



THE  
CHANGING  
FACE OF

INTERNAL  
AUDIT

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Views from FTSE 100 audit committee chairmen

SpencerStuart

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During the first half of 2008 Spencer Stuart interviewed audit committee chairmen from leading FTSE companies across a variety of sectors with experience of sitting on the audit committees of over 20 FTSE boards. Each of these committee chairmen had also acted as executive directors of FTSE companies with responsibility for overseeing the activities of their own finance function. Their collective experience of the internal audit function is extensive and spans several decades.

The consensus among the group was that the quality of audit and risk services within UK public companies has been enhanced over recent years. The scope of the internal audit function has evolved and the general trend is one of improvement.

The greatest change has occurred in the area of risk. Internal audit has had to respond to developments in risk management which has become an increasingly urgent matter for companies, boards and shareholders alike. This has clearly been a positive development, both for the standing of the internal audit function and for the long-term financial health of companies.

The rigour of internal audit processes has improved, as has the extent to which they are embedded in management decision making. One audit committee chairman commented that the internal audit had been “completely transformed”. He agreed that the shift in focus towards risk services was significant: “You hardly heard of risk registers 10 years ago, or if you had them they were buried in internal audit. Now they’re a main board agenda item several times a year.”

“All audit committees are taking internal audit a lot more seriously and are demanding a good service from it.”

To do its job properly, today’s audit committee needs a strong internal audit function. It can, however, be difficult for an audit committee to judge the effectiveness of the internal audit function: “You have your instincts — and of course you have reports — but if you don’t find many problems being raised it could either be that things are in really good shape, or it could be that the quality of the internal audit is poor and they’re not finding the problems.”

Some audit committee chairmen believe that there is still considerable room for improvement in the quality of people within the function, the quality of the work they produce and the methodology that they adopt. Effective leadership of the function is therefore vital. In the words of one chairman: “If you are going to improve the quality of internal audit it starts with the top. Once you have a good leader in place he or she will put the right people in key positions and quality will start to improve.”

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## Ideal qualities and background

With internal audit playing a crucial role in the governance of a company, the person who leads the function needs to have a broader range of skills, qualities and experience than ever before.

Among the qualities audit committee chairmen look for in a head of internal audit are independence of mind, courage, integrity, emotional intelligence, influencing and communication skills, the capacity to build relationships within the business, and above all leadership ability.

Audit committee chairmen agree that the head of internal audit should ideally bring rounded business experience to the job, rather than come straight from the profession or have a pure auditing background (although audit experience is certainly useful). However, it is uncommon for internal auditors to have such broad experience. One audit committee chairman thought it was sometimes helpful to recruit people from other industry sectors for the fresh perspective they bring to the role.

... it is increasingly likely that audit leaders will have developed a range of skills in other parts of the business.

Some people still build an entire career within the internal audit function. However, it is increasingly likely that audit leaders will have developed a range of skills in other parts of the business. For example, a finance manager with divisional experience will be more comfortable spanning the gamut of business activities when working in internal audit.

A strong finance background is important, although some chairmen agreed that the head of internal audit need not be financially qualified, providing he or she had a team with the requisite financial expertise.

In the view of one chairman, internal audit is no different from any other operational area, in that a large dose of common sense is necessary to perform the role effectively: “As a leader of internal audit you must be robust but without ever being heavy-handed or destructive. There’s danger in assuming that the business is rapaciously ignoring any responsibility. The reality is that operational managers have a lot of pressures on them and are, on the whole, trying to do the right thing. You’ve got to be willing to work with them which means being robust but not blinkered.”

For this reason, an audit committee chairman is likely to want to work with someone who understands the business. Presence and stature are also cited as useful qualities, particularly important in order to gain the attention of peers in the organisation.

Internal auditors create their own agendas and need to be self-starters with plenty of initiative and an inquisitive mind. They need to be confident operating in any area of the business, effective with people and tenacious.

Even the most technically capable internal auditors will be ineffective if they allow themselves to be intimidated ...

