

# **The Role of Internal Audit in Sensitive Communications**

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### Executive Summary

This report summarizes the results of a survey about communication channels for reporting sensitive matters (whistleblowing) required by the U.S. Sarbanes-Oxley Act of 2002 and the role internal audit plays in testing the effectiveness of such channels. Results show that a positive ethical climate is related to the existence of an ethics officer and that person's access to important parties in the organization (the CEO, internal audit, external audit, and the audit committee). Positive climate is also related to the extent to which the CEO has increased emphasis on reporting potentially sensitive acts since passage of Sarbanes-Oxley.

Generally there is a good array of reporting channels for employees, but not for others or those situated outside the U.S. About five-sixths believe the channels are well known to potential users. About five of eight systems allow anonymous reporters to follow up on their reports without requiring their identity. A large majority believe the receivers of these reports are well qualified. About four in 10 have a time limit for follow-up. Just over half send both the CEO and the board a summary status report. Of these, about eight of 10 do so monthly or more frequently.

Internal audit is the most common entity to follow up on anonymous reports of fraud. The amount of audit committee control over, and affinity with, internal audit is associated with a number of strong control characteristics. About six of 10 internal audit units regularly test the effectiveness of the reporting system and conduct a survey or other test to assess tone at the top. Nearly four in 10 regularly test for ethical culture and employee understanding of the whistleblowing system. For the units testing the whistleblowing system, over half use an extensive set of procedures.

### Introduction

This report summarizes the results of a survey of 119 chief audit executives (CAEs<sup>1</sup>) whose organizations were subject to the provisions of the U.S. Sarbanes-Oxley Act of 2002 and had filed an integrated report on financial statements and internal controls pursuant to Sarbanes-Oxley. The survey was confidential and anonymous. It was conducted electronically using The Institute of Internal Auditors' Web page facilities. The survey's principal goal was to establish baseline information about the state of communication channels for reporting sensitive matters required by Sarbanes-Oxley (whistleblowing) and the role internal audit plays in testing the effectiveness of such channels. It also sought to document processes used to identify financial reporting risks and how these risks are communicated to the audit committee and high-ranking organization officers (e.g., CEO, CFO, and general counsel).

In addition to providing descriptive information, most sections of the report also contain information about key associations among variables. These analyses rely primarily on correlation, its nonparametric equivalents, and data scanning. The survey contained items divided into five parts related to each CAE responding:

1. Organization characteristics
2. Organization current ethical climate
3. Organization reporting mechanisms for potential wrongdoing
4. Internal audit role in whistleblowing
5. Respondent's background

Our report follows this topical outline with few deviations. For example, we first address the characteristics of the CAEs who responded.

### Respondent Characteristics and Overview

During approximately a six-week period ending in mid-May 2005, we received 119 responses from CAEs whose organizations were subject to Sarbanes-Oxley and had completed filing of an integrated statement. Table 1 provides some characteristics of the responding CAEs.

Respondents include leaders of in-house audit units (87%), co-sourced units (11%), and out-sourced units (2%). We combine these last two categories for purpose of analysis. Results show several organization and system differences related to the nature of sourcing. For example, response patterns indicate that the larger the organization, the greater the tendency for audit to be sourced internally.

Most respondents' titles are chief audit executive (38%) or director of internal audit (35%) with the rest distributed widely. The average age is about 46<sup>2</sup> with the largest portion (32%) in the 38 to 45 age range; 24% in the 46-53 range; and 26% in the 54-60 range. Males represent 72% of the respondents; females 28%.

**Table 1**  
**Characteristics of the Responding CAEs**  
**(See Text for More Detail)**

Characteristic	Measure
Responses	119
Audit Sourced In-house (Outside or Co-sourced)	87% (13%)
Most Common Titles	CAE (38%); Director of IA (35%)
Mean Age	46
Gender — Male	72%
Mean Time as CAE	4 to 5 Years
Mean Overall Experience in Internal Audit	9 to 10 Years
Expected Length of Time to Continue in IA	5 to 8 Years
Highest Degree	Bachelor (54%) or Master (44%)
Number of Professional Designations	2
Most Common Designation, CPA	60%
Designation as CIA	40%
Designation as CFE	13%
Most Common Professional Organization, IIA	96%
Percent in AICPA	37%
Percent in ICFE	25%
Percent Eligible to Receive Cash Bonus	92%
Percent Eligible to Receive Stock Options	71%

Average experience as a CAE falls between four and five years, with the most common in the two- to four-year range (32%); 27% under two years, 14% from four to six years, 9% from six to eight years, and 17% more than eight years. These proportions represent considerable dispersion. For example, 59% have four years or less as CAE and 26% have six years or more. Similarly, the experience in internal audit is diverse with a mean of nine to ten years, with nearly two-thirds having over eight years and the rest with about 10% each having about three, five, and seven years' experience. Just over one-fifth indicate that they plan to stay in internal audit for either more than eight years or were unsure, while nearly one-third indicate they intend to stay for four years or less.

As a group, the respondents are well-educated with the vast majority's highest degree being either a bachelor's or a master's degree; one had a doctoral degree. Although the average number of professional certificates is nearly two (5% had none; one respondent had six), it is notable that the proportion with CPAs (60%) exceeded the proportion with CIAs (40%). The 13% with CFEs and the 25% membership rate in the ICFE may indicate an increasing importance for the internal auditor to suggest how to prevent and detect fraud.

Some researchers (Schneider, 2003) express concern that the ability to receive cash bonuses or stock options may affect the internal auditor's independence. Nearly 90% of our respondents are eligible for cash bonuses and 70% for stock options. Our results show the two eligibilities to be positively related. However, the eligibility to receive stock options is the only one significantly related to other response patterns. For example, those eligible to receive stock options are more likely to hold a CPA certification. None of these relationships seem to adversely affect independence; in fact, generally the patterns seem to exhibit favorable relationships to good practices in terms of sensitive communication systems.

### **Organization Characteristics**

The survey includes organization information related to industry, size, and the extent of foreign business. These items were included in the survey based on prior research indicating that organization characteristics affect sensitive reporting system features.<sup>3</sup> Table 2 shows industry distribution. The distribution of industries indicates a relatively wide representation. The category, financial services other than insurance, leads with just over one-fourth of organizations represented coming from that source.

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When combined with insurance the impact of the financial industry generally swells to nearly three-eighths of our sample. Manufacturing is the next most frequent with 24 representatives. The “other” category is about evenly split between service and non-service industries. Some service industries in this classification include advertising, gaming, direct selling, and outsourcing services. Included in the non-service area are mining, pharmaceuticals, and wholesale. Our analyses show very little association between type of industry and reporting system characteristics or other matters of interest; the extent of foreign business is the exception.

**Table 2**  
**Industry Frequency**

Industry	Number (% of 119)
Financial Institutions Other Than Insurance	31(26%)
Manufacturing	24 (20%)
Retail	12 (10%)
Insurance	12 (10%)
Technology	10 (8%)
Transportation	8 (7%)
Distribution	6 (5%)
Wholesale	5 (4%)
Other	11 (9%)

The extent of foreign business is measured using the extent of revenue and sourcing done inside or outside the U.S. We group into three categories: (1) completely in the U.S.; (2) minor activity outside the U.S.; and (3) extensive activity outside the U.S. These three groupings capture all firms. We classify organizations as having “minor activity outside the U.S.” when either revenue or sourcing constitutes less than 10% of that activity. “Extensive activity outside the U.S.” characterizes those organizations with at least 50% of *both* revenue and sourcing outside the U.S. Organizations in this category typically have activity in multiple countries. Table 3 shows the resulting distribution.

A relationship was found between industry and the extent of non-U.S. activity. For example, out of 31 organizations in the financial-not insurance category, 24 have exclusively domestic activity and another two have minor activity. By contrast, out of 24 manufacturing organizations, 17 have extensive activity outside the U.S. and another four have minor activity. We tried various metrics to combine the industry and extent of non-U.S. business, but none add to the insight generated by keeping the categories separate. We address the impact of non-U.S. business on reporting system characteristics and IA activity under sections in this report related to those characteristics.

