PUBLISHED BY THE INSTITUTE OF INTERNAL AUDITORS

TONE at the TOP

Issue 20 November 2003

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

Controls Are Everybody's Business

"But that's not my job!" This proclamation is certainly not something we'd expect to hear from a valuable, productive employee. And yet, it would be naive to suggest that most employees never have such a thought.

Is there anything for which we are all responsible and accountable, or does each buck stop in a specific area — the one most closely aligned with the issue under consideration? In today's work environment, employees often work in narrowly defined roles that might actually fly in the face of and even negate the bigger picture of corporate accountability. And yet, with legislative actions demanding the ultimate in responsibility from those at the top, does any organization have the luxury of not holding each and every person throughout the enterprise responsible for his or her part in the compliance process?

The Institute of Internal Auditors (IIA) believes that controls are everybody's business. Of course, those at the top are theoretically responsible for setting organizational objectives, identifying the risks that might prevent accomplishing those objectives, determining the level of risk that is acceptable, and establishing an appropriate system of internal control to mitigate the risks. But because any enterprise is only as strong or as ethical as its weakest or most unethical employee, the blame for a poor control environment must be shouldered throughout the entire organization. This means the entire organization, and each and every person who works there, should be "tuned in" to internal control.

Corporate Culture

What can you do to help ensure your organization meets its objectives and effectively manages risk? How can you create awareness and bring greater accountability to your organization? What steps can you take to change the hearts and minds of everyone in the organization?

Management and the board must set a tone at the top of the organization for a corporate culture that acknowledges and maintains an effective control environment. In order for strong controls to be an integral part of day-to-day operations, management must take steps to ensure there's a clear organization-wide understanding and appreciation of the important elements of control — the control environment, risk assessment, control activities, information and communication, and control monitoring. This can be achieved by staff education on control categories and tools, red flags, and the hallmarks of an effective control environment.

The self-test below will help you determine whether your organization's control environment provides the discipline and structure necessary to influence the corporate consciousness.

1. Is the organization's ethical tone at the top communicated in words and deeds?
2. Is an ethics program in place and does it include a meaningful code of conduct?
3. Is the board of directors active, independent, and well informed?
4. Are positions in the organization structured for optimum effectiveness in regard to productivity and communication?
5. Are all responsibilities and accountabilities clearly defined?
6. Is delegation of authority commensurate with responsibility?
7. Does a formal or informal job description include an analysis of the knowledge and skills needed to perform each position?
8. Does the organization hire qualified, ethical, and well-trained personnel?
9. Do frequent interactions occur between senior and operating management?

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10. Are appropriate policies and procedures in place for hiring, training, promoting, and compensating employees?
11. Are background checks conducted for new hires, especially those in sensitive positions?

Control Categories

The most useful control categories comprise preventive, detective, directive, and mitigating or compensating controls.

Preventive controls are built into, not onto, the system. Preventive controls, such as separation of duties, passwords, authorization requirements, and physical safeguards, are designed to prevent undesirable events from occurring. Detective controls, such as output reviews, exception reports, reconciliations, physical inventories, and audits, are deferred to the end of the process. Designed to cause or encourage a desirable event to occur, policy statements, performance guidelines, training programs, and incentive compensation plans are examples of directive controls. Mitigating controls are designed to compensate — at least partially — for a missing or excessively costly control. Examples include supervisory review where separation of duties is impractical, and monitoring budget variances in lieu of transaction processing controls.

As employees become familiar with the control categories, they are more apt to use the tools and adhere to the policies set forth by management, and watch with a sharper eye for gaps in the control system. In addition, they will be predisposed to work within the framework dictated by these control categories. This is all a part of creating a control conscious environment.

The Internal Control Mystique

Because there are many misconceptions about internal control, knowledge sharing is vitally important to maintaining an effective control system. Part of the educational process is to dispel the myths about internal control and present the straight story. Here are just a few myths and the corresponding facts:

MYTH	FACT
Internal control starts with a strong set of policies and procedures.	Internal control starts with a strong control environment.
Internal control — that's why we have internal auditors.	Management is the owner of internal control.
Internal control is a finance thing. We do what the controller's office tells us to do.	Internal control is integral to every aspect of the business.
Internal controls are essentially negative, like a list of "thou shalt nots."	Internal control makes the right things happen the first time, and every time.
Internal controls are a necessary evil. They take time away from our core activities—making products, making sales, and serving customers.	Internal controls should be built into, not onto, business processes.
With downsizing and empowerment, we have to give up a certain amount of control.	With downsizing and empowerment, we need different forms of control.
If controls are strong enough, we can be sure there will be no fraud, and financial statements will be accurate.	Internal controls provide reasonable, but not absolute, assurance that the organization's objectives will be achieved.

