CHAPTER 2
INTERNAL AUDIT AND
ORGANIZATIONAL GOVERNANCE

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Disclosure

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The Professional Practices Framework for Internal Auditing (PPF) was designed by The IIA Board of Directors’ Guidance Task Force to appropriately organize the full range of existing and developing practice guidance for the profession. Based on the definition of internal auditing, the PPF comprises Ethics and Standards, Practice Advisories, and Development and Practice Aids, and paves the way to world-class internal auditing.

This guidance fits into the Framework under the heading Development and Practice Aids.

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I. Introduction

We believe that any examination of research opportunities in internal auditing must first consider the broader context in which the internal audit function (IAF) operates. This chapter focuses primarily on the role of the IAF in organizational governance. Specifically, we:

1. Describe the meaning of “organizational governance” and present a conceptual model for effective organizational governance for both profit seeking and not-for-profit organizations.
2. Discuss the demands for “better” governance, including recent demands to improve organizational governance and accountability.
3. Review selected key issues related to boards and audit committees.
4. Consider the role of the IAF in the governance structure.
5. Offer perspectives on research to address organizational governance and the IAF.

II. What is Organizational Governance?

Organizational Governance Defined

Corporate or organizational governance is a broad concept that has been used by regulators, investors, accountants, and boards of directors. The importance of effective corporate governance has been underscored by Arthur Levitt, former SEC chairman, who described corporate governance as processes “indispensable to effective market discipline” (Levitt, 1999). He defined corporate governance as “the link between a company’s management, directors, and its financial reporting system.” Levitt further explained that governance that “does not promote a culture of strong independent oversight, risks [the organization’s] very stability and future health” (Levitt, 1999). Levitt’s definition of corporate governance clearly reflects his regulatory position and concern about financial reporting.

Monks and Minow (2001) define corporate governance as the “relationship among various participants in determining the direction and performance of corporations.” They identify the primary participants as the shareowners, management, and the board of directors.

The Organisation for Economic Co-operation and Development (OECD, 1999, 1) developed a broader definition:

Corporate governance…involves a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company

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are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring…

The above definition is broader and introduces the concepts of goal congruence, incentives, monitoring, and control. Governance principles and internal audit activity also apply to governmental and not-for-profit activities. Citizens, for example, desire effective governance from their elected officials. Not-for-profit entities require effective governance over the resources that are entrusted to them as they seek to address societal needs. These concepts are partially, but not fully, embodied within the framework of stakeholders and control.

We also recognize that effective governance approaches may be applied in different ways across different cultures. Therefore, our approach to organizational governance examines the nature of governance across diverse types of organizations and cultural settings. Such diversity leads to rich avenues of research. It also requires a broader definition of “organizational governance.”

Exhibit 2-1 portrays the key elements of organizational governance — monitoring, risk management, assurance, control, goals, accountability, recognition of stakeholders, and stewardship. One way to link these terms and define organizational governance is to expand The IIA’s governance definition as follows:

*Governance processes deal with the procedures utilized by the representatives of the organization’s stakeholders to provide oversight of risk and control processes administered by management. The monitoring of organizational risks and the assurance that controls adequately mitigate those risks both contribute directly to the achievement of organizational goals and the preservation of organizational value. Those performing governance activities are accountable to the organization’s stakeholders for effective stewardship.*

The specific stakeholders and their means of monitoring and controlling organizations to achieve mutually agreed upon goals may vary considerably. We suggest that many of these areas are ripe for research, ranging in topic content from the ability of various parties to exercise influence in the governing process to the potential for the IAF to positively contribute to the governing process.
Exhibit 2-1
Organizational Governance

Participants
Management
Board of Directors
Audit Committee
Internal and External Auditors
Regulators/Associations

Activities
Monitoring of Risks
Assurance Regarding Controls

Goals
Achievement of Organizational Goals and Preservation of Value

Accountability
Accountable to Stakeholders for Effective Stewardship

Beneficiaries of Organizational Governance
Stockholders
Investors
Lenders
Suppliers
Citizens
Charitable Contributors
The Broader Public

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Research Questions

Several possible research questions relate to this overall definition of organizational governance:

1. Are there parameters of governance that may differ across cultures or across nations that are not considered in the above model?

2. Can we develop measures of effective governance that can be applied across cultures, countries, and industries?

3. Can we identify the primary attributes of effective governance and its effect on various performance measures such as stock price movements or governmental efficiency?

4. What is the impact of regulation on the nature of governance processes and the role of the IAF in those processes?

5. Various reports, e.g., Cadbury, have called for governance reports on the effectiveness of risk management. Do mandated public reports improve governance? Has the nature of the IAF changed in countries that mandate specific governance reports? How does organizational governance differ in countries that have mandated governance reports from those that have not issued similar mandates?

6. Recent legislation in the U.S. has called for reports on the effectiveness of internal control as part of a normal reporting process on the effectiveness of governance. What models of internal control reporting best contribute to the effectiveness of organizational governance?

7. What are the major determinants of an effective governance system, and how do these determinants vary across types of organizations or cultures? What cultural differences most affect the nature of organizational governance?

8. Many organizations are multinational. Are governance processes, including processes for risk analysis and control, different in multinational companies than they are for companies that are domiciled within a unique culture (or country)? How do they differ and what works best?
9. Are there significant differences in the identification of, and accountability to, various stakeholders that may vary by type of organization, culture, organizational objectives, and so forth? How do such differences affect the nature of organizational governance?

10. What is the demand for governance reports? What kind of a report would meet the users’ needs for governance and accountability? Can we develop such a model conceptually or can we test one empirically through experimental markets research? How would these reports differ from evolving reports on internal control?

11. Under what circumstances can an audit committee or other governing structure use the work of an internal auditor to provide assurances on governance to outside parties, e.g., shareholders? Under what circumstances would internal auditors have sufficient credibility to add assurances to reports on effective governance?

12. How does an organization most effectively communicate information about the effectiveness of its governance processes to various stakeholders? Should such reports be prepared by independent assurance functions (independent public accounting firms or internal audit functions), and, if not, are such reports improved by the addition of an assurance function? Does the nature of such assurances differ based on whether the internal audit function is outsourced to an independent outside accounting firm, or whether the internal audit function is housed within the organization?

**Parties Involved in Organizational Governance**

As noted in Exhibit 2-1, organizational governance begins with a broad range of beneficiaries (usually referred to as stakeholders) who contribute resources to an organization (investments, taxes, charitable contributions, etc.). These parties are the direct or indirect beneficiaries of the organizational unit that needs to be governed.

Several parties participate in organizational governance — from management and the board to the internal and external auditors. In some cases, regulators or professional associations also contribute to the process. Exhibit 2-2 expands Exhibit 2-1 by depicting the various relationships among the parties that are active participants in organizational governance.
Exhibit 2-2
Parties Involved in Organizational Governance

Stakeholders — As shown in Exhibit 2-2, the stakeholders (owners or contributors) delegate authority to the board of directors, which in turn appoints a management team to control the organization to achieve agreed-upon goals within a framework of acceptable organizational behavior. Regulators, associations, and the legal environment also influence the nature of acceptable organizational behavior. Regulators serve a prominent role in overseeing many industries such as financial services, health care, and transportation where there is a strong public safety factor to be considered. Professional associations also may influence organizational governance either directly through recommendations that are generally accepted or indirectly through development of professional standards, codes of ethics, and educational programs. Legal considerations (liability avoidance, criminal penalties) also affect governance strategies.
**Internal Audit Function** — The internal audit function plays a unique role in the governance process; indeed it is a role that is being widely debated. We believe the outcome of this debate will dramatically influence the nature of the internal audit activity in the years to come. We also believe that researchers can contribute to this debate through a wide range of research methodologies.

