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— CENTER —

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Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

## Budgeting the Internal Audit Function: How Much Is Enough?

One hallmark of a successful internal audit function is that it is properly resourced. Chief audit executives (CAEs) must ensure that internal audit resources are “appropriate, sufficient, and effectively deployed to achieve the approved plan,” according to The IIA’s *International Standards for the Professional Practice of Internal Auditing*. Board and audit committee members are similarly responsible for approving the right level of resources. Yet there is no simple formula for developing an internal audit budget.

You can’t determine the optimal budget for next year simply by adding an inflation factor to last year’s numbers — not even if last year’s budget was a perfect fit. Keep in mind that if the internal audit function was adequately resourced in the past, audit recommendations for improving controls may actually reduce the need for certain audits in this year’s budget. Conversely, if the budget was too low in the past, making the same mistake twice may only compound the problem. There may be more need than ever for a robust audit schedule in the coming year.

Basing the internal audit budget on amounts spent at similar organizations doesn’t work either. If you compare the internal audit budgets of similar-size companies in the same industry, you might find that one budget is several times the size of another. Those similar-size companies might look the same on the surface, but their internal controls may be very different. One might have an enterprise risk management program, while the other does not. One might have manual processes while the other relies on automation. There may be efficiency, effectiveness, health, safety, technology, legal compliance, and a host of other issues that affect the two companies in different ways. So while both companies would benefit from internal auditing, spending the same amounts on internal audit would probably be a mistake.

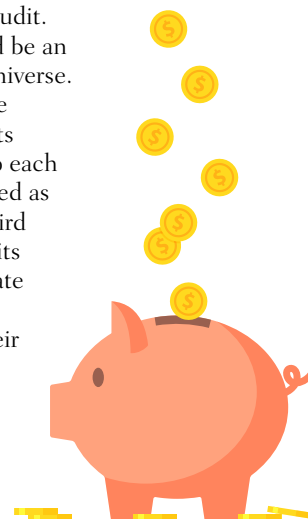
While there is no simple formula for determining an internal audit budget, there is a process that audit committees, executive management, and the audit department can use to

determine whether the internal audit budget is appropriate for the organization. By following these steps, all can be assured that the internal audit budget will likely be a good fit every time.

### 1. Define the Audit Universe

Start the process by defining the audit universe, which is made of distinct “auditable entities” that, taken together, include every part of your organization — all departments, divisions, systems, processes, subsidiaries, programs, activities, and even accounts. If it can be audited, it should be included in the audit universe as an auditable entity, even if there is no plan to perform an audit of that area in the coming year. The idea is to ensure nothing is overlooked.

Each company defines their audit universe differently depending upon the size and scope of their audits. One organization might perform an audit of the sales cycle, combining sales, accounts receivable, and cash receipts into a single audit. Therefore, the sales cycle would be an auditable entity in their audit universe. Another organization might have separate audits of sales, accounts receivable, and cash receipts, so each of these processes would be listed as separate auditable entities. A third organization might perform audits by location or might have separate audits for various product lines. Each company would define their auditable entities differently, but in each case the goal is the same: to ensure everything that can be audited is included in the audit universe.



## About The IIA

The Institute of Internal Auditors Inc. (IIA) is a global professional association with more than 190,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

## The IIA

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## 2. Assess the Risks

Developing a complete audit universe helps ensure that nothing is overlooked. But while internal audit can audit anything, it can't audit everything. The next steps in establishing the internal audit budget are to evaluate risks and determine what most needs to be audited.

Working with key personnel throughout the organization, internal audit will evaluate the likelihood of significant risks in each auditable entity. It will also estimate the probable impact of each type of risk to decide which risks are most important. Often auditors consider the velocity of risks, or the speed at which risks are likely to develop.

It's not an easy task. Internal audit must consider everything that could impact the achievement of the company's objectives — not only negative impacts, but also the risks of missed opportunities. The CAE generally will consult with management, the audit committee, and assurance providers such as external auditors, compliance officers, internal controls specialists, and risk management specialists. Questionnaires may be used as a tool to collect information or employee surveys may be evaluated. Internal audit may analyze comparative information about similar organizations or other types of evidence that can help build a complete understanding of the company's risks.

Internal auditors will also review the results of previous audits. But the primary goal is not to dwell on past mistakes. Auditors must determine where new issues might surface, so they also consider goals, objectives, budgets, forecasts, and potential changes in operations. Gathering and evaluating all the information can be time consuming, but it's the only way to ensure that limited audit resources are used where and how they are most needed.

The list of auditable entities is ordered from highest to lowest perceived risk, and brief descriptions are provided to explain why the area or process is considered high, medium, or low risk. Specific audits required by legislation or regulation are automatically moved to the top of the list. The list might also be adjusted for factors such as length of time since the last audit.

## 3. Develop the Audit Plan

The next step in determining the budget is to decide which audits must be performed. Because the auditable entities have been ranked by risk, it's usually easy to determine which audits are most important. To ensure that the schedule is flexible enough to address new and emerging risks, resources also should be allocated for unplanned "quick response" audits. The draft audit plan must also strike an appropriate balance between traditional assurance engagements and consulting work.

In some ways, deciding on the internal audit budget is like buying an insurance policy. Cost is a factor, but the coverage must be adequate to protect the company against the risks it can't afford to take. Obviously the highest-risk areas of the company should be audited, but audits of lower-risk areas may not be cost justified. The secret is to balance what your organization requires in terms of internal audit's services against specific identified risks.

