Is there need for a closer working relationship between the internal auditor and the audit committee?

The Internal Auditor's Relationship with the Audit Committee

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Internal auditing has made steady and impressive progress as a profession during the past 50 years. Audit committees, although originating some 50 years ago, are just recently becoming a functional, active part of companies' boards of directors. The 1987 *Report of the National Commission on Fraudulent Financial Reporting*[1] (also known as the Treadway Commission report) has made strong recommendations concerning internal auditing and audit committees. Statement on Internal Auditing Standards (SIAS) No. 7, entitled "Communication with the Board of Directors,"[2] has extended the roles and responsibilities of internal auditors and audit committees.

In 1991, following the recommendation from the Treadway Commission, the Committee of Sponsoring Organizations issued an exposure draft and later in September 1992 issued the final report entitled "Internal Control Integrated Framework"[3]. This report not only provides guidance in the establishment of a new, widely accepted approach to internal control, but also promotes the relationship between internal auditors and the audit committee. Each of the above standards has exerted a great influence over the functions of the internal auditor and the audit committee. The purpose of this article is to explore the need for a close working relationship between the internal auditor and the audit committee. To fulfil this purpose, the article presents:

(1) the evolution of both the internal auditing profession and of the audit committee;
(2) the Treadway commission recommendations regarding the importance and role of audit committees and internal auditors;
(3) ways in which internal auditors can work with audit committes; and
(4) benefits to be gained from this relationship.

Evolution of Internal Auditing

Internal auditing has changed dramatically over the past 50 years and is continuing to change in order to accommodate an ever-changing business environment. Internal auditing has grown from its beginnings as a clerical "quality control" function to being a challenging profession, complete with certification, standards and a code of ethics in its present stage. Courtmanche[4] described the evolution of internal auditing as taking three major forms: traditional internal auditing, modern internal auditing, and neo-modern internal auditing. The traditional form is defined as a quality control function to ensure that accounting operations were performed properly and correctly. With the passage of the Foreign Corrupt Practices Act in 1977 and its amendments in 1988, internal auditors changed their function from "accounting quality control" to "internal control".

The modern internal auditing form expanded the nature and scope of internal auditing, placing more emphasis on offering internal control and consulting service to top-level management rather than providing the traditional financial compliance and fraud detection services to controllers. According to the modern internal auditing concept, internal auditors serve all members of management in fulfilling their responsibilities.

The neo-modern concept indicates that internal auditors should provide audit services for managers at all levels including the audit committee. The neo-modern internal auditing concept views the organization as the focal point which intereacts with its various components in a manner designed to benefit the entire organization, not just one part. Under this concept internal auditors serve the organization in achieving its goals. The function of internal auditors is to measure the efficiency, effectiveness, and economy of organizational activities and controls, as well as to assist management in high-level decision making.

It is believed that neo-modern internal auditing is the way of the future for the auditing profession. Reeve[5] argues that internal auditing has moved towards much broader and more demanding responsibilities and could reach new status as a training ground for executives, including the audit committee members. In the future, internal auditors will concentrate more on training management. Thus, the role of internal auditors has shifted away from compliance and financial auditing. Its evolution is moving towards an operational type of review and an aid to top management's problem solving.

Evolution of Audit Committees

The evolution of audit committees in the US indicates that some companies voluntarily formed audit committees to provide more effective communication between the board of directors and external auditors[6]. One important reason why audit committees were formed and are still in operation is the changing role of the board of directors of which the audit committee is part. The recognition by the board of its greater corporate accountability and fiduciary responsibilities has involved various areas where special levels of expertise are needed. To fulfil effectively such specialized types of responsibility, the board of directors has typically looked to the audit committee. Common responsibilities of the audit committee related to the corporation's external auditors include:

(1) approving the appointment and retention of the organization's external auditors;

(2) reviewing the scope of the examination and fees charged by the external auditors; and

(3) discussing with the external auditors the opinion rendered and any problems encountered during the audit examination[7].

