Board Smart

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VERIFY THEN TRUST

By Rick Funston, CEO, Funston Advisory Services LLC, and Board Smart LLC and Jon Lukomnik, Managing Partner, Sinclair Capital

> *"Trust, like reputation, is gained in inches per year and lost in feet per second."*

Effective governance is essential to organizational adaptation, survival, and success. This is the sixth and final article in a series about how to improve governance and board effectiveness through the exercise of the powers reserved for the board. This article describes four leading practices to help improve the board's responsibility and power to "verify and then trust."

1. **Obtain reasonable executive assurances and constructively challenge**
2. **Obtain independent verification that information and reports are reliable**
3. **Ensure the system of internal control is effective**
4. **Obtain outside independent advice and counsel as needed**

It may seem ironic but who and what can trustees trust? "Verify then trust" evolves from the old Russian proverb "trust but verify." The reason for the evolution is simple and two-fold.

First, if you trust before you verify, you assume that verification will happen, but it may not or could be significantly delayed or diminished.

Second, trust is the result of repeated trust-building actions among the board and between the board and management so that all can reasonably rely on each other.

The logical outcome of repeated verification is trust. You may end up trusting, but you should always verify first and always. Trust is slowly earned because it can be so quickly lost.

Reasonable but not absolute assurance

The board should be reasonably assured by management and independently reassured by others that there are capable people, processes, systems, and resources in place to achieve the expected performance and manage related risks.

The board should also ensure that the reports received by the board and issued on behalf of the board are reliable by ensuring there is an effective system of internal control.

The board should be promptly informed when there are issues that require correction and where board direction and policy setting involvement is required. The board can and should also retain independent advisors and seek independent reassurance about the reliability of management's reports. These include internal audit and external, financial auditors, consultants, counsel, and other third-party "experts." Such reasonable assurance and independent reassurance are only prudent.

Verify then trust is essential to the prudent and effective exercise of oversight. This means the board obtains verification from those independent of management that management's reports are reliable. Such trust is hard-earned over time but can be quickly lost.

Challenge constructively.

Repeated verification builds trust.

Verification is a very important function provided internally by internal audit and externally by the independent auditor, consulting actuaries, general investment consultants, fiduciary counsel, and other third parties who are retained by the board specifically for this purpose. All should report directly to the board (functionally, though perhaps not administratively) to ensure their independence.

The meaning of verification

To verify means to make sure or demonstrate that something is true, accurate, or justified. Verification is how the board ensures that reports and assurances from others are reliable.

Verification is embedded in all the board's powers to conduct, approve, set, and oversee and is key to the board's confidence in management because conventional boundaries of trust have been and will continue to be challenged.

The role of the board and its committees

The board and its committees rely on management-provided information and analyses for direction-setting and oversight. For the relationship to work effectively and efficiently, the board needs to trust, i.e., have confidence in management's representations.

As discussed in the fifth article in this series, "Oversee Execution," to reduce information overload, reports to the board should be exception-based, i.e., that performance is as expected i.e., "normal" or in the "green" unless otherwise notified. Exceptions should then be escalated for board attention. Exception reporting for oversight is a leading practice but relies on the board having justified confidence that the information provided is reliable. One reason some directors seek voluminous details is a lack of trust in the information. While there is a need for both oversight and verification, trying to exercise both powers simultaneously can result in doing them both poorly.

Trust will be severely damaged if it turns out that the actual performance was not as expected despite management's reasonable assurances. This is why the board and its committees need to constructively challenge management, ensure there is a robust system of internal control, obtain independent reassurance, and seek additional advice and counsel as needed.

1. Obtain reasonable executive assurances and constructively challenge

The role of management

It is the role of management to provide the board with reasonable but not absolute assurances that the information presented can be relied upon. The board should expect that management will provide reasonable assurance concerning all assertions and reports provided.

Reasonable reliance on others

Every person who offers services to another assumes the duty to exercise such skill as they possess with reasonable care and diligence. In those cases where specific skill(s) is required, it is understood the person will possess the degree of skill commonly possessed by others in the same employment. In good faith, no one, whether skilled or unskilled, can guarantee success or be error-free. They are not infallible. However, they "are liable to the employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment."[1]

According to Keith Johnson, former Head of Institutional Investor Legal Services at Reinhart Law, "Trust law, including the Uniform Prudent Investor Act and Uniform Management of Public Employee Retirement Systems Act, provide that trustees are exonerated from liability for acts of a delegate that has been prudently selected, instructed, and monitored."

By satisfying itself with management's competence and the due diligence management used in preparing the presentations, the board is laying the groundwork for acting (or not acting) based on the information and assurances received.

Reasonably rely on others.

Absent such satisfaction, the board would be in the untenable position of either acting on information that it did not trust or, perhaps worse, attempting to collect the information itself.

