

A New Decade, a New Internal Audit Model



As businesses in these uncertain times try to do more with less, the internal audit function is no exception. A new internal audit model can help internal auditors accomplish that objective by leveraging existing activities to continuously monitor, manage, and improve business performance based on four key auditing principles.

The economic recession has created fear and uncertainty in the marketplace. Bailouts of insurer American International Group, carmakers General Motors and Chrysler, and financial behemoths Bank of America and Citigroup kept a number of the largest U.S. businesses afloat. International efforts have kept Dubai from defaulting and are under consideration to prop up the ailing economy of Greece. In all, 176 U.S. banks shut their doors in 2009, compared to only 17 during the period from 2000 to 2008.¹ Each economic setback has dealt a blow to confidence in the business sector.

Executive management and the boards responsible for internal audit programs want greater assurance that internal controls and risk management procedures are in place to help achieve business objectives, ward off unwelcome financial and operational surprises, and generate greater value.

Internal auditors can help restore that confidence, and ultimately provide “more for less,” by simultaneously addressing the four key principles of a new, more progressive internal audit model:



- 1. Compliance**
- 2. Assurance**
- 3. Business performance improvements**
- 4. Risk identification**

“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.”

– The Institute of Internal Auditors²

Trends

Crowe Horwath LLP and partner organizations commissioned a set of three surveys to determine whether companies' internal audit groups were meeting current business needs.³ The results were split. Stakeholders generally reported that the internal audit function handles the basics well but could be more proactive overall.

Stakeholders indicated that internal audit departments do a fine job testing past events and reviewing transactions to make sure controls over financial reporting are working properly. This type of compliance review identifies last month's problems but fails to inform stakeholders of two critical concerns: how the company is doing today and the areas with room for improvement.

The new internal audit model must respond to concerns about greater assurance, maximized business performance, and broader risk management.

Minimizing future surprises through risk management practices is also of concern. Seventy percent of audit committee member respondents identified managing risk across the entire organization as the most challenging near-term issue they would face in the following 12 months.

Collectively, these surveys support the evolution of the internal audit model to a new, more proactive one. This new model must respond to the existing concerns about greater assurance, maximized business performance processes, and broader risk management efforts – while providing for traditional compliance audits as well.

Gaps

Audit departments in the past have tended to concentrate on one or two audit activities at a time. Auditors would adjust priorities, skills, and duties in reaction to changes in the company's strategic objectives or external pressures. As the requirements of the *Sarbanes-Oxley Act* (SOX) became routine, more focus was placed on operational or other audit activities. Cutbacks as a result of the recent economic crisis helped to narrow further the normative scope of internal audit to SOX-compliance controls and other internal controls.

Pared-back internal audit functions can leave organizations exposed. Audit departments that focus exclusively on just one or two audit principles, such

as risk assessment and compliance, often fail to provide an adequate level of continuous assurance, leaving stakeholders without a clear picture of what today's issues really are.

In addition, as the sales, manufacturing, supply-chain, outsourcing, and other business operations of many organizations go global, new risks are emerging – compliance with the *Foreign Corrupt Practices Act* or other countries' business practices and customs, for example. Internal audits that focus on financial or operational improvements could be missing emerging risks that would otherwise be captured through risk identification and ERM efforts.



Challenges

In most cases, increasing internal audit's contribution to the organization must be done without more resources. Although stakeholders indicate they want greater output from internal audit departments, additional funds are unlikely to be forthcoming as companies devote their resources to revenue-generating efforts in the post-recession era.

To make the transition to a new model, internal audit departments must find ways to juggle four balls instead of one or two. Auditors will need to be smarter about where they spend time by relying more on automated tools and using methodologies that will allow them to focus on risks and controls at a high level and on a continuous basis.

Solution

A new model is necessary to make internal audit relevant after the dramatic changes in the business environment in 2008 and 2009. The model is built around the four principles of the audit function.

Auditors will be able to do more with less only if they leverage the work of others, hold business process owners accountable for their internal control processes, and provide for continuous coverage to each of the four principles.

- **Leverage the work of others.**
As a result of SOX requirements, advanced enterprise resource planning systems, and ongoing process improvements, business managers increasingly are relying on monitoring metrics and reporting – both financial and operational – to manage their business operations. By determining which of these reports they can rely on for assurance during their audits, internal auditors can use work that is already being done by others in order to focus on only the transaction areas where problems are indicated. Using what exists creates value with better focused, less costly audits.
- **Hold process owners accountable.**
Internal audit should not be the control or position itself to develop the controls. The business process owners need to own the controls; internal audit should ensure that they do. As the owners take responsibility for controls at the business level, the organization is better managed and internal audit can continue to focus on the principles in the new internal audit model.
- **Provide continuous coverage.**
Each of the four principles in the new audit model requires constant review, and they vie equally for time and resources when more focused attention is needed. The chief audit executive must manage resource demands expertly to address areas of higher and emerging risks without letting up on the continuous efforts to enforce the four principles.

