



## The evolution of internal audit

### Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading Canadian companies. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the evolving audit environment.

The fifth meeting of the network was held in Toronto on October 30, 2007, with the discussion focusing on the evolving role of internal audit.

This document reflects a synthesis of the key issues that emerged from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly we can disseminate this information to board directors, management executives, and their advisers, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. Those members participating in the meeting were:

- Bill Anderson, Audit Committee Chair, TransAlta
- Mike Boychuk, Audit Committee Chair, Yellow Pages Income Fund
- Denis Desautels, Audit Committee Chair, Bombardier
- Don Fullerton, Audit Committee Chair, Husky Energy
- Kerry Hawkins, Audit Committee Chair, NOVA Chemicals & Shell Canada
- Bob Luba, Audit Committee Chair, MDS
- Eileen Mercier, Audit Committee Chair, CGI Group
- Tom O'Neill, Audit Committee Chair, BCE
- Pierre Robitaille, Audit Committee Chair, Gildan Activewear

Attending the meeting from Ernst & Young were:

- Robin Hutchinson, Partner, Canadian Risk Advisory Services
- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer
- Ross Pearman, Senior Client Service Partner and Leader, Asset Management Services Practice
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services

*VantagePoint* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by Canadian Audit Committee Network members.



## Executive summary

Members of the Canadian Audit Committee Network discussed the changing role of the internal audit function, and the challenges and opportunities that presents for the company and the audit committee. The following ideas were highlighted:

- **Tackling evolving needs and an evolving role** *(Page 3)*

Despite an emphasis on compliance activities in recent years, many audit committees are reconsidering the appropriate role for internal audit as regulatory compliance needs becomes more routine. Members generally favour a broad scope of activity, driven by the company's business risks and opportunities. While companies have significant latitude in setting internal audit scope, it is important to ensure that the internal audit plan is aligned with the external audit plan. Members said that reviewing and approving the internal audit plan can take three times longer than the external audit plan.

- **Ensuring effective leadership, appropriate staffing and organizational support** *(Page 4)*

Members agreed that the best internal audit executives were leaders first, and auditors second. These individuals rely on effective communication skills and an ability to work constructively with senior management and the board. They often supplement in-house talent with outsourced or co-sourced resources in order to achieve their business objectives. Members also noted that the audit committee and the CEO play key roles in ensuring that internal audit has adequate support within the organization.

- **Internal audit and the audit committee** *(Page 5)*

In many regards, the work of internal audit is the work of the audit committee. As such, an internal audit department must have an open, independent relationship with the audit committee that is free of management's influence. Audit committees signal the importance of this relationship in many ways, including participation in performance and salary reviews, and veto power over hiring or firing decisions. However, members noted that internal audit often appears as the final item on audit committee agendas, and they questioned whether this might send an unintended message.



## Tackling evolving needs and an evolving role

Internal audit has experienced a substantial transformation over the past decade. Although the function rarely attracted high-potential finance talent in the past, internal auditors rose to prominence in the early 2000s with an *“occupational refocus on Sarbanes-Oxley [compliance].”* Audit committee chairs feel another shift is now under way, towards a *“refocus on things that are more important than SOX,”* including an impending conversion to IFRS and valuable operational audits. Like earlier evolutions, this shift requires new skills and a different type of leader. Internal audit departments and the audit committee will need to address many new questions.

### Facing and managing a broadening scope of responsibilities

Looking at the potential scope of internal audit operations, several members indicated a *“bias toward a broad and operationally focused value-add”* role in the company. Internal audit has one of the broadest and deepest views into the company, and its experience and insight can assist business unit leaders, senior management, and the board in gaining a more complete view of the company’s operations.

