PwC Advisory
Internal Audit

PricewaterhouseCoopers' State of the internal audit profession study: internal audit post Sarbanes-Oxley*

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Overview

As demands on internal audit escalate, chief audit executives must strike a sound balance between their priorities and available resources in order to meet stakeholder objectives.

The post-Sarbanes-Oxley era is a dynamic world of continual change and evolution. Demands for internal audit services are at an all-time high, spurred by regulatory and legislative reform measures. As a result, today's internal audit group often plays a key role in compliance and risk management, providing significant support to senior management and audit committee stakeholders. In addition, internal audit groups place greater emphasis on quality assurance in response to strong review mandates from the Institute of Internal Auditors (IIA).

To capture a snapshot of the internal audit profession today, PricewaterhouseCoopers conducted its first state of the profession survey for the field of internal auditing. The results yielded new insights into how a chief audit executive (CAE) can effectively balance competing demands with available resources in order to address stakeholder needs. We learned that the ties between internal audit functions and the audit committees that oversee them are significantly fortified. We have also identified how internal audit can leverage technology and other resources to strengthen its functional effectiveness.

Key indicators:

1. More than 70% of respondents indicate that Year One compliance with Sarbanes-Oxley required 50% or more of internal audit resources and squeezed other priorities in the process. In addition, 56% of respondents report overall responsibility for Section 404 project management in 2005.
2. On a functional basis, 88% of respondents report directly to the audit committee. Sixty-two percent of respondents' internal audit charters were reviewed or updated with audit committee input; 85% of respondents attend all audit committee meetings and 45% meet privately with the audit committee at every meeting.
3. Eighty-two percent of internal audit groups conduct an enterprise-level risk assessment on at least an annual basis and apply the results when developing their annual audit plans. In addition, 79% of respondents report that their internal audit groups have (a) assessed the corporate governance efforts of their organizations and (b) made specific recommendations to improve the organization's governance processes.
4. More than 30% of respondents report internal audit vacancies for six months or more, reflecting how difficult it is to attract qualified talent. Although 56% of respondents employ specific measures and metrics to assess internal audit performance, less than half use software that is specific to the internal audit function. Twenty-three percent of respondents have a formal quality assurance and improvement program in place that meets IIA Standards for the Professional Practice of Internal Auditing (*Standards*), and only 24% undertook an external quality assurance review (QAR) during the past five years.
5. Thirty-eight percent of our respondents issue an annual opinion on the overall condition of internal controls within their companies, while 33% issue an opinion limited to the company's internal controls over financial reporting.
6. Thirty-four percent of respondents use continuous monitoring techniques.

Trends

1. Sarbanes-Oxley requirements continue to significantly impact internal audit priorities.

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley, or "the Act") created an entirely new compliance environment for most organizations. In the first year of the regulation's implementation, many internal audit functions were consumed by efforts to comply with Section 404 of the Act[1]—which requires companies to *document*, *evaluate*, *test* and *monitor* their internal controls over financial reporting.

Because internal auditors are both qualified to assess and document internal controls and trained to be objective, senior management and boards of directors tended to lean heavily on internal audit to address Sarbanes-Oxley requirements.

More than 70% of reporting companies indicate that Year One Sarbanes-Oxley compliance required more than half of their internal audit resources. In complying with Section 404 during Year One, 56% of our respondents report having overall responsibility for Section 404 project management. What's more, 81% have conducted a general review of controls, 69% have conducted process test design, another 69% have conducted management testing, 60% have conducted process walkthroughs and 50% have conducted process documentation.

In Year Two of Sarbanes-Oxley, internal audit groups continued to focus heavily on the Act's requirements. Nearly half of our survey respondents estimated that Sarbanes-Oxley compliance consumed 50% or more of their time and resources during Year Two implementation.

By dedicating such a high percentage of resources to Sarbanes-Oxley compliance, internal audit often must depart from its risk-based internal audit program, according to more than 65% of respondents. Highlighting the strategic consequences of this new reality, more than half of our respondents indicate that failure to meet long-term stakeholder needs results in the same level of risk as failure to comply with Sarbanes-Oxley.

