



Do Audit Charters Need a Reality Check?

**YES, IF COMPANIES WANT TO MAKE SURE
THEY ARE REALLY FOLLOWING ALL THE
RULES.**

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The internal auditing profession is in a quandary. Recent changes triggered by the Institute of Internal Auditors (IIA) and the Securities & Exchange Commission (SEC) have created a conflict of duties for the internal auditor. On the one hand, the IIA recently redefined the internal audit function as moving away from the traditional independent attestation function and more toward risk-based auditing and consultative activities. On the other hand, the SEC, in its continued effort to improve the quality of financial disclosures, has called on the internal auditor to help the audit committee and the external auditor in the governance of public corporations. That means the internal auditor is left with balancing the acts of performing independent, objective reviews on the conduct and effectiveness of management vs. forming a partnership with management via consultative engagements.

So what's an internal auditor to do? Follow the IIA's lead and migrate toward value-adding consulting services that require a partnership with management or appease the SEC and its proponents and provide assistance toward the organization's governance, which requires the internal auditor being removed from the strategic operational decisions of management? The result is a popula-

tion of internal audit departments with vastly different orientations: from pure consulting shops to full attestation service providers. The hybrid of internal audit departments has made it imperative that the function, scope, and orientation of internal audit be clearly and effectively communicated to all associated parties. Two common mediums to convey this information are the



internal audit charter and the audit committee charter.

To find out how effective they are, we compared the charters of eight companies to information from the internal audit directors of those companies regarding the roles and activities of their departments. We gathered the charters from proxy statement disclosures and information from the directors through seven face-to-face hour-long interviews and one conference call, which was due to geographic restrictions. With more than 15 years of experience on average, these well-seasoned professionals had internal audit staffs ranging up to 70 individuals and worked at companies with average revenues around \$5.9 billion. Although questions pertained to a variety of topics, the interview concentrated on the department's current activities and orientation. Unfortunately, many internal audit and audit committee charters aren't sufficiently capturing the orientation and objectives of the internal audit activities.

Let's now look at the charter's purpose and the internal auditing environment, then see what the charters are actually saying vs. what the departments are doing.

WHAT'S THE POINT OF A CHARTER?

The Attribute Standard 1000 in the IIA's *Standards for the Professional Practice of Internal Auditing* states that the purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter. Also, an article in the October 1999 issue of *Internal Auditor* concluded that a properly constructed internal audit charter will help ensure that internal auditing activities remain in line with the expectations of management and the audit committee.

For those parties removed from the organization (e.g., external shareholders), the orientation of the internal audit department may be conveyed, at least in part, through the audit committee charter. According to the PricewaterhouseCoopers (PwC) *Audit Committee Effectiveness—What Works Best* report, which was issued in 2000, an effective audit committee charter defines the committee's purpose and scope of its responsibilities, including

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the relationship with the internal auditors. By accurately conveying the internal audit function, the internal audit and audit committee charters help ensure the department's activities are in line with the expectations of management, the audit committee, and external stakeholders.

THE ENVIRONMENT

In June 1999, the IIA officially adopted the following definition of the internal auditing function:

An independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

As discussed in the October 1999 issue of *Internal Auditor*, the new definition focuses on the assurance and consulting activity concept that conveys a paradigm-like shift to a more proactive, customer-focused orientation. Recent research published in *Managerial Auditing Journal* (vol. 15, no. 4; vol. 17, no. 3) suggests that internal auditors have indeed shifted their orientation toward consultative-type activities that require them to form a partner relationship with management. Although such a shift seems to benefit management and perhaps the organization's shareholders, it may have a negative effect on several traditional customers of internal audit services, such as audit committees.

This shift toward consultative activities potentially causes a reduction in the amount and quality of traditional attestation services internal audit departments conduct. First, internal audit departments have limited resources at their disposal, and to focus on one activity must come at the expense of another activity. According to one internal audit director we interviewed, “As an organization, we were forced to choose an orientation for the department. In the end, management won out, and we now have a consulting orientation.”

Second, the apparent conflicts of interest that result



from performing both consulting and attestation services raise the issue as to whether or not an internal auditor can perform both types of services effectively. That is, how can an auditor objectively render an opinion on the operations of an organization without being operationally removed? An internal audit director we spoke with summarizes this dilemma: “Internal audit is caught between a rock and a hard place because there is pressure for internal audit to provide value-added activities, but this type of activity undermines the auditor’s objectivity and independence.” Due to limited resources and the potential conflict of interest, parties seeking traditional attestation services from the internal auditor may be forced to look elsewhere.

Historically, the audit committee has called on the internal auditor to assist them in their financial reporting oversight responsibilities by providing attestation services on management operations and internal controls. The recent regulatory changes affecting the audit committee function have arguably increased the audit committee’s demand for these traditional attestation services. These changes are based on the Blue Ribbon Committee’s (BRC’s) *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*. Not only does the 1999 report include 10 recommendations for improving audit committee performance, but it also discusses the importance of establishing an effective communication channel between the internal auditor and the audit committee.

