BIRMINGHAM CITY UNIVERSITY

CENTRE FOR INTERNAL AUDIT, GOVERNANCE AND RISK MANAGEMENT

Ethical Business Practice: The involvement of Internal Audit

An analysis of the involvement of Internal Audit in the provision of assurance in relation to the conduct of ethical business.

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Finally we would like to thank Professor Karl George MBE for his thought provoking foreword to this study; we believe that this not only sets a distinct tone for importance of demonstrating ethical conduct as part of the governance process, but also points to the need for future internal audit planning and reporting in order to provide assurance in relation to the risks that emerge from not conducting business to the standards that are acceptable to stakeholders.

Foreword

Professor Karl George MBE

As I write the foreword to this report, I must first comment on the need for such a study. As one of the founder members of the Association of Governance Practitioners (ACGP) I am encouraged that an important aspect of corporate behaviour is being examined alongside the role of the internal audit function in providing assurance . At ACGP we believe that the integrity of any governance practitioner whether a company secretary, board member , risk manager or internal auditor is critical for two reasons. Firstly it is important as a professional community for us to try to maintain professional standards and the ethical codes of any professional discipline are developed to ensure that we have the trust of the people that rely on our expertise. Secondly, there is a requirement for professionals to use this expertise and understanding, depending on our role, where we observe, monitor, scrutinise, challenge, and provide guidance and advice on bad ethical practice.

When we reflect on the consequences of what I will call bad business ethics, we normally focus on the financial aspects. There are however other consequences which far outweigh this criteria, let's consider;

· the BP oil spill (the initial oil spill killed 11 people and 17 others and over 8000 animals were reported dead just 6 months after the spill), was this about cost cutting?

· Mid Staffs (between 400 and 1200 more patients died between 2005 and 2008 than would be expected for the type of hospital), the Francis report criticised the focus on financial and other indicators at the expense of patient care,

· the Fukushima nuclear disaster (plant's workers were severely injured or killed by the disaster conditions) Topco admitted it had failed to take stronger measures to prevent disasters for fear of inviting lawsuits.

Where pristine capitalism produces a culture of greed, complacency and a distorted focus on profit maximisation, then there needs to be some redress. I wonder whether in fact the disasters mentioned above should have been anticipated and whether there is more for us to do as a profession to understand why problems we can see brewing, might become disasters. Examining cultural practice, including ethical practice, may do more in heading it off than our traditional methods of risk assessment?

Max H. Bazerman and Michael Watkins stated that "Failure to recognise what's coming exposes, your company to predictable surprises" Perhaps it is time to recognise the inherent risk in ignoring business critical areas.

Professor Karl George MBE, is a high profile, multi-award winning business man, accomplished professional speaker, author and leading governance consultant. Having trained as an accountant, Karl formed his first business aged 23. He is now one of the leading consultants in governance in the UK and the first to highlight the need for a cross sector body for governance professionals. As such, he is the founder of the Association of Corporate Governance Practitioners (ACGP) who work across the private, public and third sectors offering professional qualifications, CPD and networking opportunities in governance. For his outstanding service to the social and business communities he was awarded an MBE in 2004.

Among his many achievements, Karl was the founding President of the first International Chapter of 100 Black Men of America, Voted in the Power 50 most influential people in the West Midlands and was chosen as one of the 20 national role *models by the Department for Communities and Local Government as part of the REACH campaign. He regularly gives back to the community through contributing in his role as a member of many boards that are both local and national.*

Introduction

The study explores the nature of ethical business practice as an essential element of strategic management and the demonstration of good governance.

History provides significant documentation to the Enron/Arthur Andersen debacle, events that the world believed could never happen. However, the early warnings signs were there as the past decades are littered with examples of poor ethical practice. We can recall the 23 year fiasco of the Asil Nadir and Polly Peck case, the demise of the Robert Maxwell empire or successive UK football industry failures culminating in the Hillsborough disaster regarding which the truth about the management of the event are only now emerging some 23 years later and more recent events at WorldCom, Olympus and Mid Staffordshire NHS Foundation Hospital Trust.

Such events led to a succession of governance reports, notably Turnbull regarding listed companies which gave birth to the concepts of risk management and the value of an Audit Committee and the Nolan report on the standards of conduct in public life which would be well remembered by those we place in office today – Selflessness, Integrity, Objectivity, Accountability, Openness, Honesty and yes Leadership!

Yet despite all this good advice and further reports since the turn of the century we continue to see business failure, which should make us question why and what are the Non-Executive Directors that we place in positions to scrutinise and challenge the executive, actually doing – they are certainly failing in terms of any responsibility for safeguarding stakeholder interest! Further examples of ethical practice failure can be seen regarding a succession of events in the banking sector, the UK high street retail sector failures around the Christmas period of Jessops and HMV where organisations take the benefit of the bounty from sale of gift tokens only to go into Administration shortly afterwards then not honouring the investments, the MP's expenses scandal and now the latest and widespread failure in the food industry where horse meat was masquerading as beef , resulting in a complete lack of confidence in Boards who place profit before the wider interests of quality and meeting stakeholder expectations.

We have heard politicians of all sides recognising the need for organisations to be more ethical – the Southern Cross Nursing Homes revelations brought every soft-hearted politician to show concern – however actions speak louder than words and enforcing ethical conduct is no easy matter, especially when profit is the prime motivation.

It seems that organisations across all sectors have recognised the value of demonstrating ethical practices but how real is this in practice – does it all represent just good public relations? The King III report (2009) draws attention to the value of triple bottom line reporting – economic value, sustainability and corporate social responsibility (or Profit, Planet, People), and there is talk of whether investment in such matters as part of demonstrating ethical practice can add value to the balance sheet? Hence the reason for this study.

In the next chapter we will consider what does being ethical mean, we will determine what best practice may look like but we are particularly interested in two questions:

- How many organisations have implemented an Ethics Policy?

- To what extent has internal audit provided assurance that such investment in implementing an ethical policy has achieved its objectives and that the policy is in fact being complied with?

Our contention is that not demonstrating ethical practice is an unacceptable risk facing organisations that can in the worst cases threaten sustainability. Internal Audit should therefore have ethical and compliance audit as a high priority in a risk based internal audit planning process as required by the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors (IIA).

The provision of assurance in relation to successful implementation of an ethics policy as a contribution to the achievement of organisational objectives is becoming increasingly critical – is internal audit responding to this challenge?

Executive Summary

The purpose of the research has been to understand how Internal Audit has responded to the increasing prominence of poor ethical practice as a source of concern amongst stakeholders, regulators, governments and the media.

The impact of the business ethics on internal audit is therefore likely to vary considerably from an organisational, sector or geographic perspective

The conclusions of this study point to two distinct and significant themes:

- At an organisational level 83% of organisations responding to the survey had put an ethical policy in place, therefore representing a good indication that organisations have understood the benefits of demonstrating good ethical behaviour, and
- Internal Audit plans are less positive regarding the importance of demonstrating ethical practice as in terms of providing assurance, respondents to the survey declared that 61.8% of organisations had not yet audited the ethical practice of their organisation.

The reasons for these different stances are not entirely clear however the explanations provided by internal audit predominantly relate to this not being seen as a priority area or ethics not being seen as a risk. As the world focuses on the regularity in which boardroom failures occur and ponders the future of corporate social responsibility reporting, it is surprising that with internal audit representing the natural source of assurance that it has not responded more definitively to this call. Of course, the answer may also simply lie in the instructions from Audit Committee to consider other areas, perhaps those more traditional areas for attention such as finance.

