THE INTERNAL AUDITING PROFESSION:

CHALLENGES AND OPPORTUNITIES

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It is a pleasure to have the opportunity to address the International Conference of the increasingly important and growing profession of internal auditing. Probably no other group has been, and will be, more fundamentally affected as a result of the increasing focus on corporate accountability. That focus is apparent in various public and private sector initiatives -- the increasing formation and effective functioning of independent audit committees, the Foreign Corrupt Practices Act, the AICPA's Special Advisory Committee on Internal Accounting Control, the Commission's recent rule proposals for reporting on the effectiveness of systems of internal accounting control, the broad reexamination of the nature and structure of the accounting profession, and your own "Standards for the Practice of Internal Auditing" -- to name a few. Virtually all of these initiatives have resulted in increased attention to, responsibilities for, and visibility of internal auditors and the internal auditing profession. However, the greatest impact on internal auditors has probably come from the Foreign Corrupt Practices Act.

As I am sure you know, that Act, which was effective upon enactment in December of 1977, includes not only antibribery provisions, from which it takes its name, but also certain accounting provisions which require reporting companies to:

- Maintain accurate books and records; and
- Devise and maintain a system of internal accounting control which provides reasonable assurances that the broad objectives of internal accounting control are achieved.

Those broad objectives, which were taken directly from authoritative auditing literature, can be summarized as follows:

1. Transactions are recorded as necessary to permit preparation of reliable financial statements and other reported financial information.
2. Transactions are appropriately authorized by management; and
3. Assets are appropriately safeguarded.

That seems fairly simple and not very novel -- indeed, I suspect that few would argue that these statutory objectives are not necessary to sound business practices. However, the codification of those objectives into law has had significant practical implications, particularly in the present environment where corporate accountability is being accorded increased attention. As a result, corporate managements are asking such questions as:

- How do we evaluate whether our system of internal accounting control provides reasonable assurances that the broad objectives are achieved?
- What must we do differently to make sure we comply with the law?
- What level of documentation of our system, and of our evaluation of it, is necessary?
- Should we be changing the emphasis of our internal audit program? <u>or</u>
- Should we have an internal audit department?

In addition, boards of directors, and particularly audit committees and outside directors, are becoming more actively concerned with the same kinds of questions.

It is not surprising that many companies are relying heavily on internal auditors to help answer these questions -- and probably even more heavily to implement the solutions. This emphasis certainly will not be short term. Indeed, I expect that it will continue to increase, particularly if the Commission adopts final rules which require public reporting on the effectiveness of registrants' systems of internal accounting control. As you probably know, the Commission recently proposed such rules for public comment.[1]

The proposed rules, if adopted, would require inclusion of a statement of management on internal accounting control in Forms 10-K and in annual reports to shareholders furnished pursuant to the proxy rules. The rules are proposed to be adopted in two stages. For years ending after December 15, 1979 and prior to December 16, 1980, the statement of management on internal accounting control would be required to include the following:

1. Management's opinion as to whether, as of the date of the audited balance sheet, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that the broad objectives of internal accounting control specified in the Foreign Corrupt Practices Act were achieved; and
2. A description of any material weaknesses in internal accounting control communicated by the independent accountants of the registrant or its subsidiaries which have not been corrected, and a statement of the reasons why they have not been

For years ending after December 15, 1980, the statement of management on internal accounting control would be required to include a similar management opinion regarding reasonable assurances of achievement of the specified broad objectives of

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[1] Securities Exchange Ac Release No. 34 – 15772, April 30, 1979. The comment period extends through July 31, 1979.

internal accounting control; however, the opinion would extend to conditions which existed throughout the period, not just as of the end of the year.

In addition, the statement of management on internal accounting control would be required to be examined and reported on by an independent public accountant for periods ending after December 15, 1980. The specific disclosure requirement relating to uncorrected “material weaknesses” would, therefore, drop out.

