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Lessons of an Auditor

Introduction

Individuals who have performed the chief audit executive (CAE) role can most likely compile a never-ending list of lessons learned from the experience. It can be beneficial to reevaluate those lessons at various crossroads in an individual career and share the experiences with others who may be considering a similar role. Through the act of sharing and identifying lessons learned, individuals who continue to pursue internal audit as a profession can assist in the advancement of the role of the internal auditor in today's business.

I have held the CAE role for two separate international companies. One company was a publically traded utility, whereas the other was a privately held engineering and construction company. The lessons learned from each experience were different, but in many ways, the challenges were similar. Lessons learned came from a variety of incidents and experiences faced while attempting to execute the responsibilities of the role. Post my role as CAE, I have worked with and trained thousands of auditors. In many ways, my own personal lessons are very similar to issues faced by other internal auditors and CAEs. The difference is the manner in which the individual involved chose to utilize the lesson or allow the challenge to define how he or she executes the role.

When speaking to auditors about the CAE role, I often relay,

> "If you can't stand the heat then stay out of the kitchen!"

This phrase is insightful when attempting to fulfill the CAE role. The phrase was one of my mother's favorite sayings when I was young. I was raised in an era prior to central air-conditioning, so my siblings and I would often complain about how hot the kitchen would get when mom cooked. My mother would get tired of our complaints, and ultimately, the dreaded phrase of "staying out of the kitchen" would be relayed.

There are CAEs who have been fortunate and had the full support of management and the board while maneuvering through challenges faced while executing their role. Other CAEs have struggled with aspects of the role, whereas others have had both challenges and successes.

Management's View

Management typically understands the basics of internal control and the role internal audit should play when validating control processes. The catchphrases of Sarbanes–Oxley, Foreign Corrupt Practices Act, Dodd Frank, whistle-blower, and internal control over financial reporting are all well understood. But in reality, management's focus is on the day-to-day operations and growth of the business. With this in mind, management periodically perceives the responsibility for internal control as one that internal audit should manage. Sarbanes–Oxley made it clear that internal control is the responsibility of management, not internal or external auditors. Confusion over the ownership of internal controls may come from how management and employees view the difference between job tasks and control points.

Consider the following scenario that involves an internal auditor interviewing an accounts receivable clerk.

Internal auditor: "Talk me through your job responsibilities and the process you follow when receiving payments in the mail."

Clerk: "I open the mail. If there is a check from a customer, I log relevant information related to the payment in a manual journal. I then take the check to the controller for deposit."

Internal auditor: "What would you describe as 'relevant information'?"

Clerk: "I have been informed that I am to log the check amount, check number, payee, customer number (if available), and the receipt date."

Internal auditor: "What controls are in place for ensuring that the check is deposited into the customer's account?"

Clerk: "That is the controller's responsibility; I just open the mail."

Internal auditor: "What happens if the controller is not at his desk when you go to deliver the check?"

Clerk: "I put the check in his top-right hand drawer."

Internal auditor: "Do you lock the drawer after placing the check in it?"

Clerk: "No."

Internal auditor: "How do you know that the controller actually found the check?"

Clerk: "Well, no one else sits at his desk."

Internal auditor: "Does anyone ever reconcile your log to deposits that are made to customer accounts?"

Clerk: "I'm not sure what you mean. I give the controller the log at the end of the month."

You should be able to identify where this conversation is leading. In essence, the purpose for the clerk opening the mail, logging the check, and taking it to the controller represents a control that auditors refer to as segregation of duties. From the conversation above, it is evident that the clerk does not understand they play a crucial link in the control system.

If you were to ask management or process owners to list specific control points within their functional area, you may find that they recite job tasks without realizing that some of the tasks are actually control points. When was the last time you evaluated if management understands that the responsibility for compliance and internal control rests in their hands and not the internal auditors? If management and the audit committee are of the opinion that internal audit and the external auditors will verify that everything is in full compliance, then the CAE role and the internal audit function may be in for more challenges than expected.

As I have revisited my own lessons learned, I have developed a Top 10 list that reflects many of the challenges of the CAE position as well as that of being an internal auditor. Individuals who consider entering a CAE role should be aware of these issues and prepared to address them head on. Undoubtedly, others will have similar or additional lessons that can be added to the list. But for purposes of this discussion, we will review the lessons and utilize them in later chapters to further develop concepts important for the CAE to address.

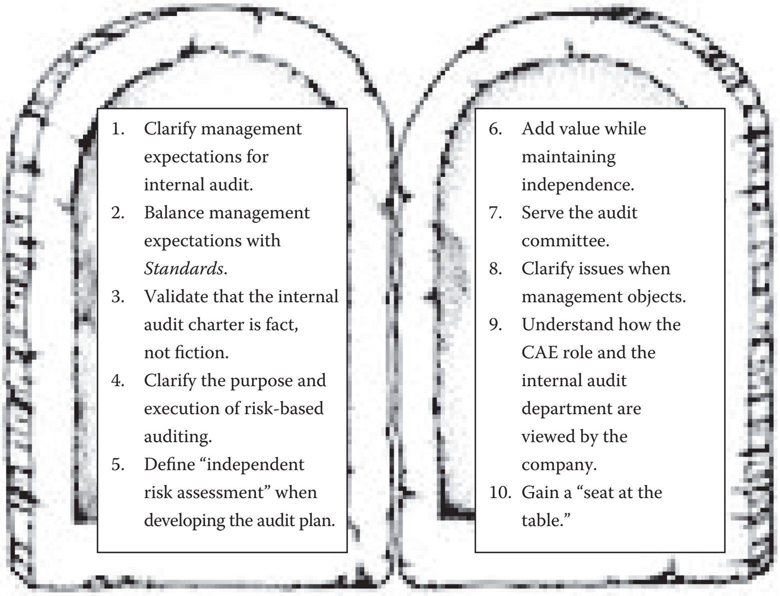

Exhibit 1.1 Lessons learned of a CAE.

