

Building an Effective Internal Audit Function: Learning from SOX Section 404 Reports

13

Dana R. Hermanson, Dinos Eminent Scholar Chair of Private Enterprise, Professor, Department of Accounting, Kennesaw State University

Daniel M. Ivancevich, Dixon Hughes Faculty Fellow, Professor, Department of Accountancy and Business Law, Cameron School of Business, University of North Carolina Wilmington

Susan H. Ivancevich, Dixon Hughes Faculty Fellow, Associate Professor, Department of Accountancy and Business Law, Cameron School of Business, University of North Carolina Wilmington

We thank Tim IIs, Graduate Assistant from the University of North Carolina Wilmington, for his help in data collection for this project.

Abstract

In the wake of the major accounting scandals, internal auditing has emerged as a powerful force in promoting effective controls, risk management, and governance in U.S. companies. This article highlights recent internal audit-related problems that were revealed in SOX Section 404 reports and offers specific recommendations for building an effective, value-adding internal audit function.

Introduction

Since the major accounting scandals in 2001 and 2002, as well as the passage of the Sarbanes-Oxley Act of 2002 (SOX 2002), the internal auditing profession has experienced

unprecedented growth and prominence. Internal audit budgets, staffing, and boardroom exposure have increased (Carcello, Hermanson, and Raghunandan 2005), and the Institute of Internal Auditors (IIA) has seen an explosion of membership and interest. In fact, one prominent CFO stated, “[Internal] auditors are rock stars now. This is their day in the sun” (Liebs 2004).

Internal auditors are experts in governance, risk management, and internal control—areas that many companies have emphasized to achieve compliance with SOX. Many public companies have dealt with SOX Section 404 audits of the effectiveness of internal control over financial reporting, and a host of organizations are

exploring the implementation of enterprise risk management tools. On top of these challenges, the pressure to produce reliable financial reports has caused many audit committees to lean more heavily on their internal auditors for information and technical guidance related to risks and controls.

Given recent developments, we believe that almost any organization can benefit from an effective internal audit function. In this article, we (a) describe the role of internal audit in the organization, (b) highlight some recent internal audit problems revealed in SOX Section 404 reports, and (c) offer practical suggestions for building an effective, value-adding internal audit function. We hope that the insights provided will be useful to managers and audit committee members in a variety of organizations.

The Role of Internal Audit

The IIA (2007b) defines internal auditing as follows:

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

The key to internal audit adding value is that it provides objective evaluations of an organization's processes and operations. The main focus is on improving risk management, internal controls, and governance so that stakeholders' value is preserved. In other words, internal audit seeks to improve the organization's operations and to reduce the chance of negative surprises, including those created by unreliable financial reporting. Through its monitoring efforts in such areas as fraud prevention, improving business processes, and promoting reliable information (including financial reports) and sound controls, a properly designed and functioning internal audit group can add significant value to an organization. Effective internal audit functions also can contribute greatly to SOX Section 404 audits, performing some work on which the external auditor can rely. Such arrangements can reduce Section 404 compliance costs.¹

New York Stock Exchange companies are required to have an internal audit function. For other U.S. companies, internal audit is a voluntary mechanism. Internal auditing appears to be growing rapidly in popularity, whether implemented as an in-house function or outsourced to an accounting firm or other provider. Research suggests that there is significant protection in having an internal audit function. For example, Beasley, Carcello, Hermanson, and Lapedes (2000) found that the presence of an internal audit function was much less common in companies that had been accused of accounting fraud by the Securities and Exchange Commission. The differences between fraudulent and non-fraudulent firms

Internal auditors are experts in governance, risk management, and internal control—areas that many companies have emphasized to achieve compliance.

were particularly noticeable in two industries. In the technology industry, none of the fraud firms had an internal audit function, versus 82 percent of the no-fraud firms. In the healthcare industry, 13 percent of the fraudulent firms had an internal audit function, versus 74 percent of the non-fraudulent firms. Clearly, there is a strong association between the presence of an internal audit function and reduced accounting fraud risk.

