Evaluating the internal and external audit function

The audit committee guide series
“Effective audit committees are critical to the quality of financial reporting and the proper conduct of business. This guide is one of a series that is meant to help audit committees meet their oversight and fiduciary responsibilities.”

– Trent Gazzaway, National Managing Partner of Audit Services

The audit committee guide series has been adapted from The Audit Committee Handbook, Fifth Edition, published by John Wiley & Sons and available for purchase at www.GrantThornton.com/ACHandbook and through major online booksellers and bookstores nationwide.
There is some truth to the saying that being on an audit committee is a part-time job with full-time responsibilities. Audit committees rely heavily on the hands-on analysis provided by internal and external auditors, making it essential that the audit work be evaluated for effectiveness and integrity.

How will financial reform impact your company?
The regulatory landscape is changing for companies and their audit committees. Go to www.GrantThornton.com/FinancialReform to review Grant Thornton’s outline of key financial reform issues and actions you can take to guide your company through them: “Financial reform: What public companies and their audit committees need to know about the Dodd-Frank Act.”
Staffing internal audit is a joint exercise that includes input from the audit committee and management. Several factors — such as an organization’s size, complexity, level of risk and geographic diversity — can influence decisions regarding the level of internal audit certification that may be desired.

**Selection criteria**

Audit committees and management might consider the following factors in staffing an internal audit function:

- **A strong leader** — Internal audit leaders (often called chief audit executives or directors of internal audit) must not be afraid to bring potential problems to light.

- **Reporting relationships** — Regardless of its defined reporting relationship to management and the board,¹ internal audit should have frequent, open and direct lines of communication with the audit committee, and the freedom to address meaningful organizational risks.

- **Need for specialists** to deal with complex or difficult transactions.

- **Geographic diversity** — Organizations with wide geographic reach may benefit from having internal audit personnel located near significant operations.

- **Form of compensation** fosters appropriate focus on audit quality.

- **Objectivity or “independence”** — Internal auditors should be familiar with the subject matter, but should not be so closely tied to the area that their neutrality is impaired.

¹ Internal auditing standards recognize that a dual reporting relationship between management and the board can provide the internal auditor with valuable access to both groups. See Braiotta, Louis Jr.; Gazzaway, R. Trent; Colson, Robert; and Ramamoorti, Sridhar, *The Audit Committee Handbook, Fifth Edition*, John Wiley & Sons, Inc. (2010): 224, footnote 4.
Audit committee considerations
To ensure that the organizational framework for the internal auditing function is comprehensive and balanced, the audit committee should consider the following three areas.

Internal audit philosophy
Corporate accountability and governance necessitate an ongoing appraisal of the entity’s auditing philosophy. Some internal audit functions focus exclusively or primarily on operations, while others extend their focus to financial reporting. The audit committee and management should:
- understand and agree with the operating philosophy, and
- be confident that internal audit has appropriately skilled resources to execute on the chosen philosophy.

Internal audit independence
Appropriate levels of independence enable internal audit to design and execute audit procedures in all necessary areas and fully support findings and recommendations to management and the audit committee or the full board. COSO’s Guidance on Monitoring Internal Control Systems contains some helpful direction regarding the broad concept of objectivity.

Objectivity refers to the extent to which evaluators and information sources can be expected to perform an evaluation or provide information with no concern about possible personal consequences and no vested interest in manipulating the results for personal benefit or self-preservation. Personal integrity is a primary consideration in assessing objectivity, but other, more easily observed factors include compensation incentives, reporting responsibilities, personal relationships and the degree to which individuals might be otherwise affected by the results of monitoring.2

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Structure and logistics
Organizations, depending largely on their nature, size and complexity, have different internal auditing needs. The audit committee should review the plans and budgets of the internal auditors in relation to the entity’s auditing needs and potential auditing benefits.

Equally important, the committee should review the organization chart of the internal auditing function to determine that it is balanced in accordance with the audit plan. An illustrative organization chart in Exhibit 1 shows how the internal audit function of a multinational enterprise might be organized on a centralized basis.

Exhibit 1: Sample internal audit organization chart
Outsourcing considerations

Some organizations find it necessary to outsource some or all of their internal audit function. Most public companies today are prohibited by statute or regulation from outsourcing internal audit services to their external auditors.

