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Current Issues in Internal Auditing

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by

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Honors Thesis Abstract

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Abstract: This Capstone project examines current internal auditing issues including behavioral factors, electronic data processing auditing, environmental auditing, ethics, fraud, operational auditing, outsourcing, and reporting. Information for the Capstone was gathered from a literature review utilizing the publications *Internal Auditor* and *Internal Auditing*. Each article is individually summarized, and each auditing issue is summarized.

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Internal auditing is a dynamic, ever-changing profession. To achieve success in the field, auditors need to understand their personal weaknesses and strengths, and how to use those weaknesses and strengths to their advantage.

One of the most essential skills an auditor should possess is the ability to communicate. Internal auditors deal with many different types of people--factory workers, middle management, clerical staff, CEOs. The ability to successfully communicate with each and every person is required. Most recent graduates are not able to communicate at the level employers require. For this reason, employers are urging the educational community to offer written and oral communication classes for students. Some schools, such as Northern Illinois University, have developed additional required English classes tailored specifically for accounting students. More schools will probably implement these classes if employers begin requiring writing samples as part of the interviewing process.

Auditors gather information from interviewing people, not just from financial statements. In order for auditors to obtain accurate information, they need to be able to conduct effective interviews. Conducting effective interviews involves knowing which questions to ask, how to ask the questions, and how to interpret verbal and nonverbal responses. Effective interviewers begin with specific objectives, outlines, and background information on the subject areas. Then, they create a comfortable interview setting and evaluate responses to interview questions. Interviewers word questions carefully so they do not bias the interviewee's response. During the interview, auditors may become suspicious that the interviewee may be involved in some wrongdoing or may have knowledge of wrongdoing. The interviewer should be suspicious of this if the interviewee gives inconsistent answers to questions, acts nervous, avoids looking the interviewer in the eye, or hesitates before answering questions. Auditors should always approach interviews with an attitude of "professional skepticism."

Listening is obviously a very large part of an auditor's job. People will open up and supply more information to an effective listener. Body posture, facial expression, and voice tone often determine whether someone is considered a "good" listener. Effective listeners lean toward the speaker, face the speaker, and appear relaxed throughout the communication process. People are perceived as effective listeners if they smile at the speaker, alter facial expressions to respond to the person who is talking, and nod to confirm points the speaker makes. Listeners should maintain eye contact with the speaker without staring and politely ask questions. Auditees will respect and confide in an auditor who is an effective listener.

Internal auditors experience a lot of inherent stress. This stress is caused by travel, time-pressure, interaction with many types of people, and auditee perception of auditors. Offering a training class with travel tips and helping auditors with personal errands will reduce travel stress. Allowing sufficient breaks throughout the day can help alleviate stress caused by time-pressure. Also, schedules need to be developed with reasonable time estimates, and flexible to allow auditors to spend extra time with audit issues if they need to. Improving communication skills can help reduce the stress caused by interacting with many different types of people. Auditors can learn to interact and respond positively to all types of people. Auditors can also help change their "watchdog" reputation. If auditors help auditees understand that auditing helps solve problems and that auditors are not a threat to the auditees, auditees will happily receive the auditors.

Auditees see auditors as watchdogs without personalities. Many auditors believe this role is necessary to remain independent. Many auditors also become carried away with trying to find issues that they forget their real mission--to help solve problems. Auditors should listen to the auditees so they can help the auditees understand why and how issues arise. Then, auditors should help the auditees solve any current issues and teach the auditees how to prevent future issues. Auditors need to remember what purpose they serve. Uncovering issues does not help the organization unless the auditor also attempt to prevent the same issues from occurring in the future.

As the business environment changes, auditors should be aware that they are not guaranteed job security. Audit departments can be downsized and reduced. To prepare for downsizing, auditors need to keep their skills on the cutting edge. Networking, building portfolios, and marketing yourself are essential for finding jobs. Auditors should prepare for their next job before they loose the current one.