The American Institute of Certified Public Accountants (AICPA) supports the concept of audit committees for publicly owned corporations, but it finds no reasonable basis for issuing a technical standard requiring their establishment[8, 9]. The US Securities and Exchange Commission (SEC), has been a long-time advocate of the audit committee but has stopped short of making it a requirement for publicly traded companies. Such a requirement is claimed to place too heavy a burden on small companies[10]. However, the SEC does require that a corporation disclose whether or not it has an audit committee[11]. In 1978, the New York Stock Exchange (NYSE) began requiring all domestic companies with common stock listed on the exchange to have an audit committee[12]. The American Stock Exchange (AMEX) highly recommends that all listed companies should have an audit committee composed entirely of independent directors[13].

The National Commission on Fraudulent Financial Reporting

During the 1980s, the public became increasingly suspicious of the truthfulness of the representations of financial statements. The National Commission on Fraudulent Financial Reporting (the Treadway Commission) was set up in 1985 to identify factors which lead to fraudulent financial reporting and to recommend steps and actions which may reduce their occurrence. During the approximately two years between the commission's formation and release to final recommendations, the Treadway Commission reviewed dozens of studies which were conducted by major universities and organizations. These studies were of topics in the areas of lawsuits brought against auditors, management, and companies for business failures and fraudulent activities, the role of the SEC in financial reporting, corporate codes of conduct, accounting education, opinion shopping, audit committees, quality assurance, and many other areas.

In 1987, the Treadway Commission issued an extensive document which set forth its recommendations with regard to fraudulent financial reporting. These recommendations were divided into four areas: recommendations for the public company, recommendations for the public accountant, recommendations for the SEC and others to improve the regulatory and legal environment, and recommendations for education. Pervasive throughout all four of these areas, the Treadway Commission specifically made 11 recommendations regarding the structure and role of the audit committee. These recommendations increase the responsibilities of the audit committee and, accordingly, put more demands on audit committees.

The Treadway Commission recognized that audit committees and internal auditors play an important role in detecting and deterring fraudulent financial reporting. Since the Treadway Commission report was issued, many organizations, especially publicly traded companies, have realized that audit committees are an absolute necessity. Three of the 11 recommendations of the commission pertain to the proper structure of the audit committee while the remainder relate to the role and responsibility of audit committees. Specifically, the commission recommended that the SEC should require all public companies to establish audit committes composed solely of independent directors and the committee should have an oversight responsibility in the areas of financial reporting and internal control structure.

Bull[14] conducted a survey of heads of the audit committees and concluded that the majority of participants (77 per cent) believed that the Treadway Commission's recommendations have a positive and desirable impact on audit committees, corporate reporting, and internal controls. With respect to internal auditors, the Treadway

Commission[14, p. 25] indicated that "It is the general belief of our Commission that the internal audit function is far too hidden from public view". The commission also stressed the need for an internal audit function and recommended that all public companies should maintain internal controls which provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection. The commission has led to tremendous growth in the internal auditing profession.

Various Ways in which the Internal Auditor Works with the Audit Committee

The major thrust of the Treadway Commission recommendations for audit committees was an increased role in the internal auditing process by overseeing all internal auditing activities. The Treadway Commission made four recommendations, outlining that the audit committee should: vigilantly and effectively oversee the company's internal control, annually review management's compliance with their corporate code of conduct, review any second opinion sought by management on accounting issues, and oversee the quarterly reporting process. To perform their duties most effectively, the internal auditor and the audit committee must work closely and must maintain an open line of communication at all times.

Reassessment of the Internal Auditing Charter

At the time an internal auditing department is established, its purpose, authority, and responsibility should be documented in the form of a charter and be formally approved by senior management and accepted by the board. The charter outlines the status and jurisdiction of the internal auditing department and facilitates the accomplishment of its objective of effectively serving the organization's needs.

SIAS No. 7[2] states that the director of internal auditing should periodically assess whether the purpose, authority and responsibility, as defined in the internal auditing department's charter, continue to be adequate to enable the department to accomplish its objectives. The result of this assessment should be communicated to senior management and the board.

