

Promoting and Supporting Effective Organizational Governance

GOVERNANCE



Core Report

Internal Audit’s Role

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About CBOK

SURVEY FACTS

Respondents	14,518*
Countries	166
Languages	23

EMPLOYEE LEVELS

Chief audit executive (CAE)	26%
Director	13%
Manager	17%
Staff	44%

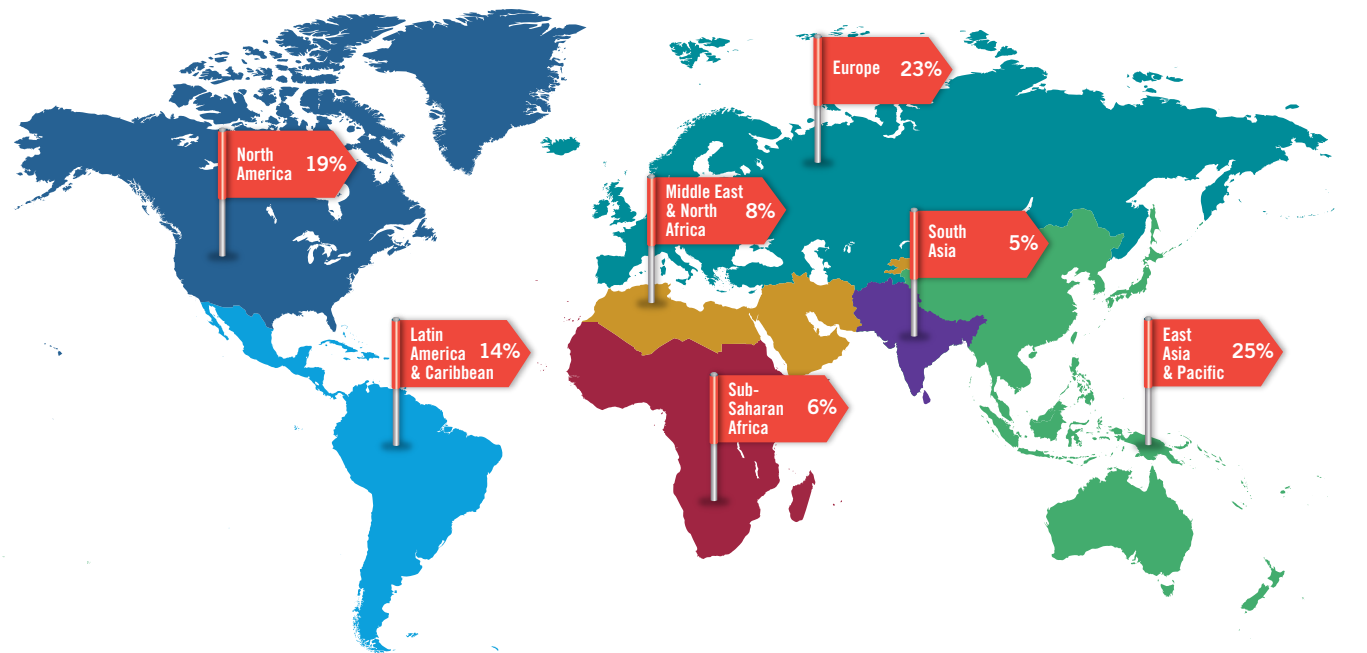
*Response rates vary per question.

The Global Internal Audit Common Body of Knowledge (CBOK) is the world's largest ongoing study of the internal audit profession, including studies of internal audit practitioners and their stakeholders. One of the key components of CBOK 2015 is the global practitioner survey, which provides a comprehensive look at the activities and characteristics of internal auditors worldwide. This project builds on two previous global surveys of internal audit practitioners conducted by The IIA Research Foundation in 2006 (9,366 responses) and 2010 (13,582 responses).

Reports will be released on a monthly basis through 2016 and can be downloaded free of charge thanks to the generous contributions and support from individuals, professional organizations, IIA chapters, and IIA institutes. More than 25 reports are planned in three formats: 1) core reports, which discuss broad topics, 2) closer looks, which dive deeper into key issues, and 3) fast facts, which focus on a specific region or idea. These reports will explore different aspects of eight knowledge tracks, including technology, risk, talent, and others.

Visit the CBOK Resource Exchange at www.theiia.org/goto/CBOK to download the latest reports as they become available.

CBOK 2015 Practitioner Survey: Participation from Global Regions



Note: Global regions are based on World Bank categories. For Europe, fewer than 1% of respondents were from Central Asia. Survey responses were collected from February 2, 2015, to April 1, 2015. The online survey link was distributed via institute email lists, IIA websites, newsletters, and social media. Partially completed surveys were included in analysis as long as the demographic questions were fully completed. In CBOK 2015 reports, specific questions are referenced as Q1, Q2, and so on. A complete list of survey questions can be downloaded from the CBOK Resource Exchange.

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Executive Summary

Internal audit's role in organizational governance has become increasingly important in the wake of the recent global financial crisis and the continuing spate of governance failures in both financial and public sectors throughout the world. Informed observers and commentators have asked initially, "Where were the external auditors?" then "Where was the audit committee?" and finally, "Where was *internal audit* in all this?"

This report draws on survey responses from internal auditors in 166 countries to take stock of the current role of internal audit in the governance process and learn how internal audit can better position itself to contribute to effective organizational governance. Key findings from survey respondents include:

- Only 4 out of 10 say a *governance code* is in place at their organizations.
- In contrast, more than 6 out of 10 say their organizations have a long-term *strategic plan* in place.
- About 27% say internal audit conducts extensive reviews of organizational *governance*.
- However, only 16% say internal audit conducts extensive reviews of their organization's *strategy*.

We believe that internal audit is well-positioned to promote and support organizational governance and thus help achieve a balance between value creation (profitability and growth) and value preservation (sustainable, long-term performance). The report addresses the following key questions:

- How can internal audit address governance?
- What do stakeholders want?
- What is internal audit delivering?
- What does it mean to audit culture?
- How can internal audit overcome potential barriers?
- What are some future trends in governance audits?

Governance reviews give internal audit the opportunity to prevent governance failures and improve strategic performance. Internal auditors must continue to adapt and evolve globally to take advantage of these opportunities.

1 The Rising Significance of Governance Audits

A Two-Pronged Approach for Value Preservation and Value Creation

Internal audit's role in organizational governance has become increasingly important throughout the world. The recent global financial crisis and the continuing spate of governance failures in the financial and public sectors have caused stakeholders to take a closer look at their respective organizations' governance structures and practices.

The dramatic increase in mergers and acquisitions in 2015—a whopping \$5 trillion globally—has also resulted in an even greater demand for transparency and accountability, and many are now

turning to internal audit for help. As a result, internal audit's activities are rapidly converging on assessments of strategic business performance and reviews of governance structures and related processes.

The need for internal audit to become involved in organizational governance has long been acknowledged by The IIA and is an integral part of the definition of internal auditing. Internal auditors have a significant opportunity to add value to their respective organizations by identifying and assessing governance risk factors as part of their ongoing assurance and advisory services.

The twin goals for internal audit in this area are both to promote value preservation (a governance orientation often preferred by the board) and support value creation efforts leading to strategic growth and success (a performance orientation often preferred by executive management). The challenge for the organization is to strike the optimal balance between these two orientations and remain relevant and competitive by achieving superior and sustainable performance in the long run.

One important and common underlying factor that drives and enables value creation and value preservation efforts is organizational culture. It is fair to say that organizational culture has a pervasive and critical influence on organizational success, achieving superior governance

Insight

“Corporate scandals continue around the globe, increasing pressure on all organizations to review their governance and their culture. As a result, more and more boards are turning to internal audit for assurance on these critical areas. Internal auditors must sharpen their skills and increase their audit activity in these vital areas.”

—Larry Harrington,
CIA, QIAL, CRMA,
Vice President,
Internal Audit,
Raytheon Company

“A composite model/view is needed when scoping any corporate governance work to ensure expectations are clearly communicated. The model I use are the drivers of stakeholder value (leadership, balance of power, protection of stakeholder interests, and strategic conversation) and bottom line value (winning strategy, risk and performance, tone at the top, and legal and regulatory compliance).”

—Rob Newsome, CIA, CRMA, PwC Partner, Nigeria, Victoria Island, Lagos, South Africa

outcomes, and how significant or how involved internal audit can be in helping achieve those outcomes.

Thus, the role of internal audit can be crucially important—both in averting governance failures as well as in effective implementation of growth-oriented strategies resulting in superior performance and value creation. Internal audit’s approach to governance audits and reviews must be based on two pillars:

- Auditing governance structures and processes (mostly based on hard controls where an analytical approach can be helpful)
- Auditing organizational culture (mostly based on soft controls, where intuition, common sense, and understanding of human behavior are indispensable)

Governance Reforms

Although there are many definitions of governance, there are certain common elements present in most of them. [Readers should refer to http://www.ecgi.org/codes/all_codes.php for a comprehensive list of codes from around the world.] The U.S. Sarbanes-Oxley Act of 2002, which was essentially governance reform-oriented legislation, was widely emulated in European countries, Canada, China, Japan, and other countries around the world.

Regulatory requirements for establishing and monitoring governance processes are already present in many jurisdictions such as the United Kingdom and India through the Companies Act, which

includes provisions related to governance. Another good example of strong governance reform is the King Report on Corporate Governance in South Africa. The King Report is regarded as a bellwether among codes of corporate governance and has been influential. Three reports have been issued: King I (1994), King II (2002), and King III (2009). King IV is expected to be released in the latter half of 2016. Similarly, the Dutch code of governance is regarded highly as well.