In complying with Section 404 during Year One, 56% of our internal audit respondents report having overall responsibility for Section 404 project management.

1 Section 404 of the Sarbanes-Oxley Act of 2002 requires management to develop and monitor procedures and controls for making their required assertion about the adequacy of internal controls over financial reporting. Section 404 also requires attestation of management's assertion by an external auditor. (*Internal Auditing's Role in Sections 302 and 404 of the U.S. Sarbanes-Oxley Act of 2002,* © 2004, The Institute of Internal Auditors, 247 Maitland Avenue, Altamonte Springs, Florida, 32701-4201, USA.)

The role of internal audit in Section 404 compliance

Section 404 of Sarbanes-Oxley requires a company's senior management to assess the design, operating effectiveness and adequacy of internal controls over financial reporting. It compels management to issue an annual report that, in part, addresses any material weaknesses in the company's internal controls. Section 404 also requires an external auditor to attest to management's assertions.

Management is responsible for ensuring that the organization is in compliance with Section 404 and other requirements of the Act—a responsibility that cannot be delegated. However, management often turns to internal audit to support compliance with these requirements.

Early discussions about internal audit's role in Sarbanes-Oxley compliance centered on objective monitoring. In practice, however, the Institute of Internal Auditors believes that many internal audit groups are assuming a far broader scope of Sarbanes-Oxley responsibilities than are described in the IIA *Standards*[2] and related guidance.[3]

With proven skills in handling large and complicated projects, internal audit has frequently been asked to manage Sarbanes-Oxley Section 404 compliance, as reflected by our survey results. When acting in an administrative capacity—such as monitoring project progress, communicating project results or monitoring deadlines—internal audit is unlikely to suffer any impairment of its perceived objectivity. If, however, the role of project manager involves serving as the chief decision maker, making judgments about work product acceptability, approving project milestones or redirecting project resources, then internal audit's objectivity may come into question.

2 On January 1, 2002, the Institute of Internal Auditors (IIA) issued revised standards for the practice of internal audit. These new guidelines, known as the *Standards,* updated the IIA's International Standards for the Professional Practice of Internal Auditing. The *Standards* require that internal audit evaluate and contribute to the improvement of the organization's risk management, control and governance processes through consulting and assurance activities.

3 *Internal Auditing's Role in Sections 302 and 404 of the U.S. Sarbanes-Oxley Act of 2002,* © 2004, The Institute of Internal Auditors, 247 Maitland Avenue, Altamonte Springs, Florida, 32701-4201, USA.

According to the IIA, it is appropriate for internal audit to help organizations address the requirements of Sections 302 and 404 of Sarbanes-Oxley[4] in any of four roles. These roles—which are consistent with IIA *Standards*—include *Project Oversight*, *Consulting and Project Support*, *Ongoing Monitoring and Testing* and *Project Audit.* In the area of *Project Oversight*, for example, the IIA indicates that it is acceptable for internal audit to join a project steering committee, as well as provide advice and recommendations to the project team. Similarly, performing quality reviews of process documentation and key controls is an IIA-approved activity under the heading of *Consulting and Project Support.* Moreover, in the category of *Ongoing Monitoring and Testing*, the IIA considers it appropriate for internal audit to help identify and correct gaps in internal controls as well as provide advice to management about test scope and frequency.

Outside of these four roles, however, internal audit's objectivity may be compromised. In particular, when internal auditors serve as consultants, specific concerns arise with respect to what constitutes a permissible activity. On the one hand, according to the IIA, consulting on internal control matters is a normal role for internal auditors—one that does not impair independence or objectivity. It is quite acceptable for internal auditors acting in a consulting role to help identify, evaluate and implement risk and control assessment methodologies as well as recommend controls to address related risks.[5] As the recognized control experts within an organization, it is also possible for internal auditors to serve as a source of training and/or information about internal controls without impairing functional objectivity.[6]

However, if an internal audit department is acting in a decision-making capacity, its objectivity can be impaired. With 56% of respondents reporting overall responsibility for Section 404 project management, concerns about decision-making and objectivity are very real.

