Special projects pose interesting challenges for internal auditors and assist in management decisions.

Special Projects by Internal Auditors

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Introduction

Most internal auditing departments perform both routine audits and non-routine special projects. While special projects include non-routine audits, they may also include analyses and informational studies, more akin to consulting than traditional auditing projects. Usually, the purpose of this second type of special project is to provide management information about contemplated or recent changes in the organization.

The main point of this article is that special projects can pose some difficult and interesting challenges for internal auditors, as well as offering an expanded arena in which internal auditors can assist management, bringing to bear valuable discipline, perspective and independence. By identifying characteristics common to special projects, the auditor can apply some general principles to help increase the chance of successful performance.

First, the article presents a broad structure of management concerns where internal auditors might play a role. Then, a few example projects are considered, differentiating basic requirements for each one. A classification scheme is proposed to differentiate special projects from routine audits, formula audits, and transitional audits. Using this classification, the article addresses several specific challenges related to the performance of special projects and finally summarizes some general principles for conducting special projects.

Overall Structure

As with other aspects of internal auditing, in order to understand the scope and nature of special projects, it helps to begin with a study of management. Two typologies from the strategic planning literature provide the context for our examination of special projects performed by internal auditors. The first typology addresses the content of business strategy at three hierarchical levels. The second addresses business strategy in terms of two processes: strategy formulation and strategy implementation.

Three Levels of Strategy

Strategic management scholars have employed a typology comprising three levels of strategy (see Table I):

(1) corporate strategy;

(2) business strategy; and

(3) functional strategy.

Corporate level strategy centres on the management of a portfolio of businesses and addresses the strategic question of, "What set of businesses should we be in?" Thus, corporate strategy involves decisions regarding mergers between firms, the acquisition of additional enterprises into the organization's portfolio of businesses, vertical integration, concentration or diversification of the portfolio, the allocation of resources, and achievement of important synergies between business units. An example of corporate level strategy would be the decision of R.J. Reynolds, traditionally a tobacco company, to acquire Nabisco and Kraft Foods, in an effort to diversify its portfolio in light of declining social acceptance of smoking in the United States.

Business level strategy focuses on the management of individual enterprise units within the portfolio. The focal question for business level strategy is how the firm will compete within its particular industry or product market segment[1]. Successful performance in the market place is dependent on achieving a competitive advantage. One of the better known typologies of business level strategy is that of Porter[2], who proposed three approaches to achieving competitive advantage and superior performance:

(1) cost leadership – having the ability to produce a competitive product at a lower cost than one's competitors;

(2) differentiation – creating a unique or superior product which can be sold at a premium price; and

(3) focus – targeting a specific niche in the market, and serving that niche better than one's competitors.

Table I. *Three Hierarchical Levels of Management Decisions*

Level	Domain of management decisions
Corporate level	*What set of businesses should we be in?* Building a portfolio of business units Mergers, acquisitions, divestitures Concentration versus diversification Achieving synergies between business units Allocation of resources between business units
Business level	*How do we compete* vis-à-vis *our competitors in this business?* Building distinctive competences Achieving competitive advantage via: ● cost leadership ● product differentiation via outstanding quality, service, innovation or unique product features ● focusing on market segment with special needs
Functional level	*What role must each functional speciality play in achieving the business level strategy?* Production/operations strategies Financial strategies Marketing strategies Human resource strategies Information strategies Other specialized strategies

Finally, functional level strategy aims within the business unit, revolving around the various functional specialities within the organization (i.e. operations, finance, marketing, human resources, information systems, etc.). The focus here centres on the strategies employed within each functional speciality to achieve the firm's desired competitive advantage at the business level.

Strategy Process: Two Phases

The strategic management process comprises two primary phases: formulation and implementation. Table II summarizes these two phases. Strategy formulation involves such things as:

- setting the firm's mission and basic objectives;
- assessing strengths and weaknesses;
- assessing environmental opportunities and threats;
- identifying and evaluating alternative strategies;
- strategy choice;
- establishing detailed goals and policies; and
- assignment of accountability for performance towards objectives and goals.