A contrary view to this might be that the Board (or Audit Committee) does not see internal audit as the appropriate source of assurance, as there were examples of organisations that had required Human Resources or External Audit to provide assurance. This should be of concern to the internal audit profession, if it is not seen to have the skills or vision to be involved. In such cases, it will be for the Head of Internal Audit to consider the degree of assurance that such review offers.

In those situations where internal audit had undertaken review, positive outcomes were noted with internal audit recommendations focusing on both strategic and operational compliance issues. The outcomes show:

- 25% of internal audit teams had made strategic observations in relation to ethics policies not meeting best practice or being aligned to strategic directions,

- 50% of reviews noted issues of a compliance nature, and

- 25% of internal audit reports commented on outcome issues related to failures to use information appropriately or publish details.

A simple conclusion to this study may reflect where internal audit is involved it can make a positive contribution to the achievement of corporate objectives; a more complex position may lie underneath – being that neither the organisation nor internal audit want to be involved in an issue that is at the centre of the stakeholder interest agenda of the future.

Business Ethics

A survey by the Institute of Business Ethics in its 2012 survey on business ethics observed a "substantial decline in the proportion of the public saying that British business generally behaves 'very' or 'fairly' ethically". This represented a 10% reduction in the assessment in 2011 and was reported as comprising of the sharpest drop in satisfaction by the 35 – 54 year age group, almost 19%, a significantly influential stakeholder group to be taken serious by our business leaders.

"Relativity applies to physics, not ethics."

Albert Einstein

(1879-1955);

The survey conducted by Ipsos MORI on behalf of the Institute identified the key influencers on this outcome:

- Issues around Executive Pay
- Corporate Tax avoidance
- Discrimination in treatment of people
- Bribery and corruption
- Freedom for Whistle blowers, and
- Fair and open pricing of products and services.

The events of 2013 which include the Francis Report on the management of Mid Staffordshire NHS Hospitals Trust and the debacle of the horsemeat for beef scandal that engulfed so many of the UK's leading food retailers and producers, will surely have had an even deeper effect when the 2013 survey is conducted.

The Edelman Trust Barometer 2013, reported a different trend globally showing that overall 'Trust in Business' increased by 5%, based on a belief that 'business would do the right thing'. However interestingly, the supporting analysis indicates that only 43% of the informed public trust CEO's as credible spokespeople, 39% in the UK; whereas globally only 18% of the general population trust business leaders to tell them the truth. Not surprisingly perhaps, banking and financial services continued to be the worst regarded in an analysis focused on industry type.

So what does this all tell us? Clearly the global crisis has had a massive impact on the business environment as organisations seek to maintain profits, or in the worst scenario merely survive. In the government and voluntary sectors the austerity measures and legislative changes have also focused attention on getting more for less as pressure on resources stretches the ability to deliver quality services.

Faced with these circumstances, boards will inevitably look to identify ways of doing things more efficiently which will place an emphasis on the key business drivers and therefore the relationship with major stakeholder groups. The six factors identified above would indicate that the decrease in trust largely results from Boards placing greater priority on achieving financial targets, perhaps therefore keeping groups such as shareholders, funders or regulators satisfied to the detriment of others – particularly customers and employees.

This link between business practice and stakeholder satisfaction is critical in considering ethical practice.

The rising prominence of ethical practice as part of governance.

The King III (2009) report provides significant commentary on the increasing relevance of Boards having a meaningful discussion with stakeholders regarding expectations. Its emphasis is focused on two way communication and not just in terms of what has happened, being dismissal of the past concentration on financial reporting to respond to a single stakeholder group. Instead King envisages a more open exchange with all primary stakeholders with reporting being forward looking and focused on a triple bottom line reflecting economic value, as opposed to book value, sustainability and corporate social responsibility.

> *"It's not hard to make decisions when you know what your values are."*
>
> *Roy Disney,*
>
> *Former Disney Executive, Nephew of Walt Disney*

Such values are widely accepted as how boards should behave; however as we see from the frequency of bad news in media reporting, our leaders whether in the business world or the government sectors continue to fail in terms of managing a successful organisation and delivering on expectations. Too often perhaps it's the financial crisis that hits the headlines when catastrophic failure occurs when the reality of the issue reflects more the way that the organisation has been structured and governed.

The manner in which Boards behave is therefore a critical component in organisational success. The three lines of defence theory is not new, but its application by todays' managers must be questioned.

Organisational responsibility

In order to consider why we perceive Boards as behaving badly, we can examine the views of recognised commentators, as we still see the hallmarks of such doctrine within Boardrooms today where the overwhelming focus is on financial matters; this is not just a practice confined to corporations.

Milton Friedman published an article in 1970 entitled 'The social responsibility of business is to make profits' recognising the focus on shareholder interest above all others. He based his assertion on three key points:

- Only human beings have a moral responsibility for their actions,
- It is a manager's responsibility to act solely in the interests of shareholders, and
- Social issues are the proper province of the state rather than corporate managers.

Recent events have shown however that current thinking suggests that corporations act as a legal entity as well as a moral one with individuals coming together to act jointly through the establishment of strategy, values and objectives that are underpinned by a framework of decision making and performance monitoring structures. Such processes determine right from wrong and have a bearing on how the organisation acts both corporately and in terms of individuals within it, therefore establishing perhaps what is known as corporate culture.

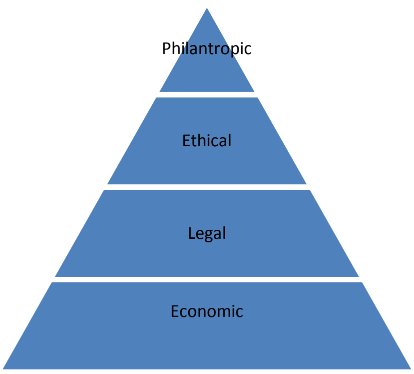
The Guardian newspaper reporting on the regulators report on HBOS failures, entitled 'An Accident Waiting to Happen', observed the parliamentary commission on banking standards calling on the three main directors to apologise for their "toxic" mistakes which caused the downfall of the bank and prompted a £20bn taxpayer bailout. The failings of the bank clearly impacted on the entirety of its stakeholder base, and as such it seems inconceivable that the Board did not recognise the risk of failure. The news article comments that:

> “The three executives who ran HBOS bank in the run up to its near-catastrophic collapse have been slated for their "colossal failure" of management in a scathing report which calls for them to be held to account by the City regulator. The highly critical account of the events that led to HBOS being rescued by Lloyds in September 2008 said the responsibility for the management failings rested with the former chairman Lord Stevenson, and the former chief executives Sir James Crosby and Andy Hornby, and says the bank would have gone bust even if the global financial meltdown of that year had not happened”.

So did the three recognise their corporate social responsibility? Clearly, what was going wrong at HBOS occurred prior to Professor Mervyn King’s reports for the South African Institute of Directors but the balance between business and morale conduct is paramount in the call for the three to be prevented from holding office in a financial institution again. The issues of the standards which stakeholders expect from directors is an ever present in the banking sector following the financial crisis but as Carroll (1991) explains it is at the higher end of the moral management of corporate social responsibility.

This aligns with previous observations regarding a corporation as a legal entity and certainly recognises that at lower levels of the pyramid there are economic and legal responsibilities that society requires an organisation to deliver. At the ethical level society expects delivery, yet in practice it is sometimes disappointed by performance and has inadequate recourse to enforce expectations that may vary from individual to individual. At the highest level Carroll discusses the desire of society as embracing the philanthropic or benevolent deeds which are inconsistently adopted by organisations in their strategic direction and for different purposes – some perhaps wholeheartedly, such as Body Shop, with others feeling that perhaps they have to be seen to be doing the right thing but recognising whatever their motives that it is still good public relations.

