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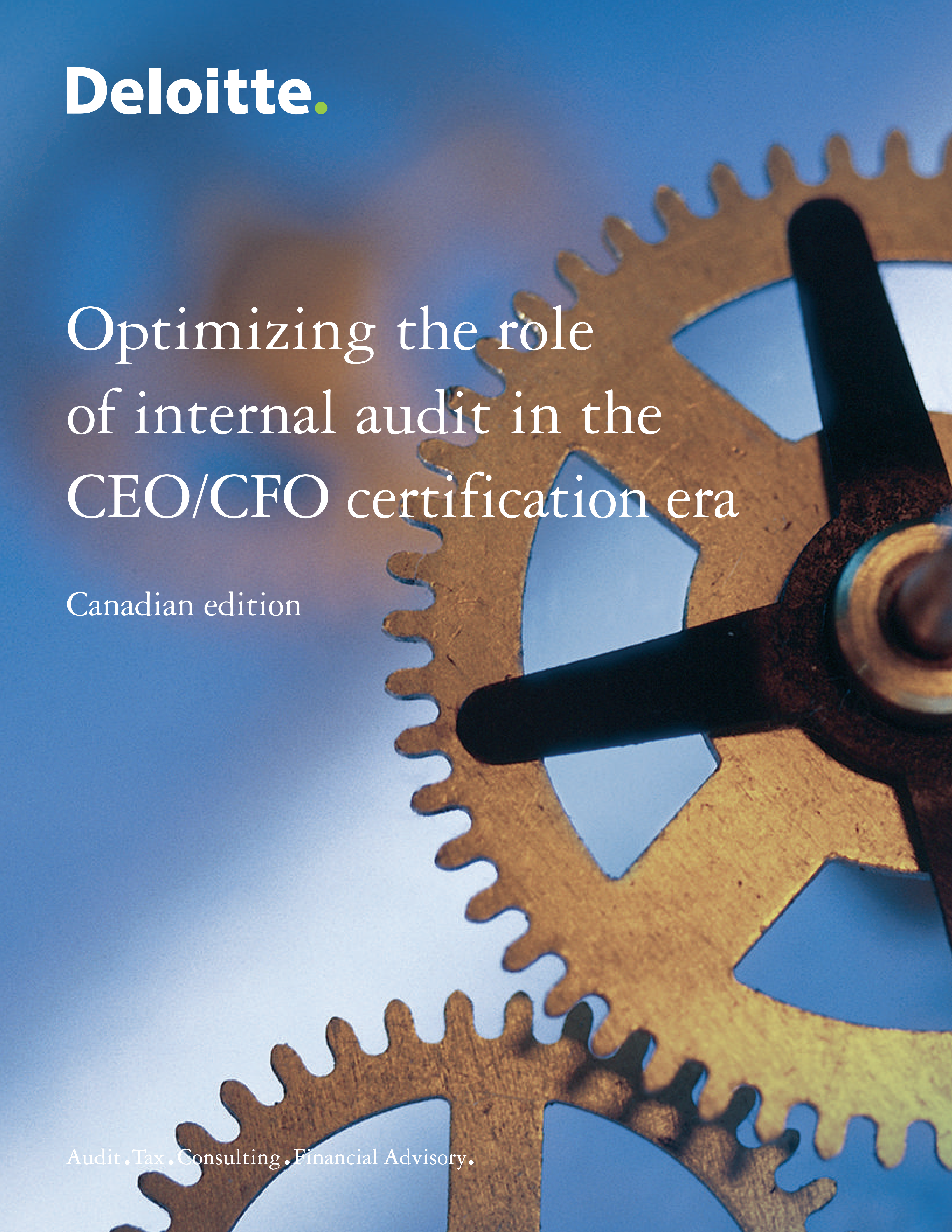

# Optimizing the role of internal audit in the CEO/CFO certification era

Canadian edition

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Canadian edition

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## Overview

Few would dispute that regulatory changes in the past few years have profoundly changed the business environment for companies listed on equity markets in Canada, the United States and around the globe. The mandated emphasis on corporate governance and internal control has transformed procedures and responsibilities at almost every level of the organization, and will likely impact the manner in which business is conducted for decades to come. Whether the benefit will commensurate with the cost remains an open question in some quarters, but scant argument can be raised against the intent of legislation designed to reduce fraud, bring reliability to financial reporting, and restore confidence to the public markets.

Particularly noteworthy (if not notorious) are the requirements for CEO and CFO certification over the design and operational effectiveness of internal controls over financial reporting ("ICFR"). Under these requirements, public companies must determine financial reporting risks, identify or establish related controls, assess control effectiveness, fix deficiencies, and then re-test and re-document anew. The challenges posted by this requirement have proven formidable, and the impact has been felt by organizations across the world.

Among the business functions most significantly affected by the CEO/CFO certification requirements, internal audit certainly ranks high. Internal auditors, with their expertise in business process analysis; financial, operational, compliance, and information technology control testing; risk management; the Committee of Sponsoring Organizations of the Treadway Commission (COSO) internal control framework[1]; and forensic accounting, faced unprecedented demand for their services to assist with the CEO/CFO certification effort.