Internal auditing is a dynamic, exciting career. Many factors determine success, but above all, communications skills are the most important. As with any career, auditors should educate themselves about changes in the profession and prepare themselves for their next challenge.

EDP Auditing

In order to effectively perform internal audits, internal auditors need to have at least a basic understanding of information systems. Internal auditors do not have to audit the software itself, but they do have to audit financial numbers and internal controls that are affected by the software. Basic system knowledge is essential since companies have many different types of systems.

Internal auditors should be concerned about software theft. Software theft occurs when individuals make unauthorized copies of software. Software purchasers are usually allowed to make one copy of their software--for emergency back-up only. Individuals who violate the copyright laws may be prosecuted with criminal penalties and/or civil action. If employees within a company illegally copy and distribute software, the company is also legally liable for damages. Software creators may be awarded damages that include profits the company earned while using illegal software. Software theft is a serious problem in the United States.

Windows has become the operating environment used by most companies, and its use is constantly increasing. More and more companies are converting to a client/server computer system. Client/server systems consist of one computer which processes information (the client) and other computers which serve as data input and output points (the servers). Companies implementing client/server systems usually have increasing information systems budgets. Lack of qualified personnel is considered to be the greatest obstacle in implementing client/server systems. Internal auditors should be aware of the consequences surrounding system development.

Internal auditors should obtain information about the Chief Information Officer turnover rate. The CIO turnover rate has consistently increased over the past few years. Internal auditors may want to investigate the turnover rate in their companies and determine why the turnover rate is lower or higher than the average.

The amount of staff in the information services area has remained fairly stable. Recently, more staff has been allocated to communication and network management, and at least half of the staff develops and maintains applications. Internal auditors should determine if the information systems area is understaffed since understaffing could cause internal control problems within the system.

Internal auditors do have a responsibility for systems development. As systems are developed, internal auditors should help develop adequate internal controls and ensure that the systems are auditable. Improving auditability and designing internal controls after the system has been developed is very difficult and expensive. Internal auditors may experience resistance as members of the system development team. If internal auditors help with system development, some auditors believe that they will compromise their independence. By serving as consultants for system development, internal auditors avoid the independence issue.

Internal auditors need to investigate system security to ensure that data integrity is maintained. Data encryption and digital signatures help maintain data integrity. Data encryption changes information so that unauthorized users cannot easily decipher it. The authorized receiver decodes information using a "key." The key is either a single private key, known only to the sender and receiver, or a combination of a public and private key. With the combination of keys, everyone knows the public key, but each private key is individually known.

Digital signatures maintain the integrity of electronic signatures. When a document is signed, the computer develops a code to attach to the signature. The code is based on the document contents and the signature so that if the document or signature is altered, the code will also change. When the message is received, the computer authenticates the electronic signature by comparing the code to a hash value.

Data encryption and digital signatures maintain data integrity. However, the benefits of implementing these system elements may not outweigh the costs. Internal auditors should carefully research each alternative before suggesting that either be implemented. Also, if either method is implemented, the internal auditor should ensure that effective controls are established for maintaining the public and private keys. If either key is lost, the data will be useless to the receiver and sender.

The electronic data processing environment is constantly changing to meet user demands. Internal auditors need to understand the current system and foresee changes which may improve the system. Internal auditors should also realize that they need to be current in technology changes since the auditing environment is constantly changing. As systems change and develop, internal auditors should ensure that information systems maintain adequate internal controls and are auditable.

Environmental Auditing

Environmental liabilities pose a serious threat to companies. Although auditors do not have the technical expertise to determine whether a company is actually committing an environmental crime, they do need to have enough expertise to know when a potential environmental problem exists. Since environmental liabilities normally cost companies large amounts of money, auditors need to know when an environmental liability may be occurring and whether an accrual should be made for the possible liability.

