Targeting key threats and changing expectations to deliver greater value*

PricewaterhouseCoopers 2008 State of the internal audit profession study

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The heart of the matter

Transformational change demands a strong response.

Rapid, pervasive change is quickly transforming the practice of internal audit, according to PricewaterhouseCoopers' 2008 State of the Internal Audit Profession survey, raising significant issues for audit leaders and their chief stakeholders.

Audit committees today are setting higher goals for internal audit. This trend is being driven by two key factors: increased turnover among audit committee chairs and the growing tendency of committee members to share best-practice ideas drawn from their current or past experience with other internal audit groups. Additionally, audit committees and senior management are putting increased pressure on internal audit functions to place a higher priority on strategic, operational, and business risks, which collectively underlie 80% of the rapid declines in shareholder value, according to recent studies. Likewise, internal auditors are being pressed by audit committees and senior management for more timely information about major risks and for faster and more actionable audit results.

As this year's State of the Profession survey indicates, there is a clear gap between the current focus of many internal audit functions and where they need to set their sights in order to deliver greater value to their stakeholders. Since the passage of the Sarbanes-Oxley Act of 2002, internal audit groups have been concentrating on financial and compliance risks, traditional areas of focus where their confidence levels are typically high. Now it's time for internal auditors to transform their thinking.

To address the rising expectations of their chief stakeholders, internal audit groups need to sharpen their focus on strategic, operational, and business risks. They need to explore ways to shorten audit cycle times and incorporate activities that promise to reduce costs and improve customer satisfaction simultaneously. They need to leverage the potential of Auditing Standard No. 5 (AS5) to help them cut back on their resource commitments to Sarbanes-Oxley compliance, and devote freed-up time to other key priorities. And they need to identify the talent and skill sets they will need in order to address non-financial risks and provide risk management assurance along with assurance over controls.

Internal audit is indeed at a crossroads. In response, members of the internal audit profession must move urgently to strengthen internal audit capabilities in the risk areas where chief stakeholders need them most.

An in-depth discussion

Audit committees are setting higher performance standards for internal audit.

The degree of interaction between audit committees and internal audit functions has increased dramatically in recent years. This trend reflects an increased focus on corporate governance, greater scrutiny of risk management, and more direct audit committee oversight of internal audit.

According to PricewaterhouseCoopers' 2008 State of the Profession survey, the vast majority of internal audit groups now report functionally to the audit committee. Such heightened reporting relationships, typically characterized by a significant amount of direct involvement between the internal audit group and the audit committee, have done much to enhance the stature of internal auditing. So, too, has the growing perception among observers that internal audit can play a key role in corporate efforts to address strategic, operational, and business risks, which underlie 80% of the rapid decline in shareholder value (see Figure 2).

Since 2004, when PricewaterhouseCoopers launched its annual survey of internal auditors, we have seen an influx of new audit committee members. Some committees are bringing these members aboard to strengthen financial expertise, while others are adding members with specific experience to address a particular business strategy, such as global expansion. We've also seen significant turnover among audit committee chairs, a reflection of the vastly increased knowledge and time required to chair an audit committee today.

It is also increasingly common for audit committee members to serve on more than one audit committee and to network with members of audit committees from other boards of directors. Service on multiple audit committees affords the opportunity for committee members to strengthen their knowledge of internal auditing and to observe what works well for other internal audit functions. As a natural consequence, members who serve on multiple audit committees are inclined to take the best ideas from each company and share them with the internal audit functions of the others. In our 2008 State of the Profession survey, 51% of the Fortune 500 respondents reported that members of their audit committees have drawn upon current or past board experience to bring new thinking to internal audit.

For chief audit executives, the influx of new audit committee chairs and members, coupled with the increased exposure of audit committee members to multiple internal audit functions, can present a number of challenges. In dealing with chief audit executives and their senior staff, members of audit committees are speaking up, asking questions, and offering guidance on a host of topics ranging from the scope of annual risk assessments to the means by which audit results are synthesized and communicated to the audit committee.

Survey addresses key value indicators for internal audit

Recognizing the significance of these challenges, we used the 2008 State of the Profession survey to learn more about how internal audit functions can address the rising expectations of audit committees. In particular, we asked respondents to assess a number of value indicators in terms of their perceived importance to audit committees as measures of internal audit value or performance (see Figure 1).

Providing assurance on the effectiveness of internal controls, which historically has been a high priority to boards of directors, is the most important role for internal audit, according to survey respondents. At the same time, however, respondents to PricewaterhouseCoopers' forward-looking study *Internal Audit 2012* (2007) said they expect the value of a strong controls-oriented approach to internal audit to diminish as the function's chief stakeholders demand a greater focus on strategic, operational, and business risks.

In the 2008 State of the Profession survey, internal auditors ranked effective communications as the second most important indicator of internal audit value to audit committees. The abilities to address financial and compliance risks ranked third and fourth, reflecting internal audit's strong focus in these areas during the Sarbanes-Oxley era.

The quality of internal audit staff and skill sets only ranked fifth as a value indicator in our 2008 survey—a result that came as a surprise to us, since the quality of an internal audit group's resources bears directly on its ability to cover more complex areas and provide greater value to the audit committee. Head counts aside, chief audit executives must first determine what types of skills they need to address heightened stakeholder expectations, and then retool their departments accordingly. Directors of internal audit must also keep in mind the audit committee's role in evaluating the internal audit function.

Of note, 63% of survey respondents consider operational risk to be of significant importance to audit committees. The fact that nearly two thirds of respondents rank operational risk this highly suggests a deepening appreciation among both audit committees and audit leaders of the need for internal audit to increase its focus on operational, strategic, and business risks. At the same time, it was surprising to learn that only 52% of respondents consider providing assurance on the effectiveness of a company's risk management processes to be of significant importance to audit committees. In our view, the ability to provide such assurance represents one of internal audit's best opportunities to deliver greater value in the years ahead.

