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AUDIT

Utilizing Internal Audit:

A CFO's GUIDE

Public companies and their external auditors currently are planning for their fiscal year 2010 financial statement audits. And, after one of the most trying economic periods in memory, there will be a lot to discuss.

Rapidly shifting economic conditions, significant regulatory changes and an uncertain future should lead to lively planning sessions on a host of important topics, from International Financial Reporting Standards (IFRS) considerations to fair value discussions and deeper conversations about risk and enterprise risk management.

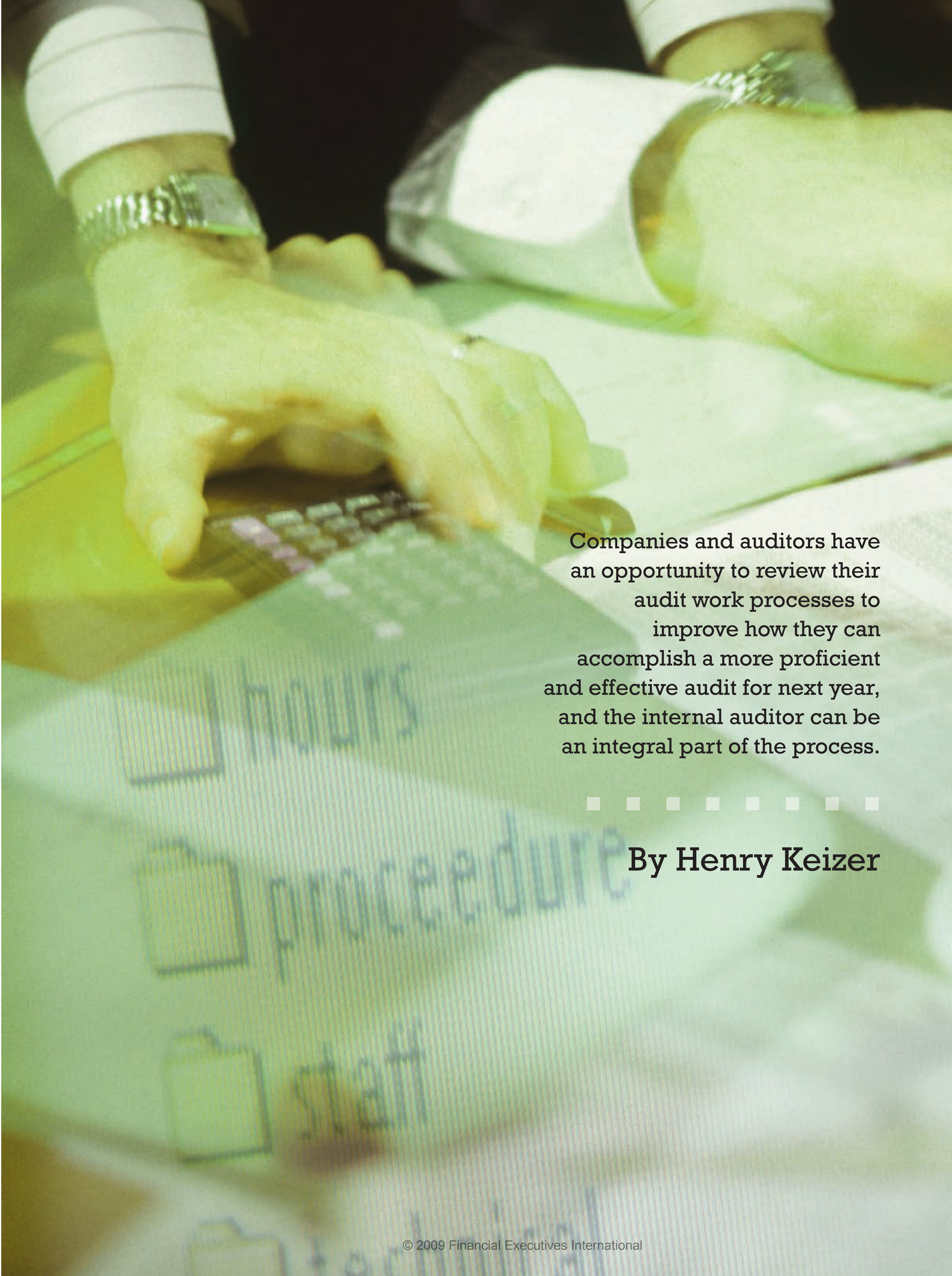
There's no question companies will be relying on their auditors to find additional cost efficiencies for next year's audit — and that auditors will be working hard to ensure their resources are properly focused in ways that enhance audit quality.

