

The future of internal audit

Introduction

On October 12, 2006, members of the Audit Committee Leadership Network (ACLN) met for the network's 14th meeting. Members began by considering the future of internal audit and then explored in depth another particular source of risk: emerging markets.¹ For further information about the network, see "About this document" on page 8.

During their discussion on internal audit, members focused on the following areas:

- **Post-Section 404, a new mission and new programs for internal audit**
- **New ways of thinking about internal audit resources and skill sets**
- **The audit committee's closer relationship with internal audit**

In a private open session, members also discussed dealing with regulators, interacting with overseas operations, overseeing risk management at board level and ensuring it is a strategic rather than a compliance activity, and working more closely with the compensation committee.

Members who participated in the meeting include:

- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Marie Knowles, Audit Committee Chair, McKesson
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Steve West, Audit Committee Chair, Cisco Systems

Others participating in the discussion on the future of internal audit included:

- Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young
- Jacquie Wagner, Senior Vice President, Chief Operational Risk Officer, and General Auditor, American Express

Audit chairs who participated in individual discussions before the meeting were:

- Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- Gene Fife, Audit Committee Chair, Caterpillar
- Shirley Ann Jackson, Audit Committee Chair, Marathon Oil
- Oscar Munoz, Audit Committee Chair, Continental Airlines
- Sandy Warner, Audit Committee Chair, General Electric Company

Collectively, audit chairs participating in the meeting, or in discussion before the meeting, sit on the boards of over 40 large-, mid-, and small-cap public companies.

¹ See Audit Committee Leadership Network, "Risk in major emerging markets," *ViewPoints*, November 6, 2006. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Nov06_View16.pdf

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Throughout this document members and guests are referred to as "participants," and their quotes are in italics.

Executive summary

In September 2004, the ACLN discussed the evolving role of internal audit in light of the new regulatory environment. *ViewPoints* reported, "Members stated that the internal audit function may be reaching an inflection point in the next 18 months, as the initial work on Section 404 is completed. Audit committees are starting to raise questions about the long-term direction of the function."² Two years later, how far has the internal audit function come, and how has its relationship with the audit committee evolved? The specific issues that network members found most important are highlighted below, with more detailed discussion on the following pages:

- **Post-Section 404, a new mission and new programs for internal audit** (*Page 3*)

While members still believe that internal audit's primary focus should be on financial reporting and internal controls assurance, they noted a return to more operationally focused work after the initial mood of urgency that accompanied Sarbanes-Oxley implementation faded. Members generally agreed that internal audit has a role in risk management assessment, but differed over how involved internal audit should be in the risk management process. Leading internal audit functions are integrating financial, operational, IT, and compliance audits to offer a more holistic answer to audit chairs' questions. For ways the audit chair can help set the mission for internal audit, see page 5.

- **New ways of thinking about internal audit resources and skill sets** (*Page 5*)

One way internal audit functions are coping with the hot employment market for internal audit staff is by opening their hiring policies to staff with non-audit skill sets. This approach is similar to the one adopted by General Electric since the early 1990s, and members debated the merits of the "GE model." Some members queried whether such an approach could work in businesses that place a high value on leaders with engineering or marketing backgrounds. Several participants described a hybrid approach combining a specialist core of career auditors (perhaps co-sourced with a Big Four firm) and the company's own high-potential employees. Members also noted the growing importance of IT specialists and auditors with foreign language skills.

- **The audit committee's closer relationship with internal audit** (*Page 6*)

Members talked about a much deeper relationship with internal audit, one in which one-to-one meetings between the audit chairs and the head of internal audit are expected. Audit chairs agreed that the audit committee plays a key role in providing strong support for the head of internal audit. A direct reporting line to the audit committee is common, but members talked about the potential for conflict of interest in the administrative reporting line.

² Audit Committee Leadership Network, "Comply, Audit, Disclose! New thinking about the role of the audit committee," *ViewPoints*, October 8, 2004, 2. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct04_View6.pdf.

Post-Section 404, a new mission and new programs for internal audit

According to the *Final NYSE Corporate Governance Rules*, companies listed on the New York Stock Exchange (NYSE) “must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control.”³ Prior to 2002, most internal audit functions were focused on financial and operational audits, with business process improvement a by-product of their work on operational audits. One participant said that 10–15 years ago, internal audit functions moved into operational audits to avoid duplicating the efforts of the external auditor on financial audits.

