CoActive Audit: The Enhancement Audit Model

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Abstract

Internal auditors are struggling to maintain their identity and purpose as the organizations they audit undergo drastic changes. Total quality management, business process reengineering, globalization, and self-directed teams are dismantling hierarchical command and control structures. Advances in information technology continuously render control procedures obsolete. The 'value' of traditional internal audit is seriously questioned from the board room to the show room.

CoActive audit is an internal audit model designed for team/technology based organization cultures, where the focus is on process enhancement rather than assessment and reporting. It provides synergistic solutions to real problems, rather than a quasi-independent appraisal offering recommendations of potentially marginal value.

Auditing has its origins in antiquity, apparently when rulers with wealth had the objective of maintaining their wealth by detecting fraud on the part of their servants. While external auditing was originally formulated with the same objective, through the years it changed its primary objective to emphasize the 'professional review of financial statements by an independent expert, so that a professional opinion indicating that financial condition and results of operation have been fairly presented can be given.' While internal auditing formulated its objective to 'assist members of the organization in the effective discharge of their responsibilities,' it continued the basic doctrine that auditing is an expert, independent, appraisal function.

While many internal auditors today keep auditing as they have in the past, the organizations they are auditing are undergoing drastic changes. Total Quality Management, Self Directed Teams, and Business Process Reengineering are dismantling the old hierarchical command and control systems that depended on auditors to verify compliance. Advances in Information Technology have rendered manual control procedures obsolete. While most internal auditors have successfully made the transition from a reactive audit process that basically reported on history to a proactive approach based on risk assessment and focused on the present, the changes occurring within our organizations demand even more fundamental changes. Contemporary internal auditors openly acknowledge that they feel change must occur within the internal auditing community, and these leaders are venturing forward trying new philosophies and approaches. CoActive Audit is a combination of these new philosophies and methodologies, with its roots in the teachings of the primary management visionaries of the times. It is a vehicle to help internal audit grow, to re-energize, to expand both its reach and grasp. It is about change, about recognizing the world has drastically changed, about realizing that some of our most basic assumptions are no longer valid, about understanding that some of our codified standards may hinder rather than help, and about replacing the old that is no longer appropriate with a new that is. It is time to focus on enhancing internal control, not merely reporting on it. It is time to build control into business processes, not simply assessing compliance with policies and procedures. It is time to recognize that the traditional internal audit methodology may be counterproductive to the goal of ensuring a reliable internal control system. It is time for CoActive Audit: the next critical step for internal audit.

CoActive Audit enhances management control processes using today's management philosophies and methodologies. It represents a fundamental transformation of traditional internal audit philosophy, a 180 shift in mental models and paradigms. The essential components are an audit approach that is:

Concurrent — rather than historical;
Collaborative — rather than autonomous;
Consultative — rather than judgmental;
Client-based — rather than standards-based;
A Catalyst — rather than an inhibitor.

1. **Concurrent — rather than historical**

Traditional financial attest audit is historical — looking at data generated during a past period in order to evaluate the reliability of the data and its usability for the intended purpose. For financial attest audit the goal is to determine whether the financial statements fairly represent the results of operations for the period then ended — including proper classification in the accounts, summarization in the statements, and existence of assets and liabilities. Internal auditing uses the same approach and techniques for financial audits — and for many other types of audit as well. While using historical data to find past problems may have been appropriate when the problems where caused by mistakes made by people performing manual procedures — and the goal was to correct the data and to make changes in the procedures for the future — this approach is of limited value when the mistakes are made within computer systems with results detrimental enough to bankrupt the organization. Analyzing old data is nice for certifying old financial statements but woefully inadequate as a process control technique. Today's internal auditor must contribute more than a detailed look at old data and reporting old mistakes. If the problem isn't important enough to come to light when the problem occurred or shortly thereafter, is the problem when discovered months later important enough to still be significant?