As auditors and their clients approach planning for future audits, it is appropriate to consider whether the company has provided for an internal audit (IA) function that can benefit the company's internal control and risk management processes as well as external audit efficiency.

Since passage of The Sarbanes-Oxley Act in 2002, public companies have bolstered their IA function to ensure that it tests and enhances internal controls over financial reporting. Now, many IA groups are fully engaged with their companies' financial reporting systems, and are looking to broaden their scope of responsibilities and improve their own return on investment. This presents an opportunity to improve company and auditor efficiencies while maintaining appropriate external auditor independence.

C-suite executives and boards of directors looking to achieve audit efficiencies should consider whether their IA function is capable of enabling their outside auditor to use internal work in connection with external audit procedures

Based on that consideration, discussion and planning should begin about how IA's work can be used to



Companies and auditors have an opportunity to review their audit work processes to improve how they can accomplish a more proficient and effective audit for next year, and the internal auditor can be an integral part of the process.

By Henry Keizer

realize efficiencies and improve audit quality.

Auditing Standards Considerations

The Public Company Accounting Oversight Board's auditing standards address the circumstances that must be considered by the auditor in this regard. PCAOB's Auditing Standard No. 5 (AS5) discusses how external auditors may consider the work of others in connection with the completion of an audit.

AS5 requires auditors to evaluate the extent to which they will use the work of others — including internal auditors — in their audit, and PCAOB AU Section 322 deals specifically with auditor consideration of the work of a company's IA function.

These standards spell out the considerations by the auditor in assessing the extent to which the work of IA can be used in connection with audit procedures in a way that does not compromise auditor independence and/or audit quality.

Many auditors will recommend that the company's chief financial officer, controller and audit committee be closely involved in discussions on the impact of using IA's work in connection with the audit before they will consider plans to utilize the work of the IA group.

While not an exhaustive list, the following issues are sure to be raised in auditor/management discussions over the applicability of IA work.

■ Can the CFO ensure the internal audit function has the requisite competencies for the external auditor to consider using its results to supplement external auditing procedures?

Before considering whether it can use any work from IA, the auditor will make an assessment of the internal auditors' competence and objectivity. As a part of the process, the external auditor will ask for information about the educational level and experience of the professionals in IA as well as their professional certifications and continuing-education track records.

Generally, as a best practice to help ensure that the IA function passes muster with the outside audit firm, the CFO (who often has daily administrative oversight of the IA function) should be closely involved in the hiring of skilled and qualified IA professionals. The board and audit committee should oversee that process.

Auditors recognize the stark differences between companies that involve the board in the hiring and setting of appropriate compensation levels for IA and those that don't. With an appropriate level of corporate oversight, external auditors typically see an IA function that operates with a high level of competence and efficiency, an appropriate focus on risk, and adequate attention from senior management and directors.

The size, depth and range of expertise in an IA function should be dictated by a company's risk profile. The audit committee needs assurance that the control environment and risk management processes are functioning effectively — meaning IA resources must have the skills and competencies to assess controls around key risks, including those that affect financial reporting.

Many audit committees regularly include on their agendas an executive session with the IA functional leader and use that session to request feedback from IA concerning such matters as adequacy of the group's resources.

The external auditor must have a comfort level based on an assessment that the work of others — in this case, that of an internal audit group — is reliable and capable of contributing to a high-quality, independent audit of financial statements.

■ Have the CFO and audit committee structured the IA function to ensure objectivity?

The external auditor must consider the governance around IA when considering the level of objectivity it can expect. Does IA report directly to the audit committee and to an officer of sufficient status to ensure broad audit coverage and adequate consideration of and action on its findings and recommendations?

Compensation policies also are a key element in achieving this objective. The CFO, with audit committee oversight, should be involved in compensation decisions affecting IA professionals. Auditors will want to know whether compensation policies are based on operational effectiveness and support IA focus on areas of risk within the organization. They will have reservations about IA compensation based largely on whether the company achieves profitability goals, for example.

Other objectivity considerations include the audit policies, programs and procedures of the internal audit function, including the assignments of internal auditors. Are there policies in place to maintain internal auditors' objectivity about the areas audited?

