

# TONE at the TOP

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

## A Global Perspective on Risk

*There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.*

~ John F. Kennedy

When the 35<sup>th</sup> president of the United States made this statement in the 1960s, it was prophetic of what leaders all around the world would be saying almost half a century later... Earlier this year, the World Economic Forum (WEF) released *Global Risks 2009*, a new report on economic risks resulting from the global financial crisis. And recently, the G20 Summit brought together leaders from the world's most powerful countries to discuss a plan of action designed to help mitigate the risks — financial and otherwise — that currently threaten all nations.

The WEF's risk report was published in cooperation with Citigroup, Marsh & McLennan Companies, Swiss Re, the Wharton School Risk Center, and Zurich Financial Services. The report points out the dangers of addressing immediate concerns without remedying the root causes of the problem, cautions against ignoring interconnected risks related to natural resources, and pleads for enhanced global governance. It challenges business leaders and decision-makers all around the world to focus on long-term strategies for mitigating increasingly complex and interlinked global risks.

### IT'S A SMALL WORLD.

As a result of globalization, the interconnection of countries and their various systems has rendered the world "small." Countries and businesses have built economic and societal ties across the world, opened new markets, provided services to broader audiences, generated employment, and reduced poverty. Just as globalization

has brought about these and many other positive outcomes, it has created a "perfect storm" in which blows to one economy are experienced beyond national borders — often to the far reaches of the earth. And although this is not the first time the world has encountered financial hardships, globalization plays a critical and undeniable role in the current financial crisis.

How did we get here? The path has been forecasted and tracked regularly in this newsletter — and the *tone at the top* has been one of the clear signposts along the way. Rippling from individual organizations to nations and now to the world economy, a trend of ineffective governance and lax oversight has played an undeniable role in our current dilemma. Too many have turned a blind eye to red flags, failed to effectively manage enterprise risks, and demonstrated a greedy mindset that tolerated and exacerbated unprecedented debt. And as a result, market volatility, lack of liquidity, rising unemployment, and record-low consumer and business confidence are the price we are all paying.



**Global Risks 2009 builds on the work of previous years and highlights the need for concerted action to mitigate risks that now more than ever are global in their nature and in their impact, as illustrated by the financial crisis. But the same is true for other risk areas; global risks require a multi-stakeholder response and cannot be appropriately tackled in isolation.**

- Sheana Tambourgi  
Director and Head of the  
Global Risk Network at the WEF



## THE BIG PICTURE

Clearly, global risks pose a challenge for policy-makers and business leaders alike, as no one group acting alone can mitigate them effectively. Not only will achieving solutions require intergovernmental cooperation, but also the involved collaboration of both public and private sectors.

*Global Risk 2009* examines the effects and inherent risks of the current global crisis and provides a big-picture perspective by exploring how financial risks and other risks are interlinked. The report encourages leaders to look ahead, but warns against losing sight of longer term risks. It builds the case for good governance and responsible leadership to help rebuild confidence, enable alignment across regions and industries, and encourage collaboration. By functioning in a proactive and coordinated fashion, leaders can foster cooperation across all regions, industries and stakeholder groups. And better governance at organization, country, and global levels will set the stage for these different levels to create greater certainty and trust, and will provide the framework for stable international relations.

The WEF's Global Agenda Council on Global Governance suggests the following recommendations for enhancing governance:

- Fostering greater commitment and new leadership on global issues.
- Developing frameworks for drawing on expertise and generating debate and awareness.
- Marrying public authority and regulatory capacity with incentives for private-sector innovation.
- Reforming existing institutions, such as the UN Security Council.
- Exploring new mechanisms to provide necessary resources.

## KEY Findings of the Risk Report

- Deteriorating fiscal positions.
- Decline in price of assets.
- Increasing resource-related risks due to climate change.
- Failure of global governance to mitigate global risk.
- Lack of a globally coordinated approach to regulations.
- Underinvestment in infrastructure.
- Health risks.
- Conflicts and terrorism.

**To be empowered guardians and builders of corporate value, board members must:**

- Learn and follow best practices.
- Avoid conflicts of interest.
- Pay strict attention to board matters.
- Draw on appropriate expertise, including their own.