Recent Internal Audit Problems

We believe that one way to learn how to “do internal audit right” is to study cases where there have been internal audit-related problems. To highlight deficiencies in the internal audit arena, we recently searched SOX Section 404 internal control reports for cases where there were material weaknesses in internal control related to the company’s internal audit function.²

Section 404 of SOX requires the external auditor to test the company’s internal control over financial reporting, and to highlight any material weaknesses that existed as of the end of the fiscal year. Compliance with Section 404 currently is required for public companies with over \$75 million in public float and will be required for smaller public companies in the future.

According to PCAOB Auditing Standard No. 2 (PCAOB 2004, para. 10), “A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material

misstatement of the annual or interim financial statements will not be prevented or detected.” The standard states that one strong indicator of a material weakness is (para. 140): “The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.”³

The Audit Analytics database revealed 16 public companies from late 2004 through mid-October 2006 with internal audit-related material weaknesses or remediation plans. In each case, either the Section 404 report highlighted an internal audit-related material weakness, or management’s plan to remedy a material weakness included some discussion of enhancing the internal audit function. While these 16 companies represent a very small percentage of public companies subject to SOX Section 404, we believe that these weaknesses illustrate important issues for managers and audit committee members to consider.

Exhibit 1 provides an overview of the 16 companies’ size, industry, auditor, and material weaknesses. The companies are reasonably large, with median market value, revenues, and assets in the \$500 million or higher range, and they are primarily manufacturing or financial firms. Most of the companies have Big 4 external auditors and typically have other internal control problems in addition to their internal audit issues (the median number of material weaknesses per company is 4.5, with a range of 1–10).

Exhibit 1
Sample Description – Companies with Internal
Audit-Related Problems (n = 16)

Panel A: Company Size (\$000s)

| | Median |
|-----------------------|---------------|
| Market Value (n = 14) | 798,959 |
| Revenues (n = 15) | 482,619 |
| Assets (n = 15) | 684,094 |

Panel B: SIC Codes

| | N |
|----------------------------------------------------|-----------|
| 1000–1999 Mining and Construction | 1 |
| 2000–3999 Manufacturing | 6 |
| 4000–4999 Transportation and Communication | 1 |
| 5000–5999 Wholesale and Retail | 2 |
| 6000–6999 Financial, Insurance, and Real Estate | 4 |
| 7000–7999 Services | 2 |
| Total | 16 |

Panel C: External Audit Firm

| | N |
|---------------------------|-----------|
| Big 4 | 9 |
| National Firms, Non Big 4 | 3 |
| Local Firms | 4 |
| Total | 16 |

Panel D: Total Number of Material Weaknesses

| | |
|-----------------------------------------------------|--------|
| Median number of material weaknesses per company | 4.5 |
| Range of material weaknesses per company | 1 – 10 |

Exhibit 2 presents wording quoted or adapted from the 16 companies' 10-Ks (which contain the management and external auditor reports on internal control) that describes the internal audit problems and management's efforts to

fix/remediate the problems. While many of the disclosures do not provide much detail (we provide the full text of the relevant portions in Exhibit 2), some interesting overall patterns emerge from reviewing this table.

In terms of material weaknesses, the most commonly cited issue is the lack of a comprehensive or effective internal audit program/function (seven companies). This problem generally refers to a pervasive failure to implement effective internal auditing, which means that internal auditors do not adequately monitor key risks and controls. This problem also can result from internal audit getting "sidetracked" by management requests. For example, the disclosure for Ligand Pharmaceuticals Inc. indicates that the internal audit department was redirected to help with the company's restatement of its financial statements, the Director of Internal Audit resigned, and the company did not complete much of its internal audit work.

Other problems with internal audit include (a) a lack of independence in the internal audit function (Composite Technology and Ligand Pharmaceuticals), (b) insufficient oversight of internal audit/internal audit focus (Cellstar and Ultra Petroleum), and (c) issues related to inadequate auditing of international operations (H. B. Fuller and Thermadyne Holdings). Other problems mentioned include having too few internal auditors, having inexperienced internal auditors, not having an internal audit function at all, or internal audit failing to address problems found in control testing.

