

## The internal auditor's perspective

### About this document

The Audit Committee Leadership Network (ACLN) is a group of audit committee chairs from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*InSights* is produced by Tapestry Networks to provide assessments of key issues of interest to audit committees. Initially, *InSights* will be distributed to network members who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

### Why the internal auditor's perspective?

One Audit Committee Leadership Network member described internal audit as “*a window into the whole company.*” Although the Sarbanes-Oxley Act put the audit committee's reporting relationship with external auditors on a new footing, there was no equivalent change in the committee's relationship with the internal audit function. Members are looking to understand how internal audit works with management, the audit committee, and the external auditors.

In order to better understand the nature of the internal audit function, Tapestry Networks conducted discussions with the chief audit executives (CAEs) of eleven internal audit functions, drawn primarily but not exclusively from corporations represented by members of the Audit Committee Leadership Network:

- Kate A. Asbeck, Senior Vice President and Corporate Controller, Corning
- Gene Bastedo, Vice President of Internal Audit, FedEx
- William Bojan, Vice President of Business Risk Services and General Auditor, UnitedHealth Group
- Hugh Donnelly, Vice President, Corporate Internal Audit, Pfizer
- Richard Gourlay, Vice President and Chief Auditor, Manulife Financial
- Richard Hudson, Vice President, Director of Audit Services, Texas Instruments
- Katy McCarthy, Vice President, Corporate Audit Staff, General Electric Company
- Chuck Pfister, Vice President, Internal Audit, The Home Depot
- Norman Tsacalis, Vice President, Internal Audit, Viacom
- Steven J. Vonderhaar, Vice President and Chief of Internal Audits, The Coca-Cola Company
- Jacqueline Wagner, Senior Vice President, Chief Operational Risk Officer and General Auditor, American Express, and former Chairman, Institute of Internal Auditors



Over the course of these discussions, it became clear that there was no single best practice in internal audit. Instead, there were several successful models being used to deliver internal audit services. This issue of *InSights* has been developed to help internal auditors and audit committee chairs understand and question:

- The range of services that are provided by internal audit and the evolving role that internal audit plays in an organization
- The interaction between internal audit and other important corporate activities, including compliance, risk management, operational improvement, and management development
- The complementary roles of senior management, the audit committee, the internal audit function, and the external audit firm in managing risk and ensuring adequate financial and process controls

### Executive Summary

- **Creating added value from the internal audit function does not necessarily require increasing the breadth of services** (*Pages 2-4*)

The scope of internal audit's role reflects a conscious or unconscious set of choices about the range of services and delivery methods requested by management and/or the audit committee. Because of the increased value placed on basic assurance activities in recent years, some internal audit departments' functional scope has become narrower rather than broader.

- **The precise mix of value-added internal audit services depends on context** (*Pages 4-5*)

The internal audit service mix is shaped by management philosophy, industry risk profile, operational complexity, corporate priorities, and assessments of internal and external capabilities. Audit committees and senior executives need to understand the implications of their decisions for both long- and short-term staffing, risk management, and audit objectivity when defining the role of the internal audit function.

- **Internal audit's relationships with its key stakeholders are not evolving uniformly** (*Pages 6-7*)

Internal and external auditors work together closely, and some CAEs feel that their roles are becoming even more aligned in the wake of Sarbanes-Oxley. However, other CAEs in our sample report that because of earlier changes in the business environment (reactions to Enron, for example), the relationship between the internal audit function and the audit committee had already changed and was therefore largely unaffected by Sarbanes-Oxley.

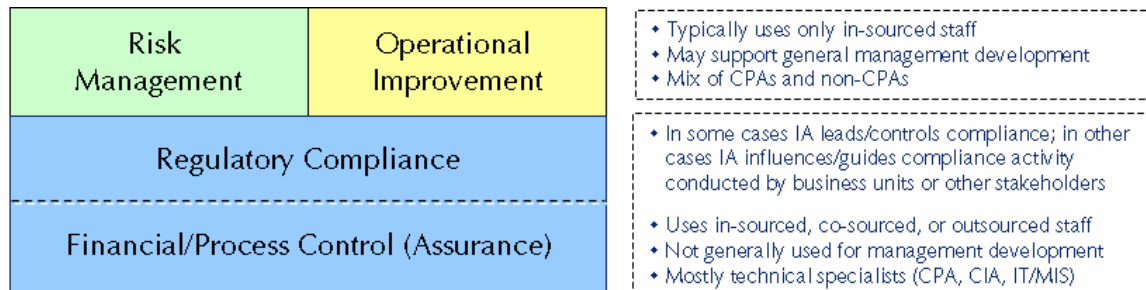
### Creating added value from the internal audit function does not necessarily require increasing the breadth of services

Although all the internal audit groups we talked to were charged with ensuring the integrity of financial and operational controls, several have a much broader set of responsibilities. At these companies, internal audit is a key contributor either to the larger enterprise risk management strategy or to a wide range of operational process improvements.

