Risk owners may be on the lower level of the organizational hierarchy, but they certainly work with the senior management to carry out the risk management activities of the organization. Figure 1-2 illustrates the role and position of risk owners in the “Governance Umbrella” and describes the relationship with senior management in the organization.

Figure 1-2: Components of Governance Oversight

Now what if risk owners are doing their best in the interest of the organization, but the structure or practices of governance in the organisation are not aligned as per expected or in sync with the industry best practices? Governance misalignment may lead to the factors that can cause corporate governance failure and their attendant inability to attain the organisational objectives but it does not happen overnight. Here are some indicators that should be noticed to check the misalignment.

- Ineffective governance mechanisms, i.e. lack of board committees or committees consisting of few or even a single member.
- Non-independent board and audit committee members, i.e. where a CEO fulfils multiple roles in various committees.
- Management, who deliberately undermines the role of the various governance structures by circumventing the internal controls and making misrepresentations to auditors and the Board.
- Inadequately qualified members, i.e. audit committee members not having appropriate accounting and financial qualifications or experience to analyse key business transactions.
- Family members holding board positions without appropriate knowledge or qualifications.
- Ignorance of the financial results and red flags by regulators, auditors, analysts etc.

As an organisation, it is a must to exhibit a clearly defined organizational structure within which functional roles can be distinctly differentiated as well as provide the direction and scope of authority. These form the effective basis of organizational or corporate governance. Secondly, the corporate entity must be one in which ownership is separated from management. Thus, management and the board of directors perform separate functions which must be properly coordinated and complementary to achieve common organisational goals and objectives. Otherwise, the top down approach of the organisation won’t be efficient anymore; and if the leaders are not able to guide in the appropriate and effective manner, middle management and thus the risk owners will be perplexed. The tone at the top should keep track of the best governance practices and efficient organisational structure.

8. VComply Editorial, Blog, May 27, 2017 : How does corporate governance failure impact your business
<https://blog.v-comply.com/corporategovernancefailure/>
Tone at the top provides a vital foundation for the transparency, openness and commitment to continuous improvement that are so necessary for effective risk management. However, the tone at the top must be complemented with an effective tone in the middle. No matter what leaders communicate to their organizations, what really drives behaviour and resonates with employees is what they see and hear every day from the managers to whom they report. If the behaviour of middle managers contradicts the message and values conveyed from the top, it won’t take long for lower-level employees to notice. Because the top-down emphasis on effective risk management is only as strong as its weakest link, it is vital that this emphasis be translated into an effective tone in the middle before it can be expected to reach across the organization. Figure 1-3 illustrates that the strategic direction and governance are under the “Governance Umbrella”. Therefore, a strong tone at the top of the organization is needed.\textsuperscript{10}, \textsuperscript{11}

Business requires undertaking economic and human resources to organize the ecosystem, based on trustworthiness embedded in ethical culture of the environment. It aims at developing the attitude of the employee to give their best in terms of productivity.\textsuperscript{9}

Understanding the consequences of problems in the structure or practices of governance, let’s discuss what rulers should internal audit be using to assess and advise governance, and if internal audit overstep its role.

\begin{figure}
\centering
\includegraphics[width=0.5\textwidth]{figure1-3.png}
\caption{Overview of Governance \textsuperscript{11}}
\end{figure}

\textsuperscript{9.} Dietz and Gillespie, 2012, The Recovery of Trust: Case studies of organisational failures and trust repair
\textsuperscript{10.} Jim DiLoach, Online Article April 2016, 5 Common Risk management Failures
\textsuperscript{11.} Internal Auditing: Assurance & Advisory Services, 4\textsuperscript{th} Edition © 2017 by the Internal Audit Foundation

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The Ruler for assessment and advising

Good corporate governance is very important for sustainable development not only for the individual company, but also for the economy as a whole. Therefore, the quality of governance should be continuously improved and good governance should be promoted. However, what is not measured, cannot be improved. Hence, there is a need for a ruler to measure the quality of corporate governance.\(^\text{12}\)

Internal auditing should remain independent, but it may also be important to participate in the establishment of governance processes. In providing assurance on the risk management, control, and governance processes within an organization, internal auditing is itself one of the key cornerstones of effective organizational governance.

