

— at the — TONE TOP[®]

Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

Issue 105 | June 2021

Recognizing the Value of *Independent Assurance*

Internal audit offers directors a unique perspective on the effectiveness and efficiency of governance, risk management, and internal control processes, based on deep, first-hand knowledge of the organization. Often, that contribution goes well beyond simple compliance concerns.

When Cynthia Cooper suspected wrongdoing at WorldCom, the vice president of internal audit and her team worked many sleepless nights to review financials and root out entries that were being reversed by the CFO to improve the numbers. The team used its own program, developed by an IT staff member, to trace and review journal entries.¹ The company ultimately declared bankruptcy in 2002 after the \$11 billion accounting fraud scheme was exposed.²

In 2018, a ransomware attack shut down various systems in the city of Atlanta's computer network. The attack might have been avoided had the city heeded warnings from its internal audit department about significant IT risk exposures, but the city's response did not come soon enough.³

Both examples provide shocking, real-world examples of risk management failures or vulnerabilities identified through objective assurance independent from management. But their headline-grabbing quality masks an important truth about the value of objective assurance.



“Internal audit is less about presenting audit results and more about engaging executives and board members in thoughtful consideration of current business challenges and in supporting the development of strategies to address the associated business risks,” according to The Institute of Internal Auditors (IIA).⁴ (See Figure 1: The Evolution of Internal Audit Activities, for more on the current scope and evolution of internal audit’s role.)

It is challenging to find the right metrics to capture and do justice to the contributions made by independent, objective, and qualified assurance providers. Unfortunately, that value often becomes crystal clear when internal audit’s insights are neglected, overridden, or ignored, as was the case at WorldCom and in Atlanta.



About The IIA

The Institute of Internal Auditors, Inc. is a global professional association with more than 200,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

The IIA

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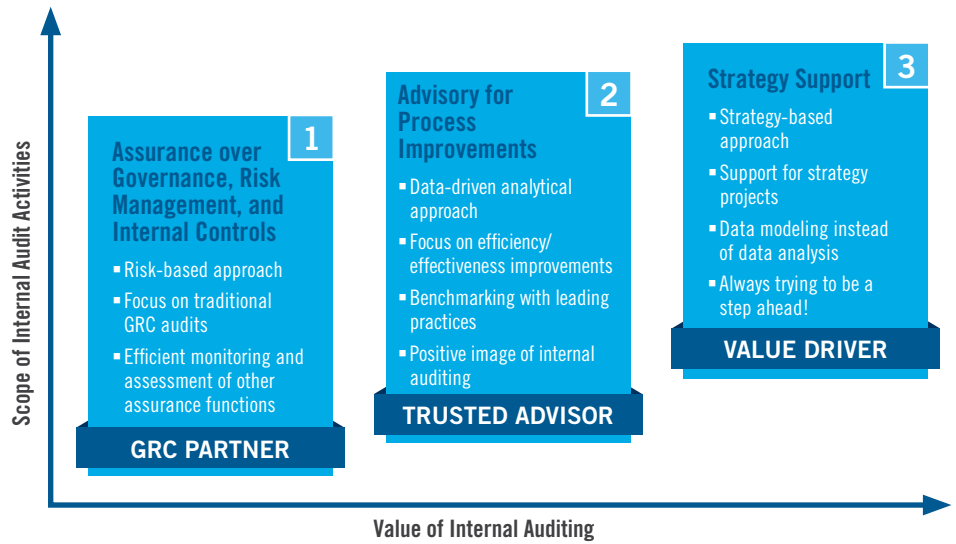
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Figure 1: The Evolution of Internal Audit Activities



Source: Defining, Measuring, and Communicating the Value of Internal Audit, IIA.

To get a sense of the role that internal audit can and should play, it's useful to understand what happens when directors fail to make the most of its value. What's more, directors should seek out and embrace guidelines they can follow to ensure that the board, management, and internal audit are working together effectively.

