ESTABLISHING AN EFFECTIVE
Internal Audit Department

It's a critical part of corporate governance and a good way to advance your business.

BY HUGH D. PFORSICH; BONITA K. PETERSON KRAMER, CMA, CPA, CIA; AND G. RANDOLPH JUST, CMA, CPA, CIA

The demand for internal auditing services has skyrocketed with two recent events.

First, Section 404 of the Sarbanes-Oxley Act (SOX) mandated public companies to include with their annual report an internal control report that contains an assessment by management of the effectiveness of the company's financial reporting internal control system. Internal auditors have the technical expertise and professional objectivity to assist in this assessment process.

Second, the New York Stock Exchange required all listed companies to "maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control" by October 31, 2004. But the benefits of an internal audit department aren't unique to public companies. They are also applicable to private companies.

If you are wondering how to establish an effective internal audit department, The Schwan Food Company did just that with the help of Randy Just, one of the co-authors of this article, when he was the chief audit executive (CAE) at the company. Sadly, Randy died unexpectedly in January. He added a tremendous amount to the body of knowledge on establishing an effective internal audit department, and his contributions will be sorely missed. His co-authors dedicate this article to his memory.

WHY ESTABLISH AN INTERNAL AUDIT DEPARTMENT?

The motto of the internal audit department (IAD) at Schwan is "advancing the business." There are a multitude of ways in which internal auditors can help accomplish that objective. First, an effective IAD can help a company reach its goals by helping management improve controls, business processes, and business risk management. Second, internal auditors serve a critical role as part of the corporate governance structure by ensuring that the com-

pany achieves its objectives in an ethical, legal, and well-governed manner.

Third, internal auditors help fight the battle against fraud. In 2004, the Association of Certified Fraud Examiners (ACFE) obtained data on 508 fraud cases totaling more than $761 million in losses. In the resulting *2004 Report to the Nation*, the ACFE stated that approximately 57% of the victim organizations in its study had an internal audit function and that those organizations suffered a median fraud loss of $80,000 compared to median losses of $130,000 for companies without internal audit departments. This result is similar to the ACFE's 2002 study where the median fraud losses were $87,500 for entities with internal auditors vs. $153,000 for those without.

The IAD is a critical part of corporate governance along with senior management, the audit committee, and the external auditors. Internal auditors can be considered the eyes and ears of management as well as the corporate conscience. Given its importance, how should a company begin to establish an effective IAD?

START WITH THE LEADER

Finding a qualified department head is a crucial first task. Not only should the chief audit executive possess the necessary internal audit technical skills, but he or she should also be able to gain respect from both management and the audit committee. Good communication skills, objectivity, and strong moral character are also desirable characteristics.

The creation of Schwan's IAD was driven by personnel changes in top management. The first nonfamily-member CEO, who had a long and distinguished career in the food business, came on board in 1999. At about the same time, a new audit committee chair began his service. In 2002, a new CFO was hired who had extensive public accounting experience.

This new leadership helped the company slowly make changes. It improved the governance structure by establishing an internal audit department while retaining the positive aspects of the company's corporate culture, including its high standards of ethics, values, and hard work. Thus, the creation of the IAD was part of a company-wide effort to improve control and governance structures for a privately held but global company that had the goal of doubling in size from 2002 to 2007.

After conducting a regional and national search through a recruiting firm, the management team chose Randy Just to be their CAE. He brought with him extensive public accounting and internal auditing experience.