This would both overstep its role and be impractical. In other words, constructively challenging management enables reasonable reliance on that same management. See the fourth article in this series "Approve Key Decisions" for a discussion of the essential elements of due diligence.

Importance of professional skepticism and constructive challenge

The board should be professionally skeptical. The American Institute of Certified Public Accountants (AICPA) defines professional skepticism as "an attitude that includes a questioning mind and a critical assessment of audit evidence."[2] In addition to questioning, being professional means that such questioning is done without emotion, rancor, or being adversarial, i.e., constructively. The purpose is to ensure a thorough understanding and assess the reliability of information for decision-making and oversight.

As discussed in the third article "Set Direction, Then Prudently Delegate," authority can be delegated but not the responsibility for oversight and verification. This includes the board's responsibility to thoughtfully question delegates. This retained responsibility raises the importance of effective questioning and constructive challenge by the board.

Another reason for constructive challenge, beyond forging a common understanding, is that it helps form the legal and logical basis for the board to prudently and reasonably rely on management's representations and information. In the end, a lack of constructive challenge and professional skepticism hurts everyone.

2. Obtain independent verification that information and reports are reliable

The role of the audit/risk committee

As noted in "Set Direction, Then Prudently Delegate" and "Oversee Execution," committees perform research to obtain a deeper understanding of areas within their purview and then report, oversee performance, and make recommendations to the board. When it comes to "verifying," the audit committee has a leading role.

Traditionally, audit committees are responsible for the board's oversight of the completeness and accuracy of the enterprise's financial statements. This overarching responsibility also means the audit committee must:

- Engage and oversee the external auditor
- Approve the external audit plan
- Approve allowable audit and non-audit fees from the external auditor
- Ensure the enterprise has an adequate system of internal control
- Ensure the enterprise has adequate disclosure controls

- Supervise internal audit and approve the internal audit plan
- Make sure the internal audit function is adequately resourced and is compliant with professional standards
- Approve the compensation, hiring, and firing of the chief audit officer

However, as extensive as those responsibilities seem, they have expanded in recent years. The most obvious example is that many audit committees also oversee both operational risk and compliance.

Caution should be exercised to prevent the audit committee from becoming so overloaded that it is unable to perform its vital oversight and verification functions. The same is true for other committees of the board as they too have oversight and verification functions.

Get independent opinions.

As with the board and its external advisors and assurers, the leading practice is for the audit committee to have executive sessions with the external auditor, internal auditor, and if so charged, the head of compliance and operational risk management.

Role of Third and Fourth Lines

Role of internal audit

The Institute of Internal Auditors defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."[3]

Internal audit strengthens governance, risk management, and verification through risk-based audits that provide reassurance and insights into the organization's critical processes and structures. As risks grow and become more complex, internal audit's role should expand in areas such as governance, cyber-security, culture and behavior, sustainability, and other non-financial reporting measures.

Given the complexities and rapid changes in 21st-century governance, including risks created by new technology, geopolitics, cybersecurity, and disruptive innovation, a vibrant and agile internal audit function can be an indispensable resource supporting sound governance.

As noted, internal audit should report functionally to the board or audit committee and administratively to management.

One mistake made by some organizations is to misuse internal audit, focusing on compliance rather than risk-based audits of processes, procedures, and controls. While the reason for this is clear – an organization has an issue and wants internal audit to clean it up – the reality is that using internal audit as a compliance SWAT team puts internal audit, and the entire enterprise, in a reactive posture.

Internal audit is not a compliance function. The Institute of Internal Auditors' (IIA) defines compliance as "adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.[4] "Compliance is a line management responsibility reporting ultimately to executive management."[5]

Assigning internal audit resources to compliance both compromises the integrity of the internal audit function (since compliance reports to management) and makes it more difficult for internal audit to determine if control systems are adequate to perform their tasks.

A correctly focused internal audit function effectively verifies the information presented to the board by testing whether the information gathering, filtering, and reporting systems are reasonably designed to present accurate and reliable information.[6]

Role of independent external auditors

External auditors perform several key verification functions. Most obviously, they issue an audit opinion as to whether or not the financial statements are accurate according to the relevant accounting standards. The standards can vary by jurisdiction. However, no matter what the auditors pronounce, the financial statements are those of the enterprise, and so the directors are legally accountable for them. Given that liability, independent auditors serve a highly valued verification function.

> System of internal control must be effective.

External auditors are also called independent auditors. When considering what makes an auditor's opinion worthwhile, there are several factors, including professional standards, training, and expertise. But independence outweighs them all. Therefore, auditors must maintain their independence from the enterprise and report only to the board (usually through the audit committee).

While verification of the financial statements is their highest-profile responsibility, external auditors can and do perform other verification functions and can perform other audit functions such as those provided by internal audit, but they should not perform consulting functions.

External auditors also have a legal obligation to "read and consider" other information disclosed by the organization, though the auditors generally will not test that information or formally opine on it unless contracted to perform an "agreed-upon procedures" review.

