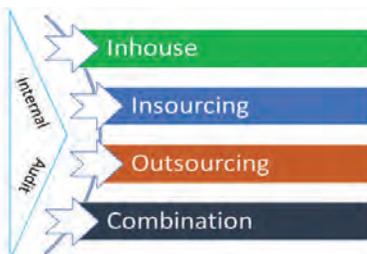


Considerations in Organisational Design for Internal Audit

Internal audit function has witnessed many changes and has evolved to acquire a key position in business. It has moved from being a mere “promoter’s eyes and ears” to carrying out a professional activity with an objective of enhancing Corporate Governance processes. Over the years, with numerous frauds coming to the light, interest of various stakeholders has increased in Corporate Governance. Internal Audit is a key activity deployed by the Board and management to enhance the governance framework. With building of expertise, internal auditors are also looked upon as advisors for adding value to the business apart from their routine assurance activities. Accordingly, the expectations from and responsibility of Internal Auditors has also multiplied. This makes it altogether important to have proper organisational structure for the internal audit department. In this regard, there are many alternatives available on how to structure the department. Internal Audit activity can be carried out by designing it as either:

1. Inhouse (dedicated team); or
2. Insourcing; or
3. by outsourcing; or
4. through a combination of some or all of the above.



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Naturally, all four alternatives have their own pros and cons ranging from cost constraints, flexibility of performance, availability of expertise or time constraints, etc.

Some of the factors driving the best decision are as follows:

1. Size of the business.
2. Complexities of business process.
3. Competitive importance of business process.
4. Availability of competent people with business/ industry knowledge.
5. Tackling high growth challenge.
6. Cost/time pressures etc.



When deciding the organisational structure of Internal Audit department, the main objective is to derive maximum benefit from it. As far as, outright outsourcing is concerned, issue of organisational design is not that important as that will become the prerogative of the firm

engaged. Hence, the importance of organisation design is greater when it is organised in the ways other than absolute outsourcing.

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Today's businesses are operating in a highly dynamic environment. It is not like doing business in pre-globalisation era, when various protections shielded the businesses. Businesses at that time were able to survive despite their high costs, poor quality and not upto the mark service, etc., due to the protectionist policies that prevailed in the countries. But now, with the advent of globalisation and cut-throat competition, companies need to streamline each and every activity to attain an enviable business position or even survival. This is possible only if each and every business activity contributes and is aligned with the overall organisational goals.

Insofar as core areas of business such as production, marketing, finance and supply chain, etc. are concerned, they tend to receive adequate attention by the business managers, business leaders and management thinkers within and outside the organisation. These areas have, most of the time, direct,

measurable and far reaching impact on the business and its survival, hence the recipient of undivided attention from business managers. But in case of internal audit, which is considered more of a support activity, and due to the lack of their visibility and measurability of results, generally less attention is paid towards how Internal Audit department should be organised.

Michael E. Porter, in his article, 'What is Strategy', has emphasised operational effectiveness alone is not enough to gain competitive advantage. He states that the problem with *operational effectiveness* is that best practices can easily be copied by the competition. However, he further states, strategy involves achieving best fit among various activities which they reinforce each other in a unique form, making it difficult for the competition to copy. When we talk about operational effectiveness of various activities and go far beyond by looking at the fitment between those activities with achieving the operational effectiveness, then we cannot afford to neglect any part of business area or activity. This warrants a necessity to pay due attention to the internal audit's operational effectiveness and its fitment with other business activities.

Good corporate governance is the hallmark of any company's success and sustainability over a long period of time.

Generally, internal audit department is very often organised in a haphazard

manner rather than based on stakeholders' expectations or based on a conscious call of management. It exists primarily to serve the immediate needs of the promoter or to address some compliance to legal requirements or to satisfy statutory auditors. It is very rarely a well thought out department keeping in view the organisational goals and the need to align the department with those goals and in the end, ensuring good corporate governance. Good corporate governance is the hallmark of any company's success and sustainability over a long period of time. Even Internal Audit professionals down the line may not be aware of what the organisation is trying to achieve and their own contribution towards this end.

Internal Audit's operational effectiveness and fitment can be achieved in a number of ways. First and the foremost is the prime decision regarding how the internal audit activity is accepted and respected within the organisation. This topic requires separate deliberation and will be covered in another article sometime in the near future. For now, we move forward to evaluate the factors that should be considered in designing the internal audit's structure within the organisation, assuming it to be some form of inhouse/insourcing activity.

Organisational structure is the most neglected area in the internal audit sphere. What the ideal design should be might differ from one organisation to another. Generally, it is observed that various aspects are ignored while designing or adjusting internal audit department to the changing business

dynamics. It goes without saying, internal audit is created to serve the pressing needs of the business / the organisation/ its stakeholders. To a limited extent, it has customers in form of various other business areas/ departments and stakeholders, it renders a set of services (a value proposition- assurance and other services); it has an environment in which it exists, both an internal and an external environment.

Internal Audit has customers; its own organisational design should be such that it is able to serve them well. These customers might differ in hierarchy so far as their importance is concerned. As far as suggestion regarding concrete design for any scenario, topic is not so simple and might require sustained investigation and research in that direction. But design will definitely play an important role in serving the needs of the internal audit and its customers.