History of The Schwan Food Company

The Schwan Food Company began in 1952 with one man and one truck. Marvin Schwan, the founder, was the son of German immigrants who came to the U.S. in 1920. He and his parents ran a creamery in Marshall, Minn., but were having trouble making ends meet. Marvin discovered that, because of government pricing structures, he could sell ice cream for a few cents more in Yellow Medicine County, immediately north of Marshall. On March 18, 1952, he borrowed some dry ice bags, and, with a used 1946 Dodge panel van, he headed north with 14 gallons of ice cream. He knocked on farmhouse doors and sold all the ice cream. The next day he did the same thing again. Now, 54 years later, Schwan has gone from one man and one truck to 6,500 drivers in the home delivery part of the business, which constitutes approximately 40% of the company's total revenues. In addition to home delivery, Schwan's primary business units have grown to include its global consumer brands and its food services group. The global consumer brands manufactures, markets, and delivers frozen foods to grocery, warehouse, club, and convenience stores across the country. The food services group manufactures, markets, and distributes value-added frozen food products to public and private schools, universities, healthcare facilities, convenience stores, and chain restaurants. Today the company's workforce consists of approximately 24,000 people.

Table 1: Business Risk Assessment Interview Topics

The following questions and topics are intended as an overview of the type of discussion we would like to foster through our risk assessment interview process. Please use this information as a guide for our discussion. It does not have to be filled out in advance.

OVERVIEW

1. Discuss business strategies for your area of responsibility.
2. Discuss key business processes performed within your area of responsibility.
3. Discuss key business initiatives: current, upcoming, and/or ongoing.

RISKS

1. What business risks do you see within your area? (See attached list of potential business risk factors.)
2. Can you estimate the likelihood of these risks occurring? (Example: high—very likely this will happen; medium; low)
3. Can you estimate the impact of these risks? (Example: high impact; medium; low)
4. Do you have a process for measuring and identifying these risks?

CONTROLS

1. Briefly describe what controls are in place to protect against these risks.

OTHER ITEMS

1. Do you have other areas of concern outside your immediate responsibilities?

Business Risk Categories and Risk Factors (for discussion)

RISK CATEGORY	RISK FACTORS	
External Environment	◆ competition	◆ industry
	◆ financial markets	◆ owner relations
	◆ political	◆ business interruption
	◆ regulatory	
Control Environment	◆ support	◆ legal
	◆ measurements	◆ strategic
Infrastructure	◆ leadership	◆ information management
	◆ human resources	
Marketing & Selling	◆ product branding	◆ product development
	◆ satisfaction	◆ products
	◆ services	◆ marketing
	◆ distribution channels	◆ competition
Supply Chain	◆ purchasing	◆ raw material management
	◆ cost	◆ vendor management
Liquidity	◆ cash flow	◆ exchange rates
	◆ assets	◆ taxation
	◆ cost of capital	◆ funding requirements
Operations	◆ processes	◆ finished product management
	◆ production cycle	◆ contingency planning
	◆ capacity	
	◆ incentives	

THE CHARTER AND MISSION

Once the CAE is hired, he/she should lead the development of the written audit charter, which sets forth the purpose, authority, and responsibilities of the IAD. Such a charter, which should be approved by the audit committee on behalf of the board of directors, is crucial for sending the message throughout the organization that internal auditing is viewed as a priority and has the endorsement of both executive management and the audit committee.

The charter should also clearly establish the independence of the IAD because it's critical that internal auditors be organizationally independent of management in order to enhance their effectiveness. This independence allows the auditors to perform their work objectively and without bias or concern that they would be unduly influenced by management.

Schwan decided its IAD should report directly to the CFO for administrative purposes. For purposes of governance, it established an advisory relationship between the IAD and the board's audit committee. But these relationships, whether direct reporting or advisory, were flexible, depending on the styles of individual managers. Schwan's audit committee chair was very "hands on" and viewed his relationship with the IAD to be as direct as the CFO/IAD relationship.

The audit charter protected the IAD's independence by ensuring full access by the CAE to the audit committee and protecting the CAE from removal without the approval of the audit committee. In addition, Schwan's audit committee charter established that the IAD was accountable to the board of directors through the audit committee.

The IAD mission statement should be specified in the charter. The mission of Schwan's IAD was:

"To provide independent, objective assurance services designed to add value and improve the Schwan Company's operations. The IAD helps the organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of the overall control environment and the network of enterprise business risk management control and governance processes."