Strategy implementation involves the execution of the chosen strategies. Important factors to successful strategy implementation are:

- leadership and empowerment of employees;
- organizational performance on key criteria;
- evaluation and control of operations; and
- rewards, adjustments, and adaptations.

The three levels and the two phases of strategy development provide a valuable context for the consideration of different potential internal audit projects.

Kinds of Potential Audit Projects

Table III combines the two typologies in one table, highlighting different types of audit projects. The table lists the three strategy levels and the columns comprise the two phases of strategy development, consisting of eight examples of potential projects that might be performed by internal auditors. These eight, of course, are only a tiny sample of the many possible projects that might have been selected for illustration purposes. Each project will be considered in turn.

Likely Impact of a Proposed Acquisition

One possible aspect of corporate level strategy is the acquisition of new enterprises. Once the decision is made by the board of directors to make an acquisition, typically, a number of candidates are considered and prioritized, and the preferred candidate, i.e. the target company, is contacted to explore possibilities.

Assuming the target company is willing to entertain the prospective acquisition further, a variety of studies are undertaken to examine the likely impact the acquisition

Table II. *Strategy Process Typology*

Strategy phase	Domain of management decisions
Strategy formulation	Assessment of current mission and strategy Assessment of opportunities and threats Assessment of company strengths and weaknesses Strategy evaluation and choice Establishing goals, objectives and policies Assignment of accountability for goals and objectives
Strategy implementation	Execution of chosen strategy Achievement of organization objectives Involves issues of: ● leadership and empowerment ● performance ● evaluation and control ● rewards, adjustments and adaptations

will have on post-acquisition operations and performance. These studies examine the possible effects on such things as the financial, production, environmental, marketing, legal, and labour aspects of performance, as well as on the overall management structure and the impact on shareholders.

Much of this analysis requires the co-ordination of a variety of expertise to construct a timely and well focused study. While internal auditing departments rarely, if ever, have the resources to perform all of this analysis, they frequently provide a less expensive source of some operational and financial analysis. Consequently, these internal auditing studies are co-ordinated within the context of other studies, usually performed by external and other internal members of the overall acquisition project team.

Identification of Causes of Unsatisfactory Acquisitions

When acquisitions do not turn out as well as management had anticipated, naturally a question arises as to why. At this implementation phase, management needs to know the reasons for unsatisfactory performance and often answers are not readily apparent from performance reports.

Again, in this context, the internal auditors often provide an inexpensive source of analytical expertise. The questions, however, will probably require some areas of expertise and a timeliness difficult for the internal auditing staff to provide by themselves. Therefore, as in the previous project, the internal auditors are likely to be working within the context of a larger team comprising members from several organizational units and perhaps even external consultants.

Comparison of Expected Product Cost Structure to Benchmarks

A typical problem for managers at the business level is to offer a product of specified quality at a competitive price. Product cost is a critical element of the pricing decision. An analysis of an anticipated cost structure, including comparisons to benchmarked competitors, can often provide important insights into both marketing and production opportunities.

Since a complete cost analysis crosses several organizational boundaries, internal auditors are often ideally situated to perform such studies. While not strictly conforming to a traditional audit project format, the structure of the analysis is similar in that the benchmarks provide specific criteria for comparison to actual cost performance. These studies can take

Table III. *The Internal Audit Domain (Integrative Model)*

	Strategy formulation	Strategy implementation
Corporate level issues	Likely impact of a proposed acquisition	Identification of causes of unsatisfactory acquisition
Business level issues	Comparison of expected product cost structure to benchmarks	Analysis of new production process on product costs
Functional level issues	Evaluate the design of controls of a proposed collection system	Evaluation performance of a collection system
	Evaluate the efficiency of a planned decision support system	Evaluation of an existing decision information system

particular advantage of the auditors' combined operational and financial perspective.

