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TONE at the TOP

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EXCLUSIVELY FOR SENIOR MANAGEMENT, BOARDS OF DIRECTORS, AND AUDIT COMMITTEES

What's on Your (Corporate) Conscience?

It has been said that having integrity is doing the right thing when nobody's watching you. Unfortunately, recent news headlines are featuring numerous executives who have made unethical business choices in private, while modeling quite a different public persona that leaves an impression of transparency.

Today, stakeholders are looking with caution at the business world and asking, "Whom can I trust?" It is disheartening to read about companies that are acting irresponsibly. Many other organizations and their governance entities, however, are working tirelessly to find ways to demonstrate their commitment to high ethics and sustainability, as well as intolerance of the slightest perception of wrongdoing or irresponsible risk taking.

Today, there's even a concept referred to as the "triple bottom line," which combines people, planet, and profit and drives sustainable performance and boardroom actions. There are entire organizations dedicated to holding corporations and other institutions accountable to act responsibly and in the long-term best interests of the environment and the human condition.

Skeptics, however, suggest that executives can hide behind a "corporate shield" of what appears to be socially responsible behavior, while in reality their actions are the antithesis of what is right for their stakeholders and the welfare of the public at large. In fact, "The Myth of the Corporate Conscience," which was written by Jerry Mander and appeared in *Business and Society Review* more than 17 years ago warned of such.

The IIA feels differently, however, and actually positions internal auditors at the forefront of ensuring their organizations have effective policies regarding ethics. The IIA's Standard 2110: Governance requires that the internal audit activity assess and make recommendations for improving the governance process in its accomplishment of various objectives, including promoting appropriate ethics and values within the organization. This standard also requires that the internal audit activity evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities.

Internal auditors play an important role in ensuring that the organization is behaving ethically, says Carlo Patetta Rotta, CIA, CFE, CISA, author of "Groundswell of Risk," a feature article in the November issue of The IIA's *Internal Auditor* magazine. Rotta explains that internal auditors can help ensure the organization complies with laws and regulations and is perceived to behave ethically in any circumstances by:

- Contributing toward establishing a company culture that is in favor of ethics and where compliance with laws and regulations is a vital success factor for employees in advancing their careers within the organization. How senior management is portrayed in its daily activities becomes pivotal. Ethics should become a significant component of its leadership.
- Convincing the board to set up an ethics and compliance department responsible for ensuring that the organization complies with laws, regulations, company policies and procedures, and ethical standards or code of conduct. The department should be managed by a chief ethical officer, or chief compliance officer, who reports directly to the board and is consulted whenever the organization faces any ethical dilemmas.
- Including ethics audits in the audit plan. This type of audit should focus on aspects of processes that could constitute an unintentional temptation for employees and management to commit unethical actions. Essentially, these are processes where the controls are not in place or are not functioning appropriately, leaving room for employees to perpetrate fraud. Purchasing would be a typical area to investigate in an ethics audit.
- Ensuring that a whistleblowing procedure has been set up that allows employees and external parties, such as clients and vendors, to highlight any ethically questionable situations anonymously so that the compliance group or internal auditing can take remedial actions.

Reputation, Risk, and Responsibility

Richard Chambers, CIA, CGAP, CCSA
President and CEO
The Institute of Internal Auditors

The Institute of Internal Auditors (IIA) President and CEO Richard Chambers, CIA, CGAP, CCSA uses a story from his past to illustrate the importance of recognizing the risk that boards of directors and executive management are taking when they do not set the right tone at the top. According to Chambers, when he was working for a public sector client, the board chairman made plans to travel to Paris. Although his trip would be funded by the agency, the purpose noted on an agency travel schedule was "to attend the Paris Air Show." Not appropriate, says Chambers, who, upon learning of the upcoming trip, immediately called the chairman and cautioned him about the risks. "Mr. Chairman," he said, "I see that you are going to attend the Paris Air Show. I think that might be perceived as a bit wasteful since we do not have operations in Paris." Chambers went on to remind his chairman about the harm such an action could bring to the agency's reputation, as well as both the precedent and example it would be setting.

Once employees see that those at the top are acting irresponsibly, it is as though they have been given "permission" to do the same. And a new, lower level of behavior that is considered acceptable within the organization becomes engrained within the corporate conscience. So, it is appropriate to suggest that both the board of directors and executive management are, indeed, responsible for modeling behaviors they would like to see emulated throughout the organization.

In "Corporate Governance and the Financial Crisis: Key Findings and Messages," the Organization for Economic Co-operation and Development (OECD) recently reported on major governance weaknesses that contributed to the current global financial crisis. The report points to inadequate risk management as one of the factors that led to the severity of the crisis.

The OECD affirms that, although risk management failures in financial institutions clearly can have important implications for systemic risk, failures in non-financial companies also can result in major costs to society. Rather than focusing on risk and internal control simply for the purpose of corporate reporting, the OECD suggests that risk management should be linked to strategy and should be an enterprise-wide undertaking. With strategy falling under the primary responsibility of the board, the management of the associated risks also would be a board responsibility. However, says the OECD, good risk management should be practiced throughout the company and should be inherent in the way the organization does business.

ABOUT THE OECD / www.oecd.org

The OECD is an international organization devoted to helping governments tackle the economic, social, and governance challenges of a globalized economy. It brings together governments of countries from around the world committed to democracy and the market economy. The OECD strives to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist economic development, and contribute to growth in world trade. It provides a setting in which governments can compare policy experiences, seek answers to common problems, identify good practices, and coordinate domestic and international policies.

