ESTABLISHING AN EFFECTIVE INTERNAL AUDIT FUNCTION
OCTOBER 2015

The presentation will begin shortly.

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WITH YOU TODAY

Vicky Gregorcyk
National Advisory Practice Leader
BDO USA, LLP
vgregorcyk@bdo.com

Brian Hayden
Director of Internal Audit
Paragon Offshore
BHayden@paragonoffshore.com

Neil Frazer
Director of Internal Audit
Leviton
Nfrazer@leviton.com

Dawn Williford
RAS Houston Practice Leader
BDO USA, LLP
dwilliford@bdo.com

Amy Rojik
National Assurance Partner
BDO USA, LLP
arojik@bdo.com

LEARNING OBJECTIVES

Upon completion of this course participants will be able to:

- Describe the role the IA function plays in the risk management of an organization.

- Recognize the structuring options for establishing an IA function and determine which structure may be most beneficial to your organization.

- Describe the audit committee's oversight role of the IA function in assessing adequacy of corporate governance.

- Identify the key elements of the IA methodology to be properly applied in designing an approach and framework.

AGENDA

- Assessing the Need for Internal Audit
- The Roles & Functions of Internal Audit
- Value Proposition – Why Internal Audit?
- Establishing An Internal Audit Function
  - Structure Options: Advantages and Disadvantages
  - IA Reporting Lines
  - Audit Committee Oversight
  - Key Skills for IA
  - Technology and Tools
- IA Methodology:
  - Business Risk Assessment
  - Approach & Framework
- Resources

ASSESSING THE NEED FOR INTERNAL AUDIT

- Growth of the business – E.g., rapid growth, small company to much larger over time; expected growth)
- Recognized need given certain events – E.g., fraud; errors due to lack of controls
- Importance of internal controls to the board/leadership
- Structure of the company – E.g., decentralized; geographic footprint; international expansion; etc.)
- More attractive to investors – E.g., private equity; banks
- Preparation for IPO
- Recent IPO
- Public company requirements

THE ROLES & FUNCTIONS OF INTERNAL AUDIT

"The role of internal audit is to provide independent assurance that an organization's risk management, governance, and internal control processes are operating effectively."
Source: Institute of Internal Auditors

The scope of the work of internal audit can encompass many aspects of an organization's operations and activities.

Internal Audit guidance: *Institute of Internal Auditors (IIA) Standards*
https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx

THE ROLES & FUNCTIONS OF INTERNAL AUDIT

- Monitor and assist the Company with Risk Management

- Assist with documentation and development of the Company's internal control framework

- Monitor/test the effectiveness of the internal control framework (SOX 404 requirement; some testing recommended for all companies)

- Monitor/test the company's operational processes for compliance, efficiency, safety, etc.

VALUE PROPOSITION – WHY INTERNAL AUDIT?

- Structured approach to assessing and monitoring the Company's risks

- Heightened awareness of controls and driver of behavior

- Change agent for key processes (operational, financial and compliance)

- Provides visibility of the processes and controls and issues to the Audit Committee

- NYSE listed companies requirement

ESTABLISHING AN INTERNAL AUDIT FUNCTION
STRUCTURE OPTIONS: ADVANTAGES AND DISADVANTAGES

Option A – In-House

- In depth understanding of the every day aspects of the Company.
- Recruitment time and effort/tight labor market for experienced IAs.
- Heads of IA commanding basic salary of $200K+.
- Senior Executives always have access to the IAD/VP/CAE
- Requires significant investment to ensure the latest IA methodology and technology.

Option B – Co-Sourced

- Can be less expensive than in-house function and provides access to specialized skill sets from co-source partner.
- Options for degree of outsourcing (extra staff for busy times, specialized expertise, etc.)
- May require an external IA partner to fill skill & resource gaps – e.g., IT & regulatory knowledge)
- Allows for advantages of A-- knowledge of Company and Senior Executive access to IAD/VP/CAE and many advantages of C.

Option C - Outsourced

- Minimal time required to establish IA function
- Can be most cost effective solution.
- Access to experts in the industry, access to information and trends that a firm understands from having large client base in internal audit.
- May not have access to leader on an everyday basis. May be harder for IA leader to stay abreast of changes/events in the Company on a real-time basis.