Since 2002, internal audit functions have been focused largely on Section 404 compliance, but as the mood of urgency that accompanied the initial Sarbanes–Oxley implementation has faded, many organizations are returning to a broader mandate for internal audit. One participant said, “*An ongoing issue is the internal audit function being usurped into SOX [compliance] – what should it be working on, and what is its ongoing function?*”

An Ernst & Young survey published in September 2006 shows that demands on the internal audit function have begun to broaden. The focus is no longer purely on financial audits and internal controls work; now internal audit is moving toward operational audits and improvement, as well as strategic involvement in areas such as risk management.⁴

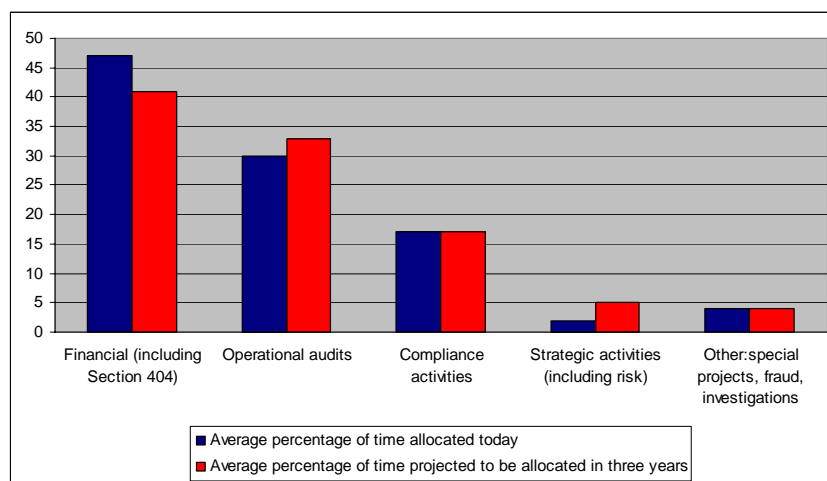


Figure 1. Allocation of internal audit hours today and expected in the future.⁵

In general, network members believe they are seeing an evolution of the internal audit mission that is in line with the trends identified in the E&Y survey. “*SOX did cause a difference. The notion of responsibilities*

³ New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 13. Available for review at: <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>.

⁴ Ernst & Young, “Internal Audit Survey Summary,” September 2006. The survey was conducted in the spring and early summer of 2006 through face-to-face interviews with 115 CAEs and direct reports. Thirty-two percent of the respondents represented Fortune 100 companies.

⁵ *Ibid.*, 5.

has expanded... [Internal audit] has extended into everything ... We have added 50% more work – more inquiries, more compliance, and more risk assessment.”

Members discussed four main roles for internal audit:

- **Financial audits and internal controls.** Members still believe that internal audit’s primary focus should be on financial auditing and testing internal controls. One participant said before the meeting, *“[Internal audit’s] number one focus is on the internal financial controls. That is where their primary responsibilities fall.”*
- **Operational audits and improvements.** Members also noted a return to more operationally focused work, with one participant saying internal audit was experimenting with process improvement work. Other audit chairs have talked about the importance of operations work for retaining talented auditors and for ensuring that business units see value in the internal audit function.

However, one participant said, *“I am concerned about internal audit getting into process improvement and added value – earning their way. Doesn’t that cloud their objectivity?”* Another participant agreed: *“I am not looking for internal audit to justify its existence; we have already decided to have an internal audit function.”* Other participants suggested that conflict of interest could be avoided by ensuring that the teams that provide recommendations are not the same as the teams that audit those operations.

- **Compliance activities.** Internal audit may support regulatory and legal compliance as well as compliance with contracts and corporate policies. One audit chair said before the meeting that internal audit needs to be involved in *“regulatory compliance control reviews.”*
- **Risk management.** Members generally agreed that internal audit plays a role in risk management assessment and/or reporting, but differed over how involved it should be in risk management itself.
 - **Internal audit plays a key role.** One participant reported, *“Internal audit [does] ERM, baked into the audit plan for the year. Risk assessment is done by internal audit.”* Another participant said internal audit can *“provide structure for the business, identify all risks, and prioritize the top risks and how they will be addressed. All parts of the business will be thinking about risks in the same way. You get the whole risk and control philosophy through the whole organization.”*
 - **Internal audit plays a minor role.** One participant said, *“Internal audit has enough to do. The head person can contribute intellectually, [but] there’s no one in internal audit who is doing a good job who isn’t overworked ... The key risks are not audit items, they are higher level.”* Another participant agreed: *“When management sees risk management as a compliance activity, internal audit has a major role. When it’s in strategic planning and the fabric of how the business is run, then a lot of the input is from top management.”*

Another participant commented that internal audit functions are *“looking for a more integrated approach”* to dealing with these roles. Internal audit functions are trying to work holistically and are integrating financial, operational, IT, and compliance audits to *“take an integrated look at a particular area.”* The participant’s company had found COSO’s Internal Control Integrated Framework particularly useful in this regard.⁶

⁶ The Internal Control - Integrated Framework Executive Summary framework by COSO is available at: http://www.coso.org/publications/executive_summary_integrated_framework.htm

How do audit chairs help set the mission for internal audit?