The global financial crisis of 2007–2009 fueled demands for transparency and accountability. The United States passed the Dodd-Frank Act of 2010, and corporate failures in Australia (e.g., HIH, One.Tel) and Italy (e.g., Parmalat) stimulated increased regulatory scrutiny and action. The United Kingdom led the way with its Bribery Act of 2010 and the creation of the Financial Conduct Authority. Clearly, the enduring interest in governance extends well beyond the financial services industry and the United States.

All over the world, corporate governance, and more generally organizational governance, has become a focal point for regulatory intervention and a matter of serious concern. The sharply increased mergers and acquisitions activity in 2015 necessitated a focus on risk management from increased competition, innovation, and consolidation. In addition, regulatory compliance risk, reputational risk, and litigation risk may need to be addressed in coming years. Worldwide, regulatory imperatives are proliferating across industry sectors, and rising stakeholder expectations are calling for a new era of governance.

The Future of Internal Audit and Governance

We believe that future efforts of both organizations and internal audit will gradually expand and go beyond the traditional financial reporting emphasis (lagging indicators/backward looking) and reliance on external audits. More reliance will be placed on strategic and operational risk and performance data (leading indicators/forward looking) and on internal audit functions for more effective monitoring and governance oversight. Operational data provide a closer look at what is really happening with the business, but they also provide

early warning signs of emerging risks which, if heeded, can prompt a critical and timely assessment of the business model and thus potentially preempt or avert business and governance failures. Similarly, adapting to changing conditions in the marketplace, such as shifting consumer tastes and preferences and making needed course corrections to strategy, can ensure continued growth and success. In all this, organizational culture is the great driver and enabler that deserves much attention. Consequently, in the future, we are likely to see increased emphasis on culture and ethics audits as well.

2 Balancing Governance and Strategy

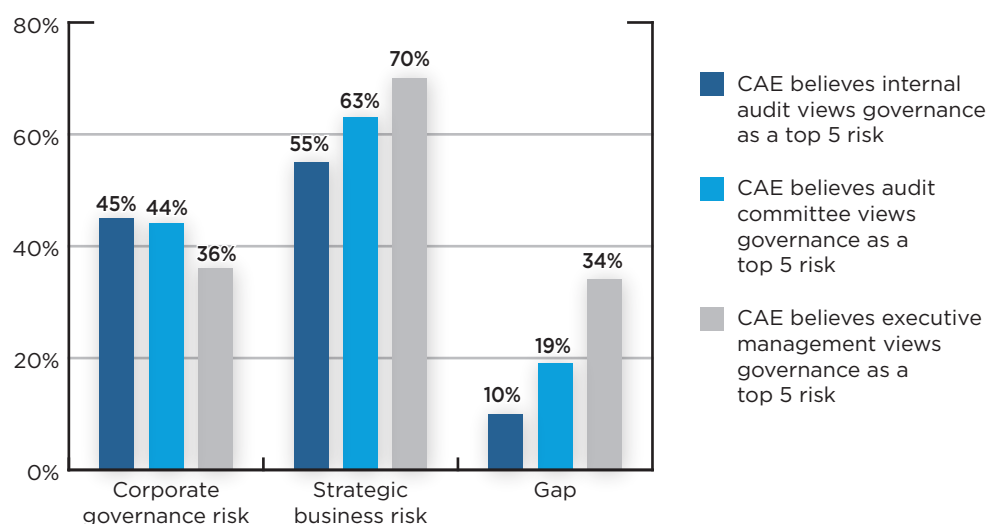
Assurance, Consulting, and the Importance of Information Integrity

As noted earlier, governance is about value *preservation* compared to performance, which is focused on value *creation*. The biggest challenge is achieving the optimal balance between risk and reward and between value creation and value preservation.

The board's focus is understandably on *governance*, while executive management's focus is more on enterprise *performance*. In other words, management is oriented toward performance metrics and the

board is oriented toward governance assessments (or sustainability of the business model). Perceptions of internal audit and the audit committee are not significantly different, especially with reference to corporate governance risk. However, executive management seems most concerned about strategic business/ performance risk (a value creation orientation). Accordingly, it is executive management that exhibits the widest gap between perceptions of risk related to governance and performance (see **exhibit 1**).

Exhibit 1 Corporate Governance and Strategy Perceived as Top 5 Risks



Note: Q64, Q65, Q66: Please identify the top five risks on which internal audit/your audit committee (or equivalent)/executive management is focusing the greatest level of attention in 2015. Topics: Strategic business risk and corporate governance risk. *n* = 2,742.

What are the implications of a governance focus versus a strategy focus? When governance is very strong, it can constrain risk-taking and thus adversely affect performance, not allowing executive management the flexibility and freedom to take calculated risks. On the flip side, if governance is too weak, then executive management can sometimes act irresponsibly, engage in speculation, and take on reckless risks. In such a scenario, the prospects of sustained and superior performance are greatly diminished or even wiped out. Both assurance and consulting activities rely on a deep understanding of how organizational culture can be both a driver and an enabler of effective governance and superior performance.

Insight

“My personal recommendation from my experience is to include bits and parts of the governance system and the organizational culture in almost every audit, if appropriate, to assure and advise your stakeholders on an ongoing basis in these top risk areas today!”

—Angela Witzany,
CIA, QIAL, CRMA, Head of Internal
Audit, Sparkassen Versicherung AG

Information Integrity

Traditionally, internal audit’s role has been to evaluate the effectiveness of controls within an organization and identify risks that could potentially impact the

organization and its ability to achieve objectives. However, that role is beginning to also include evaluations of an organization’s governance structure and practices as part of other consulting and advisory services.

Many governance failures can be traced back to poor management of *information risks*, *integrity risks*, or a combination of both (Ramamoorti & Nayar, 2013). *Information risk* is a factor when information for decision-making is of poor quality (i.e., it is unreliable, incomplete, irrelevant, or out of date). In these cases, it would be no surprise if the board and executive management are hampered in making good decisions. *Integrity risk* can be the cause of governance failure when information has been manipulated or altered deliberately, resulting in the board and executive management making decisions based on faulty or massaged information. Consequently, one of the most valuable assurance services that internal audit can provide is validating the *information integrity* of decision-relevant information, taking into account information risks and integrity risks. Such assurance about input data and the processes they are derived from increases the comfort level for the board and executive management in using information for strategic decision-making.

Assurance Services

When providing assurance with respect to organizational governance, internal audit assesses the processes used to obtain relevant, reliable, and timely information for strategic decision-making.

By providing assurance regarding the accuracy, consistency, and reliability of information, internal audit can greatly help mitigate *information integrity risk*. Thus, internal audit's work in assuring the quality of information used for decision-making allows the board and executive management to use information with confidence (Ramamoorti & Nayar, 2013). Examples of assurance services are provided in **exhibit 2**.

Advisory Services

Internal audit provides consulting/ advisory services to improve governance without internal audit assuming management responsibility. Advising the board and executive management on decision-making processes, providing information on best practices, and offering interpretation/insight are types of consulting/advisory services that internal audit can offer. It also encompasses internal audit facilitating board and executive

Exhibit 2 Internal Audit Activities for Organizational Governance Assurance and Consulting

Governance Assurance (Helping the board and executive management use information with confidence)	Governance Consulting/Advisory Services (Providing decision context, interpretation, and insight)
1. Conduct comprehensive, enterprisewide governance audits with recommendations and an opinion (big bites) about the overall governance system, enterprise risk management (ERM), and internal control effectiveness over time.	1. Conduct comprehensive, enterprisewide governance reviews for the purpose of providing advisory services to improve governance structures and processes.
2. Address governance as a part of assurance services for other audits (little bites).	2. Address governance as a part of consulting services for other audits (little bites).
3. Perform strategy execution reviews to ascertain conformance with the agreed-upon strategic plan.	3. Communicate recommendations to board committees, such as the audit, nominating, governance, and/or risk management committees.
4. Provide assurance that ERM and systems of internal control are operating effectively (as a part of the overall governance processes).	4. Educate the board/audit committee about best practices for governance.
5. Evaluate entity-level controls, which would be governance controls, such as tone at the top.	5. Provide counsel to the board nominating committee and be involved in recruiting new board members, etc.
6. Ensure regular, frequent open communication with the board and audit committee, including formal private sessions without management present (see the CBOK report <i>Interacting with Audit Committees: The Way Forward for Internal Audit</i> by Larry E. Rittenberg, pp. 10-11).	6. Educate the board about developments and trends. Tell the board about the latest developments and trends in the industry, such as new fraud risk assessment models, new technology tools (continuous monitoring), or new pronouncements (FASB, IFRS, revenue recognition 2018, which means work starts immediately).
7. Mitigating information integrity risk, permitting the board and executive management to use decision-relevant information with confidence.	7. Assist with board processes and activities (for example, help with board self-evaluation processes, help update the bylaws of the board, etc.).

Source: Authors' creation.

management awareness, education, instilling best practices in governance, briefings on trending topics, etc. In the context of mergers and acquisitions activity, for instance, internal audit can carry out important due diligence activities. Examples of consulting/advisory services are provided in **exhibit 2**.

