



## Starting an Internal Audit Function

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### 19. How do we start an internal audit function?

A suggested set of guidelines for starting an internal audit function includes:

- Clarify expectations with senior management, the board and audit committee, including required listing standards for NYSE companies. Non-NYSE-listed organizations should consider voluntary compliance.
- Develop an audit charter, with audit committee input and approval.
- Consider the appropriate budget and staffing model (e.g., in-house, co-sourced or outsourced). As part of this process, research actions taken by similar companies in your industry.
- Formulate reporting responsibilities of the internal audit function.
- Identify the “universe” of auditable entities within the organization.
- Complete an initial risk assessment with company management and audit committee involvement. Consider using recognized approaches and frameworks for this effort, such as the COSO internal control and COSO enterprise risk management (ERM) frameworks. Other recognized and acceptable frameworks include the King Report on Corporate Governance for South Africa - 2002 (King II Report) and the Turnbull Report in the United Kingdom.
- Consider the results of the work required to comply with Sarbanes-Oxley when conducting the risk assessment.
- Develop an internal audit plan responsive to the risk assessment.
- Determine staffing requirements and whether the department will be staffed internally, co-sourced or outsourced.
- Plan and execute audit work called for in the audit plan, including a system to monitor and follow up on audit recommendations.
- Update the risk assessment for changing circumstances during the year.
- Continuously enhance and modify the internal audit function to meet changing needs of management and the audit committee.

See Appendix C for a listing of 16 steps developed by The IIA for creating an internal audit function.

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## 20. How should an internal audit function be staffed?

Internal audit functions must be resourced adequately to ensure an effective evaluation and testing of internal controls, associated risks and execution of the internal audit plan and other activities as outlined in the company's written internal audit charter. The annual audit plan is based upon a risk assessment at both the entity and process levels, and should be approved by the audit committee and board.

Companies should look to their individual risk profiles to drive staffing decisions. A business facing a significant number of risks or particularly complex risks will require a broader range of specialists and expertise. Most internal audit departments are headed by a CAE and include layers of staff such as managers, senior auditors and auditors. Many companies also rely on other in-house professionals or tap into the specialized skill sets of outside providers.

Some of the more commonly accessed or desired specialized skills needed by today's internal audit function include:

- Relevant industry knowledge
- IT privacy and security
- Current, in-use enterprise resource planning (ERP) application expertise
- Business continuity management
- Specialized and complex industry or other related regulations
- Fraud prevention, detective and investigative capability
- United States GAAP and IFRS knowledge
- Specific business process knowledge in large, material and high-risk areas
- Resources needed in remote locations

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## 21. To whom should the head of internal audit report?

The reporting line of internal audit is a dynamic issue today, especially considering recent corporate scandals and continued financial restatements, the emergence of regulations such as Sarbanes-Oxley and new listing standards of the stock exchanges. All these have substantially increased the responsibilities of the audit committee.

The IIA *Practice Advisory 1110-2, Chief Audit Executive (CAE) Reporting Lines*, states, "The chief audit executive should report to a level within the organization that allows the internal audit activity to accomplish its responsibilities." The Practice Advisory goes on to state: "The Institute (IIA) 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 (CEO) of the organization."

Unlike the company's external audit firm, which by regulation must be hired by, report to and be compensated by the audit committee, internal audit has a broader role to play through serving as a resource for both the audit committee and company management. Though this "dual reporting" is a somewhat sensitive arrangement and can be tricky in practice, it nevertheless provides important benefits to the company as a whole, including its overall corporate governance objectives as well as management's objectives for reliable financial reporting, compliance with applicable laws and regulations, and efficiency and effectiveness of operations (the COSO objectives of internal control).

Until regulations or standards change, internal audit is considered a part of the internal control system of a company, yet must also remain an independent, objective assurance and consulting activity that supports and reports to a company's CEO and audit committee.

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## 22. Can employees in the company participate in internal audits?

Yes. Many companies choose to source management-training programs, employees with specific experience or guest internal auditor programs as part of resource planning. Some organizations have established two- to four-year rotation programs to help management understand the organization's internal control environment and other operational areas, and to provide individuals with management-training experience and career progression.

This type of flexibility and training often enhances organizational understanding of risk management and internal controls systems and motivates program candidates to strive for excellence. Conversely, internal audit management should be aware, in every instance, of the same conflicts of interest that arise naturally from such relationships in considering these candidates for potential positions in operations. For example, there may be a conflict of interest for individuals who join the internal audit department from an existing corporate function that would preclude them from auditing their former colleagues. Other situations include a natural tendency by a rotating internal auditor to hold a favorable bias in evaluating a business unit or function in which he or she may be seeking a full-time position.

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## 23. What are the pros and cons of outsourcing/co-sourcing internal audit?

Up through the 1980s, most company internal audit functions were staffed primarily in-house with full-time, dedicated employees. This structure worked adequately and can still be effective today, but only if full-time internal auditors possess all of the skills needed to address key business risks faced by the organization. If this is not the case, then the internal audit function places its employer company at risk by not being able to address adequately the key risks that it has been asked to audit.

During the 1980s, as the concept of "core competency" gained more attention, companies evaluated many of their business functions and the potential for outsourcing them. Payroll, benefits, real estate, printing, information systems operation and maintenance, and even aspects of design or manufacturing, among other functions, were considered. Many companies found clear and tangible benefits, positive return on investment (ROI), and improved service levels as a result of outsourcing. In some cases, capital expenditures were reduced and the cost of these functions became more variable. Internal audit functions were a part of this analysis, and several new internal audit outsourcing and co-sourcing organizations, including the large accounting firms, created new structures to provide such services.