The purpose, authority and responsibility of internal audit is defined in a charter that recognises the professional standards and that is approved by the organisation's governing body and management. Internal audit's organisational independence and internal auditors' objectivity are protected by direct reporting to the governing body. Internal auditors undertake work only when they have the knowledge, skills and other competencies necessary. Professional qualifications and commitment to ongoing learning are essential. The head of internal audit is responsible for creating an ongoing programme of activities to ensure the quality of internal audit, to obtain periodic independent confirmation of its quality, and to strive to improve continuously.\(^\text{12,13}\)

The head of internal audit works with the organisation's management and other assurance providers, to develop, deliver, and report risk-based plans along with performance and significant issues to the governing body. Internal audit's scope of work covers evaluating and helping to improve all aspects of the organisation's governance and system of internal control, including the management of risk. Internal auditors plan their work so that it meets its objectives, particularly agreeing the criteria they will use. Internal auditors identify, analyse, evaluate and document evidence on which to base their conclusions. Internal auditors communicate the results of their work to managers and governors who can take action, monitor whether agreed actions are completed, and discuss with senior management and the governing body when unacceptable levels of risk are being taken.\(^\text{13}\) The CRAFTED principle may be used by Internal Auditors for measuring the effectiveness of governance and help the management.

\(^{12}\) Dr. Yilmaz Argüden, Online Article April 2010, Measuring the effectiveness of corporate governance
\(^{13}\) IIA IPPF (International Standards) Technical Blog July 2017, Online Accessed on Feb 12, 2018
The CRAFTED Principle

“Most attempts to measure the quality of corporate governance focus on compliance-related issues. Good governance involves a lot more than compliance. Good corporate governance is a culture and a climate of Consistency, Responsibility, Accountability, Fairness, Transparency, and Effectiveness that is Deployed throughout the organisation.”

Internal auditing must be careful to consider not only the results of individual audit tasks in assessing organizational governance, but also consider the overall structure and the “big picture” of governance in the organization. At times, each part may individually appear appropriate, but when combined, could present serious issues. Internal auditing should be aware of the limitations of performing specific governance review procedures without also having considered the broader governance processes, i.e. the board. Many elements of governance are driven from the top and internal auditing should consider a top-down review of governance to ensure that designed processes are adequate and effectively embedded throughout the organization.

Auditing organizational governance requires skills and competencies that internal auditors may not possess. Before undertaking audits in the governance areas, it is critical to ensure that the internal auditors possess the relevant skills or obtains the appropriate training. Internal auditors should be encouraged to seek out the variety of tools, resources, and best practices. There is no “One for All” method to optimizing organizational governance. Each organization must tailor an individual solution that considers industry, maturity, business strategy, capabilities, culture, and competitive positions.

Internal audit in general cannot overstep its role whereas the capacity that is relevant for internal auditing depends on the maturity of the organization’s governance processes. If they have a less mature governance structure, then the focus may be more towards providing advice on the optimal structures and practices. In an organization with more structured and mature governance practices, internal audit’s role may be more focused on evaluating whether the components work together as expected. Doing either of the above will require the Internal Audit function to manage the delicate political balance in proposing, participating in, and reporting on a governance assessment where they are effectively reviewing their boss.

14. Dr. Yilmaz Argüden, Online Article April 2010, Measuring the effectiveness of corporate governance
15. Organizational Governance, Embracing Internal Audits Role – IIA Global
Effectively reviewing the Boss

The audit committee is an important governance tool to help the board discharge its responsibility for establishing and monitoring an adequate governance system within the organization. Audit committees can be seen as complementary vehicles that can improve communication and coordination between top management including the governing board and the Internal audit function, which is primarily responsible for assessing the organization’s internal control, risk management, and governance structures.

