



The future of internal audit

The North Central Audit Committee Network¹ met by teleconference on December 15, 2005, to discuss the future of internal audit. The members of the network present at the meeting, who sit on the boards of about 22 large-, mid-, and small-cap public companies between them, were:

- John Baily, Audit Committee Chair, Erie Indemnity
- Jim Broadhurst, Audit Committee Chair, National City
- Gordon Harnett, Audit Committee Chair, PolyOne
- Bill Lawrence, Audit Committee Chair, Ferro
- Mike Losh, Audit Committee Chair, TRW Automotive
- Russ Maier, Audit Committee Chair, FirstEnergy
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Al Paulus, Partner, Ernst & Young
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber
- Paul Smith, Audit Committee Chair, Constellation Brands

The discussion revolved around three important ideas, summarized below and expanded upon in subsequent pages:

- **Sarbanes-Oxley responsibilities are expected to remain with internal audit, while compliance costs remain stubbornly high** (*Pages 2-3*)

Internal audit has played a leading role in Section 404 compliance, and members now anticipate that this will continue, contrary to some prior expectations. Committees are driving down compliance costs by significantly reducing their dependence on external resources. Although some companies have created a separate function to oversee Sarbanes-Oxley compliance, members question whether the benefits of this approach outweigh the coordination challenges.

- **Members favor a focused role for internal audit and value specialist skills highly** (*Pages 3-5*)

Members placed clear emphasis on the primary responsibilities of internal audit rather than on expanding the role. Although some companies have used internal audit to support general management development, members believe that regulatory requirements and the need for internal audit independence make this approach impractical for all but the largest corporations. Furthermore, audit committees question whether internal audit groups should expand beyond their traditional responsibilities into operational consulting.

¹The North Central Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Lake Erie and Ohio Valley regions of the United States. 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.



• **Audit committees must now play a more formal, active role in reviewing internal auditor performance and compensation** (*Pages 5-7*)

As internal audit has risen in importance, audit committee chairs have become more involved in hiring the chief audit executive (CAE). Members are reluctant, however, to take on supervisory responsibility for internal audit, although they acknowledge that IIA guidance recommends that the CAE report to the audit committee chair. They believe there may be value in expanding the audit committee's formal participation in the CAE's performance review and compensation decisions.

Sarbanes-Oxley responsibilities are expected to remain with internal audit, while compliance costs remain stubbornly high

In order to meet the requirements of Section 404 during 2004 and 2005, many companies enlisted internal audit's support, diverting this group from other planned activities. Internal audit professionals generally thought that this would be a temporary shift.²

Although corporate auditors, management, and audit committees may have expected internal audit to return to its original focus in 2005, many companies have subsequently decided that Section 404 compliance should remain an important part of internal audit's ongoing role. Several members said that responsibility for Section 404 testing and reporting still remained clearly with internal audit, with one member declaring, *"I like that."*

In some cases, internal audit is helping to coordinate and monitor Section 404 activity, but not doing the actual documentation, testing, or remediation work. One member said, *"We've concluded that SOX compliance has to be part of the finance culture,"* and noted that although operating units are ultimately responsible for regulatory compliance, internal audit is coordinating the effort to ensure consistency.

Given the sheer volume of work during the first year, many companies brought in outside resources to supplement their own staff. Many companies have set targets for reducing external resources (e.g., second-year costs no more than 25% of first-year costs). However, meeting these targets may be a challenge. One member noted, *"Everybody I know added just a ton [of cost]. Shifting the balance seems to be the toughest issue."* Another member agreed: *"People want to wean themselves away from outside help and are wondering how to make this happen."*

A separate compliance function poses coordination and reporting challenges

Members acknowledged that *"more than a handful"* of companies had created separate compliance groups so that internal audit could return to its traditional role. While members said this approach has some appeal, they expressed concern about the significant challenges in coordinating activities between such a compliance group and the internal audit function. Since internal audit normally reviews internal controls as part of its

² For example, in May 2004, one corporate audit executive described 2004 as the "Year of Finance." Eighteen months later, this executive reported, "We did return to a more traditional role for the company, however [Sarbanes-Oxley] is still an important part of our overall work. The biggest surprise of '05 is the cleanup required on the non-SOX processes. We are actually having to spend time on these areas even though they have very little material risk to the company because no one wants any surprise adjustments."



work, members noted the “*obvious overlap*” in responsibilities and wondered where traditional internal audit work ends and Section 404 compliance testing begins. Some members said the challenges of coordinating the two groups were not unlike those required to coordinate internal and external audit activities.

Furthermore, members questioned the appropriate reporting structure in a dual-function model. Although the head of internal audit typically reports to the audit committee, members were not clear whether the compliance chief should report to the audit committee too. Members generally agreed it is preferable for internal audit and compliance to report to the same person, so that goals and objectives can be aligned.