Control Consciousness

Studies indicate that approximately one-third of American employees have witnessed unethical or illegal conduct in their workplace. Of these, over half did not disclose what they observed. Seventy-one percent of respondents expected that people who reported corruption would suffer for reporting it. For this reason, whistleblowers have typically been reluctant to come forward and disclose inappropriate acts. In fact, sixty-nine percent of public and private sector whistleblowers studied experienced reprisals in the form of lost jobs or forced retirement.

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Enter the Sarbanes-Oxley Act of 2002, which requires audit committees to establish procedures for receiving and handling complaints about internal controls and auditing matters; i.e., a hotline. Here again is an opportunity to shift the corporate culture to a higher level of control consciousness. Internal auditing plays an important role in this process by overseeing how it is set up, how it is publicized internally, and how employees are trained. In order for hotlines to work as intended, management must provide reassurance that whistleblowers will be protected from retaliation, and that legal safeguards are in place to help create an environment in which employees feel that disclosing their concerns is acceptable and encouraged.

Section 404 of Sarbanes-Oxley addresses Management's Report on Internal Controls over Financial Reporting. It requires public companies — other than registered investment companies — to include in their annual report a certification from management that the company has established internal controls for its financial reporting process. The internal control report must:

- State that management is responsible for establishing and maintaining adequate internal control over financial reporting.
- State that management has assessed the effectiveness of internal controls over financial reporting and stated whether or not it is effective.
- Identify the framework that management used to evaluate the effectiveness of internal controls.
- State that the registered public accounting firm that audited the financial statements also issued an attestation report on management's assessment of it internal control.

Each covered public company also is required under Section 404 to publish a similar financial reporting controls certification from the registered public accounting firm that audited its financial statements.

Bottom Line

Those at the top of today's organizations must make a concerted effort to boldly step forward with a commitment to internal control. This is no longer a choice, but a necessity for control-conscious organizations dedicated to meeting their objectives, complying with laws, operating effectively and efficiently, and protecting stakeholder interests.

IIAResources

On-site Seminars
- Controls Are Everybody's Business
- Audit Committee Training

Research Foundation Reports
- *Audit Committee Effectiveness: What Works Best, 2nd Edition*
- *Corporate Governance and the Board – What Works Best*
- *Internal Audit's Role in Corporate Governance: Sarbanes-Oxley Compliance*

Seminars
- Sarbanes-Oxley Act: Implications and Impact for Internal Auditors
- Sarbanes-Oxley Act: Impact on Information Technology

Webcasts on Sarbanes-Oxley

For more information, visit www.theiia.org and enter "controls" in the search engine.

Red Flags

Warning! These red flags could indicate big trouble ahead:

- Unusually rapid growth or profitability, especially when compared with that of other companies in the same industry. (Enron had a 151 percent increase in revenues during 2000, with $100 billion, while the second-ranked pipeline company reported revenues of less than $30 billion.)
- Financial results that seem too good to be true or significantly better than competitors, without substantive differences in operations.
- Unusual balance sheet changes, or changes in trends or important financial statement relationships, such as receivables growing faster than revenues.
- Significant bank accounts, subsidiaries, or branch operations in tax-haven jurisdictions, with no clear business justification.
- Widely dispersed business locations with decentralized management and a poor internal reporting system.
- Inability to generate cash flows from operations while reporting growth in earnings.
- Overly optimistic news releases or shareholder communications, with the CEO acting as an evangelist to convince investors of future potential growth.
- Accounting methods that appear to favor form over substance.
- Accounting principles or practices that vary from industry norms.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements.
- Especially high vulnerability to changes in interest rates.
- Significant, unusual, or highly complex transactions close to yearend.
- Failure to enforce the company's code of conduct.
- Threat of imminent bankruptcy or foreclosure. Significant related-party transactions not in the ordinary course of business.
- Overly complex organizational structure involving unusual legal entities, numerous managerial lines of authority, or contractual arrangements without apparent business purpose.
- Complex business arrangements not well understood and appearing to serve little practical purpose.

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Mission

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

Your comments about *Tone at the Top* are welcomed.

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

Established in 1941, The IIA is an international professional association with global headquarters in Altamonte Springs, FL. The IIA has more than 85,000 members in internal auditing, risk management, governance, internal control, IT audit, education, and security.

The Institute is the recognized authority, principal educator, and acknowledged leader in certification, research, and technological guidance for the profession worldwide. The IIA presents conferences and seminars, produces educational products, certifies qualified audit professionals, provides quality assurance reviews and benchmarking, and through The IIA Research Foundation, conducts research projects.

November 03-03078-th/pd
Printed in the U.S.A. on recycled paper.