

# ***Aligning Internal Audit***

## **Are you on the right floor?**

2012

*State of the internal audit  
profession study*





## **PwC's 2012 State of the Internal Audit Profession Survey Reveals: "Businesses Want Increased Internal Audit Involvement in Risk Identification and Management"**

According to the 2012 PwC State of the Profession study, global economic uncertainty is the biggest risk to companies in 2012, said almost three-quarters of the 1,530 chief audit executives and stakeholders, including audit committee chairs, polled.

Businesses are calling for internal auditors to broaden and deepen their role in helping them navigate the rapidly changing risk landscape across a range of risks, including data privacy and security, and regulation and government policies. As the risk landscape continues to evolve, the majority of business leaders surveyed said they are not comfortable with how their risks are being managed, although 74% of those surveyed have formal enterprise risk management processes. Leaders also agree to deliver what stakeholders want, the standard for an effective internal audit function has been raised and internal audit needs to elevate its performance to meet the always increasing stakeholder expectations. Businesses must evaluate total enterprise risk, coordinate with the internal audit function and break down organisational barriers to provide a holistic approach to risk management.

Successful internal audit functions create plans through comprehensive, top-down risk assessments where the entire enterprise risk management process is taken into consideration. According to the survey results, 45% of organisations still do not create their audit plans using a robust, top-down risk assessment approach. Basel II regulations implemented by Banking Regulation and Supervision Agency, declaration regarding corporate governance issued by new Turkish Commercial Code and Capital Markets Board of Turkey that are in charge of managing risk within Risk Committee emphasize the importance of this area.

A majority of respondents identified organisational and cultural resistance as the most common barriers to internal audit's ability to step up and meet stakeholders' increasing demands, followed closely by lack of internal audit resources and expertise.

As more stakeholders seek an objective point of view to more effectively manage global risks while concurrently desiring deep expertise to meet the company where it is today as well as where it is going tomorrow, internal audit groups are turning to co-sourcing to move from a reactive to proactive risk management strategy, and better anticipate and respond to growing risks in order to overcome insufficient human resources barrier.

The report adds that internal audit groups at leading companies provide stakeholders with advice on how to improve risks and controls rather than just reporting on gaps. 78% of the survey respondents whose companies were better at managing risk say their chief audit executives have an active role in the executive meetings. In addition, they take into consideration the organisation's enterprise risk management process and they adapt their approach quickly when changes are needed.

Survey result confirms that Boards and Audit Committees expect more from internal audit. They want internal audit to act as their eyes and ears and provide essential comfort that critical business risks are being well managed. But while internal audit clearly matters, the challenge for the chief audit executive is to find a way to consistently deliver on these increasing expectations.

To have a deeper conversation about how this subject may affect your business, please contact:

Best Regards,  
Işıl Kırdı  
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**Methodology:**

The 2012 State of the Internal Audit Profession survey was conducted in the fourth quarter of 2011 and the first quarter of 2012 and includes more than 1,530 respondents in 16 separate industry sectors from 64 countries across the globe. This year, for the first time, in addition to surveying internal auditors about the state of the profession, PwC surveyed the profession from the outside in, asking CFOs, audit committee directors, CEOs, and other stakeholders to share their views on internal audit's role in the organisation and its capabilities for supporting the risk management activities of the company.

More than 660 non-internal audit stakeholders shared their points of view through participation in the 2012 State of the Internal Audit Profession survey in addition to approximately 870 Chief Audit Executives across the globe. In addition, nearly 100 CAEs and stakeholders participated in one-on-one interviews, enabling PwC for the first time to share a comprehensive outside-in look at the profession.

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### **Designing for the new risk landscape**

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*The heart of the matter*

Stakeholders do  
want internal audit  
at the table

## *1,530 executives have spoken and say they face more risks than ever before.*

First there was the financial crisis. Then came the recession and regulatory reform, and disparate headlines: an oil spill in the Gulf of Mexico, a tsunami and radiation leak in Japan, heat waves and cold snaps, struggling economies, cruise ships running aground, financial firms going under, tainted food recalled, hackers stealing personal information from millions, and on top of it all, continued uncertainty over the strength of the economic recovery.

Against this backdrop, it's no surprise that of the 1,530 executives from 16 different industries and 64 countries who participated in PwC's 2012 State of the Internal Audit Profession Survey, the majority say their businesses face more risks than ever before. With global trade, supply chains, and financial markets all intricately linked, risks become apparent quickly, unexpectedly, and with significant impacts on company operations, reputations, and even survival. All this has led companies to become more engaged than ever before in improving their ability to define, communicate, and manage their global risk profile.

### ***The rising importance of risk management***

In this, our eighth annual examination of the internal audit profession, we focus on the rising importance of risk management and the increasing expectations of internal audit's contribution to the effort. While previous studies surveyed only chief audit executives (CAEs) to learn their responses to the year's most pressing challenges, this year's survey expanded to include other executives, audit committee chairs, and board members, who were asked their views on today's critical risks and the role they expect internal audit to play in addressing them. More than 660 of these stakeholders joined 870 CAEs in sharing their points of view through participation in our survey, and nearly 100 CAEs and stakeholders participated in one-on-one interviews, enabling us for the first time to share an outside-in look at the profession.

This paper highlights rising stakeholders expectations and where they want internal audit to play in the risk management challenge, to deliver

the greatest value. We also explore how leading internal audit functions have aligned themselves with these rising stakeholder expectations by expanding the footprint of risks they cover and clearly communicating deeper insights—"raising the floor" in a way that sets a new standard for internal audit functions across industries, geographies, and company sizes. Stakeholders and CAEs alike have recognized that in order for internal audit to be effective in supporting organizational risk management efforts, the minimum standard of performance has to rise. In today's ever-shifting risk landscape, internal audit can't settle for simply reacting to events; instead, it must adopt a strategic mindset that is responsive to risks and helps ready their organizations for new threats and opportunities.

By leveraging their core competencies, developing trust-based relationships, and providing deeper insights, leading internal audit functions have proven they can earn a seat at the table—one audit at a time.

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*An in-depth discussion*

# Aligning internal audit to deliver value

## Today's complicated risk landscape

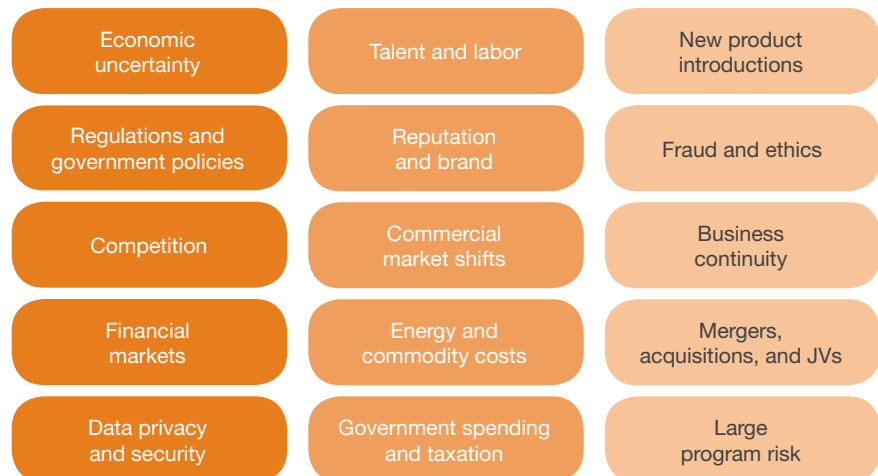
Across industries and geographies, company stakeholders have become more engaged with risk issues and have been seeking to improve their ability to define and communicate a clear, firm-wide risk appetite. The evidence of this trend is in the 1,530 responders to our 2012 State of the Internal Audit Profession Survey, among whom an overwhelming majority (80%) shared their view that risks to their organization are increasing.

Survey results and interviews revealed the risk landscape growing and rapidly changing as new risks emerge, challenges associated with more traditional risks continue to evolve,

and stakeholders and CAEs shuffle their lists of the most pressing risks facing their organizations. Along with concerns over continued economic uncertainty, ever-increasing regulatory requirements, and the financial market roller coaster ride of the past four years, we continue to see companies name traditional areas of concern such as fraud and ethics, mergers and acquisitions, large programs, new product introductions, and business continuity among their top five risks.

The response rate on the question of the most critical risks facing the organization showed that virtually all risks on which we surveyed were critical to hundreds of survey participants. Figure 1 shows the 15 critical risks cited most frequently by our survey respondents.

Figure 1: The 15 most cited risks





## 2012: The risks ahead

The significant global risks that came to fruition in 2011 weighed on the minds of the 1,530 executives who shared with us their views on the top risks facing their organizations. Regardless of organization size, industry, or geography, a common theme emerged that many of these risks have become inextricably linked. Among the interrelated risks facing organizations today are:

### **Intensifying economic and financial market uncertainty**

Nearly three quarters of companies named economic uncertainty as their biggest risk, putting it in the number-one spot. Of significant concern is the Eurozone crisis, which could put local economies in freefall, cause global financial disruption, and trigger another worldwide recession.

Even if this crisis is averted, risk managers remain wary of the impact of currency volatility and its associated uncertainty. “Many of our products are sold and priced in euros,” says one global manufacturer, “and many of our inputs are priced in US dollars, so the impact of the Eurozone turmoil on foreign markets has a big impact on our operations.”

### **Increased regulation and changes in government policy**

With governments still reacting to the financial crisis, responding to public demands for greater corporate social responsibility, and, in some countries, becoming increasingly activist, overregulation continues to rank among executives’ top concerns. US executives noted that the country could see considerable political change in 2012 due to the upcoming elections; however, companies in the United States are already facing massive regulatory overhaul via the Dodd-Frank Act’s changes to financial regulations and the Patient Protection and Affordable Care Act’s changes to the healthcare industry. On the global front, many organizations are also struggling to come into compliance with the UK Bribery Act.

### **Data security threats and reputation**

With data breaches an almost everyday headline, executives are increasingly concerned about data privacy and security issues. The growing use of social media, mobile devices, and cloud computing introduces a higher threat of IT security breaches, misuse of customer data, and reputational damage.

Relegated to IT’s jurisdiction in the past, privacy and security risk will gain further prominence as a new strategic threat to firms in an increasingly digital world. “As the globe becomes more interconnected, our customers are demanding an increased focus on data security, the cloud, regulatory data, and the financial costs of risk management,” says Microsoft’s chief financial officer, Peter Klein.