**Table 3**  
**Extent of Sourcing/Revenue Outside U.S.**

Extent	None	Minor	Extensive
# (%) of Organizations	52 (44%)	23 (19%)	44 (37%)

We asked respondents to assess organization size using the larger of sales and/or total assets. Results for this measure are presented in Table 4 and show considerable variability. For example, just over one-fifth of the organizations had sales and/or total assets over \$6 billion, which we characterize as “very large.” One-half fell into the \$1 billion to \$6 billion range, which we classify as “large.” Nearly three out of 10 fall into the \$200 million to \$1 billion category we label “intermediate.” The size for one organization was below \$200. We also label this firm to be an “intermediate.” As expected, organization size had considerable impact on reporting channel characteristics and internal audit’s role. Discussion of these effects is generally deferred to sections dealing with reporting system characteristics. As noted, the larger the organization, the greater the tendency for internal audit to be sourced entirely inside.

**Table 4**  
**Organization Size**

<b>Size</b>	<b>Intermediate</b>	<b>Large</b>	<b>Very Large</b>
<b># (%) of Organizations</b>	34 (29%)	60 (50%)	25 (21%)

Intermediate includes one organization with assets/sales under \$200 million.

### **Ethical Climate**

Questionnaire items aimed at assessing ethical climate focused on reporting system processes, tone at the top, and how information generated by the system is used. Specifically, the survey included several items that asked about the existence of an ethics officer (EO); the use of a survey to assess the ethical climate; if so, how the results are used; the extent of CEO involvement/commitment; and the role that ethics play in difficult judgments.

### **Key Positions, General Measures, and Reporting Line**

Nearly two-thirds (72) of the respondents' organizations have an EO. Existence of this position is not associated with other organization characteristics. Results show the presence of an EO is associated with several favorable reporting system features. For example, existence is positively related to the visibility of the organization's code of ethics and the extent to which that code is likely to influence ethical decision-making. Also, the extent of perceived CEO time and effort in promoting an ethical atmosphere is positively associated with existence.

We ask if organization personnel are surveyed about the ethical climate and about the use of any survey. While the development and use of such surveys are broadly advocated, little research documents whether, in fact, such surveys occur or how they are used within organizations, particularly as it relates to reporting wrongdoing. Forty-five CAEs indicate that their organizations conduct surveys while 74 CAEs indicate that their organizations do not.

For the 45 that conduct an ethical climate survey, we elicit two issues that bear on its importance in contributing to the ethical climate: (1) those who receive the report and (2) whether the report is a factor in performance evaluation. Forty-one of the 45 distribute survey results to important positions in the organization. Three stop with the CEO or executive committee; four go only to key control positions (internal audit, external audit, or the audit committee); and 34 go to both top management and key control posts. When the results go to both, they can serve as a basis for gauging tone at the top and to act as a potentially strong control by providing benchmarks.

Organizations engaged more heavily in non-U.S. business tend to distribute to both the CEO and an objective unit (internal audit, external audit, or the audit committee) more frequently than other organizations. Using the survey results as part of managers' performance assessment is consistent with the balanced scorecard concept of measuring important organizational goals (Kaplan and Norton, 1992). That is, what gets measured gets managed. Of those conducting a survey, 13 (30%) respondents' organizations use survey results for this purpose; another 12 (27%) respondents indicate uncertainty about this use; and the remaining 20 (44%) do not use it in this manner. Larger organizations tend to use survey results for evaluation more often than smaller ones.

Use of an ethical climate survey is associated with an EO and IA sourcing. Nearly half (47%) the organizations with an EO conduct an ethical climate survey compared to only one-fifth (19%) of those with no EO. When internal audit is sourced entirely in-house, the use of surveys is more common than when it is outsourced or co-sourced. As shown in Table 5, larger organizations tend to use ethical climate surveys more often than smaller organizations.

**Table 5  
Organization Size and the Use of Surveys to Gauge Ethical Climate**

<b>Size</b>	<b>Intermediate</b>	<b>Large</b>	<b>Very Large</b>	<b>Totals</b>
Use Survey	8	25	12	45
Do Not Use Survey	26	35	13	74
# (%) of Organizations	34	60	25	119

Affording the EO periodic access to the CEO is generally considered to strengthen the stature and influence of the EO. Of the 72 organizations with ethics officers, 25 (35%) schedule such a meeting monthly, quarterly, or annually. An additional 37 (51%) EOs have access to the CEO as the situation dictates, and the rest (10, 14%) indicate either no, not applicable, or not sure.

To gauge one aspect of the impact of Sarbanes-Oxley, we ask CAE respondents to agree or disagree with the statement that since the passage of the Act, the CEO has placed much more emphasis on employees' reporting potentially sensitive incidents. Table 6 shows the results. As shown, nearly 60% agree that their organizations' CEOs have increased emphasis. However, a substantial minority either disagrees or substantially disagrees with the statement.

**Table 6  
The Extent to Which Sarbanes-Oxley has Influenced CEO Emphasis on Reporting Potentially Sensitive Acts**

<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Not Sure</b>	<b>Agree</b>	<b>Strongly Agree</b>	<b>Mean (1 =Strongly Disagree to 5 = Strongly Agree) (n =119)</b>
6	34	9	53	17	3.3

The more one agrees with the statement, it is more likely that the code of ethics is highly visible and plays a significant role in any ethical judgment. Also, the more one agrees with the statement, it is more likely that managers below the executive level are required to sign off that they are not aware of any audit, control, or accounting shortcomings.

Our study includes a request to gauge the CEO's role in shaping the organization's ethical climate. Specifically, we include the following item: A CEO has many responsibilities. With this in mind, please estimate the CEO's relative time and effort aimed at promoting an ethical atmosphere within your organization. Table 7 shows the results.

**Table 7  
Assessment of the CEO's Relative Time and Effort Aimed at Promoting an Ethical Atmosphere**

<b>Extremely Low</b>	<b>Somewhat Low</b>	<b>Low</b>	<b>Between Low and Moderate</b>	<b>Moderate</b>	<b>Mean with 1 =Extremely Low to 5 = Moderate (n= 115)</b>
9	12	23	37	34	3.7

The responses in Table 7 exhibit quite a bit of variation, but on average portray a relatively favorable climate. Additional analyses show that the CEOs of smaller organizations are more likely to devote relatively more time and effort toward promoting an ethical atmosphere. Our analyses also show that when organizations have an EO, the increase in the CEOs' relative time and effort directed toward strengthening the ethical climate is greater. Considering the positive association between the presence of an EO and other measures we associate with a favorable ethical climate and measures yet to come, we believe that Sarbanes-Oxley has had a favorable impact on the ethical climate, the likelihood of reporting wrongdoing, and the role of internal audit in these matters.

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We also ask about the extent that the code of ethics is visible and likely to play a significant role in any ethical judgment. One hundred (84%) agree or strongly agree that this is the case in their organization; the balance disagree or are uncertain. As noted, the extent of the impact of Sarbanes-Oxley is positively related to this measure. Also, the presence of an EO and the EO's access to important parties in the organization are positively related to this measure.

### **Procedures in an Ethical Climate**

The survey contains several procedural questions that relate to the organization's ethical climate. One item asks whether managers below the executive level are required to sign off on the fact that they have no knowledge of audit, control, or accounting shortcomings. Ninety-two (78%) have such a requirement. Of the 92, 71 (77%) include the CAE in this requirement. Motivated by Microsoft's Standards of Business Conduct,<sup>4</sup> we inquire if reporting guidelines include the organization's right to discipline employees making false reports intended to damage the organization or specific employees. Eighty (69%) indicate that their codes of ethics contain such a clause. To follow up, we ask if they knew of an incident where their organization has disciplined an employee for making a false report. Twenty-four (30%) indicate knowledge of such discipline. Organizations with significant foreign business activity are more likely to have taken this action. It is difficult to assess the desirability of a retaliatory clause, but one "cost" of anonymous reporting is that disgruntled employees may make false reports to hurt managers or others with whom they have disagreements. Such a clause may reasonably reduce this type of reporting. However, the potential for retaliation may impair the trust needed to encourage reporting (Schultz and Hooks, 1998).

