

February 2012

Auditing Governance Processes

Internal auditors should strongly consider a risk-based approach to audits of governance.

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Should internal audit departments audit governance processes? Can they assess board operations effectively? Isn't that the responsibility of the board itself, generally through a governance committee? Are auditors sufficiently independent, since they report to the audit committee, and do they have the necessary skills?

These are questions I often hear when the profession's thought leaders suggest we need to include audits of governance processes in the audit plan. Nonetheless, professional guidance and research indicate that this will be a priority for internal auditors in the coming years. In The IIA's latest Common Body of Knowledge (CBOK) report, for example, the No. 1 imperative for change was "sharpen your focus on risk management and governance." CBOK also ranked "corporate governance reviews" as the No. 1 internal audit activity over the next five years. Moreover, IIA Standard 2100: Nature of Work states: "The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach."

A risk-based approach involves building the audit plan so it assesses how management addresses the more significant risks to the organization—the controls it has to manage those risks within desired levels. Where, then, do audits of governance fit? How do internal auditors apply a risk-based approach to audits of governance processes?

AN INTEGRAL PART OF THE PLAN

Failures in governance are perhaps the greatest single cause of corporate failures. This was reinforced by Lord Smith of Kelvin, author of the U.K.'s Smith Guidance on corporate governance, when he keynoted the 2011 IIA International Conference in Kuala Lumpur: "The real cause of major corporate scandals and failures—Enron, WorldCom, Swissair—is a series of unwelcome behaviors in the leadership culture: greed, hubris, bullying, and obfuscation leading to fantasy growth plans and decisions taken for all the wrong reasons."

In its July 2011 Governance Since the Economic Crisis report, consulting firm McKinsey & Co. found that only 25 percent of board directors surveyed globally describe their board's overall performance as "excellent" or "very good." Moreover, only 21 percent say they have a complete understanding of their organization's strategy, and 32 percent say they have limited or no understanding of the risks their company faces.

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These findings suggest that internal auditors should consider risks related to failures in organizational governance when building and updating the audit plan. In fact, because of their potential impact, governance risks may well warrant being rated at the high end of the risk spectrum.

When identifying governance-related risks to consider, auditors should keep an open mind. Even the best boards, with the most experienced and competent directors, can fail. Examples of risks to consider include:

Organizational strategies are approved and performance monitored by executives and the board without reliable, current, timely, and useful information.

There is too great a focus on short-term results without sufficient attention on the organization's long-term strategies.

Oversight by the board is limited by a lack of directors with the required business, industry, technical, IT, or other experience.

The board's dynamics do not include sufficient challenge and skeptical inquiry by independent directors.

Oversight by the audit committee is limited by a lack of experience in financial reporting and auditing.

The external auditors fail to detect a material misstatement because part of their global team lacks the necessary industry experience and understanding of relevant accounting standards.

Board oversight of risk management is constrained by a lack of risk management experience.

Strategies approved by the board are not linked to individual goals and objectives of managers in operating departments.

IT priorities are not consistent with business and organizational priorities due to a lack of communication and alignment of goals and incentive programs.

Employees do not understand the corporate code of business conduct because it is not in their native language or clearly explained to them.

Although internal audit is responsible for its plan—including its assessment of risk—the function also needs to work with management and the board. Their insights and assessment of risk levels should be considered, though an independent internal audit function should make the final decision.

Unilateral decision-making can be difficult, however, when it applies to auditing governance-related risks. Management and the board—in some instances—might consider internal audit's involvement meddling. Moreover, there may be a perception that internal audit lacks sufficient independence and the skills and experience necessary to assess board processes effectively.

Nonetheless, internal audit must find a way around these potential obstacles. After all, if auditors are to provide assurance on the more significant risks to the organization, they cannot exclude the risks related to ineffective governance.

ADDRESSING RISKS

Once governance-related risks have been identified and assessed, internal audit needs to decide which to address in the periodic audit plan. It is not necessary or appropriate to audit every governance-related risk, only those that represent a more significant risk to the success of the organization and its achievement of objectives.

The next step is to determine how to address the selected governance process risks. Internal audit management should take each in turn and determine the best approach. Several options should be considered.

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Traditional Assurance or Consulting

Using traditional audit approaches, many governance-related risk areas—such as awareness of the corporate code of conduct, alignment of management incentive plans and organizational strategies, or the quality of information used by the executive leadership team and the board—can be addressed without significant problems. Practitioners are likely to find useful The IIA's 2006 Position Paper, *Organizational Governance: Guidance for Internal Auditors*. The paper draws an important distinction between the relative values of assurance and consulting services when applied to governance processes. In a relatively mature organization, the more valuable role for the internal auditor is likely to be providing assurance that governance policies and practices are appropriate to the organization's needs—including compliance with applicable laws and regulations—and operating effectively.

However, if the organization is still refining its governance processes, the auditor may contribute more effectively in a consulting capacity. As the IIA position paper says, internal auditors are in an excellent position to serve as "catalysts for change, advising or advocating improvements to enhance the organization's governance structure and practices."

Surveys

Employee surveys can be an effective means of obtaining the information necessary for an engagement. They can be especially valuable for audits of areas such as employees' understanding of the corporate code of conduct, management's understanding of organizational strategies, alignment of managers' incentive programs with organizational strategies and objectives, and whether the external auditors have a sufficient understanding of the business.