To date, internal audit in many organizations has risen to the task and provided invaluable assistance to the CEO/CFO certification process. However, the dramatic increase in the workload of internal audit attributable to CEO/CFO certification requirements has not always been accompanied by an equal rise in resources, leading to a predictable outcome: The traditional work of the function – operations, systems, fraud investigations, and special project audit work – is often taking a back seat to the more pressing needs of regulatory compliance. For many internal audit departments, this shift of duties demands rebalancing. Meeting the requirements of the legislation is, obviously, important, but not to the detriment of other responsibilities. The function's all-encompassing focus on CEO/CFO certification requirements, adopted out of necessity in the initial stages, should diminish going forward, and in its place should be a more rational and considered distribution of duties.

This reprioritizing should not be viewed as mere administrative tinkering. The fortunes of the company can be tied to internal audit. In fact, a properly structured internal audit function can bring tremendous value to an organization, impacting not just regulatory compliance but also operational excellence. Intelligently utilized, internal audit can help manage risk, prioritize goals and activities, eliminate complexity and redundancy, streamline operations, and drive down cost. In turn, this can enhance competitiveness while protecting and enhancing shareholder value. With the business world entering unchartered territory, optimally structured and high-performing internal audit functions can help shepherd companies through this new terrain.

## Defining effectiveness

In the new regulatory environment, responsibility and liability—both perceived and actual—are elevated to unprecedented levels. Never before have financial statements and disclosures been more carefully scrutinized. And never have the consequences of getting it wrong been more severe.

Demand for heightened accountability resonates especially with two parties: management, most notably CEOs and CFOs, who now must personally certify to the accuracy of the financial disclosures and the effectiveness of controls; and the audit committee, which is compelled to move beyond a reactive to a proactive role in financial reporting oversight. Each of these groups, in turn, relies heavily on an effective internal audit function for objective validation of the effectiveness of control processes and the reliability of financial reporting.

But what, exactly, characterizes an effective internal audit function? A baseline definition of internal auditing provides a starting point. The Institute of Internal Auditors (IIA) offers the following description:

> "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."[2]

[1] Committee of Sponsoring Organizations of the Treadway Commission. www.coso.org
[2] Institute of Internal Auditors, "Defining Effectiveness," http://iia.org.au/htdocs/tech_info/code.htm

With this description forming a foundation, the essential characteristics of an effective internal audit function can be framed. Deloitte sees the following elements as key. An effective internal audit function:

- operates from a clear, updated charter
- adapts its activities to the needs of the organization
- uses a risk-based approach
- reports directly to the audit committee
- enjoys full support of management and the audit committee
- maintains open communication with management and the audit committee
- has "clout" within the executive ranks
- engenders respect and integrity throughout the organization
- teams with other internal and external resources, as appropriate
- provides leadership on issues of internal control, fraud, financial reporting, risk management, and corporate governance
- leverages technology
- deploys best-available methodologies
- engages in continuous education and staff development
- consistently reevaluates its effectiveness
- provides support to the company's anti-fraud programs

When internal audit reports to management – usually to the CFO – the effectiveness of the function can be diluted.

## Organizational structure

In the days before the harsh light of scrutiny shone on internal audit, relatively few were concerned with the function's organizational and reporting structure. But today, the issues of competence, independence, and objectivity have led many businesspeople to realize that structure and reporting lines play a critical role in effectiveness.

Complicating the structural issue is the fact that the activities of internal audit serve the needs and/or interests of numerous parties, including:

- audit committee
- board of directors
- executive management
- line management
- shareholders
- analysts and shareholder rating services agencies
- regulators
- external auditors

Despite the vested interests of all parties, not all of them exert direct supervisory influence over the internal audit function. In most companies, the lines of reporting usually lead to either of two groups: executive management or the audit committee.

In Deloitte's view, the latter choice offers clear superiority. When internal audit reports to the audit committee, the function is kept structurally separate from management, a distinct importance to many, including regulators concerned with independence, external auditors seeking objectivity, and analysts looking for strong corporate governance practices. Such an alignment also encourages: the free flow of communication regarding any issues or concerns; allows for direct feedback on the performance of the chief audit executive (CAE) and the function; ensures that internal audit is staffed and budgeted properly; and permits the audit committee to exert direct influence over the hiring, compensation, and firing of the CAE.

Conversely, when internal audit reports to management—usually to the CFO—the effectiveness of the function can be diluted. If management hires and fires the CAE, controls the budget, and sets the agenda, then the impact on objectivity and independence can be significant. Communication of concerns can become bottled up and the pressure to rationalize questionable practices or to issue favourable reports can intensify.

Although the advantages of reporting to the audit committee are clear-cut, one factor mars what might otherwise be an optimal reporting structure: The audit committee lacks a day-to-day presence in the organization. Therefore, it may be somewhat out of touch with the company's culture, issues, and personalities, as well as the ability to handle required human resource activities.

Trends are moving steadily toward audit committee oversight of internal audit. Several years ago, more than 90 percent of internal audit departments reported to the CFO. Today, according to surveys by the Institute of Internal Auditors, that number falls between 40 and 50 percent.[3]

While there are no easy answers, two points are unambiguous: The CAE must have a strong and direct reporting relationship to the audit committee; and the audit committee must take responsibility for certain supervisory activities, including approving internal audit's budget, risk assessment, and audit plan, and for hiring, evaluating, and, if necessary, firing the CAE. Having a dual reporting relationship to the CEO or perhaps a general counsel, can facilitate the required administrative activities associated with operating the function within the company.