Rather than create a separate group, one member’s company has designated a subset of the internal audit staff as lead Sarbanes–Oxley auditors. This member said, “*even though they are still called internal auditors, there’s a dichotomy.*”

Questions with implications – internal audit’s role in Section 404 compliance

- Should internal audit take primary responsibility for Section 404 testing and reporting, or should it coordinate the work of others?
- Should Section 404 compliance (or at least the related testing) be the responsibility of the whole internal audit staff, a subset of the internal audit staff, or a separate compliance group?
- How much outside support should be retained? How can internal audit reduce its dependence on outside resources without adding staff?

Members favor a focused role for internal audit and value specialist skills highly

In order to better understand the nature of the internal audit function, Tapestry Networks spoke last year with eleven CAEs, drawn primarily but not exclusively from companies represented by Audit Committee Leadership Network members. As we reported in *InSights*, “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.”³

Members have described two models for internal audit:

- **The management development model** focuses on young high-flying professionals who will stay in the function for two to four years and then return to a line management role within an operating unit. This is often described as the “GE model” because of General Electric’s extensive use of this practice.
- **The specialist model** uses internal auditors who often have a background in public accounting or information technology. Organizations using this model focus on building a high degree of specialized skills in internal audit and view the internal audit function as a career rather than as a stepping stone to other jobs in the organization.

³ Audit Committee Leadership Network, “The internal auditor’s perspective,” *InSights*, July 6, 2004, 2. Full text available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Jul04_Insights4.pdf.



Although these two conceptual models define the extremes, many members favor a hybrid in which technical specialists (e.g., accountants, information professionals) move back into the organization after a “*tour of duty*” in internal audit. Members agree that it is important to demonstrate mobility and note that “*if [recruits] see a dead end, you have a tough time attracting the right people.*” In fact, one member said it is helpful for accountants to “*do something they are familiar with*” when joining the company, even though they may ultimately pursue other control or finance positions after a few years.

Management development model raises questions about objectivity and capability

Some members describe serious challenges associated with a management development model. One member said industry regulators have started to question the independence and objectivity of internal auditors who aspire to positions in groups they are auditing. Some people wonder whether, in such a model, internal auditors “*are doing the job they are supposed to be doing.*”

Members agree it is important for internal auditors to avoid any real or perceived conflicts of interest, with one member stating, “*We don’t want anybody promoting themselves as part of this process.*”

Some companies have identified what they perceive to be an effective hybrid model, with a senior career auditors at the top and a rotational “trainee” staff playing more junior roles. One member said the trainee model (i) delivers adequate staffing, (ii) helps to establish a broad control perspective throughout the company, and (iii) ensures that nobody burns out doing Sarbanes–Oxley compliance over an extended period of time. Members believe that a respected leader overseeing and reviewing the work of less-experienced staff can bolster credibility and minimize questions about objectivity.

Members noted that in the pure management development model, the internal audit staff is not expected to have previous audit experience, and the function includes even those with non-financial backgrounds (e.g., engineering). Members who support internal audit as a development opportunity generally admit that their approach differs markedly from the management development model, since “*people are pretty well trained when they come in.*” One member said, “*I still like the [management development] model, but it’s almost impossible because of [Sarbanes–Oxley] to bring in [less-qualified] people.*”

Another member observed that while larger companies had the luxury of rotating younger, less-skilled people through internal audit, it was much more difficult for smaller companies to bring “*rookies*” into internal audit. For these companies, smaller internal audit staffs require a higher level of technical skill, more confidence in the auditor’s independence, and expanded responsibility for risk management. Given these practical requirements, “*for small- and medium-sized companies, the [management development] model just isn’t in the cards.*”

Audit chairs reluctant to broaden the scope of internal audit’s role

Members observed that some CAEs seek to expand their role to include areas such as operational improvement or enterprise-wide risk management. One member said that internal audit regularly supports acquisition due diligence and provides insight into operational issues.



While members understand a CAE's desire for a *"bigger, more important job,"* they are sensitive to the fact that there is *"a whole spectrum of ability to do that."* Recognizing some internal auditors' interest in playing a lead role in risk management, one member said, *"In some cases it doesn't seem possible to me."* Furthermore, some members worry about a lack of focus and wonder whether a broader scope will distract internal auditors from delivering on their core mission.

Questions with implications – aligning skills and practices with organizational needs

- How can a company ensure that internal audit is not viewed as a dead-end job?
- How can internal auditors avoid real or perceived conflicts of interest, given that some ambitious auditors aspire to positions in departments they are auditing?
- Can internal audit be used as a training ground for new staff? Is prior audit experience necessary?
- Should internal audit's responsibilities expand to include non-audit activities (e.g., risk management, operational improvement)?