Fig : Carroll’s four part model of CSR



Such thinking perhaps demonstrates the span of views between those who believe that a universally accepted set of moral principles exists as opposed to those who might claim that there are no moral rights or wrongs but that these are dependent on individual behaviours, culture or the context of the matter. Richard De George (1999) recognised these as Ethical Absolutism and Ethical Relativism and it is certainly true that the world consists of both characteristics. Western economies as can be seen by the increasing awareness of corporate social responsibility in governance codes tend to the absolute end of such a theory, whereas developing countries can be seen to adopt a relative stance pertinent to the local circumstances and traditional values.

The increasing prominence of the Global Reporting Initiative (GRI) supports this view where it is now regarded as one of the world’s most popular CSR instruments. The guidelines now rank among the most widely recognized among large European companies, according to new research published by the European Commission.

GRI’s Deputy Chief Executive Teresa Fogelberg, commenting on the GRI website (2013) notes:

> “This survey demonstrates that the GRI Guidelines are now the dominant framework for sustainability reporting among large EU companies. GRI’s mission is to make sustainability reporting standard practice among all companies but there is still a long way to go before a ‘tipping point’ is achieved. While 95 per cent of the world’s largest companies are producing sustainability reports, overall less than 10 per cent of publicly traded companies, and companies that do business across national borders, report on their sustainability practices.”

One might ask what might help achieve the ‘tipping point’ clearly an independent opinion as in the case of a financial opinion would go a long way to demonstrating whether or not organisation s were meeting CSR guidelines and wonders whether internal audit is sufficiently independent to fulfil this role.

Doing things right

Peter F Drucker writing in 2001 told us that “Leadership Is Doing the Right Things; Management Is Doing Things Right”; whilst a straightforward expression, the messages are much deeper in terms of both strategic and operational aspects as well as those relating to both ethics and assurance .

Yet it is the understanding of these issues that is fundamental to the successful governance of an organisation and to the responsibilities of Non-Executive and Executive Directors in respect to the achievement of its strategic objectives and the delivery of operational targets.

Establishing the strategic objectives of the organisation comprises a wide range of necessary considerations that may include using PESTLE and SWOT style analysis in order to arrive at a plan that is likely bring success. These are concepts familiar to most leaders, however it is the consideration that the Board gives to the relationship with its stakeholders that drives the values of the organisation and best reflects its commitment to doing the right things.

PricewaterhouseCoopers commenting in an Executive Summary on the messages in the King III report in 2009 observe that:

> “The stakeholder-inclusive approach to corporate governance is not a new concept in the King reports and effective stakeholder engagement is recognised as essential to good corporate governance. The days when boards could merely pay lip service to concerns such as corporate responsibility, ethical business practices and sustainability are over”.

Despite such recognition, the UK in March 2013 appears at a strange crossroads – we have the stock market showing record levels, major high street brands laying off employees in order to protect the core business or simply survive, food retailers and producers caught up in the horse for beef food quality scandal, energy costs hitting record levels, banks declaring various levels of profits depending on provisions for mis-sold PPI cover or fines by regulators, The Chancellor of the Exchequer in the UK leading calls to clamp down on companies that avoid tax through international manipulation of their trading activity, and bank lending to the SME community down. Yet despite all this we have allegedly created over a million new private sector jobs. Indeed a complex web of inter-related stakeholder interests as one could ever expect to see. Within this analysis can we must assume that each organisation has undertaken effective stakeholder engagement and transformed this into meaningful delivery of stakeholder expectations.

BSR a leader in corporate responsibility since 1992, works with its global network of more than 250 member companies to develop sustainable business strategies. BSR has developed a five-step approach to show how corporations can initiate and sustain constructive relationships over time and throughout their organization, creating shared value by engaging early and often. It sees building a stakeholder engagement strategy as fundamental to organisational success and comprises:

- Focusing on where stakeholder engagement can have the biggest impact on organisational strategy and operations.
- Streamlining processes to define and lead cost-effective stakeholder engagement activities.
- Learning from past experiences to assess ambition and clarify objectives
- Measuring the value of investing in engagement.
- Understanding and managing stakeholder expectations.

Such engagement should allow the development of shared values which reflect a meaningful understanding of what all parties expect from the relationship. This will establish a level of moral or ethical conduct to which the Board can return to in circumstances where changing circumstances impact on the business – in straight forward terms this might help inform decisions regarding comprising safety or quality at the expense of short term profitability. Such thinking will however also comprise agreeing a corporate and shared understanding of the values of the organisation and then ensuring that the organisation through effective management does things right.

Critically, gaining assurance that this is so is also an aspect of the three lines of defence; as the second line requires positive affirmation by management that the policies and procedures established to ensure that the organisation achieves its corporate objectives are adequate and effective. Such assurance can deliver reassurance that we are indeed doing things right and there is clearly a role for internal audit in this respect as a third line of independent assurance in relation to demonstrating that ethical policies are truly delivering on expectations; an opinion that might be used in communication with both internal and external stakeholders, given its independent status.

The duties of directors

Governance codes are reasonably consistent in terms of the role and responsibilities of Directors with the basics being enshrined in Company law. For the purposes of this research we will use the requirements of the Companies Act 2006 as applying principles that are generic and will apply to most situations in which a person acts as a director.

For a director of an incorporated body, the most controversial aspect of the Companies Act is section 172, which replaces the common law fiduciary duty of loyalty (often phrased as the duty to act in good faith in the best interests of the company). The new duty requires a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a collective body: not just the majority shareholders, or any particular shareholder or section of shareholders. According to statements made in Parliament, the success of the company means what the members collectively want the company to achieve. For a commercial company, this will usually mean long-term increase in value; for charitable and community interest companies, the attainment of the objectives for which the company was established.

The duty requires the director to have regard (amongst other matters) to six specified factors:

• the likely consequences of any decision in the long term
• the interests of the company’s employees
• the need to foster the company’s business relationships with suppliers, customers and others

- the impact of the company’s operations on the community and the environment
- the desirability of the company maintaining a reputation for high standards of business conduct
- the need to act fairly as between members of the company. The Companies Act 2006, highlights the connection between what constitutes the good of a company and a consideration of its wider corporate social responsibilities.

Surely this now represents an essential foundation for ethical behaviour by those with such responsibility?

The aim of the codification of directors’ duties in the Companies Act 2006 makes the law more consistent and accessible; however the degree of conformity with such requirements may still be a relatively judgemental evaluation and consideration of what takes place in practice may be a benchmark that all Boards could do well to consider and self-assess as an essential feature of demonstrating ethical behaviour.

The Act outlines seven statutory directors' duties, as detailed below.

1) Duty to act within their powers

A company director, must act only in accordance with the company’s constitution, and must only exercise powers for the purposes for which they were conferred.

2) Duty to promote the success of the company

A company director must act in such a way that would be most likely to promote the success of the company (i.e. its long-term increase in value), for the benefit of its members as a whole. This is often called the 'enlightened shareholder value' duty. However, consideration must also be given to the factors outlined above but including maintaining a reputation for high standards of business conduct. Clearly this can be directly related with the aspirations of the King III report referred to above with its focus on triple line reporting.

3) Duty to exercise independent judgment

Company directors have an obligation to exercise independent judgment. It is worth reflecting on the relative importance of independence, which provides for both scrutiny and challenge of executive directors as well as independently of each other. In this respect there is alignment with the role of internal audit, which also being independent, should be a source of assurance for directors in fulfilling their responsibilities. These duties as we will discuss represent a vital characteristic of those being required to undertake duties as members of Audit Committees.