The Four Principles of the New Internal Audit Model



1. Compliance

Viewed as a traditional internal audit role, compliance audits test past events and transactions to determine whether previous actions are in compliance with policies and procedures, laws, and regulations. The internal audit function also keeps an inventory of applicable compliance mandates and monitors the processes that manage compliance with SOX and other legal and regulatory requirements.

Using the new model, internal auditors can rely on the work of business unit managers and the reports the managers use to monitor controls in their unit as a starting point for the audit. Only those issues that are red-flagged during the audit of the control processes are then homed in on for further investigation. Auditors can use business unit reports generated within, for example, the information technology department to determine whether the control processes that are in place safeguard security adequately and provide for an appropriate segregation of duties.

Similarly, internal auditors can continuously review control reports to validate that processes are in place for timely reconciliation. As long as management checks sample transactions each month, the internal auditor doesn't need to do the same checks; rather, he or she needs simply to verify that management is doing what it needs to do.

2. Assurance

For up-to-the-moment testing, continuous monitoring systems must be in place to oversee events, transactions, and results and to generate reports that highlight early warning signs that something is outside the bounds of tolerance. By regularly analyzing and reviewing control reports generated by a system, auditors can provide a level of continuous assurance that supports stakeholder confidence that everything is under control at all times.

These real-time reports keep current events from becoming out-of-control problems. If expenses in a certain business unit are out of line or should not have been approved, for example, the continuous monitoring systems at the business-unit level should flash a warning or automatically send an e-mail to the appropriate person. The same system might also flag accounts of customers who in the past have failed to pay, so that no new sales are made to delinquent customers.

Although installing a continuous monitoring system costs money up front, it eliminates the need for auditors or staff to do these monitoring tasks manually. The time saving allows auditors to focus on the items that matter.

3. Business Performance Improvements

Internal auditors' continuous reviews of business processes for effectiveness and efficiency can lead to improved business. In the past, auditors have identified problems but might not have taken the extra step to recommend ways to improve them and thus raise business performance.

Many of the control reports auditors collect can be compared to benchmarks or best practices. This type of analysis could show that a company is taking twice as long to perform an operating procedure as its peers are, or that a company should add people to attain higher productivity. With this knowledge, changes can be made that add value to the organization as a whole.



4. Risk Identification

Future risks need to be identified and understood today so they do not prevent the company from achieving its business objectives. Key risks are always changing. By applying ongoing monitoring and review methods, internal auditors make the process of identifying and managing risk more reliable and resilient.

A number of different groups in a company are likely to be performing risk-management activities already – for compliance or safety purposes, for example. Here again, internal auditors can use their time efficiently by using the existing assessments of each of these groups to increase stakeholders' knowledge of the risk environment as a whole. Thus the risk assessment process for the organization becomes more integrated.

To evaluate emerging risks, internal auditors can review the processes various groups in the company already use for emerging risk evaluation. A company developing a new product, for example, has in place a process for estimating the return on investment (ROI) for that product. The risk to the company is that the estimated ROI of the new product is not realized. Internal audit can review and monitor reports on the process the product development group used to determine the ROI expected for the new product.

Conclusion

Redefining internal audit is a business necessity. Audit committees, CFOs, and other stakeholders want an internal audit function that is more vital and central to building financial and operational excellence with confidence. With a new, more proactive audit model built upon the foundation of four key principles, internal auditors can more effectively assess the business, identify areas for improvement, and manage risk in a business environment that is always in flux.

¹ FDIC Failed Bank List, www.fdic.gov/bank/individual/failed/banklist.html.

² See www.theiia.org

³ See Rick Julien and Jonathan Marks, "Chief Audit Executives and Audit Committees: Building a Strong Relationship," www.crowehorwath.com/Crowe/Publications/detail.cfm?id=1789; Rick Julien and Jonathan Marks, "Avoiding the Black Swan: Barriers to Improving Risk Management," www.crowehorwath.com/Crowe/Publications/PointofViewPapers.cfm; and Corporate Board Member, "Audit Committees Raise the Bar: Leveraging Resources to Oversee Risk," www.crowehorwath.com/Crowe/Publications/detail.cfm?id=1673.



Contact Us

Lawrence A. Rieger, CPA, is a partner with Crowe Horwath LLP in the Chicago office. He can be reached at 630.586.5150 or larry.rieger@crowehorwath.com.

Rick Julien, CPA, is a partner with Crowe Horwath LLP in the Chicago office. He can be reached at 630.586.5280 or rick.julien@crowehorwath.com.

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