Today, all businesses, government and not-for-profit organizations face myriad risks due to the dynamic operating climates in which they operate. New and fast-changing regulations; significant technology-related risks such as security, business continuity, and application and data integrity; heightened instances of or opportunities for fraud and abuse; and other issues such as Sarbanes-Oxley require internal audit functions to have at their disposal a larger and deeper talent pool. These professionals must be able to address, react to and effectively audit and report on this more complex and faster-changing risk universe.

Given this dynamic risk environment, it is unlikely that a majority of internal audit functions have the continuous in-house capability to adequately address every risk they and their organizations must face. Thus, contracting, partnering or working with outside organizations that can provide specialized resources improves an internal audit function's ability to address risks and meet customer expectations. Additionally, these co-sourcing arrangements often assist in the knowledge transfer process to in-house resources, raising the level of competency of the function's full-time employees.

Likewise, many companies – especially public companies, large and diverse private companies, and even governmental entities and not-for-profit organizations – may find that full or partial outsourcing of their internal audit functions makes sense, is cost-effective and provides significant short- and long-term benefits.

Benefits of outsourcing include:

- Quick start-up of the function and execution of work, including already-developed methodologies and audit tools provided by the outsourcing organization
- A variable-cost arrangement rather than a fixed-cost function
- Access to a greater number and wider range of resources
- Potentially greater objectivity and independence

The NYSE's internal audit rule allows for the outsourcing of internal audit. In its commentary to the requirement, the NYSE stated, "A company may choose to outsource this function to a third-party service provider other than its independent auditor." Companies should also consider the potential negative impact of outsourcing or co-sourcing internal audit, which can include, but is not limited to, the potential loss of control since resources are not directly employed by the company.

From The IIA's perspective, internal auditing, regardless of who provides the service, should be performed in accordance with The IIA *Standards*. The IIA states in its position paper, *Resourcing Alternatives for the Internal Audit Function*, that a fully resourced and professionally competent staff is an integral part of the organization, whether insourced or outsourced. The IIA recognizes that many "partnering" arrangements with outside providers have been effective in helping organizations obtain internal auditing services to help achieve management's objectives.

While non-NYSE companies are not required to have an internal audit function, certain limitations apply to the nature and level of internal audit services that any public company's external auditor can provide per SEC rules and regulations.

Ultimately, deciding whether to outsource internal audit is not a matter of considering the general pros and cons. Instead, each company should ask:

- If we currently do not have an internal audit function, are we better off taking the time and effort to start our own in-house internal audit function? Or should we initially outsource it to gain quick start-up and access to a greater level of expertise and broader level of resources, and then monitor this decision and delivery model to ensure it is effective?
- If we already have an internal audit function, do we have the resources we need to effectively address all of the key risks we face and in which internal audit should be involved? Do we need to have all of these resources in-house all of the time? Might we be better off considering an arrangement to have one or more outside organizations assist us with addressing our risks?

There are many excellent internal audit functions consisting of primarily in-house, fully dedicated employee resources. What makes these functions most valuable, effective and appropriate, however, is a recognition of their own limitations. Many large internal audit functions (more than 25 full-time employees) recognize that in today's complex business environment, it would be cost-prohibitive to have all of the right resources at hand all of the time. They also understand that various forms of co-sourcing arrangements have benefited them greatly along with the companies, management and audit committees they serve.

### Case Study: Co-sourcing

A large multinational corporation with a well-established and historically effective internal audit function realized that though it was well-staffed, new business risks and the need for new audit skills seemed to be surfacing all the time. Revised and complex treasury arrangements, a leading-edge information system, new joint ventures, as well as a just-acquired division in a new industry, were all stressing the department's capabilities. In addition, greater than average turnover of staff had occurred, leaving the department understaffed on a regular basis.

The internal audit director, a 20-year-plus veteran, sensed "there must be a better way." To her, co-sourcing with a firm that could meet specialized as well as just-in-time needs was the answer. Leveraging the co-sourcer's intellectual property and methods also seemed to be a valuable benefit.

After evaluation and selection of a co-sourcing partner, the audit director and her department significantly enhanced their overall capability and effectiveness in dealing with new and complex risk areas as well as auditee customer satisfaction.

### Case Study: Complete Outsourcing

A consumer products manufacturing company with a strong forecast for growth and expansion was seeking to create an internal audit function as it reached a certain level of revenues and operational scope. Both management and the audit committee believed the company's situation warranted such a function to assist in the development of a risk assessment and risk management process and to complete focused internal audits as a result of the risk assessment. They also wanted the internal audit function to be able to address unexpected operating and internal control issues, and to assist with preparation for Section 404 of Sarbanes-Oxley.

After considering the options of creating and building a function in-house, hiring selected individuals and then co-sourcing or fully outsourcing the function, the company concluded that fully outsourcing the internal audit function initially made the most sense and provided the best benefits. Flexibility, quick start-up, access to varied skills and resources, as well as the resources, quality and reputation of the outsourcer, were among the reasons supporting this decision. This arrangement allowed the company to have an effective internal audit function almost immediately to help management and the audit committee meet their fiduciary and other responsibilities.

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## 24. Where do I get more information on internal auditing?

The primary information resource on internal auditing is The IIA (see Appendix H). Other sources include consulting companies, various online information portals and universities with related programs.

KnowledgeLeader<sup>SM</sup> ([www.knowledgeleader.com](http://www.knowledgeleader.com)), a subscription-based repository from Protiviti, provides best practice guidance, topical work programs and white papers on internal audit, business risk and technology risk. Thirty-day free trials are available.

See Appendices F, G and H for more information on resources.