

## **Chapter I**

### **Introduction**

Over the last few years, the subject of ethics and compliance in organizations of various kinds and sizes has greatly increased in visibility and importance for practitioners of governance, their advisors and mentors, for monitors of ethics and compliance processes, and for those responsible for oversight. The parade of business scandals and ethical lapses that has seemed to continue without significant letup has led to continued legislative and regulatory mandates for improved governance practices.

As a consequence of these events, many organizations have made significant improvements in their governance structures. Many have come to the realization, some times belatedly, that good governance that is founded on a strong ethical climate represents a significant best business practice that benefits all stakeholders. This is true whether the organization is large or small, for-profit or not-for-profit, publicly held, or privately owned. Effective ethics and compliance programs support good governance practices.

In fact, recent research by LRN, a consulting firm specializing in governance, ethics, and compliance management provides additional evidence that a company's ability to maintain an ethical corporate culture is key to the attraction, retention, and productivity of employees.<sup>1</sup> According to the study, 94% of employees said it was either critical or important that the company they worked for is ethical. This compares with 76% who said so in a similar survey six months earlier. Eighty-two percent said they would prefer to be paid less but work at a company that had ethical business practices rather than receive higher pay at a company with questionable ethics. More than a third said they had left a job because they disagreed with the actions of either fellow employees or managers. This is true across all ages, genders, and socioeconomic factors.

As an important aspect of their organization's governance, internal auditors should be aware of all of these developments and fully familiar with the details of a majority of them, so they will be able to apply the concepts and practices they exemplify in all circumstances relevant to their own organizations. Members of audit committees, corporate counsel, and external auditors should also be knowledgeable about matters concerning ethics and compliance, as their responsibilities in ethics and compliance are also increasing.

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<sup>1</sup> LRN Press Release, "New Research Indicates Ethical Corporate Cultures Impact the Ability to Attract, Retain and Ensure Productivity Among U.S. Workers," August 3, 2006

A recent survey conducted by the IIA reports that 54% of responding internal auditors do not do ethics auditing because it is either “too hard” or “not our job.”<sup>2</sup> Major objectives of this handbook are to convince internal auditors of the importance of ethics and compliance systems to effective governance processes, a key responsibility of internal auditing, and also to provide information that will give internal auditors comfort in providing ethics-related services. A recent article in *Internal Auditor* magazine quotes a member of the IIA Ethics Committee as saying: “An ethics audit uses the exact same processes, interview, and documents as a standard business audit.”<sup>3</sup>

A principal reason internal auditors need to be especially well-informed about matters of ethics and compliance is the fact that this subject is critically important to all three of the principal areas of responsibility that are contained in the IIA definition of internal auditing:

[Internal auditing] 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.<sup>4</sup>

One of the most significant business risks facing every organization is the possibility of loss of trust and confidence by investors, customers, vendors, employees and the public at large. In terms of control, the second area of internal auditing expertise, integrity and ethical values are known to be the most important components of internal control. While not synonymous, the concepts of governance and that of ethics and compliance are closely intertwined. Internal auditing fulfills an important role in assuring that ethics and compliance programs are properly designed to achieve the objectives for which they were established, and that they continue to operate in an effective manner to assure accomplishment of these goals.

Thus, practitioners of internal auditing, as significant components of governance processes, and also persons in related fields, need to be particularly aware of all developments affecting organizational ethics and compliance. An objective of *Ethics and Compliance: Challenges for Internal Auditing* is to help fulfill those needs.

The title of Chapter II is *Ethics and Compliance in Internal Auditing Professional Standards*. This chapter discusses the numerous references to ethics and compliance processes that are contained in IIA *International Standards for the Professional Practice of Internal Auditing* and the related Practice Advisories that recommend how they should best be put into practice. The primary professional standard in this regard is Performance Standard No. 2100, *Nature of Work*. This Standard paraphrases into action requirements the portion of the definition of internal auditing set forth above. Chapter II also sets forth internal auditing responsibilities for compliance with the IIA *Code of Ethics*.