### **Mergers and acquisitions risks**

In pursuing new strategic alliances and joint ventures, especially in emerging markets (a strategy 28% of global organizations and 58% of US companies plan to follow this year, according to our 2012 *Global CEO Survey*), organizations must be prepared for a wide range of risks. Along with the challenges of different regulatory regimes and government policies, companies may find themselves dealing with government functionaries who expect a “consideration” for facilitating transactions or helping to clear hurdles. The attendant ethical questions require a thorough understanding of local cultures, local business practices, and all related laws, both local and home country (e.g., the US Foreign Corrupt Practices Act and the UK Bribery Act). Companies entering emerging markets may also face talent and labor risks, including competing with local companies for people with particularly valuable skills.

For more information about these critical risks, what organizations are doing to manage them, and much more, see our paper *Risk in Review 2012: Rethinking Risk Management for New Market Realities*.

*Complexity, unpredictability, and variety of risks are the top three reasons executives feel their risk profile has changed.*

**What is making risk more risky?**

The inextricable linkages between global trade, financial markets, and supply chains have resulted in risks arising unexpectedly and with far-reaching ramifications on reputation and even business survival. “Business has become so globally diverse,” points out Microsoft CFO Peter Klein, “that it is an ongoing challenge to scale this with different cultures and operating models—and develop the tools and technologies to adjust to the continued global diversification.”

Executives told us that the complexity, unpredictability, and variety of risks are the top three reasons they feel their risk profile is changing, and that management of critical risks continues to be a challenge. We saw this manifested in a variety of headlines throughout 2011, among them:

- **“Sony PlayStation Breach Involves 70 Million Subscribers.”** The April 2011 hacking of Sony’s PlayStation Network cost the company more than \$171 million in cleanup costs, and analysts predicted the cost of investigations, compensation, lost business, and additional data security investments could push the total much higher.

- **“News of the World Shuts Down Amid Scandal.”** Following a major phone-hacking scandal involving its employees, venerable British tabloid *News of the World* was shuttered by owner News International in a reported attempt at corporate damage control.
- **“Smartphone Parts Shortage Caused by Japanese Quake”:** The March 11, 2011, earthquake, tsunami, and nuclear reactor breach in Japan forced the temporary closure of many high-tech manufacturing plants, among them one that creates a crucial polymer used in 70% of lithium-ion batteries worldwide. The subsequent shortage affected technology companies internationally, including Nokia, RIM, Sony Ericsson, and, to a lesser extent, Apple and Samsung.

Executives we spoke with also emphasized that the speed at which information becomes public also leads to a lower confidence level regarding how well risks are being managed. As Kanwardeep Ahluwalia, managing director of financial risk with Swiss Re, observes, “In a world of ever-faster communications and instant transmission, there is also the possibility of an additional dimension of complexity brought about by the very perception that risks have increased . . . but perhaps we feel risk is growing simply because we know more.”

*Less than half (45%) of those surveyed told us they are comfortable with how well their most critical risks are being managed.*

***Many risks are not perceived as well managed***

As the risk landscape continues to evolve and shift, on average less than half (45%) of those surveyed told us that they are comfortable with how well their most critical risks are being managed— despite the fact that 74% of those surveyed have formal enterprise risk management (ERM) processes in place. The relatively low confidence level expressed by survey respondents in many risk areas tells us that stakeholders won't feel their organizations are managing risks effectively until they significantly up their game regarding both the management of risks and the communication of risk management results. It is for this reason CAEs must be focused on ensuring internal audit understands the organization's risk landscape and is aligned with stakeholders on the areas of greatest concern, putting the function in a position to address risks in a timely manner, provide insights on risk impact, and clearly communicate recommendations focused on improving business performance.

As we analyzed confidence at the risk level, we noted that stakeholders

and CAEs consider financial markets to be their best-managed risk, with a combined 63% feeling this risk is well managed. Their confidence may be the result of hard work: For the past four years, since the beginning of the recession in 2008, businesses have been engaged in a full-tilt, head-on struggle against financial turmoil. They've had to maneuver their way past frozen lending markets, major currency fluctuations, stock volatility, and other potential cataclysms, and in the process have become more adept at addressing financial challenges. While financial market issues aren't getting any less complex, businesses feel that they are in better shape to address them.

But while companies have been busy putting out financial fires, business realities have continued to change. A particularly thorny, long-term threat has become acquiring and retaining staff in a global, technology-driven market where key skills like engineering and IT are in high demand and short supply. Respondents identified talent and labor risks as a significant risk, but only 23% had confidence in their organization's ability to manage this risk well. As explored further

in our 2012 *Global CEO Survey*, competition for human capital is intense, and many companies are feeling the pressure to up their talent management game, using models and strategies that can vary significantly from those that made their organizations successful in the past. (For example, where companies might once have recruited expatriates for overseas positions, recruiting local talent with the required technical and language skills may now be a critical success factor.) Talent and labor risks are further complicated in emerging economies, where employee loyalty might be relatively low and where local companies are beginning to lure top-performing candidates into their own ranks through improved salaries and benefits, and appeals to patriotism. Overall, companies' current talent management programs may not be equipped to handle the size and range of changes currently underway, leading to a lack of confidence among stakeholders and CAEs.

33%

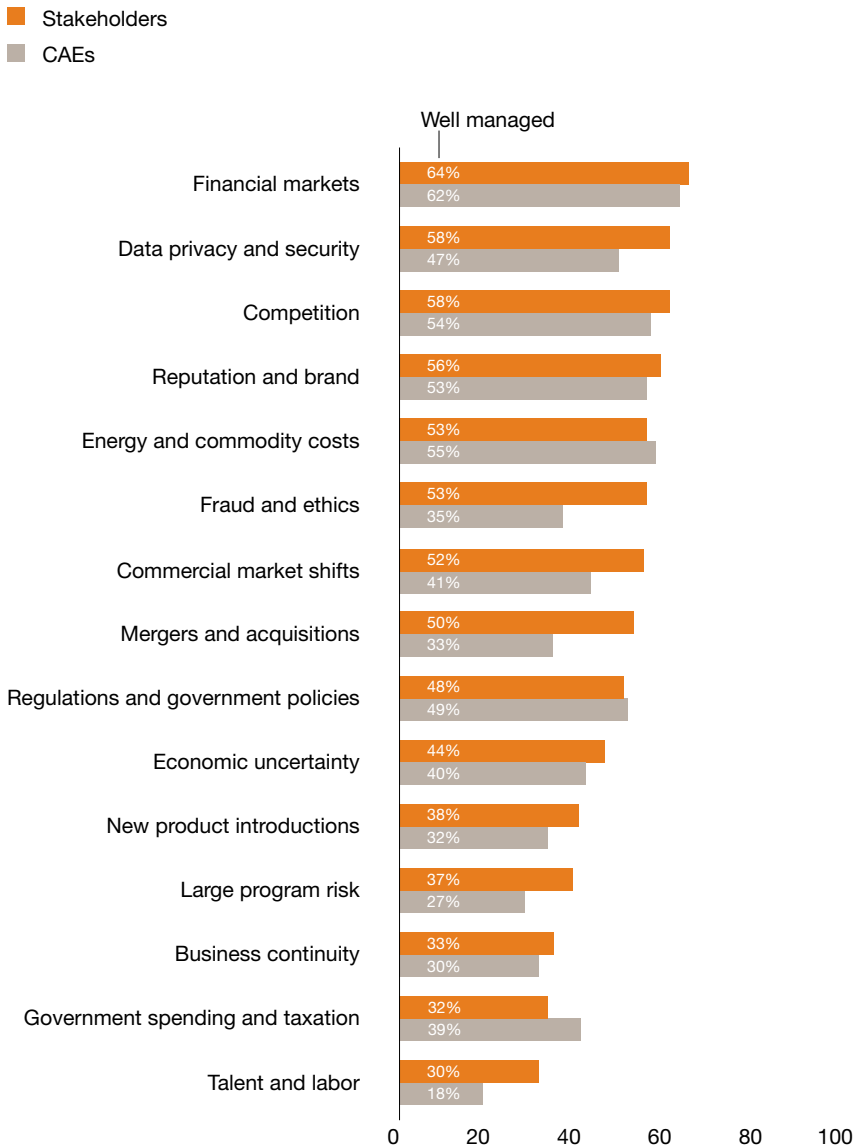
Only 33% of CAEs feel mergers and acquisitions risks are well managed

### ***The need for alignment between business and internal audit***

Gaining stakeholder insight in our survey for the first time allowed us to compare viewpoints between stakeholders and CAEs at a macro level. While these macro views may not be representative of your individual organization, they do provide indicative data for areas where alignment is being achieved, and for those areas where further dialogue between stakeholders and CAEs is needed.

Why is alignment around risks so important? For internal audit to be truly effective, an organization must create a culture whereby stakeholders and CAEs hold robust dialogue around enterprise risks, share their objective perspectives, and reach a common viewpoint on the role of internal audit around the most critical risks. Given the number of risks facing organizations today, alignment around the most critical risks is essential to prioritize and enable effective allocation of resources. Absent this alignment, CAEs may fail to target resources to those areas stakeholders consider most critical—thereby missing the opportunity to deliver value to the business.

**Figure 2: How well organizations manage each of these risks**



In our survey, 47% of stakeholders said that risks to their business were well managed, compared to 40% of CAEs. Digging into individual risks (see Figure 2) revealed six areas of more pronounced disparity, with stakeholders expressing significantly greater confidence (10 percentage points or more) than CAEs. One of the greatest divergences in viewpoint came within management of risks associated with fraud and ethics, where 53% of stakeholders felt confident in their organization’s management of risks, compared to only 35% of CAEs. Confidence around risks associated with mergers and acquisitions and joint ventures showed a similar diverging viewpoint, with 50% of stakeholders expressing confidence, compared with 33% of CAEs.

While diverging viewpoints may result from numerous factors, the takeaway here is a clear call for continued stakeholder and CAE dialogue on how well each perceives risks to be managed. Misalignment in either direction can lead internal audit to sub-optimize allocation of resources and not adequately focus on the risks most critical to the organization. With the risk landscape shifting underfoot, it is no longer good enough for internal audit to just be at the table; it must also be confident that its prioritized areas of focus are affecting the areas of greatest risk to the organization.

### Size and industry matters

Though survey respondents across the board expressed relatively low confidence levels regarding risk management, looking at the results by company indicate that the size of the organization has an impact: Overall, respondents' confidence in how well their organization manages risks was 20% higher at companies with \$10 billion or more in revenue, as compared to companies with revenues under \$10 billion. This survey finding confirmed what we've seen in our experience:

Larger companies have more advanced processes and tools to aid in their risk management challenge—yet effective risk management is no less important at mid-sized and smaller companies. Despite the higher confidence expressed by respondents from large companies, there's still considerable room for improvement. While size does apparently matter, the question for CAEs of the smaller and larger organizations alike is, what additional efforts should internal audit be undertaking to enable confidence levels around risk management to

rise? The specifics of internal audit's role may be different depending on a company's size, but the need to take action remains the same.