3. Ensure the system of internal control is effective

As noted earlier, a key responsibility of the board is to ensure there is an effective system of internal control and to obtain reasonable but not absolute assurance from management that critical controls are working as expected. Again, verification is critical to the use of exception-based reporting, i.e., normal performance is as expected and can be relied upon by the board.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines a system of internal control as "the policies combined with procedures created by management to protect the integrity of assets and ensure the efficiency of operations…. Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."

COSO has provided guidance on five components of internal control:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring Activities

4. Obtain outside independent advice and counsel as needed

One of the evolutions in governance is that the board today enjoys the ability to hire its own independent consultants and counsel as needed. Just a generation ago, that was not common; consultants and counsel were hired by management, even when the need was to counsel the board. That practice created conflicts and did not encourage independent advice. It also was less useful in verifying information and analyses provided by management.

While there may be many reasons for the board to retain various consultants besides external auditors, from board education to gaining access to specialized expertise, most of those consultants do not fall into "Verify" but rather relate to the other powers reserved.

In conclusion, "Verify" may not initially appear the most noteworthy of the powers reserved for the board. However, without it, the other four powers reserved don't work very well… if at all. Verification, done correctly, engenders trust and provides a robust foundation of accepted data and analysis that forms the basis for the board to exercise its independent judgment.

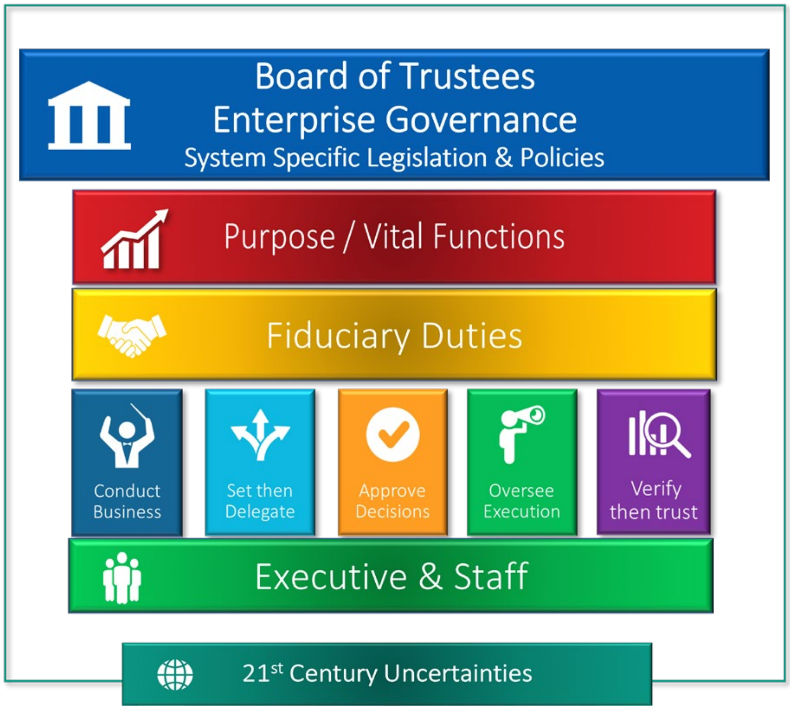
> "Verify then trust" is the ounce of prevention that is worth a ton of cure.

Summary

This, the final article in this series, has described some of the verification challenges faced by boards and four leading practices to help improve the board's exercise of its responsibility and power to "verify and then trust."

Overall Conclusion

This six-part series has described some of the governance challenges faced by public retirement system boards and provides an overall enterprise governance framework to practically apply lessons learned. The goal of the series and the enterprise governance framework is to accelerate trustees' understanding of how to improve their effectiveness, especially in times of uncertainty.



We covered a wide range of topics to provide the reader with a sense of the changing governance landscape and some leading practices. Many of these topics require further discussion beyond that which can be covered in a series of short articles. We hope the series has stimulated your thinking and contributed to some ideas on how to improve the effectiveness of your board.

[1] D. Haggard, Cooley on Torts,472(4thed.,1932). Footnote added, effective for audits of financial statements for periods ending on or after December 15, 1997, by Statement on Auditing Standards No. 82.

[2] SAS No. 1, Section 230; SAS No. 41; SAS No. 82; SAS No. 99; SAS No. 104.

[3] https://www.theiia.org/en/about-us/about-internal-audit/

[4] ibid.

[5] 2017 Guidance for the Compliance function FINAL.pdf (iia.nl)

[6] IIA Position Paper. Internal Auditing's Role in Corporate Governance extension://efaidnbmnnnibpcajpcglclefindmkaj/viewer.html?pdfurl=https%3A%2F%2Fna.theiia.org%2Fabout-ia%2FPublicDocuments%2FInternal-Auditings-Role-in-Corporate-Governance.pdf&clen=569755