### **Ethical Climate Summary**

It appears that the existence of an ethics officer and that person's access to important parties in the organization (the CEO, internal audit, external audit, and the audit committee) represents an important indicator of an overall ethical climate. Because of the importance of having an EO and that person having access to important parties in the organization, we combine these two elements to form a single metric. That combination (having an EO with greater access) proves to be positively related to conducting a comprehensive survey directed at assessing the ethical climate, the distribution of the survey results to important constituencies, and the use of the survey results in managers' performance assessments. Based on research and professional literature, we believe that these relationships point toward a healthy ethical climate.

### **Reporting Systems for Potential Wrongdoing**

In this section, we describe typical systems to the extent practicable, point out differences among organizations represented in our survey, and provide some possible reasons for the differences.

#### **Reporting Channels**

The first question in this section asks whether whistleblowing/reporting mechanisms are readily available to various classes of agents both in the U.S. and outside. Results are shown in Table 8.

**Table 8**  
**Availability of Reporting Systems to Various Agents**  
**Number of Positive Answers, Total Number of Answers, (Percent of Total Answers)**

<b>Agent Description</b>	<b>Inside U.S.</b>	<b>Outside U.S.</b>
Administrative Employees	113, 116 (97%)	57, 66 (86%)
Production/Service Employees	111, 114 (97%)	56, 66 (85%)
Vendors	57, 103 (55%)	35, 64 (55%)
Customers	62, 102 (61%)	34, 62 (55%)
Other	24, 47 (51%)	12, 30 (40%)

As expected, the proportion providing reporting channels inside the U.S. to their employees is very high (97%). This proportion drops sharply for vendors and customers, which represents an opportunity for improvement. Within the U.S. there were 47 “other” answers. These include 12 related to either a Web site link or an 800-number. Some have a channel intended solely for their investors. Several indicate that they have no channels (e.g., “our CEO says our employees do not need such a channel”).

The number having channels outside the U.S. drops as only 67 organizations have major (44) or minor activity (23) outside the U.S. Of the 44 organizations with major foreign activity, 10 (23%) do not offer any channels outside the U.S. The relative proportion is nearly the same for organizations with minor foreign activity. Few exclusively domestic businesses offer any channels outside the U.S. Adding foreign channels to the mix may represent an opportunity for improvement, especially for those organizations with heavy foreign activities.

To gain an overall picture of the available channels, we calculate a sum for all the channels available inside the U.S. for employees, vendors, customers, and others, and a comparable sum for channels available outside the U.S. In general, the higher the sum, the better the reporting system (little foreign activity restricts the need for foreign channels). These measures tend to be closely related; as one increases, the other increases. The sum of the channels available inside the U.S. is positively associated with several dimensions in the prior sections of the survey. In order of strength of association, these are: (1) the use of survey results in performance assessment; (2) the distribution of the survey to both the CEO and some objective source (internal audit, external audit, the audit committee); (3) ethics officer access to the CEO; and (4) the code’s visibility and significance in ethical judgments. These results suggest that organizations either have patterns of processes that promote an ethical climate and the reporting of wrongdoing or do not.

Other than the extent of foreign operations, the sum of the non-U.S. available channels shows a somewhat similar pattern. In particular, there are positive associations with: (1) the existence of an ethics officer; (2) ethics officer access to the CEO; and (3) the use of survey results in performance assessment. As with the availability of U.S. channels, these results portray a clustering of factors associated with a good reporting system, or, when in the wrong direction, signal the lack of a good system.

The specific channels for communicating wrongdoing and (especially) knowledge that these channels exist are important. Table 9 shows the distributions of the specific types of channels available and respondents’ beliefs about how well-known each channel is to potential reporters.

**Table 9**  
**Availability and Knowledge of Communication Channels**  
**Number of Positive Answers, Total Number of Answers, (Percent of Total Answers)**

<b>Communication Channel Characteristic for Reporting</b>	<b>Available</b>	<b>Well-known</b>
Anonymous	112, 115 (97%)	76, 92 (83%)
Via Phone	111, 115 (96%)	75, 90 (83%)
Via Web	59, 96 (62%)	39, 70 (56%)
Via Letter	94, 106 (89%)	54, 81 (67%)
Other	11, 23 (48%)	9, 21 (43%)

The top row shows that three organizations do not have an anonymous reporting channel available. Given requirements in Sarbanes-Oxley, this seems to expose them to significant risk should fraud arise. Only 83% believe that the anonymous channel is well-known. Fewer organizations indicate availability “via Web” (59 out of 119 possible) than the Web’s popularity may suggest. The familiarity with Web access (only 56%) is well below the level for either phone or anonymous (both 83%). Anonymous Web reporting does not allow for the same level of interactive exchanges as phone reporting (discussed under the next topical heading). Accordingly, organizations may prefer to deemphasize it as a medium.

To gain an overall picture of these two metrics, we calculate a sum for the number of communication channels available and another sum for the number of communication channels that are well-known. These measures tend to be positively related, but the knowledge metric is related to more positive aspects of the ethical climate. In order of strength, these are: (1) the code being visible and significant in ethical judgments; (2) the existence of an ethics officer; (3) the use of survey results in performance assessment; and (4) distribution of survey results to both the CEO and an objective party (internal audit, external audit, audit committee). It appears that a healthy ethical climate is closely related to available reporting channels being well-known among employees.

### **Improved Use of Anonymous Reports**

Several survey items address how organizations implement their anonymous reporting channels. Research suggests that an anonymous reporting channel’s effectiveness is likely dependent on the channel’s implementation. For example, when an interactive anonymous reporting option exists, a well-trained person should take the report. A well-trained person can elicit information helpful for gauging the seriousness and truthfulness of the allegation as well as setting in motion appropriate follow-up procedures. Timely feedback to the reporter also influences effectiveness. Research indicates that organizations should have a policy about the relative time limits to follow up on a report, depending on its seriousness. Finally, the reporter, while remaining anonymous, should be able to determine what resolution has occurred. Kaplan and Schultz (2005) contend that observers of suspected wrongdoing will be far less likely to report when they believe that the organization will do nothing to remedy the situation. We now turn to the questions and results dealing with these three issues.

This section’s first survey item inquires about the expertise of report recipients in an interactive mode. Results appear in Table 10. Of 112 CAEs responding, 95 (85%) believe the recipients staffing interactive channels are well-trained to elicit pertinent information; the remaining 15% do not believe the recipients are well-trained. The next item asks whether a specified time limit exists in which some response must be made for each reported incident, including assigning responsibility for following up on the incident. Of the 113 responses, 22 (20%) respond positively and include a specified time limit in their open-end response. Another 20 (18%) indicate that there is a time limit but do not specify it. The majority of the respondents (71, 63%) report that there is no time limit. The next survey item asks whether an anonymous reporter is able to receive follow-up information. Of the 111 respondents, 69 (62%) indicate that reporters of wrongdoing can get follow-up information and remain anonymous; 27 (24%) answer that follow-up information is available but that reporters must provide their names and contact information at the time of the initial report; and 15 (14%) reply that follow-up information is not available.

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The results in Table 10 are generally encouraging in two respects. First, many organizations have well-trained interactive report recipients for anonymous reports. Second, anonymous reporters can typically obtain follow-up information without divulging their names. However, our respondents' views about timely assignment and progress toward resolution are not so favorable. Considering the results across all three conditions (all an unqualified "yes"), 16 (14%) had three, 52 (44%) had two, and the remaining 50 (43%) had one or fewer. These results point to opportunities for improving organizations' response time, efficiency, and effectiveness for seemingly little cost.

**Table 10**  
**Staffing the Interactive Anonymous Reporting Channel and the Reporter's Ability to Receive Follow-up Information in a Timely Manner**

Issue	Yes	Qualified Yes	No
Interactive Report Receivers Well-trained?	95 (85%)	N/A	17 (15%)
Specified Time Limit for Response on Each Report?	22 (20%)	20 (18%)	71 (63%)
Can Reporter Get Follow-up Information?	Not Give Name? 69 (62%)	Must Give Name/Contact Data? 27 (24%)	15 (14%)

See text for important additional information on categories.

With regard to relationships with other responses, the presence of a well-trained recipient was positively associated with the ability of an anonymous reporter being able to get follow-up information and the code's visibility and likely impact on ethical judgments. As with the above procedural responses, favorable responses to these three are generally aligned with indicators of a favorable ethical climate.

