Starting a Successful Internal Audit Function to Meet Present and Future Demands

by Jeffrey Ridley

Executive Summary

- Starting an internal audit function requires a clear and inspiring vision to provide the right direction for its success.
- The services provided by the internal audit role must add value and meet the needs of all its customers, at every level in the organization. This demands a wealth of knowledge and experience of risk management, control, and governance processes in the function.
- The internal audit charter approved at board level must state the professional standards expected from all staff in the function.
- Internal auditors in the function should be trained to ask the right questions and advise on the impact of present and future change at all levels in the organization, from strategic to operational.
- Quality of performance in the function and its continuous improvement requires a total commitment, measured and reported at board level through key performance indicators, and feedback from its customers.
- The function should contribute to implementation of quality policies in the organization it serves by using its own experience of achieving performance quality.

Introduction

In 1998 on the occasion of the fifty-year celebration of the establishment of the Institute of Internal Auditors (IIA)’s five chapters in the United Kingdom, I wrote:

“We need to be seen as innovators in the world of regulation, control and auditing. Creativity, innovation and experimentation are now key to our professional success. They must be the vision of all internal auditing functions. This means improving old and developing new products and services for delighted customers, with a focus on their objectives. This means being at the leading edge in all the markets in which we sell our internal auditing services. This means beating our competitors and knowing who these are. This means having the imagination, and foresight into what our organizations will require from us, not just in the year 2000, but also in 2005 and beyond.

In this 50th year celebration of our national institute’s past and present teamwork, all IIA-UK [and Ireland] members should continue to set their sights on being inventors of an improved and new internal auditing, to delight all their customers … and increase its status as an international profession.”

Establishing a successful internal audit function requires more than just support and resources approved at board and senior management levels; or an external requirement by government and regulators; or encouragement by external auditors. These are all important drivers and influences for creating the function and setting the boundaries in which it will operate and provide services. But the present and future demands of a successful function require a clear and inspiring vision for the direction of its services, which can only be provided by those who work in the function. It demands their knowledge and experience of risk management, control, and governance processes; their professionalism; their imagination, innovation, and creativity to manage change in what is and will be required from their services. All these attributes are needed if these service providers are to delight all their customers by the quality of their performance. They are needed whether internal auditing is resourced by staff in-house, outsourced, or co-sourced.

Clear and Inspiring Vision

A vision statement is key to the mission of any organization or function. In 1991 Richard Whitely wrote some inspirational words on vision statements:
A good vision leads to competitive advantage.

One way to define vision is … a vivid picture of an ambitious, desirable state that is connected to the customer and better in some important way than the current state.

How does this vision represent the interests of our customers and values that are important to us?

A vision has two vital functions, and they’re more important today than ever before. One is to serve as a source of inspiration. The other is to guide decision making, aligning all the organization’s parts so that they work together.

If your vision is not an impetus to excellence, then it has failed.

When a company clearly declares what it stands for and its people share this vision, a powerful network is created—people seeking related goals.

Constantly communicate your vision for your organization to those who work with you and for you. Don’t let a day go by without talking about it.

This advice has not dated. It can be seen in many vision statements used by organizations today and will be tomorrow. An inspirational vision for internal auditing in an organization can have a significant impact on those who provide and receive the service. It should be aligned with its organization’s vision, creating direction for all its resources, promotion, planning, engagements, and reporting. From the vision should flow the strategic mission of the internal audit role and its business plan, which will set the scene for the resources needed for its achievement. Following the creation of an internal auditing vision statement, all internal auditing staff and senior management should be involved in its development. Seek total organization commitment and board approval for its direction. That direction will set the scene for the services it will provide.

Knowledge and Experience of Risk Management, Control, and Governance Processes

No internal audit function can be successful unless it is expert in the principles and practices of management, risk management, control, and governance in the sector in which it works and across the supply chains developed by its organization. This expertise demands not only knowledge of what these processes require but also an understanding of the principles on which they are based, experience of how they operate at all levels within an organization, and how they are reported to all stakeholders. This expertise has to be at the management level of internal auditing and with all internal auditors.

Successful organizations assess and manage their economic, environmental, and social risks, mitigating these through appropriate strategies and controls. Successful internal audit functions focus on this corporate social responsibility and its “triple bottom line” in all their engagements—across the entire range of an organization’s strategies, policies, processes, and reporting. In many organizations internal auditing is seen as a facilitator in the assessment and management processes addressing these risks. To be successful today, the planning of internal audit engagements and the conducting of assurance and consulting reviews must always be linked to risks and controls in an organization’s “triple bottom line.”

In 1991, the US Committee of Sponsoring Organizations (COSO) published its integrated control framework exposure draft. This became its risk and control guidance for management and auditors worldwide, published in 1992. Its five integrated elements of “control environment, risk assessment, control activities, monitoring, and information and communications” are basic requirements in all risk and control processes. It defines control as a process “designed to provide reasonable assurance regarding the achievement of [effectiveness and efficiency of operations] objectives.” Importance of the COSO control elements and key concepts is significant for the mitigation of risks. These have been adopted as best practices by many regulators and organizations. Their importance is even more evident today as organizations embed risk management in their processes, from strategy setting to the achievement of objectives at every level in every operation.