Most companies are conducting environmental audits. Usually a department with technical expertise in dealing with environmental issues (environmental audit) performs the audits. However, the internal audit department may also be involved in the audits. The internal audit department may be responsible for applying audit procedures during the audits, providing resources for the other department to complete the audits, and/or auditing the other department. In some companies, internal audit performs environmental audits with help from an environmental engineer. In other companies, an internal auditor helps the environmental audit group.

What can internal auditors do to help their companies avoid costly environmental liabilities? Internal auditors can be aware of current and pending legislation, environmental issues plaguing the company, and potential issues which could turn into environmental problems. Performing audits with awareness of environmental concerns will also help organizations.

Companies must understand the Superfund law. The Superfund law places responsibility for waste with the company that generated the waste. If the company that generated the waste cannot financially support their environmental obligations, the responsibility then falls on the current owner of the property. Any other company involved with waste contaminated property (one example would be insurance companies) may also be held liable for cleanup expenses. Even company management may be held personally liable for cleanup costs in some states. To effectively avoid liability under the Superfund law, companies should avoid dealing with any type of waste. Since this is impossible, companies need to manage their waste very closely.

Companies perform environmental audits for three important reasons: to monitor compliance with legal regulations, to assess environmental legal liability, and to gain a competitive advantage.

Ensuring compliance with legal regulations is extremely important since government agencies, state governments, the federal government, and private citizens may sue companies for noncompliance with regulations and/or neglecting moral obligations. Companies have been assessed astronomical fines for environmental damage.

How can companies gain a competitive advantage from following environmental regulations? If a company implements a regulation more efficiently and effectively than its competition, the company will gain a competitive advantage. Customers react positively to companies who support the "green movement." Company image improves when it takes responsibility for environmental concerns. Also, companies may discover that producing products efficiently under the environmental regulations is more cost efficient in the long run. Internal auditors can monitor the company's progress in adopting environmental regulations and make suggestions when they feel processes need to be changed to account for environmental issues.

Internal auditors should possess basic knowledge on ways to reduce environmental liability. One way to reduce the liability is to reduce the amount of waste the company produces. Some companies implement waste management programs to monitor environmental issues. Internal auditors should encourage companies to identify environmental costs and expenditures--both costs of compliance and noncompliance.

Internal auditors should ensure that their companies have adequate environmental insurance. Insurance companies can help cover the costs of environmental noncompliance; however, insurance companies often try to deny environmental claims. Insurance policies should be kept in a safe place where they are easily accessible. Invoices, canceled checks, and old records and reports can also serve as evidence of coverage for claims which occurred years ago. Insurance companies can be a valuable source of help in identifying and correcting potential problems.

Environmental concerns have increased dramatically in the past few years. Internal auditors need to be able to identify potential environmental problems and offer viable solutions to the problems. Companies that perform environmental audits have the potential for creating a competitive advantage. The most effective way to avoid environmental liabilities is to curb the problem at the source--when the waste is produced. Companies can also reduce their liabilities by performing voluntary cleanup.

Ethics

Ethics play an important role in every profession, but especially in auditing. Unethical auditors could cause havoc in the financial world. Internal auditors must understand the rules and regulations that govern their activities and the consequences of unethical decisions. Internal auditors must also understand their role in the organization and how decisions affect the organization as a whole.

The Institute of Internal Auditors (IIA) govern the internal auditing profession. Internal auditors must also follow generally accepted accounting practices (GAAP) when GAAP regulations affect financial reporting. Internal auditors are obligated to serve their company, not external parties. Therefore, the IIA does not require internal auditors to report incidents of wrongdoing to outside parties since this would not help advance the organization. Internal auditors owe their organizations loyalty which requires that they do not report wrongdoing directly or indirectly to outside parties. As auditors work on an audit, they need to be aware that anything they write in the work papers can be subpoenaed by a court of law. Therefore, any incriminating evidence should be handled by the organization's lawyers and should not be reported in the work papers.