When internal audit reports to management—usually to the CFO—the effectiveness of the function can be diluted.

[3] Institute of Internal Auditors, "Internal Audit Independence and Corporate Governance," 2003, http://www.theiia.org/iia/download.cfm?file=234.

## The certification journey – Lessons learned

No point sugarcoating it: The first few years of CEO/CFO certification have been tough. However, there have been many lessons learned and many internal audit functions have advanced sufficiently along the path to benefit from the journey. Here are a few lessons learned:

**Relationship with the audit committee:** As noted previously, an optimally organized internal audit function reports directly to the audit committee. Of course, setting up the proper reporting structure, in itself, guarantees neither open lines of communication nor strong relationships with the chair and members. Those items take effort but its worth expending because the audit committee can be internal audit's strongest ally.

The internal audit/audit committee relationship can be strengthened in various ways. For example, audit committee education programs can help members better appreciate the realities and potential of the function. If expectation gaps exist, education can help bridge them.

**Charter:** Another area for potential improvement concerns the internal audit charter. Most internal audit functions have one, yet in some cases, it is not used to align activities with the internal audit mission. The advent of CEO/CFO certification provides an opportunity to update the charter; moreover, it offers a chance to enhance or even redefine the function with full participation and approval from the audit committee and management. The more integrated these constituent groups are in the process, the better support they will provide when audit activities need to be prioritized, hard decisions made, and budget and staffing requests acted upon.

**Employee education:** New demands call for new talents, and with the enhancement and redefinition of the role of internal audit comes a need for a broadened skill-set. CEO/CFO certification, which was introduced to address internal control over financial reporting, has exposed a weakness in the traditional internal audit lineup—call it a gap in GAAP expertise. Some internal audit functions do not have sufficient financial reporting skills, including an understanding of the importance of information technology in enabling proper control over financial reporting. Until recently, many internal auditors have been more business process oriented. Today, a broader spectrum of talent is required, which can be obtained through staff education as well as focused hiring programs.

**Areas of inquiry:** A heightened role for many internal audit functions is the need to conduct governance reviews. Specific areas of inquiry that might benefit from the attention of internal audit include the appropriateness of audit committee oversight; the adequacy and enforcement of codes of conduct; the sufficiency of documentation, design, and operating effectiveness of entity-level controls; and the effectiveness of fraud risk assessment.

**Uncorrected deficiencies:** As quarter-to-quarter and year-to-year compliance data is compiled, the issue of how to handle uncorrected deficiencies can arise. The Public Company Accounting Oversight Board (PCAOB) has stated that deficiencies left unremedied may be indicative of a poor control environment and inadequate tone at the top. Further, such uncorrected deficiencies may, either individually or in the aggregate, escalate into significant deficiencies or material weaknesses. To address this issue, internal audit should evaluate management's ongoing process for monitoring and remediating prior year deficiencies in internal control over financial reporting.

## Role of internal audit in the CEO/CFO certification era

While the upheaval of the last couple of years has surely roiled the profession, certain principles remain unaffected. Most notably:

*The traditional role of internal audit—to assess controls, bring value, and improve operations—is as applicable today as it ever was.*

However, as noted previously, the department's workload has dramatically increased with the advent of CEO/CFO certification.

Finding the right balance of activities will be key to future success, both for internal audit as a profession, and for the companies that internal audit serves.

Unfortunately, that balance cannot be neatly summarized in a few paragraphs. Each company presents unique circumstances and distinctive needs. A myriad of factors complicate the equation and impact the result, including company size, industry, location(s), budget, profitability, IT infrastructure, competence of personnel, preferences of the board and management, and more.

One way to parse the proper role of internal audit is through the use of a maturity model (see Figure 1, page 4). The various activities of the department can be charted along a descriptive continuum that begins with "baseline," proceeds through "mainstream," and concludes with "leading edge."

In applying the maturity model to their own circumstances, companies will find variability to be the norm. Only the rare internal audit department will see all its data points plotted neatly under any one category. Rather, depending on goals, philosophy, and other factors listed above, the function may classify its risk management activities under, say, "leading edge" while its technology description falls under "mainstream." Virtually unlimited combinations are possible, with none necessarily being right or wrong. What works best and makes sense for one organization may be entirely inappropriate for another.

