In the early 1990’s, I was a young auditor at a large company. I recall a fellow staff member being assigned a “governance audit”. To be honest, at the time I wasn’t even sure what a governance audit would entail. When the report was issued, I was interested to better understand what types of things involved governance. The report did not have any findings that were considered significant at the time. The company had an external Board of Directors, an Audit Committee, a Code of Conduct, Ethics training, well-defined operating and accounting policies and various other elements that were tagged as part of the governance structure. Interestingly enough, just a few years later, two of the top executives in this company were indicted for various allegations of financial mis-conduct and personal use of company...
funds and resources. In today's corporate world, we know that simply having the existence of the various factors considered part of governance is not sufficient. If any type of evaluation of a company's governance process is to be effective, it must be able to measure how well the company's various governance processes actually work and not just focus on their existence.

It is a bit amazing that the topic of governance is still one that is widely written about and discussed in the professional world yet governance issues continually occur in many companies. You can open a newspaper or the Wall Street Journal on any single day and find instances where a company's governance processes are in question. Just recently, there was an article regarding a whistleblower for the SEC who reported improprieties with the manner in which records were maintained. In addition, the PCAOB has issued warnings to public companies regarding business conduct in emerging countries, particularly China. Another recent example that is just beginning to unfold is the Olympus scandal. Yet with all of the talk about governance, we still continually see many instances of questionable activities within the corporate walls.

In theory, governance refers to the act of governing. It relates to decisions that define expectations, grant power, or verify performance. It consists of either a separate process or is part of management or leadership processes. In the case of a non-profit organization, governance relates to consistent management, cohesive policies, guidance, processes and decision-rights for a given area of responsibility. Governance can be seen as the foundation of a company's overall control environment. Examples include: internal policies; internal governance boards and committees; external boards, internal and external audit, compliance and risk committees, etc.

It is intriguing to listen and discuss all the well-publicized instances of governance mis-steps over the past decade. Those are often examples where the violations were significant and we've learned that their advent may have been rooted in the very foundation of the culture and business actions of these companies. A past colleague recently had the opportunity to listen to an auditor who was involved in the World Com scandal discovery. He relayed to me that it was interesting to listen to this individual's chronology of the events. They were a bit different than those we've all heard and read about. The auditor indicated that he had brought concerns related to accounting issues to management many months before the actual discovery was brought to light. His recollection was that the early identification coincided with bonus incentive and salary adjustment timing and that the findings were "shelved" until a bit later in the year. Regardless of whether this recollection is indeed true, it brings to mind the concerns many compliance, risk and internal audit professionals have regarding their attempts to bring potential issues to the attention of management. Is it possible that the governance structure surrounding the evaluation of issue significance could be variable based on attributes like: where the issue exists in the organization; time of the year of occurrence or some other reason? As professionals, we would hope this isn't the case but we often find that this is a common practice.

In today's world where issue impact is often asked to be quantified related to financial performance, it is easy to minimize policy violations or specific governance discrepancies. Let's take an example: it is observed that the company's authorization policy (governance attribute) has not been updated in five years. The company's policy requires it to be reviewed annually. How big of a deal is this? It could be viewed as simply an administrative exercise. But what if the company's business has dramatically decreased in this time period? This may mean that authorities assigned are no longer aligned with the size of the business. So we've determined the cited issue is a policy or governance violation. Now let's dissect the issue further.

Company ABC has revenues of $3B annually. The CEO has been assigned an authority level of $1M for non-capital expenditures. In 2011 the company divested of a portion of its business. Revenues are now $1.5B annually. Does the Board and shareholders believe that the CEO's approval level should remain constant? There may not be a true black and white answer here. It could depend on the company's industry, the size of the organization structure or the tolerance level of the Board. In any event, the control finding that the authorization policy has not been updated may be an important issue for management to address. Still, if management requires a quantification of the impact of not having an updated and approved authorization policy, this can be a difficult task to accomplish. What do you look at? How do you quantify this type of impact? How deep do you look? And just because you may have had individuals approving items that are above what would be expected, how do you know whether these approvals should be questioned? The answer points back to the need to be able to articulate the importance of control gaps and overall governance processes. Many computations could be developed only to conclude that there has not been any improper expenditure authorized even though the authorization policy has not been updated. However, what consideration is given to what potentially could occur? In other words, the authorization policy is a governance document established to direct the level of expenditures management is comfortable with assigning to personnel. If it is not regularly reviewed, updated and adjusted; what level of probability can be associated with potential approval of expenditures outside management tolerance? This is virtually impossible to determine.
and points to some of the difficulties when trying to explain to management various issues or findings that may relate to policy violation or governance gaps.

Can you now visualize the walls that the concept of governance may create? We build these walls by establishing governing policies and processes and declare that we have a sound governance system because these things exist and the organization is supposed to operate within these walls. Now a gap in one or more of these policies has been identified. How do we measure the impact on the overall governing structure of the company? Or should we consider whether it even matters what impact has occurred, only that the gap exists and what risk the gap presents should an event occur? Possibly this dilemma is the very reason we continue to see governance mis-steps in corporate America.