The IIA Code of Ethics specifically prohibits auditors from whistle blowing unless the auditor has been given permission by management or is required by law. Whistle blowing is considered to be the unauthorized disclosure of wrong doing to external parties. Whistle blowing does not include informing management of internal wrong doing. Internal auditors are required to report internal wrong doing to management and/or the audit committee.

Why do people commit unethical acts? Most unethical acts are committed and tolerated because they are "for the good of the business." The most common types of wrong doing are employee theft, mismanagement, and waste. The most successful companies usually have stronger codes of ethics, and companies without strong ethical practices are usually unsuccessful. Most perpetrators of fraud are first time offenders who would not normally commit a crime, but they made a bad decision and were caught. Most people know what is right and wrong, but they do not make decisions based on that knowledge. Organizations need to have a strong code of ethics to deter unscrupulous behavior. The ethical tone needs to be set by the board of directors. Internal auditors should ensure compliance with the company's ethical code.

What do companies consider ethical issues to be? Most ethical issues involve direct public damage to the company's reputation. These ethical issues include harassment, environmental concerns, and employee conflicts of interest. Issues such as unreasonable compensation and workplace safety do not qualify as ethical issues in the business world. When analyzing ethical issues, internal auditors should determine whether the issue could cause harm, who the issue would harm, and how to deal with the situation.

The IIA has developed a Code of Ethics for internal auditors to follow. However, only members of the IIA and people using the IIA trademark need to follow the code. What do internal auditors do when their company's ethical code conflicts with the IIA Code of Ethics? Most auditors view the company code as more important than the IIA Code of Ethics. All auditors do not strictly adhere to the IIA Code of Ethics. Evidence suggests that auditors adhere to standards pertaining to personal integrity more than to standards pertaining to the quality of service.

Who has the responsibility for establishing and maintaining ethics in an organization? The board of directors should establish ethics, but internal auditors should monitor and maintain ethical standards. Internal auditors should be ethical role models for the organization. Leaders in the internal audit profession believe that ethics can be taught to children but not adults. Ethical beliefs are instilled during childhool. They also believe that the difference between right and wrong can be taught. Can ethics be audited? The industry leaders believe that the results of ethical decisions can be audited, but the decisions themselves cannot be audited.

Ethics are an integral part of earning respect for the internal audit profession. Maintaining and promoting ethical behavior is a cornerstone for building trust and loyalty for the profession. Internal auditors should support creating a strong code of ethics and even an Ethics Committee within their organizations. Internal auditors should be aware that their job is to uncover wrongdoing in the organization and report it to management. They should not violate their duty of loyalty and report wrongdoing to external parties. If the auditor feels he/she is compromising his/her own ethics by allowing an action to continue, the auditor should resign instead of blowing the whistle on the organization.

Fraud

Internal auditors are the main defense against perpetrators of fraud. Most internal auditors spend the majority of their time evaluating internal controls to reduce the risk of fraud. Companies loose millions of dollars a year because of fraud. If internal auditors understand why fraud occurs, they will be able to detect and prevent it from occurring.

Fraud will occur if companies do not set strict ethical guidelines. Companies must very clearly prohibit fraud committed against the company and for the benefit of the company. Management should set the ethical tone from the top and supply resources to fight fraud. Internal auditors should urge managers to support the fight against fraud, especially if a company does not have stringent fraud policies. Responsibility for teaching managers how to detect and prevent fraud belongs to the internal auditors.

Internal auditors detect fraud by following five general steps. First, auditors should know specific fraud exposures and symptoms of fraud. Then, auditors should design audits to uncover fraud symptoms. Auditors should investigate all instances where fraud symptoms are found. Auditors should understand that they are responsible for uncovering fraud; therefore, schedules and budgets should provide auditors with the ability to investigate fraud symptoms. Auditors cannot win the fight against fraud if the do not have adequate resources to fight it. Management cannot lead a successful fight against fraud if perpetrators are not punished to the fullest extent. The most efficient way to deter fraud is to make the consequences unsavory. After fraud investigations are complete, the auditors should assess and attempt to solve internal control weaknesses.

