



The evolution of internal audit

Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Pacific Southwest region of the United States. The network held its eighth meeting on October 17, 2007, to discuss the evolving role of the internal audit function. This document is a synthesis of insights and comments from that meeting.

The members of the network participating in the meeting sit on the boards of about 15 large-, mid-, and small-cap public companies. They were:

- Frank Biondi, Audit Committee Chair, Amgen
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- Steve Frank, Audit Committee Chair, Northrop Grumman Corporation
- Mike Meyer, Audit Committee Member, City National Corporation
- Mike Stein, Audit Committee Chair, AIMCO

Ernst & Young participants included:

- Gary Birkenbeuel, Managing Partner, Pacific Southwest Area Assurance and Advisory Business Services
- Tom Bussa, Partner, Risk Advisory Services
- Peter Griffith, Pacific Southwest Area Managing 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. However, Mr. Bussa has given permission for his comments to be attributed. Members' remarks appear in italicized quotes.

Executive summary

Members of the Pacific Southwest Audit Committee Network discussed ways in which an audit committee can help ensure that its company has an effective internal audit function. The following important ideas were highlighted:

- **Internal audit's scope should be driven by needs, not capabilities** (*Page 2*)

Members have different views about the appropriate scope of internal audit. However, they agree that the mission and charter should be aligned with the company's risk profile, the size and complexity of the organization, the capabilities of the audit staff and the resourcing plan. Although internal audit may not always drive the enterprise-wide risk management effort, it often plays an important role. An example of a world class internal audit framework has been included in this document as an Appendix.



- **Finding and retaining internal audit talent continues to be a challenge** (Page 3)

Recruiting and retaining talented internal audit staff, especially a head of internal audit, continues to be a challenge. Members feel the function can be an effective training ground for finance professionals, though it is important to blend rotational staff with a core group of career auditors. While most members feel it is important to hire dedicated staff, they agree that outsourcing and co-sourcing are viable options when specialized expertise is required, when a company's size does not justify permanent staff, or when resourcing needs are variable.

- **Audit committees should encourage continuous improvement of internal audit** (Page 5)

Members feel that the audit committee should play a significant role in overseeing internal audit and assessing its effectiveness. Is the function adding value? Who is monitoring and keeping track of it? Are the processes working the way management intended them to? Members agreed that audit committees might consider bringing in an external source to review the internal audit function every couple of years.

Internal audit's scope should be driven by needs, not capabilities

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.”¹ However, beyond this broad directive, management has significant leeway when defining the scope of a company's internal audit function.

Members agree that the best way to set internal audit's scope is to have a clear mission and charter and then to align the company's resources accordingly. Mr. Bussa, an experienced client service partner who, until recently, led Ernst & Young's global business risk services practice remarked, *“From what I have observed, audit committees that take a very active role in setting and reviewing the mission and charter of internal audit have been the most successful. With a clear plan in place, audit committees can constantly be reviewing internal audit's performance and making sure they are staying aligned with their goals.”* Many members reject the practice of adjusting internal audit's scope based on staffing levels and capabilities. Rather, they believe internal audit's mandate should reflect the needs and risks of the company. As one member said: *“We make sure our risk assessment reflects our key [business and financial] risks; then, we determine how best to source our [internal audit] needs.”*

Should the focus remain on compliance?

As the mood of urgency that accompanied initial Sarbanes-Oxley compliance has faded, many organizations report that they are returning to a pre-Sarbanes-Oxley mandate for internal audit. A 2007 study by Ernst & Young shows that “expectations for internal audit functions are not only changing, but expanding.”² The

¹ New York Stock Exchange, *Final NYSE Corporate Governance Rules*, 13. Available for review at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>.

² Ernst & Young, *2007 Global Internal Audit Survey* (New York: Ernst & Young, 2007). This 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.



focus is no longer purely on financial audits and internal controls work; internal audit is returning to operational audits and improvement and is also becoming involved in strategic areas such as risk management.