Considering all of these factors, how do we effectively establish the walls of governance and ensure they are solid and can withstand unforeseeable pressures? Here are some thoughts for consideration:

**Tone at the Top**

Tone must be more than just a phrase. It must be displayed in everyday business activities and dealings. Stated corporate values like respect, accountability, shared ownership etc. must be displayed at all levels of the organization and examples should be readily noted. Things to consider when determining your company’s “tone at the top” may include:

- How visible and accessible is senior management? Is there an open door policy or is everything controlled by calendars and appointments?
- Are there significant variances within the organization when defining compensation structure, incentive pay, benefits? If so, are those variances relational to the contribution those positions provide to the organization? If not, is there proper justification for the variance?
- What working atmosphere is embedded in the organization and does the atmosphere allow for a culture of openness?
  - Are communication methods utilized by management regarding corporate strategy and growth significantly varied in the organization? If so, does this create any type of employee morale issues?
  - How do office amenities compare for individuals at different levels in the organization? If there is variation, is it considered reasonable related to the organization’s business?
  - Are there any variances for who is allowed to attend training or external events? If so, can the variances be readily supported as to their reasonableness?
  - Are there variations in travel trends and spending habits? If so, can the variance be substantiated and validated related to their reasonableness?
- What are the official protocols for communication in the organization? Are there stated or even unstated rules to follow the chain of command? If so, how is this viewed by the general employee population?
- Are employees free to verbalize their thoughts and observations openly? Is there any fear of repercussions when employees do express their opinions?
- How is change embraced within the organization? Is it encouraged and embraced or is change slow to happen? If it is slow to happen, can reasons be substantiated or is it explained away by reasoning’s such as “that is just our culture”?
- Are key decisions made in a collaborative style or dictated style?
- Are goals reasonable and achievable with all business areas being held to the same performance metrics?
- How is the code of conduct emphasized throughout the company? Are there any requirements for periodic updates to the code and re-affirmation by employees?
- Is the code readily available for employees to read? How do you know individuals understand the code?
- Are vendors provided information about the code?
- Are there employee turnover trends in certain areas of the company and if so, can the reason be justified?
- Is the corporate hotline anonymous and free from reprisal? Is it well publicized and communicated to employees? Management should consider hotline activity or non-activity when determining if the process is known, understood and utilized.

**Policies and Procedures**

Policies that exist should be enforced, monitored by management and regularly evaluated to ensure they are aligned with the objectives of the business. Distinction should be clear between documents that are considered corporate policy and those that are considered mere guidelines. Things to consider when evaluating the effectiveness of policies and procedures include:

- Does management pro-actively monitor their policies and compliance or do they wait until someone comes in to check for compliance?
- How frequently are policies updated to ensure they align with the business? Is there a central repository for policies or is there a process required to periodically certify that policies are updated?
- Are policy gaps timely remediated and appropriately evaluated to ensure the remediation was effective?
- Do individuals responsible for the policies have the appropriate authority in the company to ensure they
are properly enforced?
• Is there a reporting mechanism to ensure that policy violations are brought to the attention of the proper level of management?
• Is it clear which policies are true corporate requirements?

Internal Committees

Internal committees are established to govern particular policies. If the organization deemed the need for a committee, it should exist further than just in name. Internal Committees may be established for governance over IT processes, authorization expenditure processes, disclosure committees for financial statements, operation standard committees, safety committees etc. When evaluating the effectiveness of a committee that is established as part of the company’s governance structure, consider:
• Does the committee have a distinct purpose? Is there a charter available for the committee which outlines authority and deliverables expected?
• Is there a pre-defined membership and are attendance requirements adhered to?
• Does the committee have appropriate accountability and authority to ensure it can effectively execute its responsibilities?
• Are expected deliverables and appropriate reporting responsibilities delivered on a timely basis?
• Does a periodic evaluation process exist to ensure the committee is functioning appropriately?

External Boards and Committees

Often, governance concepts begin with these bodies. External boards and committees should ensure they are fulfilling their charters and obligations both in form and content. When evaluating effectiveness of external compliance organizations, consider:
• Are members appropriately qualified for their positions? Do they have experience and background in the business or have do they possess other aspects of knowledge that will effectively contribute to strategies?
• Are members put through some type of a vetting or qualification process prior to being considered?
• Are activities of the boards and committees evaluated for effectiveness on an annual basis? If so, how is the evaluation completed, who is involved, what happens with the results?
• Is there periodic rotation in members to ensure adequate independence and facilitate new ideas and strategies? How is the timing of that rotation established?
• What role does the board take in understanding risk management practices and corporate strategy processes?