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<sup>2</sup> Jackson, Russell, “Keeping Companies Clean,” *Internal Auditor*, December 2006, p. 40

<sup>3</sup> Id., p. 42

<sup>4</sup> Institute of Internal Auditors, *The Professional Practices Framework*, 2005, Altamonte Springs, FL: IIA, 2005, p. xxxvii

Chapter III is titled: *Importance of Ethics and Compliance to Internal Control*. The chapter presents details of the interrelationships between ethics and compliance and that of internal control. The 1992 COSO internal control *Framework* report notes the critical importance of the control environment to effective controls. This concept has been carried forward in guidance to external auditors contained in generally accepted auditing standards.

In September 2004, COSO published a counterpart framework to its 1992 internal control document on the subject of risk management titled *Enterprise Risk Management – Integrated Framework*.<sup>5</sup> This document incorporates and expands on COSO's earlier seminal study on the framework of internal control, while providing a more robust and more extensive focus on the broader subject of enterprise risk management.

Chapter III also discusses the 2006 COSO publication that reiterates and augments its earlier guidance concerning the importance of ethics and compliance to internal control. This three-volume set is titled: *Internal Control over Financial Reporting – Guidance for Smaller Public Companies*.<sup>6</sup> Although directed primarily to smaller companies, much of the content has application to all organizations, including those established as not-for-profit and governmental entities. As the organization's experts in matters of internal control, internal auditors need to be fully familiar with the contents of each of these documents that relate to ethics and compliance and their broader implications.

Chapter IV is titled *Requirements for Ethics and Compliance Contained in Sarbanes-Oxley Legislation* and covers the statutory rules and their implementing guidance that requires all publicly held corporations in the U.S. to establish elements of an effective ethics and compliance program. Emphasis is placed on the related challenges for internal auditing. No counterpart ethics and compliance-related legislation has been enacted in other countries.

The Sarbanes-Oxley Act of 2002 (SOX)<sup>7</sup> contains a number of such requirements. Section 301 of SOX, "Public Company Audit Committees," requires the audit committees of public companies to establish a confidential system for reporting wrongdoing, a key element of an effective ethics and compliance program. Section 406, "Code of Conduct for Senior Financial Officers," requires disclosure of whether a public company has adopted a code of ethics for senior financial officers, and if not, the reason therefore.

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<sup>5</sup> Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management – Integrated Framework: Executive Summary*, New York: American Institute of CPAs, 2004.

[www.cpa2biz.com](http://www.cpa2biz.com)

<sup>6</sup> Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies: Executive Summary*, New York: AICPA, 2006.

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<sup>7</sup> P.L. 107-24

Section 302 of SOX, “Corporate Responsibility for Financial Reports,” requires the principal executive and financial officers to certify in each annual or quarterly financial report that they have designed proper internal and disclosure controls and have evaluated their effectiveness. SOX Section 404, “Management Assessment of Internal Controls,” requires public companies to publish management’s annual assessment of the effectiveness of the internal control system over financial reporting as well as an attestation by the organization’s external auditor of management’s assessment. The effective date for the Section 404 requirement to assess internal control over financial reporting and provide an independent auditor attestation has been postponed by the SEC for smaller public companies.

In 2007, the SEC promulgated conceptual guidance to provide issuers of securities to the public with the principles of how these SOX requirements are to be put in practice. As noted above, the most widely accepted COSO internal control framework describes integrity and ethical values as the most important components of an effective internal control system.

Chapter V describes follow-on initiatives of SOX, and is titled *SOX Independent Sector Implementation Initiatives*. The chapter discusses the requirement that the New York Stock Exchange and NASDAQ have published for companies listed on those exchanges to maintain an effective code of conduct for directors, officers, and employees as a condition of continued listing. Stock Exchange rules set forth the basic requirements of such codes of conduct.

This chapter also contains portions of the guidance to external auditors contained in PCAOB Audit Standard No. 2, *An Audit of Internal Control over Financial Reporting performed in Conjunction with an Audit of Financial Statements*.<sup>8</sup> Chapter V emphasizes the portions of this standard that will best enable internal auditing to provide value in testing internal controls in a manner that can be use to directly assist an external auditor’s internal control attestation and audit that is required under Section 404 of SOX.

