

Business upheaval: Internal audit weighs its role amid the recession and evolving enterprise risks

PricewaterhouseCoopers 2009
State of the internal audit profession study



PricewaterhouseCoopers' fifth annual state of the internal audit profession study reveals an internal audit profession in flux, making rapid adjustments to a world that seems at once expanding, contracting, and changing...always changing.

Table of contents

The heart of the matter Doing more with less as a fragile economy looks to regain its footing	4
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An in-depth discussion A tough period sets the stage for internal audit transformation	6
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Strapped for resources, yet faced with new challenges.	7
Company risk profiles aren't what they used to be.	9
Navigating the stakeholder perception of value now.	13
ERP implementations highlight a skills gap.	17
When governance meets continuous improvement.	21

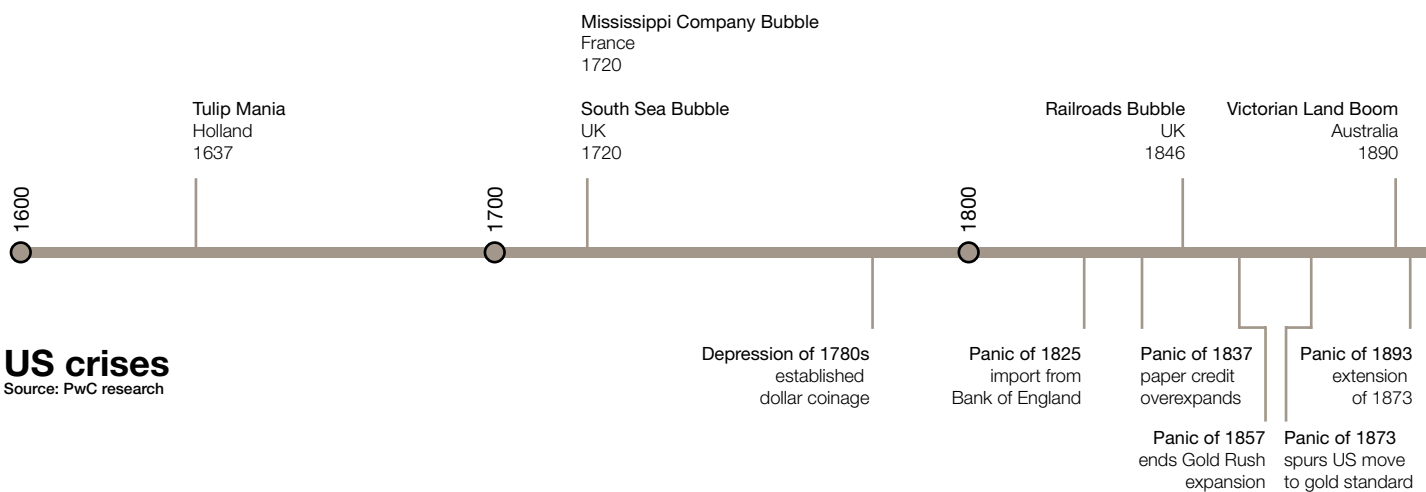
What this means for your business New strategies are needed for success in a time of transition	24
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How to determine that the ERM function is prepared for a dramatically different environment.	26
How to reduce costs and enhance the quality of internal audit services by embracing technology.	30
How to build an effective human capital strategy to acquire, develop, and retain talent needed now and for the future.	32

The heart of the matter

Doing more with less as a fragile economy looks to regain its footing

International crises



US crises

Source: PwC research

Source: PricewaterhouseCoopers. *American Perspectives*, 2008, <http://www.pwc.com/americanperspectives>.

An in-depth discussion

A tough period sets the stage for internal audit transformation

Strapped for resources, yet faced with new challenges.

Why internal audit must brace for an efficiency revolution.

Not surprisingly, this year's State of the Profession survey reflected the economy as the number one issue. With the percentage of respondents reporting budget reductions doubling from last year's survey, PricewaterhouseCoopers predicts even greater internal audit budget constraints in 2009.

About half of the survey respondents said that they expected budgets to remain flat, while a third said budgets would actually decrease in 2009. Among the Fortune 500 respondents, the outlook was somewhat darker: 51% believe there is significant risk that the economic downturn will result in budget reductions during the coming year.

While the economic outlook is uncertain, these circumstances present internal audit with a transformative opportunity. Many internal audit leaders know what they need to do to achieve greater value at lower cost. Others are eager to learn.

If internal audit is to demonstrate value in the face of declining resources, it must begin with a fresh look at the company's internal audit strategy and a reassessment of its own processes. We believe doing so will not only help gain credibility with organizational peers suffering the same cutbacks, it will also help internal audit preserve its capacity to address strategic, operational, and business risks, as well as today's emerging challenges.

As we anticipated in our forward-looking report *Internal Audit 2012*,¹ internal audit leaders have begun to recognize the need to redefine the function's value proposition and seek to increase its value by learning to operate more efficiently, intelligently, and quickly. Concerns over declining budgets are a reminder that greater efficiencies within internal audit won't come a moment too soon.

Here are highlights of what the respondents to our 2009 survey had to say about internal audit budgets and resources:

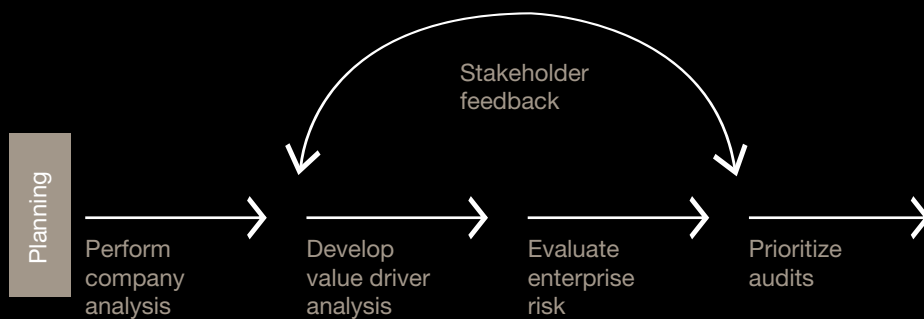
- 19% reported budget reductions in 2008 compared with 10% in 2007.
- 49% expect budgets to remain flat and 36% expect a decrease in the coming year, compared with projections of 49% and 14%, respectively, in the prior year's survey.
- 51% of Fortune 500 respondents believe that there is a medium-to-high risk of the economic downturn causing an unexpected reduction in the internal audit budget during 2009.

A 10-step plan for transforming the internal audit function.

When thinking about a major overhaul to internal audit, it is helpful to find a change management protocol to follow; then adjust it to the company's individual needs. For example, PwC's 10-step plan for transforming the audit function outlines major steps in conducting long-term sustainable change.