Executive management shows a preference for focusing on strategic business risk (a performance and value creation orientation) while the audit committee, representing the board and internal audit, shows a marked preference for corporate governance risk (a value preservation orientation). Internal audit can help support and promote effective governance by undertaking both assurance

and advisory services. Assurance services help assure the quality of information used for strategic decision-making and enable the board and executive management to use information with confidence. Advisory services provide “metadata” or the decision context as well as analysis and insight regarding decision-relevant information. They facilitate the board and executive management’s ability to interpret and use information for strategic decision-making. In addition, advisory services help build awareness about trending governance topics, educate about best practices in governance, and provide supplemental assistance with governance processes such as board self-evaluations.

3 Taking “Little Bites” of Governance

A “Nudge” Approach: Small Steps that Pave the Way

Due to politics and cultural barriers within the organization, it may be difficult to have an audit plan approved with a separate comprehensive audit of governance. The chief audit executive (CAE) may be more successful using the “little bites” strategy—a sort of nibbling at governance, done as part of other routine audits and making governance recommendations along the way. The best creative solutions have always been built on “nudge”—an insight from behavioral economics—and are inevitably more practical, more breakthrough, more persuasive, and more effective (Thaler and Sunstein, 2008).

Using the “little bites” approach, internal auditors address governance as a part of assurance or advisory services, rather than taking “big bites” of governance, such as launching an enterprisewide governance audit or a comprehensive governance review. The “little bites” can serve to change attitudes from within the business organization by providing pieces of governance audits and reviews that help lay the foundation for a subsequent comprehensive governance audit or review. By conducting governance audits in “little bites,” the entire organization is introduced to the concept of governance audits. When the time is right, the organization can then be “nudged”

to embrace the notion of a full-fledged, comprehensive, enterprisewide governance audit or review, as appropriate.

Steven E. Jameson, chief internal audit and risk officer, Community Trust Bancorp, Inc., states, “In some organizations, internal auditors may find it challenging to convince executive management, or even the board, of the need to conduct formal governance audits of management and board activities. Governance may be viewed as the proprietary domain of management or the board and therefore hands-off for review or questions from others.

Insight

“Internal audit should take care in rushing in where angels fear to tread. Boardroom politics, board composition, director appointment, and director performance and remuneration are such elements of corporate governance that fall into this category. There are plenty of other areas of corporate governance where internal audit can provide excellent value. Stepping into the minefield may blow all this value up and the auditor’s credibility as well.”

—Rob Newsome, CIA, CRMA, PwC
Partner, Nigeria, Victoria Island,
Lagos, South Africa

“In organizations subject to law or regulatory requirements, such as the Sarbanes-Oxley Act, where key controls are frequently tied to governance activities, internal auditors can often justify testing those governance activities as part of their Sarbanes-Oxley compliance program.”

—Steven E. Jameson,
CIA, CFSA, CRMA,
Executive Vice President
and Chief Internal
Audit and Risk Officer,
Community Trust
Bancorp, Inc.

Internal auditors may find that a backdoor approach to governance auditing can be successful, where various elements of governance are reviewed and tested in conjunction with other already established audits. Reviewing board committee charters or board-approved policies that require certain governance activities can be a doorway for internal auditors to enter the governance arena.”

Linking Governance Reviews to Regulatory Audits

Internal auditors in highly regulated organizations often find it easier to incorporate governance reviews into their

audit universe, especially if the regulatory agencies express specific expectations for governance activities to be performed and monitored.

In summary, the audit of “soft controls” embedded within organizational cultures consists of many intangibles that do not lend themselves to quantitative measurement and analysis. Accordingly, to be successful, internal auditors must possess soft skillsets and competencies such as relationship-building acumen, political and cultural savvy, interpersonal communication abilities, diplomacy and tact, and an ability to read people and situations quickly and correctly.

4 What Do Stakeholders Want?

The “Demand Side” for Governance and Strategic Performance Audits

Recent corporate governance scandals and disasters, many of which were due to inadequate or flawed governance systems and unacceptably high information for decision-making risk, have caused organizations to scrutinize and adjust their own governance structures and processes. Ensuring that an organization has a sound governance structure with effective and ethical policies and practices, along with decision-relevant information that is accurate, reliable, and timely, is critical to the organization’s success. These combined factors, including a credible attitude of transparency and accountability, impact the company’s reputation, stakeholder satisfaction, and overall growth and profitability. Thus, it is understandable that companies are more frequently seeking assurance that their governance structures are sound and are often turning to internal audit for help. The role that internal audit should play in the process, however, is varied.

Boards, audit committees, management, regulators, employees, and shareholders are all among the group of stakeholders who seek assurance about the information they use for strategic decision-making and that an organization’s governance system operates effectively to achieve objectives and increase company profit and longevity.

It is important that internal audit seek opportunities to identify and communicate governance risks and advise on best practices to the appropriate parties.

A prerequisite to this step, however, is support from executive management and the board for governance reviews. The majority of CAEs (57%) report that their board or equivalent supports internal audit reviews of governance policies, and this perception was fairly similar across regions, with a high of 65% and a low of 52% (see **exhibit 3**).

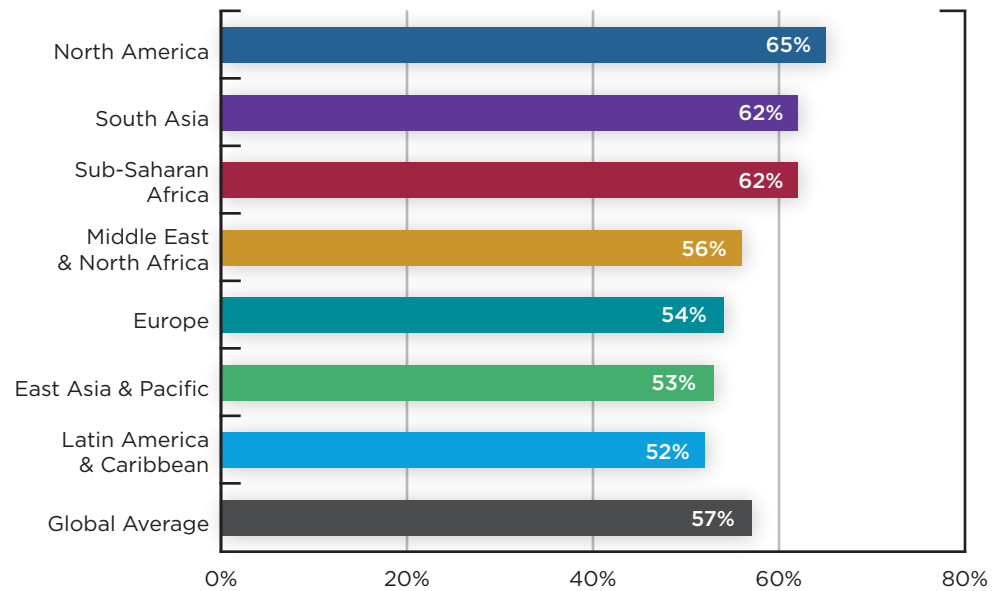
Insight

“Internal audit helps with facilitating trust. Internal audit’s main value proposition is in delivering trust. They are the gateway between management and the board in maintaining the trust.”

—Rob Newsome,
CIA, CRMA, PwC Partner, Nigeria,
Victoria Island, Lagos, South Africa

Within specific countries, however, the climate can be much different than for the region. For example, in Japan and Korea, an average of only 24% perceived support from the board for governance reviews. However, it should be noted that this percentage is likely due to the unique organizational governance structure in some Asian countries.

Exhibit 3 Internal Audit Perceives Complete Support from the Board for Governance Reviews



Note: Q67: In your opinion, how much support does internal audit have from the board of directors (or equivalent) to review the organization's governance policies and procedures? CAEs only. $n = 2,547$.

Audit leaders Lily Bi, senior manager, Kirin Holdings, and corporate auditor of Kirin's two subsidiaries, and Sakiko Sakai, owner, Infinity Consulting, note that "under the current corporate governance system in most Japanese companies, those who are in charge of directing and running a business are mostly the same people who assume an oversight role. An independent party that can monitor the board of directors and play an oversight role in corporate governance—called corporate auditors—was created. In Japan, the corporate auditors audit the activities of the directors, on behalf of the shareholders. Corporate auditors are not internal auditors and they have no authority to direct internal auditors."

Stakeholders' expectations of internal audit continue to rise. They are demanding increased internal audit involvement in governance audits and governance reviews. There is stakeholder recognition that such assurance and advisory engagements can have a salutary effect on both value preservation and value creation. As emphasized by Dittenhofer et al. (2010), internal auditors need to respond to these expectations by cultivating the appropriate soft skills and competencies, building relationships, and learning how to best contribute to an organization's profitability, growth, and sustainability.