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. In this structure, the IAF plays a unique role. The early internal audit literature, e.g., Sawyer, often portrayed internal auditors as the “eyes and ears of management.” As we note in other chapters, internal control has taken on a broader meaning to include the crucial role played by top management in setting the tone at the top. Thus, internal auditors may find themselves conflicted in helping management to assess the effectiveness of their governance processes while reporting to the audit committee on the tone at the top. The internal audit function has evolved in many organizations to a position where it is often called upon to take leadership in helping the organization implement, assess, or conceptualize risk management and control processes within an organization. In other words, internal audit has played an active role in implementing effective governance and controls while being asked to assess the effectiveness of management’s control practices. To what extent would the provision of such services conflict with the broader governance role?

**Audit Committee** — Recent legislation and stock exchange proposals on better corporate governance have elevated the role of the audit committee (at least within the U.S. structure) to a preeminent role in monitoring and reporting on the effectiveness of corporate governance. This has led to various recommendations that the internal audit function report directly to the audit committee, not to senior management. The recommendation may create tension with the more traditional role of internal audit acting as the “eyes and ears” of management. We believe the nature of that tension and the impact of such tension on both the nature of the internal audit activity and its contribution to the organization should be examined. For example, researchers should examine whether IAF activities focusing on audit committee needs (or equivalent on an international scale) create positive or negative tension with the IAF’s traditional roles in the risk and governance arena.

**Management** — Historically, management has clearly been the major driver of corporate governance. Monks and Minow (2001) detail the historical evolution of the corporation and note that “the shareholders who own the corporation are so diverse and widely dispersed that it is difficult to characterize their relationship to the venture in terms of the traditional owner” (p. 94). They also state that management “has every incentive to increase the number of shareholders. It increases available capital and helps transferability by keeping the prices
of individual shares comparatively low” (p. 95). They argue that the sheer numbers work effectively to rob shareholders of power. The recent push for improved governance structures can be seen as a backlash to this concentration of power in the hands of management.

On the other hand, all organizational governance models recognize the central role of management as one of the drivers of organizational governance. By setting the tone at the top (Treadway, 1987) and handling the day-to-day operations of the entity, management’s influence on the quality of governance is significant. Management is responsible for monitoring organizational risks and implementing controls to mitigate such risks. The specific roles of the board, audit committee, and the IAF are discussed in detail later in the chapter. All three parties focus on various dimensions of risk assessment and control. An overview of the potential tensions that might exist in having the internal audit function serve two masters is shown in Exhibit 2-3.

Exhibit 2-3
Competing Demands on Internal Audit Function

Management Requests of Internal Audit Function:
- Independent evaluation of controls.
- Assistance in preparing report on controls.
- Evaluation of efficiency of processes.
- Assistance in designing controls.
- Risk analysis.
- Risk assurance.
- Facilitation of risk and control self-assessment.

INTERNAL AUDIT FUNCTION

Audit Committee Requests of Internal Audit Function:
- Assurances regarding controls, including an independent assessment of the tone at the top.
- Independent evaluation of accounting practices and processes, including financial reporting.
- Risk analysis primarily focused on internal accounting control and financial reporting.
- Fraud analysis and special investigations.
A brief examination of Exhibit 2-3 indicates significant differences in functions and skill sets required when trying to serve audit committee needs, as opposed to meeting the needs of strategic and operational management. Management wants the internal auditor to provide both assurance and consulting based on broad operational skills that address risks, evaluate the efficiency of operations, and stimulate organizational action. On the other hand, the audit committee is more interested in assurance regarding controls.

**Research Questions**

The role of the IAF in organizational governance cannot be divorced from the reporting responsibilities. The nature of the reporting responsibility raises a number of research issues:

1. Are there inherent conflicts in reporting responsibilities when internal auditors report to both the audit committee and to various levels of management?

2. Are there differences in the nature of services performed and the perceived value of services that vary with internal audit’s primary reporting responsibility?

3. What kinds of safeguards need to be built into the IAF to ensure that internal auditing will meet its external governance responsibilities?

4. To what extent are internal auditors involved in auditing the effectiveness of the governance structure of the organization? Does the internal audit role systematically vary with organizational characteristics?

5. Does an internal audit emphasis on meeting the needs of the audit committee lead to an increase in outsourcing of the internal audit function?

6. How do organizations assess the value of various internal audit activities?

7. How have budgetary control and resources expended on internal audit changed with the increased governance requirements of stock exchanges and other regulatory organizations?

8. How does the nature of internal audit activities differ when the IAF’s primary reporting responsibility is to senior management as opposed to the audit committee?
9. Is there an ideal reporting relationship for the IAF? What are the parameters of the ideal reporting relationship, and what are the primary determinants of the ideal reporting relationship?

**Monitoring of Risks and Controls**

Exhibits 2-1 and 2-4 identify the two fundamental governance activities for internal auditing as “monitoring risks” and providing “assurance regarding controls.” According to The IIA, “Risk is the probability that an event or action, or inaction, may adversely affect the organization or activity under review.” In other words, it is the chance of something bad happening. Risk includes the opportunity cost associated with not taking action, as well as the downside risk traditionally used in the risk literature. In the governance context, the key activity with respect to risk is to monitor it, including all the subsidiary steps of identifying risk, assessing the potential effect of the risk on the organization, determining a strategy to address the risks, and then monitoring the environment for new risks as well as monitoring the existing risk strategy and attendant controls. Risk is inextricably linked to strategy. Assessing the risks inherent in new strategies and developing proper controls to mitigate risks associated with a strategy are essential management activities.

Controls exist to address risks. For example, if there were no risk that assets would be stolen, there would not have been an emphasis in accounting systems on proper segregation of duties. According to The IIA, “Control is any action taken by management to enhance the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved. Thus, control is the result of proper planning, organizing, and directing by management.” In the context of governance, the key is to ensure that controls are in place to address key organizational risks. Management implements the controls, while other participants in governance play more of an oversight or assessment role.

**Research Questions**

Research questions related to risks and controls are developed in more detail in separate chapters. Some of the research questions related to governance include:

1. What role should the IAF play in risk management? How do we determine the optimal risk management role for the IAF within the governance structure?
Exhibit 2-4
Monitoring of Risks and Controls

**Monitoring of Risks/ Risk Management**
- Systematically identifying risks.
- Facilitating risk assessment processes.
- Evaluating the risk management process.
- Measuring and monitoring performance.
- Internally communicating and taking corrective action.

**PROCESS ORIENTATION - RISKS**

**Internal Audit**

**ASSURANCE ORIENTATION - CONTROLS**

**Assurance Regarding Controls**
- Evaluating the tone at the top.
- Systematically assessing control environment.
- Testing the effectiveness of controls.
- Evaluating the effectiveness of management's monitoring processes.
- Reporting assessments to management, audit committee, and designated external parties.
2. Under what circumstances can management use the work of an internal auditor to provide assurances on risk or control to outside parties, e.g., corporate trading partners using e-commerce or joint ventures?

3. Internal auditors have often been viewed as control experts. Under what circumstances would internal auditors have sufficient independence and credibility to provide reports to external parties on the effectiveness of internal control? Is there a difference in whether the IAF is outsourced or in-house?

4. What role should the IAF play in control self-assessment and control assessment? How do we determine the optimal role for the IAF within the governance structure regarding effective control?

5. An important role of the IAF as part of a control system is effective monitoring. What is “effective monitoring”? What are the conflicts between effective monitoring and the provision of other internal audit services such as control self-assessment, risk self-assessment, or providing recommendations to improve operating effectiveness?

Goals and Accountability

As noted above, effective governance requires sufficient resources to monitor both risks and controls. These activities are directed toward helping the organization to achieve its goals or objectives, per The IIA, “the broadest statements of what the organization chooses to accomplish.” If an organization suffers a major internal control failure (e.g., massive fraud, etc.), then the likelihood of achieving its goals is greatly diminished. Effective governance activities are designed to preserve the organization’s value. According to The IIA, “Organizations exist to create value or benefit to their owners, other stakeholders, customers, and clients. This concept provides purpose for their existence.”

The final element of organizational governance is accountability. The participants in organizational governance are accountable to the organization’s stakeholders for effective stewardship. Because the stakeholders cannot directly perform monitoring and assurance activities themselves, they rely on the parties in Exhibits 2-1 and 2-2.
Research Questions

Research issues related to goals and accountability include:

1. Is the existence of an effective IAF associated with superior organizational performance? If so, are there objective measures of internal audit effectiveness?

2. Is the existence of an effective IAF associated with reduced incidence of control failures? If so, which types of control failures?

3. What type of internal audit structure enhances the accountability of governmental entities?

4. How can the internal audit function best increase accountability to various stakeholders?

5. Do organizations with more specific quantitative goals/objectives perform better than those with less measurable goals? What role does internal audit play in helping define and assess attainment of measurable objectives?

III. Demands for Better Governance

Key Factors Driving Demand

Over the past 10 years, there has been a loud call for “better” governance of organizations. This call began with a focus on major public companies and has expanded to cover a broad range of organizations.

As indicated in Exhibit 2-5, at least three key factors underlie the call for improved governance — organizational disasters, changes in share ownership patterns, and the legal environment. First, high-profile organizational disasters continue to occur with alarming regularity (e.g., financial frauds, bankruptcies, etc.), and these disasters often are accompanied by questions like, “Where was the board?,” “Where were the auditors?,” and “Where were the regulators?” From the savings and loan crisis to massive accounting frauds, such as Phar-Mor, Cendant, MicroStrategy, and Waste Management, to current disasters such as Enron and WorldCom, the quality of organizational governance continues to be questioned. In addition, research on such disasters, particularly financial fraud, consistently documents an association between weak governance (e.g., less independent boards, lower quality audit committees, or the absence of an IAF) and the incidence of problems (e.g., Abbott et al., 2000; Beasley, 1996;
Second, investors and shareholder activists have been much more vocal in recent years regarding governance issues. As share ownership of U.S. public companies has become more concentrated in the hands of institutional investors, such as TIAA-CREF and CalPERS, these institutions have become more inclined to assert their power over boards and management — often calling for changes in board characteristics or other governance mechanisms. When share ownership was more diffused across individual investors, there was much less ability for investors to pressure companies to meet their governance demands. The spirit of many recent calls for improved governance is that better governance should (a) reduce the organization’s risks, (b) reduce the organization’s cost of capital, and (c) ultimately increase shareholder value.¹

Finally, the legal environment has raised the stakes for directors and officers of public companies. According to the Stanford Law School Securities Class Action Clearinghouse, several measures of securities class action activity have risen dramatically, particularly in 2001 (see http://securities.stanford.edu/). Such increases reflect the greater legal risk of corporate director service, as well as the need for ever-improved governance practices. In such an environment, directors’ and officers’ (D&O) liability insurers also are pushing for governance improvements so as to reduce their own risk.
Groups Calling for Improved Governance

Largely in response to the three factors above, many groups have issued calls for improved governance. Selected reports and efforts are discussed below, but this sample is by no means exhaustive. Readers should refer to the World Bank Web site (http://www.worldbank.org/html/fpd/privatesector/cg/codes.htm) for an excellent listing of major governance reports sorted by country.

Treadway/COSO — The 1987 Report of the National Commission on Fraudulent Financial Reporting (Treadway, 1987) made numerous recommendations designed to reduce financial statement fraud. The recommendations are applicable to public companies, external auditors, the SEC and other regulators, and accounting educators. To improve both control and governance, the report called for a sound tone at the top of the organization, independent and effective audit committees, and careful audit committee oversight of both internal and external auditor independence (including the provision of consulting services to the organization).

The sponsors of the Treadway Commission (called “COSO” for “Committee of Sponsoring Organizations”) followed the Treadway report with two additional governance-related publications. Internal Control – Integrated Framework (COSO, 1992) provided “a standard against which businesses and other entities … can assess their control systems and determine how to improve them.” The COSO internal control model focuses on controls to “promote efficiency, reduce risk of asset loss, and help ensure the reliability of financial statements and compliance with laws and regulations.” The COSO internal control model has been widely adopted in North America and has shaped directors’ and managers’ efforts to assess and mitigate risk. Other oversight groups in different countries, e.g., CoCo in Canada, Cadbury in the United Kingdom, or the initial King Report in South Africa, have adopted control frameworks based on fundamental control objectives. While these approaches differ in some respects, they each provide for a framework of increased control; most also provide a focus on risk and risk management.

In 1999, COSO published Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies (Beasley et al., 1999). This study examined financial statement fraud cases over the 10 years since the Treadway report had been issued. Among the key findings of the study were: (1) fraud appears to be concentrated among smaller public companies, (2) fraud cases typically involve the CEO and/or CFO of the company, (3) the boards and audit committees of companies cited for fraud appear to be extremely weak (lack of independence, expertise, and diligence), and (4) fraud often devastates the company (half of the companies studied failed within a few years after the fraud). The primary governance-related
recommendation of the study was that efforts to enhance audit committee composition and performance should not exempt smaller public companies (e.g., on the basis of cost considerations), but in fact should target such companies because of their prominent role in financial fraud cases over the preceding decade.

COSO currently has another project underway, designed to develop a risk management framework for use by managers and directors. The study is designed to take the COSO model to the next level by more explicitly recognizing that risk management is an important precursor to the implementation of any control framework.

**Cadbury Report and Hampel Report** — In the United Kingdom, many efforts have addressed governance issues. The Financial Aspects of Corporate Governance (Cadbury, 1992) developed recommendations “focused on the control and reporting functions of boards, and on the role of auditors” (para 1.2). A primary output of the Cadbury effort was the Code of Best Practice — which ultimately was enforced by the London Stock Exchange. The three underlying elements of the Code were “openness, integrity, and accountability” (para 3.2).

The Committee on Corporate Governance (Hampel, 1998) focused its governance recommendations on the “board’s first responsibility — to enhance the prosperity of the business over time” (para 1.1). The Hampel committee reviewed prior governance reports in the U.K. and offered its own views on certain issues. The specific recommendations of Hampel addressed directors, shareholders, and auditors. Particular emphasis was placed on establishing principles that were consistent with maximizing the success of the organization.