4) Duty to exercise reasonable care, skill and diligence

This duty codifies the common law rule of duty of care and skill, and imposes both ‘subjective’ and ‘objective’ standards. Directors must exercise reasonable care, skill and diligence using general knowledge, skill and experience (subjective), together with the care, skill and diligence which may reasonably be expected of a person who is carrying out the functions of a director (objective). So a director with significant experience must exercise the appropriate level of diligence in executing their duties, in line with their higher level of expertise. Similarly, there is a link here to corporate behaviour where the combined attributes of the entire Board should be complementary and sufficient to deliver the strategic objectives of the organisation.

5) Duty to avoid conflicts of interest

This dictates that, a director, must avoid a situation in which they have, or may have, a direct or indirect interest which conflicts, or could conflict, with the interests of the company.

This duty applies in particular to a transaction entered into between the Director and a third party, in relation to the exploitation of any property, information or opportunity. It does not apply to a conflict of interest which arises in relation to a transaction or arrangement with the company itself.

This clarifies the previous conflict of interest provisions, and makes it easier for directors to enter into transactions with third parties by allowing directors not subject to any conflict on the board to authorise them, as long as certain requirements are met.

6) Duty not to accept benefits from third parties

Building on the established principle that you must not make a secret profit as a result of being a director, this duty states that you must not accept any benefit from a third party (whether monetary or otherwise) which has been conferred because of the fact that you are a director, or as a consequence of taking, or not taking, a particular action as a director.

This duty applies unless the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest. The extent to which benefits are received as part of the conduct of normal business and which are intended to influence business decisions represents a murky area in which personal values are perhaps tested more than any other.

7) Duty to declare interest in a proposed transaction or arrangement

Any company director who has either a direct or an indirect interest in a proposed transaction or arrangement with the company must declare the 'nature and extent' of that interest to the other directors, before the company enters into the transaction or arrangement. A further declaration is required if this information later proves to be, or becomes either incomplete or inaccurate.

The requirement to make a disclosure also applies where directors 'ought reasonably to be aware' of any such conflicting interest. However, the requirement does not apply where the interest cannot reasonably be regarded as likely to give rise to a conflict of interest, or where other directors are already aware (or 'ought reasonably to be aware') of the interest.

With such explicit conditions in place, the public, as revealed in the survey results mentioned earlier, are presumably justified in questioning whether we should trust our leaders. The occurrence of failure must comprise elements which reflect one or more instances where the above duties have not been fully complied with; whilst a constant stream of governance legislation is a reaction to this, the existence of failure across all sectors indicates that all is still not well and the ability of directors to deliver organisational success remains at the heart of the problem.

The UK Code of Corporate Governance (2010) has seen developing governance legislation in the public and charity sectors over two decades. In the Cadbury report (1992) governance was described as:

> "Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include

> setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting".

This again places Boards in the position of delivering the strategic aims and whilst this is about what the board of a company does and how it sets the values of the company; it should be distinguished from the day to day tactical and operational management of the company by full-time executives. Nevertheless for the organisation to be effective there must be an effective trust and assurance arrangement between the strategic and operational responsibilities.

Whilst the UK Code of Governance (2012) is not a rigid set of rules as it consists of principles and provisions regarding which relevant organisations are expected to 'comply or explain' – some are main criteria, others are supporting but are those that are main sufficiently explicit to ensure both understanding and compliance?

The role and responsibilities of directors is central to delivery on these expectations. The duty that above all reflects the necessity for ethical behaviour may be that which requires directors to act in a manner which would be most likely to promote the success of the company for the benefit of the members as a collective body: not just the majority shareholders, or any particular shareholder or section of shareholders. Indeed the wider consideration of social issues including consideration of the impact of the company's operations on the community and the environment demonstrates the commitment that must be given to society.

The Government had described the section added in 2007 (section 172) to the Companies Act(2006) as a radical departure in articulating the connection between what is good for a company and what is good for society at large. This reflects a cultural change in the way that companies should conduct their business – it is now recognised that pursuing the interests of shareholders must also embrace the wider responsibilities flagged in the list of factors as these are complementary purposes, not contradictory ones.

The need to demonstrate ethical practice is becoming an increasingly fundamental balance of consideration between various stakeholder groups. However the jury is still out on whether there is true balance between the needs of one stakeholder group as opposed to another.

Bloomberg (2013) commenting on a Barclays internal report highlighted 'Bonuses Incapable of Justification' explaining that Barclays PLC Chief Executive Officer Antony Jenkins is seeking to rein in executive pay and give more of the bank's profits to shareholders to help restore investor confidence in the wake of the Libor scandal, quoting that Rothschild vice chairman Anthony Salz in the report as saying –

> "Based on our interviews, we could not avoid concluding that pay contributed significantly to a sense among a few that they were somehow unaffected by the ordinary rules. A few investment bankers seemed to lose a sense of proportion and humility."

Equally, there are observations in the Francis report (2013) on events at Mid Staffordshire NHS Hospital Foundation Trust report that financial considerations were placed above the interests of the patients in terms of health and safety. Robert Francis QC in his introductory letter to the Secretary of State for Health says:

> "the story it tells is first and foremost of appalling suffering of many patients. This was primarily caused by a serious failure on the part of a provider Trust Board. It did not listen sufficiently to its patients and staff or ensure the correction of deficiencies brought to the Trust's attention. Above all, it failed to tackle an insidious negative culture involving a

> tolerance of poor standards and a disengagement from managerial and leadership responsibilities. This failure was in part the consequence of allowing a focus on reaching national access targets, achieving financial balance and seeking foundation trust status to be at the cost of delivering acceptable standards of care".

Here there is a clear indication of what mattered most to the Trust Board was the achievement government targets and particularly the delivery of financial performance that would support an application for Foundation Trust status within the constraints imposed by Monitor, the body charged with oversight of applications for such status .

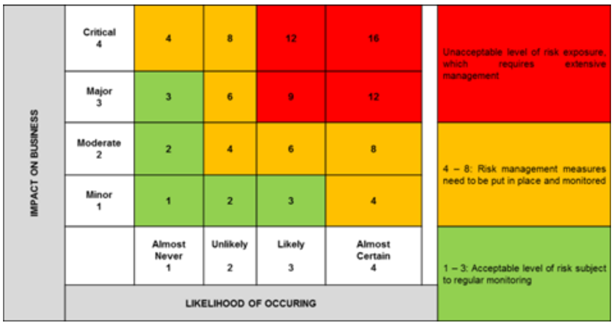
This statement is then supported by a list of findings that indeed demonstrate how the needs of one stakeholder group were placed in front of the expectations of others.

> "The report has identified numerous warning signs which cumulatively, or in some cases singly, could and should have alerted the system to the problems developing at the Trust. That they did not has a number of causes, among them:
>
> - A culture focused on doing the system's business – not that of the patients;
> - An institutional culture which ascribed more weight to positive information about the service than to information capable of implying cause for concern;
> - Standards and methods of measuring compliance which did not focus on the effect of a service on patients;
> - Too great a degree of tolerance of poor standards and of risk to patients;
> - A failure of communication between the many agencies to share their knowledge of concerns;
> - Assumptions that monitoring, performance management or intervention was the responsibility of someone else;
> - A failure to tackle challenges to the building up of a positive culture, in nursing in particular
>   but also within the medical profession;
> - A failure to appreciate until recently the risk of disruptive loss of corporate memory and focus resulting from repeated, multi-level reorganisation".

So in the case of Barclays and the Hospital Trust what might have warned the Board of such failings? The need for assurance regarding how we are performing against our corporate ambitions is clear but the process that allows effective communication between the Board and its stakeholders whether internal or external is in too many cases, broken.