Challenges to, and pressures on, internal auditors, both individually and as a profession, as a result of the enactment of the Foreign Corrupt Practices Act are abundant. Those challenges and pressures will only increase -- in some instances very significantly -- if, or when, reporting on the effectiveness of internal accounting controls is required. I say that with particular confidence in light of the Commission’s articulated views about the considerations attendant to representations about the effectiveness of systems of internal accounting control. Simply stated, the Commission recognizes that management judgment is inextricably involved in virtually all such considerations. Consequently, the Commission has not proposed detailed, prescriptive rules for control procedures and techniques which will ensure effective internal accounting controls. Quite to the contrary, the Commission has recognized that systems of internal accounting control must be designed to fit individual circumstances, and, accordingly, the control procedures which are necessary to achieve the objectives of internal accounting control must be determined by each company.

The Commission also recognizes that the cost-benefit criterion underlying the concept of “reasonable assurance” is one that is rarely likely to involve precise quantification. Rather, considerations of costs and benefits of controls -- particularly qualitative elements such as the reputation of the company and its management -- will often depend in part on estimates and judgments by management.

Similarly, while setting forth certain conceptual elements which it believes should be encompassed in evaluations by managements of systems of internal accounting control, the Commission recognizes that <u>specific</u> <u>methods</u> of approaching and implementing such evaluations will vary from company to company; and that the extent and timing of review and monitoring procedures in connection with such evaluations are among the cost-benefit judgments involved in the concept of reasonable assurance.

To put all that another way, each company must maintain a system of internal accounting control, and a method of reviewing and monitoring that system, that makes sense in the circumstances. Reviewing, monitoring and evaluating the system require a great deal of familiarity with the company and understanding of its potential exposures and related controls. If those requirements sound to you like they were taken from a description of prerequisites for an internal audit position, then I think I have made my point.

I alluded to certain conceptual elements which the Commission believes should be encompassed in evaluations of systems of internal accounting control. They are as follows:

- First, evaluation of the overall control environment;
- Second, translation of the broad objectives of internal accounting control into specific control objectives applicable to the particular business, organizational and other characteristics of the individual company;

- Third, consideration of the specific control procedures and individual environmental factors which should contribute to achievement of the specific control objectives;
- Fourth, monitoring of control procedures to determine whether they are functioning as intended; and
- Finally, consideration of the benefits (consisting of reductions in the risk of failing to achieve the objectives) and costs of additional or alternative controls.

I suspect that some of these conceptual elements will be more familiar to most of you than others will. Monitoring compliance with control procedures, of course, fits very comfortably within the traditional (although sometimes narrow) view of the internal audit function. This is not to say that it is not important. Indeed, it is an essential element of an evaluation of controls. However, it is only one of the essential elements. If the role of internal auditors is restricted to compliance testing, the high expectations which so many, including you, have for your profession will not be fulfilled. I think the reason for that should be fairly obvious: there is little benefit in monitoring compliance with controls if the controls are not appropriate to begin with.

If your profession is to make opportunities of the challenges which I have been discussing, you must make a positive contribution in more judgmental areas. You must play an active, and successful, role in determining what controls <u>should be</u> in effect. To do that will require specific identification of the control exposures which <u>your company</u> faces -- that is, translation of the broad objectives of internal accounting control into specific objectives applicable in your company's particular circumstances.

It will also require the determination of the specific control elements which, when functioning as intended, contribute to achieving the specific control objectives.

In addition, you must contribute to the cost-benefit decisions which underly the concept of reasonable assurance. I am not suggesting that internal auditors should have ultimate responsibility for making those decisions. Generally that will be the province of management. However, I believe it is essential that you contribute to the decision-making process by participating in identification and estimation of both benefits and costs of additional or alternative controls, and by maintaining and communicating an objective view regarding the cost-benefit decisions to be made by management.

I would like to discuss one other point before returning to the conceptual elements. I think it is worth emphasizing that appropriate documentation is important to each aspect of an evaluation of internal accounting control. I am sure you are all familiar with the importance of documenting tests of compliance with controls, and, in varying degrees, that is a discipline which you have traditionally incorporated in your work. However, is that equally true of documentation of specific control objectives or of the control procedures which are in place which should contribute to achieving those objectives? Whether or not it is equally true, because of the dynamic nature of internal accounting control, it is certainly equally important. I will very confidently speculate that not more than a few of your companies have, at least until recently, documented the bases for cost-benefit decisions. However, the judgmental aspects of cost-benefit analyses make such documentation particularly important.