ESTABLISHING AN INTERNAL AUDIT FUNCTION

Initial Actions:

- Develop IA audit charter & framework

- Agree process to be followed in developing the IA plan

- Decide on extent to which induction sessions will be held to familiarize management with the new IA function

- Agree on a S/T program of interim assignments (*before* risk assessment is completed)

- Develop risk registers with a view to drafting a more developed one year audit plan for approval by the AC after the risk assessment is finished

- Agree on initial reviews to start about a month after appointment.

Days 1-14	**START UP PROCESSES**
	• Develop IA charter
	• Agree reporting lines for IA
	• Agree programs, terms of reference, reporting style, etc.

| Days 15-28	**INITIAL MEETINGS**
	• With Executive Management team
	• With Chair of the Audit Committee
	• With key operational staff
	• With your external auditors
	• Development and agreement of your IA plan

Days 29-42	**PLANNING**
	• Agreement (with relevant individuals) of scope of selected audits
	• Approval of scope of work for selected audits and approval of timeline for audits
	• Carry out planning stage above for next audits

Days 42-90	**REVIEWS**
	• Selected audit reviews commence
	• Draft report issued
	• Management responses and final report issued
	• Presentation of reports to the Audit Committee

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INTERNAL AUDIT REPORTING LINES
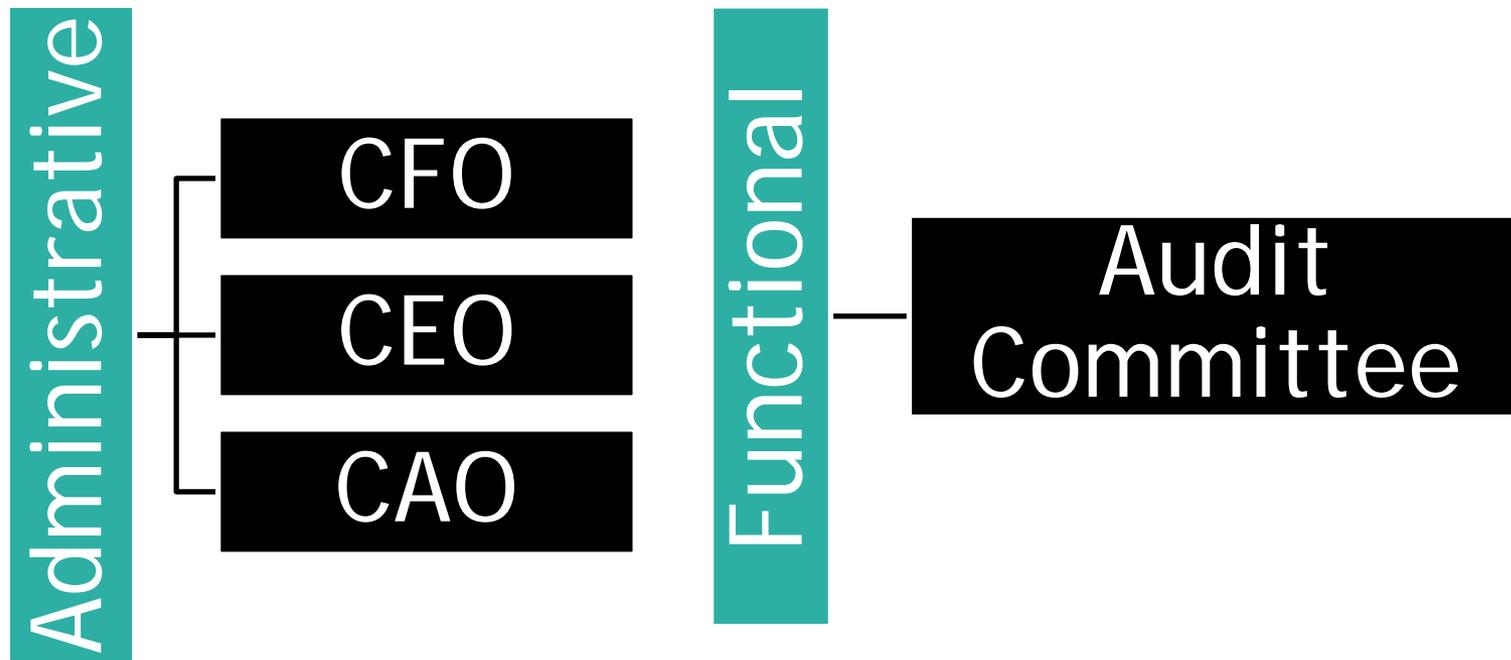
AUDIT COMMITTEE OVERSIGHT

Audit Committee oversight responsibilities with respect to Internal Audit:

- Review with management and the chief audit executive the charter, plans, activities, staffing, and organizational structure of the internal audit function.

