



## The evolution of internal audit

### Introduction

The Midwest Audit Committee Network is a group of audit committee chairs drawn from leading Midwest companies. The third meeting of the network was held in Chicago on October 7, 2008. The meeting focused on a broad set of topics, including the relationships of the audit committee with the internal and external auditors and implications of a move from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to International Financial Reporting Standards (IFRS). Members also reflected on the network's discussion of enterprise-wide risk management in light of the uncertainty in global financial markets.

This document reflects a synthesis of the key issues that emerged from the discussion of internal audit. A separate issue of *VantagePoint* has been developed to reflect the discussion about maximizing the value of the external auditor.<sup>1</sup> The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly this information can be disseminated to board directors, management executives, and their advisers, the greater the value created for all.

The members of the network present at the meeting, who sit on the boards of 25 large-, mid-, and small-cap companies between them, were:

- Howard Carver, Audit Committee Chair, Assurant
- Cheryl Francis, Audit Committee Chair, Morningstar
- Brenda Gaines, Audit Committee Chair, Office Depot
- Sandy Helton, Audit Committee Chair, Covance
- David Landsittel, Audit Committee Chair, Molex
- Cary McMillan, Audit Committee Chair, Hewitt Associates
- Rich Roedel, Audit Committee Chair, Brightpoint
- Dennis Van Mieghem, Audit Committee Chair, AEGON USA

Ernst and Young partners participating in the meeting included:

- Tony Anderson, Midwest Area Managing Partner
- Kevin Cole, Area Director of Business Development and Marketing
- Jim Logothetis, Global Client Service Partner
- Ron Weissman, Senior Partner Financial Services

*VantagePoint* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the

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<sup>1</sup> See Midwest Audit Committee Network, "Maximizing the value of the audit and the external auditor," *VantagePoint*, October 24, 2008. Available at <http://www.tapestrynetworks.com>



meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from members of the Midwest Audit Committee Network.

## Executive summary

Members agree that an effective internal audit function is invaluable to the audit committee. The discussion highlighted several important themes:

- **Internal audit is increasingly important, and it continues to evolve** *(page 2)*

Members agree there has been a meaningful change in the scope, value, and perception of internal audit over the last three to five years. Even though internal audit's role (ensuring effective financial and operating controls) is fundamentally unaffected by the financial crisis, several members questioned whether the function might be more "*nimble*" in adapting its annual plan to respond to the evolving nature of risk in the current financial crisis.

- **Many companies are actively upgrading internal audit capabilities** *(page 4)*

Several members said their companies have sought to raise the stature of internal audit by recruiting higher-quality staff and rotating talented finance executives through the function. Chief audit executives are increasingly seen as key members of the senior executive team. The most successful upgrade efforts generally have the support or encouragement of the CEO. The audit committee can play an important role, ensuring internal audit resources are aligned with needs.

- **Co-sourcing can help ensure adequate capabilities** *(page 6)*

Even though members agree it is preferable to keep most internal audit talent in-house, they say it may be acceptable – and even desirable – to strategically co-source selected talent. In particular, members highlighted the benefit of sourcing external IT and international audit talent when it is impractical or uneconomical to build those capabilities in-house.

- **The audit committee's relationship with internal audit goes beyond oversight** *(page 7)*

Members acknowledge the relationship between internal audit and the audit committee should be one of mutual support. Such a relationship requires a level of director involvement that goes beyond some interpretations of the term "oversight." Audit committee chairs rely on internal audit to be their "eyes and ears" in the company; audit chairs also have an important role to play in supporting the professional development of key internal audit executives through active mentoring.

## Internal audit is increasingly important, and it continues to evolve

Companies listed on the New York Stock Exchange (NYSE) are required to "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."<sup>2</sup> However, beyond this broad directive, management has significant leeway when defining the scope of a company's internal audit function.