The organization’s executive leadership and senior management are accountable to the board. Top management is ultimately responsible for implementing the organization’s governance system, as directed by the board. The CEO sets the tone at the top for the integrity, ethics, and conduct that will contribute to an effective governance environment. In addition, executive leadership and senior management should ensure that governance policies, procedures, and programs exist and are followed, and that there is compliance with applicable laws, regulations, and codes.\(^{18}\)

The audit function can play numerous roles in assessing and contributing to the improvement of organizational governance. Here are ten opportunities for the Internal audit function to provide insight on governance\(^{17}\)

- Provide advice on alignment of current board practices against leading practices.
- Provide input and advice on the audit committee’s charter and other charters as appropriate.
- Advise on the clarity and appropriateness of the protocol for escalating issues to the board or its committees.
- Help ensure the board and its committees receive information timely to better effectively prepare for their meetings.
- Contribute to the preparation of the board and committee agendas to ensure appropriate topics are discussed timely.
- Evaluate whether the reporting to the board and its committees is sufficiently transparent to ensure they receive the information necessary to govern effectively.
- Facilitate or advise on the board and committee self-assessment process.

\(^{17}\) Internal Auditing: Assurance & Advisory Services, 4\(^{th}\) Edition © 2017 by the Internal Audit Foundation.

\(^{18}\) IPPF Practice Guide: Assessing organisational governance in public sector, October 2014, IIA Global
- Provide the necessary information to help the audit committee oversee the internal audit activity, including information related to organizational independence, adequacy and competency of resources, scope of activities, and attention by management.
- Provide publications or links to other information that can help board or committee members keep current with emerging risks and practices.
- Provide input that helps the audit committee provide oversight on and assess the effectiveness of the independent outside auditors.

The appropriate role for the audit function and the resource commitment to each of these roles depends largely on the maturity of the governance system and the organization’s size and complexity. The CAE should discuss and reach an agreement with the board on the audit function’s role in assessing organizational governance. The board should be satisfied that there is an effective governance system in place. To that end, it should ensure that it is fulfilling all of its governance responsibilities, the right governance processes are in place within the organization and operating effectively, and transparent communication exists between the organization and its stakeholders. ¹⁹

The main desirable characteristics of an effective audit committee are the independence and competency of its members. These features empower audit committee members to seek explanations and information about crucial issues related to accountability and operational and financial performance. The audit committee can help ensure that accepted internal audit recommendations are followed up and taken into serious consideration by senior management. Effective communication along with accurate information will help to delicate political balance in proposing, participating, and reporting on a governance assessment which will not only help improve the business process, it will mitigate risks and help the organisation grow exponentially.

Conclusion

The starting point for audit function’s assessment is to gain an understanding of the organizational context for governance. Efforts to understand the context include identifying the key stakeholders, their requirements and determining how the organization defines governance. Identifying the key risks and the risk owners is very important. Furthermore, the structure of the organisation and its procedures play a key role in understanding the organisation better. Good understanding of the organisation, its policies and procedures helps the Internal audit function to better assist in the assessment and advising engagements. This will visualize if there is any problem in the governance or the governance itself is the problem.

Governance processes and structures should be reviewed as part of the assessment process and on a regular basis. This will keep check, whether or not the policies and procedures are updated to follow the industry’s best practices and corporate governance is still effective. The management and board should participate in the assessment engagements as catalysts and facilitate the ongoing audit and risk management processes. Identifying the key risks and potential problems in the organisation will assist the audit function to define rulers and to assess and advise the senior management. Auditors should keep in mind that there is no one-size-fits-all governance framework or model. By design, the organization’s governance processes and structures should respond to the requirements identified in the planning phase. Internal audit should focus on understanding the communication process within the organisation and the structure of information flow. Effective communication from the tone at the top to the granular level is desirable. This will enhance the assessment of the advising process exponentially. Efficient communication inspires the low-level workforce to believe in the senior management and the top down approach is supported from the ground level. The synchronisation of effective communication and accurate information will manage the delicate political balance in proposing, participating in, and reporting on a governance assessment.

“Corporate governance is not a matter or right or wrong -‘it is more nuanced than that.”

- Johan Myburgh
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