Internal audit processes that attempt to provide an opinion on internal control merely by reviewing historical data miss any situation which 'might have been but wasn't'. In other words, the traditional 'test the data' audit process tacitly assumes that if it didn't happen it can't happen. That is why auditors must keep doing the same audits over and over, because the process control assessment is never fully completed. Adopting a concurrent view is equivalent to adopting a process view — fully understanding the process, analyzing reliability, and fitting controls to risks. Adopting a process view means not only building appropriate controls into and through the process but also providing concurrent control — operational all the time — and that is what we really want internal control to be. Given the ever increasing importance of process reliability, and the controls within the process that determine reliability level, shouldn't today's internal auditor be focusing on concurrent monitoring and auditing systems that increase minute to minute operating reliability — rather than use 20-20 hindsight periodically to report that a problem had occurred in the past?

2. **Collaborative — rather than autonomous.**

Traditional financial attest audit is autonomous — with certified public accountants, recognized as experts in the accounting and auditing profession by examination and licensed by the state, conducting an independent review of organization records. While internal audit expertise is not recognized by the state, it is declared for those individuals who have met the examination and experience requirements of the Certified Internal Auditor (CIA) program as established by The Institute of Internal Auditors, the professional association of internal auditors. Some organizations with internal audit functions have also accepted the certified public accountant designation as proof of internal audit expertise — with some ranking it of greater importance than the CIA particularly for the highest rated position in the function. While expertise in the public accounting and auditing fields is obtained through academic study and development through highly supervised experience conducting audits, limited academic programs are available for those who wish to practice in the broader field of internal auditing. While the requirements for the financial attest auditor are strictly defined through generally accepted accounting procedures and auditing standards, the procedures and techniques of the internal auditor may be highly dependent on individual expertise and individual organization guidelines. While a peer review program is available through the professional organization for internal auditors, organizations are not required to participate. Given the wide range of areas that could be reviewed by internal audit, and the lack of standards guiding the knowledge required to audit activities other than financial reporting, it is questionable whether the knowledge base of all internal auditors qualifies them to be considered overall 'expert' appraisers.

Faced with the potential for relying on self-proclaimed experts who may not understand the limitations of their subject knowledge, organizations requiring specific skills may be better served by obtaining that specific expertise from those who have demonstrated their qualifications through experience with other organizations. Faced with the understanding that current expertise is inadequate to provide qualified assurance in all areas they should audit, internal audit directors must either subcontract certain audits to experts or increase staff skills through extensive training and development efforts — or, come to the realization that alternative evaluation techniques exist that could prove more effective. Rather than attempt to achieve functional expertise in all areas of the organization, internal auditors could choose to collaborate with those individuals within the organization who already maintain functional expertise — the auditees themselves. (If the auditees don't have functional expertise in the areas they manage a deeper problem has come to light.) This approach would permit all involved to focus on the goal of organization control improvement rather than attempting to develop redundant individual technical expertise. Rather than attempting to gain enough current expertise to be considered credible during an assignment, internal auditors could focus collective skills on the identification and enhancement of business processes with the full involvement of individuals in the area of review. This collaborative approach builds on the conventional wisdom that two heads are better than one, and that the synergy involved when the auditor and auditee accept the same goal of an improved process — rather than compete over significance of findings, and choice of words, and whose opinion has more weight — provides greater value for the organization. A collaborative approach opens to the door to participation, where the audit team broadens to include not only auditors but also auditees, not only staff but also management. Rather than being an outsider commenting on the insiders, the collaborative auditor becomes a part of the organization — a true internal auditor. Rather than waiting for the audit report to find out what is going on in the organizations they manage, senior management could find greater value through participation in a revised audit process that encourages them to be a contributing member of their own management team.

3. **Consultative — rather than judgmental**

Traditional financial attest audit is judgmental — with certified public accountants determining whether an organization's proposed financial statements are in compliance with generally accepted accounting principles or not. The organization then has the option to revise its financial statements in order to be considered in compliance in order to receive a 'clean' opinion and an unqualified certification for financial statement publication. While errors and omissions may have occurred during the period, they can be repaired before the process is complete and the final judgment published by the auditors. In other words, an organization can be judged inadequate on first inspection, but provided the opportunity to fix the problems before the world is informed. Internal audit has adopted the judgmental aspect of the financial attest audit but has not adopted the provision that those undergoing audit have the opportunity to restate their results nor revise their processes without being reported to the upper levels of the organization. As a result, the internal auditor is a 'constant and imminent' danger to the auditee, as any discrepancy discovered may be brought to the attention of their management, and most likely will. Faced with the prospect of having their abilities questioned, auditees may find that casting doubt on an internal auditor's qualifications can provide relief, as well as retribution. As the internal auditor is also typically charged with the responsibility to suggest corrections for any discrepancies reported, the audit process may degrade to discussion of the merits of a proposed solution — to an insignificant problem — rather than ensure all problems have come to light. Rather than focusing on judging and reporting, the internal auditor could offer their specific expertise in a consultative mode with those accountable for the area under review, with the goal of process improvement rather than fault finding and the assessment of blame. Rather than pursue findings the auditor could pursue improvement.