1. Identify stakeholder expectations of internal audit; ask what management, the board, and the audit committee value.
2. Gather data to assess the current state.
3. Link the company's strategic objectives and shareholder value drivers to internal audit's scope.

Figure 1. Incorporating stakeholder expectations into internal audit



4. Consider how previously unaudited areas might be audited, and then align auditable risks to the audit plan.
5. Eliminate routine, low-value audits.
6. Based on the updated audit plan, consider transformational ideas to reduce cost.
7. Identify inefficient processes.
8. Develop implementation plans for transformational concepts as well as anticipated process efficiencies.
9. Review the updated internal audit plan, along with cost-reduction ideas, with key stakeholders to gain support.
10. Implement (add measurement, feedback, and adjustment processes for continuous improvement).

Source: PricewaterhouseCoopers. *Transforming Internal Audit*, 2008.

Company risk profiles aren't what they used to be.

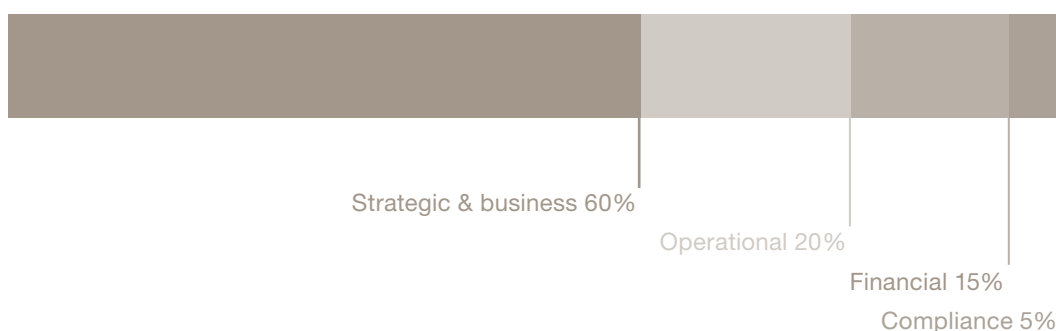
Why internal audit's focus must be aligned to business priorities more than ever before.

The nature of business risk has changed, particularly for global organizations. But whether doing business at home or abroad, risk has grown and become more amorphous. Emerging risks, which are difficult to predict from past experience, are now reverberating across entire industries and economies. These hard-to-predict, high-impact risks can manifest themselves rapidly and exponentially over a very short period of time. They are characterized by imperfect information and potentially interdependent consequences. Aligning internal audit's focus to the risks flowing from changing business priorities and conditions has become the central mission of forward-looking internal audit executives concerned with the future of their companies and their departments.

In our view, successful internal audit departments will be those that maintain alignment with the changing risk profile of their company and the evolving needs and expectations of their key stakeholders. Both our 2012 report and our subsequent white paper on internal audit transformation² delineate the reasons for changing risk profiles and the need for internal auditors to adapt. Key among them: a shift in focus from financial reporting controls to a focus on the sources of risk that destroy shareholder value.

Recent studies indicate that strategic and business risks pose greater threats to shareholder value than operational, compliance, or financial risks. These studies, which examined the factors behind rapid losses in shareholder value, focused on "large cap" companies such as those ranked in the Fortune 500 and FTSE 100 index. The results of the studies were remarkably similar. As shown in the chart below, strategic and business issues are the most common means by which value is destroyed—responsible for 60% of value loss—with operational issues driving another 20% of the loss.

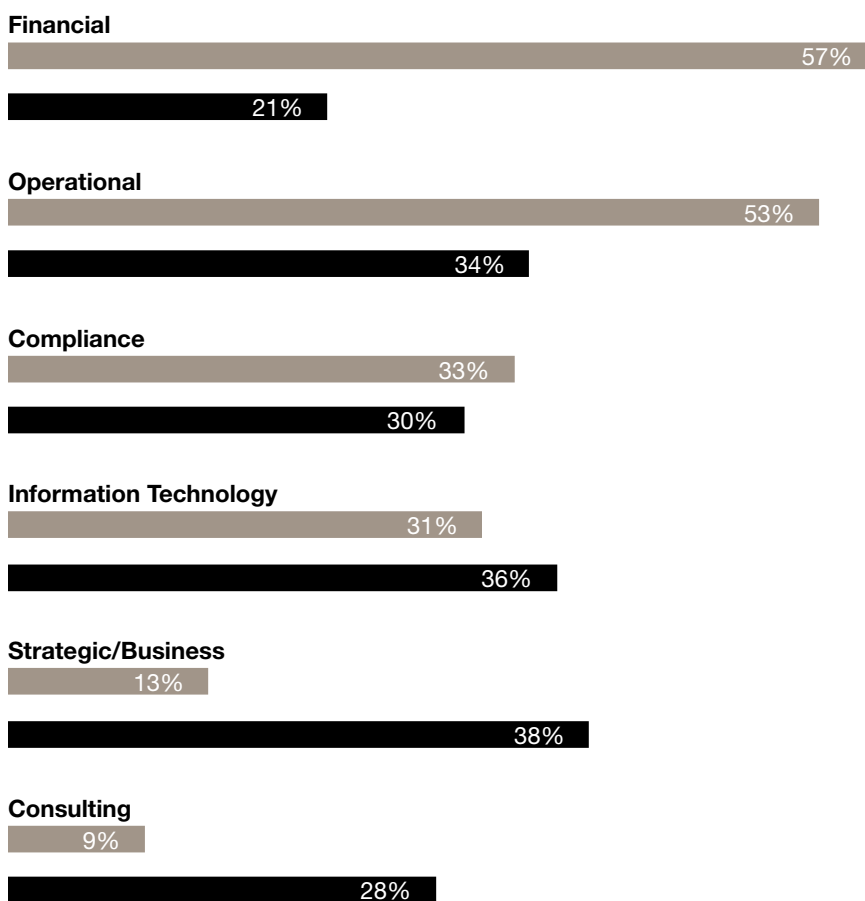
Figure 2. Strategic, operational, and business risks underlie 80% of the rapid declines in shareholder value



Source: PricewaterhouseCoopers. Composite of various studies of US and UK markets.

Nevertheless, this year's State of the Profession survey shows that many internal audit functions are still heavily rooted in the past, auditing financial reporting and compliance controls, hallmarks of the earlier Sarbanes-Oxley period. Only 13% of respondents indicated that their departments allocated at least 25% of resources to strategic and business risks, while a clear majority (57%) assigned this degree of resources to more traditional financial risk. However, things are changing: strategic, business, and operational risk categories are among the fastest-growing areas of internal audit focus.

