1982

Control of Internal Auditing as Viewed by the Audit Committee and the CEO

Jerry Bennett
University of Richmond

CONTROL OF INTERNAL AUDITING AS VIEWED BY THE AUDIT COMMITTEE AND THE CEO

for the
Audit Management Conference
Institute of Internal Auditors
New York, N.Y

by
Dr. Jerry Bennett, CMA
Associate Professor of Accounting

1982-1

E. Claiborne Robins School of Business
University of Richmond, Virginia

March 18, 1982

Internal auditing must be controlled as must all functions, yet it must be free and sufficiently independent to fulfill its audit role. Control implies constraint, restraint, restrictions on freedom to initiate, to act. Control implies oversight by an authority higher up in a hierarchy. Control implies performance toward a plan and a subsequent appraisal of performance attained, including subjective judgments of the performer.

Independence, however, implies freedom of choice, unfettered, unrestricted. Independence implies action without fear of reprisal or of punishment. Independence implies the latitude to allocate resources without notice or prior approval. Independence implies the absence of bias or of conflict of interest.

Debates regarding control versus independence often reduce to the simplistic notion that all can be solved by having for Internal Audit the proper reporting slot in the corporate hierarchy. It is proposed that management will overcontrol, hence Internal Audit must report to the Audit Committee if it is to be properly independent. Many internal auditors suggest that they must report to the Chief Executive Officer (CEO) if they are to enjoy the needed independence. Others have suggested that true independence and freedom from bias can come only if internal audit reports directly to the full Board of Directors. We shall return to this issue in a bit.

Consideration of this executive view of control of the Internal Audit function is very timely because the issues have, to some extent in recent months become better defined and polarized. This review will attempt to identify a prevailing view of control of the Internal Auditor, in terms of sources and underlying causes. Within that framework, control will be described as it is viewed by the Audit Committee and the Chief Executive Officer.

Evolution of the Audit Committee

Before we turn our attention to the control of Internal Audit by the two central parties, let's briefly review the evolution of the newer of the two: the Audit Committee. Their first major unveiling was probably their endorsement by the SEC subsequent to the McKesson & Robbins scandal. Not much of importance followed until the early 1970's. Ernst & Whinney's study in 1970 revealed that only about 30% of the companies surveyed had Audit Committees. But their followup study in 1976 revealed that over 89% of the Fortune 500 had Audit Committees. In 1977 the New York Stock Exchange made an Audit Committee a prerequisite for continued listing. And the Foreign Corrupt Practices Act of 1977 has convinced most of the laggards that an Audit Committee is a necessary part of a system of assurance of adequate internal control.

There is no longer the issue of "whether or not" an Audit Committee. The issue now is what truly should be the duties of the committee and how it should manage its affairs. The American Bar Association assigns four duties to the committee:

1. Recommend the firm to be hired as outside auditor.

2. Consult with that auditor regarding planning of the audit.
3. Review with that auditor their audit report and management letter.
4. Consult with the outside auditor and the internal auditor on the adequacy of internal controls.

Just how a particular Committee carries out its duties is a consequence of the talents and experiences of the Chairman and members. As an example, a survey of members of Audit Committees of 49 major U.S. banks revealed the following responses:

Question: Should a purpose of the Audit Committee be to provide attention to the internal audit function?
Response: Highly Important - 78%
Not Highly Important - 22%

Question: Should a function of the Audit Committee be the coordination of the audit with internal auditors?
Response: Very Important-70%
Not Important-30%

Question: Can the Committee be effective in coordinating the audit with internal auditors?
Response: Very effective-75%
Not Very Effective-25%

Metamorphosis Underway

Given such perceptions and events, one must agree that the role of the internal auditor is, indeed, undergoing an externally-caused metamorphosis. The Securities and Exchange Commission has caused certain events which are impacting quite directly on the internal auditor. The United States Congress has passed legislation which bears immediately and directly on the internal auditor. Corporate boards of directors and chief executive officers concerned with their corporate accountability responsibilities are, themselves, sources of considerable turmoil in this area.

Corporate bribe payments made to foreign officials in exchange for business opportunities has resulted in major legislation. The Protestant work ethic, which fundamentally prevails in the United States, is inconsistent with such ways of doing business; the press and the Congress have reacted in ways aimed at preventing those kinds of business dealings. The major aspect of this problem for auditors is that those bribes were concealed in the corporate books of account. The accounting requirement for full disclosure was not met when those transactions were not correctly and fully recorded as to their true purpose and the true expenditure.