Some senior executives have come to rely heavily on the internal audit function to keep him or her informed about 'what is really going on' — in the very organization he or she is responsible for managing! It is not uncommon for the internal auditor and various members of management to hold separate and special meetings for the express purpose of providing information that apparently is not available through the organization's normal information channels. While some internal auditors may consider this situation to be a positive indication of the importance of the internal audit function, it should realistically be viewed as a serious breakdown in the organization's internal communication and reporting systems. Expediting — the process of speeding up a customer's order (for example) to circumvent the organization's normal procedures — has proven to be an expensive and damaging alternative to smoothly functioning operations. Expediting not only delays other orders, which then themselves need expediting in an ever increasing downward spiral, but also never leads to identification and correction of the underlying problems that created the need to expedite — the real problem. It would be unfortunate indeed if history records a high positive correlation between an internal audit function that is highly valued by executive management and a dysfunctional management system throughout the organization. It would also be unfortunate to continue to ignore the counterproductive reality of the traditional internal auditor/auditee relationship — if the goal is organization improvement.

4. **Client-based — rather than standards-based**

Traditional financial attest audit has one client — the organization that wishes to have its financial statements certified. And the product is also simply defined, an attest audit conducted by a licensed certified public accountant in accordance with published standards and guidelines. While this client/product relationship is easily defined, that of the internal audit can vary greatly indeed. The introduction to the Standards promulgated by the Institute of Internal Auditors states that:

> "Internal Auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisal, recommendations, counsel, and information concerning the activities reviewed. The members of the organization assisted by internal auditing include those in management and the board of directors. Internal auditors owe a responsibility to both, providing them with information about the adequacy and effectiveness of the organizations system of internal control and the quality of performance."

Charged with the responsibility to serve both those who would govern and those who are governed places the internal auditor in a unique position of concurrently serving two masters that have very different objectives — especially when increasing regulation and litigation have drastically changed the focus and concerns of most boards of directors. While senior management may strive to develop a customer focused, team based, horizontal, empowered organization, the board of directors may only understand — and require — an internal control system that emphasizes policies and procedures, functional specialization, hierarchical supervision and review, and segregation of duties. This dichotomy can only be addressed by following the course established by leading world class organizations, clearly identifying the customer and not only meeting but exceeding customer needs. Internal audit must do the same. The answer lies in clearly delineating the customers and products required by those customers — and broadening the definition of internal audit and its products in the process. Internal audit must be customer focused to contribute in a world class world. The conflicting activities of assisting management improve the organization control system and reporting on the status of management's internal control systems to the board of directors could be viewed as a classic example of conflict of interest, as the internal auditor is a fundamental component of the system of internal control. Rather than offer a basic 'assess and report' service, internal audit could provide a variety of services specifically designed for each segment of the market it attempts to serve. The key is not to group all needs, but instead to delineate, understand, and meet them. Internal audit visionaries — and organization control advocates — in some organizations have already determined that the goals of enhancing control and assessing control are best met by assigning functional responsibility to separate groups. Internal audit may perform the assessment and reporting function while an internal control consulting group improves systems, or internal audit might focus on organization control enhancement through a CoActive Audit methodology while a corporate compliance group investigates and reports. Or, some organizations may conclude that internal audit can indeed perform all functions although through separate and distinct departments within internal audit.

