

Internal audit

Audit Committee Handbook Chapter 5 – Part 1

Internal audit can have a positive impact on the control environment of an organisation and the effective design and operation of internal control. Internal audit can also play a significant role in supporting the audit committee through the provision of assurance as to whether the controls implemented by management are fit for purpose and working as intended. Part of the audit committee's role is to annually review the need for an internal audit function and, where such a function exists, its effectiveness.

The need for an internal audit function will vary depending on organisation specific factors including the scale, diversity and complexity of the organisation's activities and the number of employees, as well as cost/benefit considerations. When undertaking its assessment of the need for an internal audit function, the audit committee should also consider whether there are any trends or current factors relevant to the organisation's activities, markets or other aspects of its external environment which have increased, or are expected to increase, the risks faced by the organisation. Such an increase in risk may also arise from internal factors such as organisational restructuring or from changes in reporting processes or underlying information systems. Other matters to be taken into account may include adverse trends evident from the monitoring of internal control systems or an increased incidence of unexpected occurrences.

In the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself, the audit committee and the board that the system of internal control is functioning as intended. In these circumstances, the audit committee will need to assess whether such processes provide sufficient and objective assurance.

Establishing and maintaining an effective internal audit function

Internal audit can be sourced either through an in-house function or an external service provider. The decision as to which is appropriate will usually be driven by the availability of appropriate skills and the breadth and depth of experience to cover the organisation's operations adequately. The cost implications of each approach may differ significantly.

Outsourcing continues to be a common option, not least because it arguably enhances the internal audit function's independence from operational management and provides access to a wider range of skills and experience than can typically be maintained by a small in-house team.

The relative strengths and weaknesses of different internal audit sourcing options are discussed in more detail in Appendix 1.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion or dismissal of the head of internal audit, and help determine the required qualifications, reporting obligations and compensation. The audit committee should also help to ensure internal audit has access to all appropriate persons both at board level and within the company.

The audit committee should be involved in developing and approving internal audit's remit, goals and mission, to be certain of its proper role in the oversight function. Collaboration with both management and internal audit in developing internal audit's remit should help ensure a proper balance between the assessment of internal control and any responsibilities for operational efficiency, risk management and other special projects.

Establishing the "right" role for the internal audit function is not a "one size fits all" exercise, and the focus areas and strategic ambitions of any internal audit function rarely stay the same from one financial year to the next. Indeed, if there are signs that an internal audit plan simply rolls-over, this in itself offers a warning sign that there could be an absence of the kind of robust challenge that is needed; an organisation's key risks are rarely static – especially in the current economic environment.

Audit committees looking to optimise internal audit's resources and activities need to ensure that the function's audit plans are clearly defined in the context of the organisation's overall assurance landscape. A clearly defined and communicated remit helps to remove unnecessary duplication of effort and ensure the audit teams and expertise are focused and the investment in the internal audit function is maximised.