The need to reassess the adequacy of the internal auditing charter can arise from several factors, such as changes in senior management or composition of the board, or in the environment in which the organization operates. For example, a specific recommendation of the Treadway Commission stipulates that internal auditors should be actively involved in financial audits of public corporations at the corporate level. Historically, many internal auditing departments have focused on reviewing operations of divisions, plants, or subsidiaries, and increases in the resources devoted to internal auditing coverage at the corporate level. Additionally, external quality assurance reviews of internal auditing departments show that in many cases an expansion of internal auditing scope is the single most significant recommendation resulting from the external review[15].

In response to the recommendations of the Treadway Commission, the Institute of Internal Auditors (IIA) issued SIAS No. 7[2]. This statement, which emphasizes direct communication between the internal auditors and the audit committee and suggests that such communication works best when the director of the internal audit department regularly attends and participates in audit committee meetings pertaining to oversight responsibilities for auditing, financial reporting, organizational governance, and control. Some of the matters which the internal auditor should communicate directly to the audit committee include:

(1) internal audit scope and approach;
(2) suggestions given to management;
(3) compliance with code of conduct;
(4) compliance with applicable laws and regulations; and
(5) disagreements with management.

Audit Scope and Approach

The Treadway Commission recommended that audit committees assume oversight responsibility in the areas of financial reporting and internal control. Thus, the audit committee should not only review the appointment and replacement of the director of internal auditing department, but also serve as a channel of communication between the director of internal auditing and the board. The audit committee is the recipient of the communication from the internal auditors in identifying and reporting conditions which relate to an entity's internal control structure observed during an audit of financial statements. The internal auditor needs to inform the audit committee about the scope and approach of the audit. SIAS No. 7 requires the internal auditors to ensure that the audit committee receives sufficient information regarding the scope and results of the audit. Communication is a major key in the relationship of the internal auditor and the audit committee. Direct communication represents to the organization the independent status of the auditing function.

SIAS No. 7 also deals with internal auditing scope limitations, which are defined as "restrictions which may preclude the internal auditing department from accomplishing its objectives and plans". The director of internal auditing is responsible for informing the board (preferably in writing) of these limitations and their potential effect on the achievement of the organization's goals and its integrity of financial reporting. SIAS No. 7 requires that the director of internal auditing should communicate significant audit findings to the board regardless of whether the condition has been corrected or satisfactorily resolved. Good communications between the internal auditor and the audit committee allow the auditor to receive additional guidance in setting audit objectives and to adjust the audit plan so that it addresses the areas of most concern to committee members. The internal auditor needs to meet periodically with the audit committee and always have unrestricted access to the committee to discuss the proposed audit scope and approach.

The audit committee needs to gain a general understanding of what it can expect from the audit. Some areas in which the internal auditor can help the audit committee to gain this understanding include:

(1) how the internal auditor evaluates the internal control systems;
(2) the adequacy of the corporation's internal controls;
(3) the extent to which the internal auditor works with the independent auditor;
(4) areas of major audit emphasis;
(5) how the internal auditor uses information technology;
(6) effect of major changes in the company on the audit;
(7) effects of "economic or operating problems facing the company" on the audit; and
(8) the timetable for meeting the company's financial reporting requirements.

The Treadway Commission recommended that management and the audit committee should ensure that the internal auditor's involvement in the audit of the entire financial reporting process is appropriate and properly co-ordinated with independent public accountants. The methods of reporting by internal auditors vary according to the operating style of the committee. For example, some audit committees expect a positive confirmation that controls are continuing to function properly. However, others may prefer to receive a report when there is a material breakdown in internal controls.

Suggestions Given to Management

Internal auditors' primary functions are to assist management at all levels to discharge their responsibilities. During the course of an audit, the internal auditor makes constructive suggestions to improve effectiveness, efficiency, and economy of management performance and activities. The audit committee needs to be aware of these suggestions and should ask management to respond to any significant suggestions received. The audit committee should review the reports of the internal auditors which are material to the organization as a whole and management's responses to those reports. Furthermore, the internal auditor makes recommendations to the audit committee concerning improvements in the internal controls. However, the audit committee, in evaluating these recommendations, must be aware of the cost/benefit relationship in the control structure and realize that it is management's task to determine whether the auditor's suggestions are feasible.

