



Top Priorities for Internal Audit in a Changing Environment

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Independent Risk Consulting

Business Risk

Technology Risk

Internal Audit

... our world has changed

... the risk profile of organizations has changed

... stakeholder expectations have changed

How is This Impacting Internal Audit?

In response to new challenges, changes and expectations within the business environment, internal audit functions are striving to provide greater value as a key component of the organization's governance framework. Internal audit has emerged as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. Effective internal audit functions help organizations accomplish their business objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes. This emergence needs to continue evolving, developing and changing to meet the dynamics of the business world.

Drawing from The Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing and our experience with leading internal audit functions, we provide 10 strategic priorities we recommend every public and private company – along with every government-sponsored and not-for-profit organization – employ in its internal audit function, whether it is in-house, co-sourced or outsourced.

RAISE the Bar – Live up to Heightened Expectations

Regulatory reform and a changing business environment underscore the growing importance of effective governance, risk management and control. Internal audit plays a key role as an essential pillar of the governance framework, working with management, the board of directors and the external auditors. As a result, internal audit functions are being upgraded and given greater visibility and responsibility in organizations.

Internal auditors have long sought greater prominence for their roles, but increased focus and attention bring with them the responsibility to deliver on heightened expectations. Internal audit functions must respond to demands of their new environment and the evolving needs of their stakeholders by raising the bar and moving to the next level.

By revisiting their methodology, processes and practices to focus on the right things, internal audit can provide unique insight and deliver “real-time” value to their organizations. Internal audit functions are refining risk identification and assessment capabilities to enhance risk-based auditing to align with organizationwide priorities, and are providing assurance and advisory support where it is most needed. Moreover, internal audit is aligning its activity with key business risks, recognizing that the audit universe should cover the full spectrum of the organization's major risks and activities. Audit coverage is being expanded to include governance, entity-level controls, fraud, new business initiatives, and a more comprehensive approach to information technology, security and other pervasive and/or high-risk areas. Most important, internal auditors are learning to deal with change – they constantly are monitoring their organization's risk profile and incorporating flexibility in the audit plan.

Effective internal audit functions also are re-emphasizing the basics of risk and control by adopting generally accepted risk or control frameworks as cornerstones to guide their work. Sarbanes-Oxley compliance also has reinforced fundamental skills in documentation, walkthroughs and testing with more disciplined narratives, flow charts and risk/control matrices. Testing is recognized as an essential step to validate the operating effectiveness of control with sample sizes being adjusted to more realistic levels to provide assurance based on the rigor of statistical concepts. Internal audit functions also are formalizing issue ranking and tracking mechanisms, recognizing that control deficiencies need to be prioritized and cannot be left to linger until they degenerate into bad news or disaster.

The practice of internal auditing is continuing to evolve to address heightened stakeholder needs and expectations. Internal audit functions are raising the bar and moving to the next level to provide greater value to their organizations.

REVISIT Charter and Reporting Relationship – Validate Purpose and Position

Today's directors and senior management have greater accountability for governance, risk management and control. They are relying on internal audit to assist with these responsibilities, and as a result, are revisiting and rethinking their expectations of the role of internal audit. Overall, we are seeing greater demands and heightened expectations of internal audit with a growing focus on core assurance activities as a primary value driver.

The purpose, authority and responsibility of internal audit – as well as the nature of assurance and consulting activities provided to the organization – should be articulated clearly in a charter validated with senior management and approved by the audit committee. Given changes in shareholder expectations, internal audit functions should ensure their mandate is revised and aligned with the requirements and value perceptions of their stakeholders. Ideally, the internal audit charter should be formalized as a corporate policy, subject to annual review and approval by the audit committee. This will ensure the charter properly reflects the authority, responsibility and accountability assigned to the internal audit function and that it clearly articulates functional and administrative reporting relationships.

Reporting relationships are being revisited where the ownership for internal audit is being elevated to senior management and the audit committee level. To be effective, internal audit must be both independent and objective in the performance of its work. To achieve organizational independence, the chief audit executive should report to a level within the organization that allows internal audit to fulfill its responsibilities. Internal audit should be free from interference in determining the scope of internal auditing, performing work and communicating results.

The Institute of Internal Auditors' (IIA) International Standards for the Professional Practice of Internal Auditing Practice Advisory 1110-2, Chief Audit Executive (CAE) Reporting Lines states that "The IIA believes strongly that to achieve necessary independence, the CAE should report functionally to the audit committee or its equivalent. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the organization." Interestingly, in a recent 2005 survey of members of The IIA from Fortune 1000 companies, three-quarters of the nearly 300 respondents said their organization's internal audit functions report functionally to the audit committee.

Internal audit acts as the "eyes and ears" of the audit committee and company management by providing independent objective assurance on the state of governance, risk and control in the organization. This "dual reporting" is sensitive and requires delicate balance since the CAE is both a member of management and the leader of an independent group expected to report on management's risk and control stewardship of the organization.

The CAE should be positioned for success with an appropriate place on the company's organization chart and a mandate that clearly addresses purpose, authority and scope.

REBALANCE Internal Audit Activities – Focus on Risk and Stakeholder Expectations

Sarbanes-Oxley and similar legislation have introduced measures to restore investor confidence and the integrity of financial reporting. These requirements have significantly affected management, audit committees, external auditors and the interaction of these groups. These new requirements also have had an impact on internal audit functions, as many stepped up to help their companies meet the challenges of complying with these new regulations. This diverted internal audit efforts to assist management in addressing other business priorities.