Some members are concerned that moving internal audit's focus away from compliance might decrease the function's credibility. As one member mused, *"One of the [positive] consequences of [Section] 404 is that it has raised the compliance workload. I think internal audit will now start to pull away [from Sarbanes-Oxley compliance], but it could lose the [credibility] of the function again."*

In spite of a push by some internal auditors to broaden the function's scope, several members argued that a more limited scope of activity was more appropriate. One member said, *"I'm a big believer that the scope of internal audit needs to be [more focused]. Not so [focused] that it's only [addressing] compliance, but there has to be some sort of middle ground."*

Some members have found that in times of change or transition, it can be helpful to expand internal audit's scope, but most feel internal audit is not suited to such expanded responsibilities: *"While a lot of people find it sexy to think internal audit can do operations, in my experience, internal audit does not usually have the experience or the expertise to do a [top quality] job."* Another member concurred, remarking, *"I don't think it's a good thing when internal audit gets used as a rescue crew to salvage the ship before it sinks. I think it should focus on financial risk and controls and an important overall view of risk management."*

Risk management frequently drives internal audit activity

Members believe that it is important to carefully consider internal audit's role in enterprise risk management (ERM). One member commented, *"I agree that internal audit does have a role to play when it comes to [ERM]; a lot of risks go beyond what you would expect of an internal audit department, but [the risk management process in general] definitely falls under internal audit's responsibilities."*

Many members expressed a desire to further align internal audit and risk management: *"We're working on [the ERM plan] now, with internal audit's input, and once we get the ERM plan formulated, we expect internal audit to audit it like any other division. We want to keep internal audit doing what they should be doing."* Mr. Bussa concurred: *"Leading practice is for internal audit to audit the ERM process, but not drive the ERM activity."*

Despite agreeing that internal audit should play a role in the company's risk assessment, members pointed out that risk is often hard to predict. One member said, *"Look at [the leading mortgage lenders]. Six months ago, they had no idea they would ever have a problem with credit ... It just shows how hard it can be to identify and anticipate risk."*

Finding and retaining internal audit talent continues to be a challenge

Members agree that the challenge of *"finding qualified people to fill the ranks of internal audit"* has been, and will continue to be, one of the most difficult issues audit committees face. Finding a qualified professional to lead the internal audit function is particularly challenging. As an article in the September



2006 issue of the *Journal of Accountancy* put it, “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.”³

Members agreed on one personality type they do not appreciate as a CAE: a policeman. One member shared, “*We had an [inspector]-type character who liked putting people behind bars and didn’t like to think people were innocent until proven guilty. It was clear he did not always have the company’s best interests in mind.*”

Another member described the many benefits that an effective CAE offers: “*We have a great head of internal audit who has been with us for many years. Our CAE is not only extremely proficient, but also connected to several external networks of internal auditors, and that helps a lot when it comes to recruitment.*”

Members feel that the audit committee has a significant role to play in hiring and assessing the head of internal audit. Members reported that, as audit committee chairs, they look for “*recognized leadership capability*” and consider the appointment of the CAE to be an opportunity to demonstrate tone at the top. One member reported, “*We took a high-potential individual from a finance organization because of the message it sent about the importance of the role. This person won’t be there for more than three or four years, but it does bring some star power to the position.*” Indeed, the same member who reported having the “*inspector*” CAE said that when it came time to hire a new head of internal audit, “*We had a unique opportunity to bring in a leader and set the tone for [the] kind of internal audit function we had wanted to have all along.*”

Finance staff can benefit from a rotation through internal audit

One of the best ways to improve the perception of the internal audit function is by rotating top finance employees through internal audit, a practice members say can provide multiple benefits: “*We use internal audit ... as a training ground. It can be a stepping stone into such areas as finance and operations or into the risk management arena.*”

One member shared his success with the rotational model of internal audit by recalling a management experience earlier in his career: “*Anyone we hired from public accounting came through internal audit. It was usually a two-or-more-year assignment, and then they would move into [an operations or finance role]. After a few years, this was established as common practice, and the fact that current management could say they had been in internal audit originally set the precedent, and thus we were always able to keep the pipeline full.*”