The importance of audit committee communications

To be successful, an internal audit group needs to establish and maintain a strong working relationship with the audit committee (see “How to strengthen audit committee relations: a five-step action plan,” page 10). Ideally, internal audit will report functionally to the audit committee, as do 89% of Fortune 500 respondents and 82% of other respondents to our 2008 survey. In addition, the director of internal audit should attend all audit committee meetings, a standard practice for 90% of 2008 Fortune 500 respondents and 82% of other respondents.

In many respects, the quality of the relationship between internal audit and the audit committee depends on effective communications. For example, many audit leaders consider it highly beneficial to meet privately with their audit committees from time to time. According to our 2008 survey, 81% of Fortune 500 and 64% of other respondents had conducted private sessions with their audit committees on a quarterly or more frequent basis during the preceding year. Other survey results reveal the wide range of communication techniques being employed by internal audit leaders to foster good relations with their audit committees:

- Eighty-six percent of total respondents have open lines of communication with their audit committee chairs.
- Sixty-two percent of total respondents help set the audit committee agenda.
- Sixty-six percent of Fortune 500 respondents and 61% of other respondents provide their audit committees with information that extends beyond internal audit reports.
- Forty-five percent of total respondents facilitate periodic discussions with their audit committees on key risk topics.

We also asked respondents to describe how they communicate internal audit results to the audit committee. Results are as follows:

- **Send complete audit reports:** Forty percent of non–Fortune 500 respondents do so but only 13% of Fortune 500 respondents engage in this practice. Internal audit functions at Fortune 500 companies tend to produce larger audit reports, and more of them, than their counterparts at smaller companies. As a result, internal auditors from Fortune 500 companies are more likely to provide audit committees with summary audit information as opposed to full audit reports.

- **Send abstracts or synopses of all audit reports:** Thirty-six percent of Fortune 500 respondents do so, as do 41% of other respondents.

- **Forward only those audit reports that contain significant findings or conclusions:** Nineteen percent of total respondents engage in this practice.

- **Provide audit committee with a summary list of reports:** Thirty-one percent of Fortune 500 respondents engage in this practice but only 11% of non–Fortune 500 respondents do so.

- **Provide audit committee with intranet access to audit results rather than printed audit reports:** Two percent of total respondents engage in this practice.

Figure 1. What audit committees value most from internal audit

Where do internal audit functions contribute the greatest value to their audit committees? According to 2008 survey respondents, the ten most important value indicators for internal audit are as follows:

Rank	Value indicator	Total %
1	Assurance on the effectiveness of internal controls	85
2	Effectiveness of communications and reporting	73
3	Ability to address financial risks	70
4	Ability to address compliance risks	68
5	Quality of internal audit staff and skill sets	64
6	Ability to address operational risks	63
7 (tie)	Completion of internal audit plan by end of year	55
7 (tie)	No surprises	55
9	Assurance on the effectiveness of the company's risk management processes	52
10	Prevention and detection of fraud	49

How to strengthen audit committee relations: a five-step action plan

The days of audit committee indifference to internal audit are over, and chief audit executives who have been flying under the radar at their companies are in for a major change.

To develop a solid working relationship with its audit committee today, an internal audit function must:

- Provide an objective set of eyes and ears across the organization
- Provide assurance on risks and controls
- Focus on strategic, operational, and business risks
- Presume committee members are knowledgeable, alert, and adept
- Position internal audit as a trusted strategic advisor to the committee

Below is a five-step plan for an internal audit group to develop a stronger relationship with its audit committee.[1]

Step 1: Communicate regularly with the audit committee chair

A chief audit executive needs to communicate regularly with the chair of the audit committee. By doing so, an internal audit leader can provide ongoing updates to the audit committee while positioning the internal audit function as a key resource to the audit committee. At the same time, such interactions will enable internal audit to keep abreast of the audit committee's changing needs and expectations.

To facilitate effective communications with an audit committee chair, a chief audit executive should seek to:

- Interact frequently with the audit committee chair—either in person or by phone or email—to discuss ongoing issues and concerns, answer questions, develop strategies, and plan upcoming meetings
- Share information on a real-time basis via email, enabling the chair to summarize the information for other committee members or simply forward it
- Attend selected conferences with the audit committee chair, thereby building both parties' individual knowledge bases and strengthening their relationship

1 For related information about this topic, see *Audit Committee Effectiveness: What Works Best,* 3rd edition (2005), a report by PricewaterhouseCoopers, sponsored by The Institute of Internal Auditors Research Foundation. Research for the report included face-to-face interviews with more than 50 prominent audit committee chairs, corporate governance thought leaders, and chief audit executives from around the world. The report also reflects input from a survey of audit committee chairs and audit directors in the United States.

Step 2: Build audit committee awareness of organizational risks

Many audit committees today have oversight responsibility for enterprise risk management. To address these duties, audit committees need a thorough understanding of the major risks facing the organization—and to develop this understanding, they often look to internal audit.

The chief audit executive should keep the audit committee and senior management informed about:

- The company's risk profile, how it is being affected by major events, and how the company's risk assessment plan is keeping up with changes to the profile
- The adequacy of the company's risk management processes, if an analysis is within the scope of assessment
- Emerging risks of significant concern, particularly those outside the arena of financial risk (strategic, operational, and business risks in particular)
- Risks associated with both corporate and business unit strategies
- Insights about systemic risk-related and control-related issues noted in connection with recent audits
- Risks that fall outside of internal audit's purview
- Internal audit's assessment of what the company is or is not doing to address risks outside the scope of the internal audit plan

Step 3: Get to know the audit committee, including new members

Ideally, a chief audit executive will develop a solid working relationship with all members of the audit committee, not just the chair, and gain a thorough understanding of each member's needs and viewpoints.