Figure 3. Composition of auditing activities



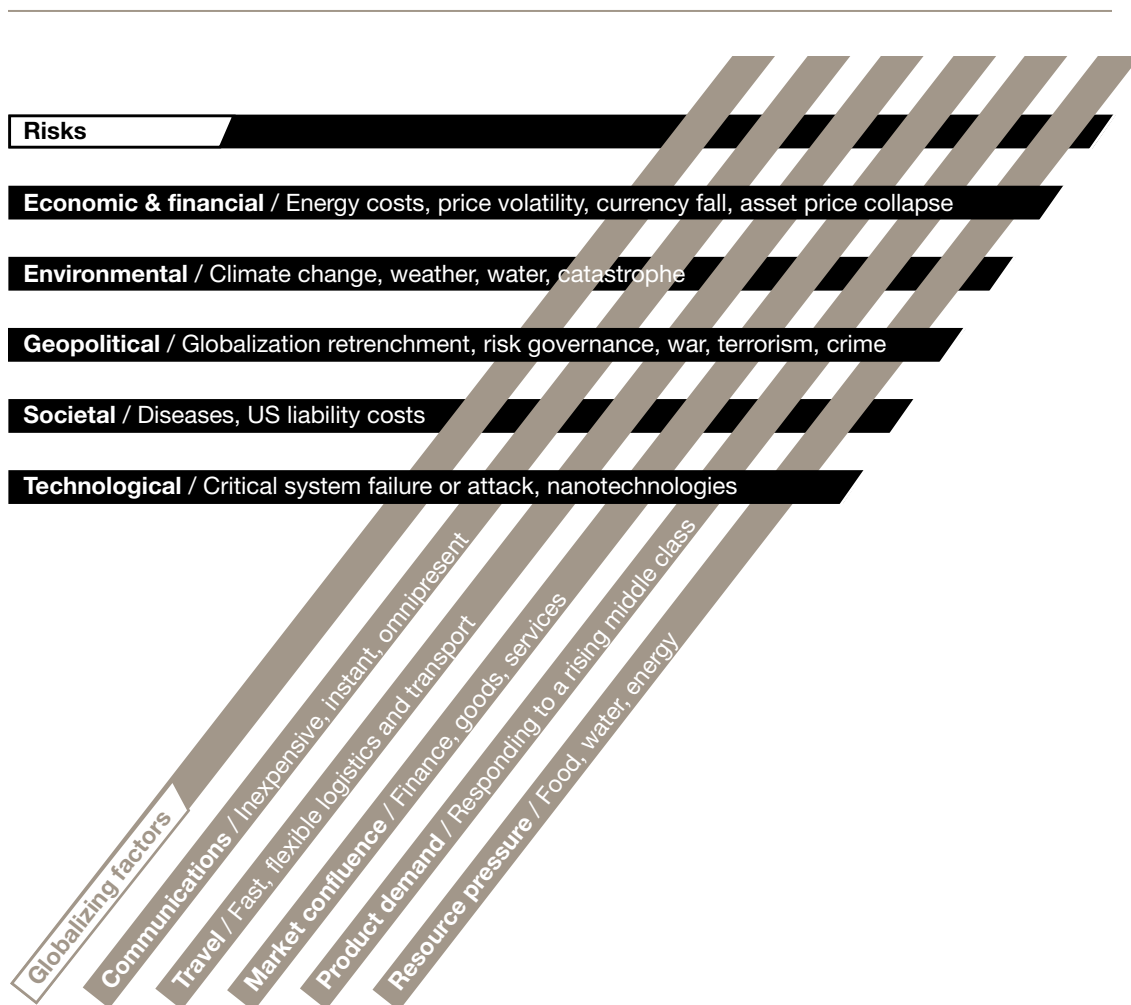
■ Percentage of internal audit departments that contribute 25% or more of their resources to key categories of risks

■ Percentage of internal audit departments that increased coverage in each area during 2008

Source: PricewaterhouseCoopers. Composite of various studies of US and UK markets.

New levels of risk complexity can also be seen when companies increase their global footprint. In multiple reports and studies, we have commented on the increased business risk that accompanies the pursuit of international growth via entering new markets or expanding existing ones. As companies venture into new territories, a multitude of differences arise in culture, language, infrastructure, available technology, accounting standards, and acceptable payment practices, just to name a few.

Figure 4. Forces of globalization cross the spectrum of risk



Source: PricewaterhouseCoopers. *American Perspectives*, 2008, <http://www.pwc.com/americanperspectives>.

Globalization trends, such as increased outsourcing and offshoring, can have a direct impact on internal audit departments. Indeed, our 2012 report³ respondents said they expected that the auditing of outsourced or offshored operations would continue to increase over the next five years.

Our 2009 State of the Profession survey participants expressed a similar expectation of increased global activity, along with a concern over the lack of foreign language capabilities among their staff.

- 56% of Fortune 500 respondents reported that their company is planning to acquire or expand operations outside of the US in the next 24 months.
- 68% of Fortune 500 respondents indicated that they use their company's internal audit resources to address needs outside of the US.
- 88% of Fortune 500 respondents reported that fewer than half of their staff are fluent in a second language.

Concerning emerging risks, our 2009 survey revealed that 57% of the Fortune 500 respondents believe the ability to identify these risks in the coming year will be a medium or high concern. Yet precisely because such risks are having the greatest impact on shareholder value, this is exactly where internal audit should be focused in 2009.

Navigating the stakeholder perception of value now.

Why internal audit needs new knowledge management and sourcing strategies.

That internal audit leaders need to change their mindset—increasing their focus in areas of strategic, business, and operational risk—is now clear and borne out by forward-looking reports and survey data. However, their efforts to do so may be hindered by their staff's ability to excel in these more complex risk categories.

Internal audit leaders have told us candidly of a nagging stakeholder perception that internal audit doesn't understand the business, and have sought our advice on overcoming this perception and its underlying realities.

We believe the answer should include a rethinking of the profession's sourcing strategies, along with a significant upgrade in knowledge management skills. As the profession scrambles to deal with emerging risks and new challenges, internal audit leaders must find effective ways to attract and retain top talent and increase business and operational knowledge among the ranks.

Our 2009 survey results reveal that 58% of the respondents' staff have five years or less of experience. Those staff would typically have spent their formative years as auditors during the Sarbanes-Oxley era and would have been heavily engaged in auditing financial reporting controls. As the current economic downturn reveals, shareholder value is being battered by new and previously unanticipated risks. Internal audit faces the dual challenges of realigning its resources to address the reality of new, value-destroying risks while demonstrating knowledge of relevant risks with staff that are potentially unprepared to identify and deal with the implications of those risks.

As the details of the broadening economic crisis have demonstrated, today's global economy is inextricably connected. Consider the once-simple home mortgage transaction. Today, the financial institution that made the loan likely no longer carries it on its books. Instead, the loan is more likely to have been bundled with other mortgages of varying quality, securitized, and sold to a pool of investors located in countries around the world.