The graphic in Exhibit 1.1 is a summary of the lessons learned outlined in the remainder of this chapter.

Section 1: Lessons Learned

Introduction

The poem by Robert Fulghum titled "All I Really Need to Know I Learned in Kindergarten" provides an analogy of how the simplistic concepts learned in kindergarten can be applied within everyday life. These concepts extend past personal lives into business and government. The poem recites simple learnings such as "share everything," "play fair," "clean up your own mess," and many other factors of leading a balanced life. The poem even speaks to the need to "hold hands when you go out in the world, watch out for traffic, and stick together."

As you review the lessons learned outlined in this chapter, consider the kindergarten rules and whether any particular phrase resonates with regards to the particular lesson identified. Consider the rule interpreted in each lesson. It some cases, the same or similar rule applies—the interpretation may vary. Consider whether the identified lesson and interpretation provide any insight to the particular challenges your function faces.

Lesson 1: Clarify/Define Management Expectations for Internal Audit

Kindergarten rule: *When you go out into the world, watch out for traffic, hold hands, and stick together.*

Interpretation: Not everyone sees things in the same light or recognizes concepts that may seem clearly outlined. It is important to make sure management and the internal audit team work together and are on the same page of the handbook when working through departmental responsibilities and expectations.

Companies utilize the internal audit function in very different manners. The profession has standards of practice; however, internal audit is not regulated by a law-making body. This allows organizations to determine how they believe internal audit should operate in their own individual environment.

When the Sarbanes–Oxley legislation was released in 2002, the role of internal audit became more standardized for publically traded companies. However, there are still a myriad of ways the function is viewed and utilized when it comes to assurance or consulting activities. The disparity can be witnessed by the many ways internal audit takes part in compliance services such as Sarbanes–Oxley versus consulting activities. The role may depend on the company's industry, culture, history, management, and a multitude of other variables.

CAEs and internal auditors strive to provide value to their organizations through a multitude of activities outlined in the *Standards*. In an attempt to provide proactive and progressive services, many CAEs evaluate how their audit groups can be involved in activities that allow for a visible profile for the department as well as initiatives that provide long-term value for the company. These may include

- Strategy and merger activities
- Operational, compliance, and financial reviews
- New system initiatives

- Consulting projects
- Continuous auditing
- Fraud and ethics reviews
- Enterprise risk management activities

Although the profession defines the internal audit activity as one that can incorporate all of the listed activities, the CAE may experience challenges from management when attempting to execute work on these various initiatives. If the internal audit function has previously been narrowly defined in scope and responsibility, the probability that the organization will embrace these additional services may be very low. An example is the experience many CAEs have when attempting to provide assistance toward enterprise risk management procedures. In some cases, the internal audit function is the actual facilitator and administrator of the process, whereas in other situations, management does not believe that internal audit should be involved with the process.

It is critical that CAEs enter their role with a full understanding of how the company has traditionally defined the responsibilities of the function along with their longer-term view for services. The inability to ensure that the CAE's expectations are in line with management and the board will result in ongoing challenges and potential stalemates on various initiatives and efforts. In the long run, this is not effective for the company.

Lesson 2: Balance Management Expectations with the International Institute of Auditors Standards

Kindergarten rule: *Play fair.*

Interpretation: Internal auditors understand the purpose and intent of the *Standards*. However, it is not unusual for management to have varying views that may conflict with the internal auditor's professional obligation to the *Standards*. The concept of playing fair correlates to ensuring that the *Standards* are not used as a bat or whipping stick when working to get management on the same page as the auditors. Keep in mind that the *Standards* are not laws; they are professional guidelines. The entire organization must understand the importance of playing fair and according to the guidelines of the profession.

Internal audit is a profession that is guided by *Standards*. Individuals entering the CAE role must be prepared to personally and professionally uphold the *International Professional Practices Framework* and *Standards* and execute the role with professionalism and independence. If there are gaps in management's awareness and acceptance of the existence of the *Standards*, the CAE will face pressures when attempting to execute their fiduciary duty.

Auditors play a role in validation and assurance. When under the scrutiny of an audit, process owners may not always be receptive to hearing that something in their area is not being properly executed. But inherently, the auditor's responsibility is to evaluate if the process was performed in accordance with controls in place. If a gap exists, the auditor may help to identify the potential exposure to risk and the related mitigating action needed to close the gap.

The internal audit profession has placed a significant focus on raising the profile of the internal audit function. As internal audit professionals, we strive to abide by the *Standards* and guidelines. With this in mind, consider a few questions:

- Have you asked management if they are aware that *Standards* for the internal audit profession exist?
- Does management understand the internal auditor's professional obligations to the *Standards*?
- Does management truly understand the concepts of risk-based auditing, independence, obligations to the board, and charter requirements?
- Have you discussed the concepts of a quality assurance review with management and the board, and do they understand the potential implications?

More often than we would like to admit, these basic concepts are not fully understood by management. Leading practice would suggest that the CAE provide periodic updates to management and the board regarding the status of the *Internal Audit Professional Practices Framework* and *Standards*. In addition, the CAE should ensure that any deviations from *Standards* is fully communicated to management and the board. The board and audit committee should understand the potential risks and exposures that exist when the internal audit group does not perform their responsibility in line with the *Standards*.