5 What Is Internal Audit Delivering?

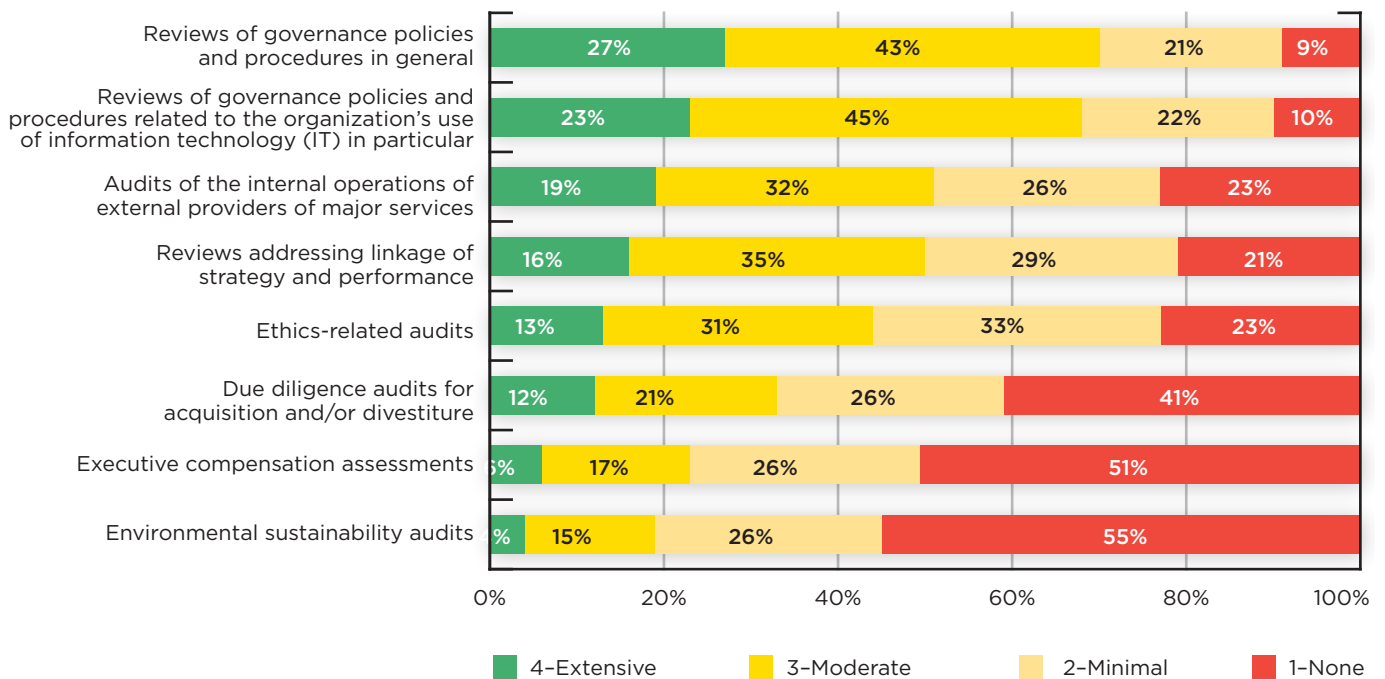
The “Supply Side” for Governance and Strategic Performance Audits

Internal auditors have multiple opportunities to assess governance risk and advise on best practices related to organizational governance, but which services are they currently providing? The 2015 CBOK practitioner survey helps to answer that question. From a supply side perspective, it is useful to learn what governance and strategic performance audit activities are currently taking place.

Overview of Governance Review Activity

Globally, an average of 70% of internal auditors report providing moderate to extensive activities related to the review of governance policies and procedures in general, and 68% report conducting reviews of governance policies and procedures related to the organizations’ use of information technology (IT) (see **exhibit 4**). Executive compensation assessments and environmental sustainability audits received the least attention.

Exhibit 4 Overview of Organizational Governance Review Activity



Note: Q72: What is the extent of activity for your internal audit department related to governance reviews? CAEs only. n = 2,580.

Insight

“Enterprise governance constitutes the entire accountability framework of the organization. It is about responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately, and verifying that the organization’s resources are used responsibly. Hence, it is essential for internal audit to be the steward of robust governance in their organization and the objective face of its effectiveness to the organization’s stakeholders.”

—Dominique Vincenti,
CIA, CRMA,
VP-Internal Audit, Nordstrom,
United States

Existence of Governance Codes Compared to Reviews of Governance

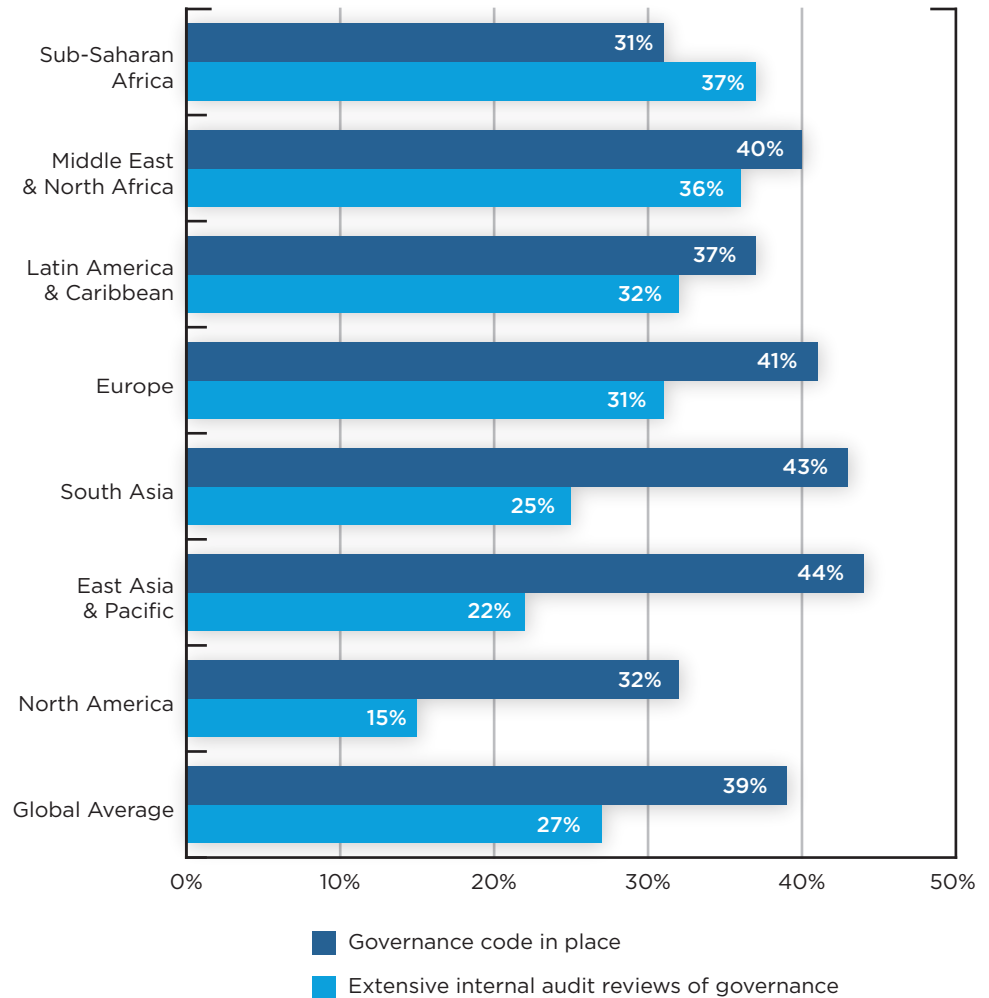
It makes sense to think of conducting governance reviews related to an organization’s strategy, operations, reporting, and compliance activities. Typically, the business processes, whether automated or not, are governed by “hard controls” that yield quantitative measurements that can be analyzed by internal auditors. However, there is also the aspect of organizational culture and “soft controls.” Organizational culture undergirds corporate behavior and provides the glue to connect different elements of the organizational governance landscape. Former McKinsey leader Marvin Bower, widely regarded as

“the father of modern management consulting,” famously remarked that culture referred to “the way we do things around here.” While business processes may yield useful information that could be quantitatively analyzed, culture embeds “soft controls” and informal communication channels that are mostly intangible and difficult to assess and evaluate. It is unwise for internal auditors to underestimate the influence and impact of culture.

Having a formal governance code and/or strategic plan could greatly facilitate, and even instigate, internal audit involvement in the governance review process. Globally, 39% of organizations have a governance code (see **exhibit 5**). However, an average of only 27% of internal auditors report that they perform extensive governance reviews. This gap varies by region. It is the largest in East Asia & Pacific, North America, and South Asia. It is much smaller in Europe, Latin America & Caribbean, and Middle East & North Africa. And, interestingly, in Sub-Saharan Africa, the gap is reversed—the percentage with extensive internal audit reviews of governance is higher than the percentage of governance codes in place. The explanations behind these differences cannot be determined entirely within the scope of this project, but some observations can be made.

Regarding Sub-Saharan Africa, compliance with the King Reports is mandated for companies listed on the Johannesburg Stock Exchange. Given the existence of this groundbreaking guidance for effective governance, and its required implementation, it is no surprise that internal auditors in South Africa are among the most engaged in conducting

Exhibit 5 Existence of Governance Code Compared to Internal Audit Reviews of Governance (Described as Extensive)



Note: Q71: Which organizational governance documents exist in your organization? Topic: Organizational governance code. *n* = 2,672. Compared to Q72: What is the extent of internal audit activity? Topic: Reviews of governance policies and procedures in general. Percentage reported for those who chose “extensive.” *n* = 2,545.

governance audits and reviews. A similar environment exists in Japan, which highlights the role of “corporate auditors,” who are much different from internal auditors, as noted earlier in this report.