In 2004 COSO further developed its framework into an Enterprise Risk Management (ERM) model providing further guidance for the management of risk and control across all levels of an organization. Based on its 1992 control framework, this model demonstrates the importance of embedding each of the 1992 integrated framework elements in the strategic, operations, reporting, and compliance decision-making...
Starting a Successful Internal Audit Function to Meet Present and Future Demands

processes across the whole enterprise. Understanding the description of each of the elements in the ERM model is a good test for management and all auditors in any organization. Such understanding is essential for internal audit success.

The IIA Inc. (2006), in its overview of organizational governance, discusses the internal auditors’ role, recommending that “they act as catalysts for change, advising or advocating improvements to enhance the organization’s governance structure and practices.” Possible steps for the internal auditor to be successful in an organization’s governance processes are seen as [my comments in brackets]:

1. Review all the relevant internal and external audit policies, codes, and charter provisions, pertaining to organizational governance. [Look for the key words and phrases about governance.]
2. Discuss organizational governance with executive management or members of the board. The objective of these discussions is to ensure internal auditors have a clear understanding of the governance structure and processes from the perspective of those responsible for them, as well as the maturity of these processes. [In these discussions relate direction and control in the organization to the achievement of its vision, mission, and key objectives.]
3. Discuss options for expanding the role of internal auditors in organizational governance with the board chair, board committee chairs, and executive managers. These discussions could involve explaining the potential actions internal auditors could take and the resources required, as well as the possibility of an assurance gap between the board’s assurance requirements and the organization’s practices, if internal auditors did not assist in this area. Ensure the internal audit charter is consistent with the expanded role being considered. [Consider providing education programs on governance for all board, management, and employee training programs.]
4. Discuss organizational governance topics with other key stakeholders including external auditors and employees of the organization’s departments such as legal, public affairs corporate secretary office, compliance, and regulatory affairs. During these discussions, explore their current and future activities as well as how an expanded internal audit role could coordinate with their activities. [This should also be in every internal audit, not only in the organization but also across all its external relationships.]
5. Develop a broad framework of the organization’s governance structure by identifying potential areas of weakness and concern. [A real opportunity to be creative in thinking and design.]
6. Draft a multi-year plan to develop the internal audit role in organization governance areas methodically [Another opportunity to be creative.]
7. Perform a pilot audit in one of the areas noted above. Select a single, well-defined, manageable topic and assess the adequacy of the design and execution of the activities related to the topic. Performing a pilot audit will allow the internal auditor a chance to gauge the organization’s response to his or her expanded role and learn how to coordinate more effectively with other stakeholders. [This should only be the start. It should lead the internal auditor along many paths in many different dimensions.]

Note how these recommendations link in to the guidance for success in this article.

Professionalism

Professional attributes and performance requirements for internal auditing are clearly set out in the IIA’s International Standards for Professional Practice of Internal Auditing. These Standards and their supporting guidelines have been continuously developed internationally since the 1970s. They represent “best practice” internal auditing and will continue to be revised by international teams to reflect both the needs of internal auditors and the organizations in which they provide their services. All internal auditing charters should require the internal audit role to comply with these standards: not all do! Yet every board would expect its external auditors to comply with developed international standards for external auditing. Why should internal auditing be different?

The Standards set out requirements and guidance for internal auditing attributes and performance of work. All are based on defined principles of Integrity, Objectivity, Confidentiality, and Competency in its International Code of Ethics, first published in 1968 and since revised to meet current and future internal auditing needs for all its members and those who have achieved the status of its qualification Certified Internal Auditor.
Managing Change

All operations in an organization have a past, a present, and a future. This must be recognized in the planning of all internal auditing services and in each of its engagements. What has happened before and what is happening today will influence what will happen in the future. What happens in the future will also be influenced by more change, not only in the organization but also externally, by many of its stakeholders and events beyond its control. Every test and observation in an internal audit engagement needs to be considered in this scenario of past, present, and future change. Future change is change that can be forecast during the engagement, and change that might be hinted at by events leading to “beyond the horizon.” Beyond the horizon is not always an easy prediction to make, but it should be attempted by the internal auditor studying events and issues surrounding the operations being reviewed, and in discussion with board members and management at all levels.

