

# Principles and Practices of the New Internal Audit Model

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Boards of directors, audit committees, executive management, and internal and external stakeholders rely on internal audit departments to provide financial statement assurance, evaluate internal controls, assess operational effectiveness, and gauge compliance with laws, regulations, and company policies and procedures. To meet these expectations, departments need to analyze their structures, maturity, and expectations. Then they can begin to follow the principles and practices of the new internal audit model.

Internal audit executives and their departments are under more pressure than in the past, and this pressure is not expected to subside in the near term. The challenges internal audit departments face today relate to an expanded audit universe, new regulations (such as the *Dodd-Frank Wall Street Reform and Consumer Protection Act*), greater technology risks (such as IT security, system implementations, and cloud computing), and increased budget pressure (doing more with fewer personnel).<sup>1</sup>

## Internal Audit Models

As a result, executive management and audit committees in their respective oversight roles are asking their chief audit executives to review their companies' risk profiles and determine if their operating models are optimal, efficient, and effective. There are three internal audit models today: an in-house function, a cosourced function, and a fully outsourced function. Which path a company takes depends on a number of factors as well as the specific applicability, inherent benefits, and potential challenges associated with each operating model.

In an in-house function, the internal audit department is composed solely of company employees. The department is responsible for recruiting and staffing, completing the risk assessment, developing an audit plan, and maintaining its methodology, technology, and knowledge. This model is driven generally by corporate cultural considerations or the company's desire to use the department as a source of future talent.



In a cosourced function, the internal audit department is composed of both company employees and personnel from a third-party provider. The third-party resources can be used to supplement resource gaps or provide specific subject matter expertise or language skills. The two parties can work in tandem or on separate internal audit assignments. Company employees can take advantage of the third-party provider's investments in methodology, technology, and knowledge. This model can be a solution for elevating the capabilities of the department and providing flexibility and a variable-cost function.

In an outsourced function, the internal audit department is composed solely of employees from a third-party provider. Under the direction of executive management and the audit committee, the provider is responsible for staffing, performing the risk assessment, developing the audit plan, and reporting results to management and the audit committee. The provider also can use its investments in methodology, technology, and knowledge to help the company drive increased efficiency and effectiveness in the internal audit function. This path is a fully flexible staffing model and the quickest route to transformational change.

Many factors influence which internal audit operating model an organization selects. The following list highlights the various qualitative factors that could be used by a chief audit executive, executive management, and an audit committee to determine the appropriate model. This list is not intended to encompass everything but does cover some of the major factors that could be used in a company's evaluation:

- At a company where internal audit is not a core competency, the company is generally more likely to have a cosourced or outsourced function.
- At a company that uses internal audit as a source of future talent, the company is more likely to have an in-house internal audit department.
- The greater the complexity of the company's information systems or the higher the company's level of geographic dispersion, the more likely the company is to have a cosourced or outsourced function.
- The more centralized a company's organizational structure is or the simpler the company's business processes are, the more likely it is to have an in-house internal audit department.
- Companies in more regulated industries are more likely to have cosourced or outsourced internal audit departments.

Once a company has reviewed these factors and determined its evaluation, it should be in a good position to assess which operating model would be most suitable.

No single model fits all situations. Stakeholders must assess their needs and make appropriate decisions.

## Internal Audit Maturity

From a maturity perspective, internal audit departments generally fall into one of five categories: basic, evolving, established, advanced, or leading. Focus areas include stakeholder expectations, business objectives, internal audit-enabled business performance, mandate, people, methodology, and technology.

Most internal audit departments that have existed for years could be classified as established or advanced in most focus areas. Due to the significant investments that would be required, few departments can be classified as leading.

For instance, a basic or evolving internal audit department is focused solely on compliance risk. However, an advanced department is focused on compliance risk, cost reduction, and risks that could affect business objectives. As another example, a basic or evolving department would not have its audit activities well-aligned to the achievement of a company's business objectives, whereas an advanced or leading department would be focused on one or more of the objectives – such as security, lean manufacturing, or cost reduction.

In terms of people, methodology, and technology at less advanced internal audit departments:

- Auditors' skill sets are not aligned with the organizations' audit needs.
- Risk assessments generally are not well-integrated with other risk functions; nor are assessments updated to reflect changes in the company's risk profile.
- Any use of technology tends to be fairly basic or limited.

At more advanced internal audit departments:

- The departments hire auditors with specific skill sets or subject matter expertise based on the companies' needs, risk profiles, and audit plans.
- The departments' risk assessments and audit plans are integrated fully with other risk functions to reduce the risk of duplication or gaps in coverage. In addition, the departments' risk assessments are updated during the year to account for changes in the business and risk profile.
- The departments have leading-edge governance, risk and compliance, and data analytic tools to conduct work and monitor controls and risks.

It is important to note that each company is unique and the level of maturity can be dictated by expectations of audit committees and executive management.

## Expectations of the Internal Audit Department

The exhibit illustrates the expectations of different constituent groups that influence the chief audit executive and ultimately the internal audit department and its audit plan. These groups are the audit committee, executive management, functional management, the internal audit function, external auditors, and external factors.