### Handling Reports with Special Designation

Our analysis now turns to the parties that receive reports and how these reports are handled. We ask who receives reports, logs them in, and establishes a record of each report. Table 11 shows the various entities that receive all reports, no matter their nature. Of the organizations represented in Table 11, approximately one-third have all reports go to multiple parties, with an outside contractor being the most common recipient.

**Table 11**  
**Recipients of All Reports of Wrongdoing**

Recipient	Receives All Reports (% of 119)
Outside Contractor	51 (43%)
Internal Audit	35 (29%)
General Counsel	34 (28%)
Ethics Officer	23 (19%)
Human Resources	12 (10%)
Corporate Secretary	10 (8%)
CFO	5 (4%)

The next question in this section focuses on whether specific types of reports are to be directly reported to internal audit or the audit committee. Of the 116 responses, 66 (57%) indicate that they do have such a requirement. We ask those responding positively to identify the types of issues that are reported to either the audit committee, internal audit, or both. Table 12 contains the answers.

**Table 12**  
**Reports of Wrongdoing Required to Be Directed to Internal Audit or the Audit Committee Out of 66 Organizations with Such a Requirement**

Wrongdoing Involving	To Internal Audit	To the Audit Committee	Total to at Least One
Senior Management	21	40	61
Fraud	27	31	58
Regulation	26	23	49
Control	33	15	48
Vendors	28	12	40
Customers	26	11	37
Joint Ventures	17	8	25
Other	12	5	17

The most frequent types of reports specifically directed to at least one of the two parties are violations involving senior management or fraud. The audit committee is most commonly the recipient of these reports. Together with the rest of the board, the audit committee has direct supervisory responsibility of management. It is noteworthy that 50 (43%) organizations do not directly report violations shown in Table 12 to internal audit or the audit committees, which seems to leave opportunity for improved control.

The next item inquires about how the audit committee gains assurance that it receives and understands all reports that it should receive based on its policy. Table 13 shows the options included in the survey and the frequencies of use. Out of 119 possible replies, 102 (86%) indicate at least one procedure.

**Table 13**  
**Procedures in Use by the Audit Committee to Assure that it Receives All Reports Designated for Its Receipt**

Procedure in Use	Number (% of 102)
Committee has the authority to independently investigate all allegations	63 (62%)
Committee has access to a complete listing of all reports	38 (37%)
Committee has ability to access all details about any report and its resolution	30 (29%)
Independent party (e.g., internal audit) conducts tests to determine that appropriate reports were forwarded	25 (25%)

Of the audit committees, 102 use procedures to assure that they receive all the reports that they should receive. Of this 102, nearly two-thirds have the authority to independently investigate all allegations. It seems that all audit committees should have this authority. Of the 102 committees represented in Table 13, about half are also represented in row two (access to a complete listing) and row three (ability to access all details) of Table 13. Based on these replies, it appears that audit committees have little independent ability to check the completeness of the information generated from the reporting system. To summarize, out of the 102 responses, 48 have more than one procedure in place to achieve this objective, 54 have one procedure, and 14 have no procedures.

We compare this metric (the total number of procedures for each audit committee) to other signals of audit committee strength. The more procedures in use by the audit committee, the more likely it is to require direct reporting of some allegations and the more likely it is to require more types of allegations (see Table 12). From a climate perspective, the number of procedures is positively related to the code's visibility and its expected significance in ethical judgments. A greater number of procedures also is positively related to the requirement that CAEs sign off as to the absence of fraud related to accounting, control, and audit. Based on the results from Table 13 and the relationships noted, it appears that a number of audit committees may strengthen the assurance about the allegations that they should know.

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Table 14 reports the results for the organization position having responsibility to follow up on anonymous whistleblowing allegations of fraud.

**Table 14**  
**Follow-up Responsibility for an Anonymous, Whistleblowing Report of Fraud**

Agent	Number (% of 115)
CAE / Internal Audit	82 (71%)
General Counsel	43 (37%)
EO	17 (15%)
Special Fraud Department	8 (7%)
Other	24 (21%)

CAEs are by far the most common agents assigned responsibility to follow up these allegations. Of the 115 organizations represented in Table 14, 70 assign follow-up responsibility only to one party, while 45 rely on more than one party. In 45 of the 70 cases where one agent is to follow up, that agent is the CAE. The next most popular choice for individual follow-up is the ethics officer (only 5), with answers in the “other” category including not sure/no policy (3), audit committee (2), depends on circumstances (2), and a number of one-time-named agents. In 37 more cases the CAE is jointly responsible for follow-up. The frequent use of multiple agents with follow-up responsibility may indicate that different agents follow up different sets of circumstances. On balance, it appears that improvement is possible for specifying the party to follow up.

A related question relates to violations of regulatory rules or laws: If a report involves a potential violation of regulatory rules or laws, who is responsible for notifying the appropriate regulatory agency? Only two broad answers are offered: (1) not reported unless explicitly required by law, and (2) reported (please complete reported by below). Out of 101 responses, 57 (56%) indicate that their organization does not report a violation unless explicitly required to do so; the remaining 44 (44%) respondents’ replies are summarized in Table 15.

**Table 15**  
**Responsibility for Reporting Non-mandated Regulatory Violations**

Agent	Number (% of 44)
General Counsel	32 (73%)
CFO	5 (11%)
CAE	4 (9%)
CEO	3 (7%)
Other	9 (20%)

The general counsel seems the logical agent to be involved with reporting any regulatory violation, including one that is not required to be reported. The reliance on finance-related agents (CFO and CAE) to make the decision is perhaps biased in favor of the respondents replying with financial violations in mind. The “other” category includes the compliance officer (3), the chief risk officer (2), and various others, most deciding in conjunction with another party (e.g., legal, the operational area).

### Other System Characteristics

Next, we turn to the remainder of items about the anonymous, confidential reporting system. We begin with the following item: The audit committee has overall responsibility for the anonymous and confidential reporting system. Who has operational responsibility for determining that each logged-in report is fully investigated, documented, and appropriately resolved? Answers appear in Table 16.

**Table 16**  
**Operational Responsibility for Investigating, Documenting,**  
**and Resolving Logged-in Reports of Wrongdoing**

Office	Number (% of 119)
Internal Audit	54 (45%)
General Counsel	43 (36%)
Ethics Office	27 (23%)
Human Resources	14 (12%)
Corporate Secretary	7 (6%)
Other	18 (15%)

Eighty-seven (73%) CAEs indicate that one office has sole responsibility for investigating, documenting, and resolving logged-in reports, while only 32 (27%) indicate that two or more offices share responsibility. Of the 87 indicating sole responsibility, internal audit is the most frequently named office (36, 41%), followed by the general counsel office (20, 23%), the ethics office (17, 20%), and the human resources office (2, 2%). With respect to shared tracking, the general counsel is first (23), followed by internal audit (18), human resources (12), and the ethics office (10). Those offices with more than one in the other category include the audit committee or its chair (3), the risk office (3), the security office (2), the CEO (2), and not done (4).

The next survey question is: Who generates a summary of incidents reported and their current status (appropriately resolved or still open)? Table 17 reflects the responses.

**Table 17**  
**Office Responsible for Preparing a Summary and**  
**Current Status of Incidents Reported**

Office	Number of Answers
Internal Audit Alone	50
General Counsel Alone	25
Ethics Office Alone	18
General Counsel and at Least One Other	8
Other	9

The office that receives summary reports is quite important as it can formulate an overall picture and is better able to make decisions about necessary follow-up. To address this, the survey next asks: Who receives a summary of incidents reported and the current status of each item reported? Rather than list each party, we elected to recode the data to reflect the following conditions in order of the strength of control/tone at the top: (1) both the CEO and the board receive; (2) the board receives but not the CEO; (3) the CEO receives but not the board. Table 18 shows the results from 113 respondents.