Such policies may include prohibitions against using a specific internal auditor in areas where relatives are employed and against auditing in areas they recently worked or are scheduled to be assigned on completion of their current IA responsibilities.

■ Do the CFO and audit committee members understand how the outside auditor currently leverages the work of the internal auditor? If so, have they explored opportunities to increase the overall effectiveness of the IA function and revisited its key objectives?

When the CFO and audit committee have a clear understanding of how the external auditor currently uses the work of internal audit, opportunities may arise to further use IA. For example, AS5 encourages the external auditor to consider and apply the work that IA has performed during the year that provides evidence of the company's external financial reporting and effectiveness of its related internal controls.

Some IA functions are more operationally than financial- and internal-controls focused. With some redirection or added resources, the IA function could shift to a more financial-audit footing. Internal auditors with financial auditing skills also are in the best position to provide direct assistance to the external auditor. It's another way in which the IA function can contribute to the independent audit.

Under AU322, the outside auditor can request direct assistance from IA, and the standard uses the example of how IA can help the external auditor better understand the organization's internal controls, including revenue-tracking systems, or in performing tests of controls or substantive tests. In essence, the internal auditors can function as assistants to the external auditor.

This focus on internal control and external financial reporting might require different skills within the internal audit department, as well as a change in mindset, but the investment in professional development or the hiring of those necessary competencies could bring added efficiency and quality to the audit. These are cost benefit and internal audit strategy decisions that companies should consider.

Whatever the value proposition is for IA, the audit committee, management and IA must be aligned in support of the mission.

■ Does the CFO engage the audit committee and lead the discussion and analysis of business risks that could result in financial reporting risk?

Often, business and financial reporting risk discussions are led by the Sarbanes-Oxley compliance manager. Without the CFO and senior management taking the lead, the emphasis on Sarbanes-Oxley compliance can be diminished.

Robust senior management support for processes that ensure high-quality financial reporting will likely be considered by the external auditors as evidence of the right "tone at the top" in assessing the control environment.

■ Do CFOs understand their roles, and the specific controls they must execute?

More involvement by the CFO in ensuring processes are in place for identifying the proper controls over financial reporting is important. It sends a signal to the auditor that can positively impact the auditor's consideration of the need to test other internal controls.

Consider financial results reviews. The CFO may be responsible for reviewing and approving those results, but the outside auditor will want to know the CFO understands the importance of his or her role in the processes that constitute the last detailed place of review, before determining the degree to which that review can be relied upon as part of the audit.

Once the audit firm is satisfied with the overall competence and objectivity of the IA function — which includes appropriate engagement and oversight by the CFO, audit committee and the full board — other considerations concerning the evaluation of the ability to use the work of IA kick in.

For one, the auditor will consider the need to test the effectiveness of IA's work. The auditor might test or re-perform some of the relevant work that IA performed during the year to assess its reliability. Accordingly, management should be prepared for requests from the auditor, who will be required to test certain facets of IA's work in order to obtain an appropriate confidence level.

The extent of the testing of IA's work will depend on the relevance of that work to the objectives of the external audit and the potential impact that work will have on the auditor's procedures.

According to AU322, that review and testing may include ensuring that:

- The scope of IA work is appropriate to meet objectives;
- Internal audit programs are appropriate;
- IA working papers adequately document work performed, including evidence of supervision and review;
- Conclusions are appropriate; and
- There is consistency between reports and the results of the work performed.

It is also likely that as utilization of the internal auditor's work increases, the auditor will want to increase its coordination with IA by:

- Holding periodic meetings;
- Scheduling specific IA audit work;
- Getting access to internal auditors' working papers;
- Reviewing audit reports; and
- Discussing possible accounting and auditing issues.

Many Benefits

The incremental effort by management needed to create and sustain a high-quality IA function may seem burdensome. However, the benefits to be derived are many. First and foremost, that effort will improve the company's own internal controls and thus increase the likelihood that it will achieve its objectives and reduce the potential for errors and fraud.

The existence of a high-quality IA function that enjoys the support of top-level management and the board also will attract high quality professionals to that organizational unit. And there is ample opportunity for the IA function to achieve audit efficiencies and derive financial benefit for its company.

HENRY KEIZER, CPA *(www.us.kpmg.com), is the global head of Audit for KPMG International and U.S. vice chair, Audit, KPMG LLP.*

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