

Internal Audit Role in Modern Corporate Governance and Business Sustainability

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Today's Agenda

- A brief on Corporate Governance.
- The Changing Role of Internal Audit.
- Role of Internal Audit in Corporate Governance.
- A basic understanding of Business Sustainability.
- Internal Audit Role in Business Sustainability.

Definition of Corporate Governance

- “Corporate Governance is the system by which companies are directed and controlled...”
 - *Cadbury Report (UK), 1992*
- “...to do with Power and Accountability: who exercises power, on behalf of whom, how the exercise of power is controlled.”
 - Sir Adrian Cadbury, in *Reflections on Corporate Governance, Ernest Sykes Memorial Lecture, 1993*

An OECD Definition

- “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders ..also the structure through which objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

– *Preamble to the OECD Principles of Corporate Governance, 2004*

BOD's / BAC's Responsibility in IA Function (1/2)

- Establish IA function
- Define expectations – strategic direction
- Set the mission – define charter
- Appointing the CIA and ensure that the internal audit function has direct access to the Chairman BAC
- Approving HR resource requirement
- Approving financial budget
- Approving annual training plan

BOD's / BAC's Responsibility in IA Function (2/2)

- Approving retention strategy and career paths
- Approving risk assessment and annual audit plan (AAP)
- Monitor the progress of the AAP
- Review audit reports and follow up status
- Assess the performance on a periodic basis (Reports / KPIs)
- Independent performance review of IA function
- Ensure internal audit recommendations are implemented
- Help to preserve the internal audit function from pressures which might otherwise impair their objectivity

The Institute of internal Auditors (IIA)

Definition for Internal Auditing

✚ The IIA defined internal auditing as :

“independent, objective assurance and consulting activity designed to *add value* and *improve the organization’s operations*. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to *evaluate and improve* the effectiveness of *risk management, control* and *governance* processes.”

Internal Auditors' Roles and Responsibilities

Comparison of Internal Audit (Pre- and Post-corporate Governance Reforms)

Prereforms	Postreforms
<ul style="list-style-type: none">• Voluntary internal audit functions• Outsourcing of internal audit functions• Auditing services to management• Inadequate resources and organization	<ul style="list-style-type: none">• Mandatory internal audit functions• Objective internal auditors• Oversight function by audit committee• Reporting responsibility to the audit committee
<ul style="list-style-type: none">• Improper oversight of internal audit functions	<ul style="list-style-type: none">• Provide assurance and consulting services in the areas of risk management, internal control, financial reporting, and corporate governance
<ul style="list-style-type: none">• Lack of cooperation with external auditors• Regarded as the “eyes and ears” of management	<ul style="list-style-type: none">• Adequate resources and authority• Better cooperation with external auditors• Regarded as the “eyes and ears” of the audit committee

Internal Audit

- Internal audit function was the party who discovered the fraudulent behavior in the WorldCom case, where around \$3.8 billion of dubious accounting was committed.
- As the CFO refused to take corrective actions, Internal auditor communicated the issue to the audit committee.

Reasons for Corporate Governance Failures

- No governance system, no matter how well designed, will fully prevent greedy, dishonest people from putting their personal interests ahead of the interests of the companies they manage.
- But many steps can be taken to improve corporate governance and thereby reduce opportunities for accounting fraud.
- The auditing profession has an important role to play.

Where does the auditor fit in?

- The auditor does not have direct corporate governance responsibility but rather provides a check on the governance system.

Corporate Governance Framework Components

- Board of Directors & Committees.
- Laws and regulations.
- Business Practices & Ethics.
- Disclosure & Transparency.
- Enterprise Risk Management.
- Monitoring.
- Communication.

BOARD OF DIRECTORS AND COMMITTEES

- Role of Effective governance rests with the board of directors.
- The board establishes the direction and values of an organization.
- Oversees performance and protects shareholder interests.
- Board responsibilities are formally defined in bylaws and charters.
- Listed companies are required, by law to have an audit Committee.
- The number of additional committees and members is up to the organization.
- The committee of greatest interest to internal audit is the audit committee.

BOARD OF DIRECTORS AND COMMITTEES – IA Role

- Assist board of directors in its self assessment and best practices;
- Assess audit committee effectiveness;
- Review audit committee charter with the help of legal counsel;
- Be interactive on the subject of governance, bringing best practice ideas about internal controls and risk management processes to audit committee members;
- Establish accuracy of information used in compensation committee decision making.

LEGAL AND REGULATORY

- This component speaks of the legal boundaries within which a company operates.
- The issues are complex, especially for large companies engaged in specialized and highly regulated businesses.
- Cost of compliance continues to increase.

LEGAL AND REGULATORY – IA Role

- Verify with legal guidance that the organization has identified, assigned responsibilities and addressed all of the key legal and regulatory requirements;
- Look for opportunities to leverage compliance activities and capabilities to reduce long-term costs and improve performance.

