



The NYSE Internal Audit Requirement

70. What companies are impacted by the SEC's approval of the NYSE rules?

Only NYSE-listed firms are affected. While the SEC also approved new listing standards for the NASDAQ, these did not include an internal audit requirement. However, many companies with diverse and complex operations, both private and listed on other exchanges, may find that developing an effective internal audit function will assist them in maintaining, validating and improving internal controls; identifying opportunities to reduce costs and improve processes; and enhancing their corporate governance.

Additionally, with these standards now in place for NYSE companies, other regulatory bodies, governments and stock exchanges outside of the United States may choose to follow the lead of the NYSE.

71. What do the NYSE rules require?

Regarding internal audit, the NYSE regulations require that listed companies have an internal audit function. In added commentary on the rule, the NYSE states:

Listed companies must 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 controls. A company may choose to outsource this function to a third-party service provider other than its independent auditor.

However, the guidance does not stipulate the minimum requirements of an internal audit function, nor does it establish any specific parameters for maintaining an internal audit function or department on an ongoing basis. The size, budget and structure of internal audit functions depend on many factors (see Questions 12 and 19–24). Most effective internal audit functions provide a risk-based assessment that incorporates appropriate personnel resources and skills to evaluate an entity's risk management processes and internal control systems. We believe the NYSE requirement begins by stating the end goal because organizations vary widely and effective risk management, internal controls and governance can be accomplished in different ways.

72. Does the NYSE provide listed companies with any instructions or guidance beyond the rule requiring an internal audit function?

The NYSE issued its own Frequently Asked Questions document, dated February 13, 2004, covering Section 303A, which includes the internal audit rule. Section 303A also contains a number of new listing rules related primarily to the board of directors and related board committee issues.

The Section 303A FAQs can be found on the NYSE website at www.nyse.com. (Please note that the internal audit rule is not addressed in detail.) This document may be amended from time to time. NYSE-listed companies should check the exchange's website periodically for updates.

73. When are the rules effective?

The NYSE internal audit rule is effective immediately for all companies on the day they list on the NYSE through an IPO or when transferring from another stock exchange.

However, there are some exceptions: Listed companies that are foreign private issuers (as such term is defined in Rule 3b-4 under the Exchange Act) are permitted to follow home-country practice in lieu of the provisions of Section 303A (except 303A.06, .11 and .12(b), which are not related to the internal audit function requirement). The NYSE-provided commentary discusses this interaction as an audit committee oversight component.

74. When and how does this rule regarding internal audit apply to companies transferring from another stock exchange?

According to the NYSE, when the exchange or market the company is transferring from does not have a similar internal audit requirement, then the company will need to be in compliance with the internal audit provision of Section 303A within one year of transferring to the NYSE.

75. Must foreign private issuers comply with this rule?

The NYSE Frequently Asked Questions document dated February 13, 2004, addresses this question in a general way as follows:

Foreign private issuers are required to comply with only the following parts of Section 303A:

- 303A.06 – Audit committee requirements
- 303A.11 – Requirements to disclose significant differences between their corporate governance practices and NYSE requirements for domestic listed companies
- 303A.12(b) – Foreign private issuer provides the NYSE with prompt notice if it fails to comply with the two sections noted above

We believe that foreign private issuers without an internal audit function must determine if these differences are significant. If so, then as required by Section 303A.11, the differences must be disclosed by the company, along with any other significant differences, either in the annual report required by the NYSE to be distributed to shareholders, or on the company's website.

As to the timing of this disclosure, the NYSE has stated:

As of the company's Section 303A compliance date, if the company chooses to include the required disclosure on its website, it must do so promptly after it makes that determination.

76. Does the rule apply to companies with public debt?

No. The internal audit rule does not generally apply to companies listing only preferred or debt securities on the NYSE. According to the exchange, to the extent required by Rule 10A-3 under the Exchange Act, all companies listing only preferred or debt securities on the NYSE are required to comply with the requirements of Sections 303A.06 and .12(b).