Lesson 3: Validate the Internal Audit Charter as Fact and Not Fiction

Kindergarten rule: *Remember the Dick-and-Jane books and the first word you learned—the biggest word of all—LOOK. Everything you need to know is in there somewhere.*

Interpretation: Internal auditors are accustomed to clarifying and documenting. We look to leading practice to guide us on the procedures most relevant to apply. We often utilize leading practice documents when developing departmental protocols and documents like charters. However, it is important to *look* at departmental charters periodically to ensure that the elements listed are executable and true in fact. Elements that appear in a charter that are not relevant to the organization or that could never be executed given the current structure may actually put the organization at greater risk.

An important attribute for an effective internal audit function is the existence of a well-defined and documented department charter. CAEs typically will ensure their department charter incorporates aspects considered appropriate by the IIA. CAEs must be cautious when adopting a generally phrased charter. Management and the audit committee must comprehend the words behind the document. The information may appear adequate on paper and may truly reflect internal audit *Standards*, but if the organization does not understand and accept the various aspects of the charter, the internal audit function will face many difficulties.

As an example, assume that the charter states, "The CAE has full access to the audit committee." *Standards* suggest this as a leading practice. Full access to the audit committee allows the internal audit department to maintain a level of independence and transparency. Although the concept may be included within a department charter, CAEs must evaluate whether the concept is embraced in practice by the organization. Consider the following:

- When was the last time the CAE had a one-on-one conversation with the audit committee chairman outside of private session?
- Does the audit committee have input to the CAE's annual review, compensation, or staffing requests?

- Is the audit committee involved in the placement or removal of the CAE?
- Can the CAE have conversations with the audit committee that remain confidential?
- Is the CAE comfortable talking to management and the audit committee about controversial issues?
- How is the CAE perceived by management and the audit committee when standing their ground on issues where facts support their position?
- Does the audit committee have sufficient input into the development of the annual audit plan?

A formal written document may exist, if the intent and purpose are not being executed, then the document is not worth the paper it is written on. The CAE must have the fortitude and conviction to surface concerns when actions are not being executed in line with the internal audit charter. If management and the audit committee do not accept the concept of free and open access, then the CAE must be able to address the fact that this is a guideline within the *Standards*. Absent this access, internal audit is not in compliance with the *Standards*. Then the question should be asked, is internal audit truly independent or performing a quality improvement function? There is a distinct difference between the objectives of a quality improvement group such as six sigma or total quality management and those of internal audit. The CAE and management must recognize this.

Lesson 4: Clarify the Purpose and Execution of Risk-Based Auditing

Kindergarten rule: *When you go out into the world, watch out for traffic, hold hands, and stick together.*

Interpretation: Make sure that management and internal audit are on the same page concerning concepts and the need for a true risk-based audit approach.

Management may communicate their expectations that the internal audit function operates utilizing a risk-based audit process. This may seem to be a clear directive. However, is it clear how management views the concept of risk-based auditing? Management may have a different interpretation than outlined in the *Standards*. Internal auditors view the concept of risk-based auditing as described by the *Standards* as well as other documents like Auditing Standard 5 and the Public Companies and Accounting Oversight Board interpretations. The CAE must gain an understanding of how management defines and views risk-based auditing.

Risk-based auditing obviously begins with identification of those risks that may prevent the organization from achieving strategic objectives. But holistic risk-based auditing can extend further than simple identification of risks to be covered within an audit plan. Auditors who execute risk-based auditing may extend the concept beyond audit plan development. Risk-based auditing can be used to determine the specific risks to test within an individual audit as well as the manner in which overall findings are reported. It can also incorporate the concepts of risk appetite and risk tolerance.

If the audit team extends their execution of risk-based auditing to include risks to be tested and the level of testing and reporting techniques, management should be in full agreement regarding the application of this process. Management must understand how the application of a complete risk-based approach will manifest in the full audit process.

If management and internal audit are not on the same page regarding how risk-based auditing will be applied, more confusion than clarity will be created. It may be important to ask a few questions to evaluate variations between management's understanding and internal audit application.

- Does management understand and embrace the term "inherent risk impact"?
- Has management and the audit committee agreed to an acceptable tolerance rate or risk appetite?
- How does management view the concept of control effectiveness rankings like strong, moderate, weak, effective, or ineffective?
- Does the internal audit function have a definitive outline of how they rank their findings (e.g., high, moderate, weak, acceptable, or unacceptable)?

- Can management and internal audit come to a consensus on the intent and meaning behind the rankings?

These questions may sound simple, but it is critical that management and the auditors sing from the same hymnal as well as from the same page. If not, the CAE should be prepared for disagreements.

Lesson 5: Define "Independent Risk Assessment" in Relation to the Audit Plan

Kindergarten rule: *Be aware of wonder. Remember the little seed in the Styrofoam cup: The roots go down and the plant goes up, and nobody really knows how or why, but we are all like that.*

Interpretation: Everyone sees things in a distinct and separate manner. Similarly, the concept of independent risk assessment may be viewed differently by each company, management, and internal audit function. It is important to clarify the concept of independent risk assessment to ensure a consistent organizational understanding and application.

The concept of independence and development of the annual audit plan can be viewed from various perspectives. Frequently, management will take the position that the internal audit group should "independently" determine areas to include on the audit plan. Auditors may understand how to structure a risk assessment and develop an audit plan; however, without management input on the related processes and embedded risks, the plan could be subject to questions when executed. In this respect, management must understand that the most effective plans are a combination of management input and assessment, auditor evaluation, and senior executive and board input. If those inputs cannot be tied together, the audit team can expect difficulties.

Lesson 6: Add Value While Maintaining Independence

Kindergarten rule: *Play fair. Put things back where you found them. Clean up your own mess. Don't take things that aren't yours.*

Interpretation: The concepts of independence are complicated, and it is important to remember to play fair when executing responsibilities.