- **Annual review process.** Many audit committees approve the internal audit charter and the annual plan. One participant reported, *“We do an annual review to set the mission and review it at the end of the year.”*
- **Participation in the selection of the chief audit executive (CAE).** One participant said, *“That is an audit committee and an audit chair role. That partnership [between management and the audit chair in the selection process] gives [the CAE] strength.”*
- **Regular dialogue with the CAE.** One participant looked to the head of internal audit to set the agenda for the function: *“They know better than I do. I try to be additive ... We get issues from the board and take a closer look in the audit committee. It is part of the audit committee agenda setting – what presentations do we need in three months’ time? It is a dialogue.”*

New ways of thinking about internal audit resources and skill sets

According to the Institute of Internal Auditors, “Audit committee members must play an active role in supporting the independence of internal auditing and ensuring it has enough resources to provide the appropriate level and quality of information.”⁷ Members’ internal audit organizations vary in size from a few dozen audit staff to more than 425. The E&Y survey states that half the companies involved in the research have projected growth for their internal audit function in 2006–07.⁸ Many participants mentioned the hot external and internal employment market for internal audit staff. One participant noted, *“Salaries are very high, globally.”*

Can the GE model be applied more widely?

One way internal audit functions are coping with the need for more talent is by opening their hiring policies to staff with non-audit skill sets. This approach is remarkably similar to the one adopted by General Electric since at least the early 1990s. GE’s internal audit function has long been considered one of the best in the country.⁹ Typically, GE’s corporate audit staff spend two to three years learning the intricate details and functions of the company and being inculcated in a control environment before they rotate out into the company in a variety of leadership roles that, unlike at other companies, are not simply restricted to the finance organization.

As they move beyond Sarbanes–Oxley compliance, most companies’ internal audit functions are once again becoming valued rotations for high-potential finance staff. While there is still no consensus on the idea of developing broader management high fliers (as in the GE model), there is more interest in this topic today than there was two years ago. One participant queried whether such an approach could work in a business that placed high value on leaders with engineering or marketing backgrounds. In reply, another participant said, *“We do run internal audit that way ... Some are engineers because we have specific technology needs.”*

⁷ The Institute of Internal Auditors, *Internal Audit Standards: Why They Matter* (Altamonte Springs, FL: Institute of Internal Auditors, 2005), 2. Available at: www.theiia.org/download.cfm?file=83632.

⁸ Ernst & Young, “Internal Audit Survey Summary,” 17.

⁹ John Pancoast, “How audit earns plaudit,” *Financial Executive* 11, no. 6 (November 1995), 30.

They do rotate in and out of internal audit.” However, a third participant knew of one company that would regard such an approach as a “waste of an engineer ... and if you are not an engineer you won’t get to run a business [unit].”

Another participant took issue with the GE model, saying, *“Rotation didn’t work for us. We had to hire professional auditors and IT forensic specialists, augmented by some outsource expertise. This is their life!”* Another potential solution to bridge the gap between internal audit and the business, mentioned by a participant, is to bring people from operations to join specific audits for a period to see how auditing is done. *“They are able to see things that financial auditors don’t see.”*

A hybrid option was also discussed. One participant described how one-third of the internal audit function is drawn from career auditors and two-thirds from outside the function – undergraduates, MBAs, and experienced hires that spend two to three years in the function and then move elsewhere in the company. The participant noted, *“You need the quality, consistency, and standard setting of the specialists. You would not want to lose that core.”* Another participant said that co-sourcing could provide the specialist core, with professionals from a Big Four firm brought in to supplement the company’s own high-potential employees.

One participant was interested in how long the CAE should be in the role. Another participant responded that it was beneficial to have a rotation every seven to ten years as *“you need continuity and a strategic view at the top.”* Several participants said they felt it was important for the CAE to move up in the organization: *“Having accomplished that a couple of times, we have energized internal audit.”* However, others pointed out that many CAEs are career auditors.