77. Does the rule affect other stock exchanges and private companies?

No. The rule applies only to NYSE-listed companies. The NASDAQ and AMEX do not have internal audit requirements at the present time. Private companies are not affected by this rule. However, these organizations, their boards, audit committees and management may want to consider whether creating an internal audit function would provide tangible benefits and serve to demonstrate a higher level of corporate governance.

Many non-NYSE listed companies, large non-U.S. companies and large private companies have recognized the benefits an effective internal audit function can bring to their operations and compliance efforts, and have created such functions with positive and measurable results.

78. Are there similar proposals in process requiring an internal audit function for companies listed on other exchanges in the United States?

Not at the present time. However, the SEC, per its ruling commentary on the NYSE's revised listing requirements, is interested in "achieving symmetry between exchanges where possible." We understand many companies are choosing to move forward with internal audit functions for "best practices" benefits and institutional investor grading purposes.

In addition, board and audit committee members of NYSE companies who also serve on boards of companies on other stock exchanges may want to consider the inconsistency with their own form of corporate governance and oversight of not having an internal audit function at the non-NYSE companies at which they serve as directors.

In January 2003, The Conference Board Blue Ribbon Commission on Public Trust and Private Enterprise issued its findings and recommendations with respect to auditing and accounting. Under Principle III: Improving Internal Controls and Internal Auditing, one of the "Suggested Best Practices" states:

All companies should have an internal audit function, regardless of whether it is an "in-house" function or one performed by an outside accounting firm that is not the firm that acts as the company's regular outside auditors.

We believe all firms should evaluate the need for an internal audit function if they do not have one. Additionally, after meeting with a member of the Blue Ribbon Commission, we have confirmed that the term "accounting firm" was not intended to preclude outsourcing to a qualified internal audit services provider.

79. When and how does this rule regarding internal audit apply to initial public offerings (IPOs) listing on the NYSE?

For companies going public after October 31, 2004, compliance with the internal audit rule must be by their listing date on the NYSE.

80. Does this rule require a company to hire new employees?

No. To the extent that the company already employs qualified professionals who can serve effectively in the professional and objective capacity of internal auditors, those individuals may be transferred to the new internal audit function (which would also have a written and approved charter in place). Existing functions should be examined for risk-based audit planning, technical competency and independence in areas such as reporting lines and scope of coverage.

The commentary attached to the rule specifically states, "A company may choose to outsource this function to a third-party service provider other than its independent auditor." Outsourcing could be an attractive option for many NYSE-listed companies that find themselves needing to quickly establish an internal audit function to achieve compliance. Companies that find they do not have the appropriate level of resources and talent internally, and that also do not want to spend time on a lengthy search process, may find outsourcing allows for accelerated start-up, potentially greater independence and objectivity, access to substantially greater skills, and more flexibility to increase or decrease internal audit activities to meet changing risks and conditions.

Additionally, outsourcing allows a company to curtail or halt internal audit work at certain times of the year when there may be conflicting priorities such as plant closings, mandatory vacations, year-end reporting, annual planning and budgeting.

Many companies find that some form of rotation in and out of an internal audit function can be beneficial to both the employee and the organization. Under this approach, a company utilizes full-time professionals with important knowledge and understanding of the company's business and operations. These individuals gain valuable experience in seeing, understanding, evaluating and helping to improve many areas within the organization. Also, once their rotation is completed, these employees are better prepared to identify, understand and deal with internal control and risk management-related issues. This type of program in a sense "fertilizes" the organization with professionals who gain practical knowledge and background regarding internal controls and business risks.