While several members agree that rotation through internal audit can provide a developmental opportunity, others describe the tension between short-term internal audit assignments and the need to develop deep

³ Larry Rittenberg and Richard Anderson, “A Strategic Player: Hiring and inspiring a chief audit executive,” *Journal of Accountancy*, September 6, 2006. Available at <http://www.aicpa.org/pubs/jofa/jul2006/rittenberg.htm>.



subject matter expertise: *“I think it’s good to [also] have people who are steeped in the function, not only to do the work, but also to serve as mentors and trainers.”*

External sourcing can help ensure adequate capabilities

Members believe that when the in-house auditors cannot meet all the needs of the organization, it is acceptable – even desirable – for companies to co-source some of the internal audit requirements. Several members reported that they have co-sourced: *“We do it selectively wherever the need is. We did it for a season with [information technology] until we were able to execute using our in-house staff.”* Another member added, *“We use it to fill slots we hadn’t been able to fill earlier.”*

While members acknowledge the benefits of co-sourcing, many agreed with the member who said, *“In general, it’s better to keep at least some of the staff in-house. I know there are some places where people have decided to outsource the whole function, but that would not be my choice.”* However, another member pointed out that the decision depended largely on the company: *“I think it really depends on the company and its size. It might not always make sense to have an internal [audit] function in-house. I can see the rationale behind outsourcing the whole thing.”*

Most members said they preferred to source internally before looking outside. One member reported, *“We sometimes ask people who are about to retire to stick around for a few more years and work in internal audit. They already know the company so well that they basically serve as in-house consultants.”*

Audit committees should encourage continuous improvement of internal audit

According to the Institute of Internal Auditors (IIA), “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.”⁴ Members spoke at length about the important relationship between the audit committee and internal audit. In particular, members discussed the reporting relationship in place at their companies and the audit chair’s role in ensuring that internal audit is constantly evaluated.

Members agree that one way for audit committee chairs to encourage continuous improvement is by being involved in the CAE’s ongoing performance evaluation. Mr. Bussa suggested that audit committee chairs might ask themselves, *“Are you taking the pulse of the internal audit stakeholders? [Do they say that internal audit is] of value? [Is it] doing what needs to be done? Are you having a number of periodic reviews?”*

An external evaluation can be valuable

Some members also described the benefits of an objective evaluation of internal audit. One member remarked, *“It’s good to have an external view of all of [the internal audit function].”* Another member shared merits of an external evaluation: *“We did an IIA [Quality Assessment], where all the stakeholders were touched and asked for various evaluations. Once we got the thing orchestrated, it was actually quite*

⁴ 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.



good. We took the pulse, and it turns out most people feel internal audit is valuable. That was great to see.”

While members for the most part agreed that external reviews were good for the internal audit function, some reported that they may not always yield candid feedback because *“we don’t like to share our dirty laundry with an external party.”*

Reporting lines between the audit committee and internal audit must be clear

Members said that one benefit of a more direct reporting relationship between the audit committee and internal audit is a deeper and more strategic relationship between the two. Members agreed that *“there should be a direct reporting line to the audit committee”* to ensure objectivity and allow the audit committee to evaluate internal audit’s performance more effectively. One member observed, *“In this post-Enron Sarbanes-Oxley environment, not only has the relationship with the external auditor evolved, but also [with] the internal auditor. Audit committees are much more involved in the scope of internal audit’s work, [and internal audit is] taking much more seriously the reporting relationship with the audit committee.”*

Most CAEs reach out to audit committee chairs informally, through weekly telephone conversations or in-person meetings once or twice a quarter.

Several audit committee chairs report that it has been a struggle to find a balance between the management responsibility typically associated with a solid-line reporting relationship and the board’s oversight role. As one member remarked, *“On my board, we try to handle the hiring, firing, assessment, and compensation [of internal audit]. However, while we ultimately have the final say, we’re still constantly working with management and working to find that balance.”*

Members were clear that there is no “one-size-fits-all” administrative reporting model. As one member noted, *“My belief has always been that internal audit should report to the highest executive that has the interest and commitment to do the blocking and tackling for internal audit and the audit committee. The CFO could do that as long as he cares and is objective.”* Regardless of how the reporting relationship is set up, most members agree that *“it has to be a real partnership between the audit committee, general management, the external auditor, and the [internal audit] staff.”*

Conclusion

Audit committee chairs have long described the internal audit function as their “eyes and ears in the company.” Unfortunately, over the past few years, most internal audit departments have been unable to play this important role because of compliance obligations.