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<sup>2</sup> New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 13. Available for review at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>



As one of the cornerstones of the internal control environment (along with the board of directors, the external auditor, and senior management), internal audit provides unique and valuable insight into the organization “by giving objective assurance on governance, risk management and control processes.”<sup>3</sup> As one member remarked prior to the meeting, *“The value of internal audit is higher than it used to be. They are playing a more important role, being pulled into things at an earlier stage, and adding a lot more value. This has turned out to be a resource that’s valued for a number of different reasons.”*

### **The scope of internal audit is expanding**

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. With the passage of the Sarbanes-Oxley Act (SOX) in 2002, many internal audit functions redeployed staff to focus largely on Section 404 compliance. In recent years, as the mood of urgency that accompanied initial Sarbanes-Oxley implementation has faded, companies are returning to a broader mandate for internal audit. As one member put it, *“There’s still a lot of focus on internal controls, but there continues to be an increasing focus on adding value elsewhere in the organization – especially when it comes to operational work. Internal auditors now find themselves sitting in on disclosure meetings and having even more responsibilities with respect to compliance. A lot has changed.”*

Another member confirmed that Section 404 work was taking far less time now: *“One issue we’re struggling with is the evolution of internal audit now that [Section] 404 has been adopted and implemented. They used to spend 80% of their time on it, but now it’s down to a science.”* Added another member; *“We continue to refine our [Section] 404 activities as we move past [the initial challenge of implementation]. We are now starting to use internal audit in more areas around the company.”*

Transactions are one area in which internal audit has an increasingly important role in some companies. As one member mentioned prior to the meeting, *“What I’ve asked management to do is get internal audit involved any time that there’s an acquisition. We also require that if it’s over a certain amount, there must be an internal audit review of that company within a year. Clearly, it makes it easier to make [internal audit] part of the acquisition team if they are part of it from the beginning.”*

In some cases, internal audit has also expanded into risk management: *“Internal audit is actually the group that has led our company through the [enterprise risk management] process, so the fact that we are where we are today is a credit to internal audit. At our last audit committee meeting, they were discussing the next steps, the high-risk areas, and their mitigation plans. Internal audit is really the conduit for doing that.”* One member stressed the importance of talent, suggesting that *“internal audit can be a place where you manage the process of risk management if you have an organization that has the kind of talent in it.”*

Many members expect the trend toward a broader scope of responsibility for internal audit to continue: *“Opportunities within the company will continue to increase and develop. I could see the function moving in more directions we haven’t seen yet.”*

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<sup>3</sup> Dan Swanson, “Twenty Questions for Directors to Ask Internal Auditors,” *Compliance Week*, May 9, 2006. Available at [http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article\\_ID=2530](http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=2530).



### **The value and perception of internal audit is improving**

Historically, regard for internal audit has been low members believe: *“My experience has been that internal audit has always been looked on as the bad guy, someone looking for problems, and the perception is that they’re not happy until they find something wrong.”* Over the past several years, however, audit committee chairs have been working hard to change that perception, with positive results: *“I don’t want to hear from people around the company, ‘Internal audit is good, but ...’ I want to hear how many times they are getting called in to help with things on the front end. People used to not want internal audit on their team, but that’s changing now.”* Another member reported, *“I think we’re hearing that the value proposition of internal audit is much different today. Internal audit now has a seat at the table.”* Many boards and executives are learning to appreciate the additional value an effective internal audit group can provide.

Indeed, members are optimistic that the image of internal audit will continue to improve and evolve as the function continues to focus on value creation. As one member pointed out, *“A great internal audit function is one that will bring new ideas, raise issues as they see them, and adapt to conditions as they change while still performing their traditional compliance work.”*

### **Can internal audit help the company deal with the current financial crisis?**

Members predict that the extraordinary economic events of the past few months will have little fundamental effect on the role of internal audit: *“Internal audit doesn’t have much to do with the economy. They are not there to tell you how to fix the problem of not being able to sell a bag of chips. They are there to tell you if people are saying they sold a bag of chips and didn’t.”*

Many members questioned whether internal audit would be able to add more value as their companies struggle to navigate through the current financial crisis. Several audit committee chairs worried about internal audit’s adaptability: *“Internal audit isn’t as nimble as we’d like it to be. They get a plan for the year, and they execute against that plan, and oftentimes there’s very little movement.”* Members intend to work with their internal audit function to help it be more responsive to the changing circumstances. One member said, *“I need to get back and look at this as an audit committee chair. Where is it, because of the recent changes in our risks, that we need to make changes in the internal audit? We may need to start doing additional reviews mid-term. I think we are really good at using internal audit to assess these risks once a year, but that’s not helpful when things are changing once a week!”*

Some members find comfort in the fact that a volatile economic cycle does little to distract internal audit from its fundamental responsibility of ensuring effective financial and operating controls: *“If internal audit does nothing else [during this economy], if they are able to [ensure] the right controls, you’re still going to be able to sleep at night.”*

### **Many companies are actively upgrading internal audit capabilities**

Given the value of an effective internal audit function, and as part of their quest to improve the value and perception of the function, some members have been upgrading the internal audit workforce at their companies.