In addition to being credible and articulate both internally and with the audit committee, the head of internal audit must demonstrate total independence. With the right person in place, this can occasionally result in a challenging relationship with the CFO.

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Even the most technically capable internal auditors will be ineffective if they allow themselves to be intimidated by management, something that can easily happen. “If you’re competent and able to win respect you’re in a virtuous circle,” said one audit committee chairman. “95 per cent of people in the company will appreciate a good internal auditor, but you’re always going to have a vocal minority who are defensive; you’ve got to have the ability to demonstrate confidence, otherwise you show that you’re vulnerable. It is far better to be open and quick to report problems than sit on them and try to negotiate with management.”

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Raising problems early is important, whether they concern relationships or financial matters. This is made easier if the head of internal audit has a good relationship with the CEO and with the audit committee chairman. Setting up a framework for regular contact is an essential aspect of those relationships. “I want sufficient face-to-face meetings with a clear agenda, comprehensive reports and good executive summaries,” said one audit committee chairman. “But between meetings I want dialogue, to be on his radar screen so that he feels he can mention something at a very early stage even if the issue might just fizzle away.”

In large or complex businesses, internal audit will need to call upon external audit services, particularly in areas such as tax, treasury or IT where specialist skills are unlikely to reside in-house. IT is an area of increasing risk for every business and indeed most financial services institutions employ a separate head of IT audit. The challenge for the head of internal audit is being able to judge what skills and services they need to buy in, evaluate potential external resources, and then manage them effectively and to a budget.

Possessing a wide range of 'soft skills' may not be the first thing that comes to mind when considering the ideal profile for a head of internal audit, but many audit committee chairmen commented on their importance. This underlines the need for effective leadership, with certain characteristics growing in significance, such as setting high standards, motivating the team and people development.

“Once a year I would expect to discuss with the head of internal audit the strengths of the department, succession planning and how talent is being developed,” commented one audit committee chairman. “Do people think that once they’ve gone into internal audit they will never come out?”

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## Attracting the best people

As internal audit plays a more central role, so it must find ways to attract the best people and introduce fresh talent to the team. Historically, audit and risk management have not been the preferred destination for aspirant finance professionals.

Several audit committee chairman commented that attracting the best people into the function presents a real challenge and requires careful planning. Both the audit committee chairman and the CEO need to be active participants in the recruitment of a head of internal audit — not just evaluating candidates but thoughtfully selling the role to them.

“I don’t think the reputation of internal audit has grown in step with the quality of some of the services it delivers.”

Prospective candidates need to feel that the role occupies a central position in the company, offers a unique vantage point from which to see much of what is happening in the business and is held in considerable respect — then they are more likely to be persuaded to join. That said, it is a tougher job to sell than, say, investor relations, said one chairman: “It is less glamorous and more rigour-laden. I don’t think the reputation of internal audit has grown in step with the quality of some of the services it delivers.”

To attract talent businesses must be able to demonstrate that working in internal audit is not a lifetime job, but instead a valuable stepping stone on the path to a successful career. Without the prospect of further career development it will be extremely difficult to attract the right person. For one audit committee chairman, the key is making it clear that a spell in internal audit is part of a career progression: “I would always say to people, ‘if you want to be a subsidiary FD or CFO then you have to be prepared to go into internal audit or investor relations. It’s going to be tough because there won’t be enough FD vacancies for everyone, so naturally you’re going to have to work at it.’ It helps if everyone understands that working in this function is part of the refining process.”

The head of internal audit is the most important person when it comes to attracting talent into the function; the credibility and reputation that he or she builds within the organisation will have a significant impact on how the function is regarded, particularly by potential high-fliers thinking of joining the team.

“... the head of internal audit should be a nurturer of talent, a mentor charged with bringing bright young people into the organisation ...”

Although salaries for internal auditors are rising and the profile of the function is growing, remuneration alone will not attract people to internal audit. Companies need to be able to demonstrate a track record of people moving on and up after their time in the department. Cadbury Schweppes, for example, boasts a list of alumni who have worked in internal audit and subsequently moved on to highly influential roles in the organisation.