Exhibit 2
Internal Audit-Related Control Weaknesses in SOX 404 Reports

| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|-----------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 99 Cents Only Stores 2004 | <ul style="list-style-type: none"> • Did not have a sufficient number of or appropriate depth of experience for accounting and finance, inventory management, real estate management, information technology, or internal audit personnel. • Did not have an adequate monitoring program, including full testing of its internal control systems and a comprehensive internal audit function. | <ul style="list-style-type: none"> • Adequately staffing its accounting and finance, inventory management, real estate management, information technology and internal audit departments. • Developing an adequate monitoring program, including full testing of its internal control systems and a comprehensive internal audit function. |
| Accupoll Holding Corp. 2005 | <ul style="list-style-type: none"> • The insufficient or lacking procedures and structures include, but are not limited to (1) a failure to authorize and empower standing committees of the Board, including an audit committee and a compensation committee, (2) a failure to approve governance structures including charters, delegations of authority, codes of ethics and appropriate conduct for officers and directors, controls regarding conflicts of interest, definition of roles and responsibilities, approval of budgets, and (3) a lack of an internal audit function. | <ul style="list-style-type: none"> • An internal audit function will be developed to perform periodic reviews to evaluate adherence to formalized procedures and controls over the financial reporting processes performed by the Company. |
| Aspen Technology, Inc. 2005 | <ul style="list-style-type: none"> • No specific mention of internal audit in material weaknesses. | <ul style="list-style-type: none"> • Hired additional accounts receivable, tax and internal audit personnel, including a Director of Internal Audit and a Director of Tax. |

(continued)

| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|-------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------|
| Bally Technologies, Inc. 2005 | <ul style="list-style-type: none"> • Ineffective controls at the entity level: As evidenced by the material weaknesses described above, and management's final assessment of our internal controls, we have determined that our entity-level controls related to the control environment, risk assessment, monitoring function and dissemination of information and communication activities did not operate effectively, resulting in a material weakness in each COSO component (COSO 1992). Such entity-level controls, and a comprehensive monitoring of internal controls by the internal audit function, are part of the framework to ensure that the designed system of internal control is operating effectively to ensure that significant transactions are adequately identified, recorded and disclosed. | <ul style="list-style-type: none"> • <i>No remediation efforts related to internal audit.</i> |
| Bristow Group, Inc. 2005 | <ul style="list-style-type: none"> • <i>No specific mention of internal audit in material weaknesses.</i> | <ul style="list-style-type: none"> • Internal audits are planned to ensure that the compliance program is followed. |
| Cellstar Corp. 2004 | <ul style="list-style-type: none"> • The Company did not maintain effective controls over the focus of the internal audit function. | <ul style="list-style-type: none"> • Increasing the level of monitoring through the internal audit function. |

Clearly, there is a strong association between the presence of an internal audit function and reduced accounting fraud risk.

| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|--------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| China Energy Savings Technology, Inc. 2005 | <ul style="list-style-type: none"> • Lack of Internal Audit System. The internal audit department was ineffective in preventing and detecting control lapses and errors in the accounting of certain key areas like revenue recognition, purchase approvals, inter-company transactions, cash receipt and cash disbursement authorizations, inventory safeguard and proper accumulation for cost of products, in accordance with the appropriate costing method used by the company. | <ul style="list-style-type: none"> • Evaluating the internal audit function in relation to the Company's financial resources and requirements. |
| Clifton Savings Bancorp, Inc. 2005 | <ul style="list-style-type: none"> • The Company's internal audit program was not sufficient to provide management a basis to assess the quality of the Company's internal control performance over time. Accordingly, management concluded that the monitoring component of the Company's internal control over financial reporting was not effective. Internal control monitoring involves assessing the design and operation of internal control on a timely basis, and taking necessary corrective actions. | <ul style="list-style-type: none"> • We will review the need for additional compliance/internal audit personnel. • We will request testing reports from our internal auditor on a regular basis. |
| Composite Technology Corp. 2005 | <ul style="list-style-type: none"> • The Company did not have an independent internal audit function due to the small size of the organization. | <ul style="list-style-type: none"> • Evaluating the internal audit function in relation to the Company's financial resources and requirements. |