Production managers and cost accountants (i.e. non-auditors) are likely to be either a part of the team conducting this kind of study, or performing other aspects of the study. Consequently, the internal auditing portion of this study is likely to fit into the context of a larger project.

Analysis of a New Production Process on Product Costs

Another product costing problem relates to the actual impact a new production process has on product cost. While production reports should reflect actual production costs, the reports probably would not reflect comparisons with previous production costs or may not provide a post-implementation overall product cost structure analysis. Timely analysis of such product costs is important to management's ability to respond to unexpected variations in these cost profiles. Results could have major implications for needed adjustments to operations.

While internal auditing is not the only function capable of performing such studies, internal auditors frequently have more flexible schedules and greater independence with respect to the issues in question. Plus, the operational perspective of internal auditing combined with financial expertise is valuable in the overall analysis.

Evaluate the Design of Controls of a Proposed Collection System

Collections of accounts receivable are a routine part of business operations in most organizations, involving many individual transactions. While formal systems are in place to control collections, sometimes systems are replaced with new ones. These proposed new systems will have control implications over many transactions on a daily basis.

Typically, internal auditors are asked to evaluate plans for these modifications before implementation, especially with respect to potential control problems.

Evaluate the Efficiency of a Planned Decision Support System

The management function of any organization is decision-focused. Making decisions is what managers do. Therefore, much of what information systems do can be described as decision support.

One management decision requiring informational support is the decision to replace a production machine. At the formulation phase, internal auditors may be asked to evaluate the efficiency of a planned information system to help managers analyse this decision. Major changes to this system probably do not occur frequently, and compared to collections transactions, machine replacement occurs infrequently.

Evaluate the Performance of a Collection System

Internal auditors are required to evaluate operating systems such as accounts receivable collections. These systems are an integral part of ongoing operations. Usually, the effectiveness of the collections system is crucial to the financial performance of an organization. Without collection, the conversion of a sale into money never occurs. Therefore, consistent control over collections is vital. Audits of these systems can usually be described as routine and relatively frequent.

Evaluate an Existing Decision Information System

This project would be similar to the one to evaluate the efficiency of a planned decision information system, except that the evaluation would be of a system already in place. Such an evaluation would probably be carried out on an irregular basis to assist management in assessing possible changes in the system.

Routine versus Special Audits/Projects

Two important factors distinguish special projects from routine audits – frequency and routinization. Frequency refers to how often the audit team conducts a given project or audit. Routinization refers to the degree to which a given project is structured, suggesting a standardized audit process and criteria. Table IV presents a simple classification of audit projects using these two dimensions. The classification scheme presents two pure types, routine audits and special projects; and two hybrid types which we label "transitional" and "formula" audits.

Table IV. *Classification of Audit Projects by Frequency and Routinization*

	Frequent examination	Infrequent examination
Routine concerns (structured questions and criteria)	Routine audits	Formula audits
Non-routine concerns (unstructured questions and/or criteria)	Transitional audits	Special projects

Routine audits are those done frequently on routine operations. Typically, only minor modifications are made in these audit programmes from one examination to the next.

Special projects, on the other hand, are those done infrequently on non-routine operations. Whole new programmes may be developed from scratch; the operations being examined may be entirely new territory for the internal auditors and may, in fact, be new to the entire organization; and the internal auditors may have to learn or develop new and unfamiliar techniques to fulfill these assignments.

Two hybrid classifications are possible. *Formula audits* include projects which are fairly standardized or structured, but are performed infrequently. In such cases, the audit team may simply need to brush up on the routine each time the audit is performed. *Transitional audits* consist of non-routine projects which are done frequently. We label these as transitional because they may have begun initially as a one time special project assigned to the audit team; however, over time the audit team is called upon more frequently to perform this service. While the audit method has yet to become routinized, increased frequency will most likely yield a standard approach and criteria, thus moving these audits into the routine audit classification.

While there is certainly some commonality among audit departments, classification of an audit project, utilizing these dimensions, will very likely be firm specific. For instance, in the case of a single business firm, assessment of the potential impact of a proposed acquisition would clearly constitute a special project. However, for a large conglomerate firm, constantly involved in merger/acquisition activities, such an audit could be routine.

