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The broken triangle?
Improving the relationship between internal audit, management, and the audit committee

The broken triangle

The disconnect between internal audit, executive management, and the audit committee is nothing new. The broken triangle has existed for decades at many organizations, with varying degrees of severity.

But dysfunction that was deemed tolerable in the '80s, '90s, and '00s is unacceptable today. The stakes — both personal and corporate — have been ratcheted to a new level. Regulators, analysts, stakeholders, and even litigators all have a keen interest in how well this corporate trio, so essential to good governance and effective risk management, works together to protect and propel the organization.

What are the symptoms of a broken triangle? Financial restatements. Material weaknesses. Regulatory noncompliance. Contentious or ineffectual board meetings. Voluntary and involuntary turnover. Missed earnings. Excessive litigation. Failed partnerships and alliances. Unmitigated risk. And so on.[1]

If your organization exhibits any of these symptoms, you have an obligation to seek a cure. A good place to start may be to examine the structural integrity of the triangle.

1 We are not suggesting that every instance of material weakness, financial restatement, regulatory noncompliance, and the like is directly attributable to the broken triangle. These problems may arise despite a functional relationship between the three parties. Nonetheless, we contend that in most cases, a dysfunctional relationship is a contributing cause, and in some cases, a primary cause.

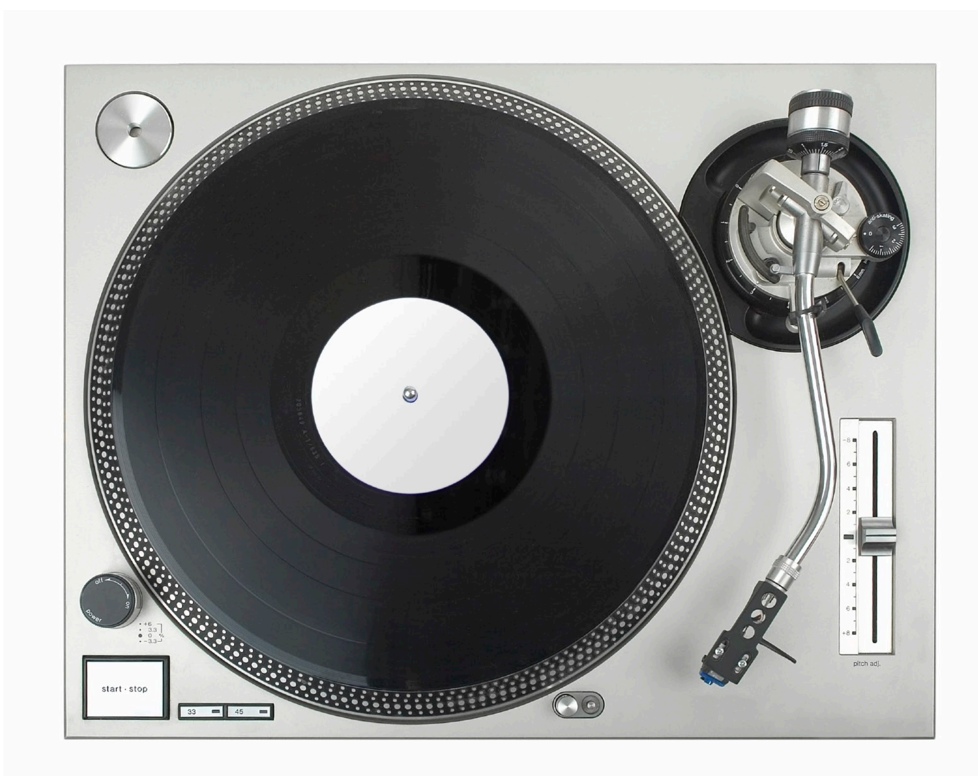
Off the record

Convince a chief audit executive to speak off the record, and you may be in for a shock: oftentimes, internal audit is not the independent, objective organization it's thought to be.

In some companies, ostensible reporting lines notwithstanding, the CAE does the CFO's bidding. The latter controls budget, staffing, and the audit plan, which, from a practical standpoint, can effectively neuter internal audit's independence and objectivity.

Ideally, internal audit serves as the eyes and ears of the board and audit committee, an essential component in the system of checks and balances. But how can a CAE confidently and reliably report up problems if he or she is worried about job security?

As Upton Sinclair famously stated: "It is difficult to get a man to understand something when his job depends on his not understanding it."



Who's your boss?