This mission statement is almost verbatim with the Institute of Internal Auditors' approved definition of the purpose of internal auditing. In other words, the department's mission corresponds with Schwan's overall mis-
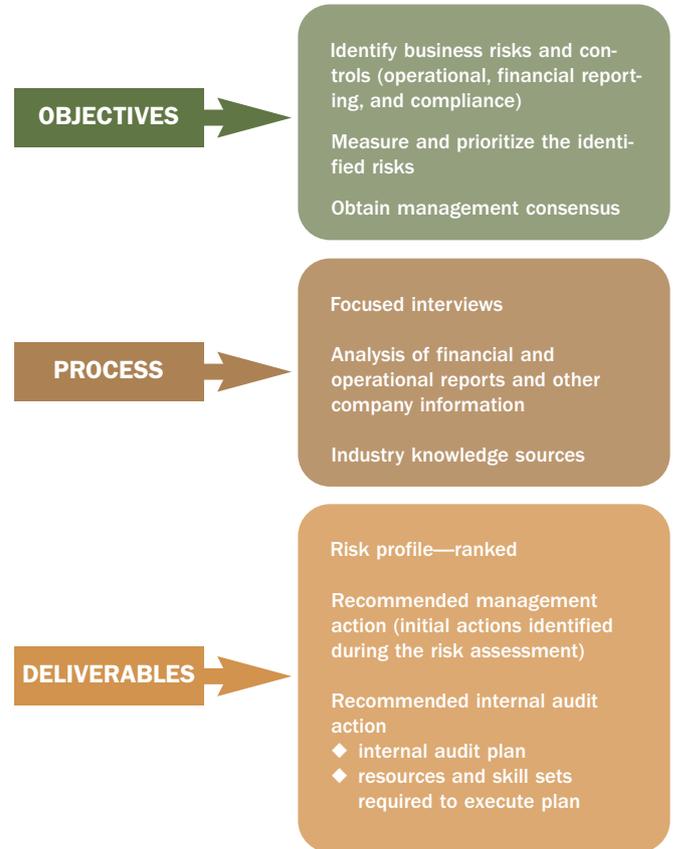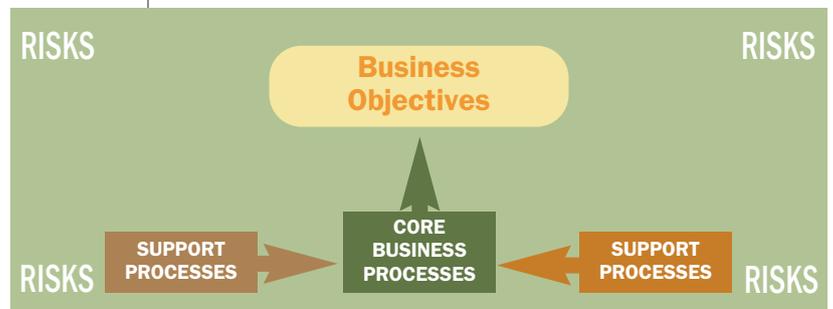
Figure 1: Risk Assessment Overview

OBJECTIVES
- Identify business risks and controls (operational, financial reporting, and compliance)
- Measure and prioritize the identified risks
- Obtain management consensus

PROCESS
- Focused interviews
- Analysis of financial and operational reports and other company information
- Industry knowledge sources

DELIVERABLES
- Risk profile—ranked
- Recommended management action (initial actions identified during the risk assessment)
- Recommended internal audit action
  - ◆ internal audit plan
  - ◆ resources and skill sets required to execute plan

Figure 2: Risk Assessment Framework

RISKS | RISKS | RISKS | RISKS

Business Objectives

SUPPORT PROCESSES → CORE BUSINESS PROCESSES ← SUPPORT PROCESSES

sion in that the IAD exists to help the company reach its goals and achieve its business objectives in an ethical, legal, well-governed manner. This mission is accomplished by helping improve controls, business processes, and business risk management.