In addition to change imposed from the political and social arena, technical changes in the tasks of the internal auditor stem from computerization of accounting systems and management control systems with attendant dramatic differences in the kinds of internal controls which are amenable to implementation. As an example, the use of stored programs in computer systems is generally a direct substitute for clerical processing. The elimination of clerical processing eliminates opportunities for separation of duties, a heretofore basic concept of preventive control. Further, computer fraud, while admittedly not pervasive, has nevertheless, captured major headlines. These headlines have caused stockholders and other publics in the constituencies of firms to be more concerned than before about accountability.

The power of the Securities and Exchange Commission to regulate the internal behavior of the American corporate business community has been radically changed as a result of the Foreign Corrupt Practices Act (FCPA), imposed as a result of failures to properly account and disclose bribes and political contributions. The Act requires all companies subject to the Securities and Exchange Act of 1934 to make and keep books and records which accurately and fairly reflect the transactions of the company; it also requires those firms to devise and maintain systems of internal accounting controls which provide reasonable assurance that transactions are executed in accordance with management's authorization, that transactions are recorded so that financial statements are in accordance with generally accepted accounting principles, and that accountability and security of assets is maintained. The internal accounting controls must insure that access to assets is in accordance with management's authorizations and that records of assets are compared with physical assets at reasonable intervals and that action is taken on all discrepancies.

In its implementation of the Foreign Corrupt Practices Act, the Securities and Exchange Commission has issued rules which explicitly make it illegal for any person to falsify company books and records. Other SEC rules make it illegal for any officer or director of a registrant to make a materially false, misleading, or incomplete statement to an auditor in connection with an audit of the financial statements. Of significance to auditors is an emphasis on materiality in only the second of those two requirements. The absence of "materiality" in the first requirement probably will create a problem of interpretation for management. In that rule prohibiting falsifying of books and records, the SEC has turned to the FCPA for its language. The Act seeks reasonableness rather than materiality. The SEC rule seeks reasonableness rather than perfection. It is important to realize that reasonableness does not mean the same thing as materiality, since the FCPA's goal of corporate accountability goes beyond a concern for financial statement content. Further, it is important to recognize that the new SEC rules are not qualified with a reference to intent. According to the SEC, any reference to intent would be inconsistent with the Foreign Corrupt Practices Act and the intent of Congress in imposing that Act. Of relevance to this audience is a recognition that these new rules apply to corporate directors, corporate officers and "other persons." These "other persons" quite clearly include the accounting officers of the firm and the internal auditors of the firm as well as the Chief Executive.

CEO's New View of Internal Audit

In earlier years, the CEO probably was ignorant of the specific tasks of internal audit. The financial officers took care of whatever needed to be done.

Not any more. Given the new corporate accountability, the President of the New England Merchant's Bank may have said it best:

> The new definition of accountability includes going to jail. The fact that internal auditors may help executives stay out of jail may have something to do with the warmth and affection top management now feels for them.

Given all of the forces for change, what do CEO's expect of Internal Audit? We should establish these expectations before we consider how CEO's wish to control actions to accomplish such expectations.

Operational auditing to improve efficiency ranks particularly high with CEO's in these troublesome economic times. As such, Interal Audit is an arm of management, evaluating efficiency and effectiveness of operations, of planning and control systems at all levels in the organization.

As to internal control, CEO's want several things, according to that bank president:

1. Assurance that assets are safeguarded.
2. Confirmation that policies are followed.
3. Confirmation of operational capabilities of production and service.
4. Early warning of potential problem matters.
5. Reduced outside audit fees. In 1977, such fees in the U.S., according to Financial Executive magazine, ranged from .16% of sales down to .02%, depending on the level of sales. For a \$100 million company this is an audit fee of \$100,000. For a \$500 million company, the average fee was \$300,000 with a range of \$54,000 to \$1,600,000. Clearly, the CEO paying the top of the range will want Internal Audit to carry some of the load.

Audit Committee Perceptions

Given the increasing pressure from the Securities and Exchange Commission, the New York Stock Exchange, and other sources for the creation of audit committees of the boards of directors, it is instructive to recognize how those audit committees perceive their major purposes and methods of effective operations. In a recent survey of bank audit committees, 78% of the respondents thought it was of high importance that the committee provide specific attention to the internal audit function and of high importance that the committee devote attention to improving the effectiveness of the financial and operating controls system.

In a question regarding functions of audit committees, 70% of these same respondents reported it very important that the audit committee be involved in coordination of the external audit with the internal auditors; 94% thought it very important that the status of implementation of internal control be reviewed with and discussed with the Audit Committee. Finally, 93% deemed it very effective to have the Audit Committee involved in being aware of and discussing the status of implementation of suggestions for improved internal control and reporting.

At a recent conference, two audit committee members of Boards of major U.S. firms made the following comments:

> Of significant importance in our firm is the impact of the change in the Audit Committee's role in internal audit operations. Two years ago the chief internal auditor had a staff of only 17 auditors and reported to the corporate controller. Currently the staff consists of 50 professionals and the chief auditor's position has been elevated to that of vice president reporting directly to the Audit Committee.
>
> It is difficult to define the role of the Audit Committees of very large well-established companies simultaneously with those of smaller and relatively new companies. I am involved in audit committees of two companies - - one large, one small - - and what these audit committees do is really quite different from firm to firm. This is because the larger company is equipped with a magnificent set of controls and a very capable internal audit staff, while in the other, smaller firm the directors must ride herd on internal auditing.

These directors reported that skills and qualifications of the internal audit staff should grow in response to an expanded scope. There has been a movement from a group with limited responsibility toward that of a highly skilled professional group of internal auditors. An additional participant in the conference reported, "We don't have juniors so to speak; most of the people on our internal audit staff have three to five years of public accounting experience. In addition, we have ex-FBI agents, lawyers, computer science specialists, and the like."

There was not unanimity in support of the need to "ride herd" on internal auditors. One audit committee member indicated that he would rely exclusively on his external auditor to appraise and to report on the adequacy of internal audit. Such reliance, however, was reported to have gotten at least one firm in trouble. A director reported the following:

> It turned out that the internal and external auditors were aware of the illegal payments being made by the firm. Management of the firm was also aware of illegal payments. None of the three groups, however, felt it necessary or appropriate to bring to the attention of the Board or to the Audit Committee this set of illegal circumstances.

The location of internal audit within the structure of the firm and access of internal staff persons to the audit committee was discussed. One member of an audit committee suggested that individual internal audit staff members should be encouraged to come forward with issues even if the manager of the internal audit were not in agreement; he felt that if any auditor has any doubts as to the validity of controls or correctness of statements he should voice those concerns to the committee. Other directors at this same conference opposed such an open-door policy. From the organizational behavior perspective, there are genuine concerns that managers of intenal audit may not be able to cope with having staff members go over their heads and thereby being overruled. There is also the concern that the Audit Committee may begin to usurp management's responsibilities to the extent that they interject themselves in day to day problems.

<u>Control Of Internal Auditing - CEO View</u>

Since operational auditing is beyond our present interest, we will only consider here internal control aspects of the CEO's concerns.

The CEO will, first of all, become personally involved. His commitment to and support of Internal Audit will be made clear by word and by deed. He will provide adequate staff, pay adequate salaries and facilitate communications between Internal Audit and operating managers. He will communicate his willingness to hear bad news.

He will, then, hold Internal Audit accountable to a high level of professionalism. They will be expected to learn how their industry and their firm operates. They will be expected to acquire state-of-the-art knowledge and skills as technology demands. As an example, they must be highly proficient in the audit of computerized operational control and accounting systems.

Because the CEO manages by delegation, he likely will look to his Chief Financial Officer to advise him when Internal Audit has failed to meet expectations and when corrective control action by the CEO is required.

<u>Control-Audit Committee View</u>

Audit Committees have, themselves, undergone a metamorphosis in recent years. There has evolved a clear dichotomy: one group of Audit Committees do very little beyond holding perfunctory meetings to engage the outside auditors and holding form without substance sessions for receipt of the audit report. This group of committees is small in number.

The other, much larger group of Audit Committees has evolved to an activist, deeply involved level of work. This group represents the committee role anticipated by the New York Stock Exchange and by the SEC. This committee's involvement with Internal Audit includes the following:

Review and approve the scope of and results of work by Internal Audit.
Review recommendations made and management's implementation.
Report to the full Board on the performance of Internal Audit.
Review the staffing, qualifications, budget of Internal Audit.
Participate in the hiring of the Director of Internal Audit.