The Statement on Internal Auditing Standards No. 3 requires internal auditors to evaluate internal controls in relation to fraud, examine fraud symptoms, and report fraud internally. Internal auditors are prohibited from reporting suspected fraud to external parties, even the external auditors. Fraud would occur less often if the internal auditors could report to the external auditors since fraud perpetrators may believe that management "sweeps fraud under the rug" by not notifying external parties.

Internal auditors may be hesitant to report fraud. Some auditors still believe that they do not share the responsibility for discovering fraud. But, more importantly, some auditors believe that their jobs are at stake if they do report fraud. If management does not fully support the fight against fraud, they may not want internal auditors to report suspected fraud. Laws should protect auditors who fulfill their professional obligations by reporting fraud. However, some auditors do loose their jobs by reporting fraud. Obviously, if their jobs are at stake, auditors will be more hesitant to report fraud.

Most people who commit fraud are first time offenders who would not normally commit a crime. However, the offenders saw an opportunity to commit fraud and they were able to rationalize committing fraudulent acts. Organizations can never be completely fraud-free; however, they can implement internal controls and ethics policies to deter most fraud. Internal controls must be constantly monitored since fraud occurs despite the existence of controls. When people commit fraud, they usually compromise the existing internal controls.

Fraud hotlines effectively prevent fraud. Usually either the internal audit department or the security department implements fraud hotlines. Hotlines allow employees to anonymously report fraud and other wrongdoing. Since fraud hotlines do not receive an unreasonable amount of calls, all calls, within reason, can be investigated. For hotlines to be successful, they must be heavily advertised within the organization. If hotlines are continuously advertised, employees will know that management takes the fight against fraud seriously. Also, by advertising the hotline, employees will be more apt to notice fraudulent activities. Offering monetary incentives to report fraud does not improve the effectiveness of fraud hotlines. Fraud hotlines can uncover external fraud also. Some insurance companies have set up fraud hotlines for their customers to use to prevent fraudulent insurance claims.

Many people will admit their fraudulent crimes if they are asked. With fraud assessment questioning (FAQ), interviewers can obtain information about fraudulent activities. If certain questions are asked in the correct order, most individuals will admit to committing or knowing of fraud. Since most people do not naturally tell lies, FAQ draws information from people without them knowing that they are providing it. FAQ usually uncovers evidence of fraud. Then, with further investigation, auditors will discover if fraud was actually committed.

Fraud is a serious issue in most companies. Internal auditors need to know what measures they can undertake to help fight fraud. Having top management support the fight against fraud is the most effective resource. However, auditors need to look for fraud in their audits. Then, they need to educate management on how to prevent and detect fraud.

Operational Auditing

Most internal audit departments spend the majority of their time performing operational audits. Internal audit departments use many different methods to complete operational audits. Which method is most effective depends upon company policies, culture, and procedures.

What factors determine whether an internal auditor will be successful? Do internal auditors need to be experts in the fields they audit or can they have only a general working knowledge? Is technical expertise more important than auditing knowledge in operational audits? Generally, internal auditors need an accounting background to perform successful operational audits. Internal auditors only need to familiarize themselves with the areas they audit, although any additional knowledge is definitely beneficial.

Companies approach operational audits in a variety of ways including: the commonsense audit approach, the risk assessment approach, and a cultural approach. The audit approach should be tailor-made for each individual audit.