Fraudulent Activities

The internal auditor is the first line of defence against fraud. The audit committee must be adequately informed about any fraudulent activities or irregularities of which the internal auditor becomes aware. By reporting "individually immaterial" frauds and irregularities on an "aggregate basis" to the audit committee, the internal auditor may be abe to reach an understanding with the audit committee on the nature and the amount of reportable frauds and irregularities. However, if fraud involves senior management, the internal auditor must communicate directly with the audit committee.

Several changes in the business world require the internal auditor to be much more involved in preventing, detecting, and investigating fraud once it has occurred. The issues of computer and telecommunications security are becoming increasingly important. As our society becomes more dependent on advanced technology, there is a greater vulnerability to abuse. Bennett[16] stated that: "Experts agree that computer crime will be the single greatest crime generator we face in the future". Internal auditors must work more closely with audit committees in this area and receive their support in their training to meet the challenges of this area in the future. The complexity and the easy accessibility of the worldwide telecommunications network has internationalized crime. Use of the telecommunications network allows some crimes to be committed from another continent as easily as they could be committed next door.

Other areas with which the internal auditor must be much better prepared to deal, currently and even more so, in the future include: electronic bulletin board systems, software piracy, high tech ethics, computer viruses, and more in-depth analysis of bank records using computers in "money crime" situations. It is very critical that internal auditors and the boards of directors to whom they report recognize that the investigation of computer and telecommunications fraud incidents will require a new type of investigative expertise. It is doubtful that many people have this expertise at this point in time. Our society is primarily conditioned to use menus and canned programs without having to think about why and how a program works, what the exposure points are, and what controls need to be in effect over those exposure points.

Internal auditors should have sufficient knowledge of fraud to be able to identify indicators that fraud might have been committed, as required by SIAS No. 3. Furthermore, additional audit work and final evaluation would be the responsibility of the independent auditor. This is an efficient division of duties, since the internal auditor focuses more on the broad administrative controls which help to establish the internal risk-control environment and related implications for the independent auditor's tests.

Audit and detection risk, according to SIAS No. 47, "Audit Risk and Materiality in Conducting an Audit", relate to the individual audit area and address the chance that material errors might remain in the financial records after internal controls have been applied and after the auditor's procedures have been performed.

The Treadway Commission studied 119 enforcement actions against public companies or associated individuals and 42 cases against independent public accountants or their firms brought by the Securities and Exchange Commission (SEC) from 1981 and 1986. In the majority of the cases, top management was the perpetrator. This problem of fraudulent financial reporting re-emphasized the need to separate monitoring duties and elevate the internal auditor's responsibility to the audit committee, not the management level. Although different means were used, the fraudulent financial reporting goal was usually to inflate or smooth earnings or to overstate the company's assets. Common methods for fraudulent financial reporting were overstatement of sales or deferral of current period expenses[17].

As the internal auditor's responsibilities for fraud detection are expanded, structural changes will be necessary within most organizations. The chief internal auditor must have the appropriate authority to accomplish these new responsibilities. Lambert and Hubbard[18] suggest that one way to accomplish this is for the SEC to require that public companies have an internal auditor on the audit committee of the board of directors. This internal auditor should be a certified internal auditor. This would give the chief internal auditor direct responsibility for the external financial reporting of the firm's financial statements. It would also mean that the internal auditor assumes a direct responsibility for reducing fraud in the financial statements.

Compliance with Code of Business Conduct

The Treadway Commission believes that the most important factor in preventing fraudulent financial reporting is the company's "tone at the top". This means a visible interest by boards of directors, and especially audit committees, in ethical behaviour, strong internal controls, and enforcement procedures to limit the risk that fraud will occur. The commission recommended that all public companies should establish effective written codes of conduct. Such codes should, at a minimum, contain clear guidelines on:

(1) conflict of interest;
(2) compliance with domestic and foreign laws; and
(3) confidentiality of proprietary information.