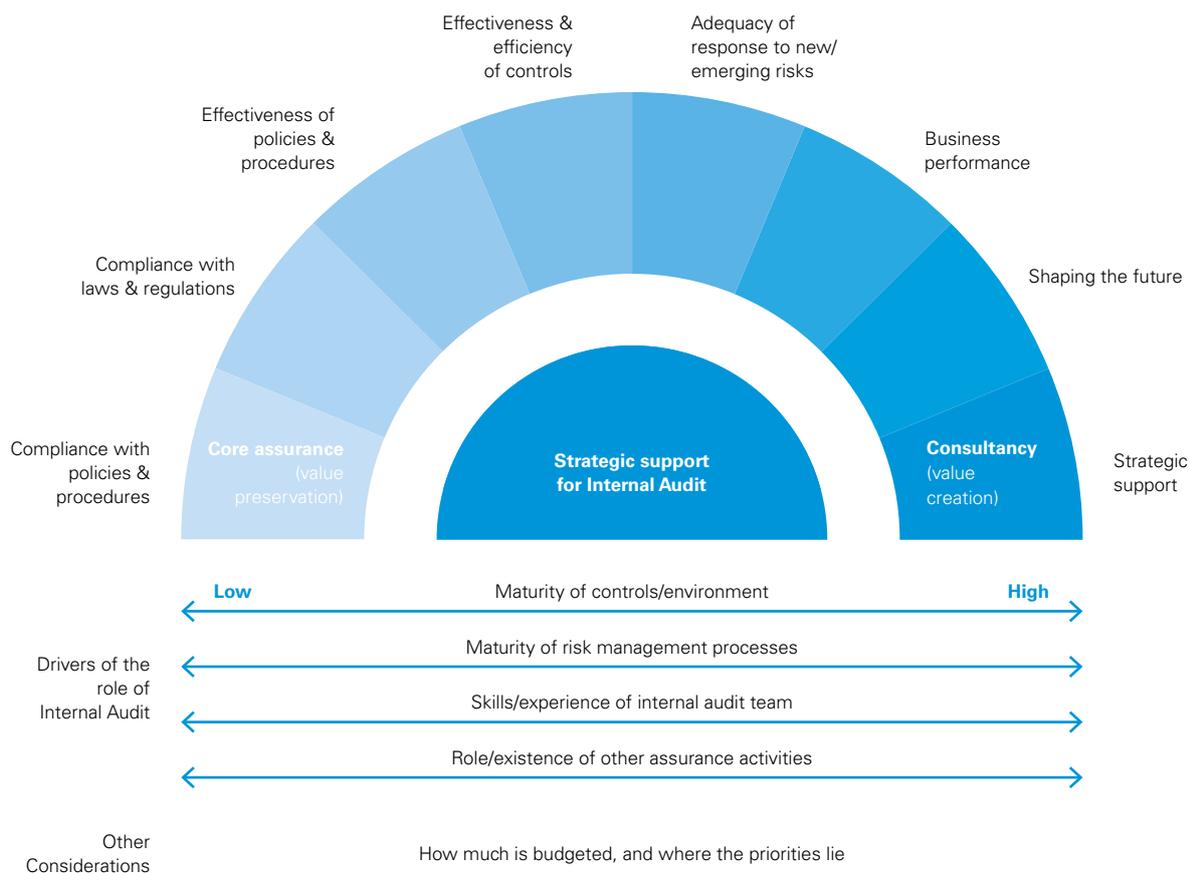
Getting the right balance between core assurance and value creation audit

In a business that has an unstable control environment, or is experiencing significant change or growth, value is often demonstrated by giving high quality assurance over the effectiveness of core controls. This helps to mitigate the risk of control failures and associated financial surprises. Newly established internal audit functions are also more likely to be focused on assessing the effectiveness of the "basic" processes and controls.

Where there is a strong and stable control environment and where the risk management processes are mature and have an experienced team in place, internal audit can focus more on risk-based auditing. Particularly where there are other sources of assurance over core controls, such as self assessment.

Adjusting the balance can see internal audit working alongside management in a business partnering role. The richness of assurance and opinion can help to support major change programmes or challenge controls design as processes are streamlined. This is at the high end of value creation and is an achievable ambition provided that a number of factors are in place [see diagram]. This type of role requires careful management to ensure the responsibilities of the business and the independence of internal audit do not become blurred.

An overview of the potential roles and range of input internal audit can provide



The audit committee should also ensure that the internal audit function has adequate resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors. The audit

committee should pay particular attention to the experience and resources within the internal audit function in times of crisis and ensure the internal audit budget and activities are not inappropriately curtailed as a result of cost cutting exercises.

