



Internal audit in transition: redefining the function

Introduction

The North Central Audit Committee Network¹ met on October 30, 2007, to discuss the evolution of internal audit, including the role of internal audit in managing risk and ways to ensure the function is staffed appropriately. Members identified ways that companies might maximize the value of internal audit.

The members of the network present at the meeting, who sit on the boards of 24 large-, mid-, and small-cap public companies between them, were:

- John Baily, Audit Committee Chair, Erie Indemnity Company
- Jim Boland, Audit Committee Chair, Goodyear Tire & Rubber Company
- Dave Dillon, Audit Committee Chair, Convergys Corporation
- Rick Fearon, Audit Committee Chair, PolyOne Corporation
- Bill Lawrence, Audit Committee Chair, Ferro Corporation
- Mike Losh, Audit Committee Chair, TRW Automotive
- Dave McCammon, Audit Committee Chair, Pulte Homes
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Gary Valade, Audit Committee Chair, Wabtec Corporation

Ernst & Young participants in the meeting included:

- Frank Gori, Americas Director, Risk Advisory Services
- Steve Klemash, North Central Area Managing Partner, Audit and Advisory Business Services
- Al Paulus, Senior Client Service Partner

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 meetings are not attributed to individuals or corporations.

¹ The North Central Audit Committee Network is a group of audit committee chairs 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.

VantagePoint 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 *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, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.



Executive summary

Five years after the passage of Sarbanes-Oxley and following the implementation of Auditing Standard No. 5 (AS5), network members believe that this is a propitious moment to work with management to rethink the future role and direction of the internal audit function. Within that overall theme, the network's discussion revolved around seven ideas for audit committees, summarized below and expanded upon in subsequent pages:

1. Clarifying the role of internal audit in risk management *(pages 3-4)*

Many companies involve internal audit in some aspects of the company's approach to risk management. Members discussed the importance of marrying broader risk management processes with the internal audit plan and defining what specific risk areas internal audit is best suited to help identify, monitor, and mitigate.

2. Shifting Section 404 compliance from internal audit to business units *(pages 4-5)*

In recent years, the internal audit plan at many companies has been dominated by Section 404 implementation and controls testing but, increasingly, Section 404 work is being carried out by finance staff within the business units. By shifting ownership of Section 404 compliance to the business units, internal audit will have more time to pursue other priorities.

3. Defining and conducting "operational audits" *(page 5)*

Most members see opportunities for internal audit to devote more time to the type of operational audits routinely conducted pre-Sarbanes-Oxley, but they were very careful to define their terms. Members agreed that internal audit staff seldom have the requisite skills to improve operational efficiency or effectiveness. These important functions are better left to staff groups with specific skills, or to external consultants. Members observe that financial audits should be closely integrated with the operational adjustments and remedies required to overcome identified weaknesses and shortcomings.

4. Matching internal audit resources to scope *(pages 5-6)*

Companies often fall into the trap of building their audit plan around the internal audit organization they have – thus constraining the scope of what might ideally be accomplished. Instead, audit committees should assess whether the function has the requisite skills and resources to match the requirements of the desired internal audit plan, and oversee whatever changes might be required.

5. Marshalling specialized expertise often requires external resources *(pages 6-7)*

Some resources are better outsourced than brought on staff. Audit chairs need to be aware of the limitations companies may have in attracting, retaining, and developing specialized expertise. Functional expertise, often cited as most difficult to keep in-house, includes IT and tax, but attracting top quality foreign nationals is seen as at least as challenging. While relatively few companies see advantages in outsourcing the entire internal audit function, many are pursuing selective outsourcing and co-sourcing.



6. Ensuring internal audit quality and assessing the value added (pages 7-8)

Members' companies ask various internal and external stakeholders to systematically evaluate internal audit performance, and augment these internal evaluations with peer reviews to develop a broad assessment of the quality of the function. Members said part of what distinguishes a great internal audit function is that it is seen as "adding value." Yet, quantifying the value of the function is seen as challenging. Several members noted that reliably ensuring the integrity of financial reports is in itself added value.

7. Cultivating the audit committee's relationship with internal audit (page 8)

Members report a close relationship with the head of internal audit. They emphasize the need to spend the time to develop a detailed understanding of their companies' internal audit organizations if they are to play a meaningful role in defining a new direction for the function.

Seizing the opportunity to reassess the internal audit function

Section 404 compliance is no longer dominating internal audit's agenda, and audit committees and management now have the opportunity to identify the most effective ways to leverage the function. One member said, *"We staffed up for 404. Well, now what are you going to do? It's a work in progress."* Network members report a close relationship with the head of internal audit, often their closest contact among members of management, and they have a particular interest in helping to shape the future of the function in their companies.

Optimizing the internal audit function doesn't necessarily require a transformation; as one member noted, there is significant overlap in internal audit's activities before Sarbanes-Oxley, during Section 404 implementation, and after. The transition taking place in many internal audit organizations is largely *"a mind-set difference."* Yet companies may need to reconsider the scope of internal audit responsibility and how to staff the function to ensure it has the right skills and resources to do what is asked of it. Network members suggested optimizing the value of internal audit by reducing the Section 404 compliance burden (including controls testing) and increasing internal audit's focus on risk management and operational audits. Members noted that every company is different and will have to determine for itself what approach is best suited for its evolving needs and what internal audit model to use.

Clarifying the role of internal audit in risk management

Because audit committees are often responsible for oversight of enterprise risk management (ERM), they are well-positioned to ensure that the internal audit function is integrated into broader risk management processes. One member said, *"A lot of internal audit organizations got bogged down in testing internal controls and lost people. We need a better marriage with ERM."* This does not mean internal audit should have responsibility for the complete range of ERM activity. On the contrary, one member said ERM issues are so diverse that they require senior management's direct involvement and added that, *"[internal audit] doesn't have the skills for ERM, though internal audit intersects with [ERM]."* Another member said, *"ERM starts at the top ... It needs to be with the top operating people."*



Although internal auditors may not be suited to manage all risks, one member said it is possible to use internal audit to help identify, monitor, and mitigate specific financial risks and to integrate that process with broader risk management: *“We shouldn’t have one set of risks identified in the ERM process and another in the audit plan.”* Audit committees can work with management and the head of internal audit to define which risks internal audit has the capability and resources to manage.

Members noted that some companies, particularly those in financial services and related industries, tend to be more advanced in their thinking about the role of internal audit in risk management, while many other companies continue to struggle with integrating internal audit into robust risk management processes. One member said, *“It has to start with risk in terms of what we have internal audit doing. There isn’t anybody else in these companies that [is] really looking at certain risks or [has] expertise.”* Members are generally comfortable with the role of internal audit in compliance risk management, but had differing views of the role of internal audit in operational and strategic risk management processes.

Shifting Section 404 compliance from internal audit to business units

Most companies have been able to reduce the time and resources internal audit commits to Section 404 testing, but some have actually shifted that responsibility away from internal audit and into the business units. One member said, *“Everybody’s gone through that evolution. [Internal audit is] more of a maintenance function now.”* Yet a recent study by Ernst & Young found that 36% of SEC registrants required to comply with Section 404 said their internal audit function still has full responsibility for testing 404 controls.²

The extent to which companies have been able to decrease time spent on 404 testing varies, but members offered three important ways to substantially reduce internal audit time on Section 404 compliance and controls testing:

- **Embed 404 testing in the business units.** An emerging practice is for companies to embed responsibility for Section 404 compliance within their operations. Several members see this as an effective way to improve the control environment and controls focus of their business units, while allowing internal audit to return to more value-added activities. One member said, *“By embedding 404 [compliance], you create a control mentality,”* and another added, *“The units are really focused on controls; it really works.”* Members recommend companies work with their external and internal auditors to train operations people to develop the skills to take on more of this work.
- **Form a separate group for compliance.** At least one member said his company has separate *“SOX auditors”* that focus solely on testing internal controls and compliance, led by the controller and reporting functionally to the audit committee and administratively to the CFO. This group is staffed on a rotational basis by people from the business units who conduct tests back and forth across business units, freeing up internal audit time for other activities.
- **Reduce reliance of the external auditor on the company’s 404 testing.** With the implementation of the SEC’s management guidance and AS5, some members see additional

² Ernst & Young, *2007 Global Internal Audit Survey* (New York: Ernst & Young, 2007). This unpublished survey was conducted January–June of 2007 and consisted of direct interviews with representatives of 138 global companies drawn primarily from the Global BusinessWeek 1000.



opportunity to work with their external auditor to avoid overlap between the external auditor's work and that of internal audit. Although that may increase the external auditor's work, members agreed this is an *"economic tradeoff,"* but it may be an option for companies with small internal audit staffs they would like to see used in different ways.

A network member said there is value in having an objective group periodically conduct a thorough review, and another said internal audit control testing is a *"check and balance you need in the system."* Internal audit will always have a role in ensuring compliance and testing internal controls, but by shifting the work and responsibility for the formal Section 404 assessment outside the internal audit function, it can then objectively audit others' work and focus remaining time on other company priorities. Several members believe it may be possible to reduce the portion of internal audit's plan that is allotted to testing controls under the company's Section 404 assessment effort to as little as 10%, a clear departure from recent history for some companies that saw as much as 80% to 90% of internal audit's time devoted to testing controls.