The role of directors is not easy; the list of considerations and their variability in terms of the context of each issue we must recognise as immense. When measured also against the constraint of limited time to perform duties, particularly where complex information comes before a meeting for decision, the responsibilities are considerable but nevertheless critical and deserving of appropriate attention so that the right decision is made. There is an assumption and a reliance that the directors have the appropriate skills and experience but there is a necessity that they are also appropriately informed – and this represents the crucial link to integrated reporting which can help ensure that the appropriate ethical decisions are made.

Without an appropriate framework for considering where organisations are going wrong, that is shared and supported by the entire organisation, the role of the Audit Committee becomes an intolerable task which threatens the very essence of governance reporting. Indeed Lord Sharman in his report 'Holding to Account' (2001) comments on the benefit of having non-executive being to provide a constructive challenge to accepted wisdom within organisations, as well as alerting them to risks and opportunities, the question remains though - do non-executive directors receive transparent and timely information regarding what may be going wrong?



If they do, why do we witness so many failures? If they don’t how can we ensure that they have a good chance of demonstrating ethical practice?

Controls Assurance

The concept of controls assurance or integrated assurance reporting as referred to in the King III (2009) report is no new concept but its use across all sectors as a formal part of the management of an organisation appears limited. This is likely linked to the extensive nature of its reach and if done effectively the administrative commitment that has to be made to keeping it relevant so that it delivers timely assurance relating to whether the policies and procedures that have been established by Board to meet its objectives have been followed.

Yet across sectors it is now consistent that the Board is required to explain its governance arrangements and in particular to explain how it conducts a review of its internal control framework commonly known as the business review.

If such reviews are being conducted then why are there still so many unexpected disasters? Could this point to directors failing to fulfil their roles and either not knowing or being insufficiently transparent regarding the true position of the organisation?

If undertaken effectively controls assurance frameworks should provide a consistent and timely assurance regarding performance as well as point to areas where significant risks exist, focusing on those that are above the Boards established risk appetite.

In simple terms the template for a formal framework should link:

- Strategic objectives
- Inherent risks (focusing on business critical risks)
- Policies and procedures (put in place to mitigate these risks) – first line of defence.
- Identification of residual risk levels (agreement that these are below risk appetite)
- Provision of documented assurance from management – second line of defence.
- Gaps in control that expose risks needing to be highlighted in governance statements.
- Actions
- Independent assurance – third line of defence.

Underlying this is of course an assumption that effective definitions of risk impact and likelihood have been defined by the Board so that those risks that are unacceptable (above risk appetite) can be clearly identified. The focus of Board can then be directed to those risks that are potentially critical or catastrophic in nature and are almost certain or likely to occur and whilst these may need to be clearly understood by internal audit, the focus of internal audit routine attention must be elsewhere. The risks that might emerge into this zone should existing controls fail or be insufficient to react to changing circumstances represent the most pressing need from the Boards point of view for effective assurance to be delivered through a robust internal audit opinion. Such risks will reflect the entirety of the organisation’s activity and whilst there may be an ultimate financial risk, the focus of the internal audit review must consider the context of the business operation.

The role of the Audit Committee

The Australian Institute of Company Directors summarises the accepted role of the Audit Committee as:

"The audit committee plays a key role in assisting the board to fulfil its corporate governance and oversight responsibilities in relation to a company's financial reporting, internal control systems, risk management systems and the internal and external audit functions".

This definition draws together the breadth of its role without bias in respect of financial reporting issues and having regard to the wider nature of both internal control and risk management. However as a KPMG advisory brochure (2009) on the Role of the Audit Committee observes that its functions and responsibilities, which are approved by the Board do vary from organisation to organisation.

Such divergence is of concern to the UK National Audit Office who in a report titled *Helping the Audit Committee to add value* (2012) warn that "even with a clear role and remit, in practice, it is very easy for the Audit Committee to drift and for the chain of governance to become inefficient and ineffective", in the report.

More explicitly the report states that:

"The work of an Audit Committee is built on its membership, and the organisation at large, understanding the role and remit of the Audit Committee in the wider governance structure".

This message both underlines the importance of having the appropriate skills on the Audit Committee as well as making sure that its role does span the whole of the activities of the organisation which is clearly logical given its accepted focus on risk management. Helpfully the guidance also links the role of the Audit Committee with the Governance statement by acknowledging that:

"The Audit Committee can assist the Accounting Officer with the Governance Statement by producing an Audit Committee Annual Report outlining activities, issues and recommendations for the year. An Annual Report can also help the Accounting Officer to better understand the role and remit of the Committee, significant areas of business risk in the organisation, and the value that the committee adds to the organisation. Some suggested areas are:

- list of activities completed in year;
- list of recommendations and resulting actions;
- sources of assurance used; and
- areas to focus on in the coming year".

This latter point links directly to recent guidance from HM Treasury in respect of recording significant risks to the organisation, as well as observations in King III (2009) relating to forward looking reporting.

Lord Sharman in his report 'Holding to Account' (2001) focusing on the review of Audit and Accountability for Central Government in the UK, stated that "Audit Committees work best if they act as a source of independent advice and warning to the Accounting Officer, and it should be recognised that, at times, the questioning of an audit committee may be uncomfortable for executive staff. Fully developed, audit committees could help to identify and focus attention on common problems and themes".

The report though seeks to clarify this point which appears to focus on routine by referencing their remit on the risk management framework within government and asking questions about particularly high level issues before discussing what a formally constituted audit Committee should look like. The basic principles that the report sets out for audit committees include that they should:

- be chaired by a non-executive director, or by a person from outside the department, appointed solely to chair the audit committee, without a wider role within the organisation (with appropriate support to ensure familiarity with the work of the department);
- if possible, consist solely of independents (or at least have a majority of such people). Committees should not include either the Accounting Officer or the Principal Finance Officer among its executive members, although they should attend the meetings;
- consider whether all risks faced by the department, not just financial risks, have been properly assessed;
- approve and review internal audit's work programme and receive internal audit reports;
- involve the external auditor and ensure that he/she receives all papers and is invited to all meetings;
- allow for the Chairman of the audit committee to hold private sessions with the internal and external auditors;
- challenge both external and internal auditors about their assumptions and methodologies; and
- prepare an annual report to the Accounting Officer on their work, which could be published alongside the departmental accounts.

In 2001 Lord Sharman started to make linkages between independent opinion and reporting to stakeholders, it seems UK PLC may still not be at the finishing post across all sectors of the economy.

To perform this role across the breadth of the activity of the organisation the Audit Committee must comprise NED's with appropriate, skills, experience and commitment including sufficient inter personal attributes that will allow appropriate and confident challenge of the executive. In this respect the NAO report on helping Audit Committees to add value contains guidance that:

> " … the qualifications and expertise of members should be targeted to meet the requirements set out in the Committee's terms of reference. The Committee should have non-executive members with an audit or finance background and, where relevant, with specialist knowledge, for example, of Private Finance Initiative (PFI) and Public Private Partnership (PPP) deals. Some Committees have found it useful to identify four or five key personal qualities and skills/experience that are desirable and have then assessed their members against this. This can help to identify a suitable training programme, or may lead to changes in membership. When considering the membership of the Audit Committee, organisations should aim to achieve a mix of individuals, expertise and qualifications relevant to the maturity of the Audit Committee and to the nature of the organisation".

Finance is an aspect of the governance of every organisation and as every risk is likely to have some degree of financial impact it will be important to be able to place this in context. Such a measure is also enshrined with the UK Code of Governance (2010) which requires that:

> "The Board should satisfy itself that at least one member of the Audit Committee has recent and relevant financial experience….It is desirable that the Committee member whom the Board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies".