- Ensure there are no unjustified restrictions or limitations, and review and concur in the appointment, replacement, or dismissal of the chief audit executive.

- Review the effectiveness of the IA function, including compliance with The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing.*

- On a regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal audit believes should be discussed privately.

Source: IIA Sample Audit Committee Charter

AUDIT COMMITTEE OVERSIGHT CHECKLIST

- ❑ The AC engages in open, transparent relationship with the chief audit executive (CAE).

- ❑ The AC reviews and approves the IA charter annually.

- ❑ As a result of discussions with the CAE, the AC has a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems.

- ❑ IA audit activity is sufficiently resources with competent, objective IA professionals to carry out the IA plan, which has been reviewed and approved by the AC.

- ❑ IA activity is empowered to be independent by its appropriate reporting relationships to executive management and the AC.

- ❑ The AC addresses with the CAE all issues related to IA independence and objectivity.

- ❑ The IA activity is quality-oriented, and has in place a Quality Assurance and Improvement Plan.

- ❑ The AC regularly communicates with the CAE about the performance and improvement of the CAE and the IA activity.

- ❑ IA reports are actionable, and audit recommendations and/or other improvements are satisfactorily implemented by management.

- ❑ The AC meets periodically with the CAE without the presence of management.

Source: IIA's *"The Audit Committee: Internal Audit Oversight"*

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KEY SKILLS FOR INTERNAL AUDITORS

Education/Background

1. Accounting
2. Finance
3. MIS
4. Business Degree usually preferred
5. Work history can include accounting, operations, finance, internal audit, risk management, public accounting, industry, engineering, etc.

A diverse internal audit group is key to a well rounded group that can assess financial, operational and compliance risks for the company.

Certifications

1. CPA – Certified Public Accountant
2. CIA – Certified Internal Auditor
3. CISA – Certified Information System Auditor
4. CRMA – Certification in Risk Management Assurance
5. CFE – Certified Fraud Examiner

There are several certifications available, some that are specific to industries, such as government. The above represent some of the most common found in the profession

