

INTERNAL AUDITING:

Adding Value Across the Board

A look at the profession & corporate governance.



A CHANGING WORLD

One does not have to sit in the boardroom or occupy the CEO's chair to recognize the rapid-fire changes going on in today's business arena. News outlets regularly report on corporate scandals and frauds, privacy invasions, compromised ethics, and governance lapses. These events and the resulting laws and regulations, coupled with electronic commerce and other information technology breakthroughs; mergers, acquisitions, and other organizational restructuring; and issues related to the global marketplace all suggest that things are likely to get even more chaotic.

Thought leaders in the business community forecast still more changes and increased organizational risks:

- Increasing litigation, legislation, and regulations will carry important compliance implications.
- Information security management for critical infrastructure areas such as financial services, transportation, telecommunications, defense, utilities, and fuel will continue to require individual and collective business commitment, planning, and intervention.
- Continuing globalization will increase the complexity of principles, regulations, and the cultures in which organizations operate.
- Ever-growing competition will put even more pressure on organizations to increase productivity.
- Re-engineering, deregulation, and other change-related activities will break down traditional hierarchical structures and alter organizational reporting relationships and management responsibilities.

Each of these phenomena suggests new demands, challenges, and opportunities for management and the board. And each one also points to the necessity for competent internal auditing. Today, more than ever, internal auditing is critical to strong corporate governance, risk management, effective internal control, and efficient operations.

WHAT IS INTERNAL AUDITING?

Internal auditing is an independent, objective, assurance and consulting activity that adds value to and improves 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.

The internal audit activity provides assurance to management and the audit committee that risks to the organization are understood and managed appropriately. And it serves as an in-house consultant on many areas of interest.

Every organization, regardless of its size, should have some type of internal control system or process in place. The Institute of Internal Auditors (IIA) believes that an organization is best served by a fully resourced and professionally competent internal audit staff that provides value-added services critical to efficient and effective organizational management.

Internal audit practitioners are charged with assisting the organization in the effective discharge of responsibilities, promoting the establishment of cost-effective controls, assessing risks, and recommending measures to mitigate those risks. An integral part of the management team, internal auditors furnish top management with analyses, appraisals, counsel, and information on the activities they review. They also monitor organizational ethics.

Evaluating emerging technologies; analyzing opportunities; assessing quality, economy, and efficiency; and providing accurate and timely communication are just some of the activities internal auditors conduct on a daily basis. The comprehensive scope of their responsibilities provides them with a broad perspective on the organization. And that, in turn, makes them a valuable resource to executive management and the board of directors in accomplishing overall goals and objectives, as well as strengthening internal control and governance. This might be a lot to ask from one organizational resource, but for internal auditors – it's all in a day's work.



IN PARTNERSHIP WITH MANAGEMENT

When internal auditing is accepted and acknowledged by an organization's leaders as a management activity, internal auditors can fulfill their most fundamental role — supporting management and the board in achieving organizational objectives. And competent internal audit professionals bring to the table objectivity, integrity, expertise in communication, the ability to identify enterprisewide risks, and the skill to assess the effectiveness of controls put in place by management to mitigate those risks.

As partners to management, internal auditors are positioned to help protect the organization against both traditional and emerging risks; provide consultation about how opportunities and vulnerabilities can be balanced; and make valuable recommendations for assessing and strengthening corporate governance. The internal auditors' broad understanding of the organization and its culture prepares them for effectively monitoring risks associated with new business lines; mergers, acquisitions, joint ventures, and other partnerships; new systems deployments; restructuring; management estimates, budgets, and forecasts; environmental issues; and regulatory compliance. In order for the internal audit activity to achieve all of this and add the most value to an organization, best-practice reporting relationships should be followed. (See page 5.)

BellSouth Corporation Chairman and Chief Executive Officer Duane Ackerman clearly recognizes the value internal auditing brings to management: "Because we are in a dynamic environment — we've got new people, new technology, a new marketplace, new competitors, and a new regulation — we need to be very vigilant about the fundamentals of this business. And that's a role corporate auditing plays...the ability to collect information and impart that knowledge on processes as well as control issues and to do it constantly through all of this change. It's easy to see how incredibly important that is to the fundamental stability of this business."