The Institute of Internal Auditors (IIA) suggests that the following factors be considered when evaluating possible outsourcing arrangements:\(^3\)

- Independence of the external service provider
- Allegiance of in-house resources versus that of external service provider
- Professional standards followed by the external service provider
- Qualifications of the service provider
- Staffing — Training, turnover, rotation of staff, management
- Flexibility in staffing resources to meet engagement needs or special requests
- Availability of resources
- Retention of institutional knowledge for future assignments
- Access to best practice or insight to alternative approaches
- Culture of the organization — Receptiveness to external service providers
- Insight into the organization by the external service provider
- Coverage of remote locations
- Coordination with in-house internal auditing
- Coordination with external auditor
- Use of internal auditing as a training ground for internal promotions
- Retention, access to and ownership of work papers
- Acquisition and availability of specialty skills
- Cost considerations
- Good-standing membership in an appropriate professional organization

Monitoring the internal audit function

The audit committee’s routine oversight of internal audit is beneficial for the following reasons. First, it enhances the audit staff’s independence and strengthens its image in the corporate structure. Second, the audit committee can help coordinate internal and external audit activity, thus improving the efficiency of both. Third, an effective internal audit function assists the audit committee in discharging its responsibilities in light of its limited time and oversight capacity.

Appraising the quality of internal auditing staff

Chief audit executives (CAEs) should be able to articulate to the audit committee how they meet the standards set forth by the IIA. criteria for which the audit committee should look include the following:

- Proficiency
- Due professional care
- Continuing professional development
- Internal and external quality assessments
- Reporting on the quality assurance and improvement program

The audit committee also should inquire of the independent auditor regarding the quality of internal auditing personnel in relation to:

- the professional qualifications and educational backgrounds of the staff,
- the use of professional training and development programs for the corporate audit staff, and
- the performance appraisal and evaluation system.

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Finally, while each audit committee may develop its own approach to monitoring the activities of the internal audit function, the following summary thoughts should be helpful. In general audit committees should:

1. assist in the overall internal auditing policy determination and approve such policies to ensure that the staff has authority commensurate with its responsibilities;

2. review the scope of the internal and external auditing plans in order to maximize the resources allocated to the audit function and minimize the outside auditing fees;

3. review copies of the internal auditing reports and critically evaluate findings, recommendations, management’s response and courses of action taken, and review the disposition of the recommendations in the independent auditor’s management letter;

4. review and appraise the staff’s organization regarding its auditing philosophy, independence and logistical operations;

5. assess the quality of the auditing personnel and training to ensure that the internal auditing function is adequately staffed;

6. assure the CAE that the audit committee supports his function in the corporate structure and the director has access to the committee and the functional areas within the entity, and obtain assurance that the staff is receiving the proper cooperation from management; and

7. determine the need for specialists, such as in complex areas of accounting or evaluation of computer security.
External audit

Selecting and evaluating the external auditor

Few decisions that audit committees make are more important than the recommendation or selection of external auditors. Audit committee members should, therefore, be diligent in selecting the right auditor and in evaluating the auditor’s performance throughout the engagement. Exhibit 2 includes some selection criteria for audit committee consideration. These same criteria also can be used to evaluate the auditor’s performance during or at the end of an audit.

Exhibit 2: External auditor selection/evaluation criteria

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry experience</td>
<td>Audit committees of large, complex organizations, and those that venture into complicated industries like software or finance, need to ensure the external auditors have an appropriate level of industry experience.</td>
</tr>
<tr>
<td>Support network available within the external auditing firm</td>
<td>Audit committees should be confident that the external auditor has access to specialized technical resources — whether in a national office or spread around its geographic footprint. Ask the prospective auditor to describe the process for answering a technical question that cannot be handled solely by the engagement team.</td>
</tr>
<tr>
<td>Independence</td>
<td>Audit committees should be confident that the external auditor has appropriately evaluated and reported the firm’s independence, considering family relationships, investment holdings or other business relationships. Independence requirements apply to the engagement team, to the firm’s local office, and in most public company situations, to the firm as a whole.</td>
</tr>
</tbody>
</table>