Quality of Performance

To be successful an internal audit function must have a total commitment to the quality of its performance and continuous improvement. This is a requirement of the IIA Standards. Such commitment will be strongly influenced by its collective knowledge, experience of risk management, control, and governance; its professionalism of service; and its ability to question change in the past, present, and future. This can be seen in the cutting-edge internal auditing framework in the figure, developed within the chapters of my book Cutting Edge Internal Auditing.8

Figure 1. Cutting-edge internal auditing framework

In Figure 1, each of the directional lines demonstrates an importance in the management of internal audit. Each touches and influences the quality of performance in an internal audit function:

- The horizontal line represents the level of knowledge and experience of risk management, control, and governance in the function across the organization’s supply chains—supplier through operations to customers, related today to economic, social, and environmental issues and risks. The wider the line the better the service provided by the function and greater the impact on the vertical and diagonal lines and the quality of its performance.
- The vertical line represents the compliance of the function with The IIA International Standards. The deeper the line, the better the compliance and greater the impact on the horizontal and diagonal lines and the quality of its performance.
- The diagonal line represents the function’s ability to question change across time past, present, and future, and into beyond the horizon. The wider the line, the greater the involvement of the function in the organization’s risk management processes; and the greater the impact on the horizontal and vertical lines and the quality of its performance.

A total commitment to quality by the staff in the function can create opportunities for it to contribute to the organization’s quality culture. Gupta and Ray9 show that “internal auditors can leverage their knowledge of business processes and play an active role in the development and implementation of [the] Total Quality Improvement process.” Their research describes the complete range of quality management tools and techniques used by organizations to implement and measure quality improvement programs showing how
a knowledge of these and experience in their use can improve an internal audit activity’s services and processes. Their research identifies seven steps (Table 4-22, p.104) to be undertaken to implement Total Quality Improvement in internal auditing:

1. Development of Mission and Vision Statements and establishing internal audit department objectives.
2. Establishment and implementation of performance measures for various stages of the internal auditing process.
3. Identification of customers of internal auditing departments.
4. Development and implementation of internal auditing customer satisfaction surveys and feedback systems.
5. Benchmarking with other internal auditing departments.
7. TQM training and education of the internal auditing staff.

Note how these steps have been woven into the guidance in this article for establishing a successful internal audit function to meet present and future needs for all its customers.

Making It Happen

Starting a successful internal auditing function requires a chief audit executive who is experienced in the implementation of professional internal auditing processes and has a full understanding of the principles and practices of management, risk management, control, and governance. That experience and knowledge must be used to educate the board and senior management in the role that internal auditing should assume to add best value to the organization. That role should be written into a charter, approved at board level, showing its purpose, authority, and responsibility. Once established, the internal auditing function should:

• create an inspiring vision linked to its aimed success;
• develop a plan to achieve its vision, focused on adding value;
• employ and train competent qualified professional staff;
• focus all its engagements on changes in the past, present, future and beyond the horizon;
• report its findings on a timely basis to appropriate management and the board;
• continuously measure and improve the quality of its services and delight its customers.

Case Study

Scope and Types of Work in Successful Internal Audit Functions\textsuperscript{10}

The scope of internal auditing covers all the activities of an organization, without regard for internal boundaries or geographical restrictions. It encompasses the adequacy and effectiveness of governance, risk management, and internal control processes in identifying and responding to all the risks facing the organization. The following are examples of the different types of work that internal audit may undertake:

• giving assurance to the board that the organization’s risks have been properly identified and managed in accordance with the approved risk appetite;
• reviewing the activities undertaken by management to implement the ethical policy across the whole organization;
• giving assurance that business continuity and disaster recovery planning, including for mission-critical information systems, are adequate given the risks facing the organization and the risk appetite;
• giving assurance that the purchase process includes adequate controls to ensure agreed levels of competitiveness, cost savings, and quality performance;
• assisting the management team in evaluating the actual return on investments over a given period of time;
• carrying out an internal audit to verify an organization’s compliance with labor laws and regulations;
• giving assurance that measures are properly designed and working effectively to address health, safety, and environmental risks on industrial sites;
• verifying that all purchase and sales contracts comply with the organization’s policies;
• giving an opinion on the efficiency and effectiveness of the customer complaints process;
• providing advice to management on the design and implementation of risk management processes.

Consider
• How many of these examples of types of work exist in your internal audit function?
• Have you promoted all of these services in your internal audit charter?

Notes


7 See the IIA website (www.theiia.org) for details of this and other internal auditing qualifications.


More Info

Websites:
• Committee of Sponsoring Organizations of the Treadway Commission: www.coso.org
• European Confederation of Institutes of Internal Auditing: www.eciia.org
• Global Reporting Initiative: www.globalreporting.org
• Institute of Internal Auditors: www.theiia.org
• Institute of Internal Auditors, UK and Ireland: www.iia.org.uk

See Also

Best Practice
• The Assurance versus Consulting Debate: How Far Should Internal Audit Go?
• Best Practices in Corporate Social Responsibility
• Best Practices in Risk-Based Internal Auditing
• Designing Corporate Systems for Success
• Incorporating Operational and Performance Auditing into Compliance and Financial Auditing
• Internal Audit and Partnering with Senior Management
• Internal Auditors and Enterprise Risk Management
• New Assurance Challenges Facing Chief Audit Executives
• Optimizing Internal Audit Checklists
• The IIA Code of Ethics

To see this article on-line, please visit