Internal and External Audit

Both Internal and External Audit are important elements of a company’s governing structure. Of course, depending on the company, its industry, its classification of public/private/not-for-profit/governmental etc., the roles of internal and external audit can have variation. If you’ve ever reviewed benchmarking studies of internal audit groups, you will see how varied the approach can be both within industries and between industries. Much of the determining factor on responsibilities lies in how the organization views the role of the internal auditors. Some companies may require a very compliance oriented role where others have a focus on risk assurance, risk awareness and risk validation. In any case, one of the most important elements of governance is to ensure that the role of a company’s internal audit function is well-defined and understood. With the advent of internal quality assurance reviews, many functions have tried to enhance their audit charters to reflect the stated role that corresponds to requirements of the Institute of Internal Auditors. As auditors, that is where the profession is guiding the evolution of responsibilities. However, it is imperative that if charters include many broad sweeping attributes, management must have agreed and bought into the concept. As with any policy or charter document, it is important that if it is outlined that a specific action is to be executed in a particular way, the organization must have the ability to execute upon that. Internal Audit must often become an advocate for change as well as an instructor for the organization regarding the value that can be provided in accepting some of the newer direction for the function. Management and the Board must be able to clearly understand the benefits that a fully engaged Internal Audit function could provide and they must also understand the resources as well as limitations that may be inherent in evolving to that structure. If changes are warranted and agreed to, then IA must define the path that must be taken to get to that stage.

From an external audit perspective, variations in how companies manage their relationships can be as broad as how we see Internal Audit functions managed. If you work for a publically traded company, your external auditors are going to follow a much more stringent and detailed approach to their validation of the financial statements. In other instances, the auditors may be providing a certain level of assurance due to debt or bonding issues or even regulatory issues. As such, the role of the external auditors in a company’s governance structure can also be different. Some
items to consider when evaluating the effectiveness of your current arrangement with your external auditors:

- What is the primary purpose for the audit? Is it due to SEC reporting requirements, regulatory requirements or other reasons? This will often impact the depth and breadth of the work that the auditors are required to perform.
- Do the auditors have full access to individuals in the organization that they may require to obtain relevant information? This includes everyone from individuals on the Board all the way to individuals at the staff level?
- When was the last time your organization changed auditors? Is this something that should be considered to ensure appropriate independence?
- What is the relationship between the external auditors and the internal auditors? Is there clear and open access between the two? Do the external auditors receive all reports issued out of the internal audit function? What reliance do they place on these reports when performing their work?
- What level of work do the external auditors do to evaluate the potential for fraud in the organization? They are required to do the typical fraud interviews with executive management but is there any process they follow to go beyond those requirements?
- How does the fee structure work with the external auditors? Are the fees appropriately aligned with the business and the changing nature of the business?
- Are there variances in opinion between management and the external auditors on areas deemed as significant deficiencies or material weaknesses?
- What other work do the external auditors provide for the company? Has it been approved by the Audit Committee?
- What is the relationship between the external auditors and the Audit Committee? Do they meet with the Audit Chair at any time outside of regular meetings?

Compliance Program

With the new Dodd-Frank act as well as the SEC’s new guidelines on Whistleblowers and the issues surrounding FCPA compliance, many companies are scurrying to solidify their compliance programs. Yet even as this is occurring, we often see much more in the way of form over function. Just like policies, it is extremely important to have a solid Compliance Program document, but if the organization cannot support that outline, then they are creating additional problems. Some items to consider when evaluating the effectiveness of your compliance program are as follows:

- Is there a full-time Compliance Officer assigned or is this a responsibility assumed by a professional who has another full-time responsibility? If it is a part-time role, can the organization reasonably execute upon compliance requirements they are held to?
- Does the Compliance function have available resources to execute its responsibilities?
- Where does the Compliance function administratively report? Is it appropriately independent?
- Is there a compliance council to support the compliance program? Does it meet regularly? Does it have a defined membership and are the members at an appropriate level in the organization to enforce rules?
- How is the effectiveness of the Compliance program monitored?
- What type of training is utilized for the Compliance program? How often does it occur and who receives and executes the training? If the training is on-line, how is its effectiveness evaluated?
- When was the last time all employees were required to reaffirm the code of conduct and conflict of interest policy?
- Is there are separate policy for officers? If so, how does it differentiate from the policy that covers all employees?
- How is information regarding the compliance program communicated to the Board?
- What processes are in place to monitor for violations to the compliance program? Specifically, are there processes in place to evaluate for violations of FCPA, Environmental, H&S or regulatory type violations?
- What processes are in place for remediation of identified issues related to an element of the compliance program?

The above areas are not meant to be an all-inclusive list of considerations that anyone who is evaluating the effectiveness of governance should look at. However, it is a strong starting point for measuring not just the existence of governance elements within your company but the effectiveness of their execution. We must keep in mind that failures of corporate governance systems are rarely due to a policy or procedure not existing; it is more often due to non-compliance with one or more elements of the governance process.