

Audit Committee:

10 Ways to Collaborate with Internal Audit



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As the scope of responsibilities grows, how can audit committees collaborate effectively with internal audit? Internal audit, through its risk assessment and monitoring role, can contribute great value to the audit committee – but only with charter alignment, experienced auditing professionals, and committee members who know how to leverage internal audit.

Summary

The expanded scope of audit committee responsibilities is daunting. More than ever, top management and boards of directors are being held accountable for identifying, managing, and monitoring company risks.

Audit committees need to oversee accurate financial reporting and disclosure, and help to sustain regulatory compliance, strengthen internal controls, and improve risk management. The increasing stakeholder expectations, along with the desire to make better use of organization monitoring and risk management, call for audit committees to marshal resources in the best ways possible.

One resource at which audit committees should be looking for help is internal audit. Here are 10 ways to help audit committees get the most out of internal audit.

Strategy and Alignment

1. Understand what your charter means and the role internal audit plays in helping you meet your audit committee responsibilities.
2. Compare the audit committee and internal audit charters side by side, then assess gaps and improve alignment.

Team-building and Competency

3. Improve the caliber of the chief audit executive (CAE), and help develop the overall quality and stature of internal audit.
4. Determine if the internal audit budget is sufficient in light of higher standards for internal controls and good governance.

Support

5. Understand internal audit risk assessments and offer input into the internal audit planning process.
6. Insist on prioritization of audit issues, along with relevant and timely reporting.
7. Ensure management accountability and follow-up of issues identified by internal audit.

Monitoring and Moving Toward Best Practices

8. Expect internal audit to provide ongoing updates and identify new risks going forward.
9. Call on internal audit's help with enterprise risk management and strategic audits (e.g., corporate governance audit).
10. Sponsor the quality assurance review (QAR) of internal audit and push for continuous improvement.

Trends

A decade ago, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) evaluated the effectiveness of audit committees. The Securities and Exchange Commission (SEC) in 1999 adopted reforms suggested by the NYSE-NASD Blue Ribbon Committee.

Responding to colossal business failures and fraud, Congress passed Sarbanes-Oxley (SOX) legislation in 2002. This act wrote many of the previous blue ribbon recommendations into law. Thus, the attention paid to audit committees and internal auditors has dramatically increased in recent years.

The profile of internal auditors has grown in light of perceived lapses in corporate oversight. The Institute of Internal Auditors (IIA) has been a strong advocate for internal audit to report directly to the audit committee. Administrative reporting can retain present links to a senior executive. But the *“functional reporting line ... is the ultimate source of its independence and authority,”* the IIA maintains, recommending the CAE *“report functionally to the audit committee, board of directors, or other appropriate governing authority.”*¹

The NYSE, as of Oct. 31, 2004, began requiring all companies listed there to maintain an internal audit function. The Nasdaq does not require an internal audit function but supports it as a best practice.

Sarbanes-Oxley makes the audit committee responsible for the appointment, compensation, and oversight of a registered public accounting firm. Section 301 does not require the same level of supervision over internal auditors, but many audit committees now believe it makes sense to take on this role as well.

¹ “Internal Audit Independence and Corporate Governance,”
Institute of Internal Auditors, Chicago Chapter, April 30, 2003.

Challenges

Some organizations are at risk of overtaxing audit committee members. In addition to duties mentioned above, the audit committee must address whistleblower complaints and establish procedures for the retention and treatment of criticism regarding accounting, internal controls, and auditing matters.

Not surprisingly, the duration and frequency of meetings and conferences with auditors have increased since passage of Sarbanes-Oxley. Using the experience gained over the last few years, it is important to make this oversight time efficient and effective.

Audit committees ideally have healthy skepticism and a willingness to ask questions. They must, however, avoid such harsh oversight that even minor transactions are magnified beyond proportion, in effect inhibiting employees and managers from focusing on the work of achieving business objectives. Risk in itself is not a good or a bad thing, after all. It is inevitable and never will be eliminated. But it does need to be identified and controlled in the appropriate context.

Thus, there is high demand for experienced executives to serve on audit committees and for internal auditors who possess both financial and business knowledge. The shortage shows no sign of abating.

Solutions

Audit committees can help improve the efficiency and effectiveness of internal audit resources, which will help audit committees and boards strengthen oversight of organizations. Following, we have outlined 10 principles of working more effectively with internal audit.

The 10 principles are grouped in four themes — strategy and alignment, team-building and competency, support, and monitoring and moving toward best practices. These themes represent time stages in the process of building a more productive and high-performance audit committee.

Strategy and Alignment

1. *Understand what your charter means and the role internal audit plays in helping you meet your audit committee responsibilities.*

The first thing the audit committee needs to do is fully understand its charter.

Does your committee charter outline responsibilities in a way you understand and can reasonably accomplish?

Look for areas in your audit committee charter where internal audit can complement and support your responsibilities.

2. *Compare the audit committee and internal audit charters side by side, then assess gaps and improve alignment.*

Do you agree with the fundamental objectives of internal audit in your organization? If not, what would you change?