Of increasing concern to management today are the risks associated with information technology and the control and auditability specifications of new systems. Internal auditors' independent review of information systems and other high-tech projects can help ensure a controlled and reliable IT environment. And their consulting services add value to the decision-making process when management must consider the cost and benefit trade-off of IT control implementation.



CORPORATE GOVERNANCE RESOURCES

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- All in a Day's Work
- Building Quality Into Practice
- Guidance for the Profession
- What Does It Take to Be a Professional?

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PRODUCTS AND REPORTS

- 20 Questions Directors Should Ask About Internal Audit
- Audit Committee Handbook, 4th Edition

www.theiia.org

VITAL TO GOVERNANCE

Internal auditors' diverse capabilities bring tremendous value to the board and the audit committee in their corporate governance responsibilities and risk management oversight. It is critical that the chief audit executive (CAE), senior management, and the audit committee have sufficient contact and communication to ensure that the parties understand and accept their individual and collective responsibilities for risk management.

Today's audit committees must deal with complex and diverse issues and ever-increasing responsibilities. As a result of laws and regulations, such as the U.S. Sarbanes-Oxley Act of 2002, audit committees are being asked to monitor such areas as: management's assessment of internal controls over financial reporting; ethical complaint hotlines; enterprisewide risk management; and governance reviews, to name a few. It is critical, therefore, that internal auditors apply risk-based audit approaches to the organization's internal control system and provide comprehensive reports to the audit committee.

The risk-based approach toward auditing is mandated by The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* and is the only way to ensure that the priorities of the internal audit activity are consistent with the organization's goals. Such an approach provides internal auditors with the opportunity to become intimately knowledgeable of the organization's risk appetite and tolerance — allowing them to target high-impact areas, appropriately allocate scarce resources, and be well positioned to advise management on vulnerabilities and corrective actions.

Implementing a risk-based approach can uncover potential organizational risks that may otherwise go undetected and provide management with a critical tool for gauging and assessing enterprisewide risk. This allows management to allocate the greatest amount of resources to the areas that will yield the highest return on investment and ensures that the organization has dedicated audit coverage for high-risk areas.

AS PART OF ITS OVERSIGHT RESPONSIBILITIES, THE AUDIT COMMITTEE SHOULD:

- Review and concur the chief audit executive (CAE) appointment, replacement, reassignment, and dismissal.
- Review/approve the internal audit charter and ensure its compatibility with that of the audit committee.
- Review the audit plan and any significant changes.
- Ensure internal auditor neutrality and objectivity.
- Review the internal audit department's budget and staffing.
- Encourage internal auditor certification and other professional development.
- Meet privately with the CAE.
- Receive reports from the CAE on audit findings and information on technological advances and trends.
- Review internal auditing's compliance with The IIA's *Standards*.



WHAT WORKS BEST

An active and knowledgeable audit committee is fundamental to achieving and maintaining an effective control environment. And an atmosphere of mutual trust and respect between the internal audit activity and the audit committee is critical to the committee's independent oversight role.

World-class internal audit departments at J. C. Penney Company, ASEA Brown Boveri, Ford Motor Company, and BellSouth Corporation offer these tips for building a strong relationship between internal auditing and the audit committee for enhanced corporate governance:

- To avoid any significant surprises, there should be straightforward, open, honest, accurate, and timely communication between internal auditing and the audit committee.
- Internal auditing should keep the audit committee members up to date on new laws, trends, and other important information and resources so they can effectively discharge their duties.
- Internal auditing should provide the audit committee with a plan to address key governance issues.
- A corporate governance program should provide a mechanism for business process improvement, integrity standards, training, a "hotline" and other reporting processes, and appropriate compliance review.
- Presentations should drive toward discussion of control issues rather than audit findings, and additional material should accompany presentations to provide contextual insight about the control issues under discussion.
- In addition to regular audit committee meetings, the CAE should have periodic meetings with the audit committee chairman and recurring closed sessions with the committee itself to discuss broader issues facing the organization.
- Internal auditing should focus on delivering results and implementing preventive actions, rather than simply uncovering problems after the fact.
- As suggested by the Internal Audit Foundation, internal auditing should perform periodic surveys to determine the specific needs of the audit committee.