By the very creation of a charter for the Audit Committee, the firm assures an activist Committee. Legal liability is a concern of every director. Audit directors are aware that courts hold directors who have special skills or special duties to a higher level of performance. As one audit director phrased it,"If you don't do what you have set out as your own guidelines, I would feel quite strongly about that."

Audit Committees recognize that there is a proper line between review on the one hand and usurpation of management duties on the other hand. They are careful not to cross this line. It has been well said that,

> If the committee tries to take over management's responsibilities, it becomes part of management, hence, part of the problem.

Because of the presence of an activist Audit committee, the CEO's controls may become more demanding. The CEO will more likely require better internal controls, knowing that he will look bad if the Audit Committee reports weaknesses. He may adopt controls which are less clearly cost/benefit justified, knowing that the committee will likely err on the side of improved controls. The CEO will assure the implementation of more recommendations, knowing that the Committee will carefully and critically question reasons for failing to adopt. Finally, the Audit Committee will be much less tolerant of mediocrity in Internal Audit than will the CEO unless stimulated by the Committee.

Full, unfettered access to Internal Audit is required by the Audit Committee. Open communication is vital. By sharp, probing questions in its meetings with Internal Audit, the Committee shows it expects the highest quality of professional performance. The Committee receives copies of all internal audit reports and should meet regularly, alone, with the Director. It will ask such questions as:

> How do you judge which areas need special attention?
> How much do those being audited know what you are going to audit?
> How do you plan to maintain your level of audit skills? What personnel changes do you anticipate? What reasons are there for turnover in the past year?
> What do you plan with regard to auditing officers' expense accounts? Personal service invoices? Consultants' services?

"Reporting To" - A Non-Issue

Too much has been made over the issue of to whom Internal Audit should report. Authors have become fond of quoting Henri Fayol who wrote, "Men cannot bear dual command." They would cite fears of loss of independence if Internal Audit were to be managed by a corporate executive. They would then conclude that only a reporting relationship with the Audit Committee would permit Internal Audit to succeed.

In rebuttal, authors would write that such an arrangement would strike at the very center of management authority. No such reporting could be tolerated. At the extreme, Internal Audit might report to the CEO, but the only practical solution would be to give this duty to the Chief Financial Officer. After all,if the Director of Internal audit were to be fired, the Audit Committee would automatically be alerted that something was amiss.

The former Chairman of the Securities and Exchange Commission, Harold Williams, urged an organizational framework that would let Internal Auditors do their job by being administratively responsible to top management and generally overseen by the Audit Committee. To the question, "To whom should Internal Auditors report?" Mr. Williams suggested two definitions of the word "report." Internal Auditors should report, in the sense of being administratively accountable, to some member of top management who is knowledgeable of the profession of auditing. Internal Auditors should report, in the sense of communicating with and discussing their finding and recommendations, to the Audit Committee.

Harvey Kapnick, of Arthur Andersen, has a parallel recommendation with regard to the reporting relationship of Internal Audit. Mr. Kapnick suggests that the chief executive officer of the corporation must be personally involved in updating the Internal Audit function. He suggests that the internal audit manager report organizationally to the chief executive officer. Internal Audit would then be perceived by the board,by the Audit Committee and by management as being truly as independent as is possible of the activities within the organization which are being reviewed. If it is argued that the chief executive officer is not qualified to supervise the Internal Audit function, such is no less true of the CEO's supervision of finance and accounting matters, marketing, production, legal or other areas of the firm's operations in which the chief executive does not have a depth of personal experience. Kapnick goes on to suggest that the Audit Committee monitor the activities of Internal Audit rather than directly supervise them, with a wide-open line of communication for the flow of information sufficient to the needs of the Audit Committee and to the needs of the Internal Auditor.

Summary

A minority of firms today view control of the Internal Auditor in an unchanged manner. In these firms, the internal audit function is buried deep within the financial organization; the head of internal auditing reports to the corporate controller or indeed in some cases below the level of the corporate controller. The role of the Internal Auditor is viewed as merely one of assuring compliance with internal accounting policies and procedures and little more than that.

However, that is assuredly a minority view of the profession. The responsibility of the Internal Auditor in the majority of firms in recent years has been dramatically broadened. The scope of internal auditing is being broadened to include EDP auditing, the evaluation of controls throughout the organization, the evaluation of data prepared by senior management, and special investigations on an as-needed basis. The reporting level of the internal auditing manager within the organization structure has been elevated.

The trends are real; they are likely to be irreversible. Demands for enhanced corporate accountability can only accelerate current trends in this direction.