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As the Director of Professional Practices with the Institute of Internal Auditors (IIA), I respond to many, and duck some, questions from practitioners and others regarding all manner of issues with which practitioners are confronted daily. In recent years one question seems to be asked more frequently. The question is:

> How can we protect our workpapers and reports from access by parties other than those for whom they were prepared?

External auditors are familiar with both protecting their workpapers from access and having their reports used by third parties. Auditing students learn early that *Ultramares v. Touche & Co.* [1931] means third parties need to be carefully considered in the audit process. Internal auditors usually aren't concerned about that sort of thing. After all, their work is only for the use of their organization and they are a part of that organization. Or are they?

How Internal Auditors See Themselves

Internal auditing is defined in the *Statement of Responsibilities* of Internal Auditing [IIA, 1990] as follows:

> Internal Auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed.[1]

It is this position that allows an internal auditor to use his or her detailed knowledge of the entity's policies, procedures, and environment to appraise the function and apprise management of existing or potential problem areas.

In earlier versions of the *Statement of Responsibilities of Internal Auditing* [1947, 1957, 1971, 1976] the wording was more narrow and implied a stronger allegiance to management: "Internal Auditing is an independent appraisal activity within an organization for the review of operations as a service to management."

In 1981 and subsequent versions "service to management" was changed to "service to the organization." This new broad allegiance provides a professional basis for departing from the interest of management. It also provides a basis for

[1] The Institute of Internal Auditors, Inc., Statement of Responsibilities of Internal Auditing (Altamonte Springs, Florida: The Institute of Internal Auditors, Inc., 1990).

others to view the internal auditor's work product as fertile ground for homing in on the organization's problem areas as identified by an objective professional.

How External Auditors See Internal Auditors

Last year the Auditing Standards Board of the AICPA wrapped up a two-year project to update Statement on Auditing Standards (SAS) Number 9: *The Effect of an Internal Audit Function on the Scope of the Independent Audit.* SAS Number 65: *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* superseded SAS 9.

One of the most hotly debated topics was the concept of internal auditor independence. It was finally decided to point out in SAS 65 that the two professions define independence differently.[2] Rather than concentrate on independence, external auditors are directed in SAS 65 to look at the internal auditor's objectivity and competence, among other things. Based on their assessment they can then determine the degree to which the work of internal auditors might be used to supplement or reduce some of their own work.

Although this professional recognition was more subtle than some internal auditors would have desired, it was viewed very positively by others. However, the point was made once again that internal audit workpapers have a broader audience than the entity's management. This recognition is a continuation of the changes that have occurred primarily in the last twenty years.

Recent Changes

The stature of internal auditors has changed dramatically in the last two decades. One milestone was the establishment of the CIA Program.[3] Although not a license, the CIA credential has afforded a means of recognizing those internal auditors who have attained professional status through education, experience and examination. As internal auditors were working on improving their own abilities to provide professional service, legislation was being forged to increase the demand for such service. The passage of the Foreign Corrupt Practices Act in 1977 was another visible milestone in the profession. Since that time the increased expectations of the profession are obvious.

Internally, the work product of internal auditors has always been viewed by management as one of the best sources of independent appraisal within an organization. In 1987, the Treadway Commission *[Report of the National Commission on Fraudulent Financial Reporting,* 1987] underscored that view and encouraged an internal audit function as a means of strengthening corporate integrity.

In the United States the issue of corporate integrity obviously has many sides. Recently we have had some spectacular examples of fraud and mismanagement which undermined the public's confidence in everyone and everything from ministers to gambling casinos. Individuals have been damaged and litigation has inevitably followed. In this climate people do search for someone to blame when things go wrong. Sometimes the search is eleemosynary and some-

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[2] SAS 65 defined independence for external auditors and indicated in a footnote that IIA Standards use the term differently.

[3] The Certified Internal Auditor Program requires completion of: a two-day, four-part written examination; two years of qualifying experience; and, a degree which equates to the U.S. baccalaureate degree. The exam is offered in French, English and Spanish at sites around the world.

times it's for profit. One of the places that people found to search was internal auditors' workpapers. Being popular is not something internal auditors are used to, so it is understandable that they are uncomfortable when unforeseen third-party clients suddenly appear.

A Call For Help

The call I receive is frequently from a director of internal auditing or a member of an organization's legal staff, either anticipating or responding to work-product access by third parties. Unfortunately the question usually doesn't come up until the circumstances have progressed too far for the organization to deal effectively with the situation. I usually ask a few questions to see if the situation is similar to any of the ones I have heard before. But it seems that there are enough differences to make a general answer difficult.

Sometimes the access is sought by a local, state, or federal regulatory authority. Typically the caller says: "We are not concerned about the issues they are raising but our workpapers contain a lot of other unrelated subjective data that we don't want them to see." The caller sometimes asks: "How will I avoid scope restrictions when word gets out that my workpapers are an open book? I am trying to help my company correct and avoid problems, not punish them."