Adding value may mean giving credit where credit is due or "putting things back where you found them." It may also mean cleaning up your own mess.

Independence and objectivity are critical attributes for internal audit, yet they are also very difficult to effectively execute. As employees of the company, an inherent conflict is created when applying independence. This is one of the reasons many CAEs struggle with exerting their independent authority.

CAEs who are unable to fully exert independence and objectivity in their job roles are not in compliance with professional *Standards*. This doesn't mean that the CAE must continually buck the system or prove their opinion is the right one. However, it does mean that the CAE should be able to openly express and relay their opinion to management and the audit committee. In the end, it is not the CAE's responsibility to make sure that management follows every recommendation that internal audit suggests. Management is responsible for internal controls, and they have the responsibility for ensuring that procedures implemented are relevant and workable in the business. It is possible that internal audit will provide a recommendation that is not in line with management's overall directions and purpose. Management ultimately must determine whether they will accept the control recommendation. However, the CAE and internal audit must execute their fiduciary role of communication of observations to the proper governance authority. Consider the following scenario.

Scenario: When the CAE Is Expected to Be a Yes Person Management may disagree with internal audit's recommendations and there can be strategic business reasons why the recommendation may not be relevant for the business at any particular point in time. However, the CAE has a responsibility to explain to management and the audit committee how the decision not to implement a recommendation will impact the company. There have been instances where CAEs have been told by their superiors that "It is not proper to disagree with management." This is a classic example of where the internal audit group may not be able to execute full independence. If the CAE sees things differently from management, they should have the ability to openly disagree and explain their opinion. Ultimately, it is management's choice as to what will occur, but for the CAE to be told that "You cannot disagree with management" is an attempt to influence or undermine the CAEs authority and position.

Lesson 7: Serve the Audit Committee

Kindergarten rule: *The complete poem*

Interpretation: In this instance, the responsibility of serving the audit committee can be correlated to almost every lesson outlined in Robert Fulghum's poem. When serving the audit committee, auditors should employ all aspects of playing fair, sticking together, taking responsibility for their own actions, and learning when and how to appropriately communicate the aspect of cleaning up messes. As a challenge, internal auditors should revisit the poem and link individual responsibilities and challenge areas to components outlined in the kindergarten rules. Think simplistically. Everything can be translated into everyday life.

The audit committee is tasked with oversight for financial reporting and oversight of internal audit. Serving the audit committee is one of the top priorities for any CAE or internal audit function. With the impetus of Sarbanes–Oxley, the audit committee's responsibilities and obligations have dramatically expanded. The time requirements to fulfill the role have become greater over the years. In addition, audit committee members are held more accountable for their increased responsibilities. This increased time commitment and responsibility can impact the ability of the internal audit group to obtain the required attention of the audit committee implied by the *Standards*. Yet, it is the responsibility of the CAE to ensure effective use of the audit committee's time through appropriate and timely reporting and communication. This can be easier said than done. Difficulties can be encountered from many angles.

One dilemma faced by internal audit is the limited time allocated to deliver reports during the quarterly audit committee meetings. Internal audit *Standards* suggest that the CAE work with the audit committee chairman to establish the quarterly agenda. However, the reality is that in many organizations, the agenda is controlled by the chief financial officer (CFO) or chief executive officer (CEO). The allocation of time is often concentrated on financial reporting procedures or legal issues. This limits the time available for internal audit reporting. In addition, often, the materials or board book provided to the committee is organized by the CFO or CEO. Internal audit may be allocated a minimal number of slides or pages to communicate their message. All of these challenges contribute to how well the audit group can truly serve the audit committee.

The manner in which internal audit groups report information to their audit committees is as varied as the manner in which administrative reporting lines are handled. Some organizations provide the audit committee with the entire audit report, whereas other companies provide the committee with an executive summary. In instances where the company has defined a risk tolerance threshold, internal audit may only communicate issues to the committee that breaches that tolerance level. In addition, the timing of delivery of the reports may be varied. In some circumstances, reports are delivered at the quarterly audit committee meetings, whereas in other instances, reports are sent to the committee at the same time they are issued to the process owners and management. All of these factors may impact the time and attention that the committee has to allocate to issues identified within the reports.

A critical concept is for CAEs to work with audit committees to ensure there is an agreed to process for the type and method for communicating audit issues. The prevalence of increased audit committee responsibilities has facilitated the utilization of risk tolerance and risk threshold when determining issues communicated to the committee. This process may assist committees in sorting through issues of significance. Auditors have been trained to document all testing exceptions or potential control gaps. This can result in lengthy detailed reports on issues that may be classified as low risk or simple policy concerns that do not have a significant impact to the organization. For internal audit groups who provide their entire detailed report to the audit committee, they may find that it becomes difficult for committee members to identify the most significant issues that were uncovered during the audit.

To most effectively utilize the limited time of the audit committee, CAEs should work closely with the committee members to understand the type and significance of issues that reach the tolerance threshold for communication.

Verbal Communication You may have heard the phrase that "A CEO's relationship with the board and audit committee is sacred." CAEs who are informed of this relationship are being softly advised to use caution in their communications outside of management purview. This advice from management can make establishment of a close and trusting relationship with the audit committee difficult.

