

## CORPORATE GOVERNANCE AND A PROGRAM FOR COMPLAINTS RELATING TO ACCOUNTING, AUDITING, AND INTERNAL CONTROL

Janet L. Colbert\*

### Abstract

Complaints relating to accounting, auditing, or internal control matters may periodically be received by corporations. Such matters may be submitted by a variety of parties including employees, vendors, customers, or others. Organizations should have in place, as a part of effective corporate governance, procedures for handling complaints. The Board of Directors, specifically the Audit Committee of the Board, should oversee the program, which is encompassed within the broader overall system of internal control. Management plays an important role in a corporate complaint program and both internal and external auditors can provide the Audit Committee with valuable information as that body monitors it.

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\*Eastern Kentucky University, USA. E-mail: jan.colbert@eku.edu

### Introduction

Corporations may periodically receive complaints regarding accounting, auditing, or internal control matters. Employees, vendors, customers, or others might submit issues of concern to the entity. As part of an effective corporate governance program, the Board of Directors, representing the shareholders, should have in place procedures for handling such matters.

### The Importance of a System for Complaints

The Board of Directors, specifically, its Audit Committee, has, as one objective, the issuance of fairly stated financial statements. An audit, required for many organizations, is a costly endeavor. The Audit Committee should continuously strive for ways to manage the cost of the external financial statement engagement. A program which enables the organization to receive complaints regarding accounting, auditing, and internal control matters allows it to address significant problems in a timely manner. Such an approach is proactive, permitting the corporation to appropriately handle such issues before the auditors discover the matter. In turn, this methodology helps to keep costs down.

Besides a report on the financial statements, the organization may engage the external auditors to opine on the effectiveness of internal control. Because a complaint program is part of the overall system of internal, its design and operation will be subjected to scrutiny by the external audit firm. Thus, the Audit Committee should stress to management the significance of an appropriately designed complaint program as well as its effective operation.

A final reason why a system to handle accounting, auditing, and internal control complaints is important is that legislation may mandate such a program. For example, the Sarbanes Oxley Act in the United States specifies that the corporation have in place a system to handle complaints.

For these reasons, the Audit Committee should operationalize a strong program to receive accounting, auditing, and internal control related complaints. Besides the receipt of complaints, the system should encompass their processing, as well as reporting to the Audit Committee on the ultimate disposition of such matters.

### Management and Internal Control

As noted, the program which the corporation establishes to handle complaints regarding accounting, auditing, and internal control matters is one part of the organization's system of internal control. Therefore, when management of the organization is designing its system internal control, the complaint program should be included. Also, evaluations of internal control by management should encompass the program for handling complaints.

As the management team works with internal control, it needs to be aware that both the internal and external audit groups are likely to test the process for handling complaints. This is because of the significance of the complaint program to the overall system of internal control. Therefore, managers' tests of internal control may be scrutinized by the audit teams.

Management is responsible for the design of the system of internal control. To monitor the system, its effectiveness is periodically tested. Management may elect to examine internal control or an internal evaluation might be mandated. Also, an opinion on

internal control by management could be required by law or regulation. If an overall opinion on internal control is to be presented, testing is typically performed by various levels of managers. Top level management then integrates the results of the internal control tests from the various parts of the entity and presents an overall assessment as to the effectiveness of internal control.

Management should communicate frequently with the Audit Committee as the complaint system within the overall system of internal control is operationalized and as it processes complaints from employees, vendors, customers, and others. The governance body wants to ensure that all complaints are taken seriously and are handled with professionalism. Also, the Audit Committee will want to be sure that upon resolution of the complaint, appropriate communication to both the complainant and to the Audit Committee occurs. Management is responsible for instituting a process to ensure that these actions are taken.

A section of the complaint program should specifically provide for whistleblower protection to the complainant. This is a critical aspect of the program if the organization is truly committed to eliciting complaints regarding accounting, auditing, and internal control issues.