Similarly, food, oil, and other commodities from other nations flow seamlessly among global markets, making the daily events of Main Street Asia, Europe, and South America of greater importance to Main Street America than ever before. This interconnectedness creates an entirely new body of risks for business. Internal audit leaders whose departments want to assume a more active role helping to anticipate and monitor organizational risk in a more complex world economy may have some development work to do. These leaders will no doubt want to take stock of their departments this year—creating and analyzing resource profiles and identifying knowledge and skills gaps, and making plans to close them.

The accumulated knowledge and experience of senior team leaders deeply familiar with the businesses in which they've spent their careers will be a key asset in this skills

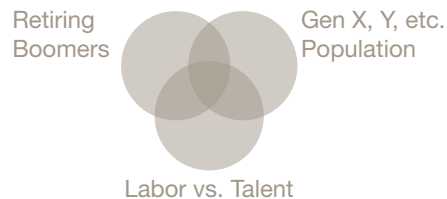
transformation process. Yet the incoming generation will bring its own gifts to the table: potentially greater technological skills, comfort with new ways of learning, and often a wider world view than their predecessors had. Given these challenges, we believe that every internal audit leader's development plan for 2009 should include an initiative to upgrade the knowledge management capabilities of his or her team, as well as to identify those team members with unique skills that can be leveraged to improve the team's overall performance.

When it comes to recruiting, internal audit may find the talent hunt easier when it can present itself as an innovative, strategically aligned organization with a seat at its company's risk management table. Our survey results also suggest that this may best be achieved by appropriately aligning internal audit's focus with the company's changing and emerging risks and effectively communicating internal audit's value to key stakeholders.

Figure 5. Is your company prepared to address these talent challenges?

Supply and demand

In spite of popular belief and current market conditions, there's actually a shortage of knowledge workers in the marketplace; thus, competition for talent is fierce. The confluence of issues cited at the right is driving this competition.



Characteristics

The shrinking pool of available workers is becoming increasingly diverse, requiring more-customized solutions.

- Gender
- Race
- Ethnicity
- Sexual Orientation
- Generation

Values and expectations

Watching years of downsizing, today's knowledge worker is loyal to the development of skills demanded by the market, not a particular employer...and expects technology-enabled flexibility and connectivity in today's 24/7 work environment.



Our 2009 survey provided a look at internal audit team experience and how leaders currently address knowledge gaps.

Chief Audit Executives (CAEs) and internal audit managers typically have deep knowledge of the business and industry:

- 79% of CAEs have eight years or more of experience.
- 59% of managers have eight years or more of experience.

However, internal audit staff typically have more limited experience:

- 27% of staff have less than three years of experience.
- 31% of staff have three to five years of experience.
- 25% of staff have five to eight years of experience.
- 17% of staff have eight years or more of experience.

Internal audit functions frequently turn to subject matter experts (SMEs) to assist in audit coverage requiring deeper knowledge of the business, industry, process, or function.

Audits of strategic or business risks are typically handled as follows:

- 48% are addressed exclusively by internal audit department resources.
- 26% are augmented by SMEs from within the company.
- 21% are either augmented by or addressed by third-party service providers.
- 5% are addressed by others.

Audits of operational risks are typically handled as follows:

- 63% are addressed exclusively by internal audit department resources.
- 23% are augmented by SMEs from within the company.
- 12% are either augmented by or addressed by third-party service providers.
- 2% are addressed by others.

Leverage technology to optimize audit operations.

High-performing internal audit functions maximize the use of technology to enhance the efficiency, effectiveness, and quality of operations.

- To increase efficiency, internal audit should automate issues tracking and reporting to achieve paperless audits and reports, and use capacity multipliers to mitigate the impact of constrained resources.
- To improve effectiveness in the search for errors or unusual transactions, internal audit should test entire data populations automatically.
- To strengthen quality, internal audit should apply technology to conduct real-time reviews, escalate issues, and ensure compliance with standards.

Technology solutions deployed in high-performing internal audit functions typically include the following:

- Integrated internal audit software to streamline the production of work papers, risk assessments, and audit reports, and to automate issues tracking, monitoring, and administrative activities.
- Data retrieval software to automate testing. Proficiency with such software should be considered a core competency for an internal audit staff.
- Data-mining/analysis software for predictive analysis and modeling.
- Knowledge tools and databases to provide best-practice insights as well as a source for business-process benchmarking tools.

Source: PricewaterhouseCoopers. *Internal Audit 2012, 2007.*

ERP implementations highlight a skills gap.

Why internal audit must get up to speed in ERP systems and data analytics.

Companies challenged by the economic downturn continue to explore technology as a means of reducing costs and improving productivity. For internal auditors, this trend brings with it a host of implications.

For starters, it reveals a growing problem: most internal auditors aren't prepared to audit in an automated environment. However, increased automation is precisely the direction most companies are headed, suggesting that internal audit will stay relevant to the changing needs of the organization only if it remains actively involved in such transformation initiatives.

As business processes and underlying technologies evolve, so do the risk assessment responsibilities of internal audit. In addition, boards and audit committees have increasing expectations that internal audit will provide additional assurance for these costly transformation projects from blueprint to post-go-live sustainability. Therefore, internal audit must evolve as well, adapting to more-automated control environments and continuous auditing tools if it intends to maintain or increase coverage with fewer resources in the future. Embracing technology at all levels, strategic and tactical, will enable internal audit to significantly increase its relevance to the technology-enabled organization and increase its productivity as well.

The current global economic crisis has also exposed a number of exceptional and brazen fraud schemes. These revelations remind us that internal audit must be more vigilant than ever in its fraud-detection activities. Therefore, internal audit's data-mining and data-analytic capabilities, instrumental to efficiently examining the large volume of data readily accessible through ERP systems for anomalies and other fraud indicators, are now even more critical.

However, our State of the Profession survey reveals that internal auditors are still grappling with a skills gap in technology, particularly in major ERP systems. Half of the participants we surveyed said that less than 25% of their non-IT auditors have experience with the company's ERP system, and only 28% reported incorporating data-mining and data-analysis tools for more than 25% of their audit work.

Such a lack of IT experience has implications for many organizations, since it may mean that auditors can't effectively audit the related processes and identify potential control deficiencies, make recommendations to create efficiencies, or even access reports needed to do their jobs more effectively. In some instances, auditors may even be auditing around the system to compensate for this skills deficiency. A large majority of respondents (87%) also said that less than a quarter of their staff were familiar with ERP governance systems.

These results indicate a growing strain on internal audit departments tasked with doing more with less, since they may be unable to effectively harness the power of technology and technologically savvy resources to achieve their productivity and audit coverage objectives.