**Figure 1 - Transforming internal audit – Internal audit maturity model**

| | Baseline | Cumulative or evolutionary?* | Mainstream | Cumulative or evolutionary?* | Leading edge |
|---|---|---|---|---|---|
| **Philosophy** | | | | | |
| **Perspective** | focus on the past: retrospective look at what happened | cumulative | focus on the present | evolutionary | focus on the future: proactive approach toward risk mitigation and development of controls |
| **Defining effectiveness** | | | | | |
| **Focus** | audit entity based on rotation plan | evolutionary | audit entity prioritized based on inherent risk | evolutionary | focus on strategic, business, and process toward risk |
| **Style** | corporate police | cumulative | supportive | cumulative | advisor |
| **Organizational structure** | | | | | |
| **Responsibility** | auditing for compliance | evolutionary | auditing and suggesting | evolutionary | auditing and consulting |
| **Existence of chief audit executive** | not likely | evolutionary | occasionally | evolutionary | member of "C" suite |
| **Internal audit reporting lines** | controller | evolutionary | CFO/COO | evolutionary | audit committee chair |
| **Role of internal audit in the CEO/CFO certification era** | | | | | |
| **Objectives and mandate** | compliance to (financial) policies and procedures | cumulative | assurance on financial control, and compliance | cumulative | business assurance |
| **CEO/CFO certification "ownership"** | N/A | evolutionary | participating in the CEO/CFO certification effort | evolutionary | management ownership/ internal audit validation |
| **Independence and objectivity** | hopefully | cumulative | generally | cumulative | absolutely |
| **Technology** | | | | | |
| **Toolkit** | automated work papers | cumulative | sampling programs and standalone data analysis | cumulative | real-time monitoring |
| **IT auditing** | ill-defined | cumulative | general computer controls (GCC), security applications | cumulative | consulting to improve IT infrastructure |
| **Fraud detection** | | | | | |
| **Fraud prevention and detection** | generally not addressed | evolutionary | reactive | cumulative | proactive |
| **Risk management** | | | | | |
| **Risk focus** | operational | cumulative | operational and financial | cumulative | all enterprise risks |

* Cumulative: The past practices of the internal audit function are absorbed into and become part of new, expanded practices.
Evolutionary: The past practices of internal audit are discarded as new practices are adopted to take their place.

But regardless of how the data points fall on the maturity model, the optimal role of internal audit clearly extends far beyond internal control over financial reporting. The imperative to attain compliance in the first years distorted that perspective, but the time has come to reestablish a broader view. Internal audit needs to play a role in CEO/CFO certification activities—indeed, one of the most essential roles—however, that should not be its sole responsibility.

A more expansive view of internal audit's optimal role begs the question: *What needs to be done to address stakeholders' needs?* Some of those stakeholders and the issues that they have are listed in figure 2 below.

A fair amount of confusion exists within and outside the profession regarding the challenges posed by CEO/CFO certification. What are the proper parameters of involvement by internal audit? At what point does the function's independence and objectivity become impaired? To answer these and other questions, Deloitte convened a meeting of its leading practitioners to debate the issues and reach consensus. The following CEO/CFO certification-related activities were found to be allowable and appropriate for internal audit:

- consultation on internal control
- consultation on internal control in relation to enterprise-wide risk management (see page 10, "Risk management," for more information on this topic)
- assistance in the identification, evaluation, and implementation of risk and control assessment methodologies for the organization
- recommendation of controls to address related risks
- assistance in the design of internal control systems (however, designing is not the same as implementing; see page 6)
- the drafting of procedures for systems of internal control
- assistance in the maintenance of the controls repository
- effectiveness testing on behalf of management (but without concluding for management)
- assistance to management in the design of tests for control effectiveness (however, in all cases, management should make the final decision on control design and operating effectiveness)
- lead project management for all or part of the efforts related to CEO/CFO certification
- provision of training and/or information on internal control identification and assessment, risk assessment, and test plan development
- provision of information, training, and/or facilitation of a control self-assessment

**Figure 2 - Is internal audit addressing stakeholders' needs?**

| | |
|---|---|
| **Board/Audit committee** | How are we managing business risks? How are we assured they are being managed appropriately? Are we dedicating enough resources to manage our risks? |
| **CEO/COO** | What unforeseen events might disrupt our strategy and prevent achievement of our goals? |
| **CFO** | What risks could materially impact our financial results? |
| **General counsel** | What could we do to further minimize our legal and regulatory liabilities and ensure compliance with laws and regulations? |
| **General managers** | How much risk am I allowed to take? What is our corporate risk appetite? What are my risk management responsibilities? |
| **Risk managers** | How efficient is our current risk financing strategy? Does the current risk management strategy adequately capture the key risks? |
| **Regulators** | How comprehensively is the company addressing the interests of stakeholders? |
| **Rating agencies** | How well does senior management understand risk? How great is management's risk awareness? What is their ability to manage risks as they emerge? |

The following CEO/CFO certification-related activities were found to be inappropriate for an objective internal audit function:

- conclusion on the effectiveness of internal controls on behalf of management
- execution or direction of key management decisions regarding internal controls, remediation activities, and CEO/CFO certification compliance
- implementation of systems of internal control
- performance of control activities

The overriding factor concerning appropriate activities hinges on decision-making and responsibility. Internal audit may serve management in many capacities, including advisory, testing, training, and development, so long as these activities don't cross the line into a decision-making role. Vigilance by all parties can maintain this critical distinction.

Readers should note that the term "allowable" activities is not necessarily synonymous with "optimal" activities. That is, just because a particular activity could be performed by the internal audit function, does not mean that it should. In Deloitte's view, internal audit groups that are involved in the "inappropriate" CEO/CFO certification activities cited above should strive to transition away from these activities and move toward independent evaluation, validation, and testing. Of course, this recommendation assumes sufficient and competent resources to take over the CEO/CFO certification responsibilities previously handled by internal audit.

## Reconciling traditional and contemporary responsibilities

Long before the advent of CEO/CFO certification, internal audit had an important role to play. Its operational audits, systems work, fraud investigations, and other activities provided an invaluable service to management and a major boost to the company's fortunes.