Another part of the complaint process should prohibit the destruction of documents, whether electronic or hard copy, which may be pertinent to the investigation of a complaint. The complaint program should either reference an existing document retention policy or include in the complaint policy guidelines for the organization in regards to retaining documents which may be relevant to a complaint.

Still another section of the program should address complaints regarding acts by the entity or its employees which have the potential to be illegal. While many issues may fall in a gray area, others are more likely to constitute illegal activities. Thus, specific attention to such potentially explosive matters is warranted in the complaint program.

### **The Auditors and the Complaint Program**

Both the internal and the external audit groups will provide valuable information regarding the complaint program to management and the Audit Committee. Because the objectives of the two sets of auditors differ, the information given by each will also vary. Information from both groups of auditors aid management and the Audit Committee as they either establish and monitor a program for complaints or seek to improve a process already in existence.

#### Internal Auditors

The internal audit group can aid the Audit Committee and management by taking an active role in the establishment and audit of the complaint program. Besides providing suggestions when the organization is setting up a system to handle complaints, the internal auditors should test the

operation of the system. Further, based on the results of tests of the program, this internal group can develop recommendations to present to the Audit Committee regarding improvement in the design or operation of the system.

An organization may have an established program to handle the receipt, investigation, and disposal of accounting, auditing, and internal control complaints. The internal audit activity will then likely perform a baseline audit. The Audit Committee can use the results to institute improvements in the program. Some organizations will not have a system to handle complaints in place. The internal audit function may find that its first task is to convince the Audit Committee and management of the importance of a complaint program. Recommendations regarding the appropriate design and operation of a system to handle complaints can then be made. As the organization implements the program, the internal auditors might be called upon to aid in training management and employees as to its operation.

Focusing the training to the specific group within the organization helps the employees to comprehend the program. This will aid in the acceptance and appropriate handling of issues processed through the complaint program. When training employees, the internal audit group should emphasize the importance of maintaining confidentiality throughout the entire complaint process. Besides the actual complaint policies and procedures, the perception of confidentiality and anonymity are critical to assuring that the complaint program is utilized by employees and others.

The internal auditors should stress to the Audit Committee and management that while the receipt of complaints is significant to the success of the complaint program, two other aspects are also critical. That is, complaints must be appropriately investigated and disposed of. Further, each of these steps, along with the design of the system, must be documented. Individuals and departments with responsibilities for each of the parts of the complaint program are tasked with documenting both the design of the system and reported activities within their section. The internal and external audit groups are likely to find such documentation of interest.

At periodic intervals, the internal auditors should examine the entire complaint program. The internal experts will provide assurance to the Audit Committee that the program is well-designed and that it is operating effectively. The receipt of complaints and their subsequent investigation will be included in the internal audit examination. Also, the disposition of complaints, which includes any reporting to the Audit Committee and management, will be examined by the internal auditors. Finally, the retention of records for all aspects of the program will be examined.

#### External Audit

As part of its audit of the financial statements, the external audit firm considers the client's system of

internal control. Further, an engagement to present a separate opinion on internal control might be performed by the external audit firm. Regardless of whether an audit of the financial statement or of both internal control and the financial statements is being performed, the external auditor will be considering the client's system of internal control. The program covering accounting, auditing, and internal control complaints will most likely be included.

When auditing internal control, the external experts may elect to evaluate any part of the complaint program. For example, the design of the system to handle complaints might be examined by the independent audit firm. The external group might also test to determine if the complaint system has been placed in operation. Further, an evaluation of the documentation pertaining to the receipt of accounting, auditing, and internal control complaints is likely to be performed. Records of the investigation of complaints and the resulting actions taken will also likely be included. Finally, tests to determine whether documentation of the receipt and investigation of complaints is retained and whether communications to the Audit Committee and management are appropriate are likely to be the subject of examination.

As the audit firm evaluates the client's internal control, its members will likely be making inquiries of management regarding the operation of the complaint program. Since management is responsible for the system of internal control, which encompasses the complaint program, questioning various members of management is helpful to the auditor. Thus, as part of its audit of controls, the external audit firm may make inquiries regarding the complaint program. Also, tests which members of management have performed related to the complaint program might be considered.