BUSINESS PRACTICE AND ETHICS

- Business practices are the operational tactics and measures a company uses to achieve its purpose and strategy.
- Ethics are the moral boundaries an organization believes it should observe when pursuing competitive objectives.

BUSINESS PRACTICE AND ETHICS –IA

Role

- Review code of conduct and ethics policies, making sure they are periodically updated and communicated to management and employees;
- Perform a behavioral sciences ethics review to assess the understanding and perception of compliance across organizational levels ;
- Help management and the audit committee hold people regardless of level accountable.
- Serve in an ethics oversight role or confer with the organization's ethics officer;
- Participate in whistleblower and other ethics complaints investigation processes;
- Conduct annual audits of hotline and follow-up processes, reporting results.;
- Assess linkage of ethics to goal setting and performance evaluation process.

DISCLOSURE AND TRANSPARENCY

- This component refers to the nature and timing of information an organization provides to its stakeholders.
- Financial reports must meet legal expectations for clarity, relevance, reliability, and comparability.
- The challenge is to strike the right balance between providing necessary information to stakeholders and protecting the company's reputation and competitive edge.

DISCLOSURE AND TRANSPARENCY –IA Role

- Conduct testing of financial disclosures and confer with the CFO;
- Understand concern for disclosure and transparency, and align risk assessment with stakeholder expectations;
- In the annual audit plan, address disclosure and transparency objectives;
- Understand the breadth and depth (spectrum) of disclosure and transparency possibilities and where the organization strives to be or should be on the spectrum.

RISK AND PERFORMANCE MANGEMENT

- Managing risks and improving performance are, in essence, two sides of the same coin.
- An organization's biggest risk is often not achieving key performance objectives.
- The process owners are in the best position to monitor operational risks.

RISK AND PERFORMANCE MANAGEMENT – IA Role

- Be proactive in advocating for and participating in an organization's ERM efforts, including a commitment to common methodologies and tools;
- Facilitate identification of key risk areas for the organization as well as all key processes;
- Assist in the development of standards and process flow documentation;
- Assist process owners in understanding, assessing, designing, and documenting controls;
- Inventory organizational risk and compliance activities, and strive to integrate them into a common methodology;
- Evaluate business and process owners on taking responsibility for ERM.

MONITORING

- To evaluate if components of the governance framework are
- operating as intended.
- At the most fundamental level, monitoring systems look at “what is” versus “what should be.”
- Timely risk and performance monitoring has a positive impact on an organization and the sustainability of corporate governance.
- Better integration among monitoring functions, methodologies, and systems ensures that corrective actions are taken promptly.

MONITORING – IA Role

- Understand what monitoring activity is taking place in the organization for each of the other components of the governance framework;
- Facilitate the implementation of a common risk monitoring methodology across all corporate governance functions, feeding an integrated reporting system;
- Perform a strategic level corporate governance audit or ensure one is conducted;
- Incorporate tactical level corporate governance aspects into audit plans.

Communication

- The increasing complexity of today's legal requirements, compliance activities, and governance best practices requires good communication.
- Communication holds together the various components of the governance framework and keeps the process improving over time.
- Maintaining the focus on good governance is one of the key elements for improving governance over time.

Communication – IA Role

- Participate in ongoing dialogues with general counsel, chief financial officer, and other senior management officers;
- Maintain steady communication with audit committee members and oversight executives ;
- Include information about corporate governance in audit reports;
- Assist in establishing a corporate governance communications calendar and solicit input on needs and articles across the organization.

Internal auditors operate in two capacities:

- First, provide independent, objective assessment on the appropriateness of the organization's activities.
- Second, act as catalysts for change, advising or advocating improvements to enhance the organization's structure and practices.

Challenges Facing Internal Auditors

- Remain independent and objective, yet being part of the organization.
- Require business knowledge, insight, good judgment and effective communications.
- Organizations to recruit and retain experienced auditors.
- Biggest challenge on organizations and auditors is that no one-size-fits-all method to improve corporate governance

Critical success factors for an internal audit function

- The mission and role of internal audit should be defined within a wider governance framework and are effectively communicated.
- The structure of internal audit should promote objectivity, consistency and business understanding.
- Internal audit should be funded in a way that promotes objectivity and consistency in the quality of services it provides across the organization.
- Internal audit should contribute values to the business as defined by appropriate success criteria.

Internal Audit Role in Business Sustainability

What is sustainability to the Business?

- A pro-active approach to ensure the long-term viability and integrity of the business by optimizing resource needs, reducing environmental, energy or social impacts, and managing resources while not compromising profitability.