New members of the audit committee deserve special attention (see "Orienting new audit committee members: a two-phase approach," page 14). The chief audit executive should develop an orientation plan to provide new committee members with information about the organization that will help them add value as quickly as possible. Begin by describing the role and scope of internal auditing. Also check for related audit-committee experience: If a new member of the committee is also serving on the audit committee of one or more other organizations, contact the audit directors of those institutions to gain potentially useful insights about their internal audit practices.

Step 4: Provide audit committee members with broad exposure to the internal audit team

It is essential for a chief audit executive to provide members of the audit committee with access to senior members of the internal audit staff. An audit committee can then develop a broader appreciation for an internal audit group's full range of capabilities.

Effective techniques for facilitating interactions between the audit committee and your senior staff include:

- Scheduling separate one-on-one meetings between the audit committee chair and your direct reports
- Having your direct reports attend audit committee meetings and make presentations relating to their areas of expertise

Step 5: Position internal audit as the go-to educational resource for the audit committee

Proactive audit committees place a high priority on training, and typically formalize their continuing-education plans at the beginning of their annual planning cycle. At this time, they will identify topics to explore and assess how best to acquire the knowledge they need (e.g., through conferences or in-house briefings from internal audit).

As described in Step 2, many audit committees have gained oversight responsibility for enterprise risk management and therefore need to develop an understanding of the major risks facing their organizations. Internal audit can help audit committee members address this important responsibility.

The chief audit executive should meet with the audit committee chair to discuss the internal audit risk assessment in detail. Together, they should determine whether other members of the audit committee could benefit from similar risk briefings, and develop a schedule of presentations on specific risk areas to be shared throughout the year. Topics to explore include:

- Emerging areas of significant risk, particularly non-financial risks
- The impact of major events on the company's risk profile and the related effect on the internal audit risk assessment
- Insights about systemic risk and control issues, based on recent audits
- Risks associated with both corporate and business unit strategies

Orienting new audit committee members: a two-phase approach

Change in the composition of the audit committee provides an excellent opportunity for chief audit executives to develop a "trusted advisor" relationship with new committee members. To facilitate the relationship-building process, chief audit executives should first prepare key information to be sent to new directors once they are assigned to the audit committee. They should also seek to meet face-to-face with each new committee member as soon as possible, making sure to prepare a robust agenda for the meeting to ensure time is well spent.

Sending background information to new members

Some audit leaders have found it useful to provide new audit committee members with orientation kits that include background information on both the committee and internal audit. Chief audit executives should develop information about the company that can help new committee members get up to speed as quickly as possible. Such information could also be useful to regulators and third parties.

The department should update and expand its orientation package on an as-needed basis, always being mindful that it be kept to a manageable size.

An initial table of contents for an orientation kit might include the following:

- Audit committee charter and planning agenda
- Internal audit charter and mission statement
- Internal audit organization chart and bios of the internal audit management group
- Budget and staffing plans for internal audit
- Summary of risk assessment and audit planning processes, including the current risk assessment and audit plan
- Description of the audit reporting and rating process, including a sample internal audit report and management response
- Description of the audit tracking and reporting process
- Description of the internal audit quality and performance measurement process, including the most recent internal and external quality reports
- The most recent audit committee reporting package

Meeting face-to-face with new committee members

Ideally, relations between a chief audit executive and members of an audit committee will be characterized by openness and trust. But developing trusting relationships takes time and commitment on the part of chief audit executives. Once a member of the board has been assigned to the audit committee, the chief audit executive should send him or her the department's orientation materials and request a face-to-face meeting, offering to travel to the new member's location. If appropriate, the audit executive may want to bring key members of the internal audit team to the meeting as well.

Imperatives for ensuring meeting success:

- **Set specific objectives for each meeting:** The primary goal is to build a trusting relationship with each new committee member, while at the same time providing new members with important information about audit committee and internal audit practices at the organization.

- **Determine the new member's familiarity with internal auditing:** A new audit committee member may have had little or no previous exposure to internal audit—or he or she may be eager to share perceived best practices. Knowing this information beforehand can help a chief audit executive develop a more effective meeting agenda. Also keep in mind that even if a member has prior audit committee experience, audit committee and internal audit practices do differ from one organization to another.

- **With new committee chairs, explore expectations and establish communication protocols:** If a new committee member is taking over as committee chair, it is particularly important to determine his or her expectations of internal audit at the outset. The same is true when dealing with an existing committee member who takes over as committee chair: Although such a person might have a solid understanding of current audit committee and internal audit practices, his or her expectations could change after assuming the committee chair. In addition, address communication protocols with the committee chair and seek agreement on the timing and nature of communications going forward.

At the end of the meeting, both the new committee member and the chief audit executive should feel that the time invested was well spent and a good first step in relationship-building. By employing the tactics described above, a chief audit executive can provide valuable assistance to new members while positioning internal audit as a trusted advisor.

Strengthen risk assessment focus on strategic, operational, and business risks

Last year, our 2007 State of the Profession survey highlighted the growing pressures on internal audit functions to concentrate more on risk and to strengthen their risk management practices. It also noted that internal audit respondents expressed a high degree of confidence when dealing with finance, compliance, and operations issues but voiced concerns about their ability to assess strategic risks, business risks, and risks relating to fraud and technology. With these perceptions in mind, we continued to explore risk assessment practices in the 2008 survey.

At the same time that the demands of Sarbanes-Oxley were easing in 2007 (due largely to three factors: the impact of AS5,[2] the increased ability of internal audit functions to deal with Sarbanes-Oxley requirements, and the shift of Section 404 testing to process owners outside of internal audit), stakeholder expectations were shifting. Audit committees and senior management are now putting increased pressure on internal audit to place a higher priority on strategic, operational, and business risks. The chief stakeholders of internal audit are well aware that those risks threaten the financial viability of major corporations, increase director liability, and have the potential to force out top executives.