**Table 18**  
**Pattern of Recipients of the Summary and Current Status of Incidents Reported Based on Control**  
**Strength, Including Tone at the Top**

Combination of Recipient(s)	Number (% of 113)
Both CEO and Board	61 (54%)
Board, but not the CEO	36 (32%)
CEO, but not the Board	16 (14%)

We believe it is important for both the CEO and the board (nearly always via the audit committee) to receive this summary as, along with other information, it provides a snapshot of incidents reported and their status. For example, an increasing number of potentially serious reports unresolved is a matter of

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concern for both the CEO and the board (and the audit committee). The preferable combination of recipients shown in Table 18 is positively related to several ethical climate variables, including the conduct of a survey by the ethics office, the use of that survey's result as part of the performance assessment, and distribution of the survey results to both the CEO and an objective party (internal audit, external audit, audit committee). Again, the pattern for "good" control and climate seems to pervade some firms but not others.

A final element in this section relates to the frequency with which such reports are generated. The more frequent the reports, the less likely that major problems may accumulate without adequate attention. Table 19 shows the frequencies reported.

**Table 19**  
**Frequency of Report Generation Showing Current Status of Incidents Reported**

Frequency	Number (% of 111)
At Least Monthly	26 (23%)
Quarterly	66 (59%)
Greater than Quarterly or None Indicated	19 (17%)

Some organizations' practices seem open to improvement by increasing the scheduled frequency for reporting as more frequent monitoring usually enhances control.

### **Summary of Reporting Systems for Potential Wrongdoing**

The most common attributes of systems for reporting wrongdoing in our respondents' organizations include:

- Good availability of reporting channels for employees.
- Limited reporting channels for non-employees (e.g., vendors).
- Limited reporting channels for those outside the U.S.
- Wide availability of anonymous and phone channels, but only five-sixths believe these are well-known.
- Limited availability of other channels (letter finishing behind phone for most commonly available, Web the least).
- Well-qualified report recipients in an interactive mode (85%); the other 15% were not.
- Anonymous reporters can get follow-up information without divulging their names (62%); others can but must give names (24%); the rest cannot (14%).
- Specified time limits for responding to reports are uncommon (38% at least a "qualified yes"); the rest have no time limit (63%).
- Recipients of all reports include outside contractor (43%), internal audit (29%), and general counsel (28%).
- Types of alleged violations required to go to the audit committee: by senior management (40), fraud (31), regulatory (23), and control (15).
- Types of alleged violations required to go to internal audit: control (33), fraud (27), regulatory (26), and senior management (21).
- Type of procedure for the audit committee to assure that it receives all reports it should receive based on organization policy: committee has authority to investigate all allegations (62%); many audit committees have others as well; 14 committees have no procedure.
- Follow-up responsibility for an anonymous, whistleblowing fraud report: internal audit (71%); general counsel (37%).
- Responsibility for reporting non-mandated regulatory violations: general counsel (32, 73% of those reporting); many (57%) do not report non-mandated violations.
- Major responsibility for investigation, documentation, and resolution of each logged-in report: internal audit (45%), general counsel (36%).
- Responsibility for preparing a summary and current status of incidents reported: internal audit alone (50); general counsel alone (25).

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- Pattern of recipients of the summary above by control strength, including tone at the top: both CEO and the board (61; 54%); board but not CEO (36%); only CEO (16, 14%).
- Frequency of reports showing status of incidents reported and their resolution: quarterly (59%); monthly (23%); greater than quarterly or none indicated (17%).

### Internal Audit's Role in Control and Whistleblowing

In this section, we report the results from survey items that focus on internal audit, its current environment, the extent of its autonomy, and how it addresses and deals with fraud, including its role in whistleblowing.

### Internal Audit Staffing and Attitude Toward Using Whistleblowing

In this section, the survey first asks our respondents how their units are staffed. Table 20 contains the results. The distribution provides an opportunity to learn how differences in staffing philosophy, if any, are associated with internal audit staff behavior so far as fraud, whistleblowing, and the other matters addressed in this section. Where significant relationships appear, we report them.

**Table 20**  
**Staffing Philosophy for Internal Audit**

Nature of Staff	Number (% of 115)
Most are Career Internal Auditors	39 (34%)
Mixture of Career Internal Auditors and Rotating Staff	50 (43%)
Most Staff Rotate Through Internal Audit to Other Positions	26 (23%)

To better understand how CAEs perceive themselves and other members of their units as potential whistleblowers, the survey includes the following question: Internal auditors regularly develop reports that go to management and audit committees. However, they may come across things that require immediate attention and prefer to report anonymously. Are there circumstances when internal auditors are expected to report through the whistleblowing process rather than the normal audit reporting process?

The results appear in Table 21. These results indicate a strong preference for items to go through the CAE, which may reflect a view affected by the respondents' position as head of internal audit. Interestingly, this view is stronger in internal audit units staffed by career internal auditors than in those units that rotate partially or predominantly. This may be due to the "lay" status of many staff in these units. The inclination to treat whistleblowers like other employees is positively associated with organizations possessing strong ethical culture and processes. These relationships may indicate that organizations which rotate some personnel through internal audit *may* hold a stronger view that whistleblowing is everyone's responsibility.

**Table 21**  
**Internal Audit Philosophy About its Own Whistleblowing**

Are there circumstances in which IAs are expected to report using the whistleblowing process?	Number (% of 115)
Yes, as Other Employees	19 (17%)
Yes, When the Issue is in an Area Not Being Audited	2 (2%)
Yes, When the Issue Discovered During an Audit is Quite Significant and Timely Completion of the Audit is Not Likely	6 (5%)
No, All Issues Should Be Reported to the CAE for Either Immediate Reporting or for Planning Future Audits	82 (73%)
No, Whistleblowing is Incompatible with the Audit Function	4 (4%)

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To recap, nearly half our participating CAEs head units consisting of a mixture of career auditors and rotating personnel, followed by units with a preponderance of career auditors (34%) and units consisting primarily of rotating personnel (23%). As the balance moves toward more rotating personnel, CAEs are more likely to hold the view that there are circumstances in which internal auditors should use the whistleblowing reporting system compared to reporting directly to the CAE. Overall, three-fourths of our respondents opine that there are no circumstances in which internal auditors should not report to the CAE.

### **Relationship of Internal Audit to the Audit Committee and Management**

The survey contains three questions about the relationships among internal audit, the audit committee, and management. First, the survey asks respondents to use the list of options in Table 22 to describe their unit's current relationship with the audit committee. Instructions state to select all that apply. On balance, these responses portray a strong link between internal audit and the audit committee, especially the large percentage (93%) with direct access to the audit committee chair and the percentage (78%) of CAEs whose appointment is subject to the audit committee approval. The regularity of reports (85%) augments this strength. Forty-three percent (100% - 57%) of audit committees do not have budget approval for internal audit.

**Table 22**  
**Relationship Between Internal Audit and the Audit Committee**

<b>Relationships with Audit Committee: Select all that apply</b>	<b>Number (% of 119)</b>
You Make Quarterly Reports to the Committee	101 (85%)
You Have Direct Access to the Committee Chair as Issues Arise	111 (93%)
The Committee has Budget Approval for Internal Audit	68 (57%)
The Committee has CAE Appointment Approval	93 (78%)
You Have Performed One or More Audits in the Previous Year Directly as a Result of the Committee's Request	55 (46%)

To gauge the strength of the relationship between internal audit and the audit committee, we sum the three middle options — direct access, budget approval, and CAE appointment approval. This score ranges from three (if all three circumstances are present) to zero (if none of the circumstances are present). This measure differentiates the affinity between the committee and internal audit.<sup>5</sup> Results appear in Table 23.

**Table 23**  
**Number of Respondents Based on a Summary Measure of Internal Audit's Relationship with the Audit Committee (i.e., Sum from Measures of Direct Access, Budget Approval, and CAE Appointment Approval)**

<b>Summary Measure Score</b>	<b>Number (% of 119)</b>
Three of a Possible Three	37 (30%)
Two of a Possible Three	40 (33%)
One of a Possible Three	25 (21%)
None or No Response to the Three Options	18 (15%)

The strongest relationship to the audit committee existed for 37 (30%) of the respondents and the weakest relationship for 18 (15%), who indicated none of the three strongest relationships.<sup>6</sup> The highly significant positive relationships between the totals in Table 23 and the committee's ability to follow up on reports of wrongdoing it *should receive* (see Table 13) and other positive elements add to the potential

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importance of differentiating between strong and not so strong audit committees and their relationships to internal audit.