As Sarbanes-Oxley and other corporate governance laws have been enacted, internal auditors responded promptly to educate their management and audit committees on new internal control reporting requirements, and to assist their organizations in scoping these compliance projects, providing guidance, and often going beyond what some might think to be the normal role of internal audit. They assisted with, or in some cases even led, documentation and design evaluation efforts, and executed much of the operating effectiveness testing and remediation required to help ensure their organizations would pass the first-year internal control audit. As efforts and resources were channeled to the immediate task of compliance, internal auditors increasingly were pulled away from their normal duties. In many instances, internal audit activities in other high-risk nonfinancial areas were cancelled or deferred.

Recognizing this, some internal audit departments are beginning to “reprioritize” and “rebalance” their activities. They are refocusing on risks encompassing the full spectrum of organizational objectives, including coverage of the reliability of financial reporting, the efficiency and effectiveness of operations and compliance with applicable laws and regulations, as articulated in the COSO Internal Controls – Integrated Framework.

In a survey conducted by Protiviti in July and August 2005, almost three-quarters of respondents at public companies reported that a rebalancing initiative is either underway or in the planning stages at their companies. Most organizations planning to rebalance say this will occur within the next year or so. High-performing internal audit functions are aligning their activities to stakeholder expectations and prioritizing their activities to areas of greatest risk and opportunity to yield the most value for their organization.

Internal auditors diverted their efforts to Sarbanes-Oxley compliance out of necessity to help their organizations. It is now time to re-evaluate internal audit activities with a focus on stakeholder expectations and risk-based auditing.

COMMUNICATE – Sharpen Dialogue with Senior Management and the Audit Committee

Communication is a key determinant of a successful internal audit function. The chief audit executive must be kept informed to stay abreast of the business, strategic plans, new developments, initiatives, events and transactions. Internal audit must have “a seat at the table,” acting as a trusted advisor without participating directly in the management process in order to preserve independence and objectivity.

Most important, internal audit must communicate effectively with management and the audit committee to support them in the discharge of their governance and stewardship responsibilities. Pertinent information must be identified, captured and communicated in a form and timeframe that is appropriate to the recipient. Clear, concise, forthright, relevant and timely communications – oral and written – are critical to the role of chief audit executive. As stated in The IIA Practice Advisory 2060-2 Relationship with the Audit Committee, “In large part the overall effectiveness of the CAE and audit committee relationship will revolve around the communication between the parties. Today’s audit committees expect a high level of open and candid communications. If the CAE is to be viewed as a trusted advisor by the committee, communications is the key element.”

Effective communication requires effort on all sides – not only should internal audit foster dialogue with senior management and the audit committee, but the audit committee should welcome and facilitate ongoing communication, while also providing the chief audit executive direct access.

ACT as a Change Agent – Facilitate Positive Change

Nothing is more constant than change itself – especially in our fast-paced environment. Internal auditors need to be alert to change, and the speed with which major risks can evolve and the momentum they can achieve if left unattended.

New risks often wreck havoc in organizations through the element of surprise. Greater vigilance is required to identify new risks, assess their exposure and ensure that the company is responding in a manner that is consistent with its defined risk appetite and tolerances. Internal audit cannot manage risks directly, but it can play a role by maintaining a flexible audit approach and a dynamic audit plan to address the emerging risks of today as well as potential future risks. Effective internal auditors want to be where the risks and action are.

Beyond the ability to cope with change, the true measure of performance for internal audit is the ability to effect and facilitate organizational change that fosters continuous improvement and gradual progression up the risk management continuum. The true worth of internal audit is not measured in the weight of after-the-fact recommendations, but in the ability to provide just-in-time advice and influence positive change that adds value to the organization. In today’s marketplace, change management is a core competency that successful companies need to develop in order to stay on top.

Internal audit should be at the forefront of positive change by recommending and facilitating the process of aligning people, processes and technology to achieve improved sustainable performance. Internal auditors should be both the guardians of established policies and procedures, and the champions of positive change and continuous improvement.

DRIVE Efficiency – “Work Smarter”

Spending on internal audit is increasing as organizations realize the value-added contribution internal audit can bring in establishing, maintaining and improving governance, risk management and control across the organization.

General data on current internal audit spending is provided annually by The IIA Global Auditing Information Network (GAIN) Reports. For example, according to GAIN's 2005 study, large companies (\$30 billion or more in annual revenue) spend an average of more than \$15 million a year on internal audit activities, and more than \$12 million a year on their external audits. Smaller companies – annual revenues of \$1 billion to \$5 billion, for example – spend an average of \$1.5 million on internal audit and \$1.3 million on external audits every year.

This and other research and information provided by GAIN represent well-established, reputable data that offers average internal audit cost based upon revenue ranges, with additional information available by industry. Although these are estimates, they provide valuable benchmarks on internal audit spending. Keep in mind that the actual level of expenditure may vary among companies based on the size, nature and complexity of the business.

While internal audit budgets are on the rise, internal audit leaders nevertheless are being asked to do much more with far less. To achieve this, internal auditors are revisiting their methods, processes, practices, capabilities and technology support to enhance efficiencies and “work smarter.”

In our experience, efficiency gains are typically available from the following:

- First and foremost, risk-based auditing connecting the risk profile of the enterprise to the internal audit plan;
- Dynamic risk identification and assessment capabilities to support a robust, comprehensive and ongoing risk assessment;
- Standardization of methods, approaches and repeatable activities;
- Utilizing self-assessment techniques to increase coverage and efficiency;
- Leveraging technology, tools and techniques to increase productivity;
- Knowledge sharing and supporting databases;
- Focused analytics, performance measures and risk indicators to facilitate desk auditing and focus follow-up activities;
- Teaming effectively with outside parