Auditing in the 21st Century

BY DUKE OKES

Personal competence and integrity are as important as ever.

SOME FOLKS (THIS AUTHOR INCLUDED) believed the 21st century offered the potential for mankind to step away from the horrors of the 20th century and before. That is, we believed that perhaps we were beginning to mature in ways that would allow individuals, organizations and society to operate in more humane and ethical ways, bringing the visions of many from the past into fruition.

But then we saw the collapse of Enron and WorldCom, and more recently the failures of Fannie Mae and Freddie Mac, many large banks, mortgage companies and rating agencies. The list goes on, but it would not be complete without including the havoc wrought by Bernard L. Madoff. It appears the first decade of the 21st century has destroyed many lives, both present and future, mostly due to greed and lack of ethics.

Management systems such as the *AISC Standard for Bridge and Highway Metal Component Manufacturers* are intended to prevent failures of critical organizational processes by defining the processes that should exist as well as some aspects of how the process should work. Audits are then intended to detect whether or not the processes are well implemented, and take corrective action to address any deficiencies. The management review process then provides the highest level of accountability by ensuring that corrective actions are adequately addressed.

Systems were in place in the aforementioned organizations, and audits were also being conducted. In the case of Freddie and Fannie there was even the Office of Federal Housing Oversight (now renamed Federal Housing Financing Agency) whose sole role was to ensure these two organizations operated appropriately. So what happened? In many cases, perverse incentives and slow, gradual deviations built up to become large systemic failures.

Cynthia Cooper, former vice president of internal audit at WorldCom, describes her experiences in finding and reporting major financial reporting problems in her book *Extraordinary Circumstances*. It should be required reading for anyone involved, internally or externally, in any type of auditing. While the focus is on audits of financial accounting and reporting systems, the lessons are just as relevant to other management systems (e.g., quality, safety, environmental).

Management systems can begin to slip especially when things aren't going as desired and there is pressure to make them "right." Also, during restructuring, downsizing and/or to cut costs, organizational resources may be constrained in ways that (at least implicitly) indicate that shortcuts have to be made. Variances might include reducing margins for error in product/process design, ignoring certain legal/regulatory/contractual requirements believed to not be critical, and/or increased management overrides of decisions.

The intent of audits is to detect variances from policies or procedures and to identify any processes which are not meeting objectives and have no related action plans. Auditors should then not just look at a single audit, but also for trends across audits. If a significant shift in compliance or performance (either positive or negative) is observed, further digging should be done to determine what led to the change. Internal auditors within your organization should be especially vigilant after any significant change in organizational structure, resources, products or processes.

Auditors should never accept the findings from a single source for assessing the process. Effective auditors triangulate data from interviews, observations and reviews of records in order to gain confidence in the degree of compliance or noncompliance. Even though it requires more effort, it is generally better to do a deep audit than a shallow one. Use of a statistically based sampling scheme should be considered when auditing critical processes.

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The internal auditor must also be careful of messages inadvertently given to coworkers during the audit. For example, suppose a process owner indicates that an issue that was found is minor and will be fixed, but prefers that "you not document it as part of the audit findings." Accepting such a request communicates the wrong thing to the process owner both about the audit process and the internal auditor.

It is most helpful if your internal quality auditors are trained in auditing principles and practices. However, it is most critical that they are extremely well versed in the requirements of the management systems to be audited. In addition, they should familiarize themselves with auditing standards such as ISO 19011, which describes not only the methods of auditing but also the personal attributes of effective auditors. The personal credibility of an auditor will have a significant impact on his ability to gain and report the necessary information.

Auditors are of course subject to pressure from management. However, in addition to auditing standards, there are several resources available which might help them. The lead auditor or audit manager is the most logical place to go first. It is hoped that most auditors will never need to seek such channels, but they exist specifically for helping ensure effective governance of the organization.

Personal barriers also may affect whether or not internal auditors are willing to do what is right. One is how well the individual can relate to and communicate with management. How the individual views personnel in management, as well as management's attitude toward quality, auditors, etc., will affect his degree of personal confidence. Another, of course, is how willing he is to do the right thing, regardless of the consequences. The author was recently impressed hearing of an engineer who refused to sign off on defective parts, even though it meant he would lose his job. Auditors are there to report whether or not processes comply with requirements, and to not do so is a professional and ethical lapse. Such lapses impact on self, the profession, the company and society. MSC