The commonsense audit approach (CAA) was devised to provide a simple outline of steps to follow in operational audits. First, audit objectives should be determined before the audit begins. Audit objectives usually deal with determining internal control effectiveness. The second step is to gain a broad understanding of the audit area including external issues, risks, and exposures. Then, an audit plan and schedule are developed. As the audit process begins, auditors should document their understanding of the internal control structure and test whether the controls are working. In most operational audits, tests of controls must be devised from scratch because operational systems are rarely similar. After performing tests of controls, auditors should identify missing controls by comparing the actual control structure to what the control structure should be. Then, the missing controls should be evaluated on a cost/benefit basis to determine if controls should be added or changed. The final step in the audit process is the audit report.

The risk assessment approach focuses on determining how to select operational audit topics in order to reduce the organization's overall risk. First, auditors must recognize audit opportunities. If an auditor believes a particular area looks suspicious, he/she may want to investigate it further. Then, the auditor determines the specific focus of the audit while considering operating efficiency, effectiveness, and economy. After the auditor determines the assertions to be tested, he/she evaluates the consequences of false assertions and assesses the possibility of a false assertion. Assertions are what the auditor believes should be occurring. After determining whether the assertion should be audited, the auditor needs to determine whether the assertion can be audited with the resources available. The auditor should weigh the costs and benefits of testing each assertion. Even if the audit topic is determined to be an audit issue, the topic must be weighed in importance according to all other audit topics. Obviously, resources should be invested in only the most important audits.

How do organizations utilize a cultural approach in operational auditing? A cultural approach includes examining specific processes and causes of problems. The cultural approach focuses on why problems occur, not on discovering problems. Cultural audits focus on how systems adapt to their surroundings. Since problems develop from overall system adaptations, cultural audits focus on discovering adaptations and evaluating the adaptation effectiveness. Audit techniques in cultural audits include numerous interactions with employees. Auditors interview employees, observe employee activities, and participate in employee activities. The cultural audit approach assimilates the working environment into audit findings and suggestions. This approach is more favorable with auditees since they believe the auditors try to understand why problems occur. The auditors are not passing judgement on the auditees.

Many organizations are focusing on responding to customer requests. Therefore, internal auditors are attempting to supply what their customers want, not what the auditors believe is appropriate. One way to respond more effectively to customer requests is to focus on audit outcomes, not audit processes. In the past, auditors have performed specific steps in each audit. However, the steps did not vary according to the audit. If the auditors had focused on the final product and devised steps to deliver a specific product instead of using predetermined audit steps, the customer would be much happier with the outcome.

No matter which audit approach is used, operational audits will be successful if auditors focus on providing quality output in response to customer needs. Successful internal auditors have technical expertise in the areas of auditing and/or accounting, and they obtain a general working knowledge of audit areas prior to beginning an audit.

Outsourcing

Outsourcing has become a hot topic in internal auditing recently. Many companies have begun to outsource their internal audit function. The outsourcing trend has caused great concern throughout the internal auditing profession. Most internal audit functions are outsourced to public accounting firms. Although public accounting firms are obvious choices for performing the internal audits, whether the outsourcing is effective and efficient is questionable.

One responsibility being outsourced is reporting on internal controls. The importance of reporting on internal controls has grown in recent years. Today, internal auditors spend much of their time evaluating internal controls. The main issue in outsourcing internal control responsibilities is the public accounting firm's legal liability. If a public accounting firm issues a clean audit report on the client's internal controls and the controls are discovered to be faulty, the public accounting firm may be liable for any losses relating to inadequate internal controls after issuing a clean audit report.

Public accounting firms claim that they are more able to provide experienced auditors for internal audits. However, professionals employed by public accounting firms rarely possess technical expertise in internal auditing. The high turnover rate in public accounting causes the average audit staff member to remain relatively inexperienced and new. If public accounting firms assign new employees to internal audits, the staff will not be experienced.