Top level management, including boards of directors and audit committees should encourage the concept of ethics, establish ethical standards, and point out the weaknesses involved in the absence of ethics. Establishing codes of business conduct is not an easy task, because ethics in its truest meaning cannot be reduced to standards. Ethics is a mental concept and a part of morals which can be neither totally written nor legislated. For the proper establishment and enforcement of a code of business conduct, the audit committee should establish an ethics committee which includes the vice-president of human resources, the head of the internal auditing department, the general council, the corporate secretary (a lawyer) and officer-level representatives from all departments. This committee, by taking into consideration the Treadway Commission recommendations, should propose the code of business conduct. These standards should include a code of ethics, statements on conflict of interest, insider and confidential information, computer security, control documents, compliance with applicable laws, technical standards, and regulations as well as a statement on fraud and dishonest acts by employees. These standards should be approved by the board of directors.

Implementation, enforcement, and monitoring ethical standards should be assigned to the internal audit department. Internal auditors should distribute a copy of the standards on an annual basis and get certification from every employee that they are in compliance with these standards and, accordingly, they are not aware of any violations personally, nor of violations of people reporting to them. The ethics committee should periodically review employees' compliance with the established code of business conduct and determine whether or not any follow-up or direction should be provided to the employee. Any infraction should be handled by the ethics committee and the management of the offender.

Compliance with Certain Regulations

The audit committee may require the internal auditor to inform them about compliance with certain required regulations such as those of the Equal Employment Opportunity Commission (EEOC) and the Occupational Safety and Health Act (OSHA). Environmental issues are another crucial area of concern where the audit committee should be informed about the company's compliance or lack of compliance, particularly given the extremely large costs of clean-up if a company fails to comply with environmental regulations. The internal auditor should inform the audit committee about inadequate controls over compliance with environmental laws and regulations which may cause material misstatement of financial statements. If a problem does arise and if management fails to take a corrective course of action, then the internal auditor should bring the matter to the audit committee's attention. In turn, it is then the responsibility of the audit committee to report the discovery to the board of directors.

Benefits Gained

Several benefits can be gained from the internal auditor working closely with the audit committee. The following are some examples:

(1) Better financial reporting should be the result of the internal auditor being assured that the audit committee is informed as to management's application of accounting principles and judgements regarding estimates. The audit committee is

typically sensitive to management's judgements and their influence on the company's financial statements.

(2) Better compliance with the company's code of conduct will result from the internal auditor keeping the audit committee informed of any areas of non-compliance. Any non-compliance with the code of conduct should be brought to the attention of the audit committee immediately as it will be in direct violation of the company's code of conduct.

(3) Quicker awareness of problems between management and the internal auditor will result from the audit committee and the internal auditor maintaining a constant, open line of communication.

(4) Better compliance with regulations imposed on the company will result from the internal auditor bringing any violations to the immediate attention of the audit committee.

(5) A reduced potential for legal liability should be a result of the internal auditor's monitoring both of the financial and the non-financial areas and the audit committee being kept apprised of possible areas where the company could be held legally liable.

(6) The most important benefit to be gained is from independence both of the audit committee and internal auditor. Their independence will help to bring a quality of fairness not only to the financial statements but also to the company as a whole.

Conclusion

Recently, audit committees have been given broader responsibilities and are assuming more visible and prominent roles within many organizations. These roles relate to the financial reporting process, internal control structure, code of corporate conduct, auditing activities, and business activities. Internal auditors have been transformed from financial enforcers to respected members of the management decision-making process. Audit committees have also assumed more oversight responsibilities in the areas of financial reporting and internal control. Internal auditors should assist audit committee members in effectively fulfilling their responsibilities. Thus, the working relationship between the internal auditor and a company's audit committee must be year-round and an open relationship in order to be most effective. The close and effective working relationship will be beneficial, not only to the company, but also to society as a whole.

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