

Public Company Readiness Bulletin

Issue 6

Internal Auditing is an Asset for Listed and Unlisted Companies

What is Internal Auditing?

The term “internal audit” usually inspires two immediate responses. The first is fear: Is something wrong in our organization? Have I done something wrong? Are we out of compliance with current laws and regulations? What will “the fix” cost us? The second is the image of a large FORTUNE 500 company with the people and other resources that an internal audit function requires.

However, smaller organizations can perform internal auditing or have it performed in an efficient and cost-effective way that produces positive change and results, improves the business and its underlying processes, and may even make employees happier about the work they do and how they do it.

Internal auditors in larger companies work directly with management and its independent audit committee in the broad areas of governance, risk, controls and compliance, helping to review and validate that the organization is operating as intended, managing its biggest risks, and complying with applicable laws and regulations.

The Institute of Internal Auditors (IIA), the global professional coordinating body for the profession, formally defines internal auditing as follows:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve the 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.

There is no regulatory requirement on how a company must define internal auditing. However, The IIA definition is generally accepted, and the SEC, NYSE and other regulatory bodies may reasonably be expected to refer to The IIA's definition when considering whether an organization has an internal audit function.

Among the many qualities of internal auditors, independence remains the primary characteristic that internal auditors need to exhibit. *The International Standards for the Professional Practice of Internal Auditing* (The IIA Standards) Standard 1100 states: “The internal audit activity must be independent, and internal auditors must be objective in performing their work.” Standard 1110.A1 states: “The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.” Independence for an internal auditor refers to an environment free from peer persuasion or other undue internal influence. It surrounds the reporting structure of the internal audit function in a virtual pressure-free zone, ensuring open and clear access equally to the audit committee, the board of directors, or the company CEO.

Regulatory Requirements on Internal Audit

Whether public companies are required to maintain an internal audit function depends on the listing exchange the company joins. The NYSE, for example, requires all member companies to maintain an internal audit function while the NASDAQ's listing standards do not. The NASDAQ and AMEX do not have internal audit requirements at the present time. Private companies are not affected by this rule. However, many non-NYSE listed companies, large non-U.S. companies and large private companies have recognized the benefits an effective internal audit function can bring to their operations and compliance efforts, and have created such functions with positive and measurable results.¹

In Hong Kong, where there is no mandatory requirement for listed companies on maintaining an internal audit function, Appendix 14 - Code on Corporate Governance Practices issued by the Hong Kong Stock Exchange states that “issuers without an internal audit function should review the need for one on an annual basis and should disclose the outcome of such review in the issuers' Corporate Governance Report.”

¹ See Protiviti's *Internal Auditing Around the World* series for the successful stories of internal audit at leading companies (available at <http://www.protiviti.com/en-US/Insights/Browse-by-Content/Resource-Guides/Pages/IA-Around-the-World.aspx>).

Internal Audit as a Valuable Resource to Executive Management

Over the past few years, organizations set up internal audit functions for a number of reasons. The most common ones are responding to the requests of audit committees (rising stakeholder expectations) or complying with corporate governance requirements. Yet, it deserves executive management's attention that, in a rapid changing business environment, internal audit represents a valuable resource to executive management by helping it effectively manage business risks which might impede the achievement of organizational goals and objectives.

Internal audit often is the one department in an organization which has wide-ranging experience and knowledge about the operations, policies and procedures of different departments. It also possesses unique skills and competencies in identifying risks, control deficiencies and improvement opportunities in business processes. Internal audit is in the best position to promote changes to existing procedures and operations for better control environment and improved business performance.

Internal audit can assist executive management to better manage the company and meet its objectives by:

- Identifying and prioritizing key risks facing the company in the achievement of its business objectives as well as assisting management in the development of plan to manage the most significant risks, both of which form part of the company's enterprise risk assessment/management process.
- Obtaining management's input during the development of internal audit strategic plan to address key concerns of management to ensure limited audit resources are devoted to areas of greatest importance.
- Planning the department's activities to support management's compliance efforts such as Sarbanes-Oxley Act Section 404, Basic Standard for Enterprise Internal Control, and Appendix 14 of Hong Kong Main Board Listing Rules.
- Identifying issues and deficiencies in core IT support processes, optimizing automated controls in business processes and enhancing system security.
- Incorporating technology to process assessment by utilizing the data that resides in a company's information systems to analyze and identify cost reduction opportunities.
- Performing special investigation or consultation upon special requests by management, such as audits in relation to suspected fraud incidents, new system implementation or construction of new office building.

- Strengthening the internal control environment via "tone at the top" by providing trainings to management and staff in aim to instill a company-wide attitude of integrity and control consciousness, and to reinforce their roles in preventing and deterring malicious activities.

Role of Internal Audit

Internal audit should most definitely be involved with a company's compliance efforts. However, it is important to remember that compliance efforts are management's responsibility. The role of internal audit is to verify that management meets that responsibility through the risk assessment and audit process. Ultimately, management must own the responsibility around compliance in the applicable locations and areas.

The IIA Standards acknowledge that regulatory compliance risk is part of internal audit's role. Compliance with applicable laws and regulations is an integral part of the definition of internal control. Internal audit's involvement in a company's compliance efforts is directly supported by *Standard 2100 – Nature of Work*, which says the internal audit activity must evaluate and contribute to the improvement of governance, risk management and control processes.

Standard 2120.A1 further notes that internal audit must evaluate risk exposures relating to the organization's governance, operations and information systems regarding the reliability and integrity of financial and operational information; effectiveness and efficiency of operations; safeguarding of assets; and compliance with laws, regulations and contracts.