Source: IIA's *"The Audit Committee: Internal Audit Oversight"*

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TECHNOLOGY & TOOLS
IA WORK DASHBOARD - METHODWARE
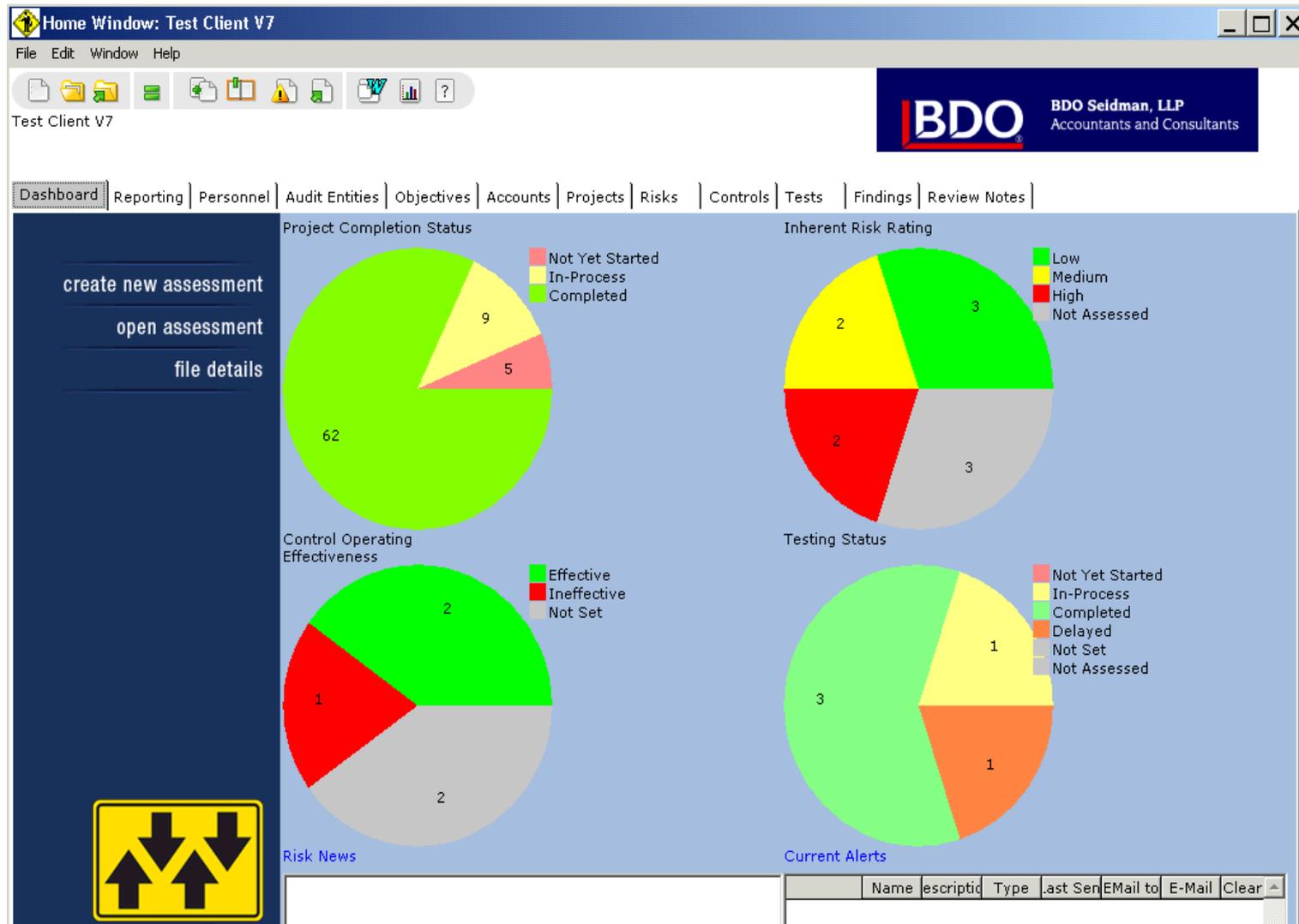
TECHNOLOGY & TOOLS

Technology	Description	Benefits
methodware / enterprise risk assessor	**Enterprise Risk Assessor (ERA), by Methodware** – This tool ERA is a scalable, flexible and cost effective software solution designed to help organizations manage risk-related data and its associated assessment processes and reporting.	ERA allows your organization to integrate all common GRC data elements such as risks and controls, related assessments and audits in a central repository. A configurable dashboard displays at-a-glance graphical summaries of your risk and audit information.
BDO Seidman, LLP Accountants and Consultants WorkSite MP	**Worksite MP** – Knowledge database that contains our methodologies and enablers, Process Models and Risk Universe, Leading Practices, professional Standards and Frameworks, such as COSO ERM and COBIT, and Implementation guidance for International Regulations such as SOX, JSOX, and Basel II.	This tool provides efficient access to critical knowledge required to bring value to IPG's overall Risk Management activities. This knowledge will be shared with IPG personnel to assist them in the performance of audits or other work.
IDEA Data Analysis Software / Oversight	**Data Analytic Tools** – These are transaction monitoring tools used to identify fraud, misuse, errors and controls violations. These tools are routinely used to analyze numeric and non-numeric information, verify calculations and scan for trends and anomalies.	These tools facilitate the review of an entire population of data rather than relying on smaller sample sizes. Use of this tool should drive better risk coverage and management insight into critical processes and transaction streams.
SAP / ORACLE	**Controls Assessment Tools** – These tools are used to audit and monitor security and control settings within ERP applications such as Oracle and SAP.	These tools facilitate the auditing of ERP systems by providing pre-identified risk and controls specifically related to that system; provide guidance as to which

RISK ASSESSMENT:
BUSINESS RISK ASSESSMENT

BUSINESS OBJECTIVES AND GOALS

Gain a firm understanding of management and the Audit Committee's goals and objectives in achieving success. Gain a firm understanding of the business risks (operational, financial, compliance, information technology and systems, strategic). **Includes:** Direct input from key members of senior administrative officials and the Audit Committee; assessment governance documentation, key reports and other relevant documentation in order to gain a full understanding of goals and objectives for a clear result.

