

*The
Truly
Integrated
Audit*

by **Richard J. Anderson**

How internal and external audit teams at one bank are combining forces to create a single, seamless audit program.

In response to an entirely new set of competitive challenges, many businesses are searching for innovative, creative, flexible ways to build shareholder value in a changing world. Unfortunately, internal and external auditors, at least in comparison to our corporate clients, have failed to make the kinds of high-impact changes and quantum leaps in efficiency and quality that today's business world demands. While we have tinkered with our methodologies, upgraded our technologies, and made adjustments in staffing and service scope, our basic audit mechanisms and approaches are fundamentally unchanged. The internal audit team continues to churn out "risk-focused" reports on a year-round basis, and the external auditors dutifully produce a boilerplate Generally Accepted Auditing Standards (GAAS) opinion at yearend. And each group, to some extent, duplicates the work of the other—questioning motives, fees, and hours—as their programs run on separate tracks toward their audit objectives. Increasingly, this state of affairs satisfies no one.

Entrenched Issues

Directors are beginning to ask tough questions about the value of the traditional audit, specifically with regard to whether or not they are receiving the highest audit quality at the lowest all-in cost. Senior management's insistence on efficiency, productivity, and value-added efforts has never been more fervent. The pressures are felt by public accounting firms, whose profit margins are already being affected by powerful competitive forces, as well as by many Internal audit staffs, who face increasing questions about their own expenses and who may now be taking on work once performed by external auditors in order to control external audit costs.

Why, then, does the traditional, separate, internal/external approach to auditing endure? Two perspectives have supported it historically and continue to do so today. First, the need for each audit team to demonstrate and maintain its independence and control its audit scope has naturally driven parallel, separate audit programs. At the same time, separate, stand-alone internal and external audit programs have been viewed as affording additional audit coverage and the opportunity for the two groups to monitor each other's work.

But do these historical perspectives still hold up in today's environment? The first—the need for independence and objectivity on the part of both internal and external auditors—undoubtedly does. Without independence, the value of any auditor's work to the client or the investing public is questionable. And neither internal nor external auditors can claim to be independent unless they have the ability to determine and control the scope of their audit tests. But does this need for independence and objectivity really justify two stand-alone audit programs and processes? Does the value of audit duplication genuinely justify its cost, or is it possible to find a better, less redundant process that would reduce costs and improve quality while still retaining the critical benefits of objectivity and independence?

A look at the businesses we audit suggests an answer. Time after time, in area after area, business managers have been able to find ways to reengineer redundant or layered work processes while both improving product or service quality and reducing all-in costs. Why should auditors, either internal or external, be held to a lesser performance standard? Why should the business practices and processes followed by auditors be any less innovative or flexible than those of their most successful clients?

Breakthrough Answers

At Continental Bank, we've tried to address these questions and challenges by leaving behind past practices and approaches and "thinking out of the box." The solution we developed—the formation of an integrated audit approach with our external auditors—was conditioned by Continental's circumstances and history, but in the current business environment it may have broader applicability. This approach, formally named the Integrated Audit Program, combines our previously separate internal and external audit programs into a single, seamless

whole, under the joint management of Continental's Audit Department and Price Waterhouse, Continental's external auditor.

We had a major advantage in establishing this integrated program since such joint or teamed approaches were not a new concept to Continental. To improve the bank's focus and reduce expenses, managers in a number of areas across the bank had previously led drives to "outsource" as many support functions as possible, including not only those just tangentially related to our core business, such as food services and properties management, but also large, mission-critical professional services like the law department and information technology.

In every case, the bank reduced the cost of running the function and obtained enhanced service levels. We found, in fact, that in every business what we need to control is our strategy. When it comes to implementing that strategy, the bank frequently stands to gain a great deal competitively by involving outside specialists.

With that experience in mind, we began to think broadly about our internal and external audit services. We kept four fundamental objectives firmly in mind:

- o Any approach we took could not compromise the independence or objectivity of the internal or external audit teams. As noted previously, each team needed to have complete, independent control over audit scope and any tests necessary to achieve their overall objectives.
- o We could not sacrifice the quality of either our internal or external audit staff in the name of cost control or efficiency. We needed to maintain our seasoned, highly skilled and experienced audit staff.
- o Any new approach to our audit program would need to provide internal and external auditors with faster, easier access to audit technologies developed by the other team, and include a commitment to maintaining state-of-the-art technological tools.
- o We needed to achieve the first three objectives while initially reducing total audit costs (internal costs plus external auditors' fees) and limiting future cost increases. Here, we had to move from the historical focus on separate and distinct internal and external budgets and expenses—the tug-of-war mentality in which Internal auditors try to keep fees down by tugging as much work as possible away from the external auditors.