Audit committees may now want to reconsider some important questions: What is the mission of internal audit? What capabilities are required to fulfill that mission, and where can they be sourced? How can internal audit remain (or become) relevant to the organization as Sarbanes-Oxley becomes just another routine compliance obligation? How can the audit committee foster an effective and supportive relationship with internal audit?



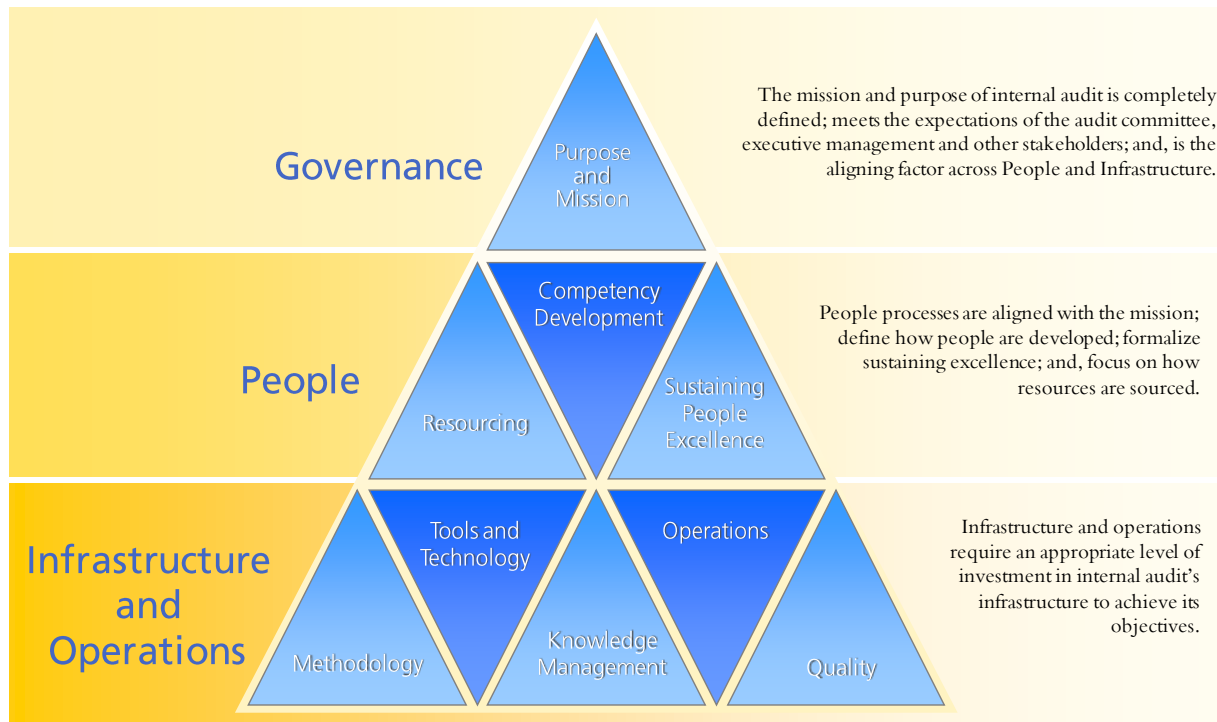
One participant noted that many audit committees are confronting the same fundamental issues today as they were ten years ago. In this regard, *"No one has [yet] cracked the code."* To achieve this objective, audit committees need to properly define internal audit's mission and charter, periodically review and update them, and make sure the people, processes and enabling infrastructure are continually aligned with them.

The views expressed in this document represent those of the Pacific Southwest 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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Appendix - Example of a world class internal audit operating framework



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