

# ***Audit Committee Excellence Series***

## Achieving excellence: Overseeing internal audit

*July 2014*

PwC's Audit Committee Excellence Series (ACES) provides practical and actionable insights, perspectives, and ideas to help audit committees maximize their performance. This edition is about effective oversight of the internal audit function.

## This ACES module discusses overseeing the internal audit function, including:

1. Why internal audit oversight is critical to audit committees
2. Directors' role in maximizing internal audit's value proposition
3. Helping internal audit define its mission
4. Reporting lines, leadership and resources
5. Reviewing internal audit findings
6. What if your company doesn't have an internal audit function?

## 1. Why internal audit oversight is critical to audit committees

The audit committee's role is not getting any easier, but an audit committee has a lot of resources in its arsenal to help meet today's high expectations. One of these tools is the internal audit function. Directors can, and should, focus on maximizing the value proposition of this group to ensure their own success.

A lot goes on in companies — and a lot can go wrong, even when you have good people and thoughtfully designed processes. That's why so many audit committees look to internal audit as their eyes and ears — a way to check whether things are working as they should. Some companies staff the function internally, while others choose to outsource some or all of the role. Some do not have an internal audit function at all.

For many audit committees, overseeing internal audit isn't just the right thing to do, it's a requirement. At NYSE companies, audit committees have to oversee internal audit's performance and periodically meet in private sessions. NASDAQ is currently considering whether to require its listed companies to have an internal audit function and what role audit committees should play.

Whether a required function or not, we believe it's critical that audit committees focus on internal audit. Why? PwC's *2014 State of the internal audit profession study* found that about one-third of board members believe internal audit adds less than significant value to the company, and only 64% of directors believe internal audit is performing well at delivering expectations. Even Chief Audit Executives (CAEs) are critical of their functions' performance, with just two-thirds saying it's performing well.

## 2. Directors' role in maximizing internal audit's value proposition

Figuring out ways to ensure internal audit is living up to its potential can be challenging and there are a number of factors to consider with regard to maximization. A priority for the audit committee should be empowering the internal audit organization by providing visible support.

The entire organization can appreciate the importance of internal audit by observing the approach the audit committee takes regarding the function. If the messaging suggests that the audit committee views internal audit as essential to the success of the organization, the efficacy of the function can be significantly enhanced. In some cases, the internal auditor may feel emasculated by the

power and influence of management without the visible support of the audit committee. Symptoms of an underpowered function can include recommendations not getting implemented; departmental assistance being half-hearted; proposed control improvements always negotiated and argued into a watered-down version; and individual auditors being intimidated into backing off from their viewpoints.

So, how does the audit committee provide the support to internal audit to ensure peak performance? We have seen the following techniques used by astute committees:

- Evaluating whether the CAE is part of appropriate leadership teams and recognized as an important player at high levels within the company.
- Having the audit committee chair attend an internal audit group gathering. Many departments have a yearly educational retreat for internal auditors in the company's worldwide network, often at corporate headquarters. The impact of having the audit committee chair attend even a portion of this event can send a message to the rest of the company how important the function is to the committee. It also can help the individual auditors feel empowered to carry out their roles, perceive themselves and their work as valuable and worthwhile, and increase their confidence as they enjoy the support from above.
- Some audit committees invite department leaders who are responsible for an area that received a poor internal audit report to attend a committee meeting to explain how they plan to remediate the situation. If there is a pattern of certain departments in the company ignoring internal audit's findings, consider whether it would be helpful to invite the leader of those areas to meet with the committee (or chair). That conversation can help the audit committee better understand if executives don't believe the findings are valid or cost-effective. If the findings are legitimate, it can reinforce the message across the company that executives need to pay attention to internal audit's recommendations.
- Some committees require an aging of how long significant internal audit recommendations have been outstanding and not implemented. Reviewing this type of information can send a clear message to management about the importance the audit committee places on the function.
- Holding a "private session" with the CAE after regularly scheduled meetings that allows for frank discussion between the group leader and the committee. These discussions can further enhance the relationship.