Every organization has a pecking order, and determining your place is as easy as answering one question: Who's your boss?

Yet reporting structures for the CAE often defy this simple analysis. In many organizations, the CAE reports functionally to the audit committee and administratively to the CFO or CEO. Consequently, the "who's your boss?" issue becomes instantly muddled. Serving two masters can present problems in terms of allegiances, independence, and effectiveness.

In other organizations, the CAE reports to the controller. Now, we have nothing against controllers. (Some of our favorite people are controllers.) But when you consider the responsibilities and expectations under which internal audit operates, placing the CAE at this level of the hierarchy makes little sense.

As the pecking order rules state: *The lower you report, the harder it is to team with executives at higher levels*. And when it comes to running an effective internal audit operation, teaming is key.

So give your CAE clout along with responsibility. Make him or her a true senior executive of the company to provide the respect and visibility accorded such positions. Remove any ambiguity as to whom the CAE reports. And make sure the boss sits high in the organizational chart.

The name game

Relatively few people outside of the UK know the queen of England's last name. She is "Her Majesty," not Liz Windsor[2], with good reason: Titles confer respect.

A name is a powerful tool, both practically and psychologically. Judges are "your honor" and governors are "the honorable." Whether or not you agree with the designation, it does exert a powerful influence over those who come in contact with the person.

The same holds true for "Internal Audit." We suggest you consider renaming the function "Audit Services." The new title will provide more of an association with value and service rather than connotations around internal affairs and policing.

"Audit Services" presents an entirely different image to the world and a fresh approach to the function. It is more accurate and descriptive, and it better informs others what they should expect from the function.

Don't take the suggestion too far, however. We recommend you avoid calling the CAE "your majesty."

2 Technically, she is not even the queen of England. She's "Queen of the United Kingdom of Great Britain and Northern Ireland."

Great expectations?

Ask leaders in your organization where internal audit's primary focus should be, and you may be surprised at the range of responses. To illustrate, take the quiz below.

Compare results with others in your organization, and you'll probably discover that this simple test highlights a vexing problem: thinking around the proper role of internal audit is not aligned.

At a high level, we usually find that the audit committee and the board want reassurance and value protection, while management seeks strategic focus and value creation.

Unfortunately, if everyone expects something different from internal audit, no one is likely to be satisfied.

IA in focus: A short quiz

What is the primary function of internal audit? This quiz will help determine if your thinking is aligned with others in your organization.

Step 1: Circle your role from the choices below.

Step 2: Where should internal audit primarily focus its attention? Circle one item.

Your role	Internal audit should primarily deliver …
Audit Committee	1. Reassurance and Value Protection
Upper Management	2. Strategic Focus and Value Creation
Board of Directors	3. Business Risk Insights and Risk Mitigation
Internal Audit	

Perfect assurance?

Sometimes audit committees and management don't know what engineers and actuaries intuitively understand: There's no such thing as perfect assurance.

For example, space shuttles are subject to tens of thousands of quality checks, yet sometimes they fail catastrophically. Insurance companies consult actuarial tables and pore over statistical probability, but sometimes they are still bankrupted by an unforeseen event.

Similarly, the audit committee and management sometimes have a false sense of reassurance as to the scope of internal audit's activities. For example, they may believe that all periods in a financial review are covered, or that 100 percent of transactions have been audited. This, of course, is rarely the case.

To avoid nasty surprises, the audit committee and management must understand the depth and breadth of coverage by internal audit. Audit plans and risk coverage should be clearly explained so that everyone understands exactly what work is being done — and not done.

Embracing risk

Any frank assessment of the current state of enterprise risk management (ERM) would have to conclude that spectacular failures define the field more so than its ability to keep businesses out of trouble.

Why does ERM so consistently fall short? Perhaps because internal audit is not sufficiently integrated in ERM activities. Considering IA's knowledge, objectivity, and methodologies, and in light of its ability to provide input to stakeholders regarding risk exposures, risk reporting, and risk management, it's stunning to discover how infrequently ERM activities and/or projects appear on IA's audit plan.

The potential for IA to enhance the effectiveness of an organization's risk management activities is immense. But to do so, internal audit needs to break free of its traditional role. Visionary IA groups can expand their job description to include roles such as the following:

- **Advisor:** advising management on risks related to strategic initiatives, organization, process and systemic changes
- **Prognosticator:** peering ahead to help management envision future risks and opportunities
- **Aggregator:** considering how risks interact and cascade
- **Efficiency specialist:** identifying inefficiencies in risk management
- **Advocate:** identifying and helping to mitigate risks associated with protecting and increasing shareholder value; advocating for resources to address risk areas deemed insufficiently covered
- **Subject matter specialist:** providing knowledge and experience in key risk areas
- **Troubleshooter:** getting involved in control remediation and design; helping to conduct and interpret risk assessments.