We took the position that the way separate components of audit expense are allocated is not the critical measure for the bank or its shareholders. The measure that impacts them is total audit costs compared to total audit coverage—and costs must be evaluated at that all-in level. This may sound elementary, but a focus on total expenses rather than on separate expense components represents a fundamental change of approach for many auditors.

Having broken with the conventional wisdom that audits must proceed at every level along separate Internal and external tracks, we researched the possibility of outsourcing our Internal audit function completely—a possibility we rejected. However, that research led to a conceptual breakthrough and a carefully crafted solution: the development of a truly integrated approach in which the internal and external audit management teams jointly created, and independently approved, a single, integrated audit program which is executed by a fully integrated team of internal and external staff auditors. The single integrated audit program contains all audit testing necessary for external and internal requirements without any duplication or retesting. This, we believe, is a truly innovative approach to audit services.

Roles and Responsibilities

Under our integrated approach, Price Waterhouse remains responsible to the Audit Committee of Continental's Board for conducting an audit in accordance with GAAS. The firm has complete control of audit scope and is free to perform any work they feel is necessary under GAAS. Price Waterhouse also performs certain agreed-upon procedures relating to internal audit testing under the direction of Continental's General Auditor and the

management of our audit department. Likewise, the corporation's internal audit department remains responsible to the audit committee for a suitable and continuous audit of Continental.

The fundamental responsibilities of Price Waterhouse and Continental's audit department haven't changed; what makes this integrated approach different from the traditional one is that the two management teams work together to ensure that all necessary audit testing is designed and completed without duplication or overlap.

To implement this integrated approach, approximately two thirds of Continental's internal audit staff were hired by Price Waterhouse, giving that firm additional, experienced staff to handle the agreed-upon internal audit procedures. Since this work is now performed by Price Waterhouse itself, the hours previously spent testing Internal audit work as required by SAS #65 have been eliminated.

How's It Working?

While we are still early in the process, the audit integration has been tested and is progressing well. We expected to face a number of transitional challenges. In addition to ensuring independence for both the internal and external audits, compliance with all regulatory requirements, staff continuity, and scheduling flexibility, we knew that we would need to provide for a high level of information sharing and teamwork. Implementing and operating an integrated approach to auditing, in fact, demands a level of openness in communications that goes far beyond what is normally expected or witnessed in most audit engagements today. Achieving this level of communication—which is one of the major benefits of our integrated approach—involves procedural and cultural changes on both sides. There also must be a mutual acknowledgment that auditors for each organization can improve their skills and effectiveness by working in a team environment, and, as a result, improve the overall skill level of the combined staff.

So far, we are pleased with the way these cultural and human resources issues are playing out. The auditors that Price Waterhouse hired from Continental have adapted well to working with their former colleagues as clients, and cultural differences that were evident between Continental and Price Waterhouse have been reduced.

The reason for that success is the cooperative management structure we established at the outset. While the scope of implemental integration is wide, the agreement maintains in the strongest possible terms the independent authority of the internal and external audit management teams. Because independence is a contractual obligation, both sides clearly understand their roles in the relationship.

Another important aspect of the audit integration is a sharper focus by both sides on the needs of the client. By breaking the tug-of-war mentality alluded to earlier, the integrated approach closely aligns the focus of both Continental and the Price Waterhouse staffs and puts it squarely where it belongs: on Continental, our mutual client.

Through our integrated approach, we have been able to reduce Continental's total audit expenses in a year when we also faced the new audit and reporting requirements of the FDIC Improvement Act of 1991 and SAS #70. Although fees paid to Price Waterhouse in 1993 increased from the level previously paid for the GAAS audit alone, Continental's combined audit expenses decreased, and further reductions are expected in 1994.

With much of the audit priced on a hard-dollar, contract basis, audit discipline has been enhanced significantly; more time is spent on the front-end clearly defining needs, concerns, and audit scope. For auditors, the process is more demanding. But it is also producing major benefits for Continental and its shareholders, reducing all-in audit costs while improving focus and quality.

Looking Ahead

Our major accomplishment in developing the Integrated Audit Program was the willingness to think and act "out of the box," to look for breakthrough approaches rather than incremental changes to traditional ones. Of course,

the specific solution we developed won't be appropriate for every company. To succeed in today's business environment, however, both internal and external audit managements need to start approaching their work with more creativity and innovation, seeking high-impact solutions to improve service to their clients and shareholders.

The business literature today is filled with stories of companies that fell into the trap of looking inward to their own operations rather than outward to the demands of the marketplace. If we as auditors are not successful in enhancing service and perceived value to clients and shareholders, future examples of entrenched, inwardly focused, and defunct organizations may include us. //

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Reprint from December 1994 Internal Auditor