

Where Internal Audit and Compliance Should Report

[Jose Tabuena](#)

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**Jose
Tabuena**
Columnist

On parallel yet similar tracks, the roles and reporting relationships of the chief audit executive and the chief compliance officer continue to be heated, contested, and ultimately muddled topics.

Although the view that CAEs and CCOs need a high degree of independence and clout to accomplish their responsibilities has gained increasing momentum, there are still naysayers and skeptics who believe they should remain where they have historically resided and reported—the CAE within finance and to the chief financial officer, and the CCO under the purview of legal and to the general counsel.

Both titles face the controversy of too many chiefs (officers that is), with many CEOs questioning whether yet another executive is needed in the crowded C-suite. Or is there indeed value, they wonder, to empower these positions with sufficient independence and authority so they can play a gatekeeping role that seems to be sorely lacking, especially at large complex organizations?

Richard Chambers, president and CEO of the Institute of Internal Auditors, recently wrote that it's time for internal audit to move out from under the CFO's shadow. He observes that the majority of CAEs report functionally to an audit committee and that there is agreement that such reporting enhances internal audit independence. But he also questions whether internal audit executives are truly as independent as they like to think they are, and if administrative reporting lines, particularly to CFOs, are problematic?

For compliance professionals, the U.S. government has increasingly made clear the expectation that the CCO is not to be subordinate to the general counsel. The government's position was recently expressed in a deferred prosecution agreement with HSBC, which requires the bank to elevate the status of its anti-money laundering unit by “separating the legal and compliance departments.”

As pointed out by Donna Boehme, principal of Compliance Strategists and frequent commentator in the field of organizational compliance and ethics, “[t]he HSBC case is further indication that U.S. regulators and prosecutors are closely scrutinizing the independence,

empowerment, and resources of corporate compliance functions—and even further, are re-thinking the relative seniority and positioning of the chief compliance officer vis-a-vis other senior managers.” The HSBC case tracks the expectations of the Federal Sentencing Guidelines which makes clear the preference for CCO independence and unfiltered access to the governing authority.

Independence Is Not Always Independence

Audit and compliance professionals should recognize that all assertions of independence are not created equal. First, true independence ideally involves professionals from outside the company. As classically defined, a gatekeeper is a *third party* who supplements efforts to deter wrongdoers by disrupting the conduct of their client representatives. Historically for the capital markets, a gatekeeper is an agent who acts as a reputational intermediary to assure investors as to the quality of information sent by a corporate issuer (and so would include investment banking, accounting firms, and lawyers in their activities related to securities issues). The ideal gatekeeper was viewed as an outsider with a career and assets beyond the firm and thus having less to lose than an inside manager.

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Recent events, however, have led to some inconvenient truths. Since the Private Securities Litigation Reform Act of 1995, external auditors have been obligated to report to the Securities and Exchange Commission any unrectified material illegalities encountered in the course of their work. Yet evidence suggests that they are reluctant to do so. The failures of big accounting firms and outside counsel in the Enron and WorldCom collapses have raised the issue as to whether outsiders actually make reliable gatekeepers.

Although all internal employees have a vested interest in the company's ongoing success—and thus cannot be viewed as wholly independent—commentators have increasingly noted that internal functions are better suited to serve as effective gatekeepers. As stated by Ben Heineman, former general counsel with General Electric:

If we want companies to fuse high performance with high integrity, the place to begin—and to be the most effective—is inside the company itself. Outside regulators and gatekeepers can never be as potent and preventative as internal governance on the front lines from the CEO on down.

Inside the organization, *internal audit* and *compliance* have served in this gatekeeping function. Their roles require the capacity and willingness to prevent misconduct. Their formal and informal communication channels means they are well-positioned to access critical information that may reveal company misconduct. I would argue that internal audit and compliance are more independent than the legal and finance functions and therefore better suited to be internal gatekeepers, especially when they are unhinged from those functions.

Originally viewed as a financial gatekeeper, the role of the CFO has expanded and evolved to a strategic partner and adviser to the CEO. Auditor independence was thus strengthened to fill the void and the important role that internal audit plays in their companies' systems of risk management and internal controls became recognized.

Likewise, the role of the GC has evolved to that of strategic partner and company advocate more so than that of an internal monitor. Otherwise, why has the legal bar vigorously opposed efforts to impose gatekeeping obligations on lawyers, such as when Congress formally recognized such a role as gatekeepers when enacting Sarbanes-Oxley Section 307? At the core of the bar's opposition (especially to the SEC's noisy withdrawal proposals) is hostility to the notion that attorneys should have any obligations that could put them at odds with their client representatives. The in-house bar can't have it both ways; if legal wants oversight over compliance they must also accept the full accountability of a gatekeeping role.

Internal Audit Reporting Lines

The internal audit profession has developed recommended reporting lines that provide a useful model for internal gatekeeping. In its guidance the IIA refers to functional and administrative reporting relationships (sometimes confusingly mixed with the terms direct and indirect reporting).

The IIA states that the CAE should report functionally to the audit committee or its equivalent. It also says that the CAE should report administratively to the chief executive officer of the organization. Finally, the guidance says, “the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role (with the CAE reporting functionally to the audit committee).”

A *functional* reporting relationship establishes a connection between positions or organizational units at different management levels based on the specialized nature of the function for which a mutual responsibility is shared. Though it is not always clear, generally the functional reporting relationship is stronger than the administrative one, because the functional body controls the individual's compensation and evaluations.

According to the IIA's Practice Advisory 1110-2, report functionally means that the governing authority would:

- Approve the overall charter of the internal audit function, the risk assessment, and the related audit plan;
- Receive communications from the results of internal audit activities or other matters that the CAE determines are necessary, including private meetings (executive sessions) without management present;
- Approve all decisions regarding the appointment or removal of the CAE including approving the annual compensation and salary adjustment of the CAE; and
- Make appropriate inquiries of management and the CAE to determine whether there are scope or budgetary limitations that impede the ability of the internal audit function to execute its responsibilities

In contrast, *administrative* reporting is the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit function. Administrative reporting typically includes:

- Budgeting and management accounting;
- Human resource administration, including personnel evaluations and compensation of department staff;
- Internal communications and information flows; and
- Administration of the organization's internal policies and procedures.

According to some estimates, more than 50 percent of chief audit executives still report administratively to their companies' CFO. While safeguards such as functional reporting relationships to audit committees may mitigate the risk of interference with internal audit, reporting to the CFO is still fraught with risks and challenges for the CAE.

If the CAE knows that he or she will be dependent on the CFO for his or her next career assignment, how objective can they really be in assessing the CFO's areas of responsibility? While a strong working relationship with the CFO is needed, internal audit also needs the independence and flexibility to evaluate financial information and to establish audit plans without undue influence or even the perception of influence.

Replace CAE with CCO and GC for CFO, and the foregoing principles still apply. Legal has a separate and distinct mandate from compliance. Companies that have placed the CCO under the thumb of the GC, and have viewed compliance purely through a legal prism, have paid a steep price. Compelling reasons are increasingly made to bolster the CCO role with independence from the GC, usually as a direct report to the CEO with unfiltered access to the board of directors.

A point often made is that the working relationship the CAE or CCO develops within the executive ranks and is more critical than any formal reporting relationship. I've heard from CAEs and CCOs who report respectively to the CFO and GC that the reporting structure was not an issue because their supervisor understood the value of their function. But such a relationship is not static and doesn't guarantee that a new CFO or GC will “get it” and similarly understand the distinctive roles. The position needs to be institutionally positioned for success. Too many chiefs do not necessarily spoil the broth.