*Ethics and Compliance Contained in Prominent Best Practice Recommendations* is the title of Chapter VI. The chapter advances other motivations for the establishment of an effective ethics and compliance program and the related internal auditing challenges. The works of two committees of the International Federation of Accountants (IFAC) provide guidance to internal auditors in assisting management to design an effective code of conduct and monitoring its performance as well as providing guidance on helping accountants and auditors to have a strong ethical compass.

Another major topic included in the chapter is a discussion of the 2004 revision to the United States Sentencing Guidelines (USSG) for organizations. The revision

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<sup>8</sup> PCAOB, Auditing Standard No. 2, 2004

places greater emphasis on ethics as a condition of enabling organizations to avail themselves of the mitigating circumstances provisions that are contained in the guidelines. The Sentencing Commission's press release reads:

Organizations must promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law. In particular, the amendment requires boards of directors and executives to assume responsibility for the oversight and management of compliance and ethics programs. Effective oversight and management presumes active leadership in defining the content and operation of the program. At a minimum, the amendment explicitly requires organizations to identify areas of risk where criminal violations may occur, train high-level officials as well as employees in relevant legal standards and obligations, and give their compliance and ethics officers sufficient authority and resources to carry out their responsibilities.<sup>9</sup>

The 2004 revision to USSG requirements also mandates continuous improvement through risk assessment and analysis. It is clearly evident that these requirements directly involve the internal audit activity.

The following two chapters in the volume discuss aspects of two important components of effective ethics and compliance programs and methods that internal auditors should consider in making assessments of them. Chapter VII, *The Role of an Effective Code of Conduct* describes guidance for the characteristics of the content of such codes and also how best they should be put into practice. Coverage includes draft good practice guidance for codes by IFAC.<sup>10</sup> Chapter VIII, *The Role of an Effective Confidential Reporting Process*, discusses the importance and key elements of this aspect of a formal ethics and compliance program. Research has shown that an effective confidential reporting process is one of the most important tools in assuring a strong ethical climate in the organization.

The subject matter of the final chapter, Chapter IX, *Assessing Ethics and Compliance Programs* includes the characteristics of effective ethics and compliance programs together with the most efficient and effective methods that internal auditors can use for assessing their quality. The chapter begins with an overall view of how internal auditors have a unique perspective from which to evaluate the ethical culture in their organization. Internal auditors have a significant head start in the area of ethics and compliance through their familiarity with the organization and how it functions.

This final chapter then describes some of the more effective organizational characteristics internal auditors may observe as well as some of the techniques that may be helpful in performing an evaluation. The chapter includes the work of PricewaterhouseCoopers, the Ethics Resource Center, and the Association of Certified

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<sup>9</sup> US Sentencing Commission News Release May 3, 2004 "Commission Tightens Requirements for Corporate Compliance and Ethics Programs."

<sup>10</sup> IFAC, Defining and Developing an Effective Code of Conduct, Exposure Draft, November 2006

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Fraud Examiners. This chapter also includes guidance published by the Open Compliance and Ethics Group (OCEG) titled *Measurement & Metrics Guide*.<sup>11</sup> OCEG has also developed an evaluation tool titled “Does the Company Get It? – 20 Questions To Ask Regarding Compliance, Ethics, and Risk Management.”<sup>12</sup>

One of the important challenges for internal auditing is to provide services that properly balance the need for independence and objectivity that is necessary to fulfill the assurance requirements of the board of directors, primarily through its audit committee, while at the same time providing value to local management. *Ethics and Compliance: Challenges for Internal Auditing* should assist internal auditors in this critically important area of governance.

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<sup>11</sup> OCEG, *Measurement & Metrics Guide*, OCEG Practice Aid, Exposure Draft, July 2006

<sup>12</sup> OCEG, Appendix I to *Internal Audit Guide – Evaluating a Compliance and Ethics Program*, OCEG Practice Aid, Exposure Draft, May 2006