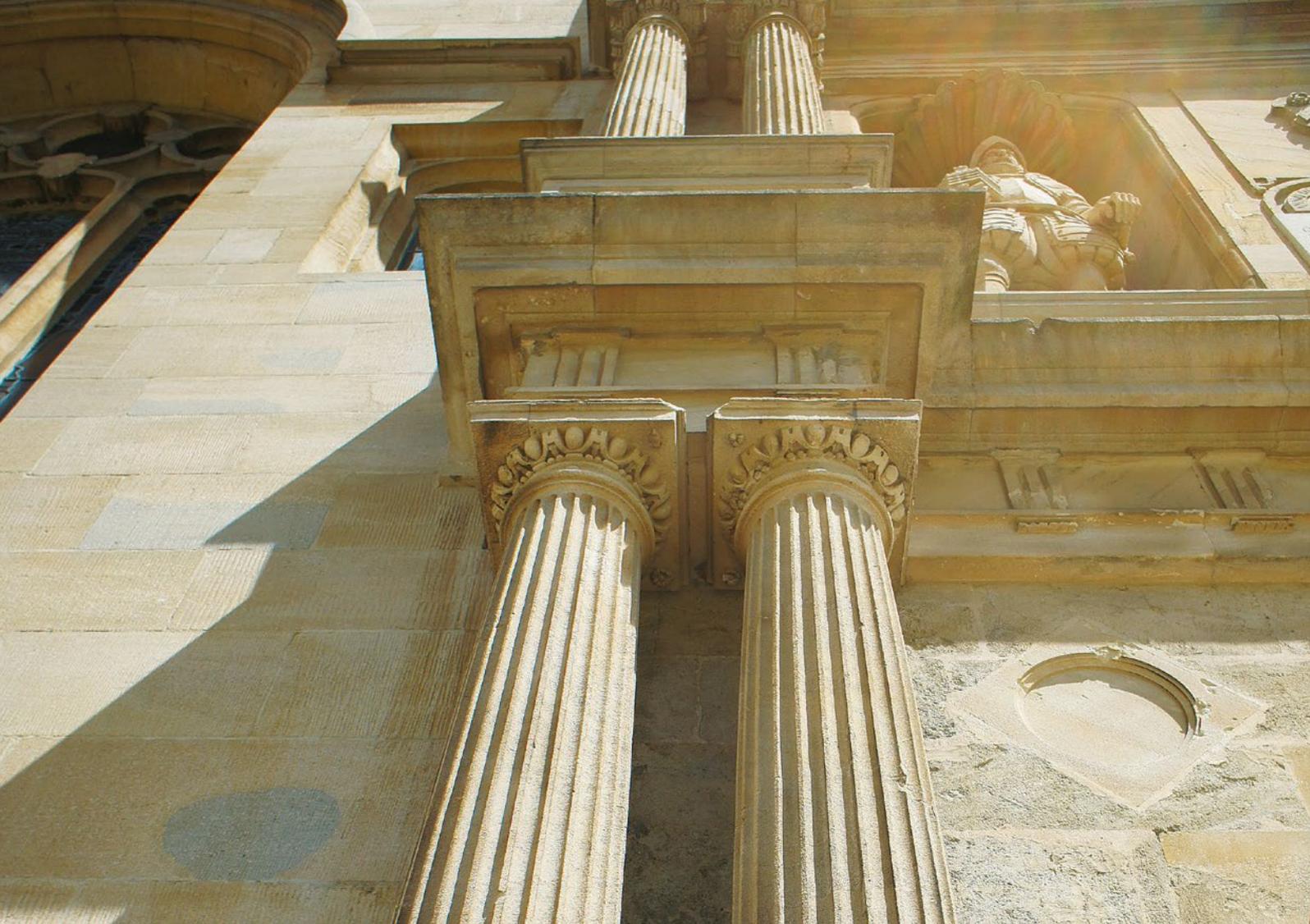
Staff costs and size (Internal Audit functions with 1 to 10 full time equivalents)

Revenue	Staff Count	Staff costs	IA cost as a % of revenue
Under \$500m	4.46	\$613,723	0.3062%
\$500m – \$1billion	4.97	\$737,837	0.1044%
\$1billion – \$5billion	6.56	\$1,103,575	0.0592%
\$5billion – \$15billion	7.73	\$1,432,760	0.0209%

Staff costs and size (all Internal Audit functions)