In theory, the CAE should be able to contact the audit committee when deemed necessary. Leading practice states that the CAE should meet with the audit committee, or at a minimum the audit committee chair, privately and more frequently than a quarterly basis. This again can be a difficult task to execute. Often, members of the audit committee reside in geographical locations other than the company they serve. This makes it difficult for the CAE to have casual meetings, lunches, or information sessions with the audit committee chair. However, there are many ways frequent and timely communication can be managed. In today's world of advanced technology, CAEs have the ability to utilize teleconferencing, web-based meetings, or even conference calls to stay in touch with the audit committee. Communication methods and frequency should be agreed to with the audit committee and fully understood by management. In addition, the CAE should have assurances that information relayed to the audit committee will be kept confidential. Many CAEs experience challenges in this area. If management's relationship with the audit committee is closer or more trusting than the relationship that the CAE holds with the committee, it is not unusual for information to inadvertently circle back to management. This creates the increased dynamics of third-hand communication, which can result in the message being altered in its delivery. Ultimately, if the CAE and the audit committee are unable to establish mutual trust and respect, the best interest of the company is not being served.

Lesson 8: Communication of Issues When Management Objects

Kindergarten rule: *Don't hit people, and when you go out into the world, watch out for traffic, hold hands, and stick together.*

Interpretation: Communication is an art. Be cognizant of how communication is perceived especially when others are not in full agreement. Gaining agreement and acceptance or sticking together will take you much further than fighting over irrelevant issues.

Auditors may be taught that overcommunication is a virtue when it comes to identified issues and communicating with the management. "No surprises" can be the mantra. There are opposing sides to this issue. Communication of findings prior to ensuring all items are validated can result in many difficulties. Auditors should ensure they have a strong protocol established within their audit methodology for how and when issues will be communicated not only to the process owner but also to management and the audit committee. Considerations include the following:

- *Ensure the observations and facts are correct and that the timing of the communication is proper.* Otherwise, management may view actions as jumping to conclusions.
- *Be cognizant of e-mail communications.* With today's technology, it is easy to default to sending a question via e-mail. However, think about the volume of e-mails received daily. What may be viewed as an efficient way of obtaining information from an audit perspective may be seen as time consuming and bothersome by the process owner. In addition, there is always the potential that the written request will be misunderstood or misinterpreted.
- *Understand the company culture and how report communications are expected and accepted.* If the company exists in a culture that operates on the principle that all T's should be crossed and I's dotted before an issue is relayed, the CAE should understand when it is acceptable to step on either side of the communication line. Some may view this as a potential independence question, but this is not the issue at hand. Lack of independence is related to the inability to report a validated finding to the respective party because of management pressure. Timing and form of communication will be variable in all companies. The bottom line is to ensure that issues are validated and communicated in the most efficient and effective manner to ensure proper risk mitigation.

Lesson 9: Understand How the CAE Role and Audit Department Are Viewed

Kindergarten rule: *Live a balanced life—learn some and drink some and draw some and paint some and sing and dance and play and work every day some.*

Interpretation: Internal auditors understand the role of the CAE as defined by professional *Standards*. However, it is important to "balance" our perceptions and how we execute the role with the manner in which management and the audit committee view the role. In essence, ensure that you are "living a balanced role."

When entering a new company or simply accepting the CAE role within your existing company, understanding the perception of the role and the function can be critical to how job tasks will be approached and executed. Think of the concept of the internal audit process from the eyes of auditees. An audit, no matter how well planned and announced, interrupts the normal flow of daily work. It is unusual when auditors are welcomed with open arms to conduct an unplanned audit. When evaluating the organization's view of internal audit and how the CAE role is viewed, consider how your organization would respond to the following questions:

- What is the CAE's organizational positioning?
- Is the CAE or the internal audit group included in strategic business initiatives?
- Is the internal audit group considered the go-to group for fraud evaluations?
- When was the last time the CAE was involved in a strategy discussion?
- How often does the CAE have an independent discussion with the CEO?
- Does the CAE have open access to all process areas, the management, and the board?

When considering a CAE role, work to obtain complete insight to the expectations of the internal audit function. Interviewers like to represent the position as one that is an important contribution to the company. The phrase "We are working to upgrade our function and obtain increased value from internal audit" may be utilized during the recruiting cycle. This is a great concept and definitely an attractive challenge for any professional. However, if the history of the organization has been one where the internal audit function has experienced significant flux or difficulty, it is important that the CAE be aware of the political challenges that may be faced. Some of the important aspects to be aware of in order to be properly prepared to execute the role include the following:

- *What is the organizational positioning of the internal audit function?* Is it buried deep within organizational ranks, or does the CAE have a direct reporting role to the CEO? The answer to these questions can provide important insight into the status of the function.
- *Has the internal audit function and CAE position experienced frequent turnover?* If so, why has this occurred? Has the CAE moved on to different areas within the company, or have they left the company? Inability to maintain some continuity within the audit department and the CAE role can be a leading indicator of how the function is viewed or valued.
- *Does the CAE have authority and responsibility for independently issuing audit reports?* What influence does executive management have on how issues are stated or outlined within reports? If the internal audit group experiences significant challenges in issuing reports due to management resistance or pushback, the CAE should evaluate whether the current reporting process is effective for the organization.
- *How does process area management respond to identified issues?* When an issue is identified, management's basic instinct may be to justify and explain why something may have not been done in the manner expected. This is a natural reaction and a challenge faced in most audits. If management refuses to accept responsibility for validated and identified issues and places blame on the auditors, the CAE must be able to address this with senior management and the audit committee.
- *Are there political sensitivities when the CAE speaks to the audit committee outside of board meetings or without preinforming management?* If the CAE feels they do not have open access to the audit committee, independence, trust, and respect are in question.