I usually share some basic information and references starting with the *Codification Of Standards for the Professional Practice of Internal Auditing.* The *Standards* state that "Audit working papers are the property of the organization." Furthermore they warn that "there are circumstances where requests for access to audit working papers and reports are made by parties outside the organization other than the external auditor. Prior to releasing such documentation, the director of internal auditing should obtain the approval of senior management and/or legal counsel."[4]

Based on my own experience it appears that most organizations have not anticipated these outside requests. They do not document internal memos and reports anticipating external publication. Since the main purpose of these reports is to get action, the wording is usually devoid of all of the caveats designed to avoid liability or shift blame. My caller is usually playing catch up and needs help immediately. So I, at this point, am forced to suggest that they balance their check book, unless they have privileges similar to U.S. congressmen, and call an attorney.

These calls started coming so regularly that I called our own attorney and asked for some sort of informational memo that I could share with our members. I also suggested to our Professional Issues Committee that they draft a position paper that would give further guidance to all internal auditors who were faced with access issues.

The question is a difficult one because there are good arguments on every side except the one I usually happen to be defending. The Professional Issues Committee did prepare an advisory report[5] in an attempt to be responsive to the

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[4] The Institute of Internal Auditors, Inc., Codification of Standards For The Professional Practice of Internal Auditing: No. 420 (Altamonte Springs, Florida: The Institute of Internal Auditors, Inc., 1989).

[5] The Professional Issues Committee of the IIA, just released a subcommittee report which provides guidance including a sample access policy statement for use by organizations in preparing for access requests.

problem. In the report they identified the basic concerns. The issues they defined go to the heart of our profession:

- Independence.
- Objectivity.
- The right of the public to know versus the right of an individual or an organization to privacy.
- The constitutional protection from self-incrimination.
- Whether the public interests are best served by openness or by confidentiality.
- The role of the internal auditor serving management as well as the board of directors in the private sector, and the role of the internal auditor as a public servant in the governmental sector.

The committee's report points out that in order to be effective as an independent appraisal function, internal auditing must be able to objectively evaluate high-risk activities and frankly communicate the results to management and the board. Unlimited access to internal auditing work-products by outside parties would have a chilling effect both on the scope of activities reviewed and the frankness with which results were communicated.

If this sounds like a plea for privileged communication or protection from self-incrimination, many would argue that it should be that way. But others might say that most organizations being called to report are simply too big and too public to demand privacy.

The Internal Auditor's Code

The *Code of Ethics* of the Institute of Internal Auditors, Inc., states in Article VIII [IIA, 1988]:

> Members and CIAs shall be prudent in the use of information acquired in the course of their duties. They shall not use confidential information for any personal gain nor in any manner which would be contrary to law or detrimental to the welfare of their organization.

Article II states [IIA, 1988]:

> Members and CIAs shall exhibit loyalty in all matters pertaining to the affairs of their organization or to whomever they may be rendering a service. However, Members and CIAs shall not knowingly be a party to any illegal or improper activity.

Now when the interests of owners, managers, regulators, and other interested parties are the same there is no problem. When those interests diverge, whose interests come first? The Board of Directors? Owners (members)? The public? Regulators? The auditor?

Self-Evaluative Privilege

I mentioned earlier that I asked our attorneys to outline this concept of the "self-evaluative privilege." Our attorney provided me with the following memorandum dated March 1990:

> The self-evaluative privilege is a judicially recognized doctrine which provides that, under certain circumstances, documents created pursuant to

> a critical self-analysis by a company should not be subject to compelled disclosure in private litigation. The rationale for the privilege is relatively simple: Company self-evaluations are beneficial, most immediately to the company and ultimately to society, and the fear of public disclosure of the results of self-evaluations would discourage such efforts. Unlike some privileges recognized by the law (e.g., the attorney-client privilege) the self-evaluative privilege is not well-defined, nor has it achieved broad acceptance. This situation is exacerbated by the fact that the privilege is currently being formulated almost exclusively by trial court judges, not appellate courts, and this leads to inconsistent application of the privilege.[6]

A few courts have subscribed to the self-evaluative privilege, including *Bredice v. Doctors Hospital Inc.,* 50 F.R.D. 249 [D.D.C., 1970], affirmed 479 F. 2d 920 [D.C.Cir., 1973], *The Washington Post Co. v. U.S. Department of Justice*, No. 84-3581 [D.D.C., Sept 25, 1987], and *Federal Trade Commission v. TRW, Inc.,* 628 F. 2d 207 [D.D.C., 1980]. However as pointed out in the above memo, this is not uniformly recognized.

Internal auditors have battled the reputation of being an adversary rather than an ally of management. If the internal auditors' workpapers become regularly accessed by true adversaries, the auditors may have more difficulty locating problem areas for early detection and correction.

In an unofficial IIA informational publication, the legal issues faced by internal auditors were explored and auditors were warned that [Fargason, 1992, p. 27]:

> Workpapers can be exposed during any legal proceeding, including interrogatories, motions/request for documents, depositions, subpoenas, etc. Internal auditors should be aware of the fact that their reports and workpapers may be the foundation for a lawsuit.

Unless internal workpapers can be protected by either the attorney-client privilege or the work-product privilege, they are likely to be discoverable [Fargason, 1992, p. 28].