Table IV has some interesting implications for staffing of the audit department. Clearly, in the case of routine audits, it appears most cost efficient to utilize the full-time audit department staff to conduct these. While some brush up may be required, formula audits can probably be conducted by the internal audit staff as well. For special projects, on the other hand, the existing audit staff may be inadequate, and additional resources may need to be acquired either from other functions within the organization or via external consultants. In the transitional audits, the audit director may now find it cost effective to begin gradually building internal expertise, due to the frequency of the audits being performed.

Classification of Example Audits

The above proposed classification scheme, based on the frequency and routineness of internal audit projects, may be applied to the eight example projects as follows. The specific classifications of the eight projects were supported by an informal survey of approximately 100 auditors attending the Internal Audit Conference, sponsored by the Institute for International Research, 13-14 August 1992 in Wellington, New Zealand.

Routine Audits
The examinations of both the performance of an existing collection system and of an existing decision information system would most likley be routine and relatively frequent.

Formula Audits
The evaluations of the design of controls of a proposed collection system and of the expected efficiency of a planned decision support system would probably be done infrequently, but would utilize fairly routine audit methods.

Transitional Audits
The analysis of the effect of a new production process on product costs would probably be a transitional audit. The reason for this classification is that although the newness of the production system would probably require some non-routine procedures initially, the audit would be done frequently in the future, thereby becoming a routine audit.

Special Projects
Examinations of the likely impact of a proposed acquisition and the identification of causes of an unsatisfactory acquisition would probably be both non-routine and infrequent for most organizations.

The classification of comparisons of an expected product cost structure with benchmarks is less straightforward. Circumstances common to many organizations could result in three of the classifications – formula audit, transitional audit, or special project – depending on the specific situation. It is unlikely, however, that this project would qualify as a routine audit.

As mentioned, the specific classification of any of the eight projects would depend on individual circumstances. The classifications were made based on circumstances common to most organizations and internal auditing departments.

Observations, Unique Challenges and General Principles

We have thus far addressed the domain of audit projects from multiple perspectives. Based on our assessment of these, especially the proposed classification scheme, we make the following observations:

- *Observation 1* – Special projects are more likely to arise from questions over higher level strategy.

- *Observation 2* – Special projects may lead internal auditors into unfamiliar organizational territory.
- *Observation 3* – Special projects are more likely to occur in the context of larger projects in which the internal auditors work as a part of a larger cross-functional team.

These three observations suggest several unique challenges for special projects from which some general principles may be drawn. The unique challenges can be expressed in the form of questions. We shall address five such questions:

How Can the Audit Director Ensure that the Project Team Possesses the Competence Required to Complete the Project Successfully?

Most internal auditing departments do not employ former corporate or business managers for whom the higher level of concerns is familiar. Indeed, many internal auditors, including directors of internal auditing, hope to be promoted into one of those positions. In addition, the non-routine nature of the questions may be quite unfamiliar to auditors who have probably been trained better in ongoing operating systems and the related controls.

General Principles

Where internal auditing staffs are not competent to perform a special project, five basic alternative strategies are available to acquire the competence:

(1) Given enough time before the project begins, the auditors may be trained.

(2) Staff assistants with the required expertise can be recruited from other departments to help perform the project, with a team leader from the internal auditing department.

(3) A team leader can be recruited from another function to lead the project team of internal auditors.

(4) Staff assistants with the required expertise can be recruited external to the firm to help perform the project, with a team leader from the internal auditing department.

(5) A team leader can be recruited external to the firm to lead a project team of internal auditors.

(6) Segments of the audit may be contracted out to external consultants.

The choice of strategy depends on available expertise within the internal auditing department and the project requirements, especially time requirements. Given enough time, most internal auditing departments would probably prefer to train their own staffs to do the special projects.

How Can the Internal Audit Team Gain a Commitment from Senior Management for a Particular Special Project?