An operating model emerged in the course of our discussions, reflecting the choices in service area and delivery method (see Figure 1 below). The baseline level includes those financial and process control assurance functions that one CAE described as “*the bread and butter of internal audit.*” In addition, internal audit often has responsibility for ensuring compliance with laws, regulations, contracts, and policies.

While all internal audit groups deliver a mix of assurance and compliance-related services, there is far less uniformity in the choice of additional value-added services related to risk management or operational improvement. Senior management or the audit committee can decide that the function should deliver each of these services in the same way as the baseline services, in a different way, or not deliver them at all.

**Figure 1. Operating Model for Internal Audit**



### Some companies are narrowing internal audit’s scope

While CAEs speak often about continuing to add value, there is some disagreement about the optimal source of that value. Rather than broaden their services to include risk management or operational improvement, some CAEs feel they can support their mission most effectively by delivering on a focused set of compliance and assurance-related activities. This avoids spreading resources too thinly. It also recognizes the fact that “*bread-and-butter*” work has taken on increased value post Sarbanes-Oxley.

At some companies, the narrower focus reflects a change in long-term orientation. At others, it is a short-term response to immediate needs. For example, one CAE called 2004 “*The Year of Finance,*” on the understanding that internal audit will return to a broader focus in 2005.

### Internal audit may be objective ... but can it be independent?

It is not clear who owns the final responsibility for defining the scope of the internal audit function. Does management propose a set of services for the audit committee to approve, or does the audit committee define a set of outcomes and ask for management’s support in securing the necessary resources? Although CAEs often report directly to the audit committee, one ACLN member observed, “*They have to feel they report to the audit committee, but in the real world they are going to be given resources by management. They truly still do work for the company, so we can’t constantly put them at odds with the company.*”

This notion of the “real world” is an interesting one to consider, as it raises an important question. On which side of the “bright line” between the board and management does internal audit fall? If the audit

committee and management envision different roles for internal audit, which has the final say? In the real world, can an internal audit function that depends on management for resources ever be truly independent?

### **The precise mix of value-added internal audit services depends entirely on context**

Some CAEs described a philosophical pendulum that has swung back and forth between a strict focus on financial and operating controls and a broader, more consultative, role supporting operational improvement. Given that internal audit functions often see themselves as *“the only department with global access to the business,”* some CAEs believe internal audit is ideally placed to promulgate best practices throughout the organization.

Audit committees, senior management, and internal auditors make many choices in structuring an effective internal audit function. These choices are impacted by factors that include differences in management philosophy, industry risk profile, operational complexity, and assessments of internal and external capabilities.

#### **Compliance**

Internal audit often supports not only regulatory and legal compliance, but also compliance with contracts and corporate policies. Of most immediate concern for many CAEs are the new requirements under Sarbanes-Oxley, including Section 404. Some internal audit groups have taken an active role leading and executing the compliance program. Others have taken a supporting role, developing templates and running pilot programs before passing ongoing program management over to business units.

While there are some obvious one-time costs of compliance with Section 404, requirements are not expected to decrease significantly in future years. One estimate from a Big Four audit firm is that between 50% and 75% of first-year effort will be required in subsequent years. It will therefore be difficult for internal audit functions to return to the status quo after the “Year of Finance” is over.

This raises some important questions for audit committees and internal auditors. Should internal audit continue to plan and execute ongoing compliance work, or should it transition ownership of these tasks to the business units or, as several companies have chosen, to a specialist compliance function? Given that Sarbanes-Oxley reflects a permanent change, what are the long-term costs and benefits of different approaches? How can internal audit support the evolution of compliance activity from a near-term project focus to a longer-term business practice?

#### **Risk management**

One CAE told us that the department’s mission was to answer the question *“Where is there risk?”* Indeed, corporations engage internal auditors to help manage the financial and control risks inherent in the business. However, not all companies approach risk management in the same way.

Some audit chairs question the value that internal audit brings to risk areas outside its core expertise. Last year, one ACLN member stated, “The things we worry about – such as pricing in the field or quality in the

plants – are outside the view of the internal auditor and the legal department.”<sup>1</sup> On this same point, one CAE observed that “... of the top 50 risks, very few are financial in nature.”

The audit committee must first determine the primary sources of enterprise-wide risk, and then articulate a risk management framework that is consistent with industry dynamics and the underlying beliefs of the key stakeholders. Internal audit may play a key role in developing and implementing a broadly-based risk framework, or it may simply verify the integrity of the operating and financial controls. The audit committee will define internal audit’s role based largely on sources of risk and the extent to which internal audit is viewed as expert in evaluating and managing those risks.