When we asked respondents about their risk assessments, we learned the following:

- Nearly 60% of total respondents have a risk assessment process in place that includes annual updates to an existing risk universe and seeks stakeholder input on key risks facing the organization.
- With respect to annual risk assessment processes, 87% of total respondents identify strategic and business risks in addition to typical financial risks.
- Two thirds of Fortune 500 respondents reported that they had addressed strategic or business risks during the past year, as had 52% of other respondents.

2 One factor contributing to the decline in internal audit resources devoted to compliance with Section 404 of the Sarbanes-Oxley Act of 2002 was Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5 (AS5), as approved by the Securities and Exchange Commission in July 2007. Along with SEC Interpretative Guidance, AS5 enables management to use a top-down, risk-based approach to its evaluation of internal controls. See page 34 for more information.

A good share of the internal auditors surveyed also claim strong support from their key stakeholders to address strategic, operational, and business risks as part of their audit coverage:

- Eighty-seven percent of total respondents believe their audit committees place a moderate to high value on the ability of their internal audit functions to address strategic and business risks.

- Eighty-two percent of total respondents believe that executive management places a moderate to high value on the ability of internal audit to address strategic or business risks as part of their ongoing audit efforts.

At first blush, these positive perceptions might seem reassuring. However, despite the obvious need to put a high priority on non-financial audit areas, there is a clear gap between the current focus of many internal audit functions and where they need to focus in order to address changing stakeholder priorities. In particular, internal auditors need to pay more attention to strategic, operational, and business risks, which are often the primary factors associated with rapid declines in shareholder value (see "Risk factors causing rapid drops in shareholder value," page 20).

Despite the perceived value that key stakeholders place on internal audit's ability to address strategic, operational, and business risks, the 2008 State of the Profession survey indicates that many internal audit functions still focus extensively on financial and compliance risks:

- Seventy-six percent of total respondents spend less than 40% of their internal audit resources on operational audits, which would likely include both strategic and business risks.

- Eighty-seven percent of Fortune 500 respondents and 79% of other respondents spend less than 20% of their resources on non-financial compliance audits.

- Sixty-five percent of Fortune 500 respondents and 73% of other respondents spend less than 20% of their resources on IT audit coverage.

- Only 7% of total respondents devote more than 20% of their resources to "consulting or management assistance projects."

Addressing strategic, operational, and business risks

Trying to determine the nature of strategic, operational, and business risks is one of the most significant challenges internal auditors will face as they strive to enhance their audit coverage. In recent years, many internal audit functions have limited their risk assessments to financial and compliance risks, in keeping with the primary focus of their audit coverage. To address strategic and business risks effectively, however, internal auditors need to take an enterprise-wide approach to their risk assessments. According to our 2008 survey, only 42% of Fortune 500 respondents and 31% of other respondents linked their risk assessments to a broader enterprise risk management activity. In addition, only 22% of Fortune 500 respondents and 13% of other respondents formally updated their risk assessments more than once a year. Clearly, there is room for improvement.

Ability to address strategic and business risks raises concerns

Last year, respondents to our 2007 State of the Profession survey were asked to characterize their relative confidence levels regarding the effectiveness of their audit coverage for six different types of risk. In the areas of finance, compliance, and operations—traditional areas of focus for many internal audit groups—respondents expressed high degrees of confidence. However, respondents were significantly less confident about their ability to address strategic risk, business risk, and risk related to fraud and technology.

Risk factors causing rapid drops in 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:

- Nearly 60% of the time, a strategic or business factor was behind rapid losses[3] in shareholder value. The causes can vary widely, from a major product or service introduction by a competitor to the impact of a new regulation.
- Operational risks accounted for 20% of rapid drops in shareholder value, financial risks were behind 15% of major losses to shareholders, and compliance risks caused 5% of the most significant hits in share prices.

3 “Rapid losses” are defined as declines of up to 50% in a one-year period.

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

Examples of financial and market risks

As internal auditors have increased their focus on business and strategic risks, they have added many non-traditional types of risk to their assessments, as the following examples indicate.

Business strategy risks

Risk type	Examples
Corporate strategy	Lack of effective measurement processes to determine whether strategies are achieving their long-term objectives
	Inadequate consideration of impacts relating to risks and of risk mitigation activities during strategic planning and budgeting
Competitor / industry	The actions and capabilities of competitors, the appearance of new market entrants, or the implementation of new industry-specific regulations, any of which can impair a company's competitive advantage or even threaten its survival
	Market forces that affect an entire industry (for example, rising fuel costs, which pose a major threat to the airline industry)
Manufacturing technology and sourcing	Failure to leverage advancements in technology to achieve or sustain competitive advantage or to compete effectively with others who are capitalizing on technology to improve products, services, and processes
	Limited sources of energy, raw materials, or skilled labor, which may affect a company's ability to produce quality products at competitive prices and on a timely basis
Customer focus	Lack of customer measurement or satisfaction process to assess whether a company is meeting customer expectations
	Failure to anticipate changing customer needs, which may lead to ineffective product development and loss of market share
Reputation	A major product failure or unethical behavior, which may have a negative impact on a company's reputation or brand

Organizational risks

Risk type	Examples
Governance	Failure to set effective objectives, which may lead to poor business decisions, operational surprises, or regulatory non-compliance
	Weak risk management policies and practices, through which companies may fail to identify, measure, and control risks effectively
Human resources	A lack of requisite knowledge, skills, and experience stemming from ineffective hiring and retention practices and weak succession planning, which may impede the successful execution of a company's business model and achievement of critical business objectives
	Incentive compensation plans that do not align effectively with an organization's long-term strategic business objectives or do not drive behaviors that support these objectives

Financial and market risks

Risk type	Examples
Interest rate	Exposure to impacts on asset valuations or product pricing as a result of changes in interest rates
Commodity	Fluctuations in the prices of commodities, which may erode margins
Credit	Exposure to financial losses as a result of customer defaults or other performance failures
Access to capital	Lack of sufficient access to capital, which may threaten a company's capacity to grow
	Movements in price, rates, or indices, which may affect asset values and stock price
Foreign exchange	Major swings in foreign exchange rates, which may result in volatile earnings and a sharp downturn in shareholder value
Tax	Tax strategies that result in non-compliance with tax regulations or other adverse tax consequences
	Failure to capitalize on available opportunities to lower effective tax rates, which may lower profitability