To gain insight into the balance of influence between the audit committee and management on internal audit, the survey asks the following question: The CAE has determined preliminary audit scope primarily based on risk analysis. In finalizing the audit plan, what is the relative influence of management and the audit committee? Table 24 shows the options and frequency of replies.

**Table 24**  
**Relative Influence of the Audit Committee and**  
**Management on Internal Audit's Audit Plans**

Option	Number (% of 117)
Management is More Influential	30 (26%)
Management and the Audit Committee are Equally Influential	53 (45%)
The Audit Committee is More Influential	34 (29%)

To compare the relative strength of influence of the audit committee and management on internal audit's plans to other survey items, we convert the responses in each row to a number (row 1 is 1; row 2 is 2, row 3 is 3). The relationship between responses from Tables 23 and 24 are highly correlated, with weaker audit committee control over internal audit associated with less audit committee influence over audit planning. Weaker audit committee control also relates to internal audit's propensity to report fraud discovery to some unit other than the committee. The measure in Table 24 is positively associated with other favorable control measures as well. For example, the greater the committee influence, the more likely it is that the EO has access to the CEO. The summed metric in Table 23 and its relationships with similar indicators suggest significant opportunities for some organizations to increase the relationship between internal audit and the audit committee to improve their control environment, control procedures, and board oversight.

Our results also show that not all control-related indicators are positively related to the audit committee's influence on internal audit. For example, our measure of audit committee influence and the CEO's increased emphasis on reporting wrongdoings since the advent of Sarbanes-Oxley are negatively related. This may be due to the CEO's preexisting emphasis on reporting relative to other CEOs in our sample or preexisting committee influence. Our measure of audit committee influence is also negatively related to increases in internal audit budget during the three-year period ending in 2005. This too may be due to preexisting relatively high funding levels for the internal audit function.

In summary, when the audit committee has greater control over internal audit (e.g., allowing direct access by the CAE, approving internal audit's budget, and approving CAE appointment, influencing internal audit's work), the audit committee is more likely to have access to reports that it should receive. The strength of the relationship between the audit committee and internal audit also reflects a greater role for internal audit in following up on fraud. Considering these and additional positive features of a strong audit committee/internal audit relationship, we believe the affinity between the audit committee and internal audit yields a stronger control environment. Our results suggest that a number of organizations have opportunities for improvement in this dimension.

### **The Effect of Sarbanes-Oxley**

In this section, the survey explores the effect of Sarbanes-Oxley on internal audit's funding and its work. The survey starts by assessing the change in the internal audit budget from 2002 to 2005. The results for this item are reflected in Table 25. Of the 117 responses, 111 indicate an increase and 6 a decrease.

**Table 25**  
**Extent of Internal Audit Budget Increase; 2002 to 2005**

<b>Percent of Increase in Internal Audit Budget from 2002 to 2005</b>	<b>Number (% of 111)</b>
Zero to 15%	29 (26%)
16% to 25%	29 (26%)
26% to 50%	18 (16%)
51% to 75%	5 (5%)
Greater than 75%	30 (27%)

To provide some insight underlying these funding increases, the survey asks the extent to which internal audit's budget for 2005 directly related to assessing and/or testing controls to meet the Sarbanes-Oxley requirements in Section 404. Responses appear in Table 26.

**Table 26**  
**Extent of 2005 Budget Directly Related to Assessing and/or Testing Controls to Meet Sarbanes-Oxley Requirements**

<b>Answer Options</b>	<b>Number (% of 117)</b>
None	9 (8%)
Less Than 10%	8 (7%)
Between 10% and 25%	35 (30%)
Between 25% and 50%	39 (33%)
Greater Than 50%	26 (22%)

Our data analysis indicates a strong positive relationship between the increases in the internal audit budget from 2002 and 2005 and the extent of assessment and testing related to Section 404. The impact is relatively straightforward. For example, if 50% of the 2005 budget was devoted to these requirements, then the budget from early years would need to increase by about 100% to "stay even" in conducting other internal audit functions. The extent of budget increase is also positively associated with the organization size, requiring CAEs to sign off indicating they know of no fraud, control, or audit concerns, and with internal audit doing its own survey to assess tone at the top (discussed below).

The survey also measures the extent to which internal audit work supports external audit work. There is little empirical evidence about the extent of external audit reliance on the work on internal audit following Sarbanes-Oxley. The question asks: To what extent does your work directly support the work of the external auditor? Responses appear in Table 27.

**Table 27**  
**Extent of Internal Audit Work Directly Supporting External Auditor Work**

<b>Answer Options</b>	<b>Number (% of 117)</b>
None	14 (12%)
Less Than 10%	46 (39%)
Between 10% and 25%	31 (26%)
Between 25% and 50%	23 (20%)
Greater Than 50%	3 (3%)

As with 404-related work, the extent of internal audit budget increases from 2002 to 2005 is strongly related to the increases in the extent of work to support external audit work.

There are other relationships in our findings that relate to one or more of the responses reviewed in this section. In particular, the mere increase or decrease in the internal audit budget plays a prominent role. However, one must interpret the increase-decrease variable cautiously due to the distribution of

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responses to the question (only 6 or 117 reported a decrease). Increases in the budget, greater emphasis on 404 testing, and more support of the external auditor are positively related to the perception that the CEO has placed much more emphasis on reporting wrongdoing since Sarbanes-Oxley.

These three are also positively associated with the likelihood that persons who reported wrongdoings anonymously could get information about follow-up actions without identifying themselves, a characteristic believed to increase the likelihood of reporting wrongdoing. A budget increase and extent of work directed to 404 are associated with more channels outside the U.S. A budget increase is also associated favorably with internal audit's testing the effectiveness of the whistleblowing system (discussed below), the existence of an ethics officer, their access to CEOs, and greater knowledge of the existence of foreign reporting channels. Arguably, the last three relationships are influenced by the nature of the organization's business, but the existence of the ethics officer is associated with many good practices independent of organization characteristics.

Based on the results presented in this section, it appears that Sarbanes-Oxley has frequently led to significant increases for internal audit budgets, shifts in emphasis to deal with 404-related issues, and greater support for improved control and ethical practices generally. Our survey and this report, however, do not provide evidence on cost-benefit aspects of Sarbanes-Oxley.

### **Internal Audit and Fraud**

The survey asks three questions to learn about internal audit's approach once it uncovers or suspects fraud. The first gauges the organization's policy about the autonomy afforded internal audit. Specifically, the question asks what internal audit would do if it learned of, or suspected, fraud while performing a regularly scheduled audit. Table 28 contains the answer options and related results.

**Table 28**  
**Organization Policy When Auditors Discover or Suspect Fraud**  
**in the Course of an Ordinary Audit**

<b>Answer Options</b>	<b>Number (% of 117)</b>
Investigates to Estimate Extent of Fraud and Determines Whether to Refer It	69 (59%)
Refers Immediately To:	
Audit Committee	13 (11%)
CEO or CFO	18 (15%)
Other than the Audit Committee or CEO/CFO	17 (15%)

The "other" category contained 42 responses as some organizations require auditors to immediately convey fraud or suspected fraud to more than one party. However, Table 28 reports 17, as this represents the number of replies that include agents other than the audit committee and the CEO/CFO.

As shown in Table 28, nearly six of 10 organizations allow internal audit the autonomy to use judgment about referring a fraud until it is investigated. This indicates considerable confidence in internal audit. On the other hand, nearly four of 10 organizations require immediate referral of detection or suspicion of fraud; most frequently to the CEO or CFO. Only one of 12 (11%) require that all fraud or suspicion of fraud go to the audit committee immediately.

To estimate which department gets fraud referred most frequently, the survey contains the options shown in Table 29.

**Table 29**  
**Organizational Units Receiving Referrals of**  
**Suspected Fraud Out of 108 Responding**

<b>Organizational Unit Title</b>	<b>Never</b>	<b>Rarely</b>	<b>Occasionally</b>	<b>Frequently</b>
Audit Committee	11	28	23	35
General Counsel	3	17	20	51
CFO	7	20	20	40
CEO	7	25	21	33
Fraud Investigation Unit	23	6	10	26
Other	3	3	5	11

The frequency of distribution to the CFO, and to a lesser extent the CEO and general counsel, are consistently related. Also, the frequency with which units have fraud referred is related to several characteristics discussed earlier. For example, the frequency of distribution to the CEO is positively associated with a time limit on resolving anonymous reports. The composition of internal audit is also related to several frequencies. As internal audit composition becomes populated with more rotated staff, the distribution to the fraud investigation unit, the CFO, and the general counsel becomes more frequent. That is, the increase in the tendency to distribute to the fraud investigation unit may signal an internal audit staff more heavily dedicated to operational audit than to financial statement audit.