### Seeking and developing talented internal audit staff is key

One of the best ways to improve the perception of the internal audit function is by recruiting higher-quality staff. Finding a chief audit executive (CAE) with the right characteristics and capabilities is therefore a critical first step: “The chief audit executive (CAE) needs to provide assertive leadership that strengthens the organization’s commitment to tough internal controls. CAEs must partner with senior management and the audit committee to help them fulfill their broad responsibilities for effective governance, risk management and control.”<sup>4</sup>

The CAE must not only be technically capable, but also sensitive to organizational dynamics. One member said, “[The individual has] to be as independent and objective as humanly possible and still be immersed in the company. They can’t be intimidated by their surroundings, though, and need to have the wherewithal to go anywhere they want in the company.”

While the CAE plays an important role, members recognize that he or she must also be supported by an effective team. As one member noted prior to the meeting, “It’s really about the quality of the people. I’ve seen too many internal audit groups that are low on the food chain, and it’s reflected in the results ... The ones that I’ve dealt with that are really top notch are the ones with the best and most talented people.”

Consequently, an effective CAE must also be able to recruit an outstanding team: “We had a wonderful head of internal audit who brought in a lot of great talent. [This person is] definitely my ideal ... You need that player who has the vision and the energy.” Another member said, “I had a great head of internal audit who saw it as his job to recruit great people to the function. He went in there and fought for internal audit.”

Several members said their companies use a rotational model, in which internal audit is a developmental training ground for promising finance and operating executives. One member described the advantages of such a model: “I think there is a great benefit to have someone come into audit, understand what’s going on [across the company], and get spun back out to one of the business units.” Indeed, another member commented, “My personal belief is that no one should be a career internal auditor. We put a young man in there who was a superstar, and when a spot opened up to be CFO of one of our business units, we moved him there.”

### The audit committee and management need to work together

Members discussed the importance of having the audit committee and management work together to elevate the stature of internal audit: “The audit committee is responsible for internal audit, and one would hope management feels [responsible for it too]. They need to work together to be proactive rather than reactive when it comes to internal audit.”

Indeed, members noted that the most successful internal audit upgrade efforts are often initiated with the support or encouragement of the CEO: “A few years ago, the CEO and I agreed that we wanted to

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<sup>4</sup> Larry E. Rittenberg and Richard J. Anderson, “A Strategic Player,” *Journal of Accountancy*, July 2006. Available at <http://www.journalofaccountancy.com/Issues/2006/Jul/AStrategicPlayer.htm>.



*reposition the internal audit function at [our company]. We said, ‘If we’re going to have a world-class company, we need to have a world-class internal audit function.’” This member went on to describe the fundamental transformation that the internal audit function underwent: “We terminated our head of internal audit when we did not see the improvement we wanted. We then did a complete assessment and removed more people, and we are now working to staff up again ... Overall, I am very happy with where our audit is going as a result [of our restructuring efforts].”*

Members came away from the discussion with several tangible objectives. One noted, “*My action item, based on this discussion, is that I need to be more sensitive to what the internal audit needs. I need to ask, ‘What backstops are in place, and how do I make sure internal audit has access to the resources they need?’”*

### **Co-sourcing can help ensure adequate capabilities**

Members believe that when in-house auditors cannot meet all the organization’s needs, it is acceptable – and even desirable – to strategically co-source selected talent. Several members reported that they have co-sourced: “*There are certain issues that are way beyond the capabilities of most internal audit people, so we bring in outside resources.*” Another member added, “*For a while we couldn’t hire the people we needed or wanted, so we chose to use external experts.*”

While specialized internal audit resources are often outsourced, members noted that they generally favor building the team internally: “*I’m much more inclined to strengthening and building the function internally because of the value it can bring inside the company, rather than bringing [talent] in from the outside.*” Echoed another member, “*I feel there’s much more value in in-sourcing. There may be certain areas we are forced to outsource, but I think it is much better to embed it in the culture, if it’s possible.*”