(continued)

| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Flagstar Bancorp, Inc. 2004</p> | <ul style="list-style-type: none"> • Management believes that the deficiencies noted above may have been the result of weaknesses such as (1) certain personnel lacking sufficient expertise in areas of U.S. GAAP, (2) inadequately trained employees, such as personnel who perform certain accounting functions that rely heavily on supervisors to identify problems and errors, (3) lack of communication between certain departments, (4) internal audit's failure to address certain issues identified in the internal controls testing and (5) security around user access rights to certain application systems. | <ul style="list-style-type: none"> • <i>No remediation efforts related to internal audit.</i> |
| <p>H. B. Fuller Company 2004</p> | <ul style="list-style-type: none"> • In its assessment as of November 27, 2004, management identified as a material weakness, insufficient supervision and oversight of certain local accounting personnel in its Chilean accounting operations. Specifically, Company policy did not provide for regional financial management or internal audit review of the local books and records of the smaller locations within the Company's Latin America region, which includes the Chilean operations. As a result of this material weakness in internal control, H.B. Fuller Company's financial statements were misstated due to the intentional recording of incorrect accounting entries by local accounting personnel under the supervision of the | <ul style="list-style-type: none"> • The company is in the process of expanding internal audit resources in the Latin America region. |

| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|-------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>H. B. Fuller Company 2004 <i>(continued)</i></p> | <p>Chilean financial controller beginning in 1999, and continuing through the third quarter of 2004. These incorrect accounting entries resulted in the overstatement of other current assets and income taxes payable, the understatement of notes payable and trade payables, and a cumulative overstatement of net income during the aforementioned period amounting to \$3.1 million.</p> | |
| <p>Impac Mortgage Holdings, Inc. 2004</p> | <ul style="list-style-type: none"> • <i>[After a discussion of a material weakness]</i> We also noted significant deficiencies in that our internal audit function did not provide an adequate or effective monitoring of our controls, and we needed to evaluate whether we have appropriate internal resources to manage and monitor work performed by our outsourced tax compliance function. | <ul style="list-style-type: none"> • We hired outside consultants to assist our internal audit group in documenting our accounting and business processes and identifying areas that require control or process improvement. • We hired a Director of Internal Audit whose primary responsibilities are to perform risk assessment and monitoring of our system of internal controls and, in addition, to oversee the establishment of formal policies and procedures throughout our organization. |
| <p>Ligand Pharmaceuticals Inc. 2005</p> | <ul style="list-style-type: none"> • Internal Audit. The Company did not maintain an independent effective Internal Audit Department. This material weakness resulted from the fact that: 1) the Internal Audit Department was redirected during the second, third and fourth quarters of 2005 to assist with the restatement of the Company's consolidated financial statements, | <ul style="list-style-type: none"> • Internal Audit Plan. As discussed under the caption Remediation Relating to Accounting Personnel, the Company is in the process of recruiting a Director of Internal Audit and such position is targeted to be filled during the second quarter of 2006, or as soon as possible thereafter. Until the position is filled, the Company has engaged a nationally |

(continued)



| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|----------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Ligand Pharmaceuticals Inc. 2005 <i>(continued)</i></p> | <p>and 2) the Director of Internal Audit resigned December 2, 2005. As a result, the Company's Internal Audit Department executed only a small portion of the activities contemplated to be performed pursuant to the 2005 internal audit plan. In late December 2005, the Company engaged a nationally recognized consulting firm to perform the planned activities of the Internal Audit Department, most notably the Company's compliance efforts with respect to Section 404 of the Sarbanes Oxley Act of 2002. While this material weakness did not result in adjustments to the Company's 2005 consolidated financial statements, it is reasonably possible that, if not remediated, given the importance of a functioning effective Internal Audit Department in the maintenance of effective internal controls over financial reporting, this material weakness could result in a material misstatement of the Company's financial statement accounts that might result in a material misstatement to a future annual or interim period.</p> | <p>recognized external consulting firm to perform the functions of the Internal Audit Department. It is anticipated that the 2006 Internal Audit Plan will be approved by the Audit Committee in the second quarter of 2006, and until the Director of Internal Audit is hired, the Company will continue to utilize the consulting firm to implement and execute the 2006 internal audit plan.</p> <ul style="list-style-type: none"> • Monitoring Controls. As discussed under Internal Audit Plan above, the Company is in the process of recruiting a Director of Internal Audit. Additionally, and until the Company has hired the Director of Internal Audit, the Company has engaged a nationally recognized external consulting firm to implement and execute the 2006 internal audit plan starting in the second quarter of 2006. As part of the internal audit plan, these consultants will be responsible for assisting management with updating and maintaining the Company's documentation of internal control over financial reporting. The consultants will also be used until and after the hiring of the Director of Internal Audit to assist with the testing of such internal controls and in monitoring the progress of any ongoing and newly identified remediation efforts to help ensure the timely completion of the Company's 2006 monitoring program. |