Operational risks

Risk type	Examples
Health, safety, and environmental	Corporate activities harmful to the environment, which may expose a company to liabilities for bodily injury, property damage, or contamination removal
	Failure to provide a safe working environment, which may increase costs related to workers' compensation and have a negative impact on a company's reputation
Procurement, manufacturing, and logistics	Lack of production capacity, which can threaten a company's ability to meet customer demands
	Excess production capacity, which can put pressure on profit margins
	Weak distribution channels, which can impede access to customers
Information technology	Operational weaknesses in information technology, which may compromise data integrity or reliability and impair a company's ability to sustain critical processes
	Inadequacy, unreliability, or unavailability within the desired time frame of data or other information needed to support key decision-making processes
Disaster / business continuity	Major disasters, which can threaten a company's ability to sustain operations, provide essential products and services, and achieve intended levels of profitability
Compliance	Failure to comply with governmental regulations, which can lead to severe financial and/or criminal penalties
	Non-compliance with organizational policies and procedures, which may result in a wide range of negative consequences, ranging from higher production costs, production delays, and lost revenues to diminished production and service quality
Third party / vendor	Dependence on vendors who might fail or be unable to meet contractual obligations

Lengthy audit cycle times can erode stakeholder support

The inability to reduce audit cycle time—which starts with the initiation of an audit and concludes with the reporting of final audit results to management—has been a long-standing challenge to internal audit functions. On the one hand, internal auditors want sufficient time to conduct audits that are well planned, well executed, and well documented. At the same time, they realize that stakeholders ascribe little value to audits they perceive as containing stale information.

What audit attributes are most important to audit committees and senior management? Historically, internal audit's key stakeholders have placed the highest priority on reports being factually correct. But at a time when access to real-time data is more essential than ever, the need for audit timeliness cannot be far behind. Directors and senior management know how quickly risks can escalate, and they are pressing for more timely information and actionable results. Yet the processes typically deployed by internal auditors to deliver information to their primary stakeholders have remained largely unchanged for more than 60 years. It's no wonder chief audit executives hear frequent complaints about audits taking too long.

According to the results of our 2008 State of the Profession survey, audit cycle times are lengthy indeed:

- For nearly 80% of our total survey respondents, average audit cycle time is three months or more per audit.
- For 10% of our total respondents, average cycle time exceeds six months.

Many internal auditors view lengthy cycle times as either a fact of life or an occupational hazard, reasoning that the need to generate accurate or reliable information outweighs the need to generate and disseminate audit information quickly. Yet excessively long audit cycle times can create a number of consequences, including such serious problems as:

- Audit results that arrive too late to be of value to management
- Extensive revision of working papers and report drafts
- Missed opportunities to address additional risks
- Erosion of stakeholder satisfaction

The factors contributing to lengthy audit cycle times span the spectrum. Those cited most frequently include:

- Planning
  - Excessively broad project scope, characterized by audit objectives that are either too broad or too numerous
  - Failure to adequately assess risks in the area being audited
  - Skill sets that do not align with the risks being addressed
  - Uncooperative management (points out need for process-owner buy-in to project goals and time frames)
- Fieldwork
  - Failure to use efficient methodologies, such as data mining
  - Limited use of electronic work papers and other technology tools
- Reporting
  - Ineffective communications with stakeholders
  - Delays in writing the draft report
  - Ineffective editing processes
  - Cumbersome quality controls
  - Delays by management in responding to draft reports

Our experience indicates that most internal auditors begin to share information about their audit results prior to delivery of final audit reports. In fact, most of the stakeholders we've talked with during typical internal audit quality assurance reviews have indicated that internal audit routinely shares important information about emerging audit results as that information becomes known. At the same time, however, management often fails to appreciate the potential gravity of the issues being raised until they have a written draft in hand for review. And no matter how far in advance internal audit provides stakeholders with initial findings, stakeholder perceptions about audit cycle times are typically influenced by when they receive final reports.

Search for the “right” resources continues unabated

In the post-Sarbanes-Oxley era, many internal audit directors are finding that they have the right head counts but the wrong skill sets to address non-financial risks that had previously taken a backseat to Sarbanes-Oxley compliance. For example, training during the Sarbanes-Oxley era tended to focus almost exclusively on internal controls over financial reporting. In addition, many less experienced staff may have spent the entirety of their careers to date on Sarbanes-Oxley projects, and as a result been unable to develop complementary skills. As a consequence, the talent shortfall cited by our State of the Profession survey respondents for each of the past three years continues unabated.

In our 2007 State of the Profession survey, internal auditors said their greatest challenge was finding enough qualified talent to address the growing demands of their stakeholders. They expressed particular concern about the shortage of qualified staff to address strategic and business risks, as well as risks stemming from fraud and technology.
The results of our 2008 survey indicate that this challenge persists.

Respondents identify key skill sets

According to the 2008 State of the Profession survey:

- Ninety-eight percent of total respondents place a medium to high priority on analytical skills, with 87% placing a high priority on those skills.
- Ninety-five percent of total respondents place a medium to high priority on risk management and risk assessment skills, with 55% placing a high priority on those skills.
- Ninety percent of Fortune 500 and 77% of other respondents place a medium to high priority on skills relating to data mining and data analytics.
- Eighty-three percent of total respondents place a medium to high priority on information technology and fraud detection and investigation.

These are the types of skills internal auditors need to assess strategic, operational, and business risks, and to conduct enterprise-wide risk assessments, audit complex IT environments, monitor key risk indicators, and comb through massive amounts of data in search of fraud.