- Having regular one-on-one meetings between the audit committee chair and CAE. This helps build trust, leading to more candid dialogue. It also provides an opportunity for the chair to gain insights into the perspectives and views of the internal audit group and can lead to a better assessment of the skillset of the group leader.

Although some of these techniques may not be appropriate for your audit committee, the examples provide ideas that may be helpful.

#### *Audit committee considerations:*

- Determine if there are actions that the audit committee can take to further empower the internal audit function.
- Consider whether private sessions and one-on-one meetings with the CAE are robust and frequent enough.
- Evaluate whether the audit committee is providing appropriate messaging to the organization about the importance of the function.

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### **3. Helping internal audit define its mission**

Another important aspect of maximizing the value of internal audit is to ensure that there is agreement across the enterprise on its priorities and scope. Think of this issue in two parts — one philosophical and one tactical.

The more philosophical element involves defining and agreeing on what roles internal audit should play in the company. These can range from auditing compliance controls (basic blocking and tackling) to auditing health and safety compliance, to cybersecurity testing, and so on.

It is a complicating factor when various members of management do not agree on where internal audit should focus its efforts. Some members of management may want internal audit to devote a large portion of its efforts toward process improvement to achieve cost savings. Others may want internal audit to focus its work on testing the company's internal controls over financial

reporting. Internal audit's focus on particular areas may not necessarily address the audit committee's major areas of concern. For example, a singular focus on internal controls may mean there is less comfort provided on whether key operational risks are addressed.

Directors and management should reach consensus on which areas should be internal audit priorities. Getting the right balance allows directors to get the comfort they need. It also helps ensure the company is using these resources in a way that provides the most value.

Internal audit, with reporting lines to both the audit committee and management, can't solve the problem of multiple and competing expectations by itself. But the audit committee can help by messaging to the rest of the company that it is behind the agreed-upon priorities.

On the tactical side, internal audit needs to make decisions about resource allocation and include this as part of its plan. Internal audit's plan should be risk-based, which requires knowing the key risks the company faces. The audit committee should oversee how internal audit's plan addresses those risks, which risks are not being covered, and why. Sometimes internal audit crafts an annual plan that leverages its group's capabilities rather than addressing the company's key risks. Audit committees will want to be on the lookout for this.

Because no internal audit function has unlimited resources that would allow it to audit every risk every year, it needs to determine which locations and functions it will cover in a given year. In larger or more complex companies, internal audit typically uses a rotation to ensure it addresses the most significant areas over a two- or three-year audit cycle. It may elect not to visit certain locations at all based on materiality or risk assessment. Experienced audit committees know how to evaluate the implications of such decisions, and may request some degree of work in lower risk locations so all employees understand that they are being held to the same standards.

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### *Audit committee considerations:*

- Evaluate whether the committee is contributing to a unified message throughout the organization about the internal audit plan, approach, and priorities.
- Ensure you're comfortable with internal audit's role. This includes discussing your expectations with management and the CAE, and reconciling any significant differences in views.
- Understand how internal audit works with other groups throughout the company to identify and assess major risks.
- Discuss how the proposed internal audit plan addresses key company risks.
- Understand whether resource constraints (e.g., restrictions on travel budgets or the ability to source technical skills) have an impact on the scope of what internal audit plans to do. If the impact of any restrictions concerns the audit committee, take steps to help internal audit get the resources it needs.

## 4. Reporting lines, leadership, and resources

### **Reporting lines**

Establishing reporting lines and having internal audit attend audit committee meetings is crucial. The best place for them to report can vary by company, and the importance of the quality of the audit committee's interaction with them cannot be overstated. About 82% of CAEs report functionally to audit committees<sup>1</sup>. Within the company, internal audit administratively reports most often to either the CFO (37%) or the CEO (30%).<sup>1</sup>

### *Audit committee considerations:*

- Periodically review internal audit's reporting lines to ensure the function has the perceived influence it should.
- Understand the relationship between the committee and internal audit to be sure it is one where internal audit would feel empowered to directly contact the committee if a concern warrants it.

### **Leadership**

Leadership of the group is key to establishing the credibility of the function across the enterprise. Is the CAE someone who is respected by other senior executives? Is the CAE position held by an executive who

is on the way up in the company? Or is it one where senior executives are assigned for a few years before retirement?