This is not always the case. In *United States v. Newport News Shipbuilding and Dry Dock Company*, CA 4 No. 87-3832 (Newport News I) the Fourth Circuit Court of Appeals affirmed the district court's order denying the enforcement of a DCAA subpoena for internal auditing work-products. In this case, the workpapers contained data that was not "closely connected."

Some of the calls I receive suggest that they are being placed under the direction of the legal department for certain investigations in order to come under the umbrella of "attorney-client" privilege. Is this in the best interest of the profession?

An example of this type of posture is described in a forthcoming book from the IIA written by James Fargason. "In *Pritchard-Keang Nam Corporation v. Jaworski,* 751 F. 2d 277 (8th Cir. 1984) the issue before the court was whether the attorney-client privilege should be applied to documentation prepared by an attorney for the audit committee of the corporation. International Systems and

[6] Internal memorandum to The Institute of Internal Auditors from the law firm of Webster, Chamberlain & Bean, (Washington, D.C., March 1990).

Controls Corporation (ISC) directed its audit committee to investigate allegations that individuals within the corporation were paying bribes to government officials of foreign countries. In order to facilitate the investigation, the audit committee hired an outside accounting firm and an outside law firm. The law firm completed its assigned investigation and issued a report to the audit committee for review." Fargason [1992, p. 30] points out that the court upheld the attorney-client privilege. The court pointed out that not privileging this information would have a chilling effect on individuals who seek legal advice. Clients would be less likely to be completely candid and honest with their attorneys.

Recent U. S. legislation seems to be increasingly directed toward compelling internal and external auditors to report problem areas directly to regulators. For internal auditors this further exacerbates an already tenuous hold on their desired recognition as "team players" who want to correct existing problems as they are found. But now, internal auditors, having fought long and hard for recognition as objective professionals, are finding that "objective" means different things to different people. Internal auditors are supposed to be objective advisors, not managers. They cannot usurp management's decision-making responsibility. At the point they cross the line and begin to make the decisions and direct activity (manage) they are no longer independent of the activity. However, there are others who see that quite differently and suggest that the auditor should be a "whistle-blower." Where the lines between legal and illegal are distinct, the answers are clear. But in many complex issues the lines are less distinct.

At the AICPA's Annual Conference on SEC Developments held January 8, 1992, attendees were warned to anticipate enforcement action against internal auditors and other in-house officials. SEC Associate Enforcement Director Bruce Hiler and former SEC Enforcement Director Gary Lynch suggested that the 1990 Securities Enforcement Remedies and Penny Stock Act gave the Commission broader authority to go after mid-level executives who "cause" violations of the securities laws either by negligence or by failure to perform an act. Hiler discussed a 1985 enforcement action against the controller and treasurer of a company for aiding the chief executive officer's alleged financial fraud. The case is known as the "good soldier" case (*SEC v. Oak Industries Inc., DC SCalif*, 6/25/85; 17 SRLR 1199).

According to Lynch this new legislation allows cease-and-desist orders to be used in a way that will make it easier for the SEC to win its cases. Previously in order to get a permanent injunction, the SEC had the burden of proving in court that the defendant had the propensity to commit the violation again. Lynch pointed out that cease-and-desist orders can be handled administratively and do not require proof that violations could recur.

Another promulgation that professionals are trying to understand is the new Organizational Sentencing Guidelines[7] which became effective on November 1, 1991. These guidelines provide for restitution, probation, and fines; with the fines appearing to be the primary instrument of punishment. Base fines range from $5,000 for the lowest offense to $72,500,000 for the highest. The base fine is then adjusted by minimum and maximum multipliers based on culpability

[7] In May of 1991 the U.S. Sentencing Commission sent to Congress proposed sentencing guidelines for companies convicted of federal crimes. These guidelines became law on November 1, 1991.

scores. A company with a $72,500,000 fine could have its fine reduced to $3,600,000 or increased to $290,000,000 based on its culpability score.

Organizations are encouraged through enormous guideline incentives to investigate and report employee misconduct. However, this "voluntary" disclosure may waive any attorney-client privilege or work-product doctrine protection. This in turn opens the organization up to the potential for civil and administrative action which may result from shareholder, competitor, and/or employee lawsuits. The documentation for all of this may be the internal auditors' workpapers.

Conclusion

In conclusion, I don't have solutions to offer but rather challenges to researchers, educators, and practitioners alike. Recently I have had the opportunity to work directly with a number of groups seeking to address reporting issues. My observation has been that most of the time we are in a reactive rather than proactive mode. As accounting and auditing professionals we should be in a position to foresee more of these problems instead of dealing with the solutions handed to us by legislators and courts. One of the basic tenets of true professions is self-subordination and a devotion to the welfare of those served.

The legislative efforts that are increasing our professional liability have been annealed in a crucible of distrust. We all find ourselves living in glass houses and will have to be ready for inspection at all times. For auditors that means documenting circumspectly. For educators that means teaching critical thinking and instilling ethical pride. For researchers that means finding new solutions to keep the professions in a proactive rather than reactive mode.

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