Since that time, nothing that has transpired has changed these basic facts. The traditional role of internal audit remains as critical as ever, even as new demands expand the workload.

How can an internal audit group balance its traditional work with its new duties? Here are a few ideas:

**Expand staff:** With new responsibilities piled upon the old, resources have become strained in many internal audit organizations. If management continues to utilize internal audit for intensive CEO/CFO certification-related work, then an infusion of personnel to accommodate the additional workload should be provided.

**Increase funding:** Historically, there has been a tendency in some organizations to under-invest in internal audit, despite the fact that CAEs have often tried to make the case for increased budgets. Today, however, the dynamic has shifted. The potential ramifications and sanctions around regulatory noncompliance have gotten the attention of those with budgetary authority, and as a result, the time has never been better to command the resources necessary to perform the job well.

Many CAEs have found that, by having a quality assessment performed, they are able to not only identify improvement opportunities but are also in a better position to support the need for additional resources and funding. (It must be noted, of course, that infusions of money and people can help internal audit attain optimal performance, but they alone will not magically transform an underperforming function. Resources must be thoughtfully and methodically deployed in the proper areas of greatest need and most potentially beneficial impact.)

**Solicit buy-in:** With a varied constituency and additional duties, internal audit must operate from a clear and vetted agenda. All of the major parties—management, audit committee, and independent auditors—should be apprised of and, to the extent that it is appropriate, weigh in on the audit plan.

**Combine and integrate duties:** Internal audit groups should look at combining traditional duties with CEO/CFO certification controls testing. That is, in many instances, operational, systems, and special project audit work can be conducted concurrently with CEO/CFO certification-related evaluation, validation, and testing. Not only can this provide cost and time efficiencies, but should also eliminate the need to knock twice on management's door, thereby minimizing the inevitable disruptions caused by internal audit activities.

## Fraud detection

Financial statement fraud generates more attention than its prevalence might warrant—significantly more misstatements can be attributed to innocent mistakes and misjudgments. But perception often trumps reality, and sensational acts of fraud have defined many of the recent corporate scandals, providing compelling news headlines and fodder for forceful political speeches. When carried out on a large scale, fraud can wipe out billions of dollars of investor wealth in a short timeframe.

Thus, given its prominence and potential magnitude, fraud—both financial statement fraud and the misappropriation of assets—needs to be on the radar screen of every internal audit function. Not that the function should become the sheriff of the organization; rather, internal audit ensures that reasonable activities are in place to help prevent and detect fraud and support company anti-fraud programs.

Indeed, given its unique skill-set, internal audit is often at the fore when it comes to rooting out fraud-related problems. Some cases are first uncovered by the function, and internal audit is frequently the primary option for investigating allegations of fraud.

That said, it must be noted that no company, no matter how vigilant, can eliminate fraud with 100 percent certainty. Determined and deceptive individuals, especially those acting in collusion, can sometimes subvert even the most carefully and conscientiously constructed anti-fraud program.

But the lack of ironclad assurance is no excuse for inaction. A number of activities and programs to combat financial statement fraud are recommended for every public company, not solely because their presence helps to minimize risk, but also because their absence may result in an adverse opinion on the effectiveness of internal control over financial reporting. Steps that address the misappropriation of assets are also highly recommended. A few of the essential elements of an effective antifraud program are noted below:

**Control environment:** Strong anti-fraud activity, just like strong internal control itself, begins with the control environment. The executive management team should continuously demonstrate, through words and actions, that ethical and legal behaviour is the only acceptable mode of conduct in the company. This principled "tone at the top" must diffuse itself through everything the organization says and does: in regular communications; company literature; codes of conduct and ethics; hiring, promotion, and termination practices; vendor and customer relations; and much more. Some internal control experts contend that establishing this culture of "doing the right thing" represents the most important component of effective internal control.

While the control environment does not necessarily lend itself to easy assessment, internal audit can gauge its strengths and weaknesses through a cultural survey given to employees throughout the organization. The survey measures hard-to-quantify components such as employee attitudes, corporate culture, communication practices, and more.

**Whistleblower hotlines:** Perhaps the most critical piece of an effective anti-fraud program can be found in a whistleblower hotline.

Whistleblower hotlines uncover more verifiable cases of fraud than any other method, according to a study by the Association of Certified Fraud Examiners.[4] An effective hotline should be anonymous and continuously available. A detailed procedure for the timely handling of reports should be developed and followed faithfully. Employees should receive guidance and encouragement on its use. And the hotline should be advertised widely, through posters, wallet cards, intranet sites, periodic communications, and other means.

**Fraud risk assessment:** CEO/CFO certification requirements clearly behoove companies to appropriately consider the risk of material misstatement due to fraud, and to subsequently design and implement appropriate programs and controls to prevent, detect, and deter relevant fraud risks and schemes.

Areas that deserve special attention during the fraud risk assessment process include management override of controls, revenue recognition, segregation of duties, significant and unusual journal entries, accounts involving judgment and estimates, and complex accounting procedures.

While internal audit has a significant role to play in fraud detection and prevention, the function should not be charged with sole responsibility in this area. The job is simply too large and too important to be left to a single business unit. Rather, the obligation should be shared by every facet of the organization, including executive management, employees, boards and committees, and augmented by oversight and assistance from the external auditor, regulatory agencies, and others.