Most of the time, expectations are generally aligned. However, there might be times when a group has a point of focus that is counter to that of one or more of the other groups. In this situation, the chief audit executive needs to consult with executive management or the audit committee. Broadly speaking:

- The audit committee focuses on completing the audit plan, providing assurance, and helping to meet risk management requirements.
- Executive management focuses on completing the audit plan, reducing financial risk, and bringing value to the business – for example, through best practices or performance recommendations.
- External auditors focus on financial risk and, if possible, using the work of the internal audit department.
- Internal auditors seek training, experience, and opportunities to expand their skill sets.
- Functional management looks for insight on how to reduce risk and bring value to functional management’s respective areas.



## The New Internal Audit Model

These increased demands require a new approach to internal auditing, one built on four auditing principles – compliance, assurance, performance improvement, and risk identification – to help internal audit departments accomplish their objectives.

### **Principle One: Compliance**

Given the economic volatility that has affected so many organizations over the past few years, expanded regulatory pressure, and the reduction in management's ranks, compliance has become even more important to almost every organization.

More and more companies have implemented periodic performance checks of the work performed by managers, certain other employees, and third parties. In addition, these organizations have begun to implement important risk indicators to identify potential issues warranting further investigation on a real-time basis.

By the nature of its mandate, internal audit can assist companies with evaluating whether these deeper reviews occur, risk items are investigated, and compliance activities occur. Reviews should include evaluating compliance with company policies and procedures; local, state, and federal laws and regulations, including the *Foreign Corrupt Practices Act*; anti-money-laundering statutes and anti-bribery provisions; security and privacy practices; and ethics and business practices.

### **Principle Two: Assurance**

Stakeholders are looking more than ever for assurance. This trend has been driven by the fact that they are held to a higher standard and significantly greater accountability than in the past. They are focused not just on financial data but on nonfinancial areas as well:

- IT security has always been an area of concern. However, recent data breaches have elevated awareness even further and brought focus to customer data and intellectual property. Cloud computing is another risk as more companies look to move data and related processing to the cloud.
- *Sarbanes-Oxley Act* compliance has become more challenging over the past several years as public accounting firms have come to expect more from process owners and finance management, particularly related to control precision and retention of evidence.
- Payment card industry compliance has become a hotter topic due to recent data breaches at a number of companies.
- The use of data analytics and continuous monitoring, which is when 100 percent of transactions are reviewed, is helping to provide a certain level of assurance. Internal audit departments are well-positioned to assist management with its assurance programs and activities.

### **Principle Three: Performance Improvement**

Internal audit departments today play a larger role in process improvement, and this shift is reflected in their respective audit plans. This trend is a function of a changing mandate and an expectation that departments provide more tangible value to their organizations.

Internal audit departments can provide a valuable service to stakeholders by comparing organizational performance data among operating companies or functions or against industry benchmarks, which are available from a wide variety of sources. The ability to identify improvement opportunities and share best practices can help organizations become more efficient and achieve their strategic goals.

Stakeholders also are focused on improving operating efficiency and effectiveness, such as through the right mix of internal controls, manual versus automated controls, transaction processing, and value-added versus non-value-added activities that are part of processes. Internal audit departments can play a role in assessing these specific areas and providing improvement recommendations.

### **Principle Four: Risk Identification**

The final principle of the new internal audit model is risk identification, a subject that offers perhaps the greatest opportunity for the internal audit function.

Through an enterprisewide perspective, internal audit is in a unique position to identify new and emerging risks and help an organization assess its vulnerabilities by linking those risks to strategic objectives. In addition, internal audit can add value by:

- Applying monitoring and review methods to make audit processes more effective and efficient
- Integrating risk assessments from all corners of the organization into internal audit risk assessment processes
- Reviewing the processes that different groups in the organization use to evaluate emerging risks
- Effectively employing an enterprise risk management program

## Three Guiding Practices

To complete internal audit's transformation, internal audit departments need to change their own behavior and adopt three guiding practices:

**Use others' work.** As a result of greater regulatory pressure, advanced enterprise resource planning systems, and ongoing process improvements, business managers rely increasingly on metrics monitoring and reporting to manage business operations. By determining which of the compliance, financial, and operational reports they can rely on for assurance during their audits, internal audit departments can use work already done by others, allowing them to focus on the transaction areas where problems are indicated. Using what exists can result in better-focused and less costly audits.

**Hold process owners accountable.** The process owners are responsible for the design and operating effectiveness of controls. Internal audit should evaluate controls, provide recommendations for improvement, and monitor control performance. When process owners take responsibility for controls at the business level, an organization is better managed, and internal audit can focus on the other key principles in the new internal audit model.

**Provide continuous coverage.** Each of the four principles of the new audit model requires constant review, and each vies equally for time and resources when more focused attention is needed. The chief audit executive must expertly manage resource demands to address areas of higher and emerging risk without letting up on continuous efforts to enforce the four principles.

## Following the Principles and Practices

By following these principles and practices, internal audit departments not only can provide better assurance over the effectiveness of internal controls but also can position themselves to provide more valuable information to organizations.

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“Transforming the Internal Audit Model,” a recording of a June 25, 2014, Crowe Horwath LLP webinar presentation by Andrew Schweik and Bill Watts, is available at <http://www.crowehorwath.com/ContentDetails.aspx?id=8838>.



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<sup>1</sup> For a discussion of the role of internal audit, the challenges of integrating it into the organization, and the need to raise its stature in the organization, see Andrew L. Schweik and William C. Watts, "What Does the Future Hold for Internal Audit?," Crowe Horwath LLP, April 2015, <http://www.crowehorwath.com/ContentDetails.aspx?id=11339>.