Public accounting firms may not want to perform the internal audit function. The cultures in internal and external auditing are vastly different. In fact, some external auditors may not respect internal auditing as a profession. If a culture difference exists and if external auditors do not respect internal auditing, it will be difficult for public accounting firms to find experienced people willing to perform internal audit engagements. The staff in public accounting firms may not want to perform internal audit engagements because their careers may be hampered by accepting the engagements. People on the "fast track" in public accounting do not perform internal audits. Also, when a staff member participates in internal audit engagements, he/she will have more difficulty advancing out of the public accounting profession.

One of the most important problems with outsourcing involves core competency. Many organizations are finding that it is essential to have an on-going internal audit function. Some internal audit departments believe their mission is to provide the organization with an ambitious, high-talent pool of accountants who are knowledgeable about all the organization's businesses. Not only do internal auditor have broad knowledge about the organization, but they understand the organization's culture and objectives. Internal auditors are experts in their company's internal controls. External auditors have difficulty duplicating this expertise.

Public accounting firms win outsourcing contracts through better prices. External auditors claim that they can perform audits with less overall cost than the internal audit function requires. Internal auditors, without a doubt, are more expensive per hour. However, they are less expensive overall. External auditors may be able to perform internal audits more cheaply than internal auditors, but what happens when the company requests special reports or engagements? Quite often, external auditors will recoup internal audit costs by charging more for special requests. Also, over time the price of regular internal audit engagements will increase. Any initial cost benefits from outsourcing may disappear within a couple of years.

Organizations should consider audit rights before they outsource any function. Audit rights allow external auditors to audit the function even though the client does not "own" the function. Functions commonly outsourced include internal audit, payroll, and information systems. Audit rights become an issue because external auditors need to acquire evidence pertaining to financial numbers and internal controls. The auditors may have a difficult time obtaining evidence if a third party "owns" a certain function. External auditors may have a difficult time auditing a third party's systems due to complexity of the systems and the auditors' inexperience with the systems. Third parties will probably not be able to grant the external auditor unrestricted access to the systems and maintain security for the third party's other clients. One way to solve this problem is to allow an independent external auditor to audit the outsourced function. These audits can then be used by internal and external auditors.

Before organizations decide to outsource their internal audit departments, they should objectively review all aspects of the decision. Outsourcing may appear to be beneficial in the short-term, but organizations need to think of their long-term plans. As a company grows and changes, its needs will also change. Once a company has replaced its internal audit department, the department will be very difficult to implement again.

Reporting

Internal auditors face the challenging job of analyzing situations, making judgements, and reporting results to management. Internal auditors generate reports for the staff, management, board of directors, and audit committee. How do auditors satisfy the needs of all the report users?

If organizations have an audit committee, internal auditors should report directly to the committee. The audit committee should be held accountable for the internal auditors. If an organization does not have an audit committee, internal auditors report to a vice-president of finance or the board of directors. Stockholders prefer internal auditors to report to an audit committee because the audit committee is independent of the actions within the company. If the vice-president of finance manages the internal audit department, he/she may have conflicting roles--improving the company's financial results versus reporting bookkeeping errors and suspicious accounting practices.

What characteristics does an effective audit committee possess? Audit committees consist of three to seven members (preferably with an odd number) who are outside members of the board of directors. The audit committee sets the internal audit charter, reviews internal audit work, selects external auditors, determines what type of audits to perform, examines financial reports, and discusses irregularities and errors. Audit committees, as a whole, should have knowledge in accounting, auditing, and the law.

The director of internal audit should meet with the audit committee at least once a year to update the committee on the department's work and to receive feedback from the committee. All internal audit reports and findings should be submitted to the audit committee. Audit committees should support internal audit's mission by supplying internal audit with needed resources and authority. The audit committee should also set a tone which unmistakably places great pride, respect, and importance on the internal audit function.

Internal audit prepares many different types of reports for different purposes. Since one of internal audit's main purposes is determining whether effective controls exist, reporting on internal control is essential. Congress recently passed a law which requires banks to report on internal controls. This requirement may be enacted for other industries too.