## Human resources for internal audit

With the advent of CEO/CFO certification, internal audit staffing challenges have frequently become acute due to the demands imposed by new regulations. Issues such as recruitment, deployment, and professional development have taken on heightened importance.

Many CAEs are grappling with the question: How can my department maintain an on-demand, flexible workforce without incurring burdensome fixed costs? The problem defies an easy answer. Maintaining the high level of staffing necessary to respond to peak demands, such as CEO/CFO certification work, can be costly; yet most internal audit functions need to deliver on those demands.

[4] Association of Certified Fraud Examiners, "2002 Report to the Nation: Occupational Fraud and Abuse." http://www.cfenet.com/pdfs/2002RttN.pdf

Given its unique skill-set, internal audit is often at the fore when it comes to rooting out fraud-related problems.

No single solution can solve the staffing quandary, but multiple approaches, in combination, can ease the burdens imposed on the function. Consider the following:

- External consultants and contractors can be utilized to cover the workload peaks and specialized skill needs.
- Recruitment activities can be stepped up, with an eye towards building a multi-disciplinary team with a healthy mix of CIAs, CISAs, CPAs, CFEs, MBAs, and specific industry experience.
- The CAE can work with the executive management team to determine a practical philosophy for moving employees in and out of the function, i.e., should internal audit be considered a career path, a stepping stone to management, or a combination of the two?
- Internal audit heads should consider the benefits of increasing education and training for their employees to enhance not only job performance but prospects for retention.
- Internal audit should stay current on the latest guidance. Internal audit practitioners can "network" through the Institute of Internal Auditors and other professional associations, identifying leading practices and lessons learned. These should then be brought back to management for enhancing their CEO/CFO certification processes.

## Utilizing internal audit to optimize compliance

Internal audit can help management develop a program of sustainable compliance and generate tangible business improvements by focusing on three areas: people, process, and technology.

**People:** Internal audit can serve as a catalyst, through education, for the company and its internal control program. Training can be delivered in the areas of codes of conduct, business ethics, and communications to create organization-wide awareness and to achieve overall compliance and sustainability. Such training activity supports a strong control environment. Ordinarily this will not escape the notice of the external auditors, who will factor it into their assessment of the effectiveness of internal control.

**Process:** Internal audit can be a driving force behind the efficiency and effectiveness of testing activities. The function can head up a control rationalization effort to weed out duplicative and immaterial controls from the test plan. Redundant processes across and within business units can be identified and eliminated by management.

**Technology:** Forward-thinking executives will strive to leverage existing technologies to create efficiencies in testing, documenting, monitoring, and other compliance functions. In the early years of compliance, companies were able to identify and reduce inefficiencies that resulted from non-standardized information technology systems in different units and business locations. Internal audit, in its consulting and advisory role, is in a position to promote other ways to reduce inefficiencies through the use of continuous monitoring technology.

## The pursuit of quality

With so much riding on internal audit—both from a regulatory and competitiveness standpoint—the optimal functioning of the department becomes a vital concern. Every stakeholder cited previously, but especially management and the audit committee, relies heavily on internal audit. How can these parties be sure that the function is up to the task?

The answer comes in the form of quality assessments—an examination of the effectiveness and efficiency of the function. Just as a person requires regular medical check-ups to remain in peak health, so too can internal audit benefit from a thorough evaluation.

Three models exist, two internal and one external; forward-thinking companies will utilize all of them:

1. **Continuous quality assurance:** There should be continuous quality assurance activities built into the job descriptions and operating routines of the department. In some respects, this program could be considered as internal audit's own set of controls that provide a window into work performed and quality of operations.

2. **Self assessments:** This process deploys internal staff to examine the operations of the function every two years. Has the charter been updated to reflect current conditions? Does a comprehensive risk assessment serve as the basis for planning and execution? Are stakeholders' needs met in a timely fashion?

3. **External quality assessment:** The Institute of Internal Auditors strongly encourages CAEs to subject their internal audit departments to independent scrutiny. The IIA's Standard 1312, issued in 2002, states that "...every internal audit department [must] have an external quality assessment at least once every five years by a qualified independent reviewer from outside the organization." In certain circumstances—such as rapid turnover of staff or a change in internal audit leadership—a more frequent assessment schedule may be warranted.

Just as a person requires regular medical check-ups to remain in peak health, so too can internal audit benefit from a thorough evaluation.

Whether internal or external, a quality assessment reviewer will look at the function for certain characteristics and performance indicators, including the following:

- independent and objective
- dynamic and flexible
- proactive
- risk-focused
- knowledgeable about company and industry
- innovative and consultative
- catalyst for change
- aligned with management and audit committee expectations
- aligned with corporate objectives
- leverages technology and leading practices
- communicates effectively
- maintains constructive relationships
- emphasizes continuous learning

Quality assessments can be time-consuming and costly; yet the rationale is compelling:

- As CEO/CFO certification-related activities become less of a fire drill and more of a standard operating procedure, realignment of internal audit's duties becomes essential. A quality assessment can help the function, audit committee, and management fully understand the needs of the business and how internal audit should be organized to meet these challenges.
- Yesterday's leading practices are today's outmoded methodologies. A qualified external quality assessment team that is continually exposed to the full spectrum of approaches and techniques can bring up-to-date knowledge to the function.
- Business moves at a breakneck pace, and to keep up, companies require continuous improvement—a fact that holds as true for internal audit as any other business function. A quality assessment can provide that edge. As an ongoing process, the quality assessment will result in a periodic list of improvement areas that the CAE can include in his/her evaluation metrics to encourage continuous improvement.