In the UK the relevance of this approach is manifestly increased as from years commencing on or after 1 October 2012, compliance with the UK Corporate Governance Code will require directors to give a description of the significant issues considered by the audit committee in relation to the financial statements and how these issues were addressed. Also from the same date, the auditor will be required to report by exception (or explicitly confirm that there is no exception to report) as to whether the directors' description of the work of the audit committee appropriately addresses matters communicated by the auditor to the audit committee.

These changes represent a further attempt to draw together strands of risk that the organisation has recognised so that these are appropriately transparent and can be considered by stakeholders. Where consideration of these matters has been undertaken at Audit Committee all relevant parties with an interest in delivering independent assurance should be party to the discussion and hence able to contribute to the governance agenda.

Internal Audit

The code of ethics of the Institute of Internal Auditors sets out the ethical standards that internal auditors should adopt. There may be a question as to whether this simply applies to members of the Institute or the internal audit community as a whole. However given the nature of the work of the internal auditor which by necessity require independence in terms of structure and objectivity, reflecting the need to be impartial in terms of reaching conclusions then this must support a view that the code is universal and applies to all those that go under the title of internal auditor.

Indeed, the code in practice is not that dissimilar to other professional codes which call for common features relating to professional and personal conduct in relation to integrity, objectivity, confidentiality, and competency. As shown, by a research study conducted by Birmingham City University in 2012, other professions particularly relating to finance and technology have a significant presence in internal audit teams and we can assume that similar ethical standards of conduct exist.

As the IIA observe, maintaining such conduct helps to ensure that the basis of trust upon which the profession is founded is fundamental in terms of it contribution to governance, risk management and control. Trust is a key word here as if the contribution of internal audit is to be felt in the boardroom then it must reflect the highest possible business standards demanding both communication and influencing skills.

If the voice of internal audit is to be both heard and respected this is a pre-requisite, as the nature of comment relating to whether the Board is acting ethically will be a sensitive issue to address. As the IIA reflect in the code of ethics:

> "Internal auditors make balanced assessment of all relevant circumstances and are not unduly influenced by their own interests or by others in forming their judgements".

As we have seen earlier in our research consideration of ethical issues is a diverse and often judgemental area in which different perspectives exist, an internal audit opinion may therefore be regarded as just one more view unless appropriate evidence to support advice can be gathered. Internal Audit will therefore need to be confident that it can provide appropriate advice regarding both the strategic and operational domains.

- Strategic – does the direction and performance of the organisation reflect accepted ethical conduct, and
- Operational – does the organisation follow the ethical policies and procedures established by the Board.

In the latter case, evidencing will be the critical determinant as to whether internal audit reports will be well received, although clearly such work must be underpinned by a full understanding of the Board's reasoning behind its ethical stance, the outcomes it seeks to achieve and the impact of the gap that exists through non-compliance.

With regard to the strategic agenda, similar understanding must also exist however where the Board is deemed to be acting 'unethically' the internal auditor may be placed in a position of conflict if internal audit opinions are disregarded. In this situation, professional conduct would suggest that under standard 2410.A3 of the IPPF, internal audit has a duty to communicate the results outside of the organisation – a step that may be regarded as one too far by many.

Value Added Internal Audit

If such arrangements are in place this is likely to satisfy the demand from the King III report of 2009 for organisations to establish an integrated reporting framework that is forward looking and thereby informs stakeholders of the sustainability of the organisation.

The formal link for internal audit through a controls assurance framework to supporting the Governance Statements of the organisation can therefore be established even more explicitly than that contained within the International Professional Practices Framework (2011) which in standard 2050 provides mandatory guidance that:

> "The chief audit executive (CAE) should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimise duplication of efforts".

In doing this the Head of Internal Audit (CAE) is placed in the position that:

- They can identify and place appropriate reliance on the assurances contained in the controls assurance framework where available, or
- Identify those assurances available, place appropriate reliance on these but then observe and report upon those instances where significant residual risk exists without appropriate assurance being available to the Board and then report accordingly as required under standard 2060 - Reporting to Senior Management and the Board.

The relevance of standard 2060 is important as it requires the CAE to report periodically to senior management and the board on the internal audit activities, purpose, authority, responsibility and performance relative to its plan. Such reporting must also include significant risk exposures and control issues, including fraud risks, governance issues and other matters needed or requested by senior management and the board. The report is not limited to only those matters that have been covered by internal audit in assignments but represents a communication between the CAE and the Audit Committee that if value is to be added must be focused on the strategic risk facing the organisation.

In this respect poor ethical behaviour on the part of the Board would be amongst those risks that would rank as significant and therefore given the prominence of the ethical debate not only should internal audit be aware of the issues but the CAE should be confident of bringing relevant matters to the Boards attention as part of a mature and meaningful discussion that has stakeholder interest as its primary concern.

This can be summarised within observations by John Rosthorn (2000) writing in the Journal of Business Ethics who in what now appears to be a prescient remark stated:

> "Knowing that the corporate social responsibility caravan is on the move, but not waiting for the sandstorm of definitions to clear, the internal auditing function has much at its fingertips already. Neither would it need to wait on successors to the Cadbury and Hampel Committees on corporate governance to redefine the scope of internal controls. The auditor knows that the long-term health of the business depends on the management of business

risk, the preservation of the de facto and de jure licences to operate, and on the improved understanding of key success factors. Thus the risk of exposure arising from unethical conduct is in triple jeopardy."

"You have only always to do what is right. It will become easier by practice, and you enjoy in the midst of your trials the pleasure of an approving conscience."

General Robert E. Lee

(1807-1870);

The significant issue for internal audit therefore reflects does it have the motivation and skills to add value in relation to the demand from stakeholders for assurance that the Board and Executive is behaving unethically.

Business Ethics today

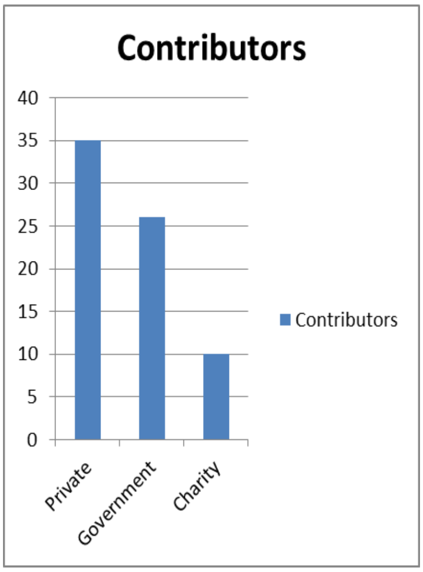
The conduct of this study was designed to gain an understanding of the importance that was being attached to ethical practices across all sectors of the UK economy, as given the attention that has been placed upon its increasing relevance it was expected that it would be a hot topic.

However, concern for ethics is not a new concept albeit its relevance to the internal audit profession is seemingly increasing rapidly as stakeholder concern rises in response to continuing reports of Board failure.

A focus for this study has therefore been not only the attention being paid to ethical practice by Boards but also the priority being given to reviewing ethical conduct by internal audit teams who as we have seen have a first-hand role to play in delivering assurance regarding what matters: in this case that the tone at the top was delivering intended outcomes.

In order to gauge the level of commitment, the study has been based on a questionnaire circulated electronically to the internal audit community which sought to explore the position regarding three key research questions.

1. What level of commitment existed to establishing an ethical policy within organisations across the UK economy?
2. Where ethical policies existed, had internal audit demonstrated that they were delivering intended outcomes?
3. Where policies were audited what reasons were being given for reducing the level of assurance being provided to Board?