Missed Opportunities

Boards that don't work proactively with their chief audit executive (CAE) may miss a number of opportunities to avoid common pitfalls that include:

Understanding the limits of negative assurance. Boards sometimes fail to understand all of the risks facing their organizations because they rely on "negative assurance," or the assumption that if nothing is brought to their attention, then nothing must be wrong.

Unfortunately, case law has established that board members can be held responsible for risk management failures of which they were unaware. According to the *Caremark* ruling, directors should act in good faith to assure that a company's compliance information and reporting system are adequate.

QUESTIONS FOR DIRECTORS

- » Are internal audit activities aligned with the strategic objectives of the business?
- » Does the CAE report directly to the audit committee, board of directors, or other appropriate governing authority, and administratively to the CEO? Are any changes needed in current reporting relationships?
- » Does the board proactively seek out insights and updates from the CAE?
- » Does the board receive a thorough assessment of governance processes, including risk management?
- » Does the board rely on internal audit to provide strategic advice and be a catalyst for improvement?
- » Has the board set expectations for the value and the level and depth of insights it expects to receive from internal audit?



A significant subsequent ruling, *Marchand v. Barnhill*, from 2019, affirmed that “ignorance about poor risk management is not a defense against board liability,” particularly in an area that is deemed “mission critical.”⁵ That case stemmed from a listeria outbreak at an ice cream manufacturer and the plaintiff’s allegation that the board did not properly monitor regulatory compliance risks related to food safety, a mission-critical concern for the company. In addition to cases involving regulatory risk, recent U.S. court decisions have also denied motions to dismiss cases related to board oversight of effective financial reporting, a concern for all organizations.⁶

“The *Marchand* case and its relevant *Caremark* implications are but one of a growing number of pressure points on boards relating to oversight duties,” according to a 2019 *Internal Auditor* magazine article. “As the list of governance failures and scandals grows, regulators, investors, and the general public are demanding more oversight and more accountability.”

The risk of insufficient information. The IIA’s *OnRisk 2021* report, which surveyed directors, members of management, and internal auditors on key risk management issues, cited “board information”—or whether boards feel confident that they are receiving complete, timely, transparent, accurate, and relevant information—as one of 11 top risk areas expected to affect organizations this year.⁷ Boards were advised to enhance communication to ensure they receive more transparent, complete, and timely information, particularly regarding key risks.

A crucial part of that effort will be the board’s communications with internal audit. “A robust internal audit function can be an indispensable resource as companies face down established and emerging threats in areas such as new technology, geopolitics, cybersecurity, and disruptive innovation,” the *OnRisk 2021* report said. It encouraged boards to establish expectations with management and the CAE about the level and clarity of the information directors want to receive and to speak up if the volume of detail is overwhelming and obscures key takeaways. CAEs can be called on to evaluate and objectively assess the information that the board has received.

Assuming management/CAE agreement. Boards may fail to proactively seek out additional input or information from internal audit because they assume that the CAE is essentially in accord with what they are hearing from management. That can be a serious misunderstanding. In evaluating the relevance of the risks identified in *OnRisk 2021*, The IIA found that while board members and CAEs were largely in agreement on the relevance of specific organizational risks, management generally saw those risks as less relevant.

“The gap between the relevance rankings by management and the board should not be easily dismissed,” the report cautioned. It signals that “management is either overconfident when it comes to organizational governance risk or simply unaware of the level of concern from board members in this area.”

A failure to challenge management. Another reason that risks may not be addressed is because the board doesn’t go far enough in challenging management and the information it offers. In The IIA’s 2020 *American Corporate Governance Index*, internal auditors gave board members a grade of only 68 when it came to seeking reassurance that the information presented to them was accurate and complete. One-third of internal auditors said board members would not object to the CEO putting off reporting bad news. When asked if board members offered opinions that disagreed with the CEO’s, internal auditors also gave directors a middling grade of C on assertiveness.