We asked our respondents to indicate the percentage of non-IT auditors (auditors who do not spend more than 75% of their time performing IT audits) who have experience in specific technology-related areas. The results included the following:

- 49% indicated that less than 25% have experience in generating reports or navigating the company's ERP system for the completion of audit work.
- 65% indicated that less than 25% have experience in providing recommendations to management regarding use and optimization of ERP applications (e.g., identifying processes not automated that could be, identifying a better way of configuring the system to improve process efficiency, and so on).
- 75% indicated that less than 25% have experience in the use of systems or live data feeds to regularly monitor business performance and risk indicators.
- 87% indicated that less than 25% have experience in the maintenance and use of governance systems such as SAP GRC, Oracle's Governance Risk & Compliance module, or Approva.

Not only did our survey reveal a knowledge gap in technology, it also indicated a corresponding resource allocation dilemma: the IT audit work is not well shared in most organizations we surveyed. For the most part, technology-related risks are addressed solely by IT auditors, who are often in short supply. In our 2012 report, 76% of those surveyed stated that increasing the core skill level of the general internal audit staff for understanding and auditing technology risks was the best strategy to address the shortage of technology resources.

We asked 2009 survey participants to indicate who, of the following, generally performs IT audits, with these results:

- IT auditors within the company's internal audit department—46%
- Third-party service providers—33%
- Internal auditors within the company who have IT knowledge—17%
- Other—4%

To begin solving the IT resource problem, internal audit leaders need to assess the skill sets of its auditors—including non-IT auditors—and look for ways to enhance and broaden technological skill sets. In doing so, specific attention should be directed toward developing integrated departments whereby technological skills are embedded within the department and are not just the domain of a typically smaller IT audit subgroup. This integrated

Strategies for addressing technology risks and IT resource needs.

Projected usage (%)	Strategy to address HR & organizational needs in IT audit
76	Increase the core skill level of the general internal audit staff for understanding and auditing technology risks
68	Acquire more sophisticated technology tools to address technology risks
60	Increase the use of third-party experts
57	Embed some auditors with IT audit skills in the larger internal audit function while maintaining a separate IT audit group to support audit teams in addressing technology risks
54	Deploy higher-level/more experienced IT auditors
49	Increase the number of IT auditors with relevant certifications
47	Increase the percentage of total staff who are IT auditors
37	Deploy technology professionals who are not auditors
26	Maintain a separate IT audit group within internal audit to address technology risks
14	Embed auditors with IT audit skill sets within larger internal audit function without maintaining a separate IT audit group to address technology risks

Source: PricewaterhouseCoopers. *Internal Audit 2012, 2007.*

approach will allow for more consistency and promote greater effectiveness and efficiency in executing audits, which is especially important during a time of reduced budgets. Later in this report, we offer some practical tips for internal audit leaders to consider in closing the technology gap.

Despite budget pressures, however, internal audit leaders still identify training and skills development as a core need that must somehow be met. We offer some suggestions for efficiently enhancing a department's learning strategy later in this report. A look at how survey participants ranked the importance of key technological skill sets shows where their priorities will lie in the coming year:

The percentage of internal audit departments that ranked the following skill sets as high or medium is as follows:

- Information technology application controls—87%
- Data analytics—84%
- Information technology infrastructure—70%
- Proficiency in navigation of core ERP systems—69%
- System implementation—67%
- Optimization of information technology application functionality—58%

Many challenges lie ahead for internal audit departments as they continue to maneuver through a changing business environment where technology remains a driving force. In the coming year, it will be important to reconcile the technological implications with the skill sets of available internal audit resources and look for cost-effective ways to manage technology-related resource needs. We believe—and our survey respondents agree—that internal audit functions must embrace technology in all phases of the internal audit process and ensure that both IT and non-IT auditors are armed with a practical application of relevant systems and data analytics. Depending on the starting point, this may mean turning the traditional audit approach upside down and redefining the nature, timing, and extent of the audit activities that are performed.

When governance meets continuous improvement.

Why internal audit faces performance measurement and customer-centric feedback.

Perhaps the enduring challenge facing internal audit leaders is the need to continually demonstrate and communicate their function's real value to the audit committee, management, and internal customers. As belts tighten to weather the down economy, companies are scrutinizing more closely the value of every support organization, making this issue more relevant now than ever.

It's often said that what gets measured gets done. Metrics derived from reliable data sources may help key stakeholders and internal customers place a value on what internal audit delivers. But although gathering data about their functions is widely practiced, many CAEs struggle to develop and communicate truly meaningful performance measures. Only 58% of our 2009 survey respondents have clearly defined metrics by which performance is measured. Of those who do, most tend to focus on inputs and outputs, such as the number of audits completed. Others include qualitative measures such as staff credentials.

We saw very few internal audit departments using outcome-based metrics such as ROI, cost, and customer satisfaction. However, experience suggests that the use of key operating metrics will continue to grow over time, as organizations make their strategic value priorities clear and do more to urge internal support organizations such as internal audit to conform.

Meanwhile, the use of data to demonstrate value is an area in which internal audit has tremendous opportunity for proactive transformation. Internal audit leaders need to look no further than how their internal customers and other corporate support functions are measured and take steps to mirror performance values set out by the organization. Our survey provided the following responses:

Metrics used included:

- Number of internal audits completed—17%
- Percentage of internal audit plans completed—14%
- Qualifications or credentials held by staff—15%

Many outcome measures are not widely used:

- Customer satisfaction—13%
- Return on investment—2%
- Cost per audit completed—2%

Audit committees are updated on results of performance metrics:

- Annually—28%
- At every meeting—26%
- Never—5%

Building a new performance dashboard.

Our 2009 survey suggests that at many companies a significant communication gap continues to exist between executive management and the internal audit function. We believe it is important that the internal audit function communicate effectively with management and the audit committee, as well as other key stakeholders, to understand their perspective, particularly around what they value most. To be effective, an internal audit team must ultimately demonstrate value-adding results in the judgment of these stakeholders. This requires a performance measurement system aligned with the stakeholder value drivers. The internal audit function should regularly measure, monitor, and report its performance under a mutually agreed-upon framework. Some illustrative metrics that can be used as a means of communicating value are listed here.