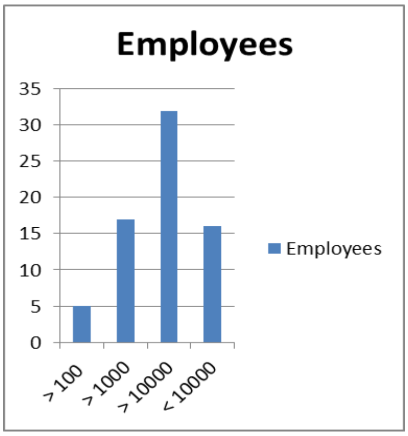


A summary of the survey questionnaire and an analysis of the outcomes is provided as Appendices A and B.

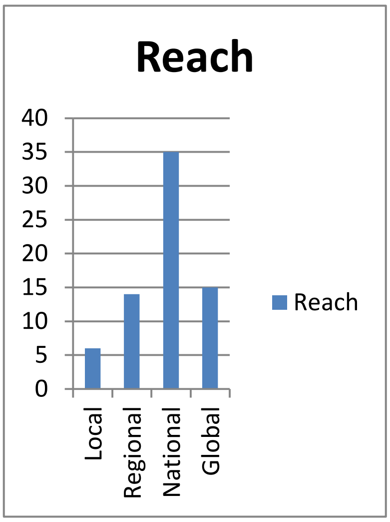
The survey

A total of 70 submissions were made to the study comprising contributions from all sectors of the UK economy. These are summarised by sector, by size and geographic span of activity in the diagrams below.

In terms of focus a little over 50% of those providing information were from a private sector background, with 37% coming from the government sector and the remaining 13% having a charitable aim. This has provided us with the ability to consider the position across the UK economy and to develop conclusions in relation to the respective commitments of the sectors.



Analysed on the basis of the size of the organisation, the spread of organisations contributing has also provided a useful cross-section of entities with a wide range of circumstances in terms of their geographic reach. In terms of business ethics, given that governance codes have generally been focused on larger organisations it was significant that 74% of contributors had a national or international reach with 70% of organisations employing over 1000 staff. This has allowed us to conclude that the findings of this study will be of relevance to the increasing focus on ethical practice by stakeholders from our leading edge organisation where demonstration of good governance is increasing.



Given the recent issue of new Public Sector Internal Audit Standards in the UK (December 2012) which will come into effect from 1 April 2013, it is also relevant that 37% of contributors have a government sector background. With austerity still an issue in public sector expenditure findings in relation to whether organisations are able to demonstrate a commitment to ethical standards whilst reducing the cost of the services or even the services themselves, will be valuable.

In terms of reach, few contributors have a local reach, indicating that organisation will potentially have a wide range of stakeholder groups and therefore demonstration of ethical practices will be diverse as opposed to in a local setting where it may be more specific.

Commitment to ethical practice

The study outcome concludes that the commitment at Board level to establishing ethical practices is strong with 83% of organisations declaring that an Ethical Policy is in place. Further analysis shows that the main reasons for not having a policy in place were:

- Ethics was not viewed as being an essential feature of the organisations success, and
- Not seen as an immediate priority.

Whilst other contributors observed that ethics was not perceived to be a risk that featured within the corporate strategy – we anticipate that these results are likely to be related to the smaller organisations in the sample for the most part.

It seems therefore reasonable to conclude that the majority of organisations have realised the need to commit to ethical standards. However the question remains does this demonstrate that ethical practices are followed in practice, as this may be the ultimate test as to whether Boardroom behaviour is reflective of the demands of stakeholders. As Martin Luther King, Jr a well-respected Civil Rights Activist comments, “Society's punishments are small compared to the wounds we inflict on our soul when we look the other way.”

This may be a reminder for the Boardroom - when commerciality has to be balanced with wider stakeholder interests and they seek an ultimate benchmark regarding an impending decision.

> *“Never, never be afraid to do what's right, especially if the well-being of a person or animal is at stake. Society's punishments are small compared to the wounds we inflict on our soul when we look the other way.”*
>
> *Martin Luther King, Jr.*
>
> *(1929-1968);*

Striking the balance between moral and financial issues may be an increasingly common decision that Boards need to address as ethical practice is placed firmly under the microscope.

Internal audit assurance

The prominence of business ethics as a theme throughout the latest global recession, financial crisis and recovery inevitably places the matter as a key issue at the Boardroom table. As a result if internal audit is connected to the strategic discussion and risk perception of stakeholders then its relevance must surely have resonated with an alert internal audit planning system.

The survey therefore sought to establish:

- The extent to which internal audit has reacted to the emergence of business ethics as a critical issue,
- What reasoning exists for not reviewing ethical practice,
- The degree to which internal audit have provided assurance regarding the appropriateness of ethical policies, and
- Where substantial assurance has not been provided, whether this relates to the quality of the ethical policy itself or matters of a compliance nature.

Internal audit planning

Respondents to the survey declared that 61.8% of organisations had not audited the ethical practice of their organisation; the reasons for not doing so predominantly relate to this not being seen as a priority area, although other key reasons related to ethics not being seen as a risk or it not being seen as an area for review by internal audit. Surprisingly, in explaining this latter point some respondents did indicate that this was viewed within their organisation as a matter for Human Resources or External Audit.

Such results are perhaps an indication of the relative focus of internal audit within organisations, where attention is often directed towards compliance matters particularly of a financial nature rather than strategic issues which may have a greater impact on the business critical risks. There is of course also an alignment here with the status of the Head of Internal Audit which relative to that of

Executive Management or the Board, does not allow challenge to given directives or indeed prevents appropriate independent review of strategic risks to the benefit of wider stakeholders.

Those internal audit teams that had undertaken reviews amounted to 26 (38%) of respondents, of these 18 (26%)x% were from major organisations with over 1000 employees. Whilst this may show that there is a marginally greater emphasis in larger organisations on ethical practice, the difference is marginal perhaps indicating that commitment is a cultural matter associated with the individuals comprising the Board, its Executive Team or indeed those within Internal Audit.

Surprisingly only two Charities confirmed that they had reviewed compliance with ethical policies which at 22% is lower than both the business sector (38%) and the government sector (44%).

Where such audits had taken place, substantial assurance was provided by 32% of organisations. We have not attempted to seek clarification of what substantial assurance may mean in individual circumstances however clearly there must be a realisation that the extent of assurance provided may range from a standard compliance rating to one that provides confidence that the organisation has ethical practice at the heart of what out to achieve and then does it – doing the right things right!

The compliance gap and its implications

An assurance gap was therefore identified by 68% of the internal audit teams that had conducted reviews. These reviews revealed three significant trends and may support a view that where internal audit were involved they were indeed looking at the right things, the outcomes show:

- 25% of organisations had made strategic observations in relation to ethics policies not meeting best practice or being aligned to strategic directions,
- 50% of organisations noted issues of a compliance nature, and
- 25% of organisations commented on outcome issues related to failures to use information appropriately or publish details.

Within these themes evidence exists to show that internal audit is considering the important role that demonstrating good ethical practice can bring to an organisation, and which may be summed up as an attitude that recognises if you are going to do it, do it right and make sure you get benefit out of it.

Our research shows that strategic alignment of ethical practice is a critical component of business success, for initiatives to succeed they must be embedded, established by setting the 'tone at the top' and then integrated within established procedures. This particular aspect is commented on by the first set of findings, perhaps indicating evidence that in some organisations we are not going far enough and perhaps paying 'lip service' to an ideal rather than setting out to make it really work for the organisation. At its worst this may indicate that there are some who are content to say the right things rather than do the right things.