Several members noted prior to the meeting that when determining how much of the internal audit function to outsource, “*you really need an explicit strategy and an understanding of what your goal is first, and then [you can] decide how much you want to in-source versus outsource. You ideally want the capabilities to have everything in-house, but it’s not plausible if you [need] niche kinds of skills that aren’t economically or geographically realistic to keep in-house.*”

Two areas that are often outsourced are information technology and international audit:

- **Information technology:** “*We outsource IT entirely. For the last 15 to 16 months, most of the IT work has been outsourced to [a Big Four firm] and overseen by a partner on a day-to-day basis. Our thought process there is that we can’t seem to hire the people we want at the numbers we need in the locations we need them in, so we just outsourced all of IT.*” Another member said, “*We had an internal IT expert and concluded that IT was too diverse [to source internally]. There are too many niche skills, so we now look to outsource so we can address all those different niches.*”
- **International audits:** One audit chair said, “*Internationally, we have chosen to outsource because it can be very difficult to cope with different environments and cultural differences.*” Members, however, were quick to point out the risks involved: “*There are no rules of the road when you outsource [international audit]. It is supposed to be an extension of internal audit, but in the end, when you outsource, there are a different set of controls and issues than if you in-source.*” In



particular, “most internal control and fraud issues happen in developing countries where the finance department isn’t separate from the operations department. Being the eyes and the ears in the fields representing the shareholders and the board is what internal audit does most for me, but the local people tend to view the client not as the board of directors and the shareholders but ... as the local management.” Consequently, members agreed with one member who said, “I think our responsibility as an audit committee needs to be just as heavy, if not more so, [when] we outsource.”

### **The audit committee’s relationship with internal audit goes beyond oversight**

NYSE listing requirements state that “the audit committee must have a written charter that addresses the committee’s purpose – which, at minimum, must be to assist board oversight of ... the performance of the company’s internal audit function.”<sup>5</sup> The Institute of Internal Auditors goes further, saying, “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.”<sup>6</sup>

Members spoke passionately about forging a deep and strategic relationship with internal audit: “There’s a level of activity as an audit committee chair that goes beyond oversight. You need to make sure internal audit is planned well, managed well, and executed well. That can’t happen with just an occasional phone call.” Indeed, members say they are actively engaged in all aspects of the internal audit function: “The audit committee has a responsibility to make sure that internal audit is running well, that it’s well staffed, that its strategic agenda and annual plans are grafted well, and that they are executing against them. We should understand what they are doing and how they are doing it. I always say to the people who run internal audit that they can call me at any hour, day or night, and I need to be on the short list if anything happens.”

Members believe audit committee chairs also have an important role to play in supporting the professional development of key internal audit executives: “It’s very much a mentoring relationship.” Added another, “I have regular contact with the head of internal audit to talk about ‘sticky situations,’ where we talk about some of the tough management issues that can come up. It’s part advisory and part career development ... If we want good people, we have to help them. You can’t just leave them out there to dangle on their own.”

Members appreciate that the relationship between internal audit and the audit committee is one of mutual support and are quick to acknowledge the value: “Without a well-developed and well-functioning internal audit department, audit committees can’t do their job.” Another member commented, “From the audit committee chair’s perspective, not only does internal audit help provide a great deal of administrative support to make sure the audit committee fulfills its fiduciary responsibilities, but they are also the eyes and ears inside the organization. I spend an awful lot of time with the companies I’m involved with, but I’m not there every day, and internal audit gets me there.”

<sup>5</sup> New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 10.

<sup>6</sup> 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](http://www.theiia.org/download.cfm?file=83632).



## Conclusion

Of all the resources at an audit committee's disposal, one of the most valuable is an effective internal audit function. Creating and sustaining such a capability is not a trivial task, and leading audit committee chairs have identified a number of helpful practices. Audit committees should partner with senior leadership to ensure internal audit is staffed by outstanding professionals whose contributions are valued and appreciated. Audit committees should ensure adequate audit resources, with sufficient technical expertise, both at home and abroad; and can encourage internal audit to play a key role in identifying a wide range of risks across the enterprise. In following these principles, audit committees often find that modest investments of time and resources yield substantial returns.

*The views expressed in this document represent those of the Midwest Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, 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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