While the scope of the internal audit function will vary greatly across organizations, we believe that just about every organization can benefit from effective internal auditing.

| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|---------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Riggs National Corporation 2004 | <ul style="list-style-type: none"> As of December 31, 2004, the Company's internal audit program was not sufficient to provide management a basis to assess the quality of the Company's internal control performance over time. Accordingly, management concluded that the monitoring component of the Company's internal control over financial reporting was not effective. Internal control monitoring involves assessing the design and operation of internal control on a timely basis, and taking necessary corrective actions. | <ul style="list-style-type: none"> The Company enhanced the internal audit program during 2004 and has now completed implementation of that program. However, as of December 31, 2004 the updated internal audit program was not in place for a sufficient time period to fully determine its effectiveness. The Company will continue to enhance its internal audit function in 2005 by expanding the scope of certain internal audits, enhancing the tracking of outsourced audit work, and modifying its existing internal audit plan as necessary. This will also include continued focus and review of regulatory risk through the use of internal audit, including outsourced internal audit resources. |
| Thermadyne Holdings Corp. 2004 | <ul style="list-style-type: none"> During the year-end financial statement close process, we identified unexpected variations in the balance sheet data provided from our Brazilian subsidiary. After a rigorous internal audit at this subsidiary, it was concluded that certain period costs were improperly capitalized and included in inventory and intangibles. In addition, certain contingent tax refunds were improperly recognized prior to being received. In response to the errors identified at our Brazilian subsidiary, we performed internal audit procedures at our South African subsidiaries and determined that key | <ul style="list-style-type: none"> In order to remediate our insufficient controls relating to the oversight and monitoring of our smaller international locations, we will augment internal audit work already performed with a more extensive internal audit program for 2005 that will include work performed at our smaller foreign locations, and additional audit resources. |

(continued)



| Company | Deficiencies related to internal audit | Remediation(s) related to internal audit |
|--------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Thermadyne Holdings Corp. 2004 <i>(continued)</i></p> | <p>account reconciliations were not being performed in accounts receivable, inventory, and accounts payable. The internal audits at these locations resulted in adjustments recorded during the fourth quarter of 2004 to accounts receivable, inventory, prepaid expenses, intangibles, goodwill, and cost of sales. We have concluded that a material weakness exists due to insufficient controls relating to the oversight and monitoring of our smaller international locations.</p> | |
| <p>Ultra Petroleum Corp. 2005</p> | <ul style="list-style-type: none"> The Company did not maintain effective company level controls. Specifically, (1) certain of its accounting personnel in key roles did not possess an appropriate level of technical expertise, and (2) the Company's monitoring of the internal audit function was not sufficient to provide management a basis to assess the quality of the Company's internal control performance over time. | <ul style="list-style-type: none"> Increasing training for the Company's current accounting personnel, hiring additional accounting personnel and engaging outside consultants with technical accounting expertise, as needed, and reorganizing the accounting department to ensure that accounting personnel have adequate experience, skills and knowledge relating to the accounting and internal audit functions assigned to them. |

Note: The wording above is quoted or adapted from the companies' auditor reports or management reports on internal control.

Management's discussion of any remediation efforts most commonly addresses staffing issues—hiring an Internal Audit Director, hiring additional internal audit staff, or engaging an outside consultant. Having the right people in place is absolutely critical to effective internal auditing, but internal audit talent is in high demand in today's market. Thus, it is challenging for some companies to attract and retain top internal audit talent.