Cop, detective, or counsel?

Popular TV crime shows often have three main character types — cop, detective, and lawyer — a cast apparently ripped straight from internal audit. Consider these typical IA lineups:

- **Police -** In heavily regulated industries, or in organizations attempting to strengthen a weak internal control environment, a policing role for IA may be the norm. The disadvantage to this role is that it often puts IA at odds with management and others in the company.
- **Detective -** In this role, internal audit focuses on identifying issues and problems, uncovering facts for presentation to management. The downside to this approach is that internal auditors may feel pressured to find a problem (thereby justifying their existence) instead of proactively focusing on pertinent risk areas.
- **Counsel -** As trusted counsel, internal audit takes on a more participative role, advising on key business risks instead of simply performing audits. The IA group builds meaningful business relationships with management and the audit committee.

For which role is internal audit most suited? In our experience, organizations are best served when internal audit predominantly takes on a counsel role, while secondarily performing the other roles as needed.

The IA police? This model can often be a dead end, fostering resentment instead of collaboration. Most internal auditors don't see themselves as police officers. Care should be taken to ensure that the rest of the company doesn't perceive them that way either.

Across the (audit) universe

Astrophysicists tell us that the physical universe is expanding. Perhaps internal audit's universe should follow suit?

New threats and opportunities arise continuously, and organizations that are focused intently on the past (financial reporting) and the present (cash flows and quarterly earnings) may get eclipsed.

Consider, for example, carbon reporting. U.S. companies may soon have to measure and report on their carbon emissions. These reports will likely be audited and the implications of noncompliance may be significant. Is your company ready to take on this burden?

Think about IFRS. Adoption of international financial reporting standards appears inevitable for U.S. exchange-listed companies. And as many organizations are now learning, conversion involves much more than shuffling the chart of accounts. Are you gearing up for the challenge?

Look at corporate responsibility and sustainability. Health and safety issues. Security and privacy risks. None of these items were on internal audit's radar a decade ago. Perhaps they should be now, for two very important reasons:

1. Internal audit is uniquely positioned to help, having the knowledge and skill sets to analyze arising threats and opportunities.

2. If internal audit doesn't address it, who will?

The expanding universe of internal audit provides a prime opportunity to improve collaboration with management and the audit committee. Working together to identify areas of greatest need and value strengthens the triangle.

Do more with less

Increasingly, internal audit is being asked to rein in expenses. We have seen many instances in the last few years where IA's budget has been slashed by up to 25 percent.

At the same time, IA is under pressure to expand coverage. Risks are increasing. Audit committees and boards are concerned. And internal audit should be providing more risk mitigation and comfort.

This "do more with less" mentality creates stress at best, dangerous gaps at worst. How to resolve this seemingly unsolvable riddle? A few approaches are possible:

1. **Make greater use of technology and continuous monitoring tools.** This, of course, may require an upfront investment of (scarce) funds. Not always, though: some existing technology tools — most notably the latest versions of ERM systems — include control monitoring tools that are often underutilized or unused.
2. **Appeal to the audit committee.** In most organizations, the AC approves the internal audit budget. But the audit committee holds additional power it almost never exercises — the ability to direct management to increase internal audit's budget. Now may be an opportune time for the audit committee to flex its muscles.
3. **Acquire outside services to address areas of concern.** An outside service can often provide a more cost-effective means of tackling labor-intensive, complex, or limited-duration projects — with short term, non-recurring costs.

Does your model fit to a T?

The structure of internal audit often mirrors that of the organization as a whole. For example, companies that make extensive use of outsourced service providers — payroll, manufacturing, order fulfillment, and the like — may be more inclined to use an outsourced or cosourced model for internal audit. Companies that go it alone in most other areas of the business may do so in IA as well.