Further, evaluating survey results by industry confirmed that the most critical risks and the confidence stakeholders have in their ability to manage those risks vary by industry. The only common thread was that respondents across the board named talent and labor as their least well-managed risk. See Figure 3 for a ranking of the three least and most well-managed risks by industry groups.

**Figure 3: Least and most well-managed risks by industry groups**

<i>Financial services</i>	<i>CIPS*</i>	<i>Healthcare</i>	<i>TICE**</i>
<b>Least well managed</b>			
<ul style="list-style-type: none"> <li>• Talent and labor</li> <li>• Government spending and taxation</li> <li>• Large program risk</li> </ul>	<ul style="list-style-type: none"> <li>• Talent and labor</li> <li>• Large program risk</li> <li>• Business continuity</li> </ul>	<ul style="list-style-type: none"> <li>• Talent and labor</li> <li>• Business continuity</li> <li>• Fraud and ethics</li> </ul>	<ul style="list-style-type: none"> <li>• Talent and labor</li> <li>• Business continuity</li> <li>• New product introduction</li> </ul>
<b>Most well managed</b>			
<ul style="list-style-type: none"> <li>• Financial markets</li> <li>• Data privacy and security</li> <li>• Competition</li> </ul>	<ul style="list-style-type: none"> <li>• Financial markets</li> <li>• Competition</li> <li>• Reputation and brand</li> </ul>	<ul style="list-style-type: none"> <li>• Reputation and brand</li> <li>• Regulations and government policies</li> <li>• Government spending and taxation</li> </ul>	<ul style="list-style-type: none"> <li>• Competition</li> <li>• Regulations and government policies</li> <li>• Financial markets</li> </ul>

\*Consumer industrial products and services

\*\*Technology, information, communications, and entertainment

*Organizations with financial performance above their peers expressed an average confidence level of 53% across the top 15 risks. By comparison, only 25% of companies that perform financially below their peers believe they manage the same risks well.*

### **A proactive approach for success**

Survey results also indicated that managing risks better may have an impact on financial performance, as organizations with financial performance above their peers (regardless of company size or industry) expressed an average confidence level of 53% across the top 15 risks. By comparison, only 25% of companies that perform financially below their peers believe they manage the same risks well.

Recent experience indicates that with the world watching a more instantaneous media, planning for the management of adverse events is as important as identifying and managing the risk in the first place. Leading companies differentiate themselves in the risk management arena by transitioning from a reactive to a proactive mindset that anticipates risks and helps position the organization for new threats and opportunities. These companies stand out by better understanding and managing their risks, protecting themselves by building financial buffers, creating supply chain redundancies, and proactively managing their response to risks. In essence, they are better prepared to react to or take advantage of opportunities resulting from risks becoming reality.

This is the strategic mindset to which internal audit should align. “Instead of just asking what might go wrong, also imagine thinking what needs to go right so as to ensure systems, processes, and management focus are aligned to achieve successful outcomes for the company’s strategy in the face of a variety of possible situations and external scenarios,” says Jason Pett, PwC’s US Internal Audit leader.

### **Stakeholder expectations of internal audit**

Stakeholders have spoken and the message is clear: With risks rising and awareness of those risks becoming a matter of ever greater investor concern, they are seeking greater assurance in their companies’ ability to manage current and future risks. In our interviews, we heard time and again that stakeholders value internal audit’s ability to identify risks, evaluate their threat, and recommend processes and controls to manage them.

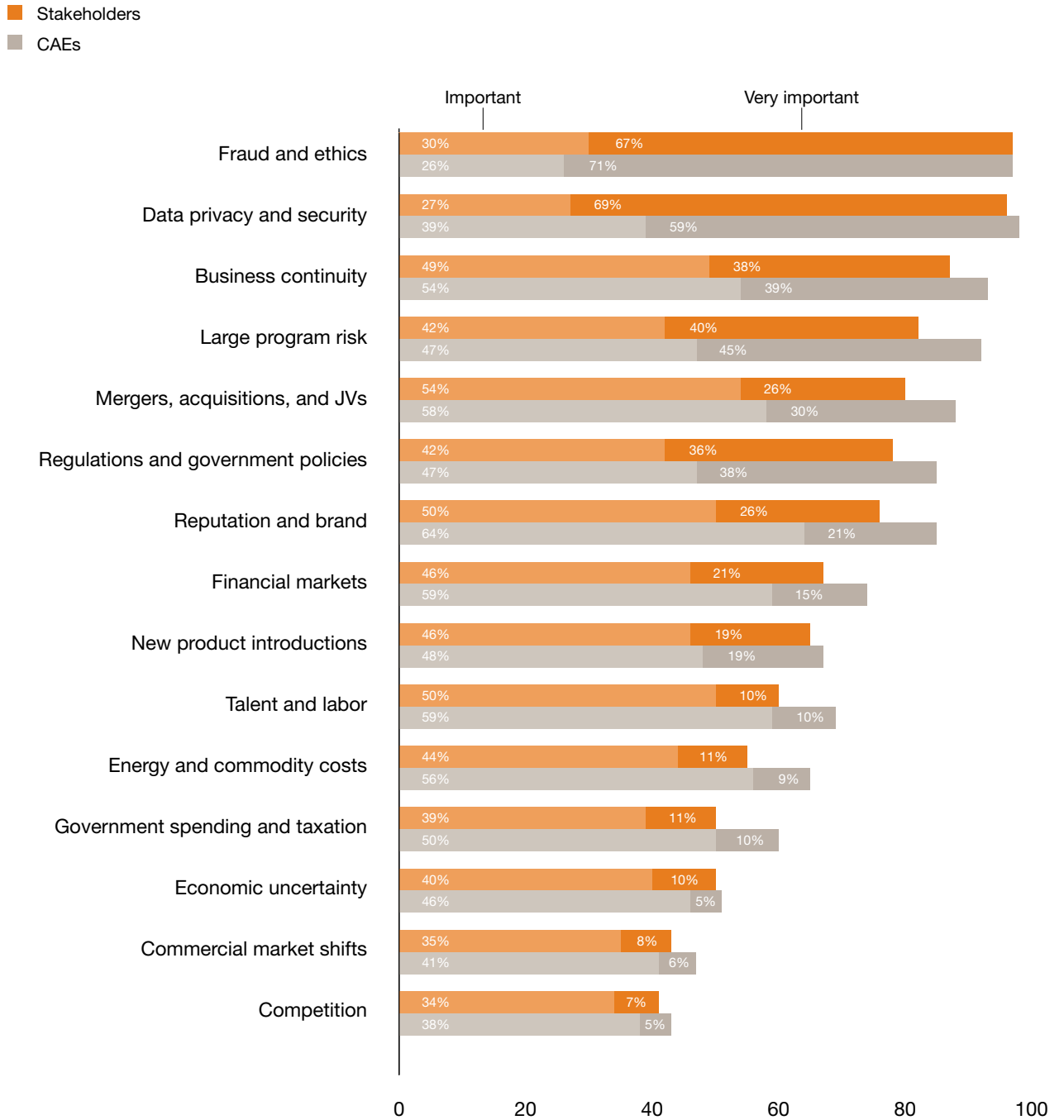
Survey results showed that stakeholders rank the traditional internal audit job of “auditing of financial controls and compliance” as their first expectation, but that “providing advice on risks and controls” rates a very close second. To add to stakeholder confidence and be seen as a vital, contributing business partner, internal audit must reach a point where it fulfills both of these expectations equally well: providing traditional assurance with deep insights and business perspectives.

In this section, we’ll discuss stakeholders’ views of internal audit’s contribution, and areas in which they desire more.

# 69%

*% of stakeholders who view internal audit’s contribution to monitoring data privacy and security risks as “very important”*

**Figure 4: Importance of internal audit's contribution to monitoring each risk**





*The fact that a risk hasn't historically been a focus for internal audit should not hinder the function's ability to play an important role.*

### **Stakeholders value internal audit's contribution**

Stakeholders consistently told us that they saw internal audit as having an important role to play in monitoring their organizations' top risks. Among respondents who selected fraud and ethics and data privacy and security among their top risks, an overwhelming 97% and 96% (respectively) value internal audit's contribution. Interestingly, these two risk areas also have the greatest level of alignment in overall viewpoint between stakeholders and CAEs.

Over three quarters of respondents who ranked business continuity, large program risks, mergers and acquisitions, regulations and government policies, and reputation and brand among their top risks also had high ratings on the importance of internal audit's contribution to monitoring them. In fact, there were only two areas of risks (commercial market shifts and competition) for which fewer than 50% of stakeholders perceived internal audit's role to be important. The takeaway? The majority of stakeholders expect internal audit to be actively engaged in helping the organization monitor and manage its most critical risks.

While this overall importance level is relatively high, there were only two areas (fraud and ethics risk and data privacy and security risk) where more than 50% of both stakeholders and

CAEs alike believe internal audit's role to be "very important." Within data privacy and security risks, however, a disparity emerged around the criticality of internal audit's involvement: Though alignment on overall importance is within 2%, stakeholders were 17% more likely than CAEs to assess internal audit's role as "very important." In our experience, this divergence of viewpoint on the criticality of internal audit's role may result from several factors, including the fact that this risk has not historically been included in internal audit's scope, and/or that internal audit may lack the specialized skill set needed to effectively audit and recommend improvements in this area. Given this rapidly developing risk area, it is almost to be expected that stakeholders and CAEs are not yet fully aligned on the critical importance of the role internal audit plays—yet another indicator that as the risk landscape shifts rapidly, CAEs and stakeholders must work to stay aligned both on the impact of this risk to their organization and on the specifics of the role internal audit should play.

Further evaluation of the data shows that for virtually all risks, it is the CAEs who place internal audit's role higher on the scale of importance. This may indicate that CAEs believe they are playing a substantive role in these areas, whereas stakeholders do not yet consider their input to be as valuable.