5 In some situations (such as the appointment of the external auditor for a company listed on a U.S. exchange), the audit committee must select and engage the external auditor. In other countries, and with most private organizations, the audit committee might merely recommend an audit firm to management, who then makes the decision regarding engaging that firm.
<table>
<thead>
<tr>
<th>Reasonableness of audit plan</th>
<th>The audit committee should be confident that the prospective auditor’s audit scope is reasonable and adequate, and that it includes locations that, on their own, are material to the financial statements. Smaller locations may be included on a rotating or limited-scope basis. Audit committees should heed unusually low competitive bids, which may signal that the auditor doesn't understand the scope required or that he plans to make up the difference through special billing. Require proposing firms to quote both hours and fees by major audit area to evaluate differences in hourly rates (which may reflect the personnel level planned for the work) and number of hours (which may reflect audit plan adequacy or excessiveness).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability to toe the line</td>
<td>Audit committees should be confident that the audit partner has the fortitude to deliver constructive criticism. Over time — in executive session — ask open-ended questions about management’s and/or internal audit’s performance, and evaluate the partner’s demeanor and response. To evaluate how well a prospective auditor communicates difficult information, ask references or the audit partner for examples of issues he has reported. Confidentiality may rightly prevent full disclosure of such issues, but the audit committee should be able to get a sense of the auditor’s candor.</td>
</tr>
</tbody>
</table>
| Form and frequency of communications | The audit committee should expect frequent, open auditor communication with management and internal audit, and may reasonably expect the auditor to spend time talking to managers and employees outside of the executive suite. Auditing standards require the auditor to have certain types of communications with the audit committee (see External auditor reporting on p. 13). At a high level the audit committee should expect:

- An audit planning discussion early in the year describing what the auditor plans to do, where he plans to do it and how much effort he expects it to take
- Interim updates measuring progress against the plan
- Immediate communication of issues like suspected fraud, major internal control problems or indication of a prior-period material error
- A wrap-up presentation covering all required communications set forth in Exhibit 3, updating the interim status and delivering recommendations for improvement |
| Lack of surprises | Audit surprises, in this context, come in two forms:  
|                  | • Those related to last-minute audit adjustments  
|                  | • Those related to last-minute cost overruns  
|                  | Both can be caused either by the company’s failure to provide necessary information to the auditor by the agreed-upon date, or by the auditor’s failure to perform necessary procedures early enough to detect a particular problem. Proper interim communication and routine audit committee/auditor exchanges about the status of requested information usually prevent auditor downtime, overruns and rushed audit procedures. |
| Partner and manager involvement | A typical audit includes 20 to 30 percent partner/manager time, but audit complexity can raise or lower those percentages. The mix of partner and manager time also varies based on the number of audit managers staffed and their level of experience.  
|                  | The quality of the hours spent, especially by the partner, is more important than the number of hours spent. The partner’s early involvement in the planning process, frequent interim reviews of the audit work, and adequate review time in the field translate into an effective and efficient audit. |
| Quality control procedures | Auditors of public companies are required to have concurring or second partner reviews, often called “engagement quality reviews.” The audit committee should inquire about the skills and involvement of the concurring partner, who should have appropriate industry experience and be available to the engagement team as needed. |
| Using the work of others | The audit committee should be confident that the external auditor is making appropriate but not excessive use of the internal control testing performed by others, including internal audit.  

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7 Ibid., “Using the Work of Others,” 214.
<table>
<thead>
<tr>
<th>Usefulness of recommendations</th>
<th>External auditors are uniquely positioned to add value beyond the assurance provided in the audit opinion, and audit committees should be confident that the auditors they select have a continual-improvement mindset. With unprecedented access to business operations and related books and records, and valuable knowledge gained from other companies' best practices, a good external auditor should always look for ways to help organizations be more effective and efficient, especially in their financial reporting processes.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Team chemistry — Balancing client relationships with duty to financial statement users</td>
<td>Audit committees should expect the audit team to be courteous, respectful and reliable, and at the same time, to maintain a &quot;healthy skepticism.&quot; Committee members should ask management periodically about the auditor relationship — looking equally for signs of excessive tension and excessive collegiality — and should ask the auditor about the nature of management's interactions.</td>
</tr>
</tbody>
</table>

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8 The 2009 SEC Handbook, Section 603.07 states, “SEC registrants may, of course, change auditors at their discretion. It is imperative, however, that when a new auditor is engaged that auditor possess the integrity, objectivity and independence required by professional and Commission standards. The auditor must, at all times, maintain a 'healthy skepticism' to ensure that a review of a client’s accounting treatment is fair and impartial.”

9 The AICPA’s Audit Committee Toolkit (2004) states: “In considering information gathered through the process of evaluating the independent auditor, it is important that the audit committee give consideration to the source of the information. For example, if the CFO/controller comments that they believe the auditor went too far in certain areas, that would probably carry less weight in your deliberations than if the CFO/controller comments that certain areas were not tested adequately. As with all deliberative processes, the audit committee should consider the different perspectives and motivations of those having input into the deliberations.”
Non-audit services

The Sarbanes-Oxley Act prohibits external auditors of U.S. public companies from conducting certain non-audit services and has established a requirement for boards (usually through their audit committees) to approve any other non-audit services that are not specifically prohibited. The prohibited services are based on three primary criteria: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit her own work, and (3) an auditor cannot serve in an external advocacy role for her client. Prohibited services include:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser or investment banking services
- Legal services and expert services unrelated to the audit
- Any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible

Thousands of examples of good audit committee preapproval policies are available on the Internet through the investor relations section of most public company websites. Two such examples can be found at the links below.