81. What is required if a company already has an internal audit function?

Nothing new is specifically required except possibly determining the adequacy of the existing internal audit function. By having an existing internal audit function, NYSE-listed companies comply with the new rule. That said, we recommend that companies with existing internal audit functions review their appropriateness and adequacy by asking themselves the following questions:

- Do we have an adequately resourced internal audit function?
- How does our function compare to that of other companies in our industry?
- Does our internal audit function meet *The IIA Standards*?
- Has our internal audit function undergone a quality assessment or peer review recently? (See Questions 44-46 for a description of QARs of internal audit functions, which are required by *The IIA Standards*.)
- Do the board, management, audit committee and key process owners believe internal audit is a value-added activity? If not, how should the function be changed to be more effective?

82. Can part-time internal auditors meet the NYSE rule?

According to our discussions with the NYSE, part-time internal auditors may meet the requirement. At smaller organizations, the extent of key business risks – and therefore the amount of appropriate time and effort required to address such risks – may not justify full-time resources. Independence and objectivity of resources should be strongly considered.

However, care should be taken to ensure that part-time internal auditors do not audit areas that they themselves supervise, or in which they initiate, complete, approve, record or reconcile transactions. Also, if part-time internal audit employees with other organizational duties are required to audit areas for which their own supervisors have responsibility, it could impair their objectivity either in fact or appearance, bringing into question the value or veracity of their audit findings.

Given the size, breadth and scope of most NYSE companies, we believe that, in most cases, part-time resources would not fulfill the spirit of the internal audit requirement and would not be in the best interests of management, the audit committee or shareholders.

83. How will NYSE-listed companies be expected to demonstrate compliance with the internal audit rule?

Every NYSE company must confirm annually, in writing, its compliance with all NYSE listing standards, one of which is the internal audit requirement. Our discussions with officials at the NYSE indicated that this written confirmation will be the primary form of compliance communication with the new rule. Under the Listing Rules of the NYSE, companies determined to have affirmed, but not actually complied with any of the listing standards, are subject to disciplinary action, including delisting from the exchange.

84. Does the rule require a written internal audit charter?

The NYSE rule makes no mention of requiring a written internal audit charter. However, Section 1000 of *The IIA Standards* makes it clear that a charter should exist for an internal audit function:

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

We believe that under the NYSE internal audit rule, it would be inconsistent to communicate that an internal audit function exists when its scope of authority, independence and reporting responsibilities are not defined in a written internal audit charter, approved by the audit committee. (See Appendices A and B.)

85. Does the NYSE rule require that The IIA Standards be followed?

The NYSE rule does not require companies to follow – nor does it mention – The IIA *Standards*. However, given The IIA's standing as the leading global professional organization for internal audit, The IIA *Standards* themselves would seem to be guidelines that most, if not all, internal audit functions would follow, particularly those functions led or staffed by CIAs.

Therefore, while there is no specific requirement within the NYSE rule, we believe there is a general expectation in the industry that a company's internal audit function would adhere to The IIA *Standards* as an accepted best practice. Additionally, in most circumstances, this would allow maximum reliance by the external auditor on the results of internal audit procedures.

86. Have internal audit functions been required previously?

No. However, certain industries have built-in requirements for internal audit and compliance functions, such as financial services (Federal Deposit Insurance Corporation Improvement Act), healthcare, government and energy, to name a few. The NYSE rule is the first broad internal audit requirement for a market.

87. Is there any minimum amount of expenditure or effort required under the NYSE rule?

No, there is no minimum specified. Our discussions with the NYSE indicated that no amount of minimum expenditure is mandated.

We believe, however, that it would be wise and prudent for boards, management and their audit committees to consider the following factors when allocating resources for an internal audit department.

A. Results of the entity-level risk assessment

- What key risks have been identified and how should internal audit be involved in those areas?
- What level of effort does the risk assessment seem to indicate?

B. Internal audit investment made by comparable companies

- What is the level of expenditure and effort of similarly sized companies in your industry?
- Are there some obvious differences that would support spending less or more? (For example, obvious or significant differences in business model, organization, degree of centralization or decentralization, regulation and scope of services.)

C. Preferences of the board and management

- What role and scope has management and the audit committee established for its internal audit function?