*Almost everyone wants internal audit to maintain or add focus to the top risk areas.*

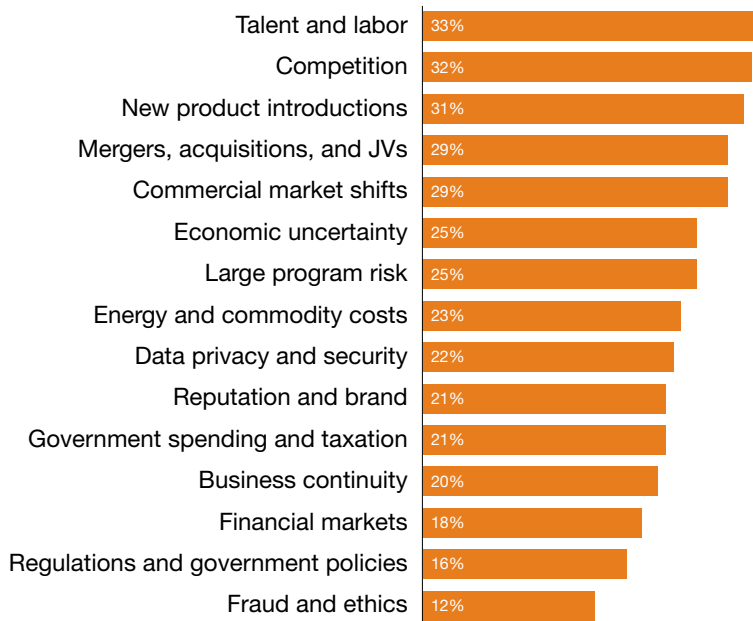
Or worse yet, it could be an indicator that internal audit understands the potential importance of their role, but something is holding them back from taking a seat at the table and effectively delivering value. In either case, CAEs and stakeholders need to consider what internal audit is doing to be relevant in these critical risks areas, and, if they are already playing a role, what internal audit should be doing to increase their level of importance and contribution in the overall risk management effort.

**Stakeholders want more**

More than 20% of stakeholders reported that internal audit paid too little attention to the vast majority of risks on which we surveyed (see Figure 5). These survey results pinpoint heightened stakeholder expectations for many areas on which traditional internal audit functions have not focused—such as talent and labor, new product introductions, and economic uncertainty. The fact that a risk hasn’t historically been a focus for internal audit should not hinder internal audit’s ability to play an important role. “Some would argue that internal audit doesn’t have a role to play in areas such as innovation or antitrust,” says the CAE of a leading technology company. “And it’s true we don’t have deep expertise in those areas. But we can ensure transparency of risk and that management has all the information it needs.”

While we recognize our survey results represent a macro point of view, they do indicate that at many organizations, internal audit may not be giving the proper focus or delivering the results stakeholders want across their most critical risks. Ongoing dialogue between stakeholders and CAEs is vital to ensure internal audit places its focus and allocates resources to the areas most aligned with stakeholders’ expectations.

**Figure 5: Risks that receive too little attention from internal audit**



### **Stakeholders want focus in all of their critical risk areas**

Consistent with stakeholders' feelings that internal audit has an overall important role to play and that there are many areas of risk where not enough attention is paid, interviews and survey results also showed that stakeholders believe internal audit functions should view all risks on which we surveyed as being within their mandate, but should also tailor their scope to focus on the greatest risks facing their organization.

The demand for overall increased attention came through in survey results, with 65% of stakeholders responding that they want internal audit to play a more substantial role in monitoring risks. And, when asked the specific areas where stakeholders want internal audit to maintain, add, or reduce focus,

# 46%

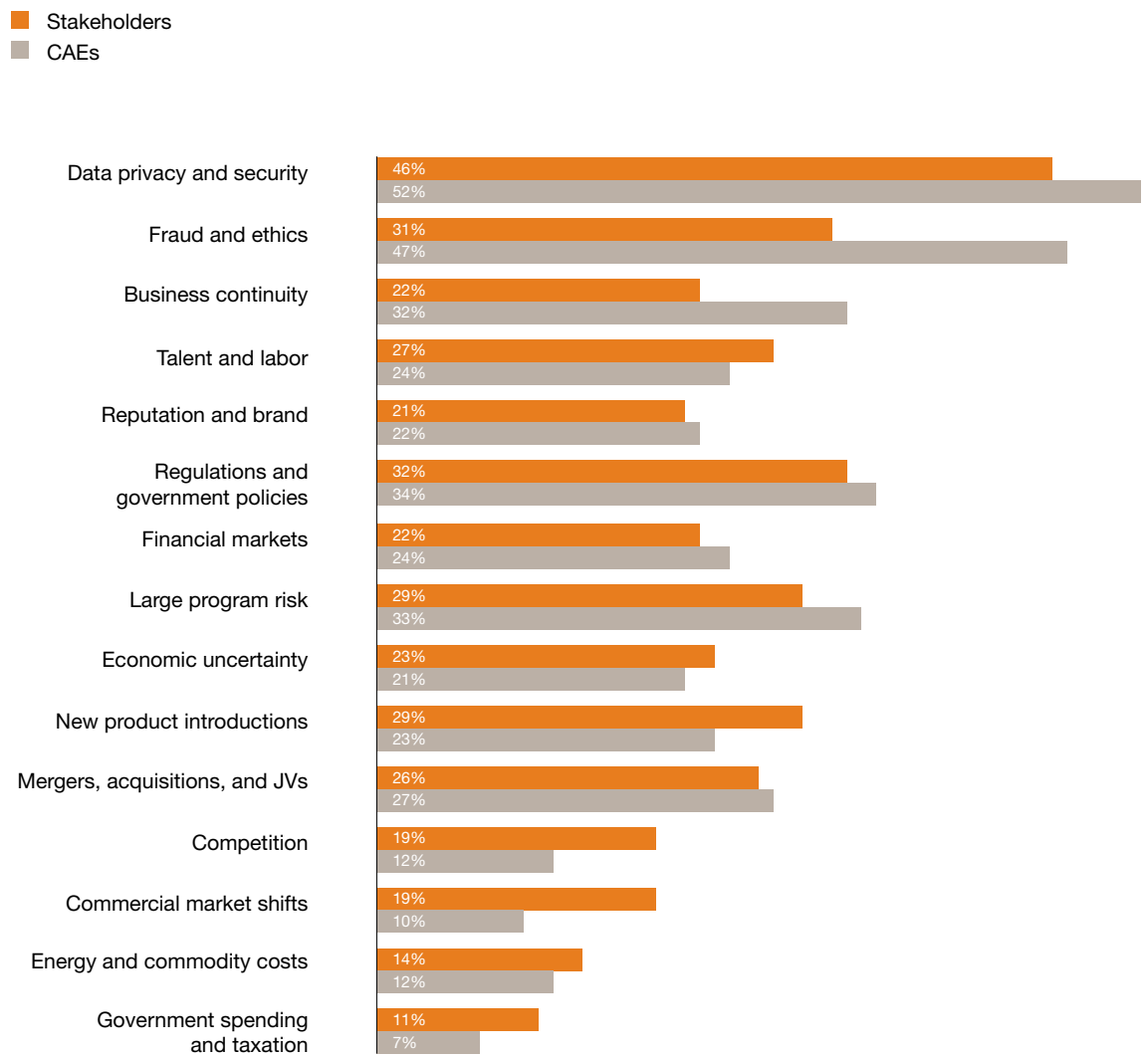
.....  
% of stakeholders who want internal audit to add capabilities to address data privacy and security

virtually no one wanted internal audit to reduce focus on the top risk areas. This is yet another key indicator of stakeholders' increasing expectations of internal audit in an ever-growing and shifting risk landscape.

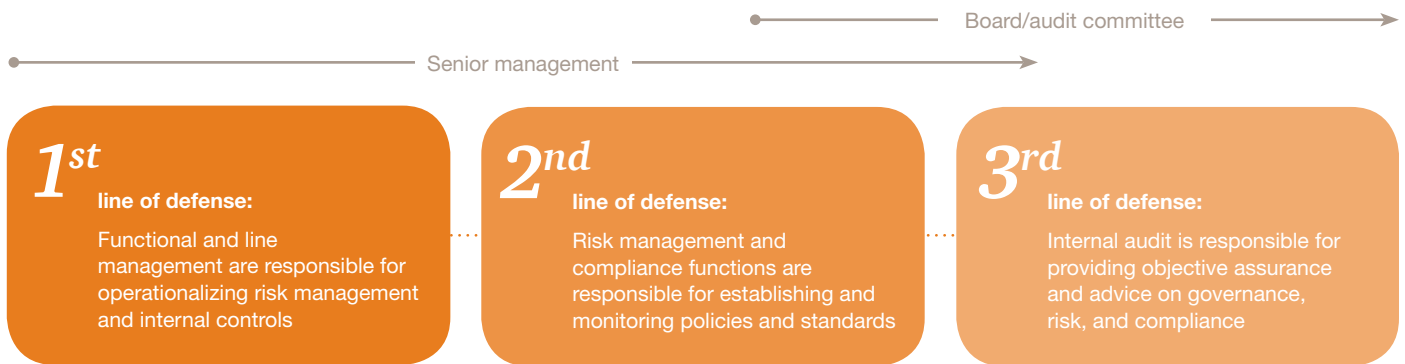
As we see in [Figure 6](#), stakeholders and CAEs have fairly strong alignment on the view that internal audit should maintain or add capabilities across all of the top 15 risk areas. However, in the areas of fraud and ethics and business continuity, CAEs' plans to add capabilities outpace stakeholders' expectations by 16 percentage points and 10 percentage points, respectively. While both of these risk areas have been on the agenda for some time now, it is clear that CAEs feel a greater need to increase their focus on monitoring them. While these risks are clearly complex and evolving rapidly, focusing too many resources on them will divert attention from other risk areas that the stakeholders we surveyed identified as more important. Faced with limited resources, internal audit must allocate resources to the most optimal areas aligned with stakeholder expectations. If they choose the wrong areas to over-invest in, the effort expended may very well be at the cost of missing a more critical business risk, leaving the organization unnecessarily exposed.

*Internal audit functions should view all risks on which we surveyed as being within their mandate, but should also tailor their scope to focus on the greatest risks facing the organization.*

**Figure 6: Risk areas in which stakeholders and CAEs want/plan to add internal audit capabilities**



**Figure 7: Three lines of defense**



**Stakeholders want coordinated lines of defense**

We often refer to risk management in terms of “lines of defense,” the multiple layers of activities that help ensure risks are efficiently and effectively managed and monitored in the manner intended by executives and non-executives. Stakeholders place value in the role internal audit plays as the third line of defense—providing objective assurance—but they value just as highly internal audit’s ability to effectively coordinate across the first and second lines.

As the third line of defense, internal audit assesses, for boards and audit committees, how well the organization’s governance, risk, and compliance processes are working—especially the first and second lines of defense. Dennis Powell, Audit Risk Committee chairman at Intuit, is one of many executives we spoke with who expects internal audit to be coordinated: “Internal audit has to identify areas where controls are not operating as they should be, and where risk management is not as robust as it needs to be.”

Of course, a pure third line of defense position is best played when the first and second lines are mature. Our experience indicates that when the second line is not in place or not mature, internal audit’s expertise should be leveraged to identify the risks and serve as a catalyst for improved risk management within the company’s individual business units.