4 Ibid.

5 Ibid.

6 Ibid.

Perceived benefits of Section 404 compliance:

Despite all the grumbling about Sarbanes-Oxley demands, it is important to note that the Act has unquestionably strengthened management and audit committee awareness of organizational risks and controls. A 2005 survey of 171 practicing internal auditors[7] for the IIA Research Foundation found substantial improvements in the identification, documentation and testing of control processes.

According to the study, the Section 404 evaluation process has led to a more engaged control environment—with active participation by the board, the audit committee and management—and a push to embed control concepts within the organization. The study also cites improved documentation of controls and control processes as well as greater structure to the year-end closing process and recording of journal entries.

Many companies also report gaining a better understanding of computer-related control risks after discovering vulnerabilities in their information technology operations as part of Section 404 implementation. Other key benefits of Section 404 implementation cited by respondents include implementation of anti-fraud activities, a more thoughtful analysis of monitoring controls and the recognition that monitoring is an integral component of control processes. The study's co-authors also believe that companies will achieve even greater efficiencies as they fully implement the information, communication and monitoring concepts described in the COSO[8] Internal Control—Integrated Framework.

7 *Sarbanes-Oxley Section 404 Work: Looking at the Benefits*, © 2005, IIA Research Foundation; Larry E. Rittenberg, PhD, CIA, CPA, Ernst & Young Professor of Accounting, University of Wisconsin; and Patricia K. Miller, CIA, CPA, CISA (Partner, Deloitte & Touche LLP; Vice-Chairman, Professional Practices, Institute of Internal Auditors).

8 COSO: Committee of Sponsoring Organizations of the Treadway Commission.

2. Internal audit strengthens relationships with key stakeholders.

Both audit committees and senior management increasingly seek help from internal audit to meet their expanded regulatory responsibilities. This trend, affecting internal audit's two most important stakeholder groups, is supported by four key survey findings:

1. **Elevated reporting relationships:** Internal audit departments are reporting to higher levels on both a functional and administrative basis.
2. **Stronger audit committee oversight:** Audit committees are providing more active oversight of internal audit functions.
3. **Expanded role for internal audit:** Internal audit is playing a significant role in addressing the strategic needs of audit committees.
4. **Need to strengthen communications with external audit:** Communications between internal and external audit are improving, but still need work.

Elevated reporting relationships

The functional and administrative levels to which internal audit reports in an organization reflect the function's strategic positioning with key stakeholders. On a functional level, 14% of responding organizations indicate that the functional reporting relationship of the chief audit executive has been elevated during the past two years. What's more, 12% of our respondents report an increase in the administrative reporting levels of their chief audit executives during the same period.

On a **functional** reporting basis, 88% of the internal audit functions at responding companies now report directly to either the audit committee or the full board of directors. Where changes in functional reporting relationships did occur at responding companies, they were initiated by the audit committee in 45% of the instances, by executive management in 29% of the cases and by the CAE in 26% of the situations.

Administratively, nearly three quarters of our responding heads of internal audit continue to report directly to the C-suite—the CEO, president or CFO. However, chief financial officers remain the predominant administrative reporting line for chief audit executives, with 39% of our respondents reporting directly to the CFO.

To better understand functional and administrative reporting relationships, look to the IIA recommendations on the following page.

Recommended reporting structures for internal audit

Where internal audit reports organizationally, from a functional and administrative perspective, is a subject of primary concern to all of internal audit's key stakeholders, including professional groups and regulators.

The IIA recommends that a chief audit executive report to a level within the organization that allows internal audit to independently determine the scope of internal auditing, perform work and communicate results.[9] Ideally, according to the IIA, internal audit should report functionally to the audit committee or its equivalent—providing internal audit with appropriate levels of independence and communication—and administratively to the chief executive officer.[10]

"The functional reporting line for the internal audit function is the ultimate source of its independence and authority," states IIA Practice Advisory 1110-2: Chief Audit Executive (CAE) Reporting Lines. "As such, the IIA recommends that the CAE report functionally to the audit committee, board of directors or other appropriate governing authority."