**NACD Blue Ribbon Commissions** — The National Association of Corporate Directors (NACD) Blue Ribbon Commissions, which are formed generally on an annual basis, have addressed such issues as director professionalism, director compensation, audit committees, CEO succession, and strategy. The two reports most relevant to the current discussion are the Report of the NACD Blue Ribbon Commission on Director Professionalism (NACD, 2001) and the Report of the NACD Blue Ribbon Commission on Audit Committees (NACD, 2000a). The director professionalism report addressed such issues as director independence, over-commitment (e.g., how many boards is too many?), and responsibilities. The audit committee report provided practical guidance for audit committees (e.g., audit committee composition, processes, legal liability, etc.) and is discussed in more detail later in the chapter.

**CalPERS and TIAA-CREF** — Two of the most vocal and progressive institutional investors are CalPERS and TIAA-CREF, both pension funds. In 1998, CalPERS issued Corporate Governance Principles & Guidelines (CalPERS, 1998). CalPERS stated that “the criteria contained in both the principles and guidelines are important considerations for all companies.
within the U.S. market” (p. 3). The primary focus of the CalPERS effort was on accountability in governance — as a result, board independence was the major theme of the report. CalPERS also addressed such issues as board processes and evaluation, individual director characteristics, and shareowner rights.


Corporate Governance Center and The IIA — In response to the Enron disaster, many groups have issued or reaffirmed calls for improved governance. For example, the Corporate Governance Center (CGC) at Kennesaw State University and The IIA issued governance-related recommendations. In March 2002, the CGC issued 21st Century Governance Principles for U.S. Public Companies (CGC, 2002). The principles were issued to “advance the current dialogue and to promote investor, stakeholder, and financial statement user interests.” The 10 principles issued point to the importance of effective interaction among management, directors, and auditors, and they also directly call for all public companies to maintain an effective, full-time IAF. The principles, which appear in Exhibit 2-6, also address such governance elements as independence, expertise, leadership, and disclosure.

### Exhibit 2-6

21st Century Governance Principles for U.S. Public Companies

1. Interaction — Sound governance requires effective interaction among the board, management, the external auditor, and the internal auditor.

2. Board Purpose — The board of directors should understand that its purpose is to protect the interests of the corporation’s stockholders, while considering the interests of other stakeholders (e.g., creditors, employees, etc.).

3. Board Responsibilities — The board’s major areas of responsibility should be monitoring the CEO, overseeing the corporation’s strategy, and monitoring risks and the corporation’s control system. Directors should employ healthy skepticism in meeting these responsibilities.
Exhibit 2-6 (Cont.)

4. Independence — The major stock exchanges should define an “independent” director as one who has no professional or personal ties (either current or former) to the corporation or its management other than service as a director. The vast majority of the directors should be independent in both fact and appearance so as to promote arms-length oversight.

5. Expertise — The directors should possess relevant industry, company, functional area, and governance expertise. The directors should reflect a mix of backgrounds and perspectives. All directors should receive detailed orientation and continuing education to assure they achieve and maintain the necessary level of expertise.

6. Meetings and Information — The board should meet frequently for extended periods of time and should have access to the information and personnel it needs to perform its duties.

7. Leadership — The roles of board chair and CEO should be separate.

8. Disclosure — Proxy statements and other board communications should reflect board activities and transactions (e.g., insider trades) in a transparent and timely manner.

9. Committees — The nominating, compensation, and audit committees of the board should be composed only of independent directors.

10. Internal Audit — All public companies should maintain an effective, full-time internal audit function that reports directly to the audit committee.

Source: The Corporate Governance Center (CGC, 2002), reprinted with permission.

In April 2002, The IIA (2002) made related recommendations to the New York Stock Exchange:

1. The major stock exchanges should “jointly issue a uniform set of corporate governance principles for publicly held companies. Moreover, the board of directors

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of public companies should be required to disclose in their annual reports the extent to which they are in compliance with those principles.” “While many models could serve as the starting point for the development of sound corporate governance principles, the 21st Century Governance Principles for U.S. Public Companies, recently issued by the Corporate Governance Center at Kennesaw State University in Kennesaw, Georgia, appear to The Institute to be particularly appropriate.”

2. “The boards of directors of all publicly held companies should be required to publicly disclose an assessment of the effectiveness of internal controls within their organizations.”

3. “All publicly held companies should establish and maintain an independent, adequately resourced, and competently staffed IAF to provide management and the audit committee with ongoing assessments of the organization’s risk management processes and the accompanying system of internal control.”

New Federal Law and Exchange Listing Proposals — In mid 2002, in response to financial disasters at Enron, WorldCom, Global Crossing, and many other companies, the Sarbanes-Oxley Act and new exchange listing proposals were passed to help restore investor confidence. Selected governance-related provisions of these developments are summarized in Exhibit 2-7 (see http://www.gcfw.com/newsletter/corp/020729/sarbanes_oxley_act.htm for an excellent summary of Sarbanes-Oxley, http://www.nyse.com for the NYSE changes, and http://www.nasdaq.com for the NASDAQ changes).

Exhibit 2-7
New Federal Law and Exchange Listing Proposals

Selected Provisions of Sarbanes-Oxley Act (www.gcfw.com):

- New oversight board for accounting profession.
- Certifications by CEO and CFO regarding financial statements and internal controls.
- Tightened definition of “independent” audit committee member.
- External auditors to report directly to audit committee.
- Prohibitions on certain non-audit services by external auditors.
- Tougher penalties for financial statement fraud.

- Require corporate boards to have a majority of independent directors.
- Require listed companies to have audit, compensation, and nominating committees composed entirely of independent directors.
- Require nonmanagement directors to meet at regularly scheduled executive sessions without management.
- For a director to be deemed independent, the board must affirmatively determine that the director has no material relationship with the listed company.
- **Require listed companies to have an internal audit function.**
- Require companies to adopt and disclose governance guidelines, codes of business conduct, and charters for their audit, compensation, and nominating committees.


- Majority of board members will be independent.
- Regular meetings of independent directors in executive session.
- Further tightening of definition of “independence.”
- Audit committees have sole authority to hire and fire independent auditors and to approve all non-audit-related services.
- Allow one non-independent director to serve on compensation or nomination committees under certain disclosed circumstances.

Research Questions

The full impact of these changes on the U.S. governance environment remains to be seen — and should provide fertile ground for research. Specifically, the following questions can be examined:

1. How did the role of the IAF change as a result of new regulations passed in 2002? Has the status of the IAF been elevated? If so, how?
2. How do potential audit committee or board members evaluate the strength of the IAF? To what extent does the existence of an effective IAF influence the composition of a board of directors?

3. Have the new regulations passed in 2002 led to a change in organizations’ control systems or governance practices?

4. Has internal audit outsourcing increased in companies where the IAF reports directly to the audit committee (assumes an audit committee focus on controls and financial reporting)?

5. What role does (should) the IAF play in assessing and reporting on risk management and control? Is the internal audit function effective in reporting on the “tone at the top” as part of its function to help assess the quality of internal control?

6. What role does (should) the IAF play in whistleblower protection, a hot line call system, or an ethics program?

7. Has the nature of the interaction of the IAF with audit committees changed? If yes, how has it changed? How has the interaction with top management changed?

8. What is the internal auditor’s role in evaluating the effectiveness of risk processes and controls associated with information technology?

9. Are there significant differences in the IAF between companies listed on the NYSE and those listed on other exchanges that have different governance requirements?

10. Are the recommendations for improved internal auditing in the private sector being carried over into the public sector? If yes, what are the mechanisms that contribute to the change?