Ultimately, though, executive management must firmly own the first and second lines, and keep ultimate responsibility for managing risks. “You must have risk management embedded within your strategy,” says David Burritt, chairman of the Audit Committee of Lockheed Martin. “Internal audit is ideally suited to advise on risk management processes and systems, but it is the business that must be ready to take action when risks emerge.”

While stakeholders value the role of internal audit as the third and last line of defense, survey results indicated that internal audit still has significant ground to gain as it relates to coordination with the second line. Seventy-four percent of organizations in our survey reported having formal enterprise

*Less than 50% of respondents believe their internal audit functions are well coordinated with other risk and compliance functions.*

risk management groups, yet less than 50% of respondents believe their internal audit functions are well coordinated with these groups.

Improving coordination between the second and third lines brings value in both directions: internal audit benefits from input that helps it focus its efforts in the right risk areas, and risk management and compliance groups benefit by leveraging internal audit's broad organizational view to bring cohesion to the organization's overall risk management efforts. "Internal audit provides value by taking a holistic view of the company," says Leslie Heisz, audit committee chair at Ingram Micro. Also demonstrating alignment with the risk management function, Andrea Cummings, VP of internal audit at BlueScope Steel, told us her internal audit group "considers the group risk profile during audit planning to identify key focus areas for the annual plan. In particular, internal audit reviews the mitigation actions proposed by management to consider if they are operating effectively."

As risk management functions continue to take shape, CAEs and stakeholders need to seek agreement on how the lines of defense should coordinate. This coordination and alignment will enable internal audit to better engage in risk identification, conduct more thorough risk assessments, and ultimately position the function to play an enhanced role in overall risk management efforts.

**Stakeholders want an insightful and objective viewpoint**

When stakeholders were asked for their top expectations of internal audit, as expected a vast majority (88%) ranked "financial controls and compliance assurance" among their top three. "Providing risk and controls advice" received an almost equally important rating, with 82% of respondents ranking it in their top three.

Our interviews showed that stakeholders are seeking deeper insights from internal audit. As one CFO told us, "CAEs should be expected to ensure the appropriate level of controls are in place to mitigate risk. They should also have a unique expertise to recommend controls." Recommending controls is highly valued, but many stakeholders we spoke with also want the insights offered to go a little deeper. Stakeholders are seeking insights that answer the question "What does this mean to my business?" and ultimately enable the business to connect the dots and operate more effectively.

While it is clear stakeholders want internal audit to provide both assurance and insights, our survey also showed that the characteristic stakeholders' value most in internal audit is its objectivity (chosen among the top three most valuable characteristics by 85% of stakeholders). Seeing objectivity

*Stakeholders do not believe objectivity constitutes an impediment to internal audit functioning as a valued business partner delivering deeper insights.*

given such priority, we dove a little deeper through interviews. While we heard a reinforcement of the need for objectivity, we also heard from stakeholders that they do not believe objectivity constitutes an impediment to internal audit functioning as a valued business partner delivering deeper insights; rather, it is a matter of finding the right balance. According to Audit Committee Chairman William Osborn, the internal audit function at Caterpillar Inc. has been successful in this balancing act. “They have done a nice job of walking the line,” says Osborn, “between internal audit coming down hard when there’s a problem, and being able to help people set something up in the right way to avoid problems.” He actually finds value in the balance, stating further that “there’s a tension there, and I’m a big believer that you need to be able to straddle the line and do both.”

45%

.....  
Respondents who say the majority of their critical risks are well managed

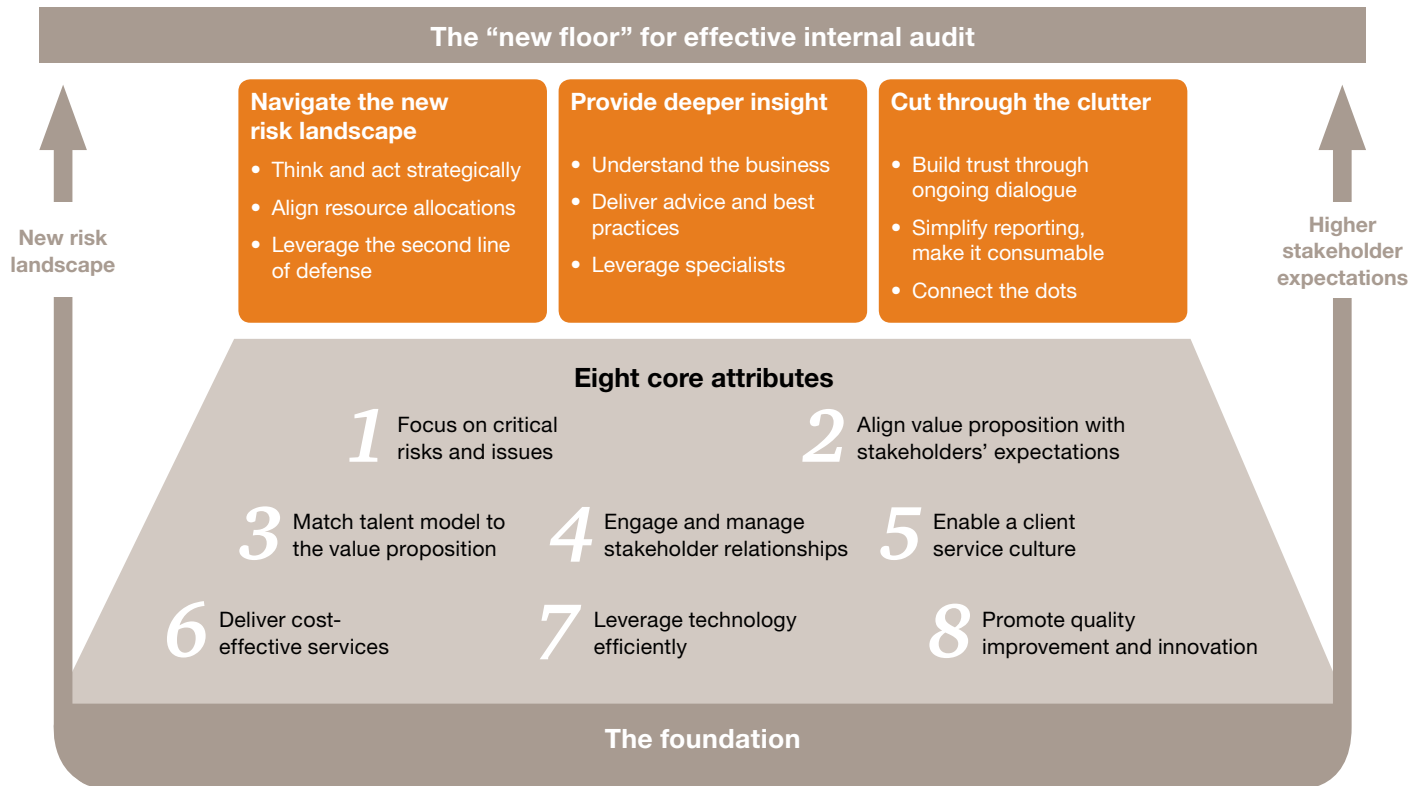
### **Seeking alignment as expectations rise**

With only 45% of respondents saying the majority of their critical risks are well managed, the door to an expanded role is open, and internal audit must walk through it and take on the attendant challenges.

However, regardless of company size, industry, or geographic location, the majority of CAEs told us that they expect their budgets to remain static or be reduced over the next 12 months—even though, as we’ve heard, stakeholders want internal audit to boost its capabilities in the face of the ever-growing and shifting risk landscape.

Through survey data, interviews, and our experience, we uncovered many leading internal audit functions that are finding ways to meet their stakeholders’ higher expectations—both in regard to enhancing value delivered in traditional control and compliance areas and in regard to addressing the most critical risk areas facing organizations today. By aligning resources in an optimal way in the right areas of the business, internal audit functions are showing they can do more with the same or fewer resources. The challenge for companies currently at or below their peers is how to rise to the new “floor” required by the combination of the new risk landscape and higher stakeholder expectations, and do so with constrained resources.

**Figure 8: Rising to the new floor**



### **Rising to the new floor for internal audit**

The “floor” (i.e., standard) for internal audit has always and will always include assurance over compliance and financial risks. But risks have shifted and expectations have risen, and all internal audit functions need to rise to this new floor: providing assurance on a broader range of critical risks and clearly communicating deeper insights, all while staying in complete alignment

with stakeholder expectations. Internal audit capabilities and practices that just a few years ago were considered leading are now part of the new floor of performance. The floor has been raised and internal audit functions need to raise their performance to meet ever-increasing stakeholder expectations.

Our discussions with stakeholders and CAEs and our experience working with a variety of internal audit functions have consistently pointed to the importance of eight core attributes

that make for an effective internal audit function, regardless of scope or size (see Figure 8). We introduced these attributes two years ago in our *Maximizing Internal Audit* whitepaper and we continued to hear throughout our research for this year’s paper that these eight attributes not only remain critical and relevant, but have become integral to the way effective internal audit functions operate. In other words, they are the foundation for the floor on which internal audit functions need to operate.



## *Top-down, risk-based planning begins with seeking management's viewpoint on their top priorities.*

### **Navigate the new risk landscape**

A significant element in addressing the challenges of the new risk landscape is the alignment of internal audit's activities with the organization's critical risks. This begins with developing a strategic understanding of the business, coordinating with existing risk management functions in the organization, and ensuring all services directly link to critical risks.

#### **Think and act strategically**

The Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing ("the Standards") emphasize top-down, risk-based planning consistent with the organization's goals, taking into consideration the input of senior management and the board. However, in practice, we see a wide variation in internal audit risk assessments, the areas of focus in internal audit plans, and the level and quality of resources devoted to internal audit efforts. Our survey indicated that only about 55% of organizations create their audit plans and allocate resources using a robust, top-down risk assessment approach. This is far lower than the Standards expect, and that CAEs should be content with.

The best top-down, risk-based planning begins with seeking management's viewpoint on their top priorities, identifies associated risks, and follows through with a thorough analysis of how internal audit can effectively incorporate these risks into its plans.

In parallel with the top-down risk assessment efforts, entity-specific data analytics are used by internal audit to further target and prioritize audit coverage. The resulting risk-based audit plan is discussed with stakeholders all the way up to the CEO and the board to gain full alignment on the approach.

We found this process is slightly different for certain financial services companies, where regulations may require that all auditable units are within internal audit's scope every three to four years (depending on the size of the institution). The most innovative of these financial institutions have nevertheless found a way to incorporate a top-down risk approach into their audit universe coverage mandate, thereby not only meeting their regulatory requirements but also gaining greater alignment with their stakeholders on the most critical risks. We have noted a number of leading financial services companies benefiting from this approach as they identify and

## *Risks aren't static. Internal audit must be flexible.*

develop a greater audit focus on specific risks (e.g., fraudulent trading, independent price verification, collateral management) than they otherwise would have using the bottom-up rotational approach.