Figure 6. Examples of internal audit department balanced performance dashboard metrics

Internal Audit Customer Service

- Key metrics based on results of auditee satisfaction questionnaires
- Measurement of enhanced shareholder value through cost reductions, reduced revenue leakage, increased working capital, and/or enhanced cash flow
- Percentage of audit activities and resources allocated to addressing key business risks
- Number of meetings with senior management to discuss business objectives, goals, and risks
- Number of best practices identified and communicated within the company by the internal audit department
- Status of internal audit recommendations implemented by management
- Number of special requests from management received and completed
- Number of personnel transferred out of internal audit into other departments or business units

Internal Audit Efficiency

- Internal audit department costs compared to budget
- Number of audits completed in accordance with the scheduled audit plan
- Number of integrated audits (operational and IT auditing)
- Internal audit department cost per internal audit full-time equivalent
- Internal audit department cost components
- Reduction in internal audit effort and/or increase in audit coverage due to use of data-mining and data-analytics technologies
- Staff utilization (% of time charged to non-administrative audit tasks and amount of overtime)
- Cost savings generated by implementing audit recommendations
- Average time it takes to issue an audit report

Internal Audit Staff Development

- Average dollar amount spent on training
- Number of hours spent in industry or other specialized training (e.g., in-house, self-study, IIA seminars)
- Staff experience, education, and certifications (CIA, CPA, CISA, CFE, MBA)
- Performance of key activities built into evaluation and reward process
- Average staff tenure
- Aggregate number of days audit positions remain open
- Internal audit staff survey results
- Number of personnel transferred out of internal audit into other departments or business units

What this means for your business

New strategies are
needed for success
in a time of transition

Our 2009 State of the Profession survey suggests, and experience in the field confirms, that the drivers of internal audit success have changed in response to dramatically changing business conditions. Some interesting conclusions may be drawn that impact how internal audit fulfills its mission amid this business upheaval.

Foremost is that in a rapidly changing world, internal audit departments will be challenged to live up to management's expectations with fewer resources if they continue to function as they always have. However, we believe that internal audit departments can be successful if they align themselves with these new economic realities, the demands of their constituents, and the changing risk profiles of their companies.

Earlier in this report we discussed steps that internal audit might consider in transforming its processes and measuring its value in the eyes of key stakeholders such as the audit committee and management. Here are three other ideas for redefining internal audit strategies that we believe will be important in helping internal audit leaders achieve success in a changing world:

- Get a handle on changing risks. Determine that the risk management function is prepared for a dramatically different environment.
- Embrace technology. Leverage technology wherever possible to reduce costs and enhance the quality of internal audit services.
- Pay attention to the talent base. Even in a stressed economy, human capital rules. An effective people strategy will help internal audit acquire, develop, and retain the talent it needs now and for the future.

Faced with rapidly changing risks and the prospect of declining resources, internal audit will be challenged in 2009 as never before to do more with less. Still, such an environment presents both challenges *and* opportunities.

If internal audit is to demonstrate value in the face of declining resources and an unprecedented corporate emphasis on cost containment and efficiencies, it must begin by reevaluating its own strategy and reengineering its processes. In doing so, it will preserve the capacity to address an organization's most pressing strategic, operational, and business risks, and ultimately to protect shareholder value.

How to determine that the ERM function is prepared for a dramatically different environment.

The current global volatility caught many organizations with sophisticated risk management activities by surprise, resulting in dramatic drops in shareholder value. This highlights the need for organizations to advance their risk assessment and risk management practices to devote more consideration to emerging risks. As discussed earlier, emerging risks are large-scale events or circumstances that arise from global trends; are beyond any particular party's capacity to control; and may have impacts not only on the organization but also on multiple parties across geographic borders, industries, and/or sectors, in ways difficult to imagine today. These risks represent those large-impact, hard-to-predict, and rare events beyond the realm of normal expectations. Examples of emerging risks can be derived from various studies. A starting point for organizations to consider may include the illustrative, non-exhaustive list in Figure 7.

But looking at a typical internal audit plan from the last several years reveals, consistent with our 2009 survey results, that the overwhelming majority of auditor time and attention are spent on financial risks and related compliance controls. Such heavy emphasis on financial reporting controls may have been appropriate to achieve Sarbanes-Oxley compliance. But now that Sarbanes-Oxley risks are generally well controlled, internal audit needs to realign itself toward risks that destroy shareholder value and perform its financial and compliance monitoring activities more cost effectively.

No one likes the kinds of surprises that we've all experienced lately—not boards, management, or regulators, and certainly not investors. Here are some practical tips to align internal audit's efforts with relevant risks and help companies avoid such surprises.

Beef up the internal audit plan to focus more on emerging risks.

Internal audit leaders may want to consider the following table when formulating the department's next internal audit plan. Included are areas of risk that have significantly impacted shareholder value but often have been left out of internal audit plans in the past. In considering emerging risks, it may also be helpful to organize relevant risks under a categorization scheme.

Figure 7. Illustrative examples of emerging risks

Increasing natural resource constraints (e.g., loss of freshwater reserves, depletion of oil reserves, loss of biodiversity) that could raise the cost of raw materials and increase food prices, human suffering, and the pressure to identify alternate energy sources.

Natural or man-made disasters (e.g., floods, terrorism, cyberterrorism, viruses, spyware) that could cause business disruption and human catastrophes.

Increased industrial pollution and rising global carbon emissions leading to climate change that could cause a decrease in biodiversity, a shift in locations of production and consumption, and regional resource shortages.

Rapidly shifting demographic patterns (e.g., ageing population) that could cause talent shortages in certain labor markets or within certain capabilities, lack of adequate skills, or shifts in customer demands and/or loyalties.

Rising labor costs driven, in part, by expanding benefits (pension, workers' compensation, and other non-salary expenses), which could result in lower profitability and loss of competitive advantage.

Increased volatility in asset prices and commodity markets (e.g., oil price shock, asset price collapse) that could cause fluctuations in cost structures that cannot readily be passed on to the consumer or otherwise absorbed.

Decline in global economic growth (e.g., caused by slowed Chinese economic growth, global recession, unsustainable deficit levels) that could negatively impact demand and put downward pressure on prices.

Political crises (e.g., failed and failing states, war, Middle East instability, failure of democratic institutions, regime change), which could result in nationalization of assets, increased regulation, protectionist tendencies, or other loss of control.

Pandemics and other health crises (e.g., fast-traveling pathogens such as avian flu, developing world disease such as HIV/AIDS, tuberculosis, malaria), which could jeopardize supply chain, consumers, employees, and others.

Economic inequality, which could exacerbate poverty and suffering and increase pressure on business to engage in humanitarian efforts.

Rise in nuclear capabilities, which could endanger global political stability and physical security.

A global liquidity crunch (e.g., resulting from sub-prime mortgage lending practices) that could raise the cost of capital for financing transactions (e.g., nanotechnology) that could evolve in unforeseen ways in an emerging market—for example, leapfrogging existing technologies as new applications arise.

Technology and communication disruptions (e.g., Internet blackout) or system failures, which could lead to business disruptions and economic loss.

Changes in laws and regulations (e.g., spread of liability regimes impacting foreign investment, or industry-specific laws such as prohibition impacting the alcoholic beverage industry) that could cause an overhaul in the manner by which businesses are run, or affect the sources of their profits.