Technology and foreign language specialists

Largely as a result of Section 404 compliance, which increased the focus on the role of IT and internal controls, there is a need for expanded technical expertise in the internal audit function. Companies have accessed this skill set through co-sourcing or hiring. One participant said, *“We had to beef up IT expertise, especially for information security and privacy. You need people with unique skills. There is a sellers’ market for that capability.”* Another agreed, saying, *“It is hard to find good IT forensic people.”*

Participants also raised the importance of foreign language skills. *“You can’t operate in Brazil without Portuguese. U.S. expats going out there doesn’t work.”* Several participants co-sourced 10–20% of their function to obtain language skills and other *“lower-level skill sets under our management control.”* One said, *“We pull them in and out as needed for language or location.”*

The audit committee’s closer relationship with internal audit

InSights reported in 2004 that “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.”¹⁰

Two years later, members talked about a much deeper and more strategic relationship with internal audit. One participant said, *“The audit chair can give shelter to make the external auditor more effective, independent, and confident. At the same time, you can empower internal audit more.”*

Since passage of Sarbanes-Oxley, private one-to-one meetings between audit chairs and lead audit partners and the CAE have become commonplace, and *“management gets uncomfortable about that.”* Most CAEs reach out to audit committee chairs informally, the frequency and intimacy ranging from weekly telephone conversations to in-person meetings once or twice a quarter.

Constructive tension

One audit chair wondered, *“How does the audit committee keep a level of healthy discontent among [internal audit, management, and the external auditor] to stop them from becoming too close? They all work closely together every day, and we don’t.”* In response, another said, *“There is an opportunity as an audit chair to create tension by asking the right questions and [to] create an environment where people can say what they need to say without repercussions. Let these guys have at it.”* However another audit chair noted, *“You want to know about [the conflict], even if they work it out.”*

Audit chairs agreed that the audit committee could play a key role in supporting the recommendations of internal audit. One member said, *“When there is a trouble spot, the person responsible on the ground comes to the audit committee. The audit chair and internal audit decide when to trigger this – it is not a pleasant thing.”* Another agreed saying, *“If there is an audit [that identifies a problem], the business unit head and CFO have to come to the audit committee and explain what they are doing about it. It is a wonderful motivator [for them to take action].”*

A third member mentioned that the audit committee regularly conducts risk- and control-based reviews of certain parts of the business. Such an approach reinforces *“risk management [as] a management responsibility.”* Internal audit helps the audit chair decide *“who needs to be at the front of the queue and who is at the back.”*

Reporting lines

In part, the relationship between the audit committee and internal audit is deeper now than in the past because reporting lines are clearer, with most members saying the CAE now reports directly to the audit committee chair. However, one participant said that it might be a problem if the CAE got the impression he or she answered only to the audit committee. *“We only spend a little time ‘supervising’ our direct report. [CAEs] may think as long as they have a great reputation with the audit committee, they can have their way. That [will] not result in a robust, healthy relationship with other parts of the business.”*

¹⁰ Ernst & Young and Tapestry Networks, “The internal auditor’s perspective,” *InSights*, July 6, 2004, 6. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_July04_InSights.pdf.

The direct report to the audit committee is essential for internal audit objectivity, but there is still potential for conflict of interest. One participant mentioned that *“more and more companies are moving away from the CFO [administrative reporting line] because of potential conflicts of interest. Reporting could be to the CEO or the CRO. It is [fairly] broad right now.”*

One participant said, *“You need to be clear that it is just administrative control. Technically, internal audit reports to the audit committee. [We get involved in] reviews of performance, setting compensation. An administrative report is a light touch.”* Although some have suggested a reporting line to the general counsel, one participant spoke against that idea: *“Most internal auditors are finance people. [The general counsel] can’t help advance their careers; you would expect the CFO to do that ... Money, job security, and career advancement motivate people. As audit chairs, we don’t have much to do with that.”* For one participant, asking, *“Who is committed to this person’s success?”* helps provide the answer to the question of who should be the administrative report.

Some members noted that ensuring a clear channel of interaction that is not controlled or unduly influenced by management is the most important factor for the CAE. One participant said, *“If internal audit has an opportunity to speak openly with the audit committee, it should work fine. It [is up to] the individual to keep their objectivity and [maintain] open communication.”*

Conclusion

Audit chairs have long described the internal audit function as their arms and legs in the company. In 2004, ACLN members predicted that internal audit would reach an inflection point about now, and they were right. Internal audit functions are starting to broaden beyond a purist focus on financial audits and internal controls. It remains to be seen whether this proves to be a temporary response to the increase in available hours post-Section 404 implementation, or a longer-term trend. In the meantime, audit chairs are focused on deepening their relationship with the head of internal audit and encouraging the function to experiment with new resourcing models to win the war for internal audit talent.

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American 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.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

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