The Three Lines Model

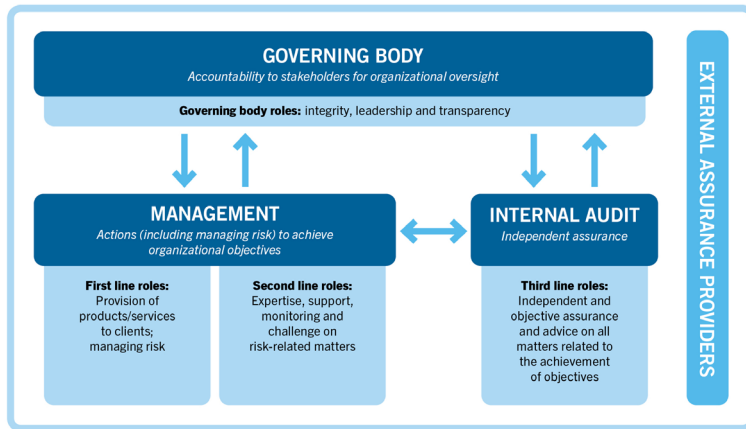
Directors can take a step toward ensuring that organizations get the most value from internal audit by following the guidelines of The IIA’s Three Lines Model, published in 2020. The model is designed to help organizations identify structures and processes that facilitate strong governance and risk management (see Figure 2). The model articulates the roles of the governing body, management, and internal audit.⁸

- Accountability by a governing body to stakeholders for organizational oversight through integrity, leadership, and transparency.
- Actions (including managing risk) by management to achieve the objectives of the organization through risk-based decision-making and application of resources.
- Assurance and advice by an independent internal audit function to provide clarity and confidence and to promote and facilitate continuous improvement through rigorous inquiry and insightful communication.⁹

“In clearly delineating roles to accomplish accountability, actions, and assurance, the model offers important guidance on assurance and the value of ‘improvement through rigorous inquiry and insightful communication’ that an independent internal audit function provides,” according to the *OnRisk 2021* report. The report found, though, that, “leaders generally feel the level of assurance they are getting is satisfactory, regardless of where it comes from. However, this laissez-faire approach fails to address the value of an independent assurance assessment.”



Figure 2: Three Lines Model



Putting the Value to Work

The complexities facing organizations and their governing bodies are only growing. As they face those challenges and the associated risks, directors can take advantage of the value of internal audit by using the information and insights it offers to enhance corporate governance, internal control, and risk management decisions.



Quick Poll Question

Who does the board rely on primarily for assurance on the effectiveness of risk management and internal control?

- Executive management
- External audit
- Internal audit
- Other
- Don't know

Visit www.theiia.org/Tone to answer the question and learn how others are responding.

¹ "Extraordinary Circumstances: An Interview with Cynthia Cooper," Dick Carozza, *Fraud Magazine*, March/April 2008.

² "Bernard Ebbers, ex-CEO convicted in WorldCom scandal, dies," CNBC, February 3, 2020.

³ "What Happens When Internal Audit Is Ignored? It Happens Too Often," Richard Chambers, *Internal Auditor*, August 26, 2019.

⁴ *Insight: Delivering Value to Stakeholders*, IIA Research Foundation, 2011.

⁵ "Blue Bell Blues: Growing case law affirms board liability," Jim Pelletier, *Internal Auditor*, October 8, 2019.

⁶ *2021 Governance Outlook: Projections on Emerging Board Matters*, National Association of Corporate Directors, 2020.

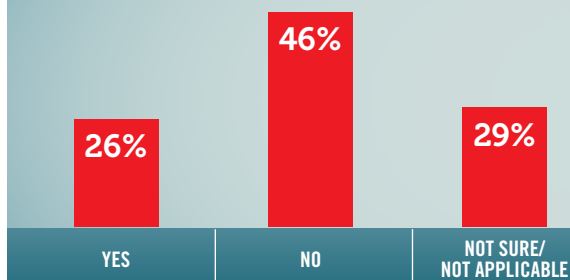
⁷ *OnRisk 2021: A Guide to Understanding, Aligning, and Optimizing Risk*, IIA, 2020.

⁸ *The IIA's Three Lines Model: An update of the Three Lines of Defense*, IIA, 2020.

⁹ *Ibid.*

QUICK POLL RESULTS

Does your board (or equivalent) have a defined DEI strategy?



Source: Tone at the Top April 2021 survey.