The demands for better governance (e.g., risk assessment and control) are clear, and they have come from a variety of sources. Factors such as continuing deficiencies in organizational accountability, changes in share ownership patterns, and the legal environment all contribute to the current call for improvement. The next section looks more specifically at the roles of two key governance participants — the board of directors and the audit committee — and considers an alternative governance structure, the two-tiered model.
IV. The Role of the Board and Audit Committee

Board of Directors

According to the National Association of Corporate Directors (NACD, 1996), the purpose of the board is to “oversee the conduct of the company’s business and to direct the affairs of the company, but not to manage the business.” NACD’s acronym for the board’s role is NIFO — “nose in, fingers out” — meaning that the directors oversee the organization, but do not meddle in day-to-day affairs.

TIAA-CREF (2002) states, “The primary purpose of the board of directors is to foster the long-term success of the corporation consistent with its fiduciary responsibility to the shareholders. TIAA-CREF supports the primary authority of the board in such areas as the selection of the chief executive officer, review and ratification of the corporation’s long-term strategy, [and] assurance of sufficient financial resources and maintenance of financial integrity…”

Monks and Minow (2001) describe the board of directors as:

*The link between the people who provide the capital (the shareholders) and the people who use the capital to create value (the managers). This means that boards are the overlap between the small, powerful group that runs the company and a huge, diffuse, and relatively powerless group that simply wants the company run well* (p. 184).

Monks and Minow go on to state the major problem:

*The single major challenge addressed by corporate governance is how to grant managers enormous discretionary power over the conduct of the business while holding them accountable for the use of that power* (p. 185).

Although Monks and Minow wrote their book before the recent corporate debacles of Enron and WorldCom, and before the Sarbannes-Oxley bill, they have successfully identified the need for greater accountability called for in the legislation. Similar calls for accountability have also occurred in the King report in South Africa and the Cadbury report in the U.K. We need to understand those calls for accountability to better visualize the roles of auditors.

The fundamental elements of the board’s role can be characterized as in Exhibit 2-8. Board activity often centers on monitoring the CEO, overseeing corporate strategy, and monitoring risks and controls.
The board’s responsibilities encompass the following general areas:

- Reviewing and approving major strategies of the organization.
- Monitoring the CEO and company operations.
- Overseeing the organization’s development and implementation of strategy.
- Monitoring risks and the organization’s control system.
- Monitoring activities and taking actions to ensure the fairness of treatment among various shareholder groups and other stakeholders.

Selecting, motivating, evaluating, retaining, and possibly firing the CEO may be the board’s most significant responsibility. In recent years, U.S. boards have been more likely to exercise their power over the CEO. Many boards are placing more emphasis on CEO succession planning and more formal evaluation of CEO performance.

The role of the board in overseeing the strategic planning process was the focus of a recent NACD Blue Ribbon Commission (NACD, 2000b). The Commission had two goals — “help CEOs and boards of all types of companies become more constructively engaged in corporate strategy, and help them work together more effectively to make sure their companies are establishing and pursuing winning strategies.” Many view the strategy arena as an iterative process between the board and CEO — with the degree of board involvement in strategy development varying across companies.

The board monitors risks and oversees the organization’s control system. The COSO (1992) internal control framework is frequently used to guide the board’s efforts in this area. Much of the board work in the area involves discussions with those parties on the “front lines” of risk assessment and control, including the internal auditors. In addition, financial-related risks often are viewed as the domain of the audit committee of the board.

Finally, the board has a responsibility to represent the shareholders who have contributed capital to ensure that the organization is operating in their best interests. For example, boards are expected to evaluate proposals that would dilute shareholder control or would transfer more responsibility for assets to management without corresponding levels of accountability.
In performing their duties, board members are held to two legal standards, the *duty of care* and the *duty of loyalty*. The duty of care requires directors to (NACD, 1996):

- “Act in good faith.
- Keep informed.
- Attend meetings.
- Commit time and attention.
- Reasonably believe in basis of their actions.”

The duty of loyalty means (NACD, 1996):

- “Do not use the position [of director] to make personal profit or gain.
- The corporation comes first (act in corporation’s best interests).
- Confidentiality is essential.”

Given the increased expectations placed on boards in recent years, NACD has performed a series of governance surveys to monitor trends in board characteristics and activities. Specific information is available by contacting the NACD (http://www.nacdonline.org).

In addition, readers should recognize that governance practices vary widely across countries. The range of board practices throughout the world is of interest to the internal audit profession, and The IIA encourages research by authors interested in the nature of organizational governance as it has evolved across the world, particularly in underdeveloped countries. Readers are encouraged to consult the World Bank Web site (http://www.worldbank.org/html/fpd/privatesector/cg/codes.htm) and other online resources for information on specific countries’ practices.

**Audit Committee**

A great deal has been written about audit committees over the past few years (e.g., PricewaterhouseCoopers, 2000). For example, each of the international accounting firms has issued audit committee guidance, the Blue Ribbon Committee (BRC, 1999) and the NACD Blue Ribbon Commission (2000a) were formed to address audit committee issues, the SEC (1999) has issued new audit committee disclosure rules, the national stock exchanges have implemented new listing requirements related to audit committees, and the Auditing Standards Board of the AICPA (AICPA, 1999, 2000) has expanded the required discussions between external auditors and audit committees. In the wake of the Enron disaster, attention on audit committees is expected to continue, and the expectations placed on audit committees are almost sure to continue to rise.

The Institute of Internal Auditors Research Foundation
The role of the audit committee has been described as:

“First among equals” in supporting “responsible financial disclosure and active and participatory oversight” (BRC, 1999, p. 7). The Blue Ribbon Committee goes on to describe the oversight role as “ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks, and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders” (p. 20).

Fulfilling “a vital role in corporate governance. The audit committee can be a critical component in ensuring quality reporting and controls, as well as the proper identification and management of risk” (NACD, 2000a, p. 1).

The three key roles of the audit committee as described by NACD (2000a) and others are portrayed in Exhibit 2-9. Typically, audit committees are charged with monitoring the financial reporting process, overseeing the internal control system, and overseeing the work of the internal and external auditors.

Exhibit 2-9
Audit Committee Responsibilities

Per the NACD Blue Ribbon Commission on Audit Committees (NACD, 2000a) and others, the audit committee’s responsibilities are to:

- Monitor the Financial Reporting Process
- Oversee the Internal Control System
- Oversee the Internal Audit and Independent Public Accounting Functions
In the eyes of many, the primary role of the audit committee is to monitor the financial reporting process — with the goal of helping to ensure reliable financial reporting. Per the NACD (2000a), activities in this area include reviewing financial statements and disclosures, assessing the organization’s quality of earnings, asking tough questions of management, and assessing the risk of fraudulent financial reporting.

In terms of overseeing the control system, the NACD (2000a) points to assessing the “tone at the top” (Treadway 1987), ensuring that organizational risks are assessed and mitigated, and ensuring that control weaknesses are addressed by management. NACD recommends that the internal control framework developed by COSO (1992) be the basis for audit committee oversight in this area.

The final area of audit committee responsibility is oversight of the internal and external audit functions. In terms of internal audit oversight, audit committee duties should include reviewing the internal audit charter, receiving internal audit reports, assessing the objectivity of the IAF, and monitoring internal audit staffing issues (NACD, 2000a).

