8-1-2011

The Corporate Ethics Audit: To Prevent and Detect Management Fraud, Internal Auditors Must Have a Sound Understanding of Human Behavior

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BY SRIDHAR RAMAMOORTI AND R. LUKE EVANS

IN THEORY, MANAGEMENT IS RESPONSIBLE not only for designing and implementing strong systems of internal control but also confirming their continued effectiveness over time through monitoring activities. Yet, management override of these monitoring activities — often described as the Achilles' heel of internal controls — is a growing trend at the executive level, as indicated by both of The Committee of Sponsoring Organizations of the Treadway Commission's fraud studies of 1998 and 2010. When the "overseer" becomes the perpetrator of fraud, how do shareholders protect themselves? Indeed, as the Roman satiric poet Decimus Juvenal wrote, "But who will guard the guardians themselves?"

The external audit function, as a monitoring agent, is supposed to examine the financial statements on behalf of shareholders and the board of directors, and thus, indirectly evaluate management's performance. However, the increasing complexity of business, and the role of financial statements as "lagging indicators of performance and risk," seem to pose important challenges to this protection. Internal audit, as the internal guardian of an organization, and as an important line of defense against threats to the organization's mission and objectives, is perhaps in the best position to address these challenges by conducting corporate ethics audits.

A corporate ethics audit measures an organization's ethical "temperature" to identify relevant behavioral risk, especially related to information integrity risk. When we speak of information integrity risk, we look at the combination of information risk (i.e., incomplete, inaccurate, inconsistent, stale, or unreliable information) and integrity risk (i.e., intentional falsification, manipulation, shading, or massaging of information to create bias). When information integrity risk is high, corporate governance failure is only a matter of time.

Preventing, detecting, and investigating management fraud requires a nuanced understanding of information integrity risk from behavioral perspectives. With management fraud on the rise, it is clear that today's internal auditors require a sound understanding of human behavior along with technical expertise. This is particularly important because much of corporate governance is predicated on culture, values, and ethics that do not lend themselves easily to any analytical framework.

Frequent reference is made to the "tone at the top," especially in assessing the quality of the control environment. But such assessments tend to be vague and highly contextual and may not be good indicators of future management actions. Corporate governance in good times can differ dramatically from corporate governance during crises. So, it is important to come back to the behavior of people holding key positions. As Luther Hodges, U.S. Secretary of Commerce in the 1960s, emphasized, "This matter of moral and ethical behavior in business or in government goes back finally to a personal situation."

Furthermore, no matter how good laws and regulations are, it is generally accepted that one cannot legislate ethics and integrity. Laws and regulations are crafted to regulate human behavior; not human thought. They rest presumably on sound reasoning intended to protect some good or virtue. Similarly, a comprehensive code of conduct that has been developed formally and communicated to all employees, with appropriate

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training for executives and key personnel, does not ensure compliance. Laws, regulations, and corporate codes merely establish expected standards for behavior and repercussions for violations.

Internal auditors can use behavioral analysis skills to assess the likelihood of those behaviors that lead to information integrity risk. An appreciation for both patterns of behavior (i.e., ethical styles) as well as patterns for behavior (i.e., ethical purpose) is needed; it is about organizational culture and behavioral dynamics. Internal auditors who possess the requisite skill sets and competencies in behavioral interviewing and pattern recognition can successfully carry out "ethics audits" of corporate culture, the antecedent to undesirable behaviors not only in the C-suite, but also throughout the corporation.

The internal audit function, for most of its history, has been regarded as the "eyes and ears" of management. Its role has been described in terms of what management wanted done and how the audit function could assist. Increasingly, the value of an independent and objective internal audit function has come to be recognized in the most progressive companies.

When the chief audit executive (CAE) reports to the chair of the audit committee, internal audit is viewed as the "eyes and ears, and even the arms and legs," of the audit committee. This role expansion can be understood simply by rephrasing the so-called "audit for management" to also include an "audit of management." This type of audit looks for the existence of information integrity risk evident from inappropriate behavior among senior members of the management team, including undisclosed conflicts of interest; ethical lapses; providing false, misleading information or misrepresentations; or engaging in immoral or illegal activities that could potentially undermine corporate reputation.

To be successful, the internal audit function needs to possess sufficient organizational independence and objectivity, a high degree of competence, and credibility. Internal auditors need to earn respect and gain unhindered access to everyone and everything to discern the facts. They need to exhibit "naïve skepticism" and relentlessly look for evidence of inappropriate behavior — ethical lapses, immoral behavior, and illegal activities that signal trouble. They need to develop patience as well as persistence in getting to the true state of affairs.

Once the internal audit function carries out an initial evaluation, perhaps through a corporate ethics audit, the chief auditor must be in a position to report the findings directly to the chair of the audit committee or the full board of directors. The corporate governance audit conducted at health-care giant Kaiser Permanente, as reported in *Directorship* magazine in October 2010, is a pioneering attempt to raise the stature of the internal audit function by also auditing committees of the board of directors while allowing internal audit to effectively meet The IIA's International Professional Practices Framework-driven corporate governance mandate.

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To be successful in this complex pursuit of assessing information integrity risk in corporate culture and the C-suite, the internal audit function must begin with the understanding that human nature and human behavior lie at the very heart of drawing inferences about the effectiveness of risk management, control, and governance processes. As Lynn McGregor explains in *The Human Side of Governance* (2004), "The organizations that survive and flourish in the longer term are the ones that get the human side of governance right." The internal audit function can take the ethical temperature of the organization, assess information integrity risk, and thus be a critical line of defense in alerting the C-suite and the board of the most serious "people risks" that warrant attention. Swift, responsive action can even prevent corporate collapse.

In *The New World of Business: Ethics and Free Enterprise in the Global 1990s* (1994), author Robert Solomon persuasively argues for the need to conduct a well-designed ethics audit and asserts that corporate ethics is first and foremost about what happens within the organization — how executives, employees, and middle managers treat one another. Often a core consideration for why one joins and stays with an organization is that it is ethically acceptable.

It is pertinent to ask the fundamental question, "Do you ever feel pressured by your organization to act contrary to your own moral judgment?" If the answer is "yes," a corporate ethics audit of considerable depth is required: What sort of pressure? Where does it come from? Is it real or imagined? Is it personally worth the cost of staying with the company? Does it demand formal reporting to the board of directors or even outside agencies? And if the answer is "no," or "very rarely," the corporate ethics audit is nevertheless revealing as it raises the most important existential question: "Is this the person I want to be?"

The corporate ethics audit is just the first step in determining how managers and executives espouse, communicate, demonstrate, and reinforce corporate culture, values, and ethics. Like any survey intended to measure ethical climate, a corporate ethics audit should be designed carefully, and it should be performed efficiently, effectively, and globally. Without a baseline understanding and framework — as Solomon outlines in his book — it becomes unlikely that internal auditors will evaluate information integrity risk comprehensively in the corporate culture and C-suite.

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