Revenue	Staff Count	Staff costs	IA cost as a % of revenue
Under \$500m	7.20	\$819,188	0.3674%
\$500m – \$1billion	7.39	\$908,637	0.1272%
\$1billion – \$5billion	13.12	\$1,966,616	0.0883%
\$5billion – \$15billion	36.69	\$4,959,768	0.0569%
\$15billion – \$25billion	40.64	\$6,499,301	0.0361%
Over \$25billion	106.29	\$19,490,205	0.0349%

The data set out above is extracted from pages 16 and 17 of the "Global Auditing Information Network (GAIN): HOIA International Network" report, May 2010, The Institute of Internal Auditors.



When considering the skills and experience of the internal audit function, the audit committee should not overlook the personal attributes of those within the internal audit function and the need to balance quality internal audit/ operational management relationships with the need to remain impartial and maintain professional scepticism. The audit committee will require internal audit to be objective and “to the point” – and this may involve implicit or explicit criticism of management. Consequently, internal audit will need the right mix of technical skills, industry/business knowledge and “soft skills” if they are to be fully effective.

Read in our next issue about oversight of the Internal Audit function.

Audit committee questions

- Does internal audit have appropriate authority and standing within the organisation to carry out its duties effectively?
- Does internal audit have clearly defined terms of reference that articulate the scope of its work? Is the charter regularly reviewed to ensure it remains appropriate?
- Are internal audit’s reporting lines unambiguous and is it clear that internal audit has direct access to the audit committee?
- Do internal audit’s terms of reference provide for regular meetings between the head of internal audit and the audit committee – including *in camera* meetings without management being present?
- Is an appropriate relationship maintained between the internal audit function and the external auditors (and other assurance providers)?

Appendix 1

Internal Audit Sourcing Options: The relative strengths and weaknesses of different sourcing models are set out below.

Sourcing model	Pros	Cons
In-house function	<ul style="list-style-type: none"> ✔ Continuity of staff ✔ Certain and controllable cost ✔ Full control of the function ✔ A resource pool for the business ✔ Training ground for employees ✔ Greater cultural alignment ✔ Insiders 	<ul style="list-style-type: none"> ✘ May not be fully employed effectively and efficiently ✘ Difficult to acquire necessary/maintain all skills and experience to meet the risk profile of the business ✘ Need to continually invest in training and development ✘ Recruitment hassles ✘ Ineffective/inefficient start up ✘ Retention and development strategies required ✘ Reduces opportunity to provide fresh perspective/risk of complacency or familiarity
Co-source	<ul style="list-style-type: none"> ✔ Long term permanent on-site presence through HIA (Head of Internal Audit) ✔ Access to broad range of skills through the partner ✔ Draw on specialist skills as and when, and only when, needed ✔ Continuity through HIA ✔ Pull in up to date skills and experience as needed ✔ Quick to implement ✔ Skills transfer to in house team ✔ Flexible approach, clearly defined service level and KPI measures ✔ Credibility to third parties ✔ No or reduced training cost 	<ul style="list-style-type: none"> ✘ Time taken to recruit HIA ✘ Possible cost impact ✘ Management resource needed in recruitment and relationship development ✘ Dependency on 3rd party ✘ Possible lack of staff continuity ✘ Other challenges for in house resource as above
Full outsource	<ul style="list-style-type: none"> ✔ Established methodologies & benefit of refreshment based on experiences across different organisations ✔ Up to date, skilled staff ✔ Ability to draw on a wide range of skills as and when required ✔ No time taken up by managing service and resources ✔ Clearly defined service level and performance measures ✔ Easily established and quickly effective ✔ Credibility to third parties ✔ Ability to manage costs by avoiding non-productive periods 	<ul style="list-style-type: none"> ✘ No permanent on-site resource to help other areas of the business ✘ Potential cost impact ✘ Possible lack of staff continuity ✘ Remote from business developments, the culture and politics ✘ Management time to establish and maintain relationships

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received, or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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