To the IIA, "report functionally" means that the governing authority for internal audit would approve the function's charter and its risk assessment and audit plans. It also empowers the governing authority to (1) communicate directly with the CAE on internal audit results and other matters of importance, (2) meet privately with the CAE without management present, (3) approve the hiring or removal of the CAE and (4) query management and the CAE about any factors that may impede internal audit's ability to execute its responsibilities.

The IIA defines administrative reporting as "the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit function." Typically, administrative oversight of internal audit includes budgeting and management accounting, human resource administration—including personnel evaluations and compensation, internal communications and information flows—and administration of internal policies and procedures.

If the CAE does not report administratively to the CEO, as it recommends, the IIA believes the head of internal audit should report to another executive who can provide the level of support and stature that internal audit needs to function effectively. With respect to administrative reporting issues, the IIA has expressed three key concerns:

- First, internal audit should be free to audit and report on any activity under the jurisdiction of its administrative head if it deems that these activities are necessary to pursue its audit plan.
- Second, the administrative overseer of internal audit needs to provide the support necessary for the function to address key stakeholder expectations. For example, enabling internal audit to play a major role in corporate risk management and/or governance activities.
- And third, the CAE's administrative overseer should not have ultimate authority over the scope of internal audit activity.

9 The chief audit executive should ensure that he/she reports to a level within the organization that allows the internal audit department to be free from interference in determining the scope of internal auditing, performing work and communicating results (IIA Standard 1000 and 1000.A.1).

10 Our experience has confirmed the IIA view that an internal audit function is best served if it reports directly to the audit committee on a functional level and to the chief executive officer on an administrative level.

Regulatory perspectives

Federal banking regulators have a more specific point of view with respect to internal audit reporting relationships. In 2003, they issued an Interagency Policy Statement recommending that a company's manager of internal audit report "directly and solely" to the audit committee with respect to *both* audit issues and administrative matters.[11] In that statement, banking regulators expressed concerns about the potential downsides to dual reporting relationships. They noted that in many institutions, the manager of internal audit reports functionally to the audit committee on issues discovered by the internal audit function and reports administratively to another senior manager.[12]

In assessing the potential benefits of a dual reporting structure for internal audit, bank regulators advise boards of directors to weigh the risk of diminished independence for the internal audit function versus reduced administrative burdens. Under a dual reporting relationship, bank regulators believe the objectivity and organizational stature of internal audit are best served if the chief audit executive reports administratively to an organization's chief executive officer.

We believe an internal audit function is best served if it reports directly to the audit committee on a functional level and to the chief executive officer on an administrative level.

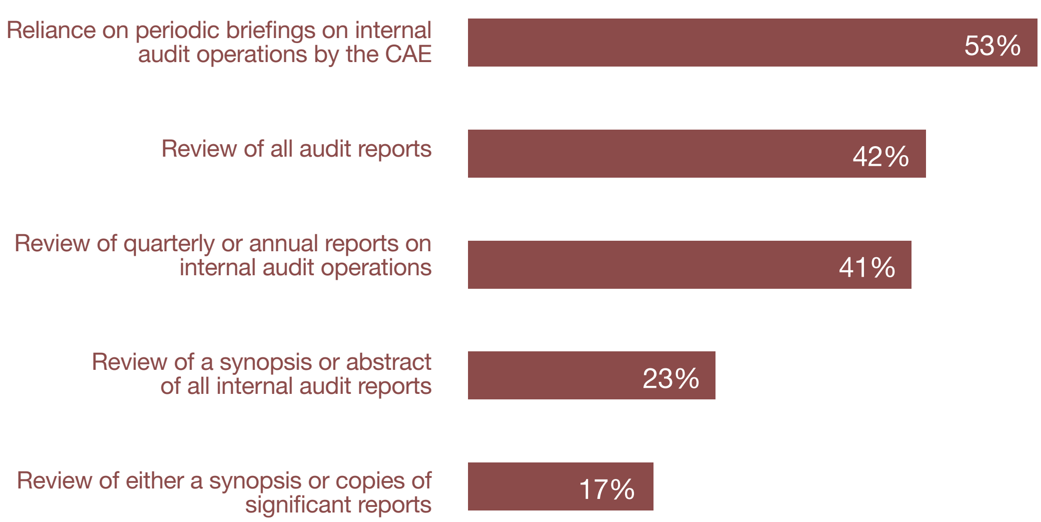
11 *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing,* issued March 17, 2003 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