In any country, the external auditor is interested in possible illegal acts committed by the entity or its employees and the potential impact of such matters on the financial statements. Auditing standards, regardless of jurisdiction, typically require the external auditor to consider the possibility of illegal acts. Also, laws and regulations, including the Private Securities Litigation Reform Act in the U.S., may specify that the external audit firm must communicate with the Audit Committee regarding possible illegal acts. Further, communication with management as to possible illegal acts may be required.

The outside auditor will evaluate remedial actions taken by either management or the Audit Committee which pertain to possible illegal acts. If such remedial actions are not deemed satisfactory, the external audit firm should consider notifying the Board of Directors. The Board may be required by statute or regulation to communicate with regulatory authorities regarding the issue.

The accounting, auditing, and internal control complaint program may provide information which results in the discovery of possible illegal acts. Further, if an effective complaint program for handling accounting, auditing, and internal control

matters is not in place, that situation may be a possible illegal act, depending upon the laws of the jurisdiction. Thus, because of the discovery of possible illegal acts via the complaint system or the absence of an effective complaint program, the external audit firms tests of internal control should encompass the complaint system.

#### A Cooperative Effort

The internal auditors may be asked by the Audit Committee to evaluate the entity's complaint program. The Committee, as well as the external auditors, may be interested in the evidence gathered by the internal auditors and in their conclusions. The two groups of auditors may wish to work together to evaluate the complaint program, as well as the entire system of internal control. The Audit Committee should encourage such a cooperative effort, as this contributes to an efficient and effective total audit effort.

#### **Reporting to the Audit Committee**

The Audit Committee will be receiving reports regarding the complaint system from both the internal audit group and the external audit firm. The report by the internal auditors will differ from that of their external colleagues, thus providing the governance group with two perspectives. This is because the objectives of the two sets of auditors differ.

The objective of the internal auditors is to add value to the entity. Armed with the results of its evaluation of the system of complaints, the internal auditors can make recommendations for improvements to the system for complaints. The recommendations can then be passed along to the Audit Committee for its consideration. The suggestions help the Audit Committee members as they monitor the complaint program and work to improve it.

The external audit objective is to present an opinion on the fair presentation of the financial statements for use by those outside of the entity who are typically making financing decisions with regards to the entity. As part of the consideration of internal control by the external auditors, the program for handling accounting, auditing, and internal control complaints is examined. Like their internal counterparts, the external auditors report findings to the Audit Committee.

The roles of the internal and the external audit teams related to the complaint program are summarized in the Exhibit.

**[Exhibit about here]**

#### **Conclusion**

In its governance role, the Audit Committee of the Board of Directors has a significant interest in complaints regarding accounting, auditing, and internal control issues received by the entity. Both the

internal and external auditors can provide valuable aid to the Audit Committee in relation to the complaint program.

The internal audit team might perform a baseline audit of the program. Further, the group can help to educate both the Audit Committee and management as to their respective responsibilities regarding complaints. The internal auditors might also aid in training employees. Internal audits of the complaint program should be performed. Any resulting recommendations are presented to both the Audit Committee and management.

Besides the internal group, the external auditors oftentimes examine the complaint system as well. This examination is likely encompassed in the evaluation the overall system of internal control. The findings from the external auditors are presented to the Audit Committee and to management.

Armed with reports from both sets of auditors, the Audit Committee can take any actions it deems prudent in relation to the complaint program. An effective program will ultimately aid the Audit Committee in its quest for fairly stated financial statements and effective internal control.

## **Exhibit**

### **The Audit Teams and the Complaint Program**

#### **Internal Audit Team**

- Perform initial examination of the complaint program
- Train management and employees as to policies, procedures, and the operation of the complaint program
- Perform periodic examinations and report to Audit Committee and management
- Develop and present recommendations for improvements in the program to the Audit Committee and management

#### **External Audit Team**

- Examine the program for handling complaints as part of the examination of internal control
- Report findings to the Audit Committee and management