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TONE at the TOP

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

You Want to Get Rid of . . . WHAT?!

Have you ever noticed that, in times of falling revenues and the need for contingency planning, often someone will speak up with the suggestion to cut the marketing, advertising, and promotion budgets? This begs the question, "If we don't let customers know about our services and products, how can we expect to increase our sales?"

Likewise, when times and money are tight, some organizations might be tempted to take cost-reduction measures in non-revenue producing, intangible areas such as risk management, internal control, and internal auditing. A few words to the wise: Yield NOT to this temptation!

Smart boards and audit committees should keep a keen eye on the "what-ifs" of an economic downturn and may task executive management with developing ideas on weathering the storm. Those at the top must decide how to make the best use of what they have, eliminate as much redundancy and waste as possible, and generate revenues to counter the effects of a slipping economy. It is critical, however, to ensure the steps taken are not counterproductive in the long run.

Making Right Choices

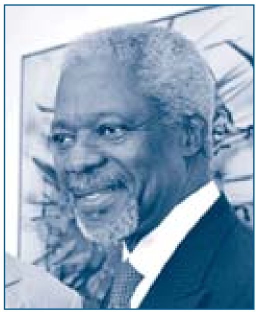
Former United Nations Secretary-General Kofi Annan reminds us that to live is to choose. "But to choose well," says Annan, "you must know who you are and what you stand for, where you want to go and why you want to get there." This advice is an excellent mantra for both individuals and organizational leaders, especially when under duress brought about by an economic downturn.

Stopping and thinking about long-term repercussions, rather than reacting out of fear and panic is wise counsel, but how do we ensure we've thought of everything? Although space here does not allow us to focus on the many ways an organization can save money, we can examine possible repercussions of cutting costs without regard for the ethical culture or the organization's system of internal control. We also can provide an argument against cutting the internal audit activity, and why such cuts would be a bad — and even dangerous — strategy for reducing expenses.

Organizational ethics are sometimes viewed as the soft side of business — something to consider when everything is going well. No organization, however, can afford to view ethics this way. Times of upheaval, layoffs, and reduced spending can increase stress, lower morale, and sometimes even increase the risk of unethical behavior.

Cutting corners to save dollars sometimes might even send a message that it's okay to cut corners on ethics and the decision-making process, turn a blind eye to ongoing oversight, and lower the enterprise-wide expectation of taking the high road. All of these, plus ineffective risk management, are real and present dangers during the tough times, and the possibility of sending mixed messages and garnering misunderstanding should not be taken lightly.

"We have to choose between a global market driven only by calculations of short-term profit, and one which has a human face."



Kofi Atta Annan
United Nations Secretary-General, 1997-2006
Nobel Peace Prize, 2001
Ghanaian diplomat

Case in Point

When a company does not demand up-front cash payment for products or services, it carries credit risk — the degree to which it is likely that a borrower or debtor may not repay the debt. Ignoring credit risk has become a trend for many businesses. For example, how many furniture ads do we regularly see on TV, promoting no money down and no payment for two to three years? If people can't afford furniture today, what are the chances they'll be able to afford it later? Is free or even cheap credit a good thing?

Changes in the mortgage industry in recent years resulted in cheaper credit that created a booming market in lending and fed higher housing prices. When competition accelerated among mortgage lenders, delinquencies escalated, resulting in loan portfolio deterioration. This was followed by a cooling housing market. NOTE: Refer to "Paying Attention," the November 2007 issue of *Tone at the Top.*

This scenario emphasizes the need for enterprise risk management in banking. It also suggests that investors should take a hands-on approach to understanding credit risk. In short, everybody is, or should be, in the risk management business these days.

A Risk-based Perspective

The International Federation of Accountants (IFAC) has published a paper, "Internal Control from a Risk-Based Perspective," after interviewing accountants from a broad range of organizations around the world. Those interviewed all struggled with similar issues and their solutions point to the fact that internal control can drive performance and create value for an organization. The paper, produced by IFAC's Professional Accountants in Business (PAIB) Committee, reveals several key findings:

Internal Controls

Every organization is different, but some essentials transcend the differences in type and style of businesses. In essence, a strong risk management and internal control system is a key and integral part of running and managing a disciplined and controlled business. Enterprise risk management forces the management team members to clearly articulate objectives, enables them to make informed decisions about the challenges and risks, and helps them to target resources to achieve the best possible results.