On the other end of the scale, North America has the lowest level of extensive governance reviews of all regions. We speculate that this may be due to one or more of the following reasons:

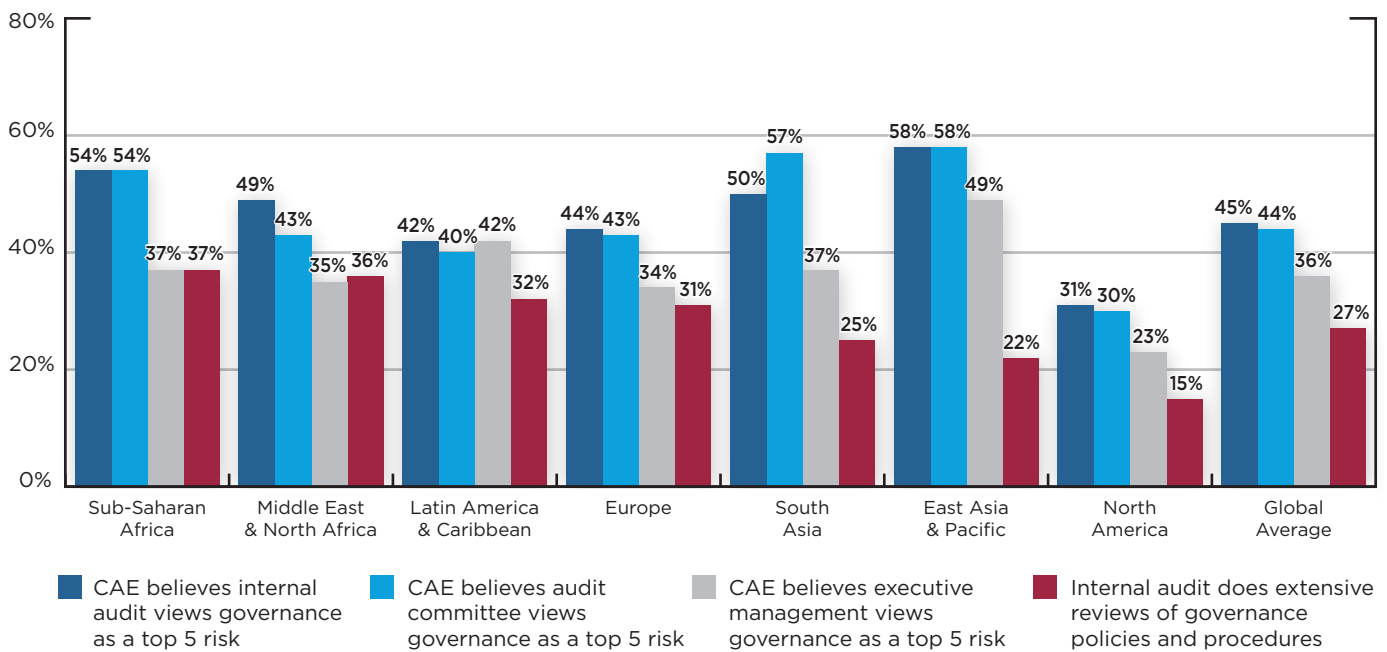
- North American CAEs may perceive or have less support from management and the board to perform extensive governance reviews, so they address governance in “little bites” as part of other audits of key business processes (as discussed earlier).

- Some North American internal audit functions may not be mature enough or sufficiently equipped to conduct extensive governance reviews.
- For established organizations that have been around a long time, North American CAEs typically follow risk-based auditing. If they feel that governance in general is a relatively low risk area, they will spend less time on it.

The Relationship between Governance Reviews and Perceived Governance Risk

So how does risk perception correlate with the number of extensive governance reviews conducted? North America has the lowest perceived governance risk and, correspondingly, the lowest activity for governance reviews. However, other regions of the world do not exhibit the same relationship. In fact, while East Asia & Pacific and South Asia have a very high perception of risk, rather surprisingly, they have some of the lowest governance activity (see **exhibit 6**).

Exhibit 6 Perceived Governance Risk Compared to Governance Reviews by Internal Audit



Note: CAEs were asked to choose whether governance was one of the top 5 risks in their organization from the perspective of internal audit (Q66), the audit committee or equivalent (Q64), and executive management (Q65). *n* = 2,704. These responses were compared to Q72: What is the extent of internal audit activity [for] reviews addressing governance policies and procedures in general? *n* = 2,545.

“Be proactive!
 There’s no point in
 being a coroner,
 doing autopsies on
 belly-up businesses,
 or shutting the
 barn door after the
 horses have bolted.
 Make your voice
 heard in real time.”

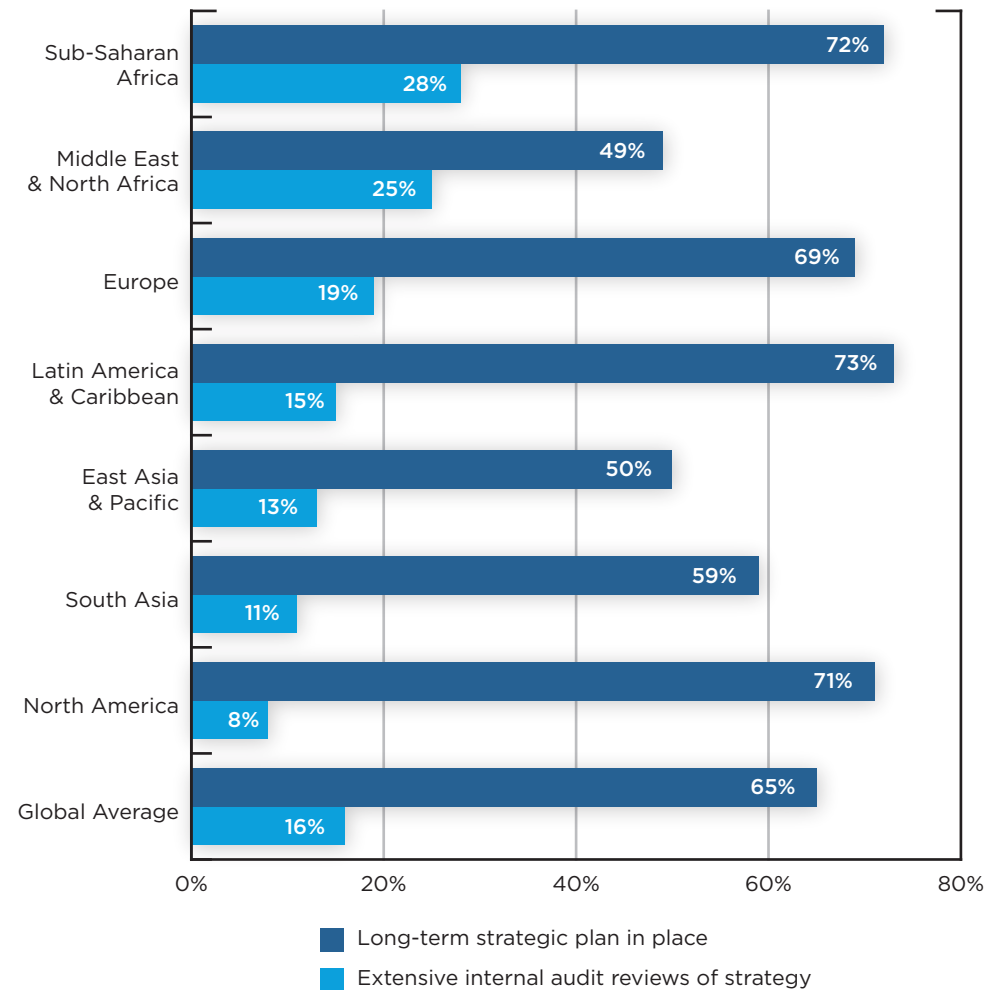
—Dr. Leen Paape,
 RA, RO, CIA, Dean,
 University Board,
 Nyenrode University and
 former PwC partner,
 The Netherlands

Existence of Strategic Plans Compared to Reviews of Strategy

It is fair to say that a huge gap exists in terms of internal audit undertaking strategic reviews even where a long-term strategic plan is in place. The CBOK survey data indicates that while approximately 50% or more of respondents’ organizations around the world have a

long-term strategic plan in place, internal audit is engaged in conducting strategic reviews from a low of 11% for South Asia to a high of 28% for Sub-Saharan Africa (see **exhibit 7**). Sub-Saharan Africa and Middle East & North Africa have the highest levels of activity for reviews of strategy linked to performance, just as they do for general governance reviews.

Exhibit 7 Existence of Strategic Plan Compared to Extensive Internal Audit Reviews of Strategy



Note: Combination of Q71 and Q72. Q71: Which organizational governance documents exist in your organization? Topic: Long-term strategic plan for the organization. n = 2,672. Q72: What is the extent of internal audit activity? Topic: Reviews addressing linkage of strategy and performance. n = 2,519.