## Deploying technology

While technology will never replace an intelligent, inquisitive, and well-trained internal auditor, certain tools can improve efficiency and enhance productivity. Two categories of tools predominate: supporting technologies and enabling technologies.

The former category is fairly commonplace and not particularly revolutionary. For example, electronic spreadsheets serve as an aid in recordkeeping; automated work papers remove some of the drudgery from documentation.

Significantly more valuable, however, are enabling technologies, which allow internal auditors to attain new levels of testing assurance. For example, instead of developing sampling procedures, internal audit can now, through technology, test a higher percentage (or the entire population) of transactions and processes. Additionally, the department can perform exception-based and fraud-related procedures with far greater levels of reliability.

Leading the way are a number of enhancements to enterprise resource planning (ERP) systems. This latest generation of software can acquire data from different repositories within the network, and can help validate whether internal controls are operating effectively.

Other examples of enabling technology include data acquisition, analysis, and monitoring tools; and administrative tools.

In the modern internal audit environment, enabling technologies are no longer a luxury, but a necessity, as they promote continuous monitoring of risk in a cost-effective fashion. CAEs can and should make a compelling case to include such tools in their budgets.

## Key business relationships

Efforts to spur corporate growth and improve operational efficiency have led to a proliferation of contract-based business arrangements such as outsourcing (payroll, benefits administration, order fulfillment, etc.), joint ventures (shared R&D, pooled manufacturing, etc.), strategic marketing alliances (companies with complementary services or products going to market together), and the licensing of intellectual property (sharing patents and copyrights with business partners and customers in exchange for royalties). The beneficial impact of these business arrangements can be substantial of course, but new risks and responsibilities also become important considerations.

Companies need to perform periodic contract compliance activities to assess the integrity and reliability of extended business relationships. By playing an active role in contract compliance activities, internal audit can not only achieve bottom-line results (such as revenue recovery or cost reduction), but can also play a critical part in identifying and mitigating significant risks throughout a company's extended business network.

Where does internal audit fit into the picture? In various areas including the:

- definition of control objectives and identification of related control activities
- assessment of the validity and completeness of any information provided by the contracting party
- validation of integrity assumptions and contract compliance with business partners, including customers, suppliers, and licensees
- identification of specific monetary and non-monetary risks present in important relationships
- recommendation of steps to mitigate the risks of those relationships
- evaluation of whether the company's own internal control environment is sufficient to identify and monitor key relationship risks

## Risk management

As noted in the early pages of this document, proper risk management lies at the heart of an effective internal audit function. The specific role the department assumes in regard to risk will depend on its placement in the maturity model cited previously (Figure 1, page 4). A "baseline" approach may deal only with operational risk, while a "leading-edge" practice may include a broad universe of enterprise risks. Many functions will fall in the middle of the two extremes, depending on philosophy, charter, goals, and other factors. Some departments may limit themselves to the identification of risk; others may participate in the mitigation of risk.

Surprisingly, during the first years of CEO/CFO certification compliance efforts, many companies failed to develop and deploy a comprehensive financial accounting risk assessment process, an outcome both unexpected—because risk assessment is an essential component of internal control over financial reporting—and unfortunate—because without proper risk assessment, some of the time and dollars devoted to documenting and testing controls may have been misspent. Clearly, this situation needs rectifying going forward. Internal audit should play a prominent role in helping management realize that without a comprehensive risk assessment process internal control over financial reporting can never be considered effective.

It should also be noted that if an organization does not have a formal risk management process in place, the Institute of Internal Auditor's practice advisory No. 2100-4 says that "the internal auditor should bring this to management's attention along with suggestions for establishing such a process."

An aid to proper risk management may be found in a publication from the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Entitled "*Enterprise Risk Management—Integrated Framework*," the document defines and discusses key enterprise risk management (ERM) principles, concepts, and components. Although not solely directed at the internal audit profession, the COSO ERM framework can provide a clear blueprint for anyone seeking more effective risk management.[5]

Augmenting the COSO ERM document is guidance from the Institute of Internal Auditor's (IIA), which reviewed the publication for applicability to the profession and deemed much of the information relevant and useful. According to the IIA, "Internal auditing's core role with regard to ERM is to provide objective assurance to the board on the effectiveness of an organization's ERM activities to help ensure key business risks are being managed appropriately and that the system of internal control is operating effectively."[6]

Thus, according to the IIA, a risk-focused internal audit function will engage in the following basic activities:

- provision of assurance on risk management processes
- provision of assurance that risks are correctly evaluated
- evaluation of the risk management processes
- evaluation of the reporting key risks
- review of managing key risks

Some companies may wish to have their internal audit department take on a more active role regarding risk management. In such cases, the IIA considers the following roles permissible:

- facilitation in the identification and evaluation of risks
- coach management in responding to risks
- coordination of ERM activities
- consolidation of risk reporting
- maintainance and development of the ERM framework
- championship and establishment of ERM
- development of a risk management strategy for board approval

While participation in risk management activities is clearly a desirable role for internal audit, care should be taken to maintain independence and objectivity. The board of directors and the management team should retain full responsibility for risk management; internal audit should diligently strive to limit itself to an advisory role.