Efficiency

A significant issue in enterprise risk management and internal control is retaining the efficiency of the process while maintaining effectiveness. Another challenge is getting people to appreciate the internal control system for its own sake, and ensuring employees see it as useful in its own context.

Improvement

A change in culture is one of the benefits of implementing risk management and internal control. Specifically, employees throughout an organization begin to expect "continuous improvement" as part of the culture. Risk management and internal control are not restrictive concepts. Rather, they enable an organization to make the most of every opportunity.

Lessons Learned

Weaknesses occur when people are not paying attention. Being aware of and responsive to the warning signs helps an organization effectively manage risk.

- It is the human touch that ultimately determines the success of the control environment. Recruiting the right people reduces costs dramatically.
- A strong system of internal control helps ensure success. An enterprise cannot survive and flourish if it's not built with an internal control design and discipline in mind.
- Well-designed controls can create a positive work environment and contribute to the bottom line.
- Management must communicate to employees that risk management and internal control are part of the organization's key values.
- Management should talk to staff members openly and honestly, and ensure that they are onboard.

- Creating commercial opportunities is no good if the business is not controlled properly.
- It is better to enhance internal controls slowly rather than too quickly, which may cause mistakes that can necessitate starting the process over.

The International Federation of Accountants

IFAC is dedicated to strengthening the worldwide accountancy profession and contributing to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant.

"Internal Control from a Risk-Based Perspective" is part of a larger IFAC project on internal control. In 2006, the PAIB Committee produced an overview paper, "Internal Controls — A Review of Current Developments," which reviewed current developments and some of the latest thinking in the area of internal control. These two publications form the groundwork for the development of principles-based guidance on internal control, which the committee plans to issue later this year.

To obtain the full interview paper, visit the PAIB section of the IFAC bookstore on www.ifac.org.

Internal Auditing: A Core Activity

Why shouldn't internal auditing be one of the functions reviewed for elimination or even reduction? There are many more reasons than space here allows. Suffice it to say that, without competent and effective internal auditing, an organization's governance, risk management, and internal control would be in jeopardy.

By definition, internal auditing clearly is a core activity:

> *Internal auditing is 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.*

A cornerstone of strong governance, internal auditing bridges the gap between management and the board, assesses the ethical climate and the effectiveness and efficiency of operations, and serves as an organization's safety net for compliance with rules, regulations, and overall best business practices. The internal auditors provide to the audit committee objective assessment on the state of the organization's risk, control, governance, and monitoring activities.

Although management is responsible for risk management and for testing controls, the internal audit activity assesses the effectiveness of the controls that are in place. As a result, the external auditors can rely on the work of the internal auditors. This coordination of activities provides assurance to management and the board that things are as they should be. It also has the potential of saving money for the organization.

Internal Control

According to COSO's globally recognized *Internal Control — Integrated Framework*, the components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. COSO acknowledges that competent internal auditing is one of the best internal controls an organization can implement.

NOTE: The Committee of Sponsoring Organizations of the Treadway Commission comprises the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), the Institute of Management Accountants (IMA), Financial Executives International (FEI), and The Institute of Internal Auditors (IIA). COSO is a voluntary private-sector organization dedicated to guiding executive management and governance entities toward the establishment of more effective, efficient, and ethical business operations on a global basis.

What is ERM?

Enterprise risk management (ERM) is a structured and coordinated entitywide governance approach to identify, assess, manage, and control potential events or situations. Implemented by management, ERM is evaluated by internal auditors for effectiveness and efficiency.

COSO's *Enterprise Risk Management — Integrated Framework* defines essential ERM components, discusses key principles and concepts, suggests a common ERM language, and provides clear direction and guidance for enterprise risk management.

For more information on these two COSO frameworks, visit www.coso.org. For more about internal auditing's roles in internal control and risk, visit www.theiia.org.

TONE at the TOP

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 activity.

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, Fla. The IIA has more than 150,000 members in internal auditing, risk management, governance, internal control, IT auditing, education, and security.

The IIA is the global voice, recognized authority, chief advocate, principal educator, and acknowledged leader in certification, research, and technological guidance for the internal audit profession worldwide. The IIA enhances the professionalism of internal auditors and is internationally recognized as a trustworthy guidance-setting body. It fosters professional development, certifies qualified audit professionals, provides benchmarking, and through The IIA Research Foundation, conducts research projects and produces educational products.

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