INTERNAL AUDIT METHODOLOGY:
BUSINESS RISK ASSESSMENT

The emergence of risk assessment and risk management in the global marketplace has given rise to several risk and control frameworks. BDO's methodology has captured valuable and important concepts and principles from several of these frameworks. The following is a graphic of our Business Risk Assessment Methodology:

Understand business goals, objectives, and strategies				
Inventory and assess events, weaknesses, and threats	Assess business risks	Evaluate risk strategies and controls	Evaluate likelihood and impact (i.e. gross and net)	Execute monitoring strategies • Internal audit • Self assessment
Assess risk tolerance and risk appetite				
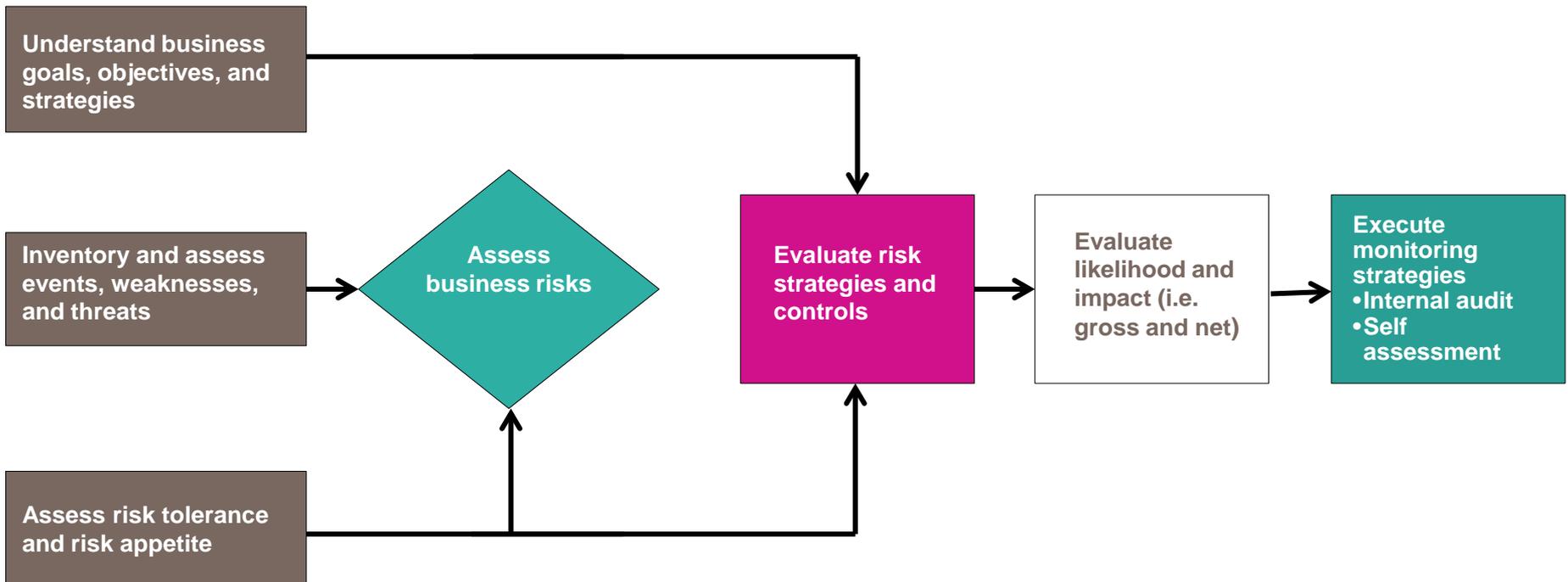
Risk Categories: Our approach evaluates all significant processes and sub-processes within finance while considering fraudulent risk.