Indeed, internal audit professionals have a much broader mandate than simply ensuring compliance. The benefits of internal audit lie in, but are not limited to, the following areas:

- **Enterprise Risk Management (ERM)** – Internal audit's core role with regard to ERM is to provide objective assurance to the board on the effectiveness of risk management. Indeed, research has shown that board directors and internal auditors agree that the two most important ways that internal auditing provides value to the organization are in providing objective assurance that the major business risks are being managed appropriately and providing assurance that the risk management and internal control framework is operating effectively.²
- **Fraud Risk Management (FRM)** – Internal audit's role in FRM is to evaluate management's fraud risk assessment, in particular, their processes for identifying, assessing, and testing potential fraud and misconduct schemes and

² IIA Position Paper: *The Role of Internal Auditing in Enterprise-wide Risk Management*, The Institute of Internal Auditors, January 2009.

scenarios, including those that could involve suppliers, contractors, and other parties.

- **Business Continuity Management (BCM)** – BCM is a management-owned process, whereby management is responsible for all decision-making regarding the design of the BCM program, internal audit can be an active participant and advisor to the organization’s business continuity project sponsor and steering committee. In many cases, BCM-related skills, experiences and core competencies reside within internal audit departments given the availability of training, as well as the day-to-day mindset of managing risk – continuity or otherwise.
- **Corporate Governance** – The role internal audit plays in governance is highly influenced by the maturity level of the organization’s governance processes and structure, as well as the roles and qualifications of internal auditors. Typically, internal auditors operate in two capacities regarding corporate governance. First, auditors provide independent, objective assessments on the appropriateness of the company’s governance structure and the operating effectiveness of specific governance activities. Second, they act as catalysts for change, advising or advocating improvements to enhance the organization’s governance structure and practices.
- **IT Security and Privacy** – As the IT environment becomes more complex, it is also intensifying security and privacy concerns for organizations. IT is a high-risk area, which is why internal audit should be involved to provide an independent layer of additional assurance.
- **Safeguarding of Resources** – Another important role of the internal audit profession is to defend and safeguard organizational resources. By reviewing company practices for protection of assets, internal audit can evaluate and recommend improvements within the company for securing cash, receivables, inventories and capital equipment and property against financial loss from theft, fire, improper or nonexistent controls, and mismanagement. Intangible resources such as information technology, knowledge management, as well as proprietary data and intelligence are also valuable resources which must be protected with equal diligence. These and other continuously emerging issues including product support, advisory and consulting roles and organizational restructuring can benefit from creative input by skilled internal auditors.

Internal auditors possess qualities of professionalism, integrity and efficiency. They are motivated to make objective assessments regarding best practices, improved controls, processes and procedures, as well as evaluating performance and risk management. Sometimes they function as stakeholder advocates, efficiency experts and problem solvers. Other times they may act as coaches and guides. They are, in a phrase, the safety nets of the organization.

Establishing an Internal Audit Function

A suggested set of guidelines for starting an internal audit function includes:

- Clarify expectations with senior management, the board and audit committee, including required listing standards.
- Develop an audit charter, with audit committee input and approval.
- Consider the appropriate budget and staffing model (e.g., in-house, co-sourced or outsourced). As part of this process, research actions taken by similar companies in your industry.
- Formulate reporting responsibilities of the internal audit function.
- Identify the “universe” of auditable entities within the organization.
- Complete an initial risk assessment with company management and audit committee involvement.
- Develop an internal audit plan responsive to the risk assessment.
- Determine staffing requirements and whether the department will be staffed internally, co-sourced or outsourced.
- Plan and execute audit work called for in the audit plan, including a system to monitor and follow up on audit recommendations.
- Update the risk assessment for changing circumstances during the year.
- Continuously enhance and modify the internal audit function to meet changing needs of management and the audit committee.

Internal Audit Outsourcing/Co-sourcing

In general, internal audit functions among listed companies may take the form of a department within the company or exist through a cosourcing or an outsourcing arrangement.

Many companies – especially public companies, large and diverse private companies, and even governmental entities and not-for-profit organizations – may find that full or partial outsourcing of their internal audit functions makes sense, is cost-effective and provides significant short- and long-term benefits.

Benefits of outsourcing include:

- Quick start-up of the function and execution of work, including already-developed methodologies and audit tools provided by the outsourcing organization.
- A variable-cost arrangement rather than a fixed-cost function.
- Access to a greater number and wider range of resources.
- Potentially greater objectivity and independence.

However, companies should also consider the potential negative impact of outsourcing or co-sourcing internal audit, which can include, but is not limited to, the potential loss of

control since resources are not directly employed by the company. Mostly importantly, as emphasized by the IIA, oversight and responsibility for the internal audit activity cannot be outsourced.³

(For more information about internal auditing and the internal audit function, please see Protiviti's *Guide to Internal Audit: Frequently Asked Questions about Developing and Maintaining an Effective Internal Audit Function*, available at www.protiviti.com/en-US/Insights/Browse-by-Content/Resource-Guides/Pages/Guide-to-Internal-Audit.aspx.)

³ IIA Position Paper: *The Role of Internal Auditing in Resourcing the Internal Audit Activity*, The Institute of Internal Auditors, January 2009.

About Protiviti

Protiviti (www.protiviti.com) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE® 1000 and Global 500 companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

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Our Public Company Readiness practice helps companies assess whether they are prepared for an IPO. We help clients create and execute a plan to optimize the capabilities of each organization, including its internal processes, human resources and information systems, for both a successful initial offering and subsequent operation as a public company.

With years of experience providing IPO readiness assistance, Protiviti has developed an approach that effectively identifies key areas of focus. We provide specialized services to fit your needs, whether they include financial reporting assistance, process/control remediation or systems enhancements. Our objective is to help IPO candidates save time and money, as well as increase the likelihood their IPO will be successful.

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