### **Leverage the second line of defense**

Robust risk assessments that navigate through the new risk landscape require internal audit to think and act more strategically as they interact with and leverage the second line of defense. The process takes commitment and dedication to bridge gaps in viewpoints with stakeholders and achieve alignment, but the resulting effect is an audit plan that targets resources to areas of greatest risk and reward for the organization.

Not all risks are created equal and there are those—such as economic uncertainty, competition, and talent and labor—for which it's particularly challenging to develop specific audit responses. However, even these risks offer opportunities for internal audit to better coordinate with the second line of defense, gain real-time insight on the organization's plans to manage these risks, and step in to provide assurance when actions are taken in response to the risks.

Consider talent and labor, perceived to be the least well managed risk. What should internal audit be doing? As we unpack this risk, we see economic uncertainties bringing about reductions in force and/or the addition of temporary and contract employees. Global expansion requires adapting hiring and employee retention policies to meet new talent pool needs. As these talent pools shift to include more emerging market resources, training programs must be adapted not only to account for language differences, but also to accommodate differences in cultural business practices. Internal audit can and should be coordinated with the second line of defense around all these areas, bringing its viewpoint to the table and evaluating planned responses. Perhaps even more importantly, internal audit should be prepared to adapt its audit plans in real time, as actions are taken by management, to provide assurance that such actions are being taken in accordance with the plan and that associated risks are properly mitigated.

Internal audit also can play a key role as a facilitator of ERM processes that enable alignment with a broad base of stakeholders on the most critical risks facing the business. This process is driven by the CAE, who in many leading organizations has a prominent role on the executive management team.

### **Align resource allocations**

Driving risk monitoring and assurance from an overall strategic risk assessment process not only creates stronger alignment between internal audit and the business, it also helps prioritize and focus audit work that will be done throughout the year. But risks aren't static, and the best internal audit groups recognize that the baseline is bound to change and that they must be prepared for flexibility. As Kai Monahan, senior vice president and CAE at Nationwide Insurance, points out, "Our organization relies on our executive leadership team and internal audit to change course if we are not focused on the right areas."

At General Motors, audit plans change regularly throughout the year. "When I show the annual audit plan to my customers and the audit committee early in the year," says General Auditor and Chief Risk Officer Brian Thelen, "the only thing that I can guarantee is that if we look at that same plan again at the end of the year, the work we accomplish will differ from the original plan due to the dynamic nature of our business." New strategic objectives arise continually, new risks appear, and risks in a given area may prove to be lower than anticipated. When changes occur, the internal audit group must be able to shift gears quickly to address

*To be relevant and add value, internal audit functions need to focus on the key and most pressing risks facing the organization.*

the needs of the moment. According to Thelen, GM's audit committee and other stakeholders respond well to a flexible plan: "I've never experienced resistance as long as I've kept stakeholders abreast of the changes and why they are happening. Our customers understand we operate in a constantly changing environment, and holding to a static view of risk can mean your resources are not deployed appropriately."

As risks shift and internal audit focus adjusts to stay aligned, it is critical for CAEs to communicate to all stakeholders the movement in their plans and the reasons for the shift in focus.

As we heard from David Burritt, "If a company makes the mistake of relegating internal audit to just accounting issues, they will never understand the business well enough to get to the root causes of issues." This is a sentiment shared by stakeholders and CAEs, who told us time and again that organizations derive the greatest value when internal audit aligns its focus and resources with the organization's most critical risks.

There are, of course, those risks that, while still challenging, allow for more concrete responses from internal audit. During our interviews, we heard numerous stories from CAEs

regarding the actions they are taking to rise to the new floor, either by including these risks for the first time or rethinking how they are addressing the risks to deliver deeper insights to stakeholders. The four areas we heard about the most from CAEs were large program, mergers and acquisitions, data privacy and security, and fraud and ethics risks. It should be noted that two of these—large program risk and mergers and acquisitions risk—were named among the least well-managed risks, demonstrating that some CAEs are willing to embark upon the difficult task of navigating this new landscape. Two other risk areas mentioned by CAEs—data privacy and security risk and fraud and ethics risk—were among those that stakeholders believed most important to receive internal audit focus, demonstrating that these CAEs are aligned with their stakeholders.

*Large program risk*

Many executives included the risk of managing large operational improvement and technology projects in the top five risks facing their organization. Many have multi-year, enterprise resource planning projects underway, all of which risk continuity of ongoing business, budget overrun, and other hazards if not tightly monitored and managed. In our experience, we see internal

audit functions taking action by being proactive and embedding resources within the program team, thus enabling the program team to leverage internal audit's deep business process and control skill sets. Evaluating the overall program for proper governance around key milestone decision points is another way internal audit is taking action and putting itself in a position to provide the insights stakeholders are looking for.

#### *Mergers and acquisitions risk*

Risks associated with mergers and acquisitions—both accurately assessing the need for such moves and assessing the risks associated with integrating new operations—were cited frequently by survey respondents, especially in the context of emerging markets. From our *Global CEO Survey*, we noted 39% of US-based organizations and 28% of global organizations having plans to expand through cross-border mergers or acquisitions in the coming year. There are numerous ways internal audit is getting more engaged in this risk, including evaluating strategies, up-front involvement on due diligence teams, post-merger integration, and post-merger benefit realization evaluation.

#### *Data privacy and security*

Data privacy and security is the single most requested area for increased internal audit focus, with 46% of stakeholders asking for internal audit to add capabilities in this area. The reality is that this risk is evolving so fast that most organizations cannot keep pace. It is becoming more complex, driven largely by the proliferation of technology, the increasing amount of personal data stored by companies, and the ever-growing sophistication of those seeking access. Leading internal audit functions we spoke with are trying to stay ahead of this risk by highlighting the need to shore up their controls through the addition of polices and oversight roles, and bringing in the right expertise to identify gaps and provide insights to fix them expediently.

#### *Fraud and Ethics*

Fraud and ethics risk was cited by CAEs as an area in which they are most likely to maintain and add capability. It also topped the ranking of risks in which CAEs consider internal audit involvement to be “very important.” With only 53% of stakeholders and 35% of CAEs believing this area is currently well managed, companies have much work ahead of them to raise overall confidence levels.

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At Ingram Micro, Audit Committee Chair Leslie Heisz has benefited from internal audit being involved in critical projects such as implementation of enterprise resource planning programs. She credits such involvement for enabling the audit committee to be more effective:

*“It brings important process matters to the committee’s attention.”*  
.....

*“In the last two years, we have completed three of the largest acquisitions Caterpillar has ever done. We’re spending unprecedented amounts of capital on building our footprint in both developed and emerging markets. Risk comes with these opportunities and internal audit needs to be prepared. We have a process in place now whereby we evaluate acquisition integration activities within months of the transaction closing, in an attempt to provide ‘preventative maintenance’ advice—followed up by robust audits about a year after the acquisition.”*

—Matt Jones, CAE, Caterpillar Inc  
.....

*“One way for internal audit to add value is to provide insight as new processes are being implemented, so that they are effective from day one.”*

—Kai Monahan, CAE,  
Nationwide Insurance

*“CAEs should be expected to ensure the appropriate level of controls are in place to mitigate risk. They should also have a unique expertise to recommend controls.”*

—Peter Klein, CFO, Microsoft

Fraud and ethics risk gets its complexity from a variety of sources, among them various territory-specific anti-corruption rules such as the UK Bribery Act, the US Foreign Corrupt Practices Act, and anti-money laundering (AML) procedure requirements of the USA Patriot Act. With severe consequences for non-compliance—including reputational damage, potential debarment from bidding for government contracts, related legal fees, and impact on investor confidence—it is not surprising that leading internal audit functions have fraud and ethics on their radar. Some CAEs are developing in-house teams of experts to address this risk area, while many others are seeking external support to ensure compliance. One organization we spoke with gave us insight on the scope of their AML procedures, which cover overall AML governance, policies, and procedures surrounding Know Your Customer checks (e.g., customer due diligence and enhanced due diligence procedures), AML sanctions monitoring, and AML training and awareness. Given the complexity of these rules, the company heavily leverages outside subject matter experts.

On another front, Steve Shelton, CAE at KBR, has made such risks a special focus of his group: “Because anti-corruption risk has been significant for our organization, I created a specialized team that has substantially reduced our exposure in that area.”

### **Provide deeper insights**

While stakeholders told us internal audit’s top priority should be auditing and reporting on risk management and control, they also placed significant value on internal audit’s ability to assess risks facing the organization and to provide insights to help enhance risk management activities.

### **Understand the business**

Navigating the new risk landscape requires internal audit to have a solid understanding of the business’s strategic objectives and the initiatives and tactics it employs to achieve them—a process familiar to the HCA internal audit group. HCA creates its audit plan after a series of meetings with all senior leadership and board members in which they identify risks to the organization’s objectives and initiatives.

To earn the respect of the business, internal audit must empathize with the challenges facing the organization, hold constructive conversations, and understand the implications of its observations on the broader risks facing the organization. By demonstrating a solid understanding of the business and its strategic direction, internal audit improves its chances of being asked to participate in strategic business initiatives.

## Leverage specialists

As risk complexity intensifies with increased velocity, internal audit functions must ensure they maintain the proper breadth and depth of experience and expertise to adequately address critical risks. Such specialist knowledge certainly enhances the value of services delivered by internal audit, and it also increases the credibility of internal audit's suggested actions and the internal audit group as a whole. Leveraging outside specialists is more efficient than hiring permanent resources for internal audit groups that might only deliver one or two of these types of audits per year.

## Deliver advice and best practices

The Standards note internal audit's responsibility to evaluate strategic, operational, financial, and compliance risks facing the business. Internal audit has long been valued for providing an objective viewpoint and control expertise, but with the complexity and level of risks increasing, stakeholders we spoke with want internal audit to look beyond just identifying problems. They want internal audit to demonstrate a clear understanding of complex situations and issues, and to provide practical advice

and counsel. In other words, they want insights embedded within the assurance services internal audit is required to provide. To deliver on this expectation, internal audit professionals must have the courage and skills to go beyond asking the obvious questions. Many CAEs are likely hearing the request for these skills firsthand from their stakeholders, as 52% told us they intend to add capabilities focused on delivering more advisory services in the coming 12 months.