Audit committees must now play a more formal, active role in reviewing internal auditor performance and compensation

An audit committee chair once told Tapestry Networks that in the past, "internal audit was a boneyard for finance people." Agreeing on internal audit's newly elevated status, members said the best auditors are now highly sought after. One member mused, *"What a difference 15 years makes, when you say internal auditors are a hot commodity,"* to which a fellow member replied, *"Fifteen years? It's actually been only three years."*

The quality of internal auditors has risen and their responsibilities have increased, and members wonder whether their compensation is being adjusted accordingly. Members agreed that CAEs will not be given the necessary respect and recognition unless they are *"put at the right level."* Having lost a CAE because of a lucrative offer elsewhere, one member said, *"Management is 15-20 years behind the times,"* and asserted it was the audit committee's responsibility to discuss with management the possibility that the head of internal audit is *"susceptible to being stolen."*

Several members said they have been involved in hiring the chief audit executive, if only to interview and approve the finalist at the end of the process. This participation, they noted, marks *"a significant change over the last five years."* Members said it was important to choose the CAE carefully and observed that the most qualified internal auditors are highly sought after.

Members agreed it was important to ensure alignment between the CAE's expectations and the organization's needs. One member said their company had to change their CAE because his desire to play a more consultative role resulted in *"a mismatch between what he was hired to do and what he thought he was hired to do."* This member urged others not to make the same mistake: *"Make sure there's an understanding up front about the job specifications and the aspirations of the person."*



Some members believed it was best to hire a late-career professional to lead internal audit. Members said many 58- or 59-year-olds would like to serve in this role for five or six years following a successful career in public accounting. These professionals bring substantial experience and respect to the position; just as importantly, they rarely aspire to more senior positions and are therefore unconcerned with ruffling feathers.

Members do not agree about appropriate reporting relationships

NYSE listing requirements include a specific reference to internal audit: “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...”⁴

The Institute of Internal Auditors “believes strongly that to achieve necessary independence, the CAE should report functionally to the audit committee or its equivalent. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the organization.”⁵

Members questioned whether the audit committee has sufficient interaction with internal audit to warrant a direct reporting relationship. However, one member was surprised to learn at a recent conference that only 30% of CAEs report to the audit committee and said there are few barriers that would prevent the practice from becoming more widespread. *“The only thing that stops us is history. We’ve never done it before.”*

Others noted that while it was important for the CAE to have unimpeded access to the audit committee, a reporting relationship involves a *“huge administrative side,”* and one remarked candidly, *“I don’t want that as an audit committee chair.”*

One member argued that audit committees *“don’t have to supervise [internal audit] anywhere near day-to-day,”* while another expressed discomfort with the view that *“internal audit works exclusively for the audit committee above all others.”* Observing that the CAE’s *“interface with the audit committee has to be somewhat shallow compared with their other activities throughout the year,”* another member asserted that a reporting relationship was *“not consistent with reality.”*

Members want to be more involved in setting compensation

Although members disagreed on the appropriate nature of the reporting relationship between internal audit and the audit committee, they generally agreed that the audit committee should have input on the CAE’s performance and compensation.

A few members believe it is inappropriate for the CFO or CEO to set compensation for the CAE. However, in most cases, members are comfortable with management proposing a salary number for the audit committee’s approval, and they agree that the CAE’s salary should be consistent with the organization’s compensation structure.

⁴ New York Stock Exchange, “Final NYSE Corporate Governance Rules,” 10. Full text available at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>.

⁵ Institute of Internal Auditors, *Practice Advisory 1110-2: Chief Audit Executive (CAE) Reporting Lines* (Altamonte Springs, FL: Institute of Internal Auditors, 2001), 1. Full text available at <http://www.iaa.org.au/pdf/CombinedAdvisories.pdf>.



Although members recognize that audit committees often provide informal feedback on the CAE's performance and compensation, several members believe that there are opportunities to formalize these processes and to coordinate more effectively with the compensation committee. As one member said, *"We want to have input on compensation and a lot of input on performance."*

Several members noted that their audit committee charters clearly state that the general auditor reports to the audit committee and that the audit committee reviews compensation. Another member said that for the CAE's performance evaluation, the audit committee independently completes the same performance evaluation form as the CEO. The two forms are then compared to arrive at a consensus view.

Questions with implications – audit committee relationships with internal audit

- Is management's sense of appropriate internal auditor compensation consistent with market realities?
- What role should the audit committee play when hiring the top internal auditor? What is an appropriate background for this individual? How can parties ensure that expectations are aligned?
- Should internal audit report directly to the audit committee? What responsibilities are inherent in such a relationship? Can internal audit effectively report to the audit committee functionally but to senior management administratively?
- What formal processes do audit committees need to provide meaningful input on the CAE's performance and compensation?

Final thoughts

Some audit committee chairs have observed that the focus on internal controls that has resulted from the enactment of Sarbanes-Oxley echoes what happened following enactment of the Foreign Corrupt Practices Act (FCPA) in the late 1970s. Within a few years, FCPA compliance evolved from a resource-intensive project to a set of sustainable business processes, and many expect Section 404 compliance to follow the same path. Without neglecting the needs of today, audit committees and management might begin to contemplate such a future state and consider with their peers how best to align people, processes, and practices in internal audit to support their organizations' longer-term needs.

About this document

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, executives, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, executives, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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