Senior management's enthusiasm for a particular special project by an internal audit team will probably be in proportion to senior management's confidence in: the internal audit team's technical expertise with respect to the project; the team's ability to co-ordinate its work with the overall project; and the auditors' understanding of how the special project fits in the broad organizational context.

Many special projects are assigned to internal audit departments by senior management for reasons mentioned earlier – particular expertise, perspective, independence, available time, and cost. Where such assignments originate with senior management, one can usually assume adequate commitment to the projects.

In contrast, when internal auditing departments are trying to gain management commitment for a particular special project, a strategy must be developed.

General Principles

The strategy to gain management commitment for a particular special project includes three phases:

(1) Determine the technical requirements and co-ordination requirements for the project, and determine management's organizational priorities. Also determine whether an internal audit team best fits the project (if not, stop here).

(2) Ensure that the special project team has the necessary technical skills, can adequately co-ordinate with others involved, and understands management's organizational priorities.

(3) Communicate any proposal for a special project in the context of senior management's priorities, demonstrating the project team's technical skills and ability to co-ordinate with other related projects and activities.

One can argue that a fourth phase is successfully performing according to senior management's judgement. Any future commitment from senior management for internal auditing involvement in special projects is dependent on performance on the present project.

How Does the Special Project Team Leader Determine Project Objectives, Expectations and Deadlines?

The fact that special projects are likely to be prompted by upper management, involve several cross-functional teams, and introduce the internal auditors into unfamiliar territory causes some special problems for the team leader. Unlike other audits, where objectives, expectations and deadlines are likely to be largely controlled within the internal auditing department, special projects take place in a larger arena.

General Principles
By performing special projects within the context of larger projects, under senior management's direction, internal audit team leaders must co-ordinate closely with other team leaders and senior management at every phase of the special project, beginning with planning.

Also, special project team leaders must determine specific objectives, expectations and deadlines that precisely meet the needs of the overall project. Failure in this regard, and any attempt to "tailor" a special project more to the needs of the internal auditing department than to the overall project, jeopardizes the success of both the special project and the overall project.

What Is the Best Way to Plan Project Time?
This question raises two important issues. First, given that internal auditors may be working in unfamiliar territory, and perhaps using unfamiliar tools and procedures, estimating project time may be more difficult than normal. Second, the overall project is likely to impose strict deadlines on individual special projects. Failure to meet any one of these deadlines could cause a disastrous domino effect on other related activities.

General Principles
Two important guidelines arise from these considerations:

(1) Build plenty of flexibility and learning time into any work schedule. It is far better to overestimate the required time and finish early than to underestimate and finish late.

(2) When scheduling a special project, start with the deadline and plan the lead time required to meet that deadline. The more typical scheduling procedure for most audits is to identify a starting time and work forwards to estimate a finish date. This more typical strategy disregards the required co-ordination with other activities and the overall project deadline.

How Should the Findings from Special Projects be Reported?
Since special projects may include special audit projects and other consulting-type special projects, there would seem to be necessary differences in different kinds of special project reports. The overall observations, however, imply some common requirements for all of these reports.

General Principles
Senior management involvement makes it imperative that special project reports focus on senior management priorities for the overall project. All findings must relate directly to overall project objectives. Presentation of the results should identify the overall objectives relevant to the special project and the specific objectives of the special project. The report should interpret any results in terms of both sets of objectives and how the results might affect other aspects of the overall co-ordinated project.

Summary and Conclusion
This article presents a rationale for identifying special internal audit projects and three observations concerning such projects. The observations suggest five important challenges that internal auditors need to overcome on special projects:

(1) How to ensure that the special project team has the necessary competence to do the project.

(2) How to gain senior management's commitment to a special project proposed by internal auditors.

(3) How to determine objectives, expectations, and deadlines for special projects.

(4) How to schedule special project procedures and activities.

(5) How to report findings from special projects.

The article then presents general principles governing the possible solution to each challenge. Each general principle is matched to a specific challenge to ensure that all the challenges can be met.

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