A realignment of power in the capital markets of a country (e.g., increased governmental control of companies, foreign investment) that could lead to classes of activist investors who could pressure for different industry approaches to capital structure, profit allocation, or strategic goals.

Terrorist threats, which could reduce economic confidence or cause direct economic losses as well as loss of life, property, and security.

Increased competition from emerging markets and/or within the home market, which could cause downward pressure on prices.

Rise in anti-globalisation sentiment and protectionism (e.g., fiscal policies, trade embargoes, heightened tariffs, or other anti-competitive practices), which could cause retrenchment from global trade and investment.

Increase in corruption (e.g., bribery in procurement or sales), which could create anti-competitive business practices and lead to regulatory fines and sanctions and reputational damage for perpetrators.

Decline in recognition or enforcement of intellectual property rights (e.g., patents, licenses), which could cause unlicensed commercial activity or loss of proprietary information.

Examples of such categorization can include:

Figure 8. Organizing risks into an audit plan

By source of the risk or theme	e.g., per categories of the World Economic Forum Global Risk Network: <ul style="list-style-type: none">• Technological• Geopolitical• Societal• Environmental• Economic
In relation to objective types	e.g., per the Committee of Sponsoring Organizations (COSO): <ul style="list-style-type: none">• Strategic• Operational• Reporting• Compliance
By characteristic of the risk	e.g.: <ul style="list-style-type: none">• Exogenous/endogenous• Predictability• Degree of control• Duration
By the manner in which the risk manifests	e.g.: <ul style="list-style-type: none">• Long-term changes• Sudden, unexpected events• Gradually deteriorating operating conditions• Local events with systemic impacts• Resulting from catastrophic events

Source: PricewaterhouseCoopers. *Exploring Emerging Risks, 2009.*

Maintain flexibility in a dynamic environment, reevaluating risks and the audit plan more frequently.

Many audit functions develop a single annual plan and devote the remainder of the year to executing the plan. However, in a rapidly changing world, that approach may be obsolete. Internal audit leaders should consider exercising greater flexibility by conducting more frequent assessments of risks and allocating resources as required, adapting the annual plan to new risks and challenges that emerge.

Consider providing assurance over the company's ERM function.

To provide the greatest value, internal audit departments, as well as a company's risk management function, should strive to anticipate and monitor the risks that are truly relevant to the success of the business. As previously noted, the strategic and business risks that have recently led to breathtakingly rapid drops in shareholder value have caught even the most sophisticated risk management functions by surprise. Now more than ever, companies need an objective evaluation of, and additional assurance over, their enterprise risk management functions. The forward-thinking internal audit leader will want to consider the following:

- Board members, shareholders, regulators, and rating agencies have questioned internal audit leaders about their risk management evaluation capabilities. Successful departments have the answers and play an important role in the company's overall ERM process.
- In 2008, S&P began to formally review ERM programs and consider risk management capabilities in their credit-rating process, putting this topic on the table with boards, CEOs, CFOs, and treasurers. With risk at the center of company creditworthiness, internal audit leaders—given their knowledge of risks and controls—should be part of the solution.
- Many companies have established risk committees to lead enterprise risk management efforts. This sets up a new constituent that requires internal audit leadership attention.

Internal audit will increasingly have a place at the table when it comes to identifying and managing risk within the organization. In broadening the scope of its activities beyond financial and compliance risks, internal audit can also demonstrate value by enhancing the organization's enterprise risk management function.

Internal audit should, therefore, align its efforts with the company's changing risk profile, especially those strategic, operational, and IT risks that are integral to shareholder value. If properly aligned, internal audit leaders will be in a position to provide assurance over the risks that are most relevant to the company, as well as to provide assurance over the company's ERM function itself.

What success looks like.

In a risk-responsive internal audit organization, the internal audit function is able to deliver a comprehensive and timely risk assessment. It also delivers an internal audit plan that better aligns to shareholder value, more broadly addresses risk and emerging risks, and provides additional assurance over enterprise risk management functions.

How to reduce costs and enhance the quality of internal audit services by embracing technology.

Our survey respondents reported that many internal audit leaders expect to manage greater challenges with fewer (and sometimes less-experienced) resources in 2009. We believe internal audit will want to do as other functions and enterprises are doing the world over: leverage technology to reduce costs and enhance the quality of its services. Here are nine practical tips that illustrate how internal audit functions may do more with less, and also narrow the technological skills gap reported by our 2009 survey respondents, by making greater use of technology:

1. Leverage existing company ERP training materials and put the entire internal audit staff (including the CAE) through ERP boot camp. We believe there is no substitute for hands-on system experience, observing the functionality and reports that are available and seeing firsthand how everything works.
2. Be an active, ongoing participant in the company's major transformation and systems implementation efforts. This helps to maintain the relevancy of internal audit to these projects and to build the internal audit team's knowledge of changing processes and systems from the ground up. In doing so, internal audit can also help to identify the processes and controls that *should be* in place, instead of coming in afterward to identify what went wrong. We believe this type of partnering is one of the easiest ways that internal audit can demonstrate value to the organization. Bear in mind, however, that it must also be done with objectivity in mind. Take care to maintain an appropriate distance from the system development team and limit any support efforts to identification of appropriate controls and processes.
3. Train up. Let more technologically savvy team members take the lead in training managers and directors on how to navigate the company's current systems and leverage system functionality, reporting, and data-extraction capabilities.
4. Ask for information sessions from the company's ERP account representative. Get the ERP system provider's most knowledgeable resources to share tips, how-tos, and FAQs on what the system was designed to do. Ask about system functionality for designated business cycles and be prepared to discuss current audit testing methods. This will help focus learning efforts on identifying and understanding those areas that may be the most opportune for audit efforts.
5. Make it a *requirement* of your internal audit methodology to include upfront data analytics and review of automated reporting as part of audit planning. At a minimum, data analytics should include performing limited fraud procedures; financial trend analysis; and ratio analysis for relevant investment, productivity, liquidity, activity, leverage, profitability, and coverage ratios. The data needed to perform these types of analyses is often readily available—particularly with ERP systems—and can be performed well in advance of fieldwork. This allows for more focused time spent in the field looking at items already flagged for some anomaly or potential concern. As such analyses are performed on a regular basis and information and expectations are gathered, results can be compared across similar locations and anomalies can be further understood.