D. Past, present and future

- Have there been, are there or will there be events, issues, risks or major changes that would warrant more or less investment in internal audit?

E. Complementary functions

- Are there other functions within the company that serve to evaluate key areas and risks objectively, such as:
 - Quality control and loss prevention?
 - Regulatory and legal compliance?
 - Risk management and insurance?
 - Operational and financial control units?

- If so, are these risk mitigation and control efforts already performed to a degree that a professional internal audit function might otherwise perform? Is there inherent conflict of interest in performance feedback for existing functions?
- Have independence and objectivity been considered? (See Questions 1 and 15.)

See Question 12 for additional guidance on what companies should spend on internal audit.

88. What must a company have in place by the effective date of the NYSE rule?

While no specific actions are mandated in the rule itself, we believe that a reasonable approach to compliance by the effective date would include the following steps:

1. Create a written internal audit charter and have it approved, preferably by both the audit committee and the board of directors.
2. Hire a CAE or sign an outsourcing arrangement with an outside organization other than the company's external auditor.
3. Complete an initial risk assessment.

Additionally, we believe it would be desirable to have in place by the effective date or shortly thereafter:

- A formal internal audit plan, responsive to the risk assessment completed and approved by company management and the audit committee.
- As needed, an appropriate level of internal audit staff if the company intends to utilize employee resources, in addition to or in lieu of any outsourced arrangements.

89. Is a formal risk assessment required? Is there a preferred framework to be utilized by the internal audit function, such as the COSO internal control framework and COSO ERM framework?

Again, officials at the NYSE state that the exchange has allowed for listed companies to be able to develop, craft and modify their internal audit functions to meet their specific needs. However, COSO is the current definitive standard for public companies to follow in connection with Section 404. (See Question 30.)

The NYSE believes each listed company should determine the most effective and practical way to accomplish internal audit activities, including the risk-assessment process. The COSO ERM framework (see Question 33) is one framework available to companies, but there are other acceptable and appropriate frameworks and approaches to risk assessment that can be equally or even more effective in certain circumstances, based upon the size, industry and nature of an organization.

90. What other authoritative views strongly recommend the establishment of an independent internal audit function?

Perhaps the most relevant and timely organization strongly advocating internal audit functions is the PCAOB. In AS5, the PCAOB notes numerous times the existence of and potential reliance on the work of internal auditors.

In addition, in a speech on February 11, 2004, at the 22nd Annual Institute of Federal Securities, PCAOB board member Daniel L. Goelzer stated, referring to the proposing release (exposure draft): "The [standard] permits the auditor in some circumstances to rely on central testing performed by company personnel, particularly internal auditors who are adequately funded and independent of management ... The proposal tries to strike a balance in a way that will encourage strong and independent internal audit functions."

A number of well-recognized organizations have issued comments about the desirability of forming and maintaining an effective internal audit function:

- The COSO internal controls framework describes the internal audit function as a critical component of monitoring and evaluating the management control structure.
- According to the National Commission on Fraudulent Financial Reporting (Treadway Commission), “All public companies must have an effective and objective internal audit function.”
- The Conference Board’s “Commission on Public Trust and Private Enterprise” recommends, through release of an analysis designed to address recent corporate scandals and decline of confidence in United States capital markets, that:

All companies should have an internal audit function, regardless of whether it is an in-house function or one performed by an outside accounting firm (or other outside provider) that is not the firm that acts as the company’s regular outside auditor.

- The internal auditors should prepare for review and approval by the audit committee a multi-year audit plan of not less than three years centered on the corporation’s risks and vulnerabilities.
- The audit committee and any other committee on the board dealing with risk management should review and update this risk-based plan on an annual basis.

– The Conference Board, January 2003

- The IIA has previously stated:

All publicly held companies should establish and maintain an independent, adequately resourced, and competently staffed internal audit function to provide management and the audit committee with ongoing assessments of the organization’s risk management processes and the accompanying system of internal control.