Internal auditors responding to our 2008 survey also place high priority on other, more basic skills:

- Ninety-eight percent of Fortune 500 and 100% of other respondents place a medium to high priority on verbal and written communication skills, with 88% of respondents placing a high priority on those skills.
- Ninety-six percent of total respondents place a medium to high priority on financial accounting skills, with 71% of Fortune 500 and 54% of other respondents placing a high priority on those skills.
- Ninety-four percent of total respondents place a medium to high priority on project management skills.
- Eighty-nine percent of total respondents place a medium to high priority on knowledge management skills.
- Sixty-eight percent of Fortune 500 and 53% of other respondents place a medium to high priority on process improvement and Six Sigma skills.

Demand for the types of skills rated highly by 2008 State of the Profession survey respondents is expected to remain strong for some time to come.

Respondents cite budget-related challenges

Many internal audit groups are beginning to experience pressures on their budgets from senior management, a trend that's expected to accelerate in a tightening economy. The double-digit percentage budget increases spurred by Sarbanes-Oxley compliance demands are a thing of the past, unlikely to be repeated anytime soon.

Our 2008 survey reflects a number of specific concerns relating to budgets:

- Fifty-one percent of total respondents perceive the lack of an adequate budget to address the audit plan as a medium to high risk during the coming year.
- Ten percent of total respondents report that their budgets were reduced during 2007; 14% of total respondents anticipate decreased budgets in 2008.
- Only 31% of Fortune 500 respondents and 39% of other respondents anticipate increased budgets in 2008, compared with 42% and 47% (respectively) who reported actual increases in 2007.

Talent-related risks identified

A number of talent-related risks were also identified by our 2008 survey respondents:

- In 2007, 30% of total respondents had vacant positions for which they had been recruiting for six months or longer, compared with 32% having such long-term vacancies in 2006.
- Eighty-four percent of 2008 Fortune 500 respondents and 75% of other respondents view the inability to recruit necessary talent in response to turnover as a medium to high risk.
- Seventy-four percent of total respondents view the lack of necessary skills to deliver appropriate audit coverage as a medium to high risk.
- Seventy-one percent of total respondents view the lack of adequate IT audit skills as a medium to high risk.

Respondents also expressed concerns about two areas that relate to both budget and talent considerations:

- Fifty-nine percent of Fortune 500 and 68% of other respondents view the inability to identify emerging risks as a medium to high risk.
- Forty-five percent of Fortune 500 and 36% of other respondents view the inability to cover geographic expansion as a medium to high risk.

Figure 3. 2008 rankings of internal audit skill sets

Category	% Fortune 500 medium	% Fortune 500 high	% Fortune 500 medium to high	% other medium	% other high	% other medium to high
Financial accounting	26	71	97	41	54	95
Risk management / risk assessment	43	53	96	39	55	94
Information technology / fraud detection and investigation	58	29	87	55	28	83
Analytical skills	12	85	97	10	88	98
Project management	44	52	96	46	48	94
Knowledge management	58	28	86	57	33	90
Specific industry knowledge	56	31	87	52	38	90
Industry regulators	44	8	52	45	16	61
Communication (verbal and written)	9	89	98	12	88	100
Process improvement / Six Sigma	58	10	68	42	11	53
Multilingual	25	12	37	11	4	15
Data mining / data analytics	62	28	90	56	21	77
Offshoring / outsourcing	31	3	34	17	3	20

How to strengthen internal audit capabilities: a ten-point plan

1. Determine the skills you need: In a risk-centric auditing environment—where risk assessment and risk management extend well beyond a narrow focus on controls and where risk and control assurance are based on the effectiveness of risk management processes developed by management—chief audit executives need a team of auditors and analysts who can access and analyze risk data as well as evaluate and monitor key risk indicators.[4] Internal audit needs a critical mass of audit professionals who can assess complex IT environments, help prevent and detect fraud, evaluate and test internal controls, assess the adequacy of financial controls, address enterprise-wide risk and governance issues, provide timely risk and control assurances, and streamline and improve business processes.

2. Target areas of low assessment confidence: According to our 2007 State of the Profession survey, internal auditors tend to lack confidence in the effectiveness of their audit coverage when dealing with risk assessments focusing on technology, fraud, and strategic risks. Knowing this, chief audit executives need to shore up their capabilities in those areas.

3. Create a skills inventory: To determine the skills your team needs, compare existing skill sets against skills ranked highly in this survey and in PricewaterhouseCoopers' *Internal Audit 2012*, which examines the future of internal audit. In the 2008 State of the Profession survey, respondents placed high priority on skills relating to analysis, risk management and risk assessment, data mining and data analytics, information technology, and fraud detection and investigation. In the *Internal Audit 2012* study, data mining and data analytics was ranked most important, followed by risk assessment, information technology, risk management, fraud detection, information security, analytical skills, and fraud investigation. In addition to comparing existing skill sets to those ranked highly in major surveys, chief audit executives should also assess their capabilities in fundamental areas such as financial accounting, project management, communications, and knowledge management.

4. Conduct a gap analysis: After creating the skills inventory, compare the current state of internal audit capabilities with where they should be. With a gap analysis of current and future states, determine what changes need to be made to processes, skill sets, systems, and technologies in order to achieve departmental objectives.

4 As noted in PricewaterhouseCoopers' *Internal Audit 2012* (2007), "Internal audit groups need people who are strong in both data extraction and analysis to evaluate key risk indicators and compare them with industry norms. Risk analysts need to understand risk factors and related control implications in order to provide more timely risk and control assurances and update organizational risk profiles. Risk analysts also need the skill sets and training to analyze a business process and determine which controls, if any, are effective or necessary and which can be removed with little or no negative impact."

5. Develop strong risk analyst capabilities: Internal audit groups need people who are strong in both data extraction and analysis to evaluate key risk indicators (KRIs) and compare them with industry norms. These capabilities will strengthen internal auditors' capacity for providing more timely risk and control assurances.