### **Operational improvement**

One internal audit group we talked to routinely looks at opportunities across operating units, analyzing and benchmarking the issues before rolling out recommended practices. The CAE overseeing this group said that they don’t refer to their role as consultancy, but admitted that some of their activities could be described that way.

While internal auditors may be able to capitalize on their birds-eye view of the company, audit committees need to ensure that in expanding the scope of internal audit’s role they do not unintentionally compromise internal audit’s objectivity.

### **Impact of choices on staffing, recruitment, and development**

Although inexperienced auditors can be trained to perform assurance functions, many companies prefer to recruit staff with a previous background in audit or IT. Because assurance-oriented auditors often have narrowly focused background and career paths, few companies are grooming them to assume leadership roles in non-financial functions such as operations, sales, or marketing.

However, some companies are less concerned with prior experience and recruit audit staff with a wide variety of experiences and backgrounds. Those companies seeking to engage internal audit in risk management or operational improvement work often find that a broader business background is desirable. One CAE reported hiring not only financial experts but also strategy consultants and engineers, noting that “we’re looking for problem solvers.”

Senior management and the audit committee must determine whether internal audit should be used for general management development, or whether it should be staffed primarily by specialists. This is a classic chicken-and-egg problem. Should internal audit services reflect the needs and capabilities of the individuals participating in a management development program, or should candidates from general management join internal audit only when necessary audit services require their expertise?

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<sup>1</sup> Audit Committee Leadership Network, *ViewPoints*, “Enterprise risk management,” December 22, 2003: 5.



## **Internal audit's relationships with its key stakeholders are not evolving uniformly**

Sarbanes-Oxley has elevated and deepened the relationship between the audit committee and the external audit firm. In order to ensure independence from management, external auditors now report directly to the audit committee and it is the audit committee that holds external auditors accountable for their work. Similarly, internal auditors report a deeper relationship with the external audit firm while also recognizing the need to preserve independence. In contrast, Sarbanes-Oxley has not dramatically changed the working and reporting relationships between audit committees and the internal auditors in our sample.

### **Working relationship with the external audit firm**

All CAEs reported close, supportive working relationships with the external auditors. However, there may be an emerging issue around the desire to align roles more closely while respecting the mutual need to maintain independence and objectivity for the sake of audit integrity.

One CAE said, *"I see our roles becoming much more closely aligned than [they] had been in the past,"* and felt that external audit was taking a *"hugely substantive audit view of the business, a role we used to play."* Another felt that the needs of the external auditors would require internal audit to shift from an intuitive, experience-based approach to one that was more structured. However, one CAE commented that under Sarbanes-Oxley the audit committee is looking for independent perspectives, remarking, *"I don't feel I can rely as heavily [on external audit]."*

Some CAEs favor a tightly integrated working relationship in order to minimize the cost of the external audit. Noting that the internal audit group plays a significant role in supporting the external audit firm, one CAE observed, *"if we didn't have the corporate audit staff, we'd have to spend an enormous amount of extra money on external auditors."*

### **Working relationship with the audit committee**

During the ACLN meeting held on September 24, 2003, one audit committee chair said Sarbanes-Oxley has led to a "great deal of activism between the internal auditor and the audit committee chair." However, few CAEs described the same experience.

One CAE admitted that the relationship with the audit committee has changed but said *"we've seen that evolution over time, and it's not a knee-jerk reaction to Sarbanes."* Another CAE said that while there are more audit committee meetings, internal audit is working with the audit committee in much the same way as always: *"I do not feel like the audit committee is managing our work more closely."*

One CAE felt *"a lot of the change was [in] the general environment – including Enron – and what was going on externally. We have more to cover now, and we give detailed updates that would not have been necessary two to three years ago."*

The last several years have seen significant changes in the structure of corporate governance. Is the internal audit function the last unreformed piece of the governance puzzle? If so, should audit committees reexamine their relationship with the internal auditor? Do audit committees and internal auditors feel they are getting



enough useful information from one another? How might the nature and frequency of their interactions shift?

## Conclusion

Internal audit's role will likely become even more important as corporate governance continues to evolve. Instead of solely evaluating process controls, internal audit is also taking a lead role in advocating higher levels of accountability throughout the organization. As one CAE said, *"I'm pushing. If I see a problem, I speak up. Management knows that and sometimes they fear me ... but we're practical too."* This spirit of collaboration and shared mission among management, the audit committee, external audit, and internal audit will help to support corporations in the changing environment.

*The views expressed in this document represent those of the individual leaders of the internal audit function interviewed herein. They are not the views and do not constitute the advice of members of Audit Committee Leadership Network, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.*

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