12 Ibid. "Under a dual reporting relationship," according to bank regulators, "the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role."

Stronger audit committee oversight

Our survey shows that nearly 90% of internal audit organizations report functionally to the audit committee. As a result, audit committee needs are paramount to internal audit's success within most organizations. Audit committees themselves are also under pressure to demonstrate their corporate governance oversight activities. In this environment, it is natural that audit committees are taking a more active role in the oversight of the internal audit function.

Consistent with the trend towards more active oversight comes a heightened interest in the results of the internal audit process. Audit committees are monitoring internal audit results in a number of ways, including:



13 By comparison, 18% of our respondents indicate that they rarely, if ever, meet privately with the audit committee.

Expanded role for internal audit

Traditionally, audit committees have been responsible for overseeing the integrity of financial statements and the audit process. As a result of Sarbanes-Oxley and other reform measures, an audit committee's oversight responsibilities have been extended to areas such as risk management and compliance with laws and regulations.

As our survey indicates, internal audit plays a significant role in addressing the strategic needs of audit committees. It helps audit committees fulfill their broad responsibilities for effective governance, risk management and maintenance of a robust system of internal control. Internal audit also actively advises audit committees on emerging risk and control issues, as well as enhancing audit committee understanding of risk management concerns.[14]

According to our survey, 74% of our respondents are performing engagements at the request of either the audit committee or the full board of directors. Looking at specific activities:

Percentage of our respondents who:

14 For further information, see *Audit Committee Effectiveness—What Works Best,* 3rd edition, a report sponsored by the Institute of Internal Auditors Research Foundation and published in mid-2005. The report describes what proactive audit committees are doing to ensure their effectiveness.

For internal audit to add significant value, its strategies and tactics must align strongly with the needs and priorities of the audit committee and other key stakeholders.[15]

Need to strengthen communications with external audit

With the passage of extensive regulatory and legislative reform, the relationship between internal and external audit is more important. Yet communication between the two groups needs work.

On the one hand, 62% of our responding internal audit groups say they are communicating more frequently with their external audit counterparts, and more than 45% of our respondents are meeting with the external auditor on at least a monthly basis. On the other hand, more than half of our respondents characterize the coordination between internal and external audit as either *minimal* or *lacking*. So although internal and external audit professionals are interacting more frequently, participating CAEs perceive room for improvement in these relationships. When conducting QARs for our clients, we often hear the same sentiments from external auditors. Many would like to enhance communications with their clients' internal audit groups.

15 The audit committee, executive management and the external auditor are the three primary stakeholders of the internal audit function. Other key stakeholders of internal audit include operating management and, in some instances, regulatory agencies.

3. Risk management and corporate governance take center stage.

Enterprise-wide risk assessments and risk-based internal audit planning lie at the heart of high-performing internal audit functions. So it is not surprising that survey results reflect an overwhelming use of risk assessments in annual planning for internal audit functions and in planning for individual internal audit engagements.

According to the survey, 82% of responding internal audit groups conduct an enterprise-level risk assessment on at least an annual basis and apply the results when developing their annual audit plans. In addition, 76% of respondents conduct a preliminary risk assessment at the outset of every internal audit engagement and base their audit objectives for the corresponding engagement on the assessment results.

