# Why Auditors Audit

**by**

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At the risk of offending some executives who want a new age auditor who is an in-house consultant that has a role that is indistinguishable from any one else in management instead of an auditor who has a role and responsibility unlike anyone else in management, I must assert the relevance and unconditional importance of the old school concept of internal audit as an independent check and balance for and on management even if it sounds like I am a knuckle dragging Neanderthal.

Just as a point of reference, the origins of the internal audit departments for many companies came about as a result of Congress passing the Foreign Corrupt Practice Act in 1977 in response to widespread corruption and "doctored" books. The SEC and Congress took this action after finding out that executive management for a number of publicly held companies paid huge bribes to foreign officials as a way of securing large contracts for their companies.  Furthermore, the CEOs' and CFO's deliberately concealed this information from their external auditors and buried it in the accounting records. Hence, the role envisioned for internal auditors during the creation of the Foreign Corrupt Practice Act was one as a double check on management and not one as an advisor or in-house consultant.

Back in 1977 with scandals still fresh in the public's memory, the value of internal audit was obvious to the SEC, the public, management and investors.  We didn't need elaborate mission statements, nor did we have to continually justify our existence to management. Internal auditors were "watchdogs" plain and simple. Furthermore, no apologies were made for their presence or for their nickname. However, during the 1990's it became unfashionable to be a check and balance on management. Apparently human vice and fallibility became a thing of the past or so we were told. This attitude predominated during the nineties despite the fact the key finding of the Treadway Commission of 1987 was that material fraud and errors in judgment most often occurred at the CEO and CFO level. The pressure from several CEO's and Board of Directors to de-emphasize audits of sensitive and high risk areas and to refocus instead on advising management on ways to increase the bottom line came at a cost.

The accounting misrepresentations and the alleged self dealings of top executives of Enron, WorldCom, and Global Crossing, alone have cost stockholders tens of billions of dollars. Apparently, greed and poor judgment could still occur in the nineties. And just as apparent is the fact that now just as in 1987 per the Treatway Report's finding; most large failures and frauds are CEO and CFO led. Hence the importance and dollar value of a truly independent and well-supported internal audit department that actually conducts double checks high-risk activities, especially of those areas under the direction of top executives.

Unfortunately, during the highflying price-earning ratios of the nineties auditing or checking-up on top management fell out of vogue. After all, the CEO's of the nineties were wizards, who shouldn't be held accountable by the Board or for that matter by the standard price-earning ratio yardsticks used Wall Street for fifty years. In this new age kind of atmosphere many of my colleagues had to present themselves as "in-house consultants" or "advisors" to management rather than as "auditors" in order to survive. With this retreat from the original purpose of internal audit, it should come as no surprise we had a rash of recent corporate fraud allegedly perpetrated and concealed at the highest level of management of such a magnitude as to bankrupt billion dollar multinational corporations. Furthermore, the old belief that a CEO was in it for the long run and would therefore never jeopardize their career earnings by making short term self serving decisions no longer holds water given their ability to fleece the company and stockholders of ten lifetimes worth of salary in stock options and severance pay buy outs.

Our auditing standards require us to maintain "professional skepticism" for a reason. Human nature is still subject to such temptations as greed and errors in judgment. As CPA's we are neither to assume that management is dishonest or right nor assume unquestionable honesty and infallibility. Moreover, we are required to obtain "persuasive evidence" to support any belief in management's honesty and competency as it regards any business issue or activity. And, we are to do so each and every audit, for each and every issue.

If management wants to know what value traditional auditors <u>add</u> to the company, just look at the billions of dollars that could have been saved, the tens of thousands of employees that would still be working, and retirements that would be secure if Enron didn't go bankrupt due to the **<u>admitted</u>** duplicity and deceptive activities of many of it's own senior executives. Furthermore, all of the corporate scandals that have been revealed to-date are exactly the kind of questionable and unethical practices that internal audit was created to find and bring to the light of the Board by double checking on high risk areas.