The next query asks that if the item is referred, does internal audit follow up to see that the item is resolved? The straight “yes-no” answer resulted in 100 (89%) responding “yes” and 10 (11%) indicating “no.” Thus, even when internal audit has little autonomy to resolve fraud independently (i.e., fraud is required to be referred immediately), it is generally able to determine that there is a resolution. Notably, when fraud is reported to the audit committee the likelihood of internal audit follow-up is especially high. However, the follow-up diminishes as the internal audit staff is populated more heavily with rotating personnel. Internal audit follow-up increases as the frequencies of distribution to the CEO and CFO increase. Showing further internal audit strength, follow-up is more frequent when internal audit tests the whistleblowing system for effectiveness (results below).

To summarize, internal audit is commonly given considerable leeway to investigate suspicions or existences of fraud before it makes a determination to refer the situation. Distribution of reports of fraud to the audit committee and top-level officers is not uncommon. The greater the number of distribution targets from this group, the greater the presence of other indicators favorable to a good ethical climate or reporting system. When internal audit tends to be populated more heavily with rotating personnel as compared to career staff, the likelihood of internal audit being involved in fraud follow-up and testing the whistleblowing system diminishes.

### **Testing the Whistleblowing System and Related Control Elements**

As with any control element, the whistleblowing system should be tested to assure that it is functioning properly and worthy of reliance. Presumably, a primary source of internal testing would be internal audit. To provide evidence on the issue of internal audit testing of the whistleblowing system, the survey poses this question: Does internal audit have responsibilities for regularly testing and evaluating the effectiveness of the whistleblowing policies and controls? Results of a simple “yes-no” answer indicate that 68 (59%) choose “yes” and 48 (41%) select “no.” Interestingly, when internal audit does test the whistleblowing system, organization policy is more likely to contain the right to discipline those making a false accusation harmful to others. Also, the testing by internal audit is indicative of a greater likelihood of some types of wrongdoing being reported directly to the audit committee or internal audit.

For those CAEs responding “yes” to the above testing question, the survey includes a list of potential procedures that they may employ. The survey asked “yes” respondents which, if any, of these they have employed in their testing. Responses appear in Table 30.

**Table 30**  
**Procedures Used by Internal Auditors Who Do Test**  
**the Whistleblowing System**

Procedure	Number (% of 68 Who Test)
Audit Committee is Properly Apprised of All Instances Appropriate for Its Purview	56 (82%)
Timely Resolution Occurs	56 (82%)
All Reports are Logged	54 (79%)
Controls are Implemented to Address Weaknesses (Risks) Noted in Reported Incidents	51 (75%)
Timely Assignments are Made to Resolve Reports	49 (72%)
Policies Comply with All Regulatory Requirements and National Laws	46 (68%)
Reports are Accurate	44 (65%)
Outsourced Hotline Agencies' Work is Performed Effectively	36 (53%)
Trends are Analyzed	32 (47%)
Other	5 (7%)

The five in the "other" category generally reflects the newness of the system in some organizations and/or the lack of reports to test. In terms of the range of testing procedures within an organization, 18 (26%) indicate nine of the procedures in use, 11 (16%) indicate eight, 13 (19%) use seven, and the remainder (26, 38%) use six or less (six use only one). Of the 68 internal audit units that do test the whistleblowing system, 42 (62%) use seven or more procedures to assure that the system is functioning properly.

Finally, the survey includes items to assess whether internal audit, independent of other units, uses surveys or other approaches to periodically assess the tone at the top elements (as described by the COSO integrated control framework), the quality of the organization's ethical culture, and employee understanding of whistleblowing activities. Table 31 contains the response to these three items.

**Table 31**  
**Internal Audit Testing of Crucial Ethical Elements**

Element	Number (% of 117)
Tone at the Top Elements (as Described in the COSO Integrated Control Framework)	72 (61%)
The Quality of the Organization's Ethical Culture	50 (42%)
Employee Understanding of Whistleblowing Activities	44 (37%)

We sum the three responses to gain an overall understanding of testing patterns and relationships to other survey items. This summed score can range from three, when internal audit tests all three, to zero, when internal audit does not test any. The distribution of this sum is: 25 units test all three elements, 27 test two (14 are tone and ethical culture), 37 test one (26 are tone), and 29 units test none of the three elements. For 10 of these 29 organizations where internal audit does not perform testing, the ethics officer or other responsible party conducts a comprehensive survey of the ethical climate, leaving 19 organizations that apparently have little or no testing of these three elements. These results suggest opportunities for improvement for some organizations.

The sum of the three elements tested by internal audit is positively related to survey results going to both the CEO and an objective party (internal audit, external audit, and the audit committee), indicating a system that favors tone at the top and control. Also, the more elements tested, the greater likelihood that CAEs are required to sign off that they knew of no accounting, control, or audit problems; that the organization has more domestic reporting channel available; and that using the regular whistleblowing channel for internal auditors in some cases is acceptable.

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## **The Role of Internal Audit in Sensitive Communications**

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To sum up internal audit's role in testing the whistleblowing system and related control elements, 61% regularly test the system's effectiveness; 39% do not. Those units more likely to test seem to be more engaged along with the audit committee in focusing more heavily on learning of any fraud. Of the 64 units that engage in testing the whistleblowing system, 42 (61%) use seven or more of the procedures listed in Table 30. Seventy-two (61%) internal audit units regularly survey or otherwise test for tone at the top and approximately 40% regularly test for ethical culture and employee understanding of the whistleblowing system. The larger the number of elements tested, generally the more favorable other elements of the ethical climate. Nineteen (one in six) of the organizations represented in the survey apparently have little or no testing of any of the three important elements.

### **Summary of Internal Audit's Role in Control and Whistleblowing**

Nearly half of our CAE respondents characterize their staff as a mixture of career auditors and rotating personnel, followed by units with a preponderance of career auditors (34%) and units consisting primarily of rotating personnel (23%). As the balance moves toward more rotating personnel, CAEs believe that auditors will use the whistleblowing reporting system as other employees rather than reporting suspected wrongdoing directly to the CAE. However, three-fourths of our respondents opine that reporting to the CAE is the preferred channel.

When the audit committee has a stronger relationship with and control over internal audit (e.g., allowing direct access by the CAE, approving internal audit's budget, and approving CAE appointment, influencing internal audit's work), the audit committee is more likely to have access to reports that it should receive. The strength of the relationship between the audit committee and internal audit also reflects a greater role for internal audit in following up on fraud. Considering our results, we believe the affinity between the audit committee and internal audit yields a stronger control environment.

Enactment of Sarbanes-Oxley appears to have led to substantial increases in internal audit budgets, a shift in emphasis to deal with 404-related issues, and greater support for improved control and ethical practices generally. Assessing the cost-benefit of Sarbanes-Oxley is beyond the scope of this project.

When potential fraud comes to the attention of internal audit, it normally is given considerable leeway to investigate before it makes a determination to refer the situation. Distribution of reports of fraud to the audit committee and top-level officers is not uncommon. The greater the number of distribution targets, the greater the presence of other indicators favorable to a good ethical climate or reporting system. When internal audit tends to be populated more heavily with rotating personnel as compared to career staff, the likelihood of internal audit being involved in fraud follow-up and testing the whistleblowing system diminishes.

The majority (61%) of internal audit units regularly tests the effectiveness of the reporting system for wrongdoing; 39% do not. Sixty-one percent regularly survey or otherwise test for tone at the top and about 40% regularly test for ethical culture and employee understanding of the whistleblowing system. Ten organizations have other positions (e.g., EO) test the ethical climate; 19 indicate no testing. Audit units more likely to test seem to be more engaged, along with the audit committee, in learning about fraud. Of the 64 units testing the whistleblowing system, 42 (61%) use an extensive set of procedures (see Table 30). The larger the number of elements tested, generally the more favorable other elements of the ethical climate. Nineteen (one in six) of the organizations represented in the survey apparently have little or no testing of any of the three important elements.