How can an audit committee tell whether a CAE is respected? One way is to get a sense for whether the CEO is willing to spend time with the CAE.

### *Audit committee considerations:*

- Is the CAE invited to meetings where senior executives are discussing strategies and new projects or products? Observe whether attendees at audit committee meetings pay attention when the CAE speaks.
- Evaluate the impact of the CAE communications and whether they are concise.
- Does internal audit participate with project teams as things develop (which allows them to influence better control processes), or is it held at arm's length until after projects are done?

The bottom line: Audit committees should determine if they are accepting a sub-excellent level of performance and competence in a CAE (and internal audit function) that it wouldn't be willing to accept for a CFO (or other key role). A well-respected CAE is vital in attracting and retaining high-level talent to the internal audit function.

### **Resources**

It can be difficult — especially for smaller companies — to maintain sufficient internal audit expertise. That can be true of general audit skills, and it's especially true when it comes to highly technical skills such as IT security or understanding complex derivative arrangements and hedging processes. Many internal audit groups feel the need to look beyond in-house resources and outsource some or all of the roles in the function.

Audit committees should understand the resourcing mix for internal audit, including plans to use third-parties. However sourced, the same questions apply. Are they competent, qualified, objective and able to perform the work effectively? Is there sufficient continuity of resources or are there so many new auditors that they don't fully understand the company?

Top quality internal audit executives want more feedback on their performance. Another way for audit committees to maximize the value of the internal audit function is to ensure a robust evaluation and feedback process.

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<sup>1</sup> The Institute of Internal Auditors' 2013 *Global Audit Information Network* survey

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*Audit committee considerations:*

- Evaluate whether your current CAE is an effective leader.
- Understand how internal audit is sourced and how quality is assured.
- Ask the CFO, the CEO, and the external auditor for their perspectives on internal audit's performance.
- If technology presents a significant risk to your company, discuss internal audit's competence with regard to IT audit skills.
- Understand how compensation practices impact internal audit's ability to attract and retain the right resources.
- Evaluate whether the CAE is getting sufficient feedback from the audit committee to promote continuous improvement and meet the expectations of internal audit's constituents.

## 5. Reviewing internal audit findings

Once internal audit has completed its work in an area, it needs to assess the importance of findings and complete its report to management and the audit committee. While some audit committees receive a copy of every report, that practice may not be ideal. Why? First, because there can be numerous findings and reports that are simply not significant enough to be important to audit committee members. Second, the sheer volume of the details of every single report may add to the audit committee's work load, which may not be productive.

The audit committee can insist that internal audit tailor its report to match the committee's expectations. For example, it can request a summary of audits completed during the period and overall ratings. The summary can indicate whether the unit is improving or declining relative to prior audits.

In larger companies, internal audit performs numerous audits every quarter. Communications should be succinct. Audit committees should expect that the CAE

will exercise significant judgment to highlight the individual findings and broader trends that are sufficiently important to be emphasized.

*Audit committee considerations:*

- Periodically discuss whether the amount and type of information internal audit reports to the committee is appropriate.
- If current reporting is lengthy and narrative-based, challenge internal audit to design a more efficient and informative format.

## 6. What if your company doesn't have an internal audit function?

Not all companies have internal audit functions. This is particularly true with small companies that may have cost constraints or less complex operations. Senior management of such organizations should be able to more easily determine if there are operational or control issues.

That said, if a company doesn't and isn't required to have an internal audit function, the audit committee should periodically assess whether they should.

*Audit committee considerations:*

- Is the company required to have or is it of a size and level of complexity that merits creating an internal audit function?
- Based on the size of the organization and available resources, if an internal audit function is necessary, consider whether the need is best met by internal resources, an outsourced arrangement, or some combination of the two.

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## How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Center for Board Governance.

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## Other topics

Other "Audit Committee Excellence Series" topics include:

- Assessing the company's forward-looking guidance practices and the potential risks of consensus estimates (March 2014)
- Financial reporting oversight (May 2014)

Upcoming topics:

- Overseeing accounting changes, including the new revenue recognition standard
- Overseeing external auditors

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