Defining and conducting "operational audits"

Members agree that internal audit is moving into, or returning to, more operational audits. But what does that mean, exactly? One member said it is often difficult to define *"whether what they're doing is financial or operational. For example, doing an audit of inventory systems. Is that operational or financial? It's both."* In many companies, internal audit helps identify failures to follow procedure, but may not have the skills to help identify or solve operational inefficiencies. As a result, some members expressed skepticism about how far internal audit organizations can or should go beyond financial audits, but one member noted, *"Financial problems are often the result of operational problems. The financial symptom often leads you back to the operational issue that internal audit may be able to identify, even if they are unable to fix it. They can often make the link."*

A network member provided a useful framework to assist audit committees in working with internal audit to determine how much operational auditing they should be doing. The framework divides operational auditing into two elements: operational compliance and operational efficiency. Internal audit is well-positioned to audit operational compliance (e.g., ensuring various plants are following the same procedures), but may not have the skills to delve too deeply into operational efficiency. Members see operational compliance as the area in which internal audit may most fruitfully expand its activities.

Matching internal audit resources to scope

If this is a transitional period for the internal audit function, it is an opportunity to reexamine the kind of resources needed for changing priorities and to ask, *"Does [the function] become what is needed for the organization, or does it just match the skills of the staff you have?"* In recent years, the market for qualified internal auditors had tightened, making it difficult to attract and retain people at many companies, but there are signs that the market for talent is loosening. A network member said, *"The pressure to fill positions is off,"* because staffing needs have lessened following Section 404 implementation, there is less competition for talent, and there are more internal development opportunities for internal auditors at many companies.



Sarbanes-Oxley implementation required companies to build their internal audit staffs and to attract quality people, improving compensation and the perception of the function within companies. One member said, *“After SOX, it’s become a new profession of well-paid, professional internal auditors – career internal auditors. There is a market for people, for professional staff.”* Another added, *“Because of the demands of SOX, ...companies had to raise internal audit pay to compete. Now people want to go work in internal audit.”* Some still question how deep the market for internal audit talent is: *“The job is more attractive, but there is still a supply-and-demand question. How many good people are out there?”*

If audit committees are to play a significant role in determining the direction of internal audit at their companies, they will need a clear understanding of the resources available to internal audit and how the function can ensure it has the necessary staff to meet its newly defined priorities. This may require a staff with a different set of skills, knowledge, and tools.

Internal audit as a development pool

A network member suggested that although internal auditor has become a more attractive job, it may still be seen as a temporary assignment used as a stepping stone into other areas of the organization: *“People come because they think it will lead to something [else], not for the audit [role itself].”* Using internal audit as a development tool to attract young talent and give them broad exposure across the organization with a formal program to rotate them on to operations positions is often referred to as the “GE model.”

Members see some benefit in rotating people out of internal audit, but are generally skeptical about the effectiveness of this model, especially in smaller companies. An obvious challenge is rotating people out of internal audit when there may be only five or six people on the staff – *“the law of small numbers.”* As one member said, *“You need a core group of people if you’re moving people through.”* Another risk is that a company may invest in developing people through internal audit and then *“they’re gone,”* recruited to work at another company.

Despite those risks, some members see value in the exposure gained from a stint with internal audit and use development opportunities as a recruiting tool. One member said, *“Once a year, we get a list of where people are that left internal audit. Most move within the company. We hire some undergraduates who move through, and some career people, but even career people change their minds.”* Another member said, *“With a larger staff, it’s good to have a balance. We have about 50% entry-level, bright people that will go elsewhere in the organization, but you want some pros.”* Regardless of their views on the efficacy of the GE model, members agreed that *“the head of internal audit needs to be a recruiter, a developer of talent.”*

Marshalling specialized expertise often requires external resources

In an increasingly global market, with a dynamic risk environment and heightened expectations of internal audit, developing an internal audit staff with all of the required skills in-house is a challenge, especially for smaller companies. Many companies have turned to outsourcing or co-sourcing to address the changing requirements of internal audit. The most common challenges members identified are staffing information technology (IT) specialists and staffing for global operations, which present language and cultural barriers for



centralized internal audit staffs. One member said, *“My sense is [that] pre-SOX, outsourcing was a wave; SOX shrank that, but now it’s coming back.”*

Members discussed different approaches to sourcing internal audit:

- **Outsourcing.** One member’s company outsourced Section 404 implementation, providing stability in staffing levels and work for the relatively small internal audit staff. Another member said his company struggled with high turnover and found outsourcing an economically favorable alternative. It also provided helpful flexibility because, the member said, *“They bring other [specialist] resources in on some issues. From a resource standpoint, it’s a lot easier.”* Even when the function is almost completely outsourced, members see value in retaining internal management. One member regretted not having done so: *“We didn’t retain the internal structure to monitor and manage ... we didn’t have control over the quality of people.”* Another said, *“You absolutely need to retain that management internally when you outsource.”*
- **Co-sourcing.** More common than full outsourcing is teaming with an audit firm to co-source the function. Members said most companies require external support for staffing IT specialists, global operations, and tax specialists in particular.
- **Insourcing.** At least one member recommended retaining as much resourcing in-house as possible: *“To me, if you can do it inside, you ought to. There are other benefits to your own audit staff. They get familiar with the company, how you’re supposed to do things, the tone at the top, etc. They’re yours. They’re part of the team. Outside people may see it as a temporary job.”*

Ensuring internal audit quality and assessing the value added

Members say it is important for internal audit to be seen as adding value, but how should companies measure the value and effectiveness of the function? One member said, *“I haven’t seen any good processes ... a lot [of the value] is intangible.”* Though it is challenging to quantify the value of internal audit, members identified a number of ways to evaluate the function:

- **Peer reviews.** The Institute of Internal Auditors (IIA) recommends the company have another internal audit organization conduct a peer review of their own internal audit function every five years. One member said, *“You don’t see many [peer reviews], but they are extremely helpful.”* The IIA has an exchange program to connect companies for peer reviews, and some audit firms also conduct them.³
- **Field assessments.** Several members said they conduct a survey of *“satisfaction within the organization”* to be sure management sees value in the work internal audit has completed. At least one member’s company conducts such an assessment after each internal audit report, which equates to a monthly review of the function. The status of the organization within the company tells a lot about how successful the function is. One member said, *“They need to be seen as adding value,”* and another said, *“They are more collaborative, with better people, and are well-respected. It’s an outdated notion that they are ‘police.’”*

³ Details regarding the IIA’s exchange program are available in full at http://www.theiia.org/index.cfm?doc_id=5249&bhpc=1.



- **External auditor evaluations.** One member said, *“We talk to the external auditor each year about the quality of the [internal audit] organization.”*

Members identified two key elements that differentiate a great internal audit function from one that is merely good:

- **Leadership.** *“The right leader will build the staff and lead them. They are proactive, strategic, and work with the operations people.”* Leadership from senior management, especially the CFO, is also important as it sets the tone for how the function is regarded within the organization: *“The CEO and CFO have a desire to have a strong function versus just having one.”* That includes ensuring that the head of internal audit *“has a seat at the table in management discussions, with a respected opinion”* and is seen as a peer by executives with appropriate seniority.
- **Ability to adapt to a dynamic risk environment.** As internal audit plays an increasing role in monitoring particular risks, the function must be nimble enough to adjust as necessary and avoid becoming *“stale.”*

Cultivating the audit committee’s relationship with internal audit

Network members report a close relationship with the head of internal audit, often their closest contact among members of management: one member speaks with the head of internal audit monthly. Network members stressed the importance of scheduling sufficient time for the head of internal audit in the audit committee meeting agenda, and all network members report having executive sessions with the head of internal audit at each audit committee meeting. Some speak to the head of internal audit “off-cycle,” and one member said, *“It’s worked well to talk more often, on a less formal basis.”* One member said his audit committee spent a large portion of one meeting with the internal audit staff, deconstructing internal audit’s charter. That member said, *“It was very educational and an opportunity for a good dialogue, which resulted in a solid charter.”*

Audit committee chairs in particular have to be well-informed about the people and tools available within the internal audit function if they are to play a meaningful role in strategic and tactical decisions about the function. As one member said, *“The chair spends much more time [than the rest of the committee working on internal audit’s plan] and then reviews the plan with the full audit committee.”* Ultimately, one member said, *“Internal audit needs to be aligned with all of the stakeholders, the audit committee, management, the external auditor ... If they go in a different direction, everybody gets frustrated.”*

Conclusion

As companies re-evaluate the role of internal audit, audit committees can have significant influence in determining internal audit’s scope as the function shifts emphasis away from Section 404 compliance testing to achieve greater balance with risk management and operational audits. To do so, audit committee chairs need to be closely involved with management in strategic and tactical planning for the function. Audit committee chairs can also assist management by evaluating internal audit’s performance on a regular basis and



encouraging the use of external resources when necessary, thereby also ensuring that the best resources are at hand to match any expanded internal audit scope and plan.

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