### Summary and Conclusion

#### Overview

CAEs representing 119 organizations that filed integrated financial and internal control reports replied in early summer 2005 to a questionnaire with items on their organizations' demographics, current ethical climate, reporting mechanisms for potential wrongdoing, and internal audit's role in the whistleblowing system. Many of the items in the questionnaire dealt with elements from prior research or professional literature that suggested "good" characteristics. Typical respondents were head of a completely in-house audit function (87%), 46 years old, male (72%), in the leadership post between four and five years, and expecting to remain in internal audit for another five to eight years. Organizations represented in the survey came from a wide array of industries, had a mix of revenue/sourcing that ranged from entirely domestic (44%) to heavily non-U.S. (37%), and ranged in size measured in the larger of revenue or total assets from between \$200 million to \$1 billion (29%) to over \$6 billion (21%).

#### Ethical Climate

The existence of an ethics officer and that person's access to important parties in the organization (the CEO, internal and external audit, and the audit committee) is perhaps the strongest single indicator of an organization's commitment to fostering and developing an ethical climate. This indicator is positively related to the conduct of a comprehensive survey directed at assessing the ethical climate, the distribution of the survey results to important constituencies, and the use of the survey results in managers' performance assessments. Consistent with the notion that tone at the top represents an important element of the control environment, a second major element associated with best practices is the respondents' perception of the CEO's increased emphasis on reporting sensitive issues since the passage of Sarbanes-Oxley. A requirement that all managers below the executive level sign off that they have no knowledge of wrongdoing is also important. Based on existing research and professional literature, we believe that these relationships point toward a healthy ethical climate.

#### Reporting Systems for Wrongdoing

The most common system attribute includes multiple reporting channels for employees, but fewer for those situated outside the U.S. and non-employees (e.g., vendors). As expected, anonymous channels are nearly universally available with the phone being the most common. Consistent with the spirit of Sarbanes-Oxley, the ability to report anonymously can be expected to increase the likelihood of a report as the expected cost for anonymous reporters is lowered. However, only five-sixths of the respondents believe that these channels are well known to potential reporters. Another major factor reducing the likelihood of reports involves the belief that nothing will be done to address or correct the sensitive matter. To mitigate employees' forming this belief, anonymous reporters should have the ability to get follow-up information without divulging their names (only 62%) and there should be specified time limits for responding to reports (38% at least a "qualified yes"); the rest (62%) have no time limit. A well-qualified report recipient operating in an interactive mode is likely to expedite a resolution eliciting important information related to the potential severity of the reported wrongdoing, its location, and other important information. A significant majority (85%) believes that their recipients are well-qualified; the balance does not.

Forty-three percent of the respondents report that *all* reports go to the outside contractor; 29 percent to internal audit; and 28 percent to general counsel. Having all reports accumulated by at least one party provides a basis for testing "completeness" and how each report was resolved. In order of frequency, the types of alleged violations required to go to the audit committee include violations by senior management (40), fraud (31), regulatory (23), and control (15). For those required to go to internal audit, the order is control (33), fraud (27), regulatory (26), and senior management violations (21). In order for audit committees to assure receipt of all reports that it should, audit committees should have access to and authority to investigate all reports (62%); 14 respondents indicated no related audit committee

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authority or procedure for this type of assurance, leaving a void in the audit committee's interest or ability to follow up on the reporting system.

Internal audit is the dominant choice (71%) to follow up on anonymous fraud reports followed by the general counsel (37%). The total percentage exceeds 100% because some organizations have more than one unit follow up when circumstances dictate. For example, regulatory violations may involve both internal audit and the general counsel. Internal audit (45%) is also the most popular choice to investigate, document, and resolve each logged in report, again followed by the general counsel (36%). Similarly, when one function has sole responsibility for preparing a summary and current status of each incident reported, internal audit is the most popular (50), followed by the general counsel (25).

The recipients of the summary and current status report, ranked by our judgment of strongest to weakest internal control — including tone at the top, is both the CEO and the board (54%); the board but not the CEO (32%); and only the CEO (14%). Twenty-three percent of the respondents indicated that this type of summary is provided monthly, 59% quarterly, and 17% less frequent than quarterly or not at all.

### **Internal Audit's Role in Control and Whistleblowing**

Nearly 45% of our CAE respondents characterize their staff as a mixture of career auditors and rotating personnel, followed by units with a preponderance of career auditors (34%) and units consisting primarily of rotating personnel (23%). As the balance moves toward more rotating personnel, CAEs believe that internal auditors will use the whistleblowing reporting system as other employees rather than reporting suspected wrongdoing directly to the CAE. However, three-fourths of our respondents opine that reporting to the CAE is the preferred channel.

When the audit committee has greater control over internal audit (e.g., allowing direct access by the CAE, approving internal audit's budget, approving CAE appointment, and influencing internal audit's work), the audit committee is more likely to have access to reports that it should receive. The strength of the relationship between the audit committee and internal audit also reflects a greater role for internal audit in following up on fraud. The affinity between the audit committee and internal audit is associated with a stronger control environment.

Enactment of Sarbanes-Oxley appears to have led to substantial increases in internal audit budgets, a shift in emphasis to deal with 404-related issues, and greater support for improved control and ethical practices generally.

When potential fraud comes to the attention of internal audit, it normally is given considerable leeway to investigate before making a determination to refer the situation. Distribution of reports of fraud to the audit committee and top-level officers is not uncommon. The greater the number of distribution targets, the greater the presence of other indicators favorable to a good ethical climate or reporting system. When internal audit tends to be populated more heavily with rotating personnel as compared to career staff, the likelihood of internal audit being involved in fraud follow-up and testing the whistleblowing system diminishes.

The majority (61%) of internal audit units regularly tests the effectiveness of the reporting system for wrongdoing; 39% do not. Sixty-one percent also regularly survey or otherwise test for tone at the top. About 40% regularly test for ethical culture and employee understanding of the whistleblowing system. Some organizations have other positions (e.g., the ethics officer) test the ethical climate; however, nearly one out of six organizations' CAEs do not indicate any testing at all for key ethical measures. Internal audit units more likely to test seem to be more engaged, along with the audit committee, in learning about fraud. Of the 64 units testing the whistleblowing system, 42 (61%) use an extensive set of procedures (see Table 30). The larger the number of elements tested, generally the more favorable other elements of the ethical climate.

### Conclusion

The organizations represented in this study and their CAE characteristics, ethical climate measures, reporting systems for wrongdoing, and internal audit's role in control and testing reporting systems indicate significant diversity. Based on existing research and our analysis of the information presented, we believe that considerable opportunities exist for a number of the organizations represented in our study to improve their practices. The information in this report should assist those organizations as well as others to move more closely to best practices.

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### Notes

<sup>1</sup> We use this term for all respondents, even though some had different titles.

<sup>2</sup> Exact means, etc. are not possible in all cases due to the fact that we used categories expressed as ranges. The approximate measures provided should be materially correct.

<sup>3</sup> Rather than repetitively cite research studies in this report, we rely on two relatively recent summaries of the whistleblowing literature unless otherwise noted. The first is Hooks, K. L., Kaplan, S. E., and Schultz, J. J., Jr., "Enhancing communication to assist in fraud prevention and detection," *Auditing: A Journal of Practice & Theory* (Fall 1994), 86-117, which the benefit of being related to COSO, *Internal Control - Integrated Framework*, (Harborside, NJ, AICPA, 1992). The second is a work by two leading whistleblowing scholars, Near, J. P., and Miceli, M. P., "Effective whistle-blowing," *Academy of Management Review* (1995), 679-708.

<sup>4</sup> See "Microsoft Standards of Business Conduct," Published: May 15, 2003. Updated: May 4, 2004, at <http://www.microsoft.com/mscorp/legal/buscond/#standards>

<sup>5</sup> This sum is highly (correlation significant at .01) and positively related to the sums that include the first and last options and each individual item shown in table 22. However, we believe that making a quarterly report and performing work at the audit committee's request do not connote the strength of relationship represented by these three.

<sup>6</sup> When all five options were considered, only four (3%) indicated no relationship option.

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