There are likely to be very practical benefits to thorough documentation of evaluations of internal accounting control as well. To the extent that independent accountants are involved in a "second look" capacity in reporting on internal accounting control, I suspect that the magnitude of their fees will be very heavily dependent on the quality of the evaluation, and documentation thereof, performed by internal auditors. In addition, to the extent that you are successful in increasing the effectiveness of your company's internal accounting controls, the independent accountant will be able to increasingly rely on those controls, rather than on extensive substantive testing, in examining the financial statements.

Let me now revisit the first conceptual element of an evaluation of internal accounting controls -- the overall control environment.

In discussing internal accounting control, and evaluations thereof, it is very important to keep in mind that systems of internal accounting control are not limited to specific control procedures.

Since the enactment of the Foreign Corrupt Practices Act there has been considerable discussions about which controls are accounting controls and which controls are administrative controls. In my view, those discussions are generally misguided -- misguided because they focus on types of control procedures. The scope of internal accounting control cannot be defined in terms of types of control procedures or in terms of organizational or functional departments. The focus must be on the objectives of internal accounting control -- preparation of financial statements, authorization of transactions and safeguarding of assets. Anything which affects the achievement of those objectives must be considered in evaluating whether reasonable assurances of their achievement are provided.

Factors such as the effectiveness of the organizational structure as a framework for authorization and control of transactions; the role of the board of directors in overseeing the establishment and maintenance of strong systems of internal accounting control; communication of corporate procedures, policies and related codes of conduct; communication of authority and responsibility; competence and integrity of personnel; accountability for performance and for compliance with policies and procedures; and, of course, the objectivity and effectiveness of the internal audit function, are critical to the effective functioning of any system of internal accounting control. The AICPA's Special Advisory Committee on Internal Accounting Control quite descriptively termed these factors the "internal accounting control environment" -- the simple point being that it is only possible to realistically assess the effectiveness of specific internal accounting control procedures and techniques in the context of the environment in which they operate.

I suspect that, for many of you, consideration of the control environment may require an excursion into largely untested waters. If you are to succeed in meeting the challenges which face you -- in making them opportunities, not vulnerabilities -- it is essential that you navigate -- and chart -- some untested waters.

I think it is quite clear that the challenges to the internal auditing profession -- and to individual internal auditors -- are great. Converting those challenges to opportunities will require increasing competence, objectivity and professionalism.

Your profession has taken a significant step in promulgating the Standards for the Practice of Internal Auditing. It is, nevertheless, only a first step. It is essential that you incorporate those standards in your practice and continue to improve your capabilities to effectively meet your increasing responsibilities and fulfill your changing role.

You must accomplish this not only as individuals, but also as a profession through the Institute of Internal Auditors. The IIA, institutionally and through its members, has a responsibility to ensure that your profession continues to grow and respond to changing circumstances. To do that, the Institute must assume a leadership role and speak out on issues -- not only issues which impact internal auditors, but perhaps more importantly, issues on which internal auditors can, and should, have an impact. This is an important distinction. It is the distinction between a trade association and a professional organization. If the IIA is to fulfill the latter role, it must provide a substantive voice on issues like internal accounting control, not merely a call for increased recognition of internal auditors.

As individuals, to be in a position to be able to meet your increased responsibilities will require that you are able to function as objectively as possible within your organization. As I am sure you know, SEC Chairman Harold Williams has stressed the importance of an organizational structure that promotes the ability of internal auditors to function objectively. Chairman Williams' remarks that, in most instances, the Director of Internal Auditing should not report to the chief financial officer or chief accounting officer have prompted considerable controversy. However, I do not think his point was to be prescriptive about internal auditors' reporting responsibilities. Rather, it was to stress the importance of an organizational structure which allows internal auditors to function objectively and to be responsible to someone high enough in the organization to ensure appropriate consideration of their recommendations. For the same reasons, I think it is also important that internal auditors are able to communicate directly with the board of directors. These concepts are, of course, recognized in your Standards for the Practice of Internal Auditing. I think they are critical to your success in meeting the challenges you are facing -- and the related opportunities available to you.

I sincerely hope that you succeed in meeting these challenges. Your success in doing so is important to the entire business community.