- *Does the CAE maintain responsibility for their departmental budget?* When the internal audit function is buried deep within organizational ranks, periodically, the CAE may not have responsibility for control of their own budget. When this occurs, it is difficult for the CAE to properly manage their resources and execute their responsibilities.
- *What is the method for determining staffing for the internal audit function?* Companies utilize many methods to determine necessary staffing for internal audit. Staffing may be tied to the perceived role of internal audit. If an organization views internal audit as an asset assurance area, the function may be staffed utilizing benchmarking of company physical assets. Other companies may view auditors as responsible for revenue assurance. In this instance, the function may be staffed based on the scale of revenue generated by the company. Still, other functions may see internal audit as a compliance function and staff with resources based on needs for Sarbanes–Oxley compliance or other regulatory and legislative compliances. However, if staffing is sparse or limited when comparing to benchmarks, the CAE has the responsibility to alert the audit committee regarding the ability for the department to meet expectations.

  As a CAE, understanding the charge and obligations of the function and how the organization views staffing needs will assist in appropriately managing resources. If the organization is typically staffed based on a revenue scale, and expectations are changed to include asset verification or Sarbanes–Oxley compliance, it is important that the CAE be able to explain to management and the audit committee the ramifications or needs for changes to the internal audit staffing levels. Today's business world is one in which professionals are often expected to do more work with less resources. Internal audit is not immune to that theory. Even though there are many ways internal audit can gain and achieve efficiency in their work, it is still critical that the appropriate resources exist to meet expectations.
- *How does the company view the need to utilize internal audit as a training ground for professionals?* Some companies view the need to rotate professionals through the internal audit

function to provide them with a more holistic view of organizational processes. The exposure an auditor may be able to obtain through various audits can be invaluable to the company. But there are a few things to remember and consider.

- *How large is the audit group?* Large audit groups may be able to more efficiently absorb the need for ongoing retraining and organization flux resulting from a rotation program.
- *Does the organization view internal audit as a profession?* Just like any strong profession, the desire to be a career auditor should not be viewed negatively by an organization.
- *Does internal audit staffing maintain some semblance of stability?* This is critical to provide overall value to the organization. Continual rotation or turnover within the function exacerbates the concern that many process owners will often express that "the auditors don't understand our processes."

These may be a few red flags that the CAE may have a tough road to climb in transforming the function to one that abides by the *Standards* and is accepted and embraced by the organization. Understanding the challenges faced and the road that must be traveled will assist in mapping out the right path.

We will discuss the concepts of internal audit staffing and auditor rotation within Chapter 3 of this book. For our initial purposes, the important lesson learned is to understand the various implications of staffing scenarios that may be presented.

Lesson 10: Gaining a "Seat at the Table"

Kindergarten rule: *When you go out into the world, watch out for traffic, hold hands, and stick together.*

Interpretation: To gain the perennial seat at the table, the CAE must build strong relationships with management that include developing trust and respect. It is important that internal auditors stick together and understand the professional *Standards* to enable proper communication of requirements and expectations to management. Through holistic application of the *Standards* by all CAEs, internal auditors will be able to more readily gain the coveted seat at the table. However, absent CAEs sticking together and abiding by the *Standards*, management will continue to view the profession as one in which they can dictate the acceptance of guidelines.

The term "seat at the table" is in reference to having the ability to provide direct input or influence to the company's strategy and leadership processes. The internal audit profession refers to the need for the CAE to gain a seat at the table. If management would fully embrace the *Standards*, this concept would be much easier to facilitate.

Statistics continue to show the majority of CAE's report to someone other than the CEO. This is one factor that makes the ability to gain a seat at the table very difficult. Even when the CAE has open access to the CEO, the ability to understand the direction, strategy, and risks of the company is difficult unless they are part of the table where those decisions are openly discussed and vetted.

As a CAE, I have been in the position where I had a true seat at the table and in other positions where I did not. The advantage and knowledge gained by being part of a formal leadership team afforded me as well as the audit department invaluable information. In my case, prior to having the perennial seat at the table, I had been employed by the company for over six years. The CAE position had reported to a variety of functional areas including a chief risk officer, corporate compliance officer, and corporate financial officer (CFO). In the later years of the company's history, the CFO resigned, and the company chose not to replace the position. A decision had to be made on how to realign the CFO's direct reports.

This was an instance where, as a CAE, I faced a very difficult and political challenge. When the CFO resigned, the company immediately realigned three of his direct reports to the CEO. However, my position and another direct report were left in limbo for a period of time. I was not consulted regarding my opinion for alternative reporting lines for internal audit.

As time passed, I felt that the company was considering realigning the internal audit function under the legal department. Although that is a possible alternative, I did not believe that it was the proper alignment for our company at the time in our evolution. I made a personal decision to voice my opinion. I contacted the CEO to set up a meeting to provide him information about recommendations from the *Standards* and potential alternatives for reporting lines. Unfortunately, he was not available and would be out of contact for several weeks. This resulted in having to break one of the golden rules of strong communication. I had to carefully script my message and relay it via voice mail. My next step was to reach out to the audit committee. I was fortunate that I had gained the trust and respect of the committee members. I had been placed in the CAE position for the company after an exhaustive search performed by a retained search firm. After my promotion, the committee often expressed their appreciation regarding my openness and transparency of communication. In this instance, I made the decision that the proper and ethical thing to do was to inform the committee about the alternative reporting line options and to also further educate them on the *Standards*. Ultimately, the committee agreed with my recommendation. The audit committee chairman informed the CEO that my reporting line should be moved directly to him.

This action and decision came with many political and social ramifications that lasted for almost a full year. Obviously, several leadership team members were not happy with the fact that I brought the issue to the audit committee. However, as outlined in the *Standards*, part of the committee's responsibility was oversight of the CAE and input into the authority, reporting responsibility, and compensation. Since my company was a publically traded entity, I felt responsible to ensure that the committee knew the various options as well as the pros and cons of the alternatives. Although there were many challenges ahead, the issue worked out positively. It was a difficult time but one that I accepted. Two years later, my company entered into a strategic sale process. My ability to have a true seat at the table allowed our internal audit group to continue to effectively function during the sales process and transaction close.