Many CAEs we spoke with viewed "providing insights with assurance" as a critical step for their functions to earn a seat at the broader risk management table. "In order to earn the respect of management and stakeholders and become part of the core business, it is critical to not only identify issues but to also help solve problems and identify solutions, without compromising transparency or objectivity," says Melvin Flowers, vice president of internal audit at Microsoft. "It is critical for internal audit to understand the business issues and drive value above and beyond the execution of the audit plan."

We also heard that performing audits and providing advice are not mutually exclusive propositions. "We are probably about 40% advisory and

60% assurance," says Nationwide Insurance's Kai Monahan. "When you are performing an 'assurance project,' you can provide some advisory services along the way in terms of control improvement and ideas."

Further, the most flexible and adaptive internal audit groups don't rely on a standard portfolio of approaches and templates; instead, they create approaches to meet the needs of new situations as they arise. At Google, CAE Lisa Lee is providing deeper insights by challenging her auditors to link their business strategy knowledge with underlying risks to develop the best means of auditing the matter at hand. "We have an established methodology," she explains, "but we don't have a lot of established templates or audit program guides that we re-use, because I challenge our auditors to look at every initiative as standalone. What is our objective here, what are we trying to achieve, and what's the best way to accomplish it?"

# 52%

.....  
% of CAEs who intend to add capabilities focused on delivering more advisory services



## **Cut through the communication clutter**

Communication of audit focus, activity, and perspective is a critical component of the foundation of an effective internal audit function. As the business environment becomes more complex, alignment on critical risks becomes more important and the need for effective and efficient communication rises in importance.

### **Build trust through ongoing dialogue**

The majority of stakeholders told us that face-to-face meetings are the most valuable form of communication from internal audit. Such direct communication allows key stakeholders to respond quickly to critical issues requiring their knowledge and action, helps resolve questions, and allows for discussion of interpretations. Audit committee presentations were named the second most valuable communication, with individual audit reports rounding out the top three.

During interviews, almost every audit committee chair pointed to face-to-face interaction as the most important communication they had with the CAE. Drilling down, they placed particularly high value on

informal and private discussions, which were viewed as crucial towards building a relationship with the CAE in which they can feel free to talk in person or pick up the phone whenever an important matter arises.

Most CAEs surveyed also prefer face-to-face meetings. As one said, “I like to have more relaxed conversations with our audit committee where they can provide their insights about what they see in the company, what they’re concerned about, and what they think we should be concerned about. These get-togethers help enormously in getting to know one another and build rapport.”

Risks are complex and audit findings are often commensurately complex. Building in time for face-to-face dialogues around the issues can help cut through the clutter of audit findings, saving time and energy while opening the door to insights that may only arise through discussion.

### **Simplify reporting, make it consumable**

Stakeholders also told us that they want internal audit to present assurance about risk management activities in a succinct, easily consumable manner. As the variety

and complexity of risks within internal audit’s purview increases, this challenge of developing and providing effective and efficient communication increases as well. Further complicating the ability to effectively communicate findings in the shifting risk landscape is the variety of expectations stakeholders have for what makes for “effective communication.” Detailed audit reports are sufficient for some stakeholders, while others want summary-level presentations and still others want one-on-one meetings to discuss audit findings. Stakeholders and CAEs are spending more and more time discussing the risk assessment process, enabling them to lay the groundwork for a better understanding of how audit findings might impact the organization.

CAEs and stakeholders we interviewed said that simplifying the message for the audit committee has become very important to ensure that linkages between findings and resulting risks are clearly communicated, and that impacts are understood. Some favor a storyboard approach for keeping the committee informed and focused. As one audit committee chair told us, “The audit committee is traveling at 50,000 feet because that’s where we need to be from an oversight perspective,

*During interviews, almost every audit committee chair pointed to face-to-face interaction as the most important communication they had with the CAE.*

so you have to get your message across fast, clean, and clear, in a language we can quickly process.”

To address the complexity of reporting issues, leading CAEs told us they are simplifying formal presentations through the use of more graphs, charts, and metrics. They are also streamlining written reports to leave more time for valuable face-to-face discussion.

#### **Connect the dots**

Several stakeholders told us about increasing the use of trend analysis as a way to connect similar findings and clearly portray the organization’s exposure to potential risks. As Caterpillar’s William Osborn notes, “A cluster of items falling into a particular audit area in one vertical may not seem significant. But if you can look at that area across the whole company and the same items appear, it can signal systemic problems that need to be addressed. When internal audit has the ability to see those patterns, it puts itself in a position to guide management before controls break down, risk events occur, and the organization must deal with the consequences.”

Trend reporting better identifies issues that cut across many parts of the organization, helping assess risk across country borders—which is increasingly important for multinationals that need to stay nimble. Trend information can be collated centrally and then analyzed, allowing for conclusions that can drive improvement across the organization. If similar risks have been identified in different countries or business units, it may be possible to cover them with a single solution.

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Driving risk monitoring and assurance based on top-down, strategic risk assessments, focusing resources on critical risks, providing deeper insights, and using effective communication techniques are all part of the new floor from which internal audit needs to operate. It’s where internal audit needs to be to play in today’s business world, but often internal audit has to overcome barriers such as organizational and cultural resistance to get there. In the following section, we’ll discuss the most critical barriers to rising to the new floor.



## **Overcoming the barriers**

Even organizations that are operating well above the floor have told us that they've had to overcome barriers. Stakeholders and CAEs identified the most common barrier as organizational and cultural resistance, followed by lack of internal audit resources and expertise and lack of a mandate.

Even without a catalyst or mandate from stakeholders, many leading CAEs have made a conscious effort to change the way internal audit operates, determining how they can best help the organization monitor its critical risks and then building their scope and staff model accordingly. These CAEs have created an internal audit by design and function. In contrast, we found that internal audit functions at organizations performing below their peers tend to limit their focus based on their resource capacity and skill set. They base their efforts, by default, on their staff size, budget, and existing capabilities. Those that operate by design set themselves a harder task, but they make greater contributions and have discovered ways to overcome barriers.

## **Cultural and organizational resistance**

The cultural and organizational challenge is multifaceted and is only overcome through building respect and trust-based relationships in which stakeholders understand and value internal audit's contributions. "Internal audit's relationship with stakeholders must be based on mutual respect and trust," says the CAE of a leading technology organization. "Internal audit functions that just want to play a policing role don't need to earn a great deal of respect or trust in an organization. However, if they want to help functional managers improve their risk management, audit professionals must actively work to build trust and shed age-old perceptions."

For the internal audit function at \$4.2 billion software company Adobe Systems Inc., "Small wins are critical to gain confidence and trust," says Chief Audit Executive Eric Allegakoen. "Every small project should bring a valuable gain to that seat at the table." He adds, "By helping managers improve their processes, internal audit can change its image, and be seen as more than internal policemen on the lookout for policy offenders."

By leveraging core competencies, developing trust-based relationships, transcending outdated misperceptions, and providing clarity and deeper insights, internal audit can begin earning respect and win a seat at the table.

*For the internal audit function at \$4.2 billion software company Adobe Systems Inc., “Small wins are critical to gain confidence and trust,” says Chief Audit Executive Eric Allegakoen. “Every small project should bring a valuable gain to that seat at the table.”*

### **The role of the CAE**

With 57% of respondents listing organizational and cultural barriers as the leading reason why internal audit does not play a more substantial role, it is important to understand the value organizations place on the role of the CAE. Our experience indicates that those companies that are committed to the importance of internal audit place an executive who is held in high esteem within the organization in this role. As David Burritt told us, “The CAE role is vital, and employees have to look no further than the person leading internal audit to know how executive management regards it.”

Of course, when the CAE is a respected member of the executive management team, internal audit’s activities are far more likely to be aligned with stakeholder expectations and critical business objectives. We learned in our survey that the CAE actively participates on the executive team at approximately 80% of responding companies that exhibit superior risk management practices and perform above their peers financially. At trailing companies, only 60% of respondents indicated that the CAE takes part in and contributes to executive meetings. Such participation, of course, is part and parcel of the enlightened perception of internal audit’s role that led to the installation of a top-notch CAE in the first place.

### **Lack of resources and expertise**

As CAEs strive to address their organizations’ talent and labor risks, they feel the impacts of this risk firsthand as they focus on filling their own talent pools. Many we spoke with are finding the market unable to effectively meet their demand for people with the deep, varied, and specialized skills needed to focus on complex issues ranging from multi-jurisdictional regulatory compliance to ingenious data privacy and security threats.

The demands of emerging markets are also changing the mix of required skills. For example, strategies for curtailing fraud and corruption in the West may not be very useful in many emerging markets, which require different controls and approaches. Several executives in emerging markets told us their internal audit functions have had to quickly acquire and develop local expertise in order to avoid being blindsided by local language and customs issues.

Internal audit functions that have risen above the new floor have developed and are executing on plans to gain the experience and knowledge they need for their teams to excel on the global stage. The most innovative internal audit groups of all have done so primarily using two approaches: staff rotation and co-sourcing.

*Too often we see internal audit functions that are clearly struggling with resources and expertise constraints, and are allowing those constraints to limit their focus.*

### **Staff rotation**

Many companies have long used staff rotation to bring business skills into internal audit and to give high-potential employees broader experience and exposure within the company. Today this practice is helping companies leverage talent when talent is scarce. There are two strategies for staff rotation that seem to work the best:

- **Formal staff rotation programs.** Staff rotation programs work best when they are formally supported by the business. Our experience has shown that organizations that do this well have significant percentages of their staff come from the business and return to the business. An example of the business commitment was noted at one leading global manufacturing company, where holding a position in internal audit for at least three years is considered a necessity to advance within the finance organization.
- **Guest-auditor programs.** With certain talent in short supply and high demand, internal audit is learning how to leverage skill sets within the organization by borrowing resources for short-term assignments. These guest auditors are partnered with existing, trained internal audit staff to bring relevant knowledge to a particular audit area. In fact, one leading online retailer has a formal “borrowed resource program” through which

experts from throughout the company participate in audits and exchange knowledge, increasing the collective capability of the internal audit staff. Microsoft’s Melvin Flowers believes that bringing in outside help and leveraging expertise from within different specialized areas of his organization both help his internal audit function be more successful.

Whether companies use a formal rotation program or a guest-auditor approach to getting the talent they need to execute the audit plan, the elements of effective rotation programs remain consistent:

- Inclusion of internal audit rotations within the organization’s overall talent development strategy—including sources of talent, specific skill sets required, length of tours, and desired percent of staff with rotational positions.
- Viewpoint communicated by business leadership around the importance of internal audit as a source of talent development.
- Well-communicated success stories of staff who have contributed to internal audit and achieved leadership positions within the organization.