Members acknowledge that internal audit was overtaken by internal controls work leading up to and immediately following initial Sarbanes-Oxley compliance. In order to free up internal auditors for other work, some directors suggested, *“setting up an internal controls office with responsibility for [ongoing] compliance. Internal audit will provide some input, but [creating such an office] prevents [internal audit] from having SOX [take up] 75% of their efforts.”* Another participant supported the concept and shared the belief that *“the majority of accelerated filers have that [internal controls compliance] function now.”* Still, members recognized the challenges inherent in such a structure. Who, they asked, should report to the audit committee? The head of internal audit? The head of the compliance function? Both? None of these alternatives seemed entirely satisfactory, leading some to conclude that internal audit should retain responsibility for compliance activities.

### Finding the right balance and sticking to the plan

Determining internal audit scope can be a chicken-and-egg problem: *“Do you start with the problems that need to be addressed [and then find people with the requisite skills],”* one member asked, *“or [start] with the skills and abilities your people have [and scope the work accordingly to focus on] the relevant problems?”*

Either way, members strongly emphasized the need for a detailed, comprehensive internal audit plan, and said that items in that plan would receive higher priority than other tasks that might later be assigned. One member felt strongly that *“you accomplish the audit plan first. If that’s not done, you’ve got a problem. You do not vary the plan, period. Once you deviate, there’s a problem.”* While members generally agreed, one noted that there has to be *“an exception for material issues that arise.”*

The internal audit plan and the external audit plan, taken together, should cover all areas of the business. One member observed that *“the internal auditor and the external auditor are [ideally] both moving down*



*similar paths*” and should work together effectively to satisfy the needs of the business. Managing this properly, audit committee chairs said, requires *“jigsaw puzzling [to ensure that] internal and external audit are not overlapping efforts”* and that no key risk areas are overlooked. Interestingly, many audit committee chairs find that reviewing and approving the internal audit plan can take up to three times as long as the external audit plan.

### **Ensuring effective leadership, appropriate staffing and organizational support**

Members felt strongly that when searching for a head of internal audit, *“We want a leader first and foremost, and an auditor second.”* Noting that, *“you don’t need to be a pilot to run Air Canada,”* members said the head of internal audit must have effective leadership and communication skills, and an ability to work constructively with senior management and the board. An accounting background, or experience in internal audit was a *“nice-to-have,”* but not a requirement in the eyes of most audit committee chairs.

Finding the right leader for internal audit is not an easy task, and there is no single model of an ideal candidate. One member remarked, *“Our chief internal auditor is a former Big Four partner. They’re outstanding, very smart. If you compare their profile to another successful [head of internal audit], it could be very different. You can’t say one background will meet [every company’s] needs.”* Other members agreed and shared examples of good hires not only from Big Four firms, but also executives who moved into the role from within the company, and finance professionals recruited from other companies.

Members noted increased demand for internal auditors, and rising expectations for leaders in the internal audit organization. Candidates are expected to have a multitude of talents and the ability to draw upon those talents quickly. *“We had a false start with our first head,”* one member shared. While the candidate had the perfect technical background, *“they lacked the ability to mesh with management.”* Similarly, members agreed that *“communication skills are essential in the position,”* and that candidates who lack the ability to communicate with people throughout the company would not succeed, irrespective of their other qualifications.

The staffing challenges are not limited to the head of the organization. *“Salary and career progression”* are constant issues for internal auditors, who are in high demand in most organizations. Members felt it was critical to *“have a career path for internal auditors, especially the hot shots,”* and recognized that *“if you’re developing high-talent individuals, you know they’ll be poached”* by other companies.

### **Insourcing, outsourcing, and co-sourcing the internal audit function**

Whether because of the challenges of geographic diversity, the need for technical skills, or a desire for specific industry experience, most organizations eventually need to source specialized skills in their internal audit organization. Members represented a diversity of practice: some kept the internal audit function entirely in-house, some outsourced the entire function to an outside firm, and others co-sourced, complementing a core internal team with external resources as required.



Irrespective of the sourcing model, most members favoured a full-time employee as a head of internal audit. This individual can provide *“insider knowledge of the organization, access to resources”* throughout the company, and easier access to senior executives and the board.