The corporate charters for each internal audit department deliberately established us as the ***"Doubting Thomas"*** of the company. On behalf of my colleagues and myself, I am sorry in advance if our unique role creates tension between us: but rest assured it is professionally driven and nothing personal. Internal auditors should not be subject to the continued harassment of the "how did you help me make more money today" mentality that several of my besieged colleagues endured. We should not need an elaborate algebraic formula to continuously justify the "value" of a strong, independent internal audit department. For as the world has seen, the internal auditors could have prevented Enron stockholders from losing billions of dollars had they stopped the fraudulent misrepresentations of top management. All the auditors needed to do was spend a week examining and reporting on the high risk and very misleading "off-the-books" Enron partnership when they were immaterial instead of waiting until they accumulated to such a magnitude as to bankrupt Enron and lose stockholders and employees tens of **billions** of dollars.

In answer to the question of "value added," what could be more valuable to an organization than to help ensure the organization remains a going concern. If internal audit doesn't double check, audit or look over the shoulder of management on behalf of the common stockholder and the Board who will? Towards this end the Audit Committees worldwide should vigorously defend, promote and protect the internal auditors in the performance of their unique and critical duties. The payoff is obvious.

But just as obvious is the fact that internal audit will never be truly effective unless it is able to double check the activities, decisions, "pet" projects and compensation of the CEO, CFO and other top executives. After all, the scandals that have brought down corporate giants were the decisions and behaviors of the top executives and not the rank and file employees. Enron is not bankrupt because some secretary made a personal phone call on the company line or because some sales agent fudged the cost of a meal. Its time that the Audit Committees for each company quit undermining the internal auditors by having them report to CEO or CFO who were the originators of massive fraud in over two dozen Fortune 100 companies these past few years. The director of internal audit should report both functionally and administrative to the Audit Committee. The old notion that it doesn't corrupt or hinder the internal audit department to report to top management instead of the Audit Committee itself needs to be abandoned because it didn't work!

Over the years, my colleagues and I have found the professional standards promoted by the IIA to be true to the bone in predicting and ensuring the effectiveness, if not vitality, of internal audit departments. The crux to the success of any internal audit function starts and ends with the first standard of Independence. Without a single exception my colleagues and I have found the single most important factor affecting the effectiveness of internal audit is its organizational status. The higher the level in the organization the internal auditor reports to, the more effective s/he is in exerting independence in both selecting the areas to audit and in the conclusions drawn regarding them. The reason independence is so directly correlated to effectiveness is simple. The more independence from retaliation and peer pressure the auditor has the more likely s/he will audit high-risk areas regardless of who in management oversees them. After all, how realistic is it to expect a person to audit the most problematic areas of the person who hired and can fire them?

Over the years as a Peer Reviewer I have found that there are ten questions pertaining to the organizational status of internal audit that predict with almost certainty the effectiveness of the department. I have found that any department that answers “yes” to six or more of the ten questions will be in full compliance of the Standards for the professional practice of internal auditing. I refer to these questions as THE BLUE RIBBON BEST PRACTICES. The grades conform to the normal distribution of the bell-shaped curve with a score of 90 and above being an A. The consequence of a “no” answer typically means that the Director has to invest more and more time in the persuading, cajoling, and lobbying of management to actually get to audit than in auditing. The ten questions are as follows:

**BLUE RIBBON BEST PRACTICES:**

1. Does the Board or its equivalent (exclusive of management and general counsel) hire, fire and set compensation and award bonus payments to the Chief Audit Executive or Director (CAE) of internal audit?
2. Does the CAE develop in conjunction with the Board the budget; establish the appropriate job classifications, and staff salaries for the internal audit department?
3. Does the CAE report exclusively to the Board on both a functional level?
4. Does the CAE by charter signed by the Board establish the scope, nature, timing, content, and report format of his audits?
5. Does the CAE have unrestricted authority per charter and in practice to audit whatever activity, practices, policies, and procedures the entity may have within the confines of legal considerations and parameters?
6. Is the CAE provided with a contract of a minimum length and does it provide for no-fault severance pay if terminated?
7. Are all auditees required to respond to the satisfaction of the CAE within a specified time limit with all exceptions referred to the Board or its equivalent for resolution?
8. Does the CAE have the authority to develop and complete his Audit Plan with the input and upon approval of the Board?
9. Is the CAE authorized to obtain legal advice and expertise at his discretion regarding any audit or issue that comes to his attention?