Oversight of the external auditors involves similar activities. Some oversight activities now are expressly required for U.S. public companies, such as discussing certain audit issues with the external auditor, assessing the independence of the external auditor, and the audit committee having the authority to hire/fire the external auditors (e.g., see Carcello et al., 2002).

The academic literature on audit committees is growing rapidly, consistent with the increasing professional focus on audit committees. A current literature review paper by DeZoort et al. (2002), classifies the empirical audit committee literature into four areas — audit committee composition, authority, resources, and diligence. Among the numerous audit committee issues examined to date are: (1) audit committee formation or existence and its relation to reporting quality (McMullen, 1996; Wild, 1996), (2) audit committee composition differences between companies with versus without financial statement fraud (e.g., Abbott et al., 2000; Beasley et al., 2000), (3) the association between audit committee characteristics and interaction with the IAF (Raghunandan et al., 2001), (4) the association between audit committee composition and auditor reporting for distressed companies (Carcello and Neal, 2000), and (5) factors associated with voluntary audit committee disclosures (Carcello et al., 2002). Collectively, the academic literature suggests clear benefits of having an independent, diligent, and expert audit committee.
Research Questions

Additional research questions related to audit committees include the following:

1. What kind of an information system does an audit committee need to be effective? What role can the IAF play in providing that information?

2. Is there an association between the quality of the IAF and the effectiveness of the audit committee?

3. Is there a conflict in the duties of audit committees, as presently constituted, regarding reporting relationships? The audit committee is a subcommittee of the board and may report to a board that could be dominated by management. Does the composition of the board influence the effectiveness of the audit committee?

4. How does an audit committee meet its external governance needs while operating in a framework that makes it part of a larger body dominated by internal personnel?

5. Most discussions of board activities warn against “micromanagement.” However, many of the internal auditors’ recommendations address needs for improving controls, risk management, information technology security, efficiency of operations, and so forth are clearly intended for management action. How do effective audit committees manage the detail often found in internal audit recommendations?

6. Does the increased reporting responsibility of the IAF to the audit committee decrease the value of the IAF as a management tool?

7. Are audit committees becoming more financially literate, as required by the SEC and legislation? How is financial literacy measured? Does the focus on financial literacy improve or hinder the effective performance of an audit committee and the board of directors?

8. What level or style of communication is most effective in portraying internal audit information to audit committees?

**Alternative Governance Structures: The Two-Tiered Governance Structure**

The corporate structures found in the Netherlands, France, and Germany differ from the structure described earlier. They are generally two-tiered structures. This form of governance
separates the board into the supervisory board and the management board. The management board, composed solely of insiders, is responsible for the company’s daily business activity. The supervisory board has general oversight functions and is responsible for safeguarding a company’s overall welfare by reviewing management board activities (Fraser et al., 2000). This system has been commended by some for the separation of the responsibilities of the board and criticized by others for its opaqueness in the specific responsibilities. On one hand, the two-tiered structure represents some attributes that have been found worthwhile in previous governance research:

- The supervisory board is independent of management.
- The supervisory board is knowledgeable, meets often, and devotes sufficient effort to be effective.
- The supervisory board is powerful (i.e., it has the ability to shut down operations and to dismiss current management).

On the other hand, the supervisory board differs from a traditional board in that:

- It operates on a near full-time basis.
- It violates the general principle of “nose in, fingers out” advocated for good corporate governance in the U.S. (NACD, 1996).
- It is active in directing internal audit activities, thereby creating a potential greater division of internal audit work for management versus the supervisory board.

**Research Questions**

Research questions related to the two-tiered system include:

1. How might we measure the effectiveness of single-tier approaches to governance versus the two-tier structure found in some European and Asian countries?

2. Are organizations with full-time, outside governing structures more effective in protecting stakeholders? Are there things that we can learn from the two-tier governance structure that can be applied to improve the single-tier governance structure?

3. How does the role of the IAF differ in single-tier versus two-tier governance structures?
V. The Role of the IAF in the Governance Structure

With the organizational governance framework established, we turn more specifically to the role of the IAF within this context. The IIA defines internal auditing as “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.”

Several common elements appear in this definition and the definition of organizational governance, particularly the elements of assurance, risk, and control. In many ways, an effective IAF is an important “frontline player” in the two fundamental governance activities — monitoring of risks and providing assurance regarding controls (see Exhibit 2-1). The internal auditor’s risk-driven efforts provide critical inputs to other governance participants, including the audit committee and management. In fact, some now describe the IAF as the “eyes and ears” of the audit committee.

Perhaps the best summary of the IAF’s role in governance is that developed by The IIA (http://www.theiia.org):

[Internal auditors’] roles include monitoring, assessing, and analyzing organizational risks and controls; and reviewing and confirming information and compliance with policies, procedures, and laws. Working in partnership with management, internal auditors provide the board, the audit committee, and executive management assurance that risks are held at bay and that the organization’s corporate governance is strong and effective. And, when there is room for improvement anywhere within the organization, the internal auditors make recommendations for enhancing processes, policies, and procedures.

Exhibit 2-10 summarizes the key roles of the IAF. Risk assessment, control assurance, and compliance work comprise the bulk of internal audit activity, and all three of these elements map directly into organizational governance. In addition, internal auditors also may spend considerable time on consulting or operational-oriented work, with the objective of enhancing the organization’s effectiveness or efficiency.
Exhibit 2-10
Nature of Internal Audit Activity

*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.* (The IIA)

The IAF has historically contributed to an organization’s understanding of risk and control in a number of diverse ways. For example, internal auditors have performed each of the following functions (although not always in the same organization):

**Risk:**

- Assess existing risk of audited area and report that assessment to management, the audit committee, or both.
- Develop a plan to systematically assess risk across the organization.
- Lead the risk management activities when a void has occurred within the organization.
- Facilitate risk assessment through risk self-assessment techniques.
- Evaluate risks associated with new computing developments and stop the project if risks are not controlled at predetermined acceptable levels.
- Assist management in implementing a risk model across the organization.
Control:

- Test compliance with controls in functional areas. Report findings to management, and if important, to the audit committee.
- Assist management in designing a comprehensive assessment, including testing of controls across the organization.
- Assist management in preparing a report on the effectiveness of internal controls.
- Identify significant control deficiencies, including elements of the tone at the top, and communicate to the audit committee (for areas examined).
- Implement computerized testing techniques, e.g., continuous control monitoring techniques, to monitor effectiveness of controls.
- Facilitate the understanding and development of controls within functional areas through control self-assessment (CSA) techniques.

The overall conclusion of this discussion of organizational governance and internal auditing is that the IAF is a critical part of the governance structure. When the IAF is effective, it can significantly enhance the organization’s potential for success.

Research Questions

Research questions include the following:

1. Can we develop a model of an effective and efficient IAF? What are the primary factors that lead to positive assessments of the IAF? Does the nature of the IAF vary by key characteristics of an audit committee or other governing structure?

2. Is there any evidence that sourcing the IAF in-house or outsourcing it makes a difference in governance?

3. How can smaller organizations, which may lack the resources for a separate internal audit department, best implement an internal audit process that will support their governance needs?

4. In many ways the IAF plays an integration role within an organization. For example, internal auditors have leveraged their expertise in both controls and risk to develop control self-assessment (CSA) activities and risk self-assessment (RSA) activities. In other words, internal auditors have filled roles where there are voids in the organization. Under what circumstances is the IAF most effective in performing an
integrating role? Does the integration role potentially impair the effectiveness of other internal audit functions?