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For one audit committee chairman, the head of internal audit should be serious about acquiring and developing talent: “I would argue that the head of internal audit should be a nurturer of talent, a mentor charged with bringing bright young people into the organisation who can develop through the experience that internal audit affords them.”

Another audit committee chairman agreed, suggesting that if internal audit is going to be successful it has to view itself as a net exporter of people: “I see the head of internal audit’s job as constantly bringing people into the function and then turning them out into the business. That means that you have to get yourself into the mindset that says ‘I must let my good people go’ — after all, one of the great ways to improve the financial management of the business is to push good people into the operations.”

Given the emphasis placed on independence, some believe that the head of internal audit role should be encouraged to move on after approximately five years in the post. Much longer and the head of internal audit may become too closely aligned with management, losing the objectivity that is so essential for the post.

## Reporting lines

The consensus among the audit committee chairmen we spoke to was that the head of internal audit should have two reporting lines, one to either the CEO or CFO and one to the audit committee chairman. A lot of the internal auditor's work covers the domain of the CFO, so a case could be made for a direct reporting line into the CEO. The problem with this is that CEOs are generally overworked and may be tempted to relegate internal audit down their list of priorities: "The CEO needs to show proper interest, be prepared to meet regularly with internal audit and send the message out to the rest of the organisation that he or she considers the function to be important."

Reporting to the CFO can, of course, work perfectly well, not least because a CFO will find internal audit an important source of business information. The CFO will also be more likely to take an active interest in the career development of those working in the function.

One audit committee chairman commented that the issue was less about whether this reporting line into him was fixed or dotted and more about having the right relationship, creating the right environment for dialogue: "The channel has to be absolutely unimpeded, even though as audit committee chairman you're not that influential over the head of internal audit's future. You are not his sponsor and you may not even know the HR person who takes care of internal audit. Ideally you have a good triangular relationship with the CFO and head of internal audit."

Another audit committee chairman was adamant that the head of internal audit should not report to him for two reasons: "First, it would create some conflict for a non-executive director to assume what is

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effectively an executive responsibility. Second, it would take the head of internal audit out of the management team, which is wrong. He or she should be an executive within the business, with checks and balances to ensure that they retain independence and objectivity.”

“[as audit chair] Ideally you have a good triangular relationship with the CFO and head of internal audit.”

However good these key relationships are, there is always the potential for tension between the head of internal audit and the CFO. On the whole, any tensions that exist are more likely to arise from inconvenience than from a fundamental difference in values or approach between the two parties. One audit committee chairman advised that: “There will always be points of disagreement, for example where internal audit are pushing too hard or they have perhaps taken a polarised view. If there’s a major problem that gets aired at board level the CFO may well be sensitive to that, but you’ve got to rise above it.”

## The relationship between the audit committee chairman and the head of internal audit

To be at their most effective, the audit committee chairman and head of internal audit must have a strong working relationship. This is cemented through regular, face-to-face meetings anywhere from once every four weeks to once a quarter. It is important that the head of internal audit feels comfortable picking up the phone to the committee chairman at any time; ease of communication will largely be determined by the chairman's demeanour, as demonstrated by the following observation:

“Every internal auditor that I deal with as chairman of an audit committee has my direct number. I speak to them one-on-one every quarter and if they want to speak between those formal appointments they just call me. Occasionally one of them will ring up and say, I thought you should know that I'm taking this particular position on an issue and wanted to make you aware, just in case it finds another route onto your radar screen.”

Some audit committee chairmen make a point of meeting the head of internal audit a few days before each audit committee meeting to discuss the issues in an informal session. One chairman suggested that the best place to hear what is really going on is at the bar after dinner: “Problems rarely surface suddenly like sky rockets; usually several people have seen them coming for months.”

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Most audit committee chairmen are involved in the annual review of heads of internal audit, although as one said: “Working out the effectiveness of the current internal audit function is difficult. On an annual basis your ability to judge is as much subjective as anything else.” He did, however, recommend undertaking an external benchmarking review of the work of internal audit, an exercise that would typically be initiated by the CFO with the head of internal audit agreeing the terms of reference and reviewing the conclusions at the end.