Other remedial steps cited include:

- enhancing international auditing efforts,
- evaluating the overall internal audit function in light of company characteristics,
- developing/enhancing a comprehensive internal audit function, and
- addressing such issues as compliance auditing, additional testing/scope, greater communication through internal audit reports, better tracking of outsourced internal audit work, and increased training.

Suggestions for Managers and Audit Committee Members

How can organizations build their internal audit functions to provide maximum value? Based on the types of weaknesses identified in Exhibit 2, as well as our own experience researching internal audit issues for several years, we offer the following suggestions for management and audit committee members. We also encourage interested readers to consult a host of IIA resources available online at <http://www.theiia.org/theiia/about-the-profession/about-the-internal-audit-profession/> and the AICPA's (2004) *Evaluating the Internal Audit Team: Guidelines and Questions*.

- **Setting up an Internal Audit Function.** Some organizations do not yet have an internal audit function, due to small organization size or lack of management or board support. While the scope of the internal audit function will vary greatly across organizations, we believe that just about every organization can benefit from effective internal auditing. Those beginning the process of establishing an internal audit function are encouraged to visit the IIA website (see *Establishing an Internal Audit Shop*, IIA 2007a) for tips in this regard. This process may start with one internal auditor, perhaps even part time, but we believe that this function is critical to effective governance, risk management, and control in the organization.
- **A Clear Internal Audit Charter.** The internal audit charter should clearly establish the role and responsibilities of the internal audit function. If the charter is deficient, it increases the chance that internal audit will be sidetracked into non-core activities or simply fail to comprehensively monitor the organization's risks and controls. The charter should unambiguously describe the scope of internal audit's activities—both for the benefit of keeping internal audit on task, as well as informing others of the role of internal audit (see Tarr (2003) for specific guidance).
- **The Right People.** If internal audit is going to be a major player in the organization, getting the right people on board is critical, especially in the Director of Internal Audit role (referred to as the "Chief Audit Executive")

in IIA professional standards). Organizations need to consider the quantity of internal audit personnel needed, which may be less than some would imagine. Also critical are desired skill sets, which should match the types of risks faced by the organization. Some internal audit groups may require people with backgrounds in environmental issues, complex financial instruments, healthcare regulations, etc. Organizations need to recognize that internal audit talent can be expensive in today's market. Finally, the organization should carefully consider whether internal audit will be an in-house function or will be outsourced to major accounting firm or other provider. There are advantages and disadvantages to each structure (see Rittenberg 1997; Rittenberg, Moore, and Covaleski 1999).

- **Carefully Constructed Reporting Channels.** To whom does internal audit report? An internal audit group cannot easily provide objective oversight of management if the Chief Audit Executive reports only to management. After all, it is difficult to be the watchdog of one's boss. What many, including the IIA, have called for is primary internal audit reporting to the audit committee, with administrative reporting to management (CFO, Controller, or even CEO) since the audit committee is not on-site most of the time. If the internal audit function is to be sufficiently independent, then it is critical that it report to the audit committee and not be under the control of management. Currently, the pendulum clearly has swung toward audit committee (rather than management) oversight of internal

audit. Many of internal audit's activities now are related to performing assurance work for the audit committee, rather than "internal consulting" or special projects for management.

- **Covering International Risks.** As indicated by two of the companies in the sample, covering international risks can be a challenge for internal audit. Remote locations often involve language and culture issues, as well as significant travel and time costs. Despite these challenges, it is worthwhile to carefully consider international risks and to appreciate the implications of a reduced emphasis on international operations due to the hassle and cost of auditing them. Problems in an international location can become significant corporate issues.
- **Monitoring the Internal Audit Function.** Once the internal audit function is designed and operational, it is important to continue to monitor internal audit's activities. Both the audit committee and top management may participate in this monitoring, as each party benefits from internal audit's efforts. Questions to consider in this monitoring process include the following:
 - Are we comfortable with the quality of internal audit's work? Are we learning new things from internal audit's reports?
 - Does the scope of internal audit's work seem adequate? Does it appear to match our understanding of organizational risks?
 - How is internal audit viewed in the organization? Is internal audit a major

“player” in organizational decisions? Do people in the organization seek internal audit’s advice, or do they avoid internal audit at all costs?