[5] Visit www.coso.org for ordering information. See also the enterprise risk management section of Deloitte website for additional materials and publications: http://www.deloitte.com/dtt/section_node/0,1042,sid%253D3674,00.html
[6] Institute of Internal Auditors, "The Role of Internal Auditing in Enterprise-wide Risk Management," Sept. 29, 2004.

## Leveraging outside perspective and leadership

How can CAEs keep their internal audit function at the top of its game? Where should CAEs turn for thought leadership, fresh ideas, and leading internal audit practices? Many avenues can lead to improvement:

- Conducting a quality assessment of internal audit (see page 8) can help ensure that the function is performing optimally. Having an outside, objective party perform an evaluation can infuse new thinking and provide perspective.
- Inviting a guest auditor to join the function for a period of time can help share leading practices and promote thought leadership throughout the internal audit function. These "guests" can be drawn from other departments within the organization, which can help diffuse institutional knowledge, or can be brought in from another organization, which can provide a valuable outside perspective.
- Developing training and education programs can improve internal audit and internal control skills. Using outside trainers can provide new perspectives.
- Adopting more formal programs that rotate internal auditors from different regions in the company can bring in new viewpoints and skill-sets.
- Benchmarking the practices of internal audit units at other companies may inspire internal auditors to adopt new practices or look at old problems in new ways. Developing relationships with other CAEs can lead to the sharing of new ideas and approaches.

During the first years of CEO/CFO compliance efforts, many companies failed to develop and deploy a comprehensive financial accounting risk assessment process.

## Beyond compliance

Pre-CEO/CFO certification, the internal audit function faced no shortage of worthy projects. Today, it's time to place many of them back on the agenda. Here are a few that merit consideration:

**Evaluate new business initiatives:** Dynamic companies constantly seek out new opportunities; those that don't may soon find their fortunes lagging. However, with each new opportunity also brings new risks. Internal audit should take a significant part in identifying and helping the company control that exposure. Obviously, anything as monumental as a merger or acquisition requires due diligence on the part of internal audit. However, less weighty initiatives, such as a new product design or new services, could also benefit from internal audit's wisdom and guidance.

**Manage information technology (IT):** IT usually presents significant risk management challenges to an organization, whether the computer systems are static, undergoing an incremental upgrade, or in the midst of a complete migration. CEO/CFO certification compliance has also inspired many companies to consolidate disparate IT systems to bring more efficiency and reliability to internal control; in such cases, management should be drawing heavily on internal audit expertise.

**Contribute to corporate growth:** Bringing value to the organization has always been a prime concern of internal audit, and building top line revenue growth certainly falls under that rubric. Specific activities in support of the growth objective will vary by company. If corporate growth is attained through acquisition, then the function should participate in due diligence. When organic growth defines the strategy, either through expansion into new regions, distribution channels, or customers, internal audit should be involved in all the "auditable" processes. In other words, internal audit plans and activities should be skewed towards the company's areas of focus and risk. If the company is thinking about "betting the farm" in a particular area, internal audit should be calculating the odds.

**Other activities:** Certain prime areas for internal audit involvement include:

- research and development effectiveness
- decision-making processes
- inventory management
- ethics compliance

## Peak performance indicators

How does internal audit measure success? The particular method employed is less important than the act itself. Performance of the function should be constantly monitored and rated. Here are some critical performance indicators:

- adoption of recommendations
- implementation of recommendations within a certain time period
- stakeholder surveys
- timely issuance of reports
- training and certification of staff
- cost-saving opportunities and actual cost recoveries
- turnover in internal audit
- transfers in internal audit (with employees moving to other units within the business considered a positive outcome)
- measurement of professional staff satisfaction via internal audit employee survey
- utilization of internal audit staff
- training hours

## Conclusion

For companies that must comply with CEO/CFO certification requirements, the regulatory environment stands in a state of unprecedented flux. Internal audit can and should take a leading role in restoring equilibrium.

But before internal audit takes on that enterprise-wide challenge, the department must first be sure its own house is in order. Charters and job descriptions should be updated. Traditional roles must be reconciled with new responsibilities. Audit work should be judiciously balanced between financial, operational, strategic, compliance, and information technology. Risks must be carefully weighed and the needs of stakeholders should figure prominently in the action plan.

Moving forward, CEO/CFO certification-related work should become a visible and permanent part of internal audit's job description. Helping to sustain compliance with CEO/CFO certification requirements will remain a critical responsibility. Providing objective assurance to the board and management on the effectiveness of the company's ERM activities will deliver significant value to the organization. But the organizational structure and specific activities of any particular internal audit department will vary considerably by company.

Adaptability and flexibility will stand out as key characteristics of successful internal audit functions. The "one size fits all" model was probably never an accurate description of any ideally structured department, and it certainly doesn't apply today. Rather, an optimized internal audit function will tailor its activities to areas of greatest risk and opportunities for greatest value. Their companies will reap the benefits of sustainable compliance and enhanced competitiveness.

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