KEY IIA MESSAGES ON BEST-PRACTICE REPORTING RELATIONSHIPS

- To ensure transparency and thwart collusion and conflicts of interests, best practice indicates that the internal audit activity should have a dual reporting relationship. The CAE should report to executive management for establishing direction, support, and administrative interface; and to the organization's most senior oversight group — typically the audit committee — for validation, reinforcement, and accountability.
- The audit committee of the board of directors and the internal auditors are interdependent and should be mutually accessible, with the internal auditors providing objective opinions, information, support, and education to the audit committee; and the audit committee providing validation and oversight to the internal auditors.
- The internal auditors keep the audit committee informed and up to date on the state of the organization in regard to risk, control, governance, and the coordination and effectiveness of monitoring activities.



INTERNAL AUDITING: ADDING VALUE ACROSS THE BOARD

Competitive pressures demand that today's organizations squeeze the most they can from all their resources – and as this brochure indicates, the internal audit process is clearly among the most critical. In addition to their responsibility for assessing and recommending internal controls, internal auditors' skills in risk management and their broad-based perspective of the organization uniquely position them as a valuable resource for strong corporate governance.

As a result, informed senior managers and boards are relying on internal auditors for advice and counsel on everything from analysis of operations and assessment of risk to recommendations for improved corporate governance. Moreover, internal audit practitioners are increasingly being challenged to apply their expertise in much broader ways than ever before – such as evaluating emerging technologies, detecting and deterring fraud, analyzing the effectiveness of policies and procedures, and identifying opportunities to save the organization and its shareholders money.

When it comes to adding value across the board, there's no better resource than internal auditing.



WORLD-CLASS INTERNAL AUDIT SHOPS SPEAK OUT ON THE IMPORTANCE OF THEIR RELATIONSHIP WITH THE AUDIT COMMITTEE:

"Internal auditing is the primary resource of the audit committee in carrying out its duties and responsibilities. With those responsibilities increasing and continued pressure from the SEC for financial reporting integrity, a functioning partnership of the audit committee and internal auditing is vital."

– *BellSouth Corporation*

"Internal auditors should not have to report through layers upon layers of management as this could compromise or dilute recommendations and their effectiveness. Audit services' relationship with the audit committee is critical and contributes to the success of our company."

– *Carolina Power & Light Company*

"Internal auditing's relationship to the audit committee is important to assure there are no organizational levels below the board of directors that could prevent necessary actions or appropriate decisions from taking place or being made to enhance business opportunities and mitigate risks."

– *ASEA Brown Boveri*

"An active and informed audit committee provides the ultimate independent and objective oversight of the corporate control environment, including focus on emerging trends and risks. Internal auditing is the primary agent of the audit committee within the company."

– *Ford Motor Company*

"The relationship affords auditing with some degree of independence from the organization and management. In certain cases, it can be used to ensure management addresses key findings. It is our main vehicle to communicate important issues to the entire board."

– *J. C. Penney Company*

The Institute of Internal Auditors (IIA) is the internal audit profession's global voice, recognized authority, acknowledged leader, chief advocate, and principal educator worldwide. Established in 1941, The IIA serves members from all around the world in internal auditing, governance, internal control, IT auditing, education, and security.

The world's leader in certification, education, research, and technological guidance for the profession, The Institute sets the *International Standards for the Professional Practice of Internal Auditing* and provides various levels of accompanying guidance; certifies professionals through the globally recognized Certified Internal Auditor® (CIA®) and specialty certifications in government, control self-assessment, and financial services; presents leading-edge conferences, seminars for professional development, and web-based training; produces forward-looking educational products; offers quality assurance reviews, benchmarking, and consulting services; and creates growth and networking opportunities for specialty groups.

The Internal Audit Foundation works in partnership with experts from around the globe conducting valuable research projects on the top issues affecting the business world today. It also delivers leading-edge educational products through the IIA Bookstore. The Institute's website, www.theiia.org, is rich with professional guidance and information on IIA programs, products, and services, as well as resources for IT audit professionals.

The IIA also brings great value to its members through *Internal Auditor*, an award-winning professional magazine, and through other outstanding periodicals that address the profession's most pressing issues and challenges and present viable solutions and exemplary practices.

And in support of quality, professionalism, and ethical practices, The Institute provides internal audit practitioners, executive management, boards of directors, and audit committees with guidance for internal auditing and governance best practices.

The IIA is dedicated to providing extensive support and services to its members, so they can continue to add value across the board.

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