This strong use of assessments also serves as an implicit endorsement of best-practice recommendations from the IIA. According to IIA Standard 2010, internal audit should conduct an annual or more frequent risk assessment to serve as the basis for its plan of engagements.[16] The IIA also recommends that internal audit's risk assessments—*whether annual or at the engagement level*—include input from senior management, directors or other parties knowledgeable about operations or potential risks to the organization.[17]

In the area of risk management, internal audit has two significant opportunities to strengthen stakeholder relations. First, it can help senior management implement the company's risk management program and activities. Second, it can provide the audit committee with assurance that management is effectively executing its risk management responsibilities.

To assess risk management activities, internal audit should initiate a top-down review of the organization's risk management structure, activities, policies and reporting practices. In addition, internal audit needs to document the organization's risk profile and risk appetite—and verify that its risk management structure and processes are aligned effectively with that profile and appetite.

16 The chief audit executive should direct internal audit to conduct a risk assessment, either annually or at more frequent intervals, to serve as the basis for internal audit's plan of engagements (IIA Standard 2010).

17 Internal audit's risk assessments–whether annual or at the engagement level–should include input from those knowledgeable about operations or potential risks, such as senior management or the board (IIA Standard 2010.A.1 and 2201).

It is also useful for internal audit to compare the organization's risk management structure and policies with the new COSO Enterprise Risk Management Framework and Application Guidance (written by PricewaterhouseCoopers for COSO), which identifies eight key elements of an effective enterprise risk management framework:

1. Establishment of an effective internal environment
2. Objective setting
3. Event identification
4. Risk assessment
5. Risk response
6. Control activities
7. Information and communication
8. Monitoring processes

Internal audit plays a growing role in corporate governance.

New regulations mandate that effective, verifiable governance activities assume a much higher organizational profile. As a result, boards of directors and audit committees are looking to internal audit to play a more prominent role in assessing the effectiveness of current governance practices.

In our survey, 79% of respondents report that their internal audit groups have (1) assessed the corporate governance efforts of their organizations and (2) made specific recommendations to improve the organization's governance processes. These results clearly indicate that internal audit functions are providing substantive input to corporate governance processes and operations.

The IIA *Standards* acknowledge the close link between corporate governance and the practice of internal auditing, suggesting that work related to corporate governance is fundamental to the basic practice and performance of the internal auditing function. According to the *Standards*, internal audit should evaluate the design, implementation and effectiveness of an organization's ethics-related objectives, programs and activities. In addition, internal audit should seek to (1) promote appropriate ethics and values within the organization, (2) ensure effective organizational performance management and accountability and (3) communicate risk and control information to the audit committee, board of directors, external auditors, senior management and other appropriate areas of the organization.

With the heightened focus on good governance in today's business environment, the IIA recommendations carry a lot of weight. To an increasing extent, the failure of internal audit to comply with the *Standards* will be unacceptable to senior managements and directors, who bear significant responsibility in the area of corporate governance. Thus, internal audit departments are well advised to make corporate governance a high priority.

To meet the governance-related expectations of management and the audit committee, however, an internal audit department needs to be both independent and objective. Failure to meet these criteria can have serious consequences for the organization and its key stakeholders.

In terms of opportunities in the governance arena, internal audit is well-positioned to assess both internal and external governance-related reporting procedures. In conducting such assessments, the objective is to verify and evaluate the presence of specific governance-related reporting procedures within corporate organizations. To initiate the assessment process, internal audit should first identify and inventory governance-related reporting procedures and then test the accuracy and adequacy of any internal and external governance-related reports. To be effective, such reports need to be just as accurate and complete as financial reports, reflecting heightened levels of scrutiny from shareholders, regulators and other members of the financial community.

In coming years, organizations may choose to issue governance-related reports to their stakeholders. Prior to being made public, these reports need to be subjected to the same levels of internal review and control as financial information in order to address potential risks to an organization's reputation. To this end, internal audit needs to take strong ownership of governance-related reporting to ensure the adequacy of oversight and controls relating to this increasingly critical area.