6. Conduct targeted audits: With a core group of risk analysts, develop a rapid-response team of auditors and analysts who can quickly conduct targeted audits or address situations in which key risk or performance indicators have exceeded acceptable values. By conducting audits on a targeted basis, internal audit can concentrate on higher-risk areas and increase the likelihood of identifying problems at an early stage. Targeted audits also help produce more timely information about changes in risks and controls than can be achieved from the traditional audit cycle's more rigid schedules. In addition, when targeted audits are facilitated by technology, internal auditors can expand their coverage of lower-risk areas, deploy audit resources more effectively, and conduct random audits in search of likely areas of fraud.

7. Emphasize career development and planning: Position internal audit as a function that offers talented people multiple opportunities for development as well as varied experiences.

8. Tap both internal and external sources for talent: To strengthen capabilities in critical areas such as risk analysis, fraud detection, and technology, consider the use of capacity multipliers (for example, strategic co-sourcing) to acquire needed skills. Tapping third-party internal audit service providers can provide access to particular skill sets, expand geographic coverage, and provide the flexibility needed to deliver a responsive audit plan.

9. Consider launching a guest auditor program: By launching a guest auditor program, an internal audit group can recruit subject-matter experts from within its company to conduct audits requiring specific areas of expertise. These programs can serve as an excellent means of recruiting individuals who demonstrate an aptitude for internal audit.

10. Adopt a rotational staffing model: With leading companies relying on internal audit as a major source of talent, rotational staffing has become the prevalent staffing model for large corporate internal audit groups. Typically, recruits are offered career opportunities in company business units after a two- to three-year rotation within internal audit, so the rotational model can serve as a good recruiting tool —providing talent with both an attractive career path and the potential for professional experiences that are often highly valued by other corporate functions.

AS5 helps ease the burden of Sarbanes-Oxley compliance demands

Compared with previous years, 2007 saw a dramatic decline in the amount of internal audit resources dedicated to Sarbanes-Oxley compliance: Only 27% of 2008 State of the Profession survey respondents reported that they'd dedicated 50% or more of their internal audit resources to Section 404 compliance in 2007, compared with 41% of 2007 State of the Profession survey respondents who reported having done so in 2006. As Figure 4 shows, the year-to-year decline in internal audit resources devoted to Section 404 was even more dramatic for our Fortune 500 survey respondents.

Figure 4. Percent of survey respondents devoting 50% or more of their resources to Section 404 compliance

Year	Overall respondents	Fortune 500 respondents
2007	27	13
2006	41	28
2005	45	N/A
2004	71	N/A

Two factors in particular contributed to the decline:

- The ability of internal auditors to achieve greater efficiency in complying with the demands of Sarbanes-Oxley Section 404
- The implementation of AS5

AS5, along with related SEC Interpretative Guidance, requires management to use a top-down, risk-based approach to its evaluation of internal controls over financial reporting. In approving AS5, the SEC said it expects the new standard will make Section 404 audits and management evaluations more risk-based and scalable to company size and complexity. According to our survey results, AS5 had a noteworthy impact on efforts to cut back on the resource demands of Sarbanes-Oxley:

- Sixty-two percent of Fortune 500 respondents said they believe AS5 contributed to a reduction in the level of internal audit resources needed to comply with Sarbanes-Oxley.[5]
- Sixty-five percent of other respondents believe AS5 contributed to a reduction in the level of internal audit resources needed to comply with Sarbanes-Oxley.[6]

5 Looking at Fortune 500 respondents as a whole, 35% perceived a reduction of less than 10% in the amount of resources needed to comply with Sarbanes-Oxley, 23% estimated a reduction of 10% to 25%, and 4% projected a reduction of more than 25%. Thus, a total of 62% of the Fortune 500 respondents perceived a positive impact from AS5 on their resource allocations. At the same time, 38% of Fortune 500 respondents either perceived no impact or believed that AS5 caused an increase in such resource allocations.

6 Of those respondents who were not from Fortune 500 companies, 29% perceived a reduction of less than 10% in the amount of resources needed to comply with Sarbanes-Oxley, 28% estimated a reduction of 10% to 25%, and 8% projected a reduction of more than 25%. Thus, a total of 65% of the non–Fortune 500 respondents perceived a positive impact from AS5 on their resource allocations. At the same time, 35% of this respondent group either perceived no impact or believed that AS5 caused an increase in such resource allocations.

Of note, there is a direct connection between the top-down, risk-based approach to internal-control evaluation that is central to AS5 and the top answer our survey respondents gave when asked to predict the most significant change in their approach to Sarbanes-Oxley compliance in 2008: A quarter of respondents anticipated reductions in the number of key controls required to evaluate internal controls, due to the requirement to employ a top-down, risk-based approach to such evaluations. At the time of the survey, 41% of respondents said they had completed implementation of AS5 at their companies and 40% said they were in the process of implementation.

Asked to project when they expect to realize the full impact and benefit of AS5, 15% said fiscal 2007 and 45% said fiscal 2008. Eleven percent said they expect the impact to be spread evenly over fiscal 2007 and 2008, and 6% said they expect AS5 benefits to be realized later than 2008. Nearly a quarter of respondents (23%) do not expect to receive any significant benefit from AS5.

Although it is too early to gauge the full impact of AS5 on internal audit functions, initial indicators suggest that it will allow internal auditors to free up time from Sarbanes-Oxley compliance and use it to conduct audits in areas unrelated to financial risk.

What this means for your business

Sharpen risk focus and streamline audit reporting to deliver more value.

Audit committees and senior management are placing increased value on the ability of internal audit to address strategic, operational, and business risks. To pursue this goal, and to reduce audit cycle time, consider the following four imperatives:

- Assess the needs and expectations of key stakeholders.
- Develop a risk-based audit plan for audit committee approval.
- Sharpen internal audit's focus on strategic, operational, and business risks.
- Transform and streamline audit reporting.