The compliance issue is more concerning perhaps and demonstrates that in 50% of reviews internal audit found evidence of complacency. The organisation has a policy in place but for whatever reasons it is not seen as 'business essential' – one might argue that this places organisations in no better place than those who simply didn't have a policy. There is also a case for considering the inefficiency of what has happened; at least those that haven't tried to put ethical policies in place have not wasted resources in showcasing a commitment.

The third theme identified amplifies this scenario. It shows organisations not considering the question “So what are we getting out of it?” This would not be the case if the investment were in a new product line so it is absolutely fair comment for internal audit teams to be asking the question as to what ethical practices are delivering in terms of benefits to the organisation. The survey has contributions from the private, government and charity sectors and whilst it might be expected that the latter groupings would be more ethical the results do not conclusively show that this is the case; reviewing the outcomes of being ethical is probably the conclusive aspect of whether the organisation is both doing the right things <u>and</u> doing them right.

Conclusions and Recommendations

Introduction

This study has given us tremendous insight into the current activity of internal audit in relation to an organisations attitude to ethical practice and the degree to which internal audit resources have been applied to demonstrating its conduct as a contribution to helping the organisation achieve its corporate objectives.

The research has shown the increasing prominence of the ethical debate at a political level, within the boardroom and by regulators and commentators and in this respect the survey confirmed that the majority of organisations had responded to this by implementing ethical policies.

The first major research question had therefore been answered; the second therefore reflects the more interesting aspect of the study in respect of had internal audit provided assurance that policies were effective.

The role of Internal Auditing

In essence, the role of internal audit is now globally accepted as being as that summed up in the definition of the Institute of Internal Auditors (2013)

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

Horizon scanning may bring internal audit into an area in which it is unfamiliar

However, at an organisational level it is recognised that this is interpreted in different ways by the key players, as internal activity focuses on a wide range of approaches from compliance audit, through risk based internal audit to consultancy. In this respect the degree to which internal audit has reacted to the emerging need for organisations to demonstrate that they are indeed ethically compliant may simply rest upon whether a clear and shared understanding exists regarding what can be achieved through investment in Internal Audit. Board, Audit Committee, Executive Management and indeed the Head of Internal Audit have in practice a wide range of views which impact on where the focus of internal audit attention should be. Within this array of options horizon scanning may bring internal audit into an area in which it is unfamiliar, and therefore questioning unethical practice may well be a step too far for most.

It is not surprising therefore to see that only a little over a third of internal audit teams had undertaken a review of the implementation of ethical policies. The reasons given for not conducting assurance work in this area included reference to not being seen as a priority and not an area for internal audit. An interpretation of this position may reflect simply a misunderstanding of the role of internal audit but it may also reflect a focus on operational objectives rather than strategic ones. In the words of Ian Peters, Chief Executive of the Chartered IIA UK & Ireland speaking at the IIA Midlands Region Conference in July 2011 *"Our vision must be to ensure the Internal Audit is seen as essential to an organizations success"*, unfortunately our study shows that we may still have a long way to go, as internal auditors, in terms of getting involved with boardroom issues that are at the centre of the challenge that our leaders are facing.

The ethical discussion is about concerns for a wider group of stakeholders than the shareholder and this does not appear to be on the radar of a large proportion of internal audit teams at present. What is unclear is whether this is a restriction imposed on us or a reluctance to engage with the bigger issues.

Assurance

The survey did reveal however that where internal audits had been conducted, two thirds of the opinions had been restricted for reasons reflecting the establishment, implementation and review of ethical policies.

This is a positive result as it provides evidence that internal audit has reacted to the prominence of ethical concerns by not only conducting compliance based work but seeking to add value through consideration of matters relating to both best practice and ensuring that the organisation receives benefit through investment in and embedding ethical practice within standard operating procedures.

Role of the Audit Committee

World events are littered with accounts of failure and that have a legacy of poor ethical practice. We can identify themes of an ethical nature running through Enron, BP Deepwater Horizon, the Cornucopia Ferry disaster and the more recent horsemeat scandal impacting on businesses and their stakeholders – so one is bound to ask where were the Audit Committee and were they asking the right questions?

The answer relates perhaps to the wider role of independent non-executive directors to provide appropriate scrutiny and challenge with a necessity to consider the inherent risks that the organisations activity is subject to. Only in doing this on a consistent basis can Boards be confident that they are doing the right things right, consistently and therefore acting ethically in respect of the wider stakeholder community.

Does the Audit Committee consistently ask the right questions?

The role of the Audit Committee is therefore likely to be fundamental in this respect, as whilst the ultimate risk may have a financial factor, it is the ability of the Audit Committee to focus on the potentially catastrophic risk that will pinpoint the likelihood of disaster arising from poor ethical conduct.

In turn, the wise Audit Committee will seek assurance from internal audit that things happening on the front line, including ethical practice are unlikely to have an impact on the bottom line.

Working with Non-Executive Directors

It is recognized that the limited time that the non-executive director has in worthwhile contact with the organisation is a barrier; as such it is incumbent on organisations to deliver as part of standard governance arrangements mechanisms by which independent directors can match corporate objectives against timely and accurate measures of success as well as understand the real and substantial risks that the organisation is facing. This demands recognition of inherent risk in a manner that allows traditional first and second lines of defence to be put in place with a view to maintaining risk within the risk appetite of the Board and its stakeholders.

In this respect there is a demonstrable need for establishing an appropriate assurance framework in which both independent non-executive directors and executive management can place faith regarding assurance and performance reporting and as a result ultimately control. If such assurance is in place, then it is natural where doubt exists, for Internal Audit to be called upon as a third line of defence – to provide independent assurance on, an as and when required basis, that will inform integrated reporting mechanisms and in turn governance statements within Annual Reports.

The ultimate risk may have a financial factor but it is the ability of the Audit Committee to focus on the potentially catastrophic risk that will pinpoint the likelihood of disaster arising from poor ethical conduct

Internal Audit attention in its planning is therefore likely to focus on:

- Assurance work in relation to key controls that are designed to maintain risk to within the risk appetite.
- Consultancy work and advice in relation to areas in which risk remains above risk appetite and is therefore at a level which is unacceptable to Board, and
- Compliance work.

In each of these areas, issues relating to ethical practices will exist and therefore it is likely that the Audit Committee will seek comfort from internal audit at two levels:

- At the strategic level to ensure that ethical policies are in effect ‘fit for purpose’, and
- At an operational level where there is a need to demonstrate that ethical practices are embedded in everything that the organisation does.

Such assurance and therefore transparency would promote the concept that an organisation was serious about its ethical commitments. The assurance could then underpin Governance Statements in Annual Reports and support a wider call for demonstration of the value of ethical business conduct on a global scale.

About the Author

Professor Robin Pritchard is Professor of Internal Audit, Governance at Risk management at Birmingham City University and leads the specialist Centre dedicated to the delivery of academic programmes that offer a dual award aspect that provides for equivalent recognition by a professional body.

In his previous career Robin held senior positions at partner level with a number of the UK's leading firms of Chartered Accountants and led his own specialist practice on two occasions. In each situation, Robin developed service lines focused on risk assurance and consultancy services and worked with Boards, Audit Committees and Executive Management teams in an Internal Audit Partner capacity and in a facilitation and advisory role.

Robin currently holds a number of positions at Non-Executive Director level with:

- Severnside Housing, where he is Chair;
- Association of Corporate Governance Practitioners;
- AW Electrical Ltd;

and as a specialist advisor to the Audit and Risk Committees at the following bodies:

- Accord Housing Group; and
- Animal Health Veterinary Laboratories Agency.

Robin has previously acted at non-executive level with National Patient Safety Agency, Fircroft College, Shrewsbury and Telford Hospitals NHS Trust, Medical Research Council and South Staffordshire and Shropshire NHS Foundation Trust.

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