To promote good relations and introduce the IAD's mission at Schwan, Randy Just initially met with all the members of executive management and then the senior management to gain an understanding of their expectations. Through these meetings he was able to introduce

Table 2: Examples of Residual Risk Ratings

Risks and controls are compiled by process. The average ratings per process are used to construct bar charts.

DESCRIPTION OF RISK	PROCESS	PROBABILITY	P	IMPACT	I	P X I	CONTROL EFFECTIVENESS RATING	C	DESCRIPTION OF CONTROL/ RESPONSE	REVISED PROBABILITY	P2	REVISED IMPACT	I2	P2 X I2
Uncertainty of exchange rates and volatility of oil price makes profit assurance difficult.	Treasury and Finance	likely	4	moderate	3	12	weak	1	No preventive controls are available. Management monitors profitability levels. Hedging is not performed by Sub. ABC Co. — US performs any hedging activity.	likely	4	moderate	3	12
Risk related to the inaccurate forecast of volume requirements of ABC company.	Procure materials	moderate	3	major	4	12	strong	3	Specialize in the farm-to-fryer concept. Employs geographic diversification to help mitigate risk.	moderate	3	moderate	3	9
Poor visibility of inventory distribution chain can result in product stock-outs and oversupply.	Manufacture products	likely	4	minor	2	8	moderate	2	Moving from weekly to daily order processes and a more automated replenishment process.	moderate	3	minor	2	6

Gross Risk Ratings

Residual Risk Ratings

internal auditing as a service function charged with helping management to achieve company objectives rather than as something to fear or view as a threat.

STAFFING THE DEPARTMENT

Based on the analysis of Schwan's external auditor, the audit committee and senior management decided to staff the IAD with 10 internal auditors supported by an annual budget of approximately $1.63 million. The size of the function was expected to increase as the company grew. Ideally, Just wanted people at the senior and manager level to have public accounting experience as well as internal auditing work in industry. He recognized that it wasn't possible to find people at the staff level with that combination of experience. He staffed the IAD so it possessed a fairly broad-based assortment of expertise in financial, operational, compliance, and information systems auditing.

Initially, the greatest challenge was convincing qualified people to relocate to Schwan's corporate headquarters in Marshall, Minn., a community three hours from Minneapolis with a population of 12,000. While this is an attractive community for individuals with a family-based lifestyle, it was a hurdle to overcome in seeking to completely staff a new IAD. The company used industry contacts to recruit staff in addition to receiving assistance from outside recruiting organizations. After a few months, Schwan was able to fill all the positions.

OVERALL STRATEGY

Once the staffing was completed, Just worked with two of his managers to develop a risk-based assessment methodology tied to the COSO (Committee of Sponsoring Organizations of the Treadway Commission) internal control framework and a consumer products business process model. The IAD used this risk-based approach to determine the scope of its services.

As part of this risk assessment process, Just reviewed the strategic plans of the company and its business units. The IAD's efforts focused on the key areas and objectives on which the company and the business units focused. This was accomplished by having auditors meet with executives at the various business units and walk through a questionnaire they developed as part of the risk-based assessment approach (see Table 1).

The IAD then weighted and prioritized potential projects across all the business units, giving consideration to the volume of their activities and their importance to the company's overall strategic plan (see Figure 1).