*Director Liability: Myths, Realities and Prevention*  
— National Association of Corporate Directors

## GOVERNANCE ROLES AND RESPONSIBILITIES

The current global circumstances are extraordinarily complex. It will take time, diligence, coordination, and a systematic approach to adequately address all the inherent issues. But how can a single organization ensure that — from a micro view — it is well operated and effectively governed? What can those at the top of their individual companies do to make a positive difference?

The Institute of Internal Auditors (IIA) promulgates the core belief that, to ensure effective organizational governance, four cornerstones must operate, interact, and perform at the highest, most professional level. Those cornerstones are:



Today's governance arena requires boards of directors and their committees to be proactive, informed, investigative, and accountable. While this is good news for stakeholders, it's a wake-up call for boards and their committees. Directors need to be realistic about their personal liability under local and national law, neither exaggerating nor ignoring their exposure. Fiduciary duties — the duties of care and loyalty, and the expectation that directors will act in good faith — are still a primary source of director liability. This has not changed with recent events. However, activism has increased the risk that directors may need to defend themselves in litigation alleging such a breach.

## Audit committee responsibilities include:

- Ensuring that financial statements are understandable, transparent, and reliable.
- Ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic.
- Helping achieve an organization-wide commitment to strong and effective controls, emanating from the tone at the top.
- Reviewing corporate policies relating to compliance with laws and regulations, ethics, conflicts of interest, and the investigation of misconduct and fraud.
- Reviewing current and pending corporate governance-related litigation or regulatory proceedings to which the organization is party.
- Continually communicating with senior management regarding status, progress, and new developments, as well as problematic areas.
- Ensuring the internal auditors have access to the audit committee and encouraging communication beyond scheduled committee meetings.
- Reviewing internal audit plans, reports, and significant findings.
- Establishing a direct reporting relationship with the external auditors.

Balancing their role as advisor and counselor to management with their fiduciary duty to monitor and oversee management is challenging for most audit committees. They must communicate openly with management, carefully review information received, and challenge management as appropriate. They must not, though, play the management role.

Although the board of directors at a single organization cannot make a significant impact on solving the current global crisis, it can and should ensure effective governance at home. Also, it can and should ensure that the internal auditors are empowered to bring their knowledge and expertise to the governance table. The audit committees must understand the role and value of the internal auditors if the two groups are to work effectively and share a healthy interdependence. This understanding and empowerment positions the internal auditors to provide independent and objective assessment of the enterprise-wide risks and the effectiveness of the controls designed to mitigate those risks.

Whether working toward enhancing governance on a global scale or simply working to improve the governance of a locally-owned company in a small town, those at the top have an opportunity that should not be overlooked. And whether the task at hand is to focus on the micro- or macro-level, today's leaders in private and public sectors have their work cut out for them. Now, more than ever, is the time for demonstrable accountability and decisive action.

## As they fulfill their governance role, members of the board's audit committee should be most concerned about:

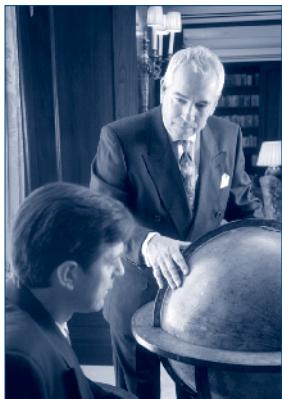
- **Financial Accuracy** – completeness of financial disclosures, significant business and accounting policy changes, correct and truthful reporting, and interim reviews of financial statements.
- **Risk Management** – an enterprise risk management process, such as COSO's *Enterprise Risk Management – Integrated Framework* should be implemented.
- **Control Assessment** – audit committee members must have upfront involvement and an understanding of management's process for assessing internal controls.
- **External Auditor Oversight** – the audit committee should own the relationship with the external auditors, who provide an annual opinion on the financial statements.
- **Effective Use of Internal Auditing** – Internal auditors and the audit committee are interdependent and should be mutually accessible. The internal auditors should provide objective opinions, information, support, and education to the audit committee; and the audit committee should provide validation and oversight to the internal auditors.

# TONEattheTOP

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## Mission

To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and

responsibilities for, the internal audit activity.

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Established in 1941, The IIA is an international professional association with global headquarters in Altamonte Springs, Fla. The IIA has more than 160,000 members in internal auditing, risk management, governance, internal control, IT auditing, education, and security.

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