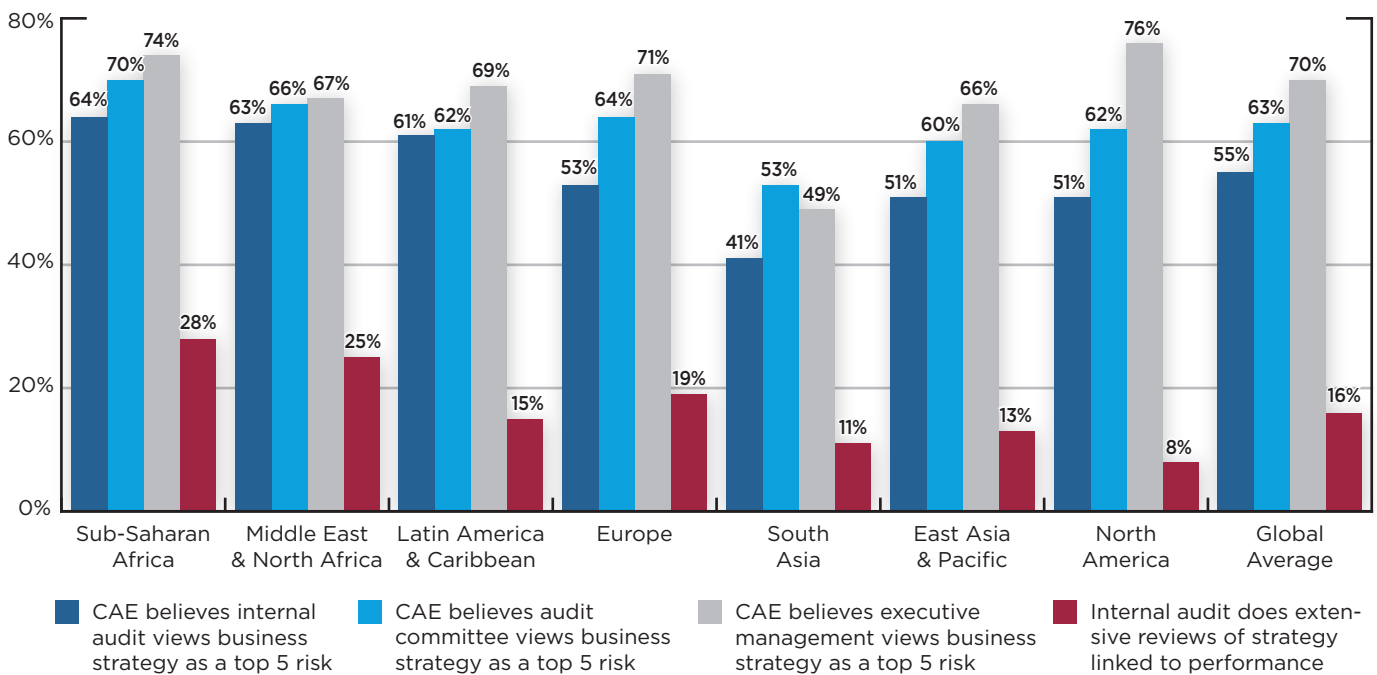
The most surprising finding relates to North America. Here, an average of 71% of respondents report having a long-term strategic plan in place, but only a meager 8% of internal auditors report that they actually review the organization’s strategic plan. We suspect that the reasons for this huge “strategic plan existence vs. extensive strategic reviews” gap are that they perform such reviews in “little bites” rather than comprehensively; have insufficiently mature or inexperienced internal audit functions that do not feel adequately supported or confident to carry out such strategic reviews; or a possibility that strategic risks are given a low priority because they are not perceived to be a matter for concern.

The Relationship between Strategy Reviews and Perceived Strategic Risk

All over the world, internal audit seems to take action more on risk indicators from perceived or actual weaknesses in internal controls over financial reporting, rather than those pertaining to strategic performance and operational risk factors. This happens even though internal audit acknowledges the importance of strategic risk and believes that management and the board place a high priority on strategic risk as well.

As shown in **exhibit 8**, an average of 55% of respondents worldwide say that internal audit views strategy as one of the top five risks for the year. The numbers

Exhibit 8 Perceived Strategic Business Risk Compared to Strategy Reviews by Internal Audit



Note: CAEs were asked to choose whether strategic business risk was one of the top 5 risks in their organization from the perspective of internal audit (Q66), the audit committee or equivalent (Q64), and executive management (Q65). *n* = 2,704. These responses were compared to Q72: What is the extent of internal audit activity [for] reviews addressing linkage of strategy and performance? *n* = 2,519.

are even higher when respondents were asked about the opinion of audit committees (63%) and management (70%). With perception of strategy so high, the level of internal audit activity appears very low in contrast.

As noted before, financial reporting indicators are by definition historical and

backward-looking and thus lagging indicators. Consequently, we believe that the increasing involvement of internal audit in governance audits and reviews is going to make the profession shift its focus to performance and risk indicators that relate to strategy implementation (leading indicators) in the coming years.

6 What Does It Mean to Audit Culture?

Looking at Hard Controls and Soft Controls

Organizational culture and “tone at the top” play a significant role in how involved the internal audit function is in reviewing and adding value to organizational governance.

IIA President and CEO Richard Chambers focused on organizational culture in his 2016 General Audit Management (GAM) Conference presentation titled “When Culture Is the Culprit.” He explained that there are both hard controls and soft controls that can be audited when the internal audit activity is looking at organizational culture. A similar analogy can be made that this also applies in auditing organizational governance (Organizational Culture, 2015, Chartered Institute of Internal Auditors at <https://www.iiia.org.uk>).

There are hard controls that can be audited to help improve organizational governance:

- Codes of ethics/conduct
- Human resources policies and procedures
- Other policies, rules, and defined procedures
- Organizational structure
- Defined roles, responsibilities, and authorization levels

Auditing these hard controls is within our comfort zone, and many internal

audit functions routinely conduct these types of audits. Thus, it is often not that difficult for internal audit to add some value to the governance processes by auditing these areas. However, the challenge arises when significant judgment has to be used when trying to audit the soft controls (Organizational Culture, 2015, Chartered Institute of Internal Auditors).

Insight

“Poor culture leads to organizational disaster.”

—N. G. Shankar,
FCA, CIA,
AdityaBirla Group, India

In particular, it is instructive to draw attention to an observation made by the late Peter Drucker, internationally recognized management guru, who said, “Culture eats strategy for breakfast.” No matter how well-thought-out the strategy is, if you do not have a positive, healthy culture, or do not consider the culture in your organization to support strategy, your efforts are unlikely to succeed. Indeed, many business leaders have underestimated the power of culture and failed in their strategy implementation because they ignored the organizational culture’s relevance and impact. Thinking about “strategy vs. culture” is posing a false dilemma; it is not an “either/or” question.

Instead, it is critically important that culture and strategy are aligned and working hand-in-hand. Thus, if a company proposed a new strategy that deviated from the current mode of operation, it would require a lot of change in the employees' thought processes and behaviors to translate that strategy into action.

The meaning behind Drucker's quip is simply that we should not ignore culture or take it for granted. Instead, we must plan for it, recognize its value as a driver and an enabler, and make it work, particularly when auditing governance structures, processes, and practices.

Culture embeds many intangibles, including "soft controls." Some of the soft controls that can be audited to help improve organizational governance include:

- Management and board competence, philosophy, and style
- Mutual trust and openness
- Strong leadership and powerful vision
- High performance and quality expectations
- Shared values and understandings
- High ethical standards

These are areas that most internal auditors lack experience in auditing and for which there are less formal training and tools.

Cultural Risks and the Three Lines of Defense

Internal audit has a very key role in holding up the Third Line of Defense regarding assessing governance culture and how the values and behaviors that

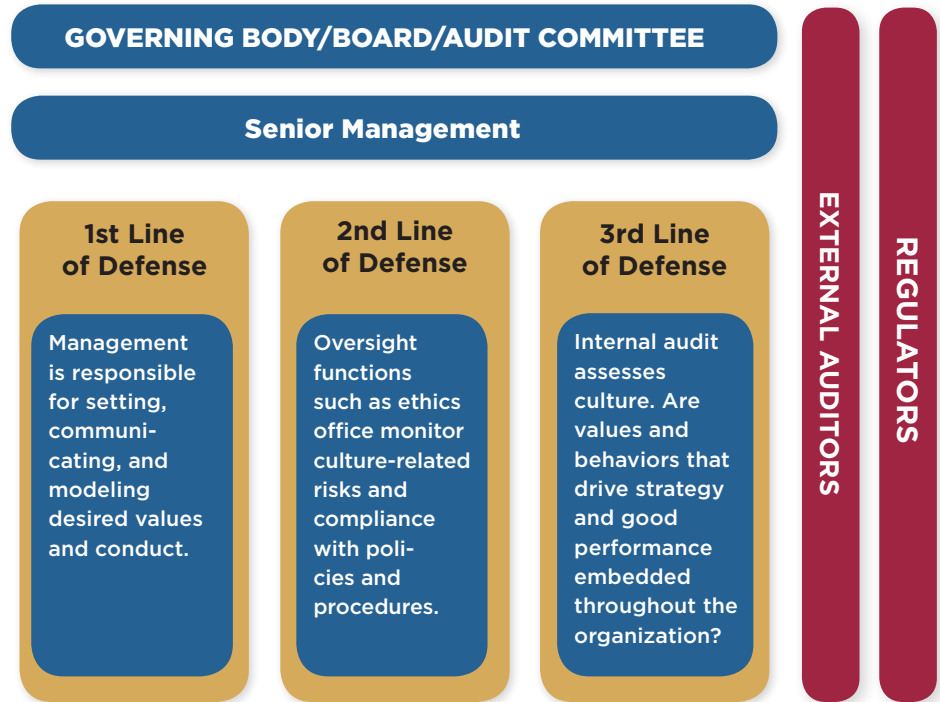
drive good strategy and good performance are embedded throughout the organization. Oversight functions such as ethics office monitor culture-related risks. Other second-line functions are compliance, risk management, environmental, quality assurance, etc. **Exhibit 9** illustrates the Three Lines of Defense Model applied to cultural risks.

An alternative to the Three Lines of Defense Model is the Five Lines of Defense Model, where the first line is the tone of the organization, the second line is business unit management and process owners, the third line is independent risk management and compliance functions, the fourth line is internal audit, and the fifth line is board risk oversight and executive management. *Source:* "Applying the Five Lines of Defense in Managing Risk" (Protiviti, *The Bulletin*, volume 5, issue 4, 2013).