I am often asked, "How does the CAE gain a seat at the table?" In my opinion, there is not one universally correct answer. Many variables must be considered. Those include the following:

- *Trust and respect for the internal audit function and the CAE position*. If the internal audit function is not viewed as a respected area of the company, it is doubtful that a seat at the table is in the CAE's near future.

- *An open and transparent relationship with the audit committee.* When the CAE has a close and trusting relationship with the audit committee, their voice and opinion are more likely to be solicited.
- *The company's industry and status as either a publically traded organization or a privately held entity.* A CAE in a publically traded company is in a stronger position to work their way to the table. In a privately held company, the internal audit function is not necessarily a requirement, and as such, the CAE position is seen in many different lights. The ability to gain the seat at the table may be more difficult in those situations.
- *The company's overall structure and geographic disparity.* In complex organizational structures, the positioning of internal audit can be very different than it may be within a more simplistic organizational structure. This dynamic may contribute to where the CAE role resides in the organization.
- *Internal audit's relationship with the external auditors.* Often, the opinion and relationship with the external auditors can impact how management views the organizational positioning of the CAE. Management typically sees the external auditors as independent. If the external audit firm supports the need for the CAE to have a seat at the table and can assist management in understanding the strategic value that could be provided, the organization is more likely to consider such a move.

Regardless of the variables involved, an important element of gaining a seat at the table is ensuring that management understands the internal audit *Standards*, the reasons behind the *Standards*, and the suggested reporting lines. Also, the ability to have the respect and trust of the audit committee is a critical hinge pin in the decision.

Section 2: Is It Legal or Is It Ethical?—The CAE's Dilemma

Introduction

The phrase "Is it legal or is it ethical?" can be a mini mantra of the internal audit function. Auditors will sometimes describe the dilemma when identifying a control gap that legally may be acceptable but morally may not. Many professions have their own code of conduct. The code is established to ensure that professionals follow proper morals and behavior as expected in their roles. Lawyers, doctors, certified public accountants, as well as other professional roles have detailed codes of conduct. The IIA has defined a code of ethics for the profession. The code states the principles and expectations governing the behavior of individuals in the conduct of internal auditing. It also describes the minimum requirements for conduct and behavioral expectations. But the ethical line is not always a black-and-white demarcation. In addition, legal implications can impact how gray the line may appear.

The business world has become very complicated. Business ethics can be difficult to instill in everyday business practices. The concept in a vacuum seems obvious, but in application, actions and consequences can become blurred. The development of voluntary, written codes of conduct has been a practice for many years. The American Medical Association established its first code of conduct in 1847. The concept of business ethics didn't become common in the United States until the early 1970s. The idea of a socially responsible company or one that is motivated to behave morally or ethically arose following public outrage over various business scandals. Scandals led to increased regulatory scrutiny, which led to companies developing their own business ethics policies.

Outsiders have questioned the motivation of the trend for businesses to put in writing a business ethics policy. In spite of increased regulatory attention and companies' self-promotion of ethical conduct, years after the Enron scandal, incidents of questionable business conduct continue. The actions of the financial industry in the fall of 2008, which nearly brought down the national economy, is a case in point. "What went wrong?" or "What wasn't clear?" Let's dissect the term ethics and discuss components that contribute to the concept.

Everyone is responsible.
Tone at the top is essential.
Honesty is still the best policy.
Integrity can be a measure of ethics.
Corporate responsibility and communication must be prevalent.
Silence is not acceptable.

Everyone Is Responsible

When the word ethics is surfaced, individuals tend to promulgate that its primary responsibility lies with the leaders of the organization. Although it is true that ethical behavior must be demonstrated at the top, it is an imperative for everyone in the organization to display similar behavior. Think back to the first real ethical dilemma you encountered. It may have occurred long before you entered into the business world, whether it was an incident you faced with some decision as a child or later into your teenage years. Often, those experiences and how they evolved impacted your moral sense of ethical responsibility. If professionals view that certain individuals are not held accountable for their actions, they may question the concept that everyone is responsible. Ethics can be an unquestionable choice for some, whereas others may find that certain elements can be rationalized. This is why organizations find it important to standardize their view of conduct and ethics into a written, well-communicated, and well-trained code that is made an integral part of the organization. However, the code must be more than a written document; it must be practiced and evident in the behavior of the organization. Professionals must be able to clearly see that all employees are held equally accountable for their actions and behavior. If questions exist, some will debate the concept of whether ethics is truly valued by the organization or whether the organization places more value on protecting certain individuals through legalities.

Tone at the Top Is Essential

Many experts will claim that ethical behavior and conduct must start with tone at the top. Although it is a critical attribute, we must accept that not all individuals will have the same morality and opinion as ours. In other words, simply addressing tone will not ensure that the organization appropriately acts when faced with an ethical dilemma. If there is any question as to the path that is most appropriate, individuals may find it easier to rationalize alternatives that may not be in line with the company's overall code. This is exactly why organizations must not only rely on what they deem as tone at the top but also ensure that that tone is actually exemplified in day-to-day practices.

Tone at the top must be communicated frequently, openly, and honestly and put into practice by every individual within the organization. Individuals will follow their leaders and learn from their actions. These actions should be undeniable if questioned.