5. Catalyst — rather than inhibitor

A traditional financial attest audit is an external catalyst — spurring the management of the organization to react to correct material errors in financial statement presentation so they can achieve the goal of certification. While suggestions to improve specific accounting system controls might be made during the course of the annual audit, these improvements result from observations made and tests conducted which disclose errors, not a comprehensive evaluation of the organization's overall system of control. These suggestions are also made in order to enhance the perceived 'value' of the audit product to the customer. While internal audit may think it is a catalyst in uncovering and correcting both material and non-material errors, the traditional audit process borrowed from the public accounting profession applied internally can actually inhibit detection and correction, as well as forgo any significant improvements to the organization's control system. While the goal of internal audit is to identify and report discrepancies, the operating mangers whose discrepancies are being reported may have a goal set that is quite the opposite — that is, to prevent discrepancies from being identified and reported. Given that a negative audit report can have severe career and financial implications, auditees may choose not to share knowledge of known deficiencies with the auditor and/or act in other ways that best serves their self interest. Combining this aspect with the possibility of questionable subject matter expertise on the part of the internal auditor could easily produce a situation where a relatively 'clean opinion' is provided, but not deserved. Rather than enhancing the control system the auditor has actually made it weaker by providing false assurance. If the goal of internal audit — and senior management — is to improve the organization control system, the traditional role of the internal auditor must change. And the role of senior management must change as well, to accept broad accountability for the functioning of the internal control system in the organizations they are charged with controlling. Internal audit is but one small segment of the overall organization control system.

6. CoActive Audit Methodology

CoActive Audit is both a philosophical approach that affects all audit work, and an audit methodology — applying business process engineering tools to primary business processes. The methodology includes both a process and opportunity/exposure/risk focus. The CoActive Audit Methodology begins with the questions — 'what are we really trying to do here, what unrecognized opportunities exist, what are the exposures inherent in this process, how can we redesign the process to achieve inherent control rather than paste Band-Aids on Band-Aids, what are the significant problems, and what are the real solutions?' The phased approach begins with a collective opportunity/risk/exposure assessment and process flow understanding, analyzes process performance from a multi-metric standpoint (cost, cycle time, quality, service, reliability, etc.), produces not only a process enhancement plan but also implements the plan (and the enhancements), and concludes with a self assessment process. The audit team is composed of internal auditors, auditees, and other resources that may be required. The audit team may also include all levels of staff and management — even those executives who in the past only became involved when they received the final formal audit report.

Opportunity/Risk Assessment
Process Mapping
Process Performance Analysis
Process Enhancement Plan
Process Enhancement
Self Assessment

7. **CoActive Control**

CoActive Control is the other piece of the solution. It begins with the realization that the traditional concept of internal control is derived from attest auditing, that traditional internal control techniques are 80-90% manual (and discretionary), and that the traditional internal control system will not work if poor judgment, collusion, or management override is present. It would be difficult to imagine an organization purchasing the COSO Integrated Framework as a process control system to manufacture product or provide service. While the concept of "reasonable assurance" may appeal to accountants, engineers demand a much higher level of reliability — and the world is the better for it. The airline industry would not survive if they admitted they can only provide 'reasonable assurance' you will reach your anticipated destination! What those who support COSO call 'a breakdown in judgment' would typically be called a fundamental design flaw by the engineering profession.

Traditional control techniques depend highly on controlling people — through supervision and review, separation and authorization, and individual reward and punishment. While these techniques might seem to provide some degree of control in the traditional hierarchical authoritative organization (and if the high costs of these controls can be absorbed as well), tomorrow's organizations won't have the hierarchies, will operate on a team basis, and will share authority! Such a fundamental change will require comparable fundamental changes in control techniques.

CoActive Control strives for inherent organization control, and realizes that individual based controls are only as effective as each individual. If the individual understands and accepts their responsibility in the organization control system, and their individual goals are in alignment with organization goals, discretionary controls may provide an acceptable degree of reliability. If the individual has very different goals than the organization the internal control system will fail. In other words, true control can only be inherent, not imposed. The belief that imposed control is effective is proven incorrect on a daily basis.

Internal audit is uniquely positioned to redefine both the concept and techniques of organization control as required by world class organizations, and is obligated to do so. The CoActive Audit principles address focus, relationship, and value issues. The CoActive Audit Methodology can directly enhance organization control systems and processes. Many internal auditors share an uneasy feeling about their profession and know 'deep down inside' that significant change must take place. Albert Einstein's words might provide the proper perspective —

> "The world we have created today has problems which cannot be solved by thinking the way we thought when we created them."