A Note about Addressing a Toxic Culture

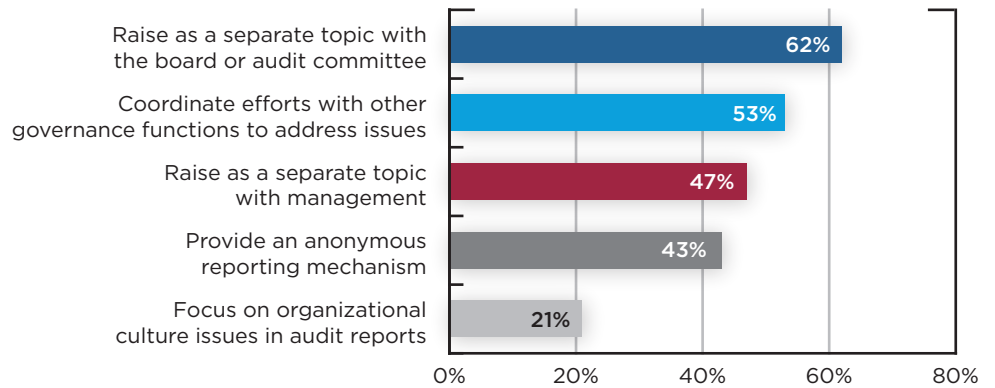
There are times when addressing culture becomes urgent, when the culture has become toxic. The IIA's 2016 Pulse of Internal Audit Survey in North America asked CAEs how they would address a "toxic culture" in their organizations. The option they say would be most effective in this situation was "raising culture as a separate topic with the board or audit committee." Sixty-two percent say this is an extremely effective way to address a toxic culture. The weakest support went to "focusing on organizational culture issues in audit reports" (21%), perhaps indicating that in a very dysfunctional environment, issues need to be addressed at the top rather than through the normal processes of auditing. See **exhibit 10**.

Exhibit 9 The Three Lines of Defense Model, Adapted to Focus on Cultural Risks



Note: This exhibit comes from the presentation “When Culture Is the Culprit” delivered by IIA President and CEO Richard Chambers at The IIA’s 2016 General Audit Management (GAM) Conference in Dallas, Texas. The exhibit is an adaptation of the Three Lines of Defense Model from The IIA’s Position Paper, The Three Lines of Defense in Effective Risk Management and Control (January 2013), which was developed using the ECIIA/FERMA *Guidance on the 8th EU Company Law Directive*, article 41, part 1.

Exhibit 10 Effective Methods for Addressing a Toxic Culture



Note: From the 2016 North American Pulse of Internal Audit (The IIA, March 2016), page 14. Q12: Rate the effectiveness of the following methods for addressing a toxic culture in an organization. Due to rounding, some totals may not equal 100%. The exhibit shows those who said the method was “very or extremely” effective. n = 206.

Strategies for Addressing Culture

Finally, it is important to get everyone on board and set the appropriate expectations for internal audit to perform governance audits. To achieve this, the following are recommended as good first steps:

- Communicate with senior executives about their views of governance culture.
- Develop trust with the audit committee that allows subjective judgments.
- Find a champion who supports auditing organizational governance culture.

- Define the roles of what internal audit can do to help improve organizational governance.
- Consider incorporating governance auditing culture into the internal audit charter.

We believe that if these steps are followed, internal audit will be much more likely to be able to get involved in effective organizational governance auditing that will help prevent governance failures and help improve the organization's strategic performance. (This section is adapted from "When Culture Is the Culprit," GAM 2016, Chambers.)

7 How Can Internal Audit Overcome Potential Barriers to Governance and Strategy Audits?

A Look at Positioning, Board Support, and Regulatory Effect

For their part, internal auditors should consider how they can overcome the barriers that they will probably encounter when they take steps to conduct reviews or audits of governance or strategy in their organizations. Internal audit functions may find it difficult to strike an appropriate balance among various obligations under The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)*, realistically attainable goals, and board and senior management interest. This section covers the following conditions and strategies that can facilitate internal audit getting involved in governance:

- Positioning
- Board support, audit committee, and charters
- Regulations or mandates

Positioning

Due to recent crises and anticipated trends, internal audit has become an essential part of the organizational structure. Many organizations say that internal audit is present to assist the organization in achieving objectives and mitigating risks. However, once implemented, how does the organization

Insight

“Focusing your audit activities step by step on the organization’s strategies, on the governance system, and on the organizational culture is the key to success in the future—it is challenging but worth starting it! It might be a balancing act, but if you have built a solid basis of relationship with your board and have in place a cultural environment of trust and credibility, these efforts and undertakings will be much more accepted and supported by your stakeholders.”

—Angela Witzany,
CIA, QIAL, CRMA, Head of Internal
Audit, Sparkassen Versicherung AG

respond to internal audit’s purpose? To fulfill its responsibilities, internal audit must be positioned within the organization’s governance structure so that it can effectively communicate to executive management and the board and provide value-added services. Internal audit must also be regarded as independent and objective in order to provide sensitive information, when necessary, and offer guidance in organizational politics. Achieving this position within the organization, however, requires acceptance (or

buy-in). To accomplish the latter, internal audit should ensure that the CAE reports functionally to the board and administratively to senior management. Should this organizational structure not exist, internal audit may not be truly independent and objective and therefore not be able to provide the necessary audits of an organization's governance and strategy processes (Gramling et al., 2013).

Results of the 2015 CBOK practitioner survey support The IIA's International Professional Practices Framework (IPPF). A total of 72% of internal auditors around the world indicate that CAEs in their organization report functionally to either the audit committee (or equivalent) or to a board of directors. In addition, 75% report that the CAEs in their organizations report administratively to either the CEO/president or audit committee/board of directors. Organizations with audit

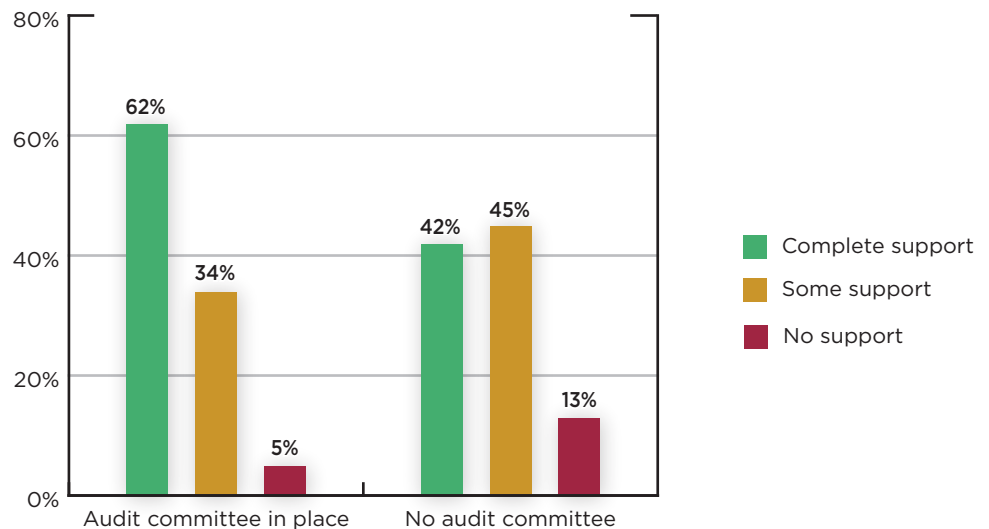
committees are more involved in governance reviews than organizations without.

Board Support, Audit Committee, and Charters

The position of internal audit within an organization is important, but it is only one step toward internal audit effectiveness. An effective audit committee also helps to support a system of checks and balances. Unfortunately, creating an audit committee in an organization in which the culture or regulators do not require one can often be a challenge for internal audit.

However, organizations that have mature internal audit functions are most likely to have strong board support and audit committee commitment for performing governance audits (see **exhibit 11**). Also, more mature internal audit functions are more likely to have

Exhibit 11 Perceived Support from the Board for Reviews of Organizational Governance



Note: Q67: In your opinion, how much support does internal audit have from the board of directors (or equivalent) to review the organization's governance policies and procedures? CAEs only by Q78: Is there an audit committee or equivalent in your organization? *n* = 2,533.

“I work for a newer organization. This has allowed me to be able to make the initial investments in strong communications both with management and the governing body, achieve good organizational positioning of the internal audit function, and build trust and confidence with management and the governing body. As a result, I have been able to overcome potential barriers and obtain the needed support to conduct a corporate governance audit.”

—Lesedi Lesetedi,
CIA, QIAL,
Director - Internal Audit,
Botswana International
University of Science and
Technology, Botswana

effective charters that state the need for governance reviews.

Regulations or Mandates

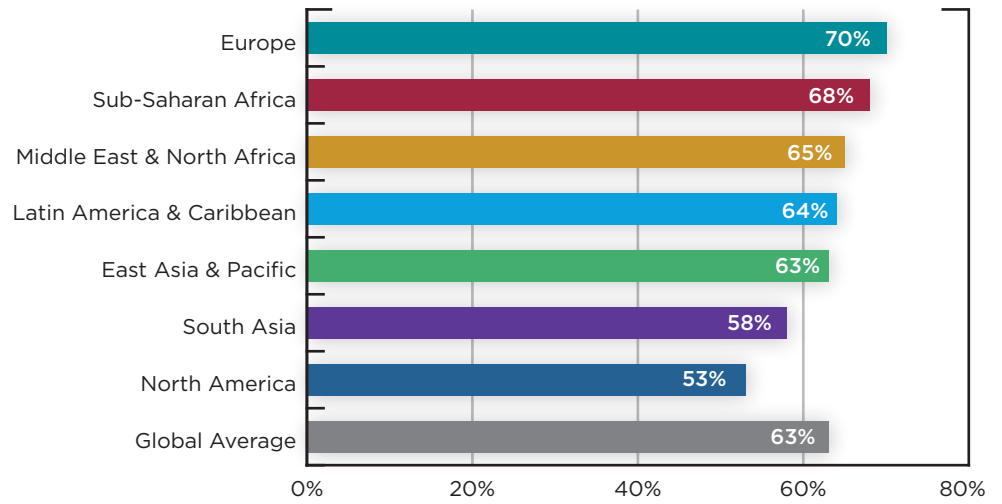
Regarding a mandate for the internal audit function, there is remarkable similarity for regional averages. Between 53% and 70% say the internal audit function is mandated by law (see **exhibit 12**). The two lowest regions are North America (53%) and South Asia (58%). Clearly, in industries where there is an internal audit function mandated by law and an audit committee is present, one can expect a governance audit and/or review to be championed or supported.