4. Rising demands strain internal audit resources and processes.

When it comes to resource management, today's internal audit organization faces a number of serious challenges. It needs specialized knowledge and skill sets to evaluate and test internal controls across the organization as required by Sarbanes-Oxley and other reform measures. It needs a sufficient breadth of capabilities in order to audit complex areas, address enterprise-wide risk and governance issues and cover intended geographic scopes. Finally, it needs people who can work effectively in teams.

Given such pressures, it is not surprising that nearly a third of our survey respondents have had open internal audit positions for six months or more, a clear measure of how difficult it has become to attract and retain internal audit talent. Although 37% of our respondents use a mixture of career and rotational positions in internal audit, 56% of our respondents indicate that all positions in their functions are considered to be career positions. Only 4% of respondents indicate that all of their internal audit positions are rotational in nature.

To address shortfalls in resources and strengthen skill sets and productivity, an internal audit function can leverage "capacity multipliers"—ranging from co-sourcing solutions to process enhancement and technology applications. As our survey reflects, many internal audit organizations have already entered strategic co-sourcing relationships with third-party service providers. In fact, the use of third-party resources on an *as-needed basis* has become so common within the world of internal audit that third-party sourcing is now viewed as a *best practice* in many audit circles. In the past year alone, 63% of our survey respondents have reportedly engaged one or more third-party service providers to assist in the delivery of internal audit services.

Internal audit processes are strong candidates for streamlining.

Our survey suggests there is ample room to expand the application of technology to improve the efficiency, quality and value of internal audit processes.

According to our survey, 56% of our responding internal audit functions report employing specific measures and metrics to assess internal audit performance. However, less than half of our respondents report using software specific to the internal audit function, such as electronic work papers or other forms of an automated internal audit management system.

Technologies that can significantly enhance internal audit processes include data analysis software, internal audit infrastructure software and best-practices knowledge bases. They also include our own Profiler™ Internal Audit Benchmarking Tool. Profiler is used to measure an organization's current internal audit processes against a set of ideal best practices that reflect an organization's culture, ethical values, size and risk management priorities as well as stakeholder objectives.

Through process enhancement, an internal audit group can gain efficiencies in core internal audit activities and can maximize audit coverage with available resources. Key internal audit processes that may be streamlined include risk assessment, audit planning, audit program design and development, documentation and review, internal audit reporting and the monitoring and follow-up of internal audit findings.

Participation in quality assurance programs and reviews is surprisingly low.

The quality assurance process is another key target for improvement. When the IIA unveiled its new *Standards* in 2002, it mandated that internal audit groups conforming to the *Standards* adopt formal quality assurance and improvement programs as well as secure a QAR.[18] Although compliance with the IIA *Standards* is not generally mandated by statutes or regulations, most internal audit departments view these revised guidelines as mandatory.

At the time of our survey, only 23% of our respondents had a formal quality assurance and improvement program in place that was consistent with the *Standards* and included periodic internal and external quality assessments. What's more, only 24% of our respondents had undertaken an external QAR during the past five years.[19] QARs are considered to be particularly important in management and audit circles, reflecting the enhanced role played by internal audit departments in the risk, control and governance activities of many major corporations today. In addition to confirming compliance with the *Standards*, a well-designed external assessment will provide benchmarks and measurements that can be used to improve internal audit performance long after the external QAR report is issued.

18 *How quality assurance reviews can strengthen the strategic value of internal auditing** November, 2005. PricewaterhouseCoopers, 300 Madison Avenue, New York, New York.

19 Internal audit departments established after January 1, 2002, have until five years from the date they initiated operations to undergo an initial external quality assessment review.

5. Chief audit executives are increasingly asked to provide formal opinions on internal controls.

A key requirement of the Sarbanes-Oxley Act requires management to issue a formal assessment of its company's internal controls over financial reporting. To assist in complying with these requirements, a number of senior management groups are asking their CAEs to provide formal opinions on the state of internal controls within their organizations. In some cases, these internal audit evaluations deal broadly with internal controls. In other cases, such opinions are restricted to internal controls over financial reporting.