Triggered by the BRC report, several handbooks and guides soon emerged to help companies establish and/or maintain effective audit committees. Invariably they included recommendations concerning the relationship between audit committees and internal auditors. In the March 2001 edition of IIA’s “Tone at the Top,” Curtis C. Verschoor, author of the IIA handbook *Audit Committee Briefing: Understanding the 21st Century Audit Committee and its Governance Roles*, offered his insight. He said, “Inclusion of internal auditing in the BRC’s *Guiding Principles* signals that internal auditing should be recognized as a partner with external auditing in the governance of public corporations,” and continued to report that “...as with external auditors, internal auditors need to acknowledge the audit committee as their primary client, and not management.”

In addition, the PwC report suggests that “by monitoring how well risk management, internal control, and governance processes are operating in a company, internal audit provides useful information to senior management

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and valuable support to the audit committee. Being operationally removed, internal audit can provide an objective view of the state of control.” The key words here are “operationally removed.” These audit committee handbooks, as well as others, suggest that an independent, objective internal auditor can assist the audit committee in its financial reporting oversight responsibilities.

In this environment organizations need to choose the orientation of their internal audit department—one that partners with management and offers consulting services or one that appeases the SEC by providing governance support.

INTERNAL AUDIT DEPARTMENT CHARTERS

After reviewing the internal audit department charters, we found that two consisted of just a brief mission statement with very general goals for guidance, while the remaining six provided more detail about the department’s purpose, authority, and responsibilities.

Seven out of the eight directors suggest that the orientation of their departments has moved toward consulting activities over the past several years. The degree of this shift varies from a pure consulting orientation to a mix of undertaking some consultative activities while not abandoning the traditional attestation function. Despite this admitted shift toward consulting activities, six of the eight charters portray the department inaccurately, stating that internal audit is an “independent, appraisal function” and describing the internal audit role as the traditional attestation service provider for management and the audit committee. For example, one director described the department as moving strongly toward consultative activities over the past two years, yet the internal audit charter states: “Internal audit is an independent appraisal activity established to conduct reviews of operations and procedures and to report findings and recommendations to Company management or the Audit Committee, as appropriate.”

Two charters, however, appear to be in sync with department activities. One department clearly adopted a consulting orientation, and its policy statement within its charter listed the department's goals and objectives as improving the company's business processes and promoting "best practices." But the charter wasn't very detailed. The other department was the only one that hadn't shifted toward consulting in recent years, and its charter accurately portrayed the primary function of internal audit as a reviewer of the internal control system.

Despite outdated and inconsistent internal audit charters, we're convinced that the directors clearly understood their role within the organization and often used other mechanisms to communicate this information to the appropriate parties (e.g., management and audit committee meetings). Nevertheless, the audit profession and prior literature suggest that internal audit charters are important mechanisms to formally and explicitly convey internal audit's scope, role, and activities. Thus, internal audit charters, along with other less formal means of communication, should be used to ensure the expectations of management and the audit committee are aligned with the activities of internal audit. Furthermore, the effects of the internal auditor's role as a consultant on the independent appraisal function should be considered by management, the internal auditor, and the audit committee and be stated clearly in the internal audit charters.

Let's now discuss the consistency of the audit committee charters in conveying the role and orientation of the organization's internal audit department.

AUDIT COMMITTEE CHARTERS

Based on the BRC recommendations, the SEC, the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers issued regulations that increased the independence and financial literacy requirements of audit committee members. In addition, audit committees have been handed more responsibility regarding their financial oversight function. One of the new regulations requires audit committees to maintain a written charter specifying their duties and file it with the SEC every three years. Audit committees are further required to state that they have written and approved a charter as a proxy statement disclosure.

All the sampled audit committee charters state that the audit committee reviews the annual internal audit program along with the external audit program and considers how the internal and external auditors coordinate their activities. Arguably, this verbiage implies that the

internal auditor is assisting the audit committee in their financial statement oversight responsibility by providing traditional attestation services. That is, by stating that the level of coordination between the external and internal auditors is considered, the audit committee charters imply that the internal auditor assists, or potentially assists, the external auditor with attestation duties. Furthermore, by stating that the internal audit programs are reviewed, the audit committee charters suggest that the internal audit function helps the audit committee in some capacity. Otherwise, why would the audit committee consider internal audit's annual program and its coordination with the external auditor? The shift toward consultative activities potentially hinders the internal auditor's ability to perform effective attestation services, which means the majority of the audit committee charters we examined are potentially inaccurately conveying the internal audit function as a traditional attestation service provider.

REEVALUATE, RESTATE THE DEPARTMENT'S SCOPE

The shift toward consulting activities seems to infringe on the internal auditor's ability to remain operationally removed and render objective, unbiased opinions on the company's operations. Despite this apparent conflict of interest, the internal audit and audit committee charters of most of the companies we examined imply an internal audit department that performs traditional attestation services. In reality, this wasn't the case most of the time.

We suggest that appropriate parties evaluate the role of their internal audit department and formally state its scope and orientation in the internal audit charter. Furthermore, audit committees should consider the effects that migrating toward consultative activities have on the internal auditor's role in the financial reporting oversight function and clearly state this in the audit committee charter.

Properly constructed internal audit and audit committee charters can help communicate the department's orientation and role to the appropriate parties. A breakdown in this communication could lead to a misunderstanding of the role and function of the internal auditor and potentially weaken the organization's governance system. ■

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