- PepsiCo Inc.: http://www.pepsico.com/Company/Corporate-Governance.html

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11 See the Sarbanes-Oxley Act of 2002, Section 201.
**External auditor reporting**

Auditing standards require the external auditor to communicate certain things to “those charged with governance,” which usually includes management and the board (through the audit committee). In general, the audit committee should expect the auditor to communicate:

- the auditor’s responsibilities in relation to the financial statement audit,
- planned scope and timing of the audit,
- significant findings from the audit, and
- auditor independence.

Exhibit 3 lists the types of communications the audit committee should expect from the auditor and a general time frame within which those communications might be made.

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**Exhibit 3: Required external auditor communications to the audit committee**

<table>
<thead>
<tr>
<th>Communications</th>
<th>When delivered*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independence and retention matters</td>
<td>Prior to acceptance and annually</td>
</tr>
<tr>
<td>Auditor’s responsibilities under the relevant auditing standards</td>
<td>Prior to commencing services</td>
</tr>
<tr>
<td>Audit committee preapproval of services</td>
<td>Prior to commencing services</td>
</tr>
<tr>
<td>Fraud and illegal acts</td>
<td>When event becomes known</td>
</tr>
<tr>
<td>Inquiries and investigations by authorities</td>
<td>When event becomes known</td>
</tr>
<tr>
<td>Significant accounting policies, judgments and estimates</td>
<td>End of audit</td>
</tr>
<tr>
<td>Auditor’s judgments about the quality of accounting principles</td>
<td>End of audit</td>
</tr>
<tr>
<td>Audit adjustments, including uncorrected misstatements</td>
<td>End of audit</td>
</tr>
<tr>
<td>Disagreements with management</td>
<td>End of audit</td>
</tr>
<tr>
<td>Difficulties encountered when performing the audit</td>
<td>End of audit</td>
</tr>
<tr>
<td>Management’s consultations with other accountants</td>
<td>End of audit</td>
</tr>
<tr>
<td>Material weaknesses and significant deficiencies in internal control</td>
<td>Prior to issuing report</td>
</tr>
<tr>
<td>Auditor’s internal quality control procedures</td>
<td>Prior to issuing report</td>
</tr>
<tr>
<td>Material issues raised during most recent quality control or peer review</td>
<td>Prior to issuing report</td>
</tr>
<tr>
<td>Material written communications with management</td>
<td>Prior to filing</td>
</tr>
</tbody>
</table>

* If necessary, all of these matters should be discussed promptly on an interim basis with the audit committee.

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12 See ISA 260 and SAS No. 114.
Credible, timely and relevant financial information is fundamental to promoting confidence in a company. Audit committees, as well as management, play a unique role in establishing and maintaining that confidence. Because audit committee members must rely heavily on both internal and external auditors being independent and candid, finding the right auditors is paramount to the audit committee’s oversight role.

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**Information overload: How to make data analytics work for the internal audit function**
Learn how your internal audit department can effectively use data analytics to add value to your organization.
Suggested reading


The Audit Committee Handbook is co-authored by Grant Thornton LLP audit committee experts R. Trent Gazzaway, national managing partner of Audit Services, and Robert H. Colson, retired partner in Public Policy and External Affairs, along with Louis Braiotta Jr., professor of accounting at SUNY — Binghamton’s School of Management, and Sridhar Ramamoorti, principal at Infogix Advisory Services. The Audit Committee Handbook provides practical, in-depth guidance on all audit committee functions, duties and responsibilities. This latest edition features regulatory updates, new chapters on audit planning and oversight, heightened focus on fraud risk, and broad international coverage. The Audit Committee Handbook is available at www.GrantThornton.com/ACHandbook and through major online booksellers and bookstores nationwide.


Today’s demanding marketplace expects CFOs, auditors, compliance officers and forensic accountants to take responsibility for fraud detection. These expectations are buoyed by such legislation as the Foreign Corrupt Practices Act, which makes it a crime for any U.S. entity or individual to obtain or retain business by paying bribes to foreign government officials. Written by William P. Olsen, the national practice leader of Forensics, Litigation and Investigation Services at Grant Thornton LLP, The Anti-Corruption Handbook provides guidelines addressing the challenges of maintaining business integrity in the global marketplace.
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