### **Co-sourcing**

With the complexity of risks increasing at a rapid pace and internal audit organizations moving into more of the critical risk areas, many functions struggle to deliver

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Caterpillar CAE Matt Jones told us that co-sourcing helped his internal audit group improve dramatically after the decision was made to undertake a transformation:

*“We didn’t have all of the right skill sets, the right processes, or the right systems. So we engaged a co-sourcing partner and have dramatically changed all of that.”*

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*“Sometimes you have to get the skills from an outside source as there’s just not the depth or breadth within internal audit.”*

—Dennis Powell, Audit Risk Committee chairman, Intuit

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*“When we look at a new area that needs specialized resources we don’t have, we often rely on outside providers. We want to bring the most knowledgeable person to the table, especially when we’re dealing with process owners who are experts in that area. We always make sure to have a Googler involved who understands the culture and the messaging, and also to learn.”*

—Lisa Lee, CAE, Google

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*“To be successful, you have to have the right level of expertise. Sometimes this means you have to hire it. You can’t be afraid to use consultants to help support your existing talent pool.”*

—Melvin Flowers, VP of internal audit, Microsoft

specialist expertise to evaluate them. Effectively auditing areas such as large program risks that include complex system implementations, persistent data and security threats, and multi-jurisdictional fraud, ethics, and regulatory compliance requires deep, up-to-date understanding of the subject matter. These types of expertise are difficult to grow within an organization as a whole, let alone within an internal audit function that may perform only one or two of these types of audits per year. In our interviews, stakeholders and CAEs shared a variety of co-sourcing models they have employed, including bringing in specialists to assist with scoping and framing issues, using subject matter specialists to execute more complex audits, and adding semi-permanent team members to provide better global coverage.

Too often we see internal audit functions that are clearly struggling with resources and expertise constraints, and are allowing those constraints to limit their focus. By not overcoming the resources and expertise barrier, they are not meeting stakeholder expectations, let alone rising to the challenges of tomorrow. As specific expertise is needed to address the complex and rapidly shifting risk landscape, staff rotation and co-sourcing have enabled effective internal audit functions to respond quickly when, where, and as risks arise.

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*What this means for your business*

# Designing for the new floor

*“Internal audit functions also need to meet higher expectations, as the floor has risen and the status quo for many is not enough.”*

—Brian Brown, PwC principal and leader of Risk Assurance Innovation in the US

Today’s global business community faces a more complex and uncertain risk landscape where previously unknown risks can manifest themselves with unprecedented speed. To respond effectively, companies must adopt more sophisticated and integrated risk management approaches. And internal audit functions also need to meet higher expectations, as the floor has risen and the status quo for many is not enough.

Our survey and interviews showed that while stakeholders and internal audit are generally well aligned on what risks need the most attention, few organizations are utilizing internal audit as a natural partner in providing an added level of confidence over risk management—this despite the fact that most stakeholders say they value internal audit’s contribution. With the risk landscape shifting rapidly, stakeholders’ expectations have shifted too. In addition to internal audit’s traditional assurance role, they now view providing insight and advice on a wide range of risks and controls as one of the function’s critical and baseline responsibilities.

Stakeholders and CAEs need to be confident that their priorities are aligned and that internal audit resources are appropriately allocated to the most critical risk areas. To achieve this, organizations must create a culture in which stakeholders and CAEs coordinate on the lines of defense and hold robust dialogue around risks facing their organization. Internal audit should be expected to share and evaluate perspectives on how well these risks are being managed and align their resources to address the most critical risks. Often, shifting to this new, expanded role and delivering the right talent to evaluate the complex risk landscape will require that internal audit overcome organizational and cultural barriers.

In the past, raising the bar each year in response to current and looming risks was good enough for internal audit. But in today’s landscape of fast-emerging and quickly shifting risks, where stakeholders are asking for deeper insights and clearer communications, internal audit needs to rise to the new floor or they will not meet stakeholder expectations.

Rising to the new floor takes deliberate action on the part of stakeholders and CAEs alike. Internal audit functions are expected to:

- Align the scope of work and allocation of resources to the organization's most critical risks through comprehensive, top-down risk assessments.
  - Hold ongoing, robust dialogues with stakeholders to adapt internal audit's response in a timely manner, as changes are needed.
  - Leverage and coordinate with the organization's other risk management and compliance functions to navigate through the shifting risk landscape.
  - Lend expertise to enable the organization to enhance its second line of defense if it is not already robust.
  - Move beyond just reporting on gaps and instead provide stakeholders advice on risks and controls that improve business performance.
  - Communicate complex matters in a clear, consumable fashion, with summaries of recurring themes and deeper, interpersonal interaction with stakeholders.
- Address organizational and cultural resistance by ensuring stakeholder sponsorship on the importance of the CAE role and positioning the function to be built and operated by design.
  - Earn stakeholder respect and a seat at the table through ongoing dialogue, one audit at a time, with a mindset of enabling the business to function better.
  - Face the talent and resource shortage challenge head on. Do not limit audit focus based on existing resource capacity or skill set; rather, leverage organizational capabilities and acquire new ones so internal audit can act when required—going where the risks are emerging now, not where they were last year, last month, or last week.

Leading companies stand out by their ability to anticipate risks and position themselves to survive and even find opportunity in the midst of risk-related events. With the risk landscape shifting under their feet, internal audit functions must follow the same path, transforming and strengthening the floor from which they operate and becoming the partner stakeholders increasingly want and expect.

Today's typical CAE faces a more complicated risk landscape, higher stakeholder expectations, and constrained resources. While some

wait for catalysts such as control-related crises or increased regulation, others have chosen to rise to the challenge. Below are key questions

and considerations stakeholders and CAEs should use to evaluate whether they are performing at the new floor.

**Figure 9: Meet the challenge of a higher floor**

<i>Navigate the new risk landscape</i>	<i>Provide deeper insights</i>	<i>Cut through the clutter</i>
<b>Questions</b>		
How well aligned is audit's plan with the critical risks facing the organization?	Does internal audit provide a point of view to help the business improve its responses to risk?	How effectively does internal audit communicate with stakeholders?
<b>What internal audit should do to rise to the new floor</b>		
<ul style="list-style-type: none"> <li>• <b>Think and act strategically</b> Internal audit understands the organization's strategy, initiatives, and related risks; audit activities are derived from a top-down risk assessment and aligned with stakeholder expectations.</li> <li>• <b>Leverage the second line of defense</b> Internal audit contributes to and coordinates with risk management efforts, providing insight to the overall risk management process and focusing audit efforts appropriately.</li> <li>• <b>Align resource allocations</b> Internal audit provides services linked to critical areas of risk, not only those related to existing talent and expertise. It stays aligned in a constantly changing environment.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Understand the business</b> Internal audit's business acumen is clearly evident in all it does, fostering the desire for internal audit involvement in the most significant business initiatives.</li> <li>• <b>Leverage specialists</b> Internal audit uses specialists — both internal and external—to support work in areas where it does not have the breadth and depth of expertise to effectively provide a point of view.</li> <li>• <b>Deliver advice and best practices</b> Internal audit provides deep insights in all of its activities, as well as proactively offering advice on the design of future processes.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Build trust through ongoing dialogue</b> Significant attention is given to face-to-face communication with stakeholders, including the audit committee. In these meetings, additional perspective is provided around the management of critical risks.</li> <li>• <b>Simplify reporting, make it consumable</b> Internal audit reports contain concise messages clearly linked to underlying business risks.</li> <li>• <b>Connect the dots</b> Internal audit identifies common themes and trends across the organization, enabling the business to close gaps.</li> </ul>



## Research approach

This study is based on results from an online survey carried out in November and December 2011. The majority (57%) of our survey participants were chief audit executives, with the remainder encompassing audit committee chairs, audit committee members, CEOs, CFOs, chief risk officers/risk controllers, chief compliance officers, and general counsels. The survey reached a wide range of industries, with no sector accounting for more than 15% of the total sample. More than half of our survey participants worked for companies headquartered in the US, with the remainder spread among another 63 countries. Some 75% of survey participants were associated with companies with at least \$1 billion in annual revenue, with 18% connected to companies with at least \$20 billion in annual sales. We also leveraged results of the PwC 2012 *Global CEO Survey*.

To understand the statistical trends and gain a qualitative perspective, we conducted in-depth case-study interviews with nearly 100 executives, comprising chief audit executives, senior executive management, audit committee chairs, board members, and other stakeholders of internal audit. To further develop our qualitative perspectives, we leveraged our experience in performing internal audit services for a number of clients across a broad range of industry sectors and financial sizes.

Executives from the following organizations were among those who participated in our interviews.

Company	Country/region
Abu Dhabi National Energy Co. PJSC	Middle East
Adobe	US
Aircel Limited	India
Al Dorra Petroleum Services	Middle East
Australian Postal Corporation	Australia
Amazon.com	US
Barrick Gold Corp.	Canada
Bharti Airtel Ltd.	India
BlueScope Steel Ltd.	Australia
Brookfield Office Properties, Inc.	Canada
Canadian National Railway Co.	Canada

Company	Country/region
Canadian Pacific Railway Ltd.	Canada
Caterpillar Inc.	US
Cenovus Energy, Inc.	Canada
Dubai World	Middle East
Eli Lilly and Co.	US
Ford Motor Co.	US
General Motors Co.	US
Google, Inc.	US
Hong Kong Monetary Authority	HK/CN
Hutchison Whampoa Limited	HK/CN
Indus Towers Limited	India
JOHN SWIRE and SONS LTD	HK/CN
KBR, Inc.	US
Lonmin Plc	South Africa
Maruti Suzuki India Ltd.	India
Metro AG	Germany
Microsoft Corp.	US
Mindray Medical International Ltd.	HK/CN
Murray & Roberts Cementation (Pty) Ltd	South Africa
Nationwide Mutual Insurance Company	US
Qatar Telecom QSC	Middle East
Royal Bank of Canada	Canada
Sherritt International Corp.	Canada
Sterlite Technologies Ltd.	India
Suncor Energy, Inc.	Canada
Swiss Re	Switzerland
Talisman Energy, Inc.	Canada
Tata Steel Ltd.	India
Technova Imaging Systems Private Limited	India
Telkom SA Ltd.	South Africa
The Wave Muscat S.A.O.C.	Middle East
The Wharf (Holdings) Ltd.	HK/CN
Zhuhai Zhongfu Enterprise Co., Ltd.	HK/CN

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Member of Audit Committee, Western Union Co.

***Leslie Stone Heisz***

Member of Board of Directors, HCC Insurance  
Holdings Inc.  
Member of Board of Directors, Ingram Micro Inc.

***Michael J. Joyce***

Chairman of Audit and Compensation  
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***Denis J. O’Leary Jr.***

Member of Audit Committee and Nominating and  
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***Dennis Powell***

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