The audit committee should have a role in creating, designing, and molding the internal audit mission, strategy, and focus. The internal audit function should have a well articulated charter that supports the desires and responsibilities of the audit committee.

Have your CAE compare your charter to internal audit's, looking for overlapping areas of responsibility and where internal audit can assist you. Once you have compared the two charters side by side, assess the gaps and work to improve alignment.

You may also want to consider comparing all the committee charters to assure alignment. While there is no prescriptive solution, some organizations choose to have separate committees and groups responsible for risk and compliance. Internal audit and the audit committee play key roles in those areas. Charter comparisons can point out duplicative activities and improve alignment.

Team-building and Competency

3. *Improve the caliber of the CAE, and help develop the overall quality and stature of internal audit.*

As previously mentioned, to ensure objectivity of internal audit, increasing numbers of companies now have audit committees (rather than the CFO) taking a key role in selecting, hiring, and evaluating the performance of the CAE.

Having the right CAE is critical to allowing the audit committee to fully meet its requirements. Does your CAE have the respect of board members and senior management? Is he or she able to fulfill the mission, strategy, and focus of internal audit?

The audit committee may need to require executive coaching and increased training for the CAE, and the internal audit function as a whole, to improve skills and capabilities.

If not, alternatively you could work with a third party in any of a number of cosourcing relationships that are possible and commonly practiced today.

4. *Determine if the internal audit budget is sufficient in light of higher standards for internal controls and good governance.*

Given the growing number of compliance and risk management activities in your company, the demands upon, and responsibilities and competency required of your CAE have skyrocketed. Have your internal audit resources kept up with the expectations?

The gap assessment (discussed in Point 2) helps to determine if internal audit has the right blend of skills and competencies. If you have superb alignment, you probably won't need to spend a great deal more to close the gaps.

If you have large gaps, however, you will need to allocate additional resources or change the resources you have, develop your internal audit talent, and possibly hire additional personnel.

Support

5. *Understand internal audit risk assessments and offer input into the internal audit planning process.*

Internal audit has finite resources. Are they being used in strategic ways?

Consider: Are the risk assessments and priorities that internal audit identifies in line with the key risks you believe face your company? What recent industry changes or new risks might the group have overlooked?

Are internal audit's risk assessment and audit plan aligned with the risk assessments completed for SOX compliance and enterprise risk management? How can you aggregate compliance activities to improve coordination, save on costs, and receive greater value?

6. *Insist on prioritization of audit issues, along with relevant and timely reporting.*

Audit committees can be easily overwhelmed with reports. Prioritization is important to use everyone's time wisely. Setting priorities requires maturity and business experience, and is unlikely to happen without an experienced CAE at the helm.

The CAE must be able to prioritize, summarize, and communicate what is important. He or she must also differentiate between an important internal controls weakness, for example, and an improvement opportunity that would best be communicated solely to management.

The CAE can also assist by helping organize the agenda for committee meetings, preparing materials (including coaching others on important levels of detail), and working with general counsel on high-level company controls.

7. *Ensure management accountability and follow-up of issues identified by internal audit.*

You can have the world's best internal audit group, but it hardly matters unless the board follows up by ensuring corrective action is taken on control weaknesses and management is held accountable. One way to do that is to have management throughout the organization respond in person to significant internal audit findings and recommendations.

Another way to demonstrate support for internal audit is by having members of the audit committee periodically address the internal audit group. Such discussions demonstrate to the internal audit function their importance, and also send a message to the organization that internal audit plays an important role in the governance of the company.

Internal audit can be called on to review hotline or whistleblower calls — a new oversight responsibility for audit committees, mandated by SOX. Audit committees will need to ensure appropriate follow-up on these issues for compliance reasons, and to help promote ethical business behavior in the organization.

Monitoring and Moving Toward Best Practices

8. *Expect internal audit to provide ongoing updates and identify new risks going forward.*

Risk is a moving target, and business risks don't sit still for a portrait once a year. Internal audit groups need to be involved continuously in various company risk management activities. These activities might include enterprise risk management, compliance, SOX 302 disclosure committee, SOX 404, and periodic assessment of key controls.

Additionally, the audit committee chair should meet with the CAE between meetings, staying in touch by phone. The audit committee, with its business experience, can alert internal audit to emerging business risks, thereby encouraging a healthy, interactive, and continuing dialogue.

9. *Call on internal audit's help with enterprise risk management and strategic audits (e.g., corporate governance audit).*

Investors want reassurance that companies are doing more than the bare minimum in terms of legal compliance. The audit committee can use internal audit as one of the tools to create a sustainable process to improve risk management, business ethics, and good governance.

A well-respected and qualified internal audit function can be called on to audit the effectiveness of your company's corporate governance processes, practices, and performance. Internal audit can also offer input into the evaluation of the external auditor, and the organization's other risk and compliance monitoring functions.

10. *Sponsor the quality assurance review (QAR) of internal audit and push for continuous improvement.*

To comply with the IIA "International Standards for the Professional Practice of Internal Auditing," internal audit departments need to obtain a QAR, or do a self-assessment and obtain an independent review every five years (effective Jan. 1, 2007).