INTERNAL AUDIT METHODOLOGY:
BUSINESS RISK ASSESSMENT

EXHIBIT 4: EXAMPLE OF AN INTERNAL AUDIT SCHEDULE

#	ENTITY/ PROJECT	2015	2016	2017
1	Business Risk Assessment and Audit Planning	R	R	R
2	Assertion Sourcing / Controls Rationalization	R	R	R
3	Packaging Materials Manufacturing	IA		
4	Equipment Manufacturing		IA	
5	Sales			IA
6	Commissions	IA		
7	Transfer Pricing		IA	
8	Debt Management			IA
9	Accounts Payable	IA		
10	Treasury		IA	
11	Vendor Pricing			IA

KEY:
R – Recurring Activity
IA – Internal Audit – Once per three year cycle

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INTERNAL AUDIT METHODOLOGY:
BUSINESS RISK ASSESSMENT

EXHIBIT 3: EXAMPLE OF AN INTERNAL AUDIT PLAN

#	PROCESS AREA	PROJECT NAME	BUSINESS IMPACT (INHERENT RISK)	LIKELIHOOD/ RISK OF PROBABILITY	AUDIT OBJECTIVE	PROJECT DESCRIPTION
1	Customer Operations	Customer Complaints Process	Medium	Medium	▶ Ensure the process to collect, monitor, and reply to customer complaints is sufficiently effective to ensure sufficient quality and integrity of customer care.	▶ Evaluate the process to collect, monitor, and respond to customer complaints. Evaluate measures to track such issues as timeliness of response, difficulties encountered, and customer feedback.
2	Finance and Accounting	Treasury Process Review	Medium	High	▶ Ensure the process over cash receipts and disbursements accounts for all funds effectively and efficiently.	▶ Assess the process to control the receipt, disbursement, and movement of funds across all operations of the Company.
		Procurement, Purchasing, and Payables	High	Medium	▶ Ensure that corporate purchasing and payables practices operate with integrity and efficiency, and optimize contractual arrangements with vendors.	▶ Assess the integrity and efficiency of controls related to procurement, purchasing, and payables processes. ▶ Evaluate areas of high expense and invoice transaction processing to determine if optimal purchasing arrangements have been established for the Company.
3	Payroll / Human Resources	Payroll Processing	High	Low	▶ Ensure the accuracy and completeness of selected payroll processing controls.	▶ Evaluate the design of internal controls related to payroll processing to ensure objectives are achieved effectively and efficiently.

INTERNAL AUDIT METHODOLOGY:
APPROACH AND FRAMEWORK

For many IA functions, having more stakeholders with multiple and differing risk coverage needs has created a situation of competing priorities between compliance requirements and broader ERM concerns. IA functions are compelled by the renewed focus on risk management to align their risk coverage to meet stakeholder needs. The skill sets of IA resources and additional investments must also be aligned to meet these risk coverage needs.

BDO's approach is based on a widely accepted COSO Internal Control evaluation framework and Institute of Internal Auditors (IIA) Standards. The IA framework is comprised of five iterative phases

Engagement Planning

Audit Scoping

Control Adequacy Assessment

Control Effectiveness Assessment

Reporting & Monitoring

1
2
3
4
5

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RESOURCES

INTERNAL AUDIT RESOURCES

- Leveraging COSO Across Three Lines of Defense: https://na.theiia.org/standards-guidance/Public%20Documents/2015-Leveraging-COSO-3LOD.pdf

- Pulse of Internal Audit: https://na.theiia.org/services/Pages/Pulse-of-the-Profession-Study.aspx

- The Framework for Internal Audit Effectiveness: International Professional Practices Framework: https://na.theiia.org/standards-guidance/Pages/New-IPPF.aspx

- The Audit Committee: Internal Audit Oversight: https://na.theiia.org/about-ia/PublicDocuments/08775_QUALITY-AC_BROCHURE_1_FINAL.pdf

- CAQ Intersecting Roles: Fostering Effective Working Relationships Among External Audit, Internal Audit, and the Audit Committee: http://www.thecaq.org/docs/reports-and-publications/caq-intersecting-roles-report.pdf?sfvrsn=4

BDO BOARD GOVERNANCE - PUBLICATIONS

Available at: https://www.bdo.com/services/assurance/board-governance/overview

- Q3 2015 Significant Accounting and Reporting Matters
- FASB Votes to Affirm the Proposal to Require Classification of All Deferred Income Taxes as Noncurrent
- FASB Issues ASU to Simplify the Accounting for Measurement-Period Adjustments
- SEC Publishes Request for Comment on Regulation S-X
- FASB Makes Tentative Decision With Respect to Disclosure of Unrecognized Tax Benefits
- Continuous Monitoring
- FASB Issues ASU to Add SEC Staff Announcement About Loan Costs to the Codification
- SEC Adopts Rule Requiring Pay Ratio Disclosures