Table 3: Schwan Audit Services Client Satisfaction Survey

	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree	No Basis to Respond
1. I was pleased with Audit Services':						
a. Knowledge	○	○	○	○	○	○
b. Professionalism	○	○	○	○	○	○
c. Communication	○	○	○	○	○	○
Please provide comments:						
2. Audit Services respected my existing workload:	○	○	○	○	○	○
Please provide comments:						
3. The objectives, purpose, and scope were clearly communicated to me:	○	○	○	○	○	○
Please provide comments:						
4. Communication of results and status was timely and adequate:	○	○	○	○	○	○
Please provide comments:						
5. My business concerns and perspective were adequately considered:	○	○	○	○	○	○
Please provide comments:						
6. The action items made business sense:	○	○	○	○	○	○
Please provide comments:						
7. Overall, this audit or project provided value to me:	○	○	○	○	○	○
Please provide comments:						
8. I consider Schwan Audit Services to be a valuable business partner:	○	○	○	○	○	○
Please provide comments:						

9. Please provide recommendations that would improve the process:

RISK-BASED ASSESSMENT

The risk assessment framework closely incorporated the concepts of risk and control. Schwan established business objectives at all levels of the company from corporate down through each business unit. To achieve these objectives, it put in place core business processes that were groupings of related business activities (e.g., procure materials, manufacture products, distribute products, sell products, serve customers). The core business practices were supported by processes that provided resources and services to them.

Risks threaten the achievement of business objectives at all levels, while controls are the activities put into place to manage or mitigate the risks (see Figure 2). Controls are often built into the core business processes and support processes.

Within each process, the IAD assessed:
◆ Gross risk (threats or impediments to the accomplishment of corporate or process objectives),
◆ Strength of relevant controls and management's response to the identified risks, and
◆ Residual risk (a reevaluation of risk in light of controls and management's response).

The IAD rated the risks based on the magnitude of the impact of the risk as well as its probability. They conducted residual risk assessments through focused interviews with multiple levels of management, a review of business plans, analysis of financial and operational reports, and a review of miscellaneous information (e.g., industry information, process documentation). For validation, they discussed the assessment results with the appropriate levels of management.

At Schwan, food quality and safety is one area of continual vigilance. Every single batch of raw materials or product that comes into Schwan's factories is tested for contamination, and the IAD assesses a gross risk of contamination of raw materials at a certain level. As a result of Schwan's very stringent controls, residual risk has been assessed as extremely low. (For more examples, see Table 2.)

ASSESSING EFFECTIVENESS

On average, Just reviewed the status of the internal auditing plan with the auditing committee five times a year. The main criterion against which the success of the IAD was measured was whether the internal auditors were adding value. For example, were the major projects being performed? Was the IAD receiving requests from the business units for other projects?

Just budgeted approximately 80% of the internal audit staff time for projects identified through the risk assessment process, leaving 20% of their time open for emerging priorities. In its first year, the department received a large number of requests for other projects, and that was clearly viewed as a substantial measure of success.

During the meetings with the audit committee, Just also reported what percentage of the audit plan was complete, although that wasn't the primary measure of success since the IAD was created to address risk as it arises. Consequently, the annual internal audit plan could be revisited throughout the year and changed as need dictated.

Another major measure of success was the open acceptance by the business units and their willingness to work with the internal auditors. On the audits that came up in the risk assessment process, company personnel were willing to offer ideas on areas where they felt they could use audits, and they called the internal auditors for projects.

For additional monitoring of the effectiveness of the IAD, Just implemented a nine-question, Internet-based client survey that was used to gather input and feedback from the audit customers about each of their projects (see Table 3). As time passes and the IAD becomes more established, other metrics of success could be developed such as the percentage of audit recommendations implemented by the various business units. ■

Hugh D. Pforsich, Ph.D., is an assistant professor of accounting in the Accountancy Department at California State University-Sacramento. You can reach him at (916) 278-7141 or pforsich@csus.edu.

Bonita K. Peterson Kramer, CMA, CPA, CIA, Ph.D., is a professor of accounting at Montana State University-Bozeman. You can reach her at (406) 994-4620 or bonitap@montana.edu.

G. Randolph Just, CMA, CPA, CIA, CFE, CISA, CFSA, CCSA, was vice president, Audit Services, at Allina Hospitals & Clinics in Minnetonka, Minn., when he died in January. He was previously chief audit executive for The Schwan Food Company.