Many chief audit executives deliberately shun any discussion about outsourcing or cosourcing, operating under the belief that these models can undermine or even make redundant their position. Yet dismissing these models outright can ignore some significant benefits:

- **Cost:** Outsourcing and cosourcing can be cost effective, allowing companies to avoid hiring, training, benefits, taxes, and other associated expenses.
- **Talent:** Sourcing provides access to skills and talents that may not be available in-house.
- **Flexibility:** IA groups can quickly bring people on as required by need; and can easily scale back when budget, workload, or other considerations dictate.
- **Objectivity:** Tackling difficult or controversial issues may be easier for an outside party than those in the organization, who might worry about job security and financial well-being.
- **Capabilities:** Through sourcing, internal audit groups can access global resources, bridge language barriers, and gain new perspectives.

Unattended elephants

In virtually every organization with which we have worked, the audit committee and/or management has harbored mistaken assumptions about the activities of internal audit. These differing expectations mean that the CAE is almost inevitably disappointing someone. But, more significantly, it represents a loss of opportunity and a squandering of resources. The value that internal audit can bring to the organization is too great to be frittered away.

The first step toward mending the triangle rests with the CAE. This may mean adopting a more assertive role than in the past. The CAE should ensure that management and the audit committee have full visibility into the activities of internal audit and are full partners in the development of the internal audit objectives, audit plan, and related activities.

CAEs need to have an appropriate level of executive/boardroom presence and leadership skills to position their functions for success. Internal audit needs a firm hand at the wheel; CAEs can't allow their functions to get blockaded or diverted off course. They will face resistance as they attempt to refocus their organizations toward a more strategic and consultative role; this resistance must be overcome.

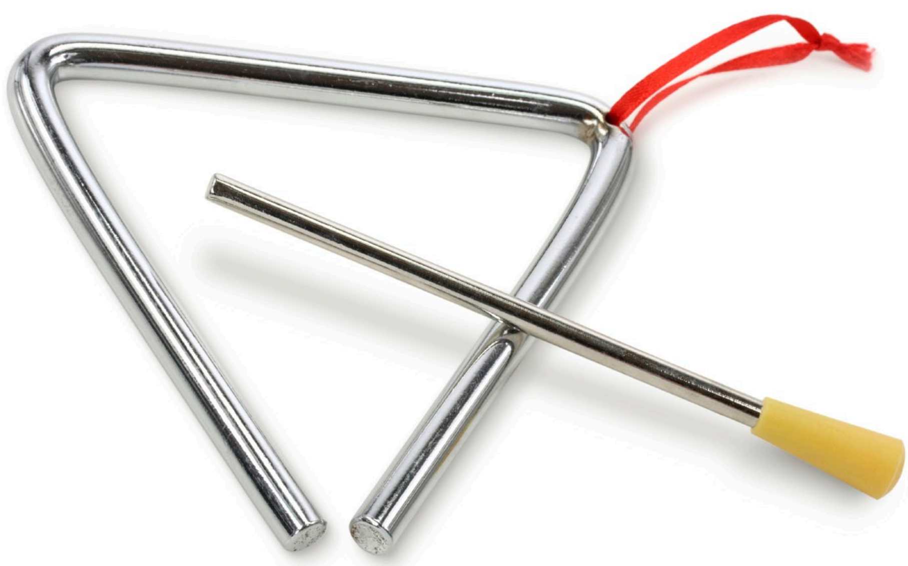
Remember that the alignment of internal audit needs to be regularly revisited. A changing competitive landscape, evolving needs of the business, turnover of personnel, and other factors necessitate constant review and refreshing. It can never be "set and forget."

The broken triangle has existed for far too long. Don't ignore the elephant in the room. (Unattended elephants tend to make huge messes.)

Make the triangle sing

Here are eleven practical steps to bring harmony to your triangle:

1. **Communicate:** Be open about the relationships between internal audit, the audit committee, and executive management.
2. **Check your reporting lines:** Determine whether your current reporting structure for the CAE is optimal.
3. **Rebrand:** Consider renaming your internal audit group as "audit services" or another more descriptive and appropriate name.
4. **Align expectations:** Ensure that IA's audit plan and areas of strategic focus are understood and agreed upon by all parties.
5. **Manage expectations:** There's no such thing as perfect assurance.
6. **Embrace risk:** Expand your attention to risks that can impede your growth and profitability objectives.
7. **Define IA's identity:** Cop, detective, or counsel?
8. **Expand your audit scope:** Address emerging issues and trends.
9. **Take control of your budget:** Can you do more with less?
10. **Adopt a workable model:** Determine what fits best for your organization: In-house? Cosource? Outsource?
11. **Make the CAE an officer:** Bestow a title that helps garner the respect accorded to those in leadership positions.



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