The form of organisation design may also differ based on the customer's emphasis on assurance or value addition/problem solving activities, i.e., value proposition. As far as assurance is concerned, it is of routine nature. It requires auditors to follow set procedures and practices to give assurance except for considering key changes that might have transpired in the last year in various processes.

Prerequisite for performing assurance services is independent of the internal audit department. When designing the organisation from this perspective, it requires department's working to be shielded from the influence of other departments and top leadership, so that it can provide assurance service in an unbiased and objective manner.

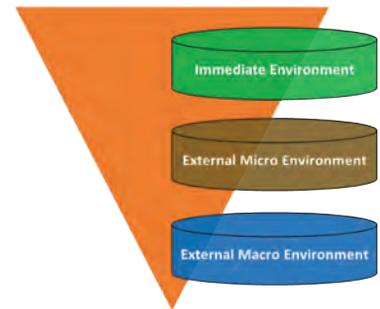
As far as assurance is concerned, it is of routine nature. It requires auditors to follow set procedures and practices to give assurance except for considering key changes that might have transpired in the last year in various processes.

However, when demand is more for value addition/ problem solving part from internal audit, then same organisational design as was considered adequate for assurance services, may not suffice for a value addition proposition. These activities, one can also refer to as consulting services which might include both problem solving and value addition, demand innovative ideas. Rendering of these special services, might ask for deployment of field and professional experts, which requires altogether different sort of organisational design. This is due to the differing cultural requirements and needs, when compared with orthodox style in which at the present movement internal audit organisations are designed.

Now if we consider the environment, internal audit too has both internal and external environment. Its internal environment consists of environment within internal audit department. We can classify remaining environment between following categories:

1. Immediate environment (within organisation)
2. External micro environment (relevant for the internal audit)

3. External macro environment (in which business is operating)



Brief listing of all three types of external environments is given below to provide broad overview:

- Immediate environment consists of environment outside the internal audit department but within the four walls of the organisations. Main components of this environment are – policies, procedures, rules, financial conditions, various budgets, various authorisation limits, manpower types and other resource availability, senior leadership background, management styles, etc. It is an environment created by functioning of various department/activities and management. It might not be specific to the internal audit. Same environment might be experienced by other departments when interacting with each other. Culture of organisation has lot of role to play in creation of this environment or vice-versa. Each department/ activity is dependent upon other department or activity, which leads to reciprocal influence upon each other. Organisations to large extent have control over this immediate environment for each department. But

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same is out of the control of any individual department or activity. This immediate environment might play a major role in the organisation design of internal audit activity.

- External micro environment relevant to the internal audit consists of developments in the field of internal audit in the outside world. These are in the nature of, availability of qualified manpower, available IT solutions, availability of consulting services, knowledge dispensations, etc. This environment more or less is same for all internal audit departments of other companies. Survival in this environment (threat) or taking benefit out of it (opportunities) depends upon the internal environment described earlier and internal audit's capability to cope up with such forces. Internal audit's organisational design plays an important role in it. At the same time, no readymade solution for the design can be given to best fit under differing environmental conditions. It calls for further in-depth study.
- Lastly, the major component is the macro environment which has impact on the business as a whole. About this macro environment, literature is written widely. One way of describing is PESTLE acronym (See the diagram for a snapshot of the concept). Lot of emphasis is paid on this environment by the business houses because it can make or break a company as a whole. Naturally, internal audit too cannot afford to neglect this environment when designing its own structure. There is an overlap

between micro and macro level environment. One can pay attention towards that overlap while designing structure for internal audit.



Beyond routine or innovations in internal audit activities and environmental factors, there are many other considerations which might go into the design of the structure. Such as level of differentiations, i.e., division of labour/specialisation one wants to achieve within internal audit activities. Different set of specialists can be created for different business areas, if company can afford to do so. Level of vertical and horizontal differentiation will depend mainly on two of factors, such as size of organisations and complexities of business. One can establish, if business is big conglomerate, business wise internal audit specialists. Establishing internal audit specialists is also possible on a functional basis.

Centralisation or decentralisation of internal audit activities will depend upon the geographical spread of the business house. Higher level of geographical spread may call for decentralisation of the department but might not be essential due to availability of modern technologies. If the business is a large multinational conglomerate, geographically spread out, then decentralisation can be an option

and may also increase vertical differentiations along various activities. It might also contribute towards horizontal expansion of various roles. Such expansion may have limited utility for regional business houses.

If the organisation really wants to achieve sustained competitive advantage for its business, then internal auditors and business leaders cannot afford to neglect design of internal auditor activities to have proper organisational fit.

How much coordination and integration are needed between internal audit activities internally and with other functions and business units may also play part in deciding about designing organisational structure. In case of multinational conglomerate, there might arise, a requirement for specific roles such as internal audit quality control and standardisation. Need may also be felt for coordinating between various parts of internal audit, also for coordinating with other departments to keep it abreast with latest business developments and resolution of various issues.

In the end, if the organisation really wants to achieve sustained competitive advantage for its business, then internal auditors and business leaders cannot afford to neglect design of internal auditor activities to have proper organisational fit where various activities gel with each other and make it harder for competitors to copy, which ensures its long-term survival. ■