According to our 2005 survey, 38% of our respondents issue an annual opinion on the *overall condition of internal controls* within their companies, while 33% issue an opinion limited to the company's internal controls *over financial reporting*. We were surprised that the percentages were so high. In our 2006 survey of internal audit functions, we will seek greater insight into why, at so many institutions, the CFO or another member of senior management is asking internal audit to provide an opinion about the organization's internal control systems and capabilities.

The issuance of such reports can be problematic for internal audit. Given survey data showing that a significant amount of internal audit resources are being diverted to Sarbanes-Oxley testing, senior management groups and audit committees must determine if internal audit has the expertise, depth and experience needed to assess an organization's *overall* system of internal controls—including controls over financial reporting, operations and compliance. Prior to providing such an opinion, it is important for a chief audit executive to ensure that the scope of the work performed by internal audit during the relevant period is adequate to support such an opinion. If not, the CAE should, at a minimum, consider including an appropriate qualifier in the opinion.

In theory, three separate entities—*senior management, external audit* and *internal audit*—can potentially provide an audit committee with opinions on the adequacy of financial controls. Although the audit committee might find it beneficial to receive all three perspectives, such overlapping assessments can easily cause conflicts among the parties involved.

External audit, for example, is now required to evaluate the effectiveness of a company's internal controls over financial reporting, including the effectiveness of the internal audit function. The process typically employed by external audit in evaluations of internal controls is generally considered to be both highly structured and robust.

By comparison, the process typically employed by an internal audit group to evaluate internal controls may not be as structured or robust, raising questions about the substance, quality and efficacy of such an assessment. As a practical matter, such assessments amount to *negative assurance* rather than a positive assertion about internal control effectiveness.

6. Continuous auditing and monitoring techniques gain momentum.

On a promising note, 34% of our respondents are reportedly using continuous monitoring techniques as part of their audit plan—a trend we intend to explore further in our 2006 survey.

Continuous auditing is a technology-driven process in which control and risk assessments are performed automatically. As a result, instead of conducting periodic reviews of transaction samples, the company is engaged in ongoing audit testing of all transactions.[20] This shift impacts the nature of evidence as well as the timing, procedures and levels of effort required by internal auditors.

The adoption of continuous auditing is a major undertaking. After first gaining audit committee and senior management support for its implementation, auditors need to develop and maintain the technical competencies necessary to access, manipulate and analyze the data contained in disparate information systems. However, the benefits of continuous auditing can be substantial.

The continuous auditing process enables auditors to analyze data more frequently by performing control and risk assessments in a real-time environment. It provides an opportunity to go beyond the confines of traditional audit approaches, such as sampling and point-in-time assessments, to provide timely notification of control gaps and weaknesses, laying the groundwork for immediate follow-up and remediation.

Continuous auditing also improves an organization's management and control frameworks by separating them from the underlying operational and financial systems and from the monitoring performed by management. Monitoring techniques can reduce error and fraud, increase operational efficiency and improve profitability by lowering costs and reducing overpayments and revenue leakage. They also facilitate the review of key business systems for *anomalies* at the transaction level and for *data-driven indicators* of control deficiencies and emerging risk. The results of such reviews can be integrated throughout the audit process—from the development and maintenance of the enterprise-wide audit plan to the implementation and follow-up of specific audits.

20 GTAG Guidance on Continuous Auditing, The Institute of Internal Auditors, November 1, 2005.

Methodology

The 2005 *State of the Profession* survey for internal auditing conducted in the third quarter of 2005 includes responses from 271 audit managers. Of the respondents:

- 82% are either chief audit executives or internal audit managers
- 73% are from companies with $1 billion or more in revenue
- 70% are from internal audit departments with four or more staff

The survey had three purposes:

1. Capture a snapshot of the internal audit profession.
2. Share insights and observations from PwC experts about the 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.

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