- FASB Issues ASU to Provide Guidance on Application of Normal Purchases and Sales Scope Exception
- PCAOB Audit Quality Indicators and SEC Audit Committee Disclosure Fact Sheets for Audit Committees
- PCAOB Issues Proposal to Improve Transparency & Provide Insight into Audit Quality
- FASB Issues ASU to Defer Effective Date of the New Revenue Standard
- BDO Knows: Variable Interest Entities (Practice Aid)
- FASB Issues ASU to Simplify Financial Reporting by Employee Benefit Plans
- FASB Issues ASU to Simplify the Measurement of Inventory

For a complete listing of BDO publications, refer to: https://www.bdo.com/insights/

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BDO BOARD GOVERNANCE - WEBINARS

Upcoming BDO Governance and Financial Reporting Knowledge Webinars:

- Effective Audit Committees – November 9
- Quarterly Technical Update (Q4 2015)* - January 7, 8 and 11

Registration will be available shortly on https://www.bdo.com/events

Recent Archived Webinars:

- Quarterly Technical Update (Q3 2015) – October 2015
- The Board's Role in Anticorruption Compliance – October 2015
- Revenue Recognition Transition Resource Group 2015 Update – September 2015
- Quarterly Technical Update (Q2 2015) – July 2015
- How ASU 2015-02 Changes Consolidation Accounting - May 2015
- Data Analytics and Risk Management – A Board Primer – April 2015
- 2015 Q1 Technical Update – April 2015
- 2015 Executive Pay Outlook for Mid-Cap Companies – March 2015
- What's On the Minds of Boards – January 2015

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▶ **Board Governance** — Resources that include BDO's proprietary studies, publications, practice aids, and educational programs to keep board members of both public and private companies up to date on emerging issues and trends to assist in fulfilling their corporate oversight responsibilities. Such resources contain customized information for the various committees of the board. For example, refer to our Effective Audit Committees in the Ever Changing Marketplace practical guide and related tools. Visit our Insights page on http://www.bdo.com.

▶ **Significant Accounting and Reporting Matters Guide** — Quarterly digest of final and proposed financial accounting standards designed to help audit committees, boards and financial executives keep up to date on the latest corporate governance and financial reporting developments.

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▶ **Technical Research Tools** — BDO uses Accounting Research Manager™ (ARM) as a primary source of insightful interpretations on GAAP, GAAS and Securities and Exchange Commission rules. ARM is updated daily and is considered to be one of the timeliest and most comprehensive online databases of analytical interpretations of accounting, auditing and SEC matters. Access to ARM, and a number of other research tools, provides each professional the technical research capability to respond immediately to client-specific technical issues.

▶ *BDO Knows* **Flash Reports** — Provide briefs about select technical and regulatory developments and emerging issues are made immediately available to BDO professionals and to clients.

▶ *BDO Knows* **Financial Reporting Letters** — Provide more in-depth discussions and practical guidance on technical guidance affecting both public and private entities.

▶ **Industry Newsletters, Alerts, Reports, Proprietary Studies and Surveys** — A variety of publications depicting specific industry issues, emerging trends and developments.

▶ **BDO Knowledge Webinar Series** — An educational series designed to assist those charged with governance (e.g., Audit Committees) and financial executives in keeping up to date on the latest corporate governance, risk management and financial reporting developments. The program is multi-faceted and consists of complimentary CPE webinars and archived self-study courses, covering both broad and specific topics of interest, publications and links to various BDO and external resources.

Additionally, consider our monthly tax series that provide insights and perspectives on the tax issues most important to our clients and their businesses. Visit our Event/Webinar page for a current listing of programming on http://www.bdo.com.

EVALUATION

We continually try and improve our programming and appreciate constructive feedback.

Following the program, we will be sending out a thank you e-mail that contains a link to a brief evaluation.

Thank you in advance for your participation!

CONCLUSION
THANK YOU FOR YOUR PARTICIPATION!

Certificate Availability – If you participated the entire time and responded to at least 75% of the polling questions, click the **Participation tab** to access the print certificate button.

Please exit the interface by clicking the red "X" in the upper right hand corner of your screen.