The World Economic Forum Global Risk Network categorizes risks as technological, geopolitical, societal, environmental, and economic. By contrast, the Committee of Sponsoring Organization of the Treadway Commission's (COSO's) perspective includes strategic, operational, reporting, and compliance risks. And we've already discussed the dangers of reputational risks. Regardless of how risks are categorized, acquiring a holistic and effective enterprise-wide approach can be an overwhelming undertaking.

To help boards of directors strengthen their oversight of enterprise risks, COSO recently released the paper, "Effective Enterprise Risk Oversight: The Role of the Board of Directors." COSO Chairman David Landsittel acknowledges that the role of the board of directors in enterprise-wide risk oversight has become increasingly challenging, especially in light of the current economic crisis.

"The challenge facing boards," says Landsittel, "is how to effectively oversee an organization's enterprise risk management

ABOUT COSO / www.coso.org

Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, COSO is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. COSO comprises the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), the Institute of Management Accountants (IMA), and The Institute of Internal Auditors (IIA).

(ERM) in a way that provides improved oversight while adding value to the organization."

The paper, as well as the executive summary of COSO's *Enterprise Risk Management – Integrated Framework*, can be downloaded from the COSO Web site at www.coso.org. In addition, COSO soon will release a paper providing in-depth discussion on senior management's role in strengthening risk management processes.

RISK-BASED INTERNAL AUDITING

The internal auditors can be instrumental in ensuring their organizations identify and mitigate risks. The IIA guides its membership — more than 165,000 internal auditors from all around the world — to use a risk-based approach to their work. In fact, one of the *International Standards for the Professional Practice of Internal Auditing (Standards)* requires internal audit departments to conduct a comprehensive, enterprise-wide risk assessment at least yearly, and to design an audit plan that is based on the results of that risk assessment. The *Standards* are one of the mandatory components of The IIA's authoritative guidance—the International Professional Practices Framework (IPPF).

Recently, The IIA issued a related Practice Advisory (PA) to encourage chief audit executives (CAEs) to develop a risk-based plan that considers the organization's risk management framework and the risk tolerance levels that have been established. Already, this PA has been recognized as critical guidance for managing enterprise risks throughout an organization. According to Chambers, it has caught the attention of regulators looking for assurance on compliance. He indicates that several of the largest banks in the world have called him, asking about the PA for assessing the effectiveness of risk management.

For the most responsible companies and their high-performing internal audit activities, the minimum standard of once-yearly risk assessment is not enough. Because every risk ultimately results in a financial risk, any failure to pay attention to day-to-day activities, changes in the economy, and the demands of consumers and regulators can result in immeasurable losses. History has proven this as fact.

Today's audit committees want to know that risks are being assessed — not just yearly — but on an ongoing basis. Risk-based internal auditing helps ensure they will not receive bad news indicating that a risk with devastating potential has bypassed the risk management process. And after all, helping avoid such bad news is part of the audit committee's critical role in effective governance and in maintaining a clear corporate conscience.

TONE AT THE TOP SURVEY RESULTS

Recently, this newsletter conducted its yearly survey of readers to garner their unique insights based on their experience in the business arena. When asked about the traits of high-performing internal audit activities, independence, objectivity, and integrity were cited more than any other characteristics. Other results are below with the percentage of survey participants in agreement, prior to each statement:

- **86.2 percent** — The internal auditors should ensure that a proactive and effective fraud prevention and detection program is in place.
- **77.5 percent** — It is extremely important for the internal audit activity to provide assurance that the organization's risks are addressed.
- **72.7 percent** — The audit committee should regularly rely on the internal audit activity to provide proactive consulting on organizational risks.
- **71.9 percent** — The audit committee should rely heavily or very heavily on the internal audit activity to provide an objective and independent assessment of the organization's tone at the top and ethics.

Read the full survey results at:
www.theiia.org/periodicals/newsletters/tone-at-the-top

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The Institute of Internal Auditors
247 Maitland Ave.
Altamonte Springs, FL 32701-4201 USA

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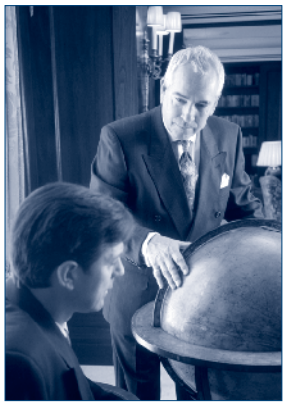

Mission

To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and responsibilities for, the internal audit activity.

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PR@theiia.org
+1-407-937-1247

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The Institute of Internal Auditors
Corporate Communications
247 Maitland Ave.
Altamonte Springs, FL 32701-4201 USA
Fax: +1-407-937-1101

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The Institute of Internal Auditors (www.theiia.org) is dedicated to the global promotion and development of internal auditing.

Established in 1941, The IIA is an international professional association with global headquarters in Altamonte Springs, Fla. The IIA has more than 160,000 members in internal auditing, risk management, governance, internal control, IT auditing, education, and security.

The IIA is the global voice, recognized authority, chief advocate, principal educator, and acknowledged leader in certification, research, and technological guidance for the internal audit profession worldwide. The IIA enhances the professionalism of internal auditors and is internationally recognized as a trustworthy guidance-setting body. It fosters professional development, certifies qualified audit professionals, provides benchmarking, and through The IIA Research Foundation, conducts research projects and produces educational products.

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