However, it is important to note that the private sector is well below the global average in this area (29% compared to 63%) (see **exhibit 13**). Only one out of three private sector organizations has an explicit mandate requiring the existence of an internal audit function. Public sector organizations are by definition dealing with public monies and are obliged to act in the public interest with a focus on service efforts and accomplishments rather than profit maximization. Accordingly, their commitment to

transparency and accountability is frequently enshrined in the law or charter that gave rise to them in the first place. In such scenarios, internal audit naturally comes to have a key role to further the organizational mandate and becomes engaged in governance audits and reviews.

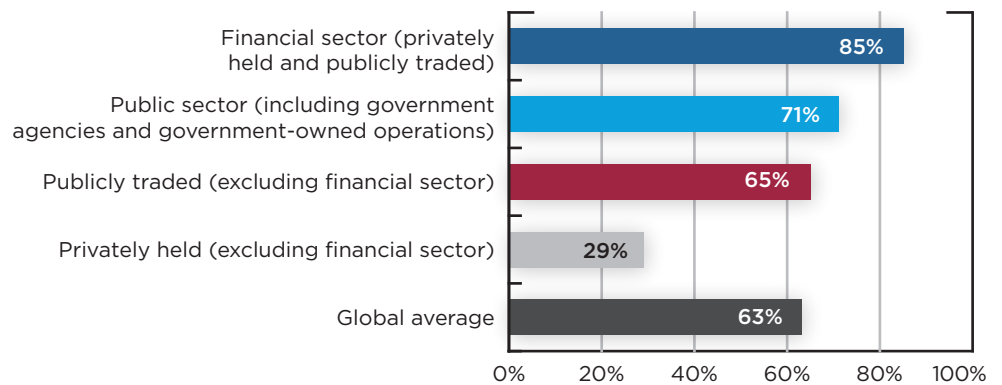
In summary, carrying out governance audits and reviews is no easy task because there are a host of challenges, barriers, and impediments to overcome. Specifically, the internal audit function and CAE must consider whether it has the organizational positioning, stature, and credibility to undertake and complete a governance audit successfully. It is very important that for the purposes of conducting a governance audit or review, the CAE and the internal audit function have “champion stakeholders” and the support of the board and executive management. The existence of a mandated internal audit function, as well as a strong and supportive audit committee, can go a long way in supporting the performance of governance audits and reviews.

Exhibit 12 Internal Audit Mandated by Law (Regional View)



Note: Q68: Is the existence of an internal audit department mandated by law for your organization? *n* = 10,668.

Exhibit 13 Internal Audit Mandated by Law (Sector View)



Note: Q68: Is the existence of an internal audit department mandated by law for your organization? *n* = 10,812.

Conclusion

Promoting and supporting effective organizational governance is crucial to achieving organizational objectives of superior performance, growth, competitiveness, compliance, and long-term sustainability. However, balancing performance and conformance can be challenging for most organizations. Fortunately, internal audit is well-positioned to provide value-added services to the organizational governance process.

Internal audit functions not currently involved in organization-wide governance reviews should preferably begin the process by taking “little bites”—gradually including evaluations of their organization’s governance structure and practices as part of other assurance and advisory services in other areas. In behavioral economics, this is called the “nudge” strategy (Thaler and Sunstein, 2008). Internal audit can assist board committees in discharging their oversight responsibilities effectively and even help board self-evaluation of their performance (Ramamoorti, 2011a, 2011b).

In addition, both the governing body and internal audit should recognize that organizational culture is a key driver and enabler of both successful performance and effective governance outcomes. Typically, business processes, internal controls, and policies and procedures feature hard controls, while organizational culture, by definition, is distinguished by

many intangibles and behavioral issues that necessitate soft controls. However, auditing soft controls has proven to be much more challenging. Auditing the organizational culture can be accomplished by conducting “culture” and “ethics” audits using ethnographic surveys in a global organization to take the pulse and temperature of the organization with respect to assessing how healthy the culture is as well as the organization’s ethical climate (Ramamoorti & Evans, 2011).

Organizational positioning, stature, and credibility of the internal audit function are also undeniably important in the context of conducting governance audits and reviews. It is extremely important for CAEs to excel at “relationship-building acumen” and communication skills, and be adept in undertaking and executing governance reviews and audits successfully and competently (Abdolmohammadi et al., 2013; Dittenhofer et al., 2010).

Due to the recent spate of governance failures, the auditing of governance structures and processes has become a resurgent theme in organizations around the world. It therefore seems inevitable that both organizations and internal audit will recognize stakeholder expectations and gradually expand the scope and range of their activities. In particular, we conjecture that there will be an expansion

from the traditional backward-looking financial reporting emphasis and reliance on external audits to a forward-looking position focused on strategic operational and performance data that will increase the involvement of internal audit for more effective monitoring and governance oversight. The emerging future

governance landscape presents exciting opportunities for internal audit to add value by conducting governance audits and reviews, auditing hard and soft controls, including a focus on organizational culture, and thus promoting and supporting effective organizational governance.

Appendix A

A Corporate Governance Journey

“Governance is a process, not a manual.”

—Bismark Rodriguez,
CIA, CFSA, CRMA, CCSA,
EY Partner | FSO |
Financial Services
Risk Management,
Panama office, Panama

Note: This appendix presents a summary of how one internal audit function based in the United Arab Emirates (UAE) led the way to governance reviews at an oil and energy company in UAE. This case example is provided courtesy of Aley Raza, CIA, director of internal audits, Emirates National Oil Company (ENOC), Dubai.

Insight

“In the end, I have always seen corporate governance at my organization as a continuous journey involving many vehicles (key stakeholders, both internal and external), having dedicated drivers (champions, committees, policy owners), using multiple routes (assessments, workshops, benchmarking bodies, policy toolkits, etc.) and reaching several destinations (major/minor mileposts) designed to produce superior governance outcomes.”

—Aley Raza, CIA,
Chief Ethics and Compliance
Officer/Director Internal Audits,
Directorate of Internal Audit
and Business Ethics, Dubai,
United Arab Emirates

Implementing Governance Reviews in a Large Oil and Energy Company

In any organization that wants to implement governance reviews, there is a need for a corporate governance (CG) champion, but this need not be the compliance officer/company secretary only. It could be the chief financial officer (CFO) or the CAE as well. The CAE is normally very well-positioned to assume this role when a CG culture is still fairly new and less advanced, because the CAE is well-versed with the internal control environment and governance gaps. Of course, this “champion role” will usually be well-supported at the board level because the CAE normally reports to the audit committee (and his/her appointment, as such a champion will have the audit committee’s and CEO’s blessing), which makes it a lot easier to improve the overall governance and control frameworks. The audit committee can thus formally adopt an initial CG improvement program on behalf of the board and give guidance to management regarding embedding it into their governance and control structures (with the advisory support of the CAE as a CG champion on their behalf). Meanwhile, some of the

key steps that the CAE can take in this role include:

- Establish a CG program steering committee (best if chaired by the CEO and includes the CFO, legal head, company secretary, and CAE as members) and an initial project team (six to nine months), with regular reporting to the audit committee, executive committee, and the board to create the right platform and build a governance culture gradually.
- Use the above project team to develop a high-level CG improvement program and have it benchmarked to incorporate governance best practices—usually easier for listed entities or highly regulated companies.
- Use the CG project team to conduct CG assessments based on the available CG guidelines/codes/best practices (internal audit should be part of this team, along with others). I have found this to be more acceptable by management as it is a diversified team having wider roles and responsibilities as against only assurance/auditing.
- Invest a lot of the initial time and effort on awareness, educational workshops, and automation across the

organization for launching any new CG policy/guideline—this gives you credibility in the eyes of management as they can see some quick wins and deliverables up front—e.g., facilitating workshops (with optional use of external service providers where necessary) on setting up committees/charters, company secretary functions/roles, director development programs, authority mandates, ethics codes, ERM/creating CG portals on IT platforms for knowledge sharing/creating CG assessment and progression toolkits (e.g., directors’ handbook, etc.). These are tools, some which I have personally applied at my organization, that were very well received. Do remember to recognize both major and minor milestones in the CG journey, as it makes it more fun, interesting, and motivational for all the concerned stakeholders.

- Ultimately, conclude the project with some form of CG guidelines (or code or program) with assigned responsibilities and authorities—a board approval would be just great here. Now the CAE may exit here as a “project champion,” but believe me, he/she stays a CG expert for life at the organization, which eventually helps him/

her in conducting future internal audits and fulfilling the audit committee's assurance requirements! The CAE

should, however, continue to serve in an advisory capacity on any governance and/or risk compliance committees.

Appendix B

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In Memory of
Mortimer A. Dittenhofer
“Mort the Immortal”
1914–2016

*An Incredibly Prolific Internal Auditing Pioneer
Who Continued Making Significant Contributions to the Profession as a Nonagenarian*



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