Sustainability & Business continuity

- Sustainability has many related expressions:
 - ❑ Continuity
 - ❑ Future.
 - ❑ Steady growth.
 - ❑ Balancing short-term financial viability with long-term strategic goals.
 - ❑ meeting the needs of present stakeholders without compromising the ability of future generations to meet their own needs
 - ❑ Environmentally-friendly or green activities and Businesses.

Definition

- A sustainable business is any organization that participates in environmentally-friendly or green activities to ensure that all processes, products, and manufacturing activities adequately address current environmental concerns while maintaining a profit. In other words, it is a business that “meets the needs of the present world without compromising the ability of the future generations to meet their own needs.”

Definition

- Business sustainability is the increase in productivity and/or reduction of consumed resources without compromising product or service quality, competitiveness, or profitability.
- Issues to be considered in sustainability auditing:
 - Facility management effectiveness and efficiency.
 - Operations effectiveness and efficiency.
 - Material and process improvements
 - Supply chain efficiencies
 - Products or services that are more efficient
 - Recycling
 - Telecommuting
 - Optimization of the use of resources.

Sustainability as Part of Risk Management

- **Financial risk:** Avoid fines or higher interest rates imposed by banks that view your business as a high-risk association.
- **Operational risk:** Prevent safety, health or environmental issues from shutting down operations.
- **Customer risk:** Limit the risk of a negative corporate image alienating current or potential customers.
- **Strategic risk:** Do not miss the boat on what your stakeholders require.

Current Trend

- The recent events and the global financial crises have emphasized the need for internal auditing within corporate governance structures.
- Companies are realizing that sustainable development is an essential part of corporate governance.
- The number of companies publishing sustainability or corporate social responsibility reports continues to grow

Internal Audit Functions and Business Sustainability

Internal Audit Activity may help in building more sustainable operations and enable all the businesses to effectively identify and manage strategic and operational risks and to create strategic advantages through its diversified functions

Internal Audit Functions

1. Identifying and evaluating significant exposure to risk and contributing to the improvement of Risk Management.
2. Evaluating the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information system and promoting their continuous improvements.
3. Evaluating the reliability and integrity of financial and operational information.

Internal Audit Functions

4. Evaluating the effectiveness and the efficiency of operation
5. Evaluating the safeguarding of assets.
6. Evaluating the compliance with laws, regulations, bylaws, and contracts.

Internal Audit Functions

7. Determining the extent to which operating and program objectives have been established in conformity with those of the organization.
8. Reviewing operations and programs to determine whether the results are in conformity with the objectives and goals.
9. Ascertain whether the management has established adequate control criteria to evaluate the accomplishment of objectives and goals.

Internal Audit Functions

10. Making appropriate recommendations for improving the governance process with regard to its functions.
11. Promotion of appropriate ethical values.
12. Ensuring effective performance management and accountability.
13. Communicating risk and control information.

Internal Audit Functions

16. Preventing and detecting fraud.
17. Coordinating activities and sharing information with other internal and external providers of assurance and consulting service .
18. Taking an active role in support of the organization ethical culture.

Internal Audit's Role in Maintaining Sustainability

- Rendering advisory services on sustainability programs.
- Participation in committees established for sustainability or aspects of sustainability.
- Including tests of sustainability in the audit programs to examine the policies and procedures set to guarantee sustainability.

Examining Sustainability as an Integral Part of the Audit Program

- While auditing the *Purchasing Activity*, auditor may seek answers for the following questions:
 - Are the sustainability policy aspects been integrated into the tendering process?
 - Are the vendors' contracts prepared in consistency with the sustainability policy?
 - Does the company buy sustainable products and equipments?

Examining Sustainability as an Integral Part of the Audit Program

- While auditing the *Facilities Management*, auditor may seek answers for the following questions:
 - Is there a sustainability phase of the facilities management plan?
 - Does the management conduct training and education activities for facilities staff on energy savings aspects?
 - Does the management monitor the use of energy to ensure its consistency with targets set by the sustainability program?

Examining Sustainability as an Integral Part of the Audit Program

- While auditing the **Facilities Management** auditor should seek answers for the following questions:
 - Does the management use sustainable cleaning products?
 - Is there sufficient controls over the energy saving programs?
 - Is there pre-established criteria used to evaluate the use of water and the disposition of the wastes?

Examining Sustainability as an Integral Part of the Audit Program

- While auditing the *Construction projects*, auditor may seek answers for the following questions:
 - Have energy efficient equipment, lighting and water systems been considered in planning?
 - Have partial renewable power sources been considered?
 - Are transportation efficiencies incorporated into the planning for project?

Services rendered by IA to maintain business sustainability

Internal auditors provide expanding range of assurance and consulting services, which in aggregate contribute to business sustainability and corporate governance.

1. Audit service:

- 1) *Financial audit service*: performed in accordance with generally accepted auditing standards to express an opinion regarding whether the financial statements represent fairly, in all material respects, the financial position, results of operations, and the entity cash flows in conformity with the generally accepted accounting standards.