10. Does the CAE have the right to meet or confab individually and in confidence with each key Board member or their equivalent on a regular basis?

It is recognized for some in the profession that haven't been through the school of "hard knocks" that these BEST PRACTICES may seem a bit extreme if not unnecessary. However, rest assured that when the rubber hits the road having this superstructure in place will guarantee as much as can be guaranteed that the Internal Audit Department will be able to live up to its charter. These practices were selected from other "best practices" suggested and considered because of their proven, not theoretical, effectiveness by an informal panel of five experts in the field of internal auditing. On this panel there were individuals who had worked in audit for the Defense Contractor Audit Agency, the Internal Revenue Service, fortune 500 corporations, governmental agencies, states, counties, cities, universities and public accounting firms. Cumulatively they possessed over 200,000 hours of audit experience.

It is both my observation as well as the panel that any organization that truly believed in what it espouses and asserts in their audit charter would voluntarily adopt every one of these ten best practices without exception. This is because these ten provisions would truly insulate Internal Audit from organizational and executive pressure to subordinate their professional opinions and independence regarding the ethics, propriety, and soundness of organizational practices and activities.

I recognize that these BLUE RIBBON PRACTICES will, at face, surprise many organizations and executives because, once in place, the internal audit department will have the independence that helps ensure that executives and manager live up to the promos in their companies' brochures regarding ethical behavior and commitment to such practices. Over the years the panel has found that the level and degree of resistance mounted against the adoption of such provisions is a bell weather of the true attitude of boards and executives and of the number and type of skeletons that usually are hidden in the organizations' closets.

The panel is appreciative of this fact and understands why many Internal Audit Departments have to ease their way into an organization and at times conform to group dynamics within that organization. Furthermore, without the insulation of a no-cut contract, many directors of internal audit have, and will continue to, put themselves in harms way when asserting their chartered independence. An informal survey completed by the panel noted that over a third of the directors of internal audit queried have either worried about losing their job or have actually been pressured to quit their position due to being the bearer of bad news or the pursuer of information that was felt to be to the detriment of top executives.

Its unfortunate that many organizations today parrot support of the independence and objectivity of their Internal Audit Department, yet knowingly and calculatingly continue to put directors of internal audit in harms way whenever they buck the system. The fact that many senior and seasoned directors of internal audit fear losing their job for merely doing their job is alarming and explains the recent rash of corporate scandals. All the above underscores the basis for the Blue Ribbon Committee's challenge to organizations to "walk-the talk" as regards truly supporting the independence and objectivity of their internal audit departments. If organizations really do mean what they say about supporting a strong internal audit function, then the Blue Ribbon Criteria are available to adopt today. Diluted provisions usually result in diluted results.

## Biography of Author

**Dr. Peter Hughes, Ph.D., MBA, CPA, CITP, CFE is the Audit Director for the County of Orange in Orange County, California. Email: Peter.Hughes@gov.com**

Dr. Peter Hughes is a CPA who has worked for over 25 years as both an internal and external auditor in both private and governmental positions. He has been the Director of Internal Audit at for Oregon University System comprised of seven universities, the NASA Jet Propulsion Laboratory, Caltech and is currently the Director of Internal Audit for the sixth largest County in the United States, the County of Orange in southern California. (If Orange County's was a Country its GNP rates it as the 35 largest in the World.) As the Director of Internal audit for the County of Orange, he enjoys the full support of the Board of Supervisors and management in the performance of his audit responsibilities. In this position Dr. Hughes is hired by and reports exclusively to the elected Board of Supervisors. His direction from the Board is simple: " Audit where the Director thinks there might be problems or trouble." Furthermore, in the five years Dr. Hughes has been the Director no one has asked him to explain the "value" he adds to the County. Given this support, it should come as no surprise that the County of Orange adheres to every one of the Blue Ribbon Criteria. Should the readers be aware of any other organization that comply with the Blue Ribbon Criteria, feel free to email me of this fact so I can share this information with our professional colleagues.