Assess the needs and expectations of key stakeholders

Talk to the audit committee and senior management about the capabilities of the internal audit group and about emerging trends affecting the profession. Many audit committee members, in particular, have a narrow view of internal audit's scope because they have never seen internal auditors venture beyond providing assurance about financial and compliance controls. Take the opportunity to change such perceptions.

Develop a risk-based audit plan for audit committee approval

It's important to keep the audit committee, senior management, business unit leaders, and other key players informed about the company's changing risk exposures. To do so effectively, develop a risk-based audit plan and, at a minimum, discuss it with the chair of the audit committee before submitting it to the full audit committee for approval. Some key pointers for developing an effective plan:

- Address the full spectrum of risks facing the organization and link the risk assessments to a broader enterprise risk management framework.
- Strengthen audit coverage of risks relating to information technology and fraud as well as strategy, business, and operations—areas of high priority.
- Update risk assessments on at least a quarterly basis.
- Tie risk assessments to risk frequency. Some risks, such as new legislation that affects the company, occur on an infrequent basis. On the other hand, financial risks such as those involving currencies, interest rates, and commodities often change rapidly.
- If possible, provide assurance on the effectiveness of management's risk management processes, an area where internal auditors tend to underestimate the potential value of their contributions.

Sharpen internal audit's focus on strategic, operational, and business risks

Strategic, operational, and business risks have the power to topple chief executives and cripple corporations. For years, these risks have been top priorities for senior management and directors yet seemingly secondary concerns for internal audit. It's time for internal auditors to strengthen their focus on the areas of risk that pose the greatest threats to their companies.

How can internal audit functions address strategic, operational, and business risks more effectively? First, they can help senior management define, identify, and assess risks across a wide scope, including risks by market, geography, and the like. In addition, internal auditors can document what the company is or is not doing to address each identified risk and whether there is a process in place to evaluate those risks on a periodic basis.

For risks that are difficult to assess (e.g., competitive risks), internal auditors can evaluate management's effectiveness in managing this risk, noting whether management has identified the risk and developed a risk mitigation plan to address it—and if so, whether it is working as planned. If there is no apparent way to audit a particular risk, internal audit can provide assurance around the effectiveness of the risk management and mitigation plan. If risk assessments have identified gaps in a company's risk management coverage, internal audit can help the company address those gaps.

Transform and streamline audit reporting

As noted earlier, the 2008 State of the Profession survey found that average audit cycle times are at least three months. That can seem like an eternity to senior management and directors, who have frequent access to real-time data. Knowing this, and given that internal audit budgets are under pressure, internal auditors need to get serious about streamlining their audit processes.

Although audit reporting is but one phase of the audit cycle, it often consumes a disproportionate amount of total cycle time, as the 2008 State of the Profession survey indicates: A third of total survey respondents reported devoting more than a quarter of their total cycle time to the reporting process.

To streamline the audit reporting process, consider the following five-step approach to reducing audit cycle time, which is based upon current activities of innovative internal audit groups.

Step 1: Re-engineer the audit reporting process

To achieve major change, start with a clean slate. Challenge current practices. Experiment with alternative approaches and weigh the pros and cons of each. Above all, strive to eliminate the repetitive editing that's often associated with the report-generating process.

Some possibilities to consider:

- Issue reports without management comments to speed up the process.
- Develop a summary PowerPoint presentation as opposed to a lengthy written report.
- Use a standardized report format or issue audit findings on a piecemeal basis while the audit is in progress.

Once a preferred solution has been identified, test it with senior management and the audit committee.

Step 2: Retire long, narrative reports

For years, internal auditors have been tinkering with how to improve lengthy, narrative-format audit reports. Some internal audit departments are eliminating this time-consuming approach to audit reporting altogether.

Companies plagued by lengthy audit report narratives should create a streamlined approach to the report-generation process. First, develop several streamlined report formats that will enhance the communications process. Then, determine how to re-engineer the report-generation process to achieve desired communications objectives.

Step 3: Keep ancillary information outside of the main report

Quite often, lengthy audit reports will include a significant amount of nonessential background about core issues. Given that gathering and editing this information can add substantial time to report production, consider removing it from the report and instead making it accessible to the audit committee and senior management in another format—for example, via the company's intranet.

Step 4: Apply "less is more" thinking to audit communications

In rethinking the audit reporting process, pay particular attention to the time spent reworking drafts, perhaps the most time-consuming aspect of report generation. While striving to produce a high-quality product, internal auditors can quickly reach a point of diminishing returns in their editing activities. Make it a point to cut down on redrafting. Make use of Six Sigma and lean productivity concepts to add efficiency to the process.

Step 5: Focus on clear, concise reporting of key points

By focusing on core messages and delivering them in a streamlined fashion, internal auditors can deliver a superior report in less time while freeing up valuable internal audit resources to focus on other important activities.

To facilitate production of a streamlined audit report, first draft an outline of the main points you want to convey, then develop concise bullet points to support those main points. It's a straightforward process.

In practice, some internal audit groups today are producing bullet-point summaries of their audit results while others are experimenting with one-page reports. Stakeholder feedback will determine the success of these alternative approaches.

Methodology

The 2008 State of the Profession survey for internal auditing was conducted in the fourth quarter of 2007 and includes responses from 674 internal auditors.

Of the respondents, 86% are either chief audit executives or internal audit directors/managers, and 62% are from companies with $1 billion or more in annual revenue.

The survey had four purposes:

1. Capture a snapshot of the internal audit profession.

2. Share insights and observations from PricewaterhouseCoopers 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.

4. Provide a baseline to measure ongoing changes in the profession.

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

Dennis Bartolucci
Partner
312.298.3584
dennis.d.bartolucci@us.pwc.com

Tom Snyder
Partner
631.753.2807
thomas.h.snyder@us.pwc.com

Andy Dahle
Partner
312.298.3582
andrew.j.dahle@us.pwc.com

Richard Chambers
Managing Director
678.419.7004
richard.f.chambers@us.pwc.com

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