Because the appropriate level of internal audit resources can be subjective, many audit committees periodically review the top five risks that internal audit will not be able to address with current resources. If the audit committee is not comfortable with the level of risk in the areas that are not included in the proposed audit schedule, it's time to consider whether the budget should increase so additional audits can be performed.

## 4. Determine Training, Cosourcing, and Administrative Expenses

Obviously there is more to the internal audit budgeting process than simply performing an organizationwide risk assessment and agreeing on a schedule of audits. Budgets and schedules must also allow for time off, as well as time spent on administrative tasks, training, and activities such as quality assurance and audit follow-up.

It's usually easy to estimate administrative and overhead costs based on past budgets. But it is important to consider training needs carefully — not just training budget, but also the impact training might have on the number of audits that can be performed during the year.

The CAE must ensure that internal audit resources will be appropriate, sufficient, and effectively deployed to achieve the approved plan with the breadth, depth, and timeliness expected by senior management and the board. When CAEs assign auditors to planned engagements, they may discover gaps in the knowledge, skills, and competencies of staff needed to complete audits successfully. If the quantity or mix of resources is insufficient to cover planned engagements efficiently and effectively, the CAE may need to hire additional staff, cosource or outsource engagements, or use “guest” auditors from other parts of the organization. Each of these approaches has advantages and disadvantages, and each can have an impact on the budget process.

## 5. Review and Approve: Independence Matters

It's important to review the operating budget periodically to ensure that it remains realistic and accurate, identifying and reporting any variances promptly. In most organizations, the CAE prepares the budget and senior management reviews it, but final review and approval is left to the audit committee or board of directors.

Surprisingly, one factor that makes a significant difference in internal audit budgets is audit committee independence. In a recent survey by The IIA's Audit Executive Center, CAEs were asked to indicate their level of agreement with the statement, “The internal audit activity at my organization is sufficiently resourced with competent and objective professionals able to carry out the internal audit plan.” In organizations with an independent audit committee, a full 70 percent of CAEs strongly agreed or somewhat agreed with that statement. But at organizations where the audit committee was not independent, only 56 percent agreed that resources were adequate.

CAEs were significantly more likely to state they had sufficient resources at organizations with independent audit committees than at organizations where the audit committee was not independent of management.

## Getting the Most From Your Internal Audit Budget

### 1. Perform solid risk assessments.

The best way to plan effective audits is to know your risks. In addition to periodic enterprisewide risk assessments, assessment should be a standard part of every assurance engagement performed by internal audit.

### 2. Embrace automated audit tools and analytics.

Computer-aided tools can enable auditors to capture and analyze big data in real time, spotting errors and fraud faster and heading off problems before they can grow. Getting started entails new costs and training time, but these tools often enable auditors to increase the efficiency and effectiveness of audit coverage.

### 3. Coordinate plans and schedules with other assurance providers.

Coordination should involve sharing strategic and audit plans, as well as establishing close working relationships with other assurance providers such as internal control specialists, risk management functions, and external auditors.

### 4. Use remote auditing techniques to cut travel time and expenses.

Some things can only be done face to face, but if auditors have remote access to systems and information, it may be possible to reduce travel time significantly.

### 5. Invite “guest auditors” from other parts of the organization.

Guest auditor programs can call upon the talents of non-auditors throughout the organization, improving consistency and sharing best practices throughout operating divisions while increasing understanding of risks and controls.

Internal audit budgeting is a complex process. Preparing, reviewing, and approving the budget takes time and effort, but a sound budget is an important tool for decision making. Internal audit plans and budgets serve as road maps for the internal audit function, clarifying performance goals and controlling excess spending. An adequate budget can help ensure that auditors, executive management, and the audit committee agree on the organization's risk profile and on audit goals and objectives. That's why all internal audit departments are required by professional standards to communicate plans and resource requirements, including significant interim changes, to senior management and the board for review and approval. It is just one of the ways to ensure that internal audit resources are appropriate, sufficient, and effectively deployed.

## Internal Audit Has Resource Sufficiency

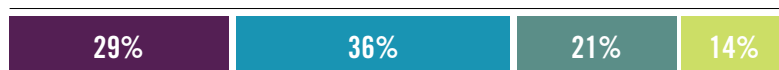
### Independent audit committee



### Not independent audit committee



### All



■ Strongly agree   
 ■ Somewhat agree   
 ■ Somewhat disagree   
 ■ Strongly disagree

*Note: North American Pulse 2018 survey, Q44: Please indicate your level of agreement with the following statement: The internal audit activity at my organization is sufficiently resourced with competent and objective professionals able to carry out the internal audit plan. n = 634.*

*CAEs were significantly more likely to state they had sufficient resources at organizations with independent audit committees than at organizations where the audit committee was not independent of management.*



### Quick Poll Question

How often does the audit committee review the internal audit budget and plan of engagements at your organization?

- Ongoing or at least quarterly.
- At least twice a year.
- At least annually.
- Never or less than once/year.
- N/A (We do not have an audit committee, or we do not have an internal audit function.)

Visit [www.theiia.org/tone](http://www.theiia.org/tone) to answer the question and learn how others are responding.

## Quick Poll Results:

How often does your audit committee meet in executive session with the chief audit executive (without the presence of management)?



29%

Never or less than once each year

13%

Once each year

23%

More than once each year, but not after each in-person audit committee meeting

34%

After each in-person audit committee meeting

Source: *Tone at the Top* October 2018 survey.