Honesty Is Still the Best Policy

All too often, ethics and corporate responsibility don't equate to honesty in the workplace. Honesty may mean admission of wrongdoing, poor judgment, or even an honest mistake. If employees are conditioned to act with caution when discussing actions in the workplace that may have negative implications, the concept of open and transparent communication is not being upheld. Organizations must ensure that all professionals can openly discuss concerns with the appropriate level of management. This doesn't mean that everyone's word or opinion is taken at face value, but if employees do not feel that they can freely express their thoughts, ideas, and observations, the culture may be sending the wrong message. Ethics deals with morality issues. Most people's level of morality reaches varying tolerances. When you are personally faced with an ethical dilemma, ask yourself whether you are looking at the situation as honestly and transparently as possible. If questions still arise, it is your obligation to raise those questions to individuals in positions of responsibility. The legality of the issue may not be the right answer when looking at the moral side of the issue. That is when the assistance of others must be enlisted to ensure that the organization's needs are being met.

Integrity Can Be a Measure of Ethics

Can you identify three individuals who you feel display unquestionable integrity? Do those same individuals measure high on the ethics scale? Most likely, they would. Integrity is adherence to a moral code reflected in honesty and harmony in what a person thinks, says, and does. Those regarded with high integrity normally possess a strong set of morale ethics. From a corporate viewpoint, are the members of your leadership team individuals whom the employee population will view as having strong integrity and moral ethics? These are the professionals employees will attempt to emulate. This can be the mirror into your organization. If the concept of integrity is masked through legalities, employees may question adequate tone at the top.

Corporate Responsibility and Communications Must Be Prevalent

Since the early 1960s when business ethics came in vogue, the topic of corporate responsibility, ethical behavior, and compliance has been on the radar for the Securities and Exchange Commission and other federal and state regulatory agencies. Yet, corporate responsibility goes far beyond environmental initiatives, community support, and being a good neighbor. Corporate responsibility is owned by each and every employee. Whether it is a dedication to recycling efforts, contributing to community causes, or providing appropriate feedback to your staff and supervisors regarding how to make the business better, this is the true intent of corporate responsibility. Organizations must learn to embrace the concept that individuals who work in the organization have daily observations that can improve operations and business processes. The inability to encourage feedback from employees and to find an outlet to use these creative ideas is a failure of corporate responsibility.

Silence Is Not Acceptable

Silence can occur due to the fear of retribution. The only way to advance the elimination of business scandals that have pervaded our everyday life is to erase the concern that silence is golden. Many employees see things in their day-to-day job that may be questionable. However, they turn the other eye due to fear of retribution or potential legal threats. Ensure that your employees know the appropriate outlet for surfacing concerns or questions. Consider the following questions:

- Do you have an independent hotline? If so, how many calls does the hotline receive?
- Do those numbers appear to be realistic given your employee base and business?
- How well is your hotline publicized?
- What comprises the issues reported to the hotline?
- Do vendors know about your hotline and understand that they can register a complaint?

- How is your hotline managed?
- Have you ever attempted to call the hotline yourself? You may be surprised at the level of questions/comments you do or don't receive.

Ethics and corporate responsibility will continue to be hot topics in corporate America for years to come. As the economy continues to struggle, or rebound, the ethical behavior of those within business will dramatically impact the success of that recovery. It is no longer acceptable to be the Enrons of the world where a best-practice code of conduct sits on the shelf but is not embraced or actually displayed in practice. Organizations must focus on all aspects of their ethics program and look further than the policy itself. They should ensure that the policy is practiced, enforced, and updated, and compliance is adequately measured and reported. Those are the true signs of a policy in action.

Internal audit may face specific challenges if the administrative reporting line runs through the corporate legal department. There can be an inherent conflict when determining which side of the gray line is best for the organization. Lawyers have a duty to legally protect the company. Although internal auditors also have a strategic interest in protecting the company, when sensitive issues are identified, the manner in which they must be communicated and relayed may create legal exposure to the company. As they say, a picture is worth a thousand words. So let's paint a picture.

Scenario: Legality versus Ethics Assume a scenario where internal audit has completed a review of executive expenditures. During the review, abnormalities are identified in a senior leader's business expense reports. The auditors find that not only were expenditures artificially inflated, but also there were numerous instances where proper documentation was not maintained. Assume that the internal audit group also found discrepancies with issues that may have Internal Revenue Service income-reporting issues.

Now, view the issue from both the legal side and the internal audit side. The legal side would definitely have an interest in rectifying the issue; however, they are also obligated to legally protect the company and its employees and executives. They may prefer that the issue be reported quietly and discretely to eliminate the exposure to public criticism. The legal department is interested in protecting reputational or customer perceptions. From an internal audit viewpoint, regardless of the level of dollar impact, this instance could be viewed an intentional misappropriation that the auditors feel obligated to communicate to the audit committee. So, the question becomes, "Is it legal or is it ethical?" From a legal perspective, it may be sufficient to resolve the issue and ensure that the proper reporting occurs. From an ethical perspective, the issue reflects the tone of the company and the overall control environment, thus the dilemma and predicament.

Ethics is often tied to individual or organizational morality. Legal issues are a matter of stated law or legislation. As evidenced by the many opinions and challenges that exist on various legal standards, the ethical question can be just as debatable. The answer to "Is it legal or is it ethical?" can be very different. Ultimately, how an organization addresses this question contributes to how the organization tone and culture are maintained.

As auditors, we must expect resistance and skepticism when it comes to certain issues, especially those involving senior leaders. However, the internal auditor must acknowledge that the profession maintains a code of conduct. If the auditor feels that the issue is one that should be reported to the audit committee, they have an obligation to follow through on that action.

Summary

These are a few lessons learned. These concepts will be used in later chapters to further analyze their connection to the *Standards* and their challenges to internal auditors.