- Does the internal audit staffing level appear adequate? Does the internal audit budget consider all essential areas? Does management try to constrain internal audit through budgetary means?
- Have internal audit’s findings and recommendations been communicated to us in a timely and understandable manner? Have the recommendations resulted in value-adding changes in the organization?
- Does the Chief Audit Executive communicate well with the audit committee? Does this person appear to have the respect of management and the external auditor?
- Has internal audit’s work improved our understanding of the organization’s internal controls and risks?
- Is internal audit responsive to audit committee requests for work in certain areas?
- Is internal audit responsive to audit committee suggestions for improvement?
- Do we perceive that the benefits of the internal audit function outweigh the costs of the function? Do we gather any metrics that are used in making such an assessment of internal audit costs and benefits?

Conclusion

Internal audit can be a powerful tool for improving operations, enhancing controls, managing risks, and promoting sound corporate governance. In the current environment of high accountability and continuing governance failures (e.g., stock option backdating), such elements are vital to organizational success.

Our review of recent internal audit problems cited in SOX Section 404 reports illustrates that not all companies have implemented effective internal audit functions. We believe that companies can learn from these problems, and we have offered several suggestions to managers and audit committee members for building an effective, value-adding internal audit function. We hope that these suggestions will help to drive future internal audit improvements.

References

1. American Institute of Certified Public Accountants (AICPA). (2004). *Evaluating the Internal Audit Team: Guidelines and Questions*, New York: AICPA. http://www.aicpa.org/Audcommctr/guidance_resources/ia_and_audit_cmte/15.htm.
2. Beasley, M. S., J. V. Carcello, D. R. Hermanson, and P. D. Lapedes. (2000). Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms. *Accounting Horizons*, (December), 441–454.
3. Carcello, J. V., D. R. Hermanson, and K. Raghunandan. (2005). Changes in Internal Auditing During the Time of the Major U.S. Accounting Scandals. *International Journal of Auditing*, (July), 117–127.
4. Committee of Sponsoring Organizations of the Treadway Commission (COSO). (1992). *Internal Control—Integrated Framework*, New York: COSO.
5. Institute of Internal Auditors (IIA). (2004). *Internal Auditing's Role in Sections 302 and 404 of the U.S. Sarbanes-Oxley Act of 2002*, Altamonte Springs, FL: IIA. <http://www.theiia.org/download.cfm?file=1655>.
6. Institute of Internal Auditors (IIA). (2007a). *Establishing an Internal Audit Shop*, Altamonte Springs, FL: IIA. <http://www.theiia.org/guidance/standards-and-practices/additional-resources/establishing-an-audit-shop/>.
7. Institute of Internal Auditors (IIA). (2007b). *International Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, FL: IIA.
8. Liebs, S. (2004). New Terrain, *CFO.com*, (February). <http://www.cfo.com/printable/article.cfm/3011491?f=options>.
9. Public Company Accounting Oversight Board (PCAOB). (2004). *Auditing Standard No. 2: An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements*, Washington, DC: PCAOB.
10. Rittenberg, L. E. (1997). *The Outsourcing Dilemma: What's Best for Internal Auditing*, Altamonte Springs, FL: Institute of Internal Auditors.
11. Rittenberg, L. E., W. Moore, and M. Covaleski. (1999). The Outsourcing Phenomenon. *The Internal Auditor*, (April), 42–46.
12. Sarbanes-Oxley Act (SOX). (2002). *Public Law No. 107-204*, Washington, DC: Government Printing Office.
13. Tarr, R. (2003). *Establishing an Internal Audit Activity Manual*, Altamonte Springs, FL: Institute of Internal Auditors.

Endnotes

- ¹ See IIA (2004) for details on the role of internal audit in Section 404 audits.
- ² We examined management's internal control report and the auditor's opinion on internal control over financial reporting, which often contain identical language to describe the material weaknesses. Typically, the auditor identifies the material weaknesses.
- ³ See COSO (1992) for discussion of the internal control framework and the importance of monitoring internal controls over time. Internal audit often takes the lead in monitoring the control system.