One variation of this option is to collaborate with the organization's human resources (HR) department to include desired questions in an HR employee survey. Many HR functions conduct periodic surveys to gauge employee satisfaction, confirm understanding of corporate policies, or collect information for other purposes. Including governance-related questions in the survey can provide a key source of information for the audit.

Outsourcing

To overcome the perception that the internal audit team lacks either the necessary independence or skills to audit governance processes, it may be appropriate to engage an expert third party to perform the work. Internal audit would select the consultant, approve the scope of work and the selection of individuals to perform the work, and dictate the form of the report.

Relying on Board Self-assessments

Many of the organization's governance-related risks are likely to be covered by board self-assessments. However, there is a risk that the board's assessment of its own performance—including that of its committees and members—may not be objective. The board may also lack sufficient insight into best practices and the ability to understand its own failings.

Before relying on board self-assessments, the internal auditor should assess the self-assessment process to reduce the risk of a poor result to a minimum. However, the board might direct internal auditors to rely on its self-assessment. In that case, the auditors should ensure the audit committee understands that related risks are not being addressed in the audit plan. (See also "Partnering With the Board or a Board Committee" below.)

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Relying on the Work of a Third Party The board may decide to engage a third party—such as a consulting firm or law firm—to assess certain governance processes and practices. The IIA provides guidance on such arrangements in Practice Advisory 2050-3: Relying on the Work of Other Assurance Providers. Internal auditors should ensure that the scope of work is sufficient to cover the risk, the other assurance provider's process is adequate, and the individuals involved can provide a quality assessment. If the internal auditor has concerns about any aspect of the engagement, these should be reviewed with the appropriate committee of the board—generally, either the audit committee or the governance committee.

Partnering With the Board or a Board Committee

Partnering with the board or one of its committees can be highly effective—the involvement of internal audit can provide a reasonable level of assurance that the board's self-assessment process will be sufficient. Internal audit could, for example, help the board develop the assessment questionnaires and process, as well as provide facilitation assistance. The internal auditors could also consider lending support to the audit committee's oversight of the external auditor, such as surveying management, summarizing results, obtaining responses to issues from the external audit partners, and facilitating a discussion among audit committee members.

Partnering With Another Assessor

There are times when the board or general counsel wants the assessment of a particular governance risk area to be performed by the in-house legal department or by a third-party expert. In such instances, internal audit might consider partnering with these experts, forming a relationship distinct from full reliance on another assurance provider or consultant. The arrangement can offer significant advantages, including:

- Ensuring that the engagement team has excellent subject-matter expertise (through the consultant) as well as knowledge of the company (from internal audit).

- Exercising more control over the scope of work, the way the engagement is performed, the conclusions drawn, and the report itself. For example, some consultants might be reluctant to express an opinion on whether the risk is managed effectively.

- Learning from the expert so that future audits can be performed in-house.

Excluding the Risk Area

While exclusion of the risk area from the scope of audit work is perhaps the least preferred option, internal auditors may find that their board does not believe internal audit would add value or that it should be part of their remit. The board might even ask that the internal audit charter exclude certain areas of the business, such as the adequacy of board processes. Internal audit may have to accept this direction for the present but work with board members to help them understand the value of internal audit assurance in this critical area.

CAREFUL PLANNING

In most instances, the chief audit executive (CAE) will need to "sell" the governance audit to executive management and the board, who are probably not accustomed to having internal audit examine this area. Governance is a politically charged subject, and many of the activities are performed or managed by individuals at the top of the organization. The CEO, chief financial officer, general counsel, and other top executives may not react with enthusiasm to the prospect of being the subject of an audit.

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Planning for an audit of a governance risk area should consider this possibility, with early engagement of those on the board or in key executive positions—such as the general counsel—who might sponsor and support the engagement. Planning should also address:

How the results will be communicated. Not only may the results be sensitive, because of the people who own the governance processes, but they might also have an impact on other matters. For example, an audit that finds defects in the audit committee process could affect the assessment of internal control over financial reporting required by the U.S. Sarbanes-Oxley Act of 2002. Strong consideration should be given to consulting with the general counsel and agreeing on the most appropriate manner for reporting the results, which might fall under client-attorney privilege.

Whether access to sensitive and confidential information may be needed. The audit team should discuss with management up front whether it will need to review documents such as board minutes or assessments of individual director performance.

Who should be on the audit team. In addition to ensuring that the team includes individuals with sufficient expertise in the subject risk area, it may be prudent for the CAE or other senior audit executive to participate. Depending on the sensitivity of the documents and discussions, CAEs may want to perform certain parts of the audit themselves.

The internal audit team may want to refer to the related guidance in The IIA's Practice Guide, Auditing the Control Environment. The guide's "Practical Considerations" section is especially relevant.

A KEY RISK AREA

A risk-based audit plan is probably not complete unless it includes consideration of the risks inherent in governance processes. Selecting which areas of governance to audit should be based on the assessed level of risk, determined with input from management and—in all likelihood—the board. Different governance risk areas may merit different audit strategies, but whatever approach is taken careful planning is required.

Audits of governance, whether assurance or consulting in nature, may not be easy, and they often carry political risk. However, they are clearly important and should be given strong consideration in the audit plan—not just because they are required by professional standards, but because governance process failures can be high risk. After all, as Lord Smith so aptly put it, "The fish rots from the head down."

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