While outsourcing or co-sourcing arrangements can provide significant flexibility, members did note some drawbacks. Because of non-solicitation agreements, *“If you see good people [you’d like to hire], you run into problems.”* Additionally, audit chairs worry that a change in the lead internal audit partner could potentially be disruptive. One member, whose company outsources most of its internal audit needs, described a gentleman’s agreement with the partner leading the internal audit team, in which the company would get two years’ notice of any partner changes, along with the right to approve the replacement. While such agreements can’t prevent a change, they can help assure a smooth transition.

Overall, members recognized the value of strategic co-sourcing. Several members said their companies had successfully contracted with Big Four firms to complete significant portions of the internal audit plan, thereby minimizing recruitment, retention and development challenges. As an added benefit, one member remarked that the outsourced staff have *“a tighter relationship with the audit committee. The head of outsourced [internal audit] is much more forthcoming with the audit committee,”* than in-house staff.

### **Ensuring a positive perception of internal audit**

Members recognized that, in the past, internal audit had often been considered the *“boiler room”* of the company. Overcoming that historical perception requires action on the part of both the internal auditors and senior management. *“The CEO has to drive the culture,”* one audit chair remarked. *“Is the CEO making sure internal audit can play a role in the company? [The CEO] can ensure internal audit has broad relationships”* throughout the company.

Even with the support of senior management, business leaders lower in the organization can still put up roadblocks to internal audit’s success. One member cautioned, *“There are mechanisms within organizations that can make life a pure hell. Be aware of that, and access the grapevine”* to know when it might be occurring. If the internal audit head is perceived as rocking the boat, other employees might, at best, not proactively engage with the function. At worst, they may go out of their way to hinder its work. The audit committee chair needs to recognize this fact and be prepared to intervene if necessary.

That intervention can take a number of forms. *“We had people telling the internal auditor to buzz off and then not doing anything they were told to do,”* one member said. *“So, we invited the most overdue respondents to visit with the audit committee and ‘tap dance’ with us.”* It worked.

### **Internal audit and the audit committee**

Members agreed that internal audit plays a critical role in supporting an effective audit committee, and felt the audit committees might better demonstrate this importance. One member asked, *“Where is internal audit on the audit committee’s agenda?”* Several members responded, *“Last,”* leading another to remark, *“That sends a message.”*



Members agreed that the audit committee chair, if not the full committee, should also be involved in decisions regarding the evaluation and compensation of the head of internal audit. On one board, the audit committee chair does the evaluation of the internal audit head, but *“the full audit committee is exposed to the report beforehand. It’s not done as a one-person to one-person report [between the chair and the head]; the whole audit committee is in sync with what it says.”* And, in at least one situation, during the hiring process *“the chief audit executive candidate requested that their salary, bonus, and review be done by the audit committee [as a condition of employment]. It worked out quite well.”*

Additionally, the head of internal audit *“should have unfettered, direct, 24-hour access to the audit committee chair”* to demonstrate the independence of the function. While it’s appropriate for internal auditors to *“get input from management”* on their work, there should be no inappropriate directions or pressure from senior management. One member said this tied back into the audit committee chair’s role in evaluating performance and approving compensation: *“If the CEO or CFO can neither hire nor fire the head of internal audit [without the audit committee’s approval], you’ve got [the independence] you want.”*

## Conclusion

Charged with substantial compliance responsibility in recent years, most internal audit departments have deviated from their traditional role as the audit committee’s “eyes and ears.” However, internal audit is now beginning another transformation, evolving toward a more value-added role providing guidance to the audit committee and assistance to the business units. Consequently, the audit committee must reconsider issues of internal audit scope, resources and leadership. The audit committee must work with senior leadership to demonstrate appropriate tone at the top and support this critical corporate function.

*The views expressed in this document represent those of the Canadian Audit Committee Network, a group of audit committee chairs from Canada’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.*

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