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Another chairman adopts the view that “life is a continual appraisal” and that every contact contributes to the process of review, ultimately assessing performance on whether the head of internal audit carried out an agreed set of actions and whether any surprises surfaced that reflected poorly on the function’s effectiveness

## Structuring internal audit and risk

According to the text book, risk and internal audit functions should be kept separate. However, they have been merged in quite a number of high-profile companies. The head of internal audit must have — and to be seen to have — the confidence of the board and work in close partnership with the risk management function. One chairman felt that in certain organisations the same individual could easily assume responsibility for both risk and internal audit: “It’s as much a question of skill sets and competencies as it is about structure. In most companies the centre of gravity for the audit function is financial. Risk assurance could sit perfectly well under the head of internal audit providing that person has the right bundle of skills.”

Part of the risk management function is about defining the risk appetite of both the CEO and the board, which is quite different from the task of internal audit. Where there is a combined department the audit committee needs to be fully satisfied that proper independence (and sufficiently broad experience) exists across the two areas. One chairman pointed out that the convergence of risk and internal audit makes the leadership role more substantial and interesting.

For the big banks, separating risk from internal audit is essential, but the picture is different in sectors. Some chairmen felt that internal audit should not be responsible for establishing risk management systems, but should instead be auditing and monitoring those systems and the controls that mitigate the risks.

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One chairman pointed out that however risk and internal audit are structured they should work “almost hand-in-glove”, since the two are intrinsically linked. Nevertheless, he added that it is not always appropriate for internal audit to get involved with questions of strategy or operational effectiveness and it is probably up to the CEO to decide where the boundary should be set.

Combining risk and internal audit could result in a move away from rotational auditing of profit centres to using the risk register as the basis for determining audit plans.

“It is the duty of the board to review the risk register,” remarked one chairman. “The responsibility of the audit committee is to make sure that the board is seeing the facts, that the risk management process is robust and to monitor execution.”

## Business risk assurance reporting

Boards and audit committees are seeking more assurance on business risk all the time, because of growing financial complexity and also as a defence against reputational damage. In the financial services sector in particular, it is extremely difficult for boards and indeed audit committees to keep abreast of all risk issues.

The prevailing view is that the standard of risk management and governance in UK corporates is high, though evolving all the time. According to one audit committee chairman, business risk assurance reporting has been gradually improving since publication of the Combined Code: “I don’t think it can be perfected overnight, since it often involves cultural change for a company. What makes the difference is if the CEO really buys into it and risk assurance starts getting embedded in the organisation.”

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Another pointed out that business risk assurance reporting can be overly bureaucratic — “death by reporting”. This needn’t be the case if management is thinking carefully about the balance between opportunity and risk, discussing changes in risk appetite with the board, reporting on risk and mitigation measures that affect the major drivers of the business and taking appropriate action.

As to who should be responsible for compiling the risk register, one respondent’s view was that a single department should be responsible and internal audit is probably better placed than finance, simply because its brief extends beyond purely financial risk: “The compilers can’t be partisan; they have to be looking right across the organisation.”

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## Looking ahead

With a greater focus on risk, internal audit is playing a broader and more central role in the organisation. The kind of person best suited to leading internal audit is quite different to the person who ran the function five to ten years ago. Exposure outside audit is increasingly valuable, since broad business experience will equip the leader to form a better view of the role and of the risks facing the company.

Over the next five years — partly on the back of further improvements in governance — we are likely to see a continual upgrading of services provided by internal audit, although this will require a conscious effort by companies to invest in and elevate the status of the function.

The head of internal audit will play a more influential leadership role, exhibiting a mix of skills and personal qualities that will enable him or her to win the trust of, and influence, a wide range of constituents. If the role continues to be positioned as desirable on its own merits, as well as providing a valuable step in the career trajectory for talented, ambitious individuals, it may succeed in attracting the very best candidates.

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