6. Ensure that each audit makes maximum use of automated controls. This means that internal auditors will remain focused on higher-risk, non-routine activities and will not waste time auditing around the system by performing unnecessary manual controls testing. We recommend that internal audit leaders integrate audit teams to include technologically savvy, process-focused team members as well as team members who can review systems configuration. Doing so can improve audit observations, root cause analysis, and related recommendations.
7. Don't forget about a location or auditable entity just because it's not included on this year's audit rotation. We believe internal audit leaders should consider dedicating a portion of the company's audit resources to mining all data on a regular basis for predictive red flags, control issues, and unusual transactions. Use the results of these reviews as a means to continuously confirm or refresh internal audit risk assessment results and to steer audit focus on a real-time basis. This can be accomplished effectively by identifying a core set of audit tests that address key risks, and working with IT to leverage existing data extraction capabilities or to design audit routines as appropriate. While there is some upfront time and resource investment needed, we believe it will more than pay off in the long run, as these tests can be leveraged year after year.
8. Use ERP knowledge and relationships with ERP account representatives to enhance audit recommendations. We recommend that internal auditors don't just tell auditees that they need to perform a control or enhance a process—tell them specifically what ERP functionality or report to use and how to use it. As a result, internal audit's relationships with key process owners and the overall control environment will be improved.
9. Tap in-house and external system experts to fill technology-related resource needs that are only temporary or one time in nature. Maintaining a network of technology-related resources for each of the significant systems, business units, and locations is helpful so that as needs arise, a reliable resource can be called upon. As part of the annual planning efforts, consult with IT and external providers so that resource needs can be appropriately identified and considered.

What success looks like.

By incorporating technology into every aspect of the internal audit plan and the internal audit team's capabilities, we believe internal audit will be well positioned for whatever lies ahead. Importantly, the effective use of technology should help internal audit pursue high-value opportunities while keeping a lid on operational costs.

How to build an effective human capital strategy to acquire, develop, and retain talent needed now and for the future.

Our 2009 survey respondents, consistent with past surveys, continue to identify important gaps in key skills they believe will be necessary for success. In addition, they currently face growing challenges with less-experienced staff that were trained for the risks of an earlier era. Finally, like the leaders at most companies today, internal audit leaders must blend effective teams from a diverse group of individuals. To successfully navigate these challenges while also closing the stakeholder value perception, internal audit leaders will want to have—or to create—an effective strategy to hire, train, and keep their most important resource: their people. Accordingly, they may want to consider the following perspectives as they strive to achieve improved results and more-effective talent management.

Remember that compensation is just one piece of the puzzle.

While important, compensation is just one step in attracting and retaining talent during tough times. Pivotal employees demand competitive compensation from every potential employer in the market. But a winning strategy also recognizes that these professionals often take a more nuanced view of workplace satisfaction. The ability of an internal audit department to offer and articulate other benefits beyond compensation may make the difference in the end.

Reassess internal audit's key positions in light of the talent available today.

With the fluctuating economy, a competitor's headcount reduction or poor performance could lead to many high-quality candidates entering the job market. This is a good time to reassess the criticality of internal audit positions and the talent that may be available in the marketplace.

Challenge valued employees at every turn.

Every business has those “can't lose” employees. How can a company keep them happy? Try proven retention strategies such as exposing high performers to different areas of the organization, promoting them as soon as they are ready, and providing opportunities for foreign assignments.

Help develop stronger talent leadership.

A new breed of human resource leader has emerged that is equally at home with both theory and practicality. From articulating the goal of aligning talent priorities with business objectives to implementing employee training programs, a good talent leader is indispensable. Internal audit may want to take advantage of any quiet periods caused by the economic downturn to redefine what it wants from the company's talent leadership.

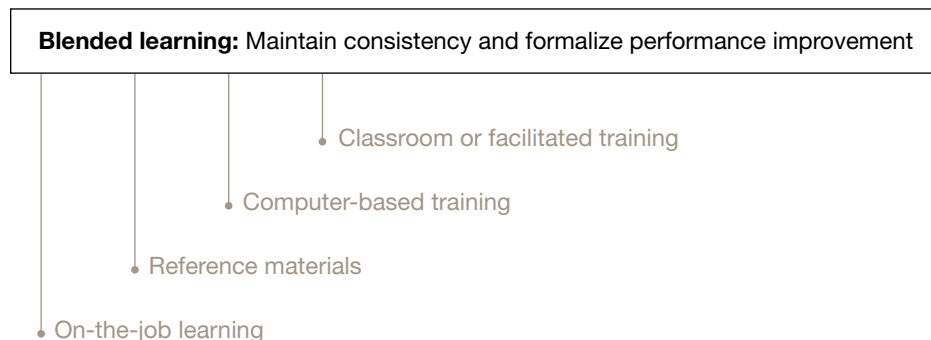
Develop an effective learning strategy.

In order to stay abreast of the changes affecting the businesses they serve, internal audit departments should devote adequate resources to develop an on-boarding and training curriculum that considers:

- Robust and comprehensive content allowing just-in-time training to address the changing landscape of risks, teams, functions, and systems
- The consistency and quality of audit delivery, with a focus on producing measurable value as defined by internal audit's key stakeholders
- Training developed for a generationally diverse as well as a dispersed workforce
- Alignment of learning strategy with overall business objectives
- The integration of training and knowledge management
- Future growth and changes
- A variety of topics to help internal auditors also learn the operational side of the business

To help with costs, growth, and turnover, a combination of delivery models should be considered:

Figure 9. Internal audit department training delivery model



Finally, in light of the competition for budget dollars in the current environment, internal audit leaders should consider leveraging the ready-to-use tools that can be licensed from third-party business partners to improve the department's curriculum and enhance the capabilities of the team.

What success looks like.

A highly trained, motivated talent base is the heart of a high-performing internal audit organization. By implementing a talent strategy that works, internal audit leaders will begin to address the stakeholder perception problem, more effectively cover emerging risks, demonstrate continual improvement in the people side of the internal audit function, and justify internal audit's place at the company's strategy and risk table.

Methodology

The 2009 State of the Profession survey for internal auditing was conducted in the fourth quarter of 2008 and includes responses from 700 internal auditors.

Of the respondents, 88% are either CAEs or internal audit directors or managers, and 69% are from companies with \$1 billion or more in revenue.

The survey had four purposes:

1. Capture a snapshot of the internal audit profession.
2. Share insights and observations from PricewaterhouseCoopers about major issues, trends, and changes reshaping internal auditing today.
3. Collect benchmarking data to help organizations compare and contrast their internal audit processes and procedures.
4. Provide a baseline to measure ongoing changes in the profession.

- ¹ *Internal Audit 2012*, a study examining the future of internal auditing and the potential decline of a controls-centric approach, PricewaterhouseCoopers LLP, 2007.
- ² *Internal Audit 2012*, a study examining the future of internal auditing and the potential decline of a controls-centric approach, PricewaterhouseCoopers LLP, 2007, and *An opportunity for transformation—How internal audit helps contribute to shareholder value*, PricewaterhouseCoopers LLP, 2008.
- ³ *Internal Audit 2012*, a study examining the future of internal auditing and the potential decline of a controls-centric approach, PricewaterhouseCoopers LLP, 2007.

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