5. Does the integrating role of internal audit enhance or detract from effective governance? For example, effective CSA and RSA require that the auditor act primarily as a facilitator and consultant rather than as an assurance function. Is there a potential conflict here, and if so, can it be managed effectively?

6. What are the relative roles of internal and external audit in contributing to effective governance processes?

7. Is the effectiveness of the IAF associated with the amount of consulting services it provides? Is the association positive or negative? Who judges the effectiveness of internal auditing in most organizations?

8. Is the credibility of the IAF as assessed by the audit committee (or other governing structure) influenced by the amount of consulting services provided? Is the association positive or negative?

**Cultural and Industry Factors Affecting Governance Structure and the IAF**

A cursory review of internal audit literature reveals that internal auditing is practiced differently in various parts of the world and across industries. This raises additional questions:

1. While internal auditing in governmental units embraces the broad definition of internal auditing found in Exhibit 2-11, some governmental IAFs focus only on compliance work, while others focus on evaluating economy and efficiency of operations. Why does this difference exist? What factors are associated with this difference?

2. Does the nature of the IAF reporting relationship vary with the nature of the organization, the power of the audit committee, or across different cultures? How does the nature of the reporting relationship affect the size, structure, and nature of services performed by the IAF? For example, how does internal audit in developing countries differ from internal audit in economically advanced countries? Does the IAF go through specific development stages that mirror the economic development?

3. How does the IAF differ in companies with distinctively different governance constraints and objectives? Can the nature of the IAF be modeled across different governance and organizational forms, as well as across different industries?
4. What are the primary drivers of the nature of the IAF? For example, is governance more of a driver than industry? Is the nature of governance and the IAF different in organizations or industries that are heavily regulated? How do they differ? What are the drivers of the differences?

5. We also know that the IAF operates in governance structures that are evolving in developing countries to meet different needs than those met by the governance structure in more developed countries. What are the major drivers of these differences? Are there cultural or societal values that drive the nature of internal audit practice, or is it primarily the attributes of the governance structure?

VI. Research on the IAF and Governance

The IAF represents a unique research setting for at least four important reasons. First, as noted above, the IAF often serves parties integrally involved in governance processes, such as the board of directors, audit committee, external auditor, and senior management. However, the IAF also serves and adds value to those who are governed, such as management and individual organizational units such as treasury, information technology management, and operations. As a result, IAFs are often called upon to serve two masters: those primarily responsible for governance and those being governed. This unique relationship raises interesting research opportunities for those interested in internal audit research and the important role the IAF plays in adding value to governance processes.

Second, many activities performed by IAFs can be incorporated into an organization’s control structure. For example, the IAF often performs significant monitoring activities that could be incorporated into an organization’s control processes. This often raises questions about the proper role of the IAF—serving as a direct part of the control system versus an assuror regarding the effectiveness of controls.

Third, the IAF may be sourced internally within the organization or may be outsourced to a third-party. Outsourcing is not unique. However, internal audit outsourcing is unique in that the major purveyors of such services are the external audit firms. In addition, outsourcing is unique in the sense that a major part of the governance structure is not part of the organization. It remains to be seen whether outsourcing creates additional independence and improves the effectiveness of the overall governance process, or whether the broad organizational view developed by sourcing internal audit internally enhances governance.
Fourth, the expansion of the IAF to provide consulting services in addition to assurance services may be seen by some as potentially jeopardizing its value as an assuror and independent analyst of the effectiveness of the governance process. The concern often raised is not dissimilar from that of the external auditor (i.e., does the provision of any consultative activity impair the value of the assurance process?). These various governance and structural factors can be seen in Exhibit 2-11.

Exhibit 2-11
Potential Structural Conflicts of Internal Audit and Governance

<table>
<thead>
<tr>
<th>Consulting</th>
<th>Management</th>
<th>Internal Audit</th>
<th>Board and Audit Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assurance</td>
<td>Internal Audit</td>
<td>Assurance</td>
<td></td>
</tr>
</tbody>
</table>

VII. Summary

Recent research has shown the IAF to be an integral part of effective governance processes. However, the research on organizational governance and the broader aspects of effective organizational governance is still emerging. How important is the role of the IAF in governance? Does that role vary across cultures? Does it matter whether the IAF is housed within the organization or if an external provider provides the services? Do we have a measure of effective governance that can be applied across countries, cultures, industries, or governmental entities that would help us better predict attributes of effective governance? The opportunities for research are rich. The following table summarizes the research questions posed throughout the chapter. We hope that this discussion will prompt additional research on the IAF and governance.
VIII. Appendix I: Chapter Research Questions

Organizational Governance Defined

- Are there parameters of governance that may differ across cultures or across nations that are not considered in the above model?

- Can we develop measures of effective governance that can be applied across cultures, countries, and industries?

- Can we identify the primary attributes of effective governance and its effect on various performance measures such as stock price movements or governmental efficiency?

- What is the impact of regulation on the nature of governance processes and the role of the IAF in those processes?

- Various reports, e.g., Cadbury, have called for governance reports on the effectiveness of risk management. Do mandated public reports improve governance? Has the nature of the IAF changed in countries that mandate specific governance reports? How does organizational governance differ in countries that have mandated governance reports from those that have not issued similar mandates?

- Recent legislation in the U.S. has called for reports on the effectiveness of internal control as part of a normal reporting process on the effectiveness of governance. What models of internal control reporting best contribute to the effectiveness of organizational governance?

- What are the major determinants of an effective governance system, and how do these determinants vary across types of organizations or cultures? What cultural differences most affect the nature of organizational governance?

- Many organizations are multinational. Are governance processes, including processes for risk analysis and control, different in multinational companies than they are for companies that are domiciled within a unique culture (or country)? How do they differ and what works best?
• Are there significant differences in the identification of, and accountability to, various stakeholders that may vary by type of organization, culture, organizational objectives, and so forth? How do such differences affect the nature of organizational governance?

• What is the demand for governance reports? What kind of a report would meet the users’ needs for governance and accountability? Can we develop such a model conceptually or can we test one empirically through experimental markets research? How would these reports differ from evolving reports on internal control?

• Under what circumstances can an audit committee or other governing structure use the work of an internal auditor to provide assurances on governance to outside parties, e.g., shareholders? Under what circumstances would internal auditors have sufficient credibility to add assurances to reports on effective governance?

• How does an organization most effectively communicate information about the effectiveness of its governance processes to various stakeholders? Should such reports be prepared by independent assurance functions (independent public accounting firms or internal audit functions), and, if not, are such reports improved by the addition of an assurance function? Does the nature of such assurances differ based on whether the internal audit function is outsourced to an independent outside accounting firm, or whether the internal audit function is housed within the organization?

Parties Involved in Organizational Governance

• Are there inherent conflicts in reporting responsibilities when internal auditors report to both the audit committee and to various levels of management?

• Are there differences in the nature of services performed and the perceived value of services that vary with internal audit’s primary reporting responsibility?

• What kinds of safeguards need to be built into the IAF to ensure that internal auditing will meet its external governance responsibilities?

• To what extent are internal auditors involved in auditing the effectiveness of the governance structure of the organization? Does the internal audit role systematically vary with organizational characteristics?

• Does an internal audit emphasis on meeting the needs of the audit committee lead to an increase in outsourcing of the internal audit function?
• How do organizations assess the value of various internal audit activities?

• How have budgetary control and resources expended on internal audit changed with the increased governance requirements of stock exchanges and other regulatory organizations?