Services rendered by IA to maintain business sustainability

- 2) ***Compliance audit:*** review of the financial and operating controls and transactions for conformity with laws, standards, regulations and procedures.

- 3) ***Operational audit:*** review of the various functions within the enterprise to evaluate the efficiency, effectiveness, and economy of these functions.

Services rendered by IA to maintain business sustainability

2. Consulting services
3. Advisory and other related activities that intended to add value and improve an organization's governance, risk management, and control process.

Services rendered by IA to maintain business sustainability

4. Participation on a merger and acquisition team, or system conversion team.
5. Participation on a team established for recovery or maintenance of operations after a disaster or other extraordinary business.

Services rendered by IA to maintain business sustainability

6. Process following up engagement:

That means following up a process that crosses organizational lines such as:

- 1) Purchasing and receiving.
- 2) Distribution of service, material, and supplies to users in the organization.
- 3) Modification of products.
- 4) Safety practices.
- 5) Scrap handling.
- 6) Development of budgets.
- 7) Management of depreciable assets.

Services rendered by IA to maintain business sustainability

7. A program-result engagement:
 - 1) A program is funded activity not part of normal, continuing operations such as adopting a new information system.
 - 2) The engagement is intended to obtain information about the costs, outputs, benefits and effects of a program. It measures the accomplishments and relative success of the program.

Services rendered by IA to maintain business sustainability

8. Due diligence engagement:

Auditors Due diligence term is usually applied to a service in which internal determine the business justifications for a major transaction (acquisition, combination, joint venture, divesture, etc.). It examine and facilitate the realization of the transaction's benefits through improving its effectiveness and efficiency.

9. Reviewing operations, internal control over systems, the compatibility of company culture, finance and accounting issues.

Services rendered by IA to maintain business sustainability

10. Environmental Auditing Engagement:

1. Environmental Management System: is a structure of responsibilities, policies, practices, procedures, processes, and resources for protecting the environment
2. Environmental auditing is an integral part of the system whereby management determines whether the organization's environmental control systems are adequate to ensure compliance with regulatory requirements and internal policies.
3. Environmental auditing includes reviewing the adequacy and effectiveness of the controls over hazardous waste, reviewing the reasonableness of contingent liabilities accrued for environmental remediation.

Critical Characteristics of the 21st Century Internal Auditor

- Risk-based orientation
- Global perspective
- Governance expertise
- Technologically adept
- Business acumen
- Creative thinking and problem solving
- Strong ethical compass

Internal Audit will be **VITAL**...

- **V**ersatile: Maintaining a big-picture, proactive perspective on the entire organization-Value
- **I**nvolved: Performing roles critical to organizational success-Integrated
- **T**echnologically proficient: Using technological skills to mitigate risks, improve processes, and upgrade efficiencies
- **A**dept: Fully capable of evaluating business, technology, risk management, control and governance challenges in their organizations
- **L**eader: Taking a leadership role in risk management & organizational effectiveness

Internal Auditors' Roles and Responsibilities

IIA's Performance Standards

Managing the internal audit activity	<ul style="list-style-type: none">• The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization.
Nature of work	<ul style="list-style-type: none">• The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.
Engagement planning	<ul style="list-style-type: none">• Internal auditors should develop and record a plan for each engagement, including the scope, objectives, timing, and resource allocations.
Performing the engagement	<ul style="list-style-type: none">• Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.
Communicating results	<ul style="list-style-type: none">• Internal auditors should communicate the engagement results.• Communications should include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.
Monitoring progress	<ul style="list-style-type: none">• The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.
Resolution of management's acceptance of risks	<ul style="list-style-type: none">• When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, he or she should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

Internal Auditors' Roles and Responsibilities

IIA's Ethics Code

Principles

- | | |
|-----------------|--|
| Integrity | <ul style="list-style-type: none">• The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment. |
| Objectivity | <ul style="list-style-type: none">• Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments. |
| Confidentiality | <ul style="list-style-type: none">• Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so. |
| Competency | <ul style="list-style-type: none">• Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services. |

10 TAKE-AWAYS FROM TODAY'S SESSION

1. Ramp up communication with management and the audit committee.
2. Place renewed focus on risk management and governance processes.
3. Strengthen your risk assessment process
4. Operate with a more flexible and adaptable audit plan.
5. Serve as a risk management educator.
6. Focus on recession – related risks and activities.
7. Expand fraud testing in the audit plan.
8. Strengthen business knowledge
9. Strengthen your relationships and communications with the organization's other governance, risk, and control functions.
10. Enhance the efficiency of your audit processes.

It is easy to be ethical until it costs
you something!

*General Gordon Sullivan
US Army Chief of Staff*

Questions

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