The QAR process is a tool the audit committee can use to ensure internal audit is prepared to add value to the audit committee. One step some committees are taking is having the QAR arrangement letter and report addressed to them.

Rather than mere compliance-with-the-standards review, consider extending the QAR to a best practices review. This additional step will give the audit committee insight as to whether internal audit has access to, and is making good use of, effective tools, databases, best practices information, training, and continuing education.

Conclusion

The challenges facing audit committees have never been greater. This is a demanding time for everyone involved in the corporate governance process because of increasing scrutiny and skepticism. It is important for auditors and audit committees to review their working relationships.

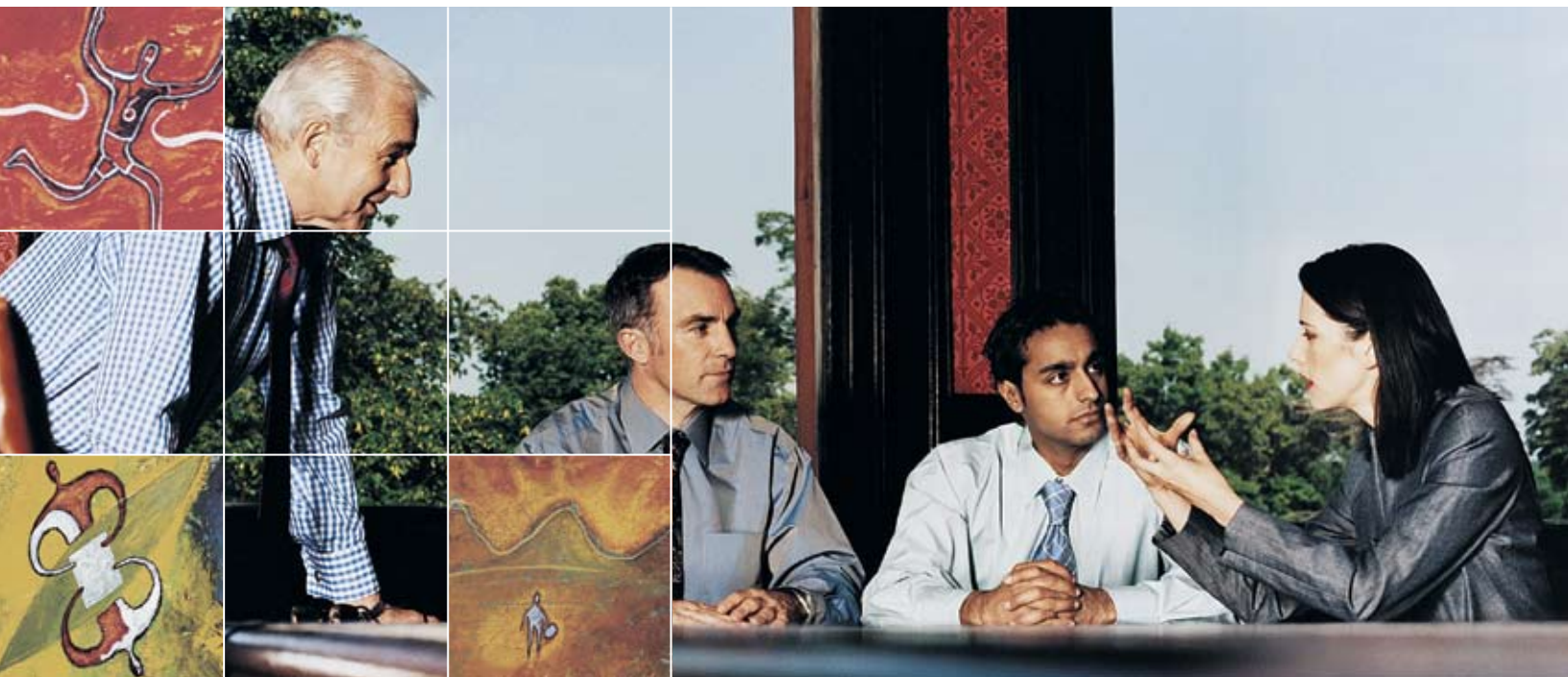
Aligning audit committee objectives with those of internal audit helps to unify oversight and allocate limited resources in the most efficient and effective ways. Internal audit is likely to appreciate a closer working relationship in assessing risks, planning the audit process, and interacting with experienced board members about emerging business risks.

Members of audit committees need to determine if internal audit has the right mix of skills and experience to do the job. Will additional hiring and training fill the gaps and create a much stronger team? If not, other short- and long-term internal audit cosourcing opportunities exist that can help meet audit committee needs.

The stakes are high, and the tolerance for mediocre or poor performance is much less than it used to be. The best internal audit organizations provide audit committees with relevant reports and ongoing updates. They identify new risks and are entrusted to conduct high-level reviews in strategic ways, such as corporate governance audits. Audit committees have a great deal to gain by developing and empowering internal audit, and by working more closely with internal auditors to improve organizational oversight.

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