• How does the nature of internal audit activities differ when the IAF’s primary reporting responsibility is to senior management as opposed to the audit committee?

• Is there an ideal reporting relationship for the IAF? What are the parameters of the ideal reporting relationship, and what are the primary determinants of the ideal reporting relationship?

Monitoring of Risks and Controls

• What role should the IAF play in risk management? How do we determine the optimal risk management role for the IAF within the governance structure?

• Under what circumstances can management use the work of an internal auditor to provide assurances on risk or control to outside parties, e.g., corporate trading partners using e-commerce or joint ventures?

• Internal auditors have often been viewed as control experts. Under what circumstances would internal auditors have sufficient independence and credibility to provide reports to external parties on the effectiveness of internal control? Is there a difference in whether the IAF is outsourced or in-house?

• What role should the IAF play in control self-assessment and control assessment? How do we determine the optimal role for the IAF within the governance structure regarding effective control?

• An important role of the IAF as part of a control system is effective monitoring. What is “effective monitoring”? What are the conflicts between effective monitoring and the provision of other internal audit services such as control self-assessment, risk self-assessment, or providing recommendations to improve operating effectiveness?
Goals and Accountability

- Is the existence of an effective IAF associated with superior organizational performance? If so, are there objective measures of internal audit effectiveness?

- Is the existence of an effective IAF associated with reduced incidence of control failures? If so, which types of control failures?

- What type of internal audit structure enhances the accountability of governmental entities?

- How can the internal audit function best increase accountability to various stakeholders?

- Do organizations with more specific quantitative goals/objectives perform better than those with less measurable goals? What role does internal audit play in helping define and assess attainment of measurable objectives?

Groups Calling for Improved Governance

- How did the role of the IAF change as a result of new regulations passed in 2002? Has the status of the IAF been elevated? If so, how?

- How do potential audit committee or board members evaluate the strength of the IAF? To what extent does the existence of an effective IAF influence the composition of a board of directors?

- Have the new regulations passed in 2002 led to a change in organizations’ control systems or governance practices?

- Has internal audit outsourcing increased in companies where the IAF reports directly to the audit committee (assumes an audit committee focus on controls and financial reporting)?

- What role does (should) the IAF play in assessing and reporting on risk management and control? Is the internal audit function effective in reporting on the “tone at the top” as part of its function to help assess the quality of internal control?
• What role does (should) the IAF play in whistleblower protection, a hot line call system, or an ethics program?

• Has the nature of the interaction of the IAF with audit committees changed? If yes, how has it changed? How has the interaction with top management changed?

• What is the internal auditor’s role in evaluating the effectiveness of risk processes and controls associated with information technology?

• Are there significant differences in the IAF between companies listed on the NYSE and those listed on other exchanges that have different governance requirements?

• Are the recommendations for improved internal auditing in the private sector being carried over into the public sector? If yes, what are the mechanisms that contribute to the change?

Audit Committees

• What kind of an information system does an audit committee need to be effective? What role can the IAF play in providing that information?

• Is there an association between the quality of the IAF and the effectiveness of the audit committee?

• Is there a conflict in the duties of audit committees, as presently constituted, regarding reporting relationships? The audit committee is a subcommittee of the board and may report to a board that could be dominated by management. Does the composition of the board influence the effectiveness of the audit committee?

• How does an audit committee meet its external governance needs while operating in a framework that makes it part of a larger body dominated by internal personnel?

• Most discussions of board activities warn against “micromanagement.” However, many of the internal auditors’ recommendations address needs for improving controls, risk management, information technology security, efficiency of operations, and so forth are clearly intended for management action. How do effective audit committees manage the detail often found in internal audit recommendations?
Does the increased reporting responsibility of the IAF to the audit committee decrease the value of the IAF as a management tool?

Are audit committees becoming more financially literate, as required by the SEC and legislation? How is financial literacy measured? Does the focus on financial literacy improve or hinder the effective performance of an audit committee and the board of directors?

What level or style of communication is most effective in portraying internal audit information to audit committees?

An Alternative Structure: The Two-Tiered Governance Structure

How might we measure the effectiveness of single-tier approaches to governance versus the two-tier structure found in some European and Asian countries?

Are organizations with full-time, outside governing structures more effective in protecting stakeholders? Are there things that we can learn from the two-tier governance structure that can be applied to improve the single-tier governance structure?

How does the role of the IAF differ in single-tier versus two-tier governance structures?

The Role of the IAF in the Governance Structure

Can we develop a model of an effective and efficient IAF? What are the primary factors that lead to positive assessments of the IAF? Does the nature of the IAF vary by key characteristics of an audit committee or other governing structure?

Is there any evidence that sourcing the IAF in-house or outsourcing it makes a difference in governance?

How can smaller organizations, which may lack the resources for a separate internal audit department, best implement an internal audit process that will support their governance needs?

In many ways the IAF plays an integration role within an organization. For example, internal auditors have leveraged their expertise in both controls and risk to develop control self-assessment (CSA) activities and risk self-assessment (RSA) activities. In
other words, internal auditors have filled roles where there are voids in the organization. Under what circumstances is the IAF most effective in performing an integrating role? Does the integration role potentially impair the effectiveness of other internal audit functions?

- Does the integrating role of internal audit enhance or detract from effective governance? For example, effective CSA and RSA require that the auditor act primarily as a facilitator and consultant rather than as an assurance function. Is there a potential conflict here, and if so, can it be managed effectively?

- What are the relative roles of internal and external audit in contributing to effective governance processes?

- Is the effectiveness of the IAF associated with the amount of consulting services it provides? Is the association positive or negative? Who judges the effectiveness of internal auditing in most organizations?

- Is the credibility of the IAF as assessed by the audit committee (or other governing structure) influenced by the amount of consulting services provided? Is the association positive or negative?

### Cultural and Industry Factors Affecting Governance Structure and the IAF

- While internal auditing in governmental units embraces the broad definition of internal auditing found in Exhibit 2-11, some governmental IAFs focus only on compliance work, while others focus on evaluating economy and efficiency of operations. Why does this difference exist? What factors are associated with this difference?

- Does the nature of the IAF reporting relationship vary with the nature of the organization, the power of the audit committee, or across different cultures? How does the nature of the reporting relationship affect the size, structure, and nature of services performed by the IAF? For example, how does internal audit in developing countries differ from internal audit in economically advanced countries? Does the IAF go through specific development stages that mirror the economic development?

- How does the IAF differ in companies with distinctively different governance constraints and objectives? Can the nature of the IAF be modeled across different governance and organizational forms, as well as across different industries?
• What are the primary drivers of the nature of the IAF? For example, is governance more of a driver than industry? Is the nature of governance and the IAF different in organizations or industries that are heavily regulated? How do they differ? What are the drivers of the differences?

• We also know that the IAF operates in governance structures that are evolving in developing countries to meet different needs than those met by the governance structure in more developed countries. What are the major drivers of these differences? Are there cultural or societal values that drive the nature of internal audit practice, or is it primarily the attributes of the governance structure?
Footnote

1Although some governmental institutions have been active in calling for increased and improved corporate governance, Monks and Minow (2001) point out that recent trends have also worked to diffuse initiatives for better governance. For example, they point out that pension funds, insurance companies, and bank trust companies almost invariably vote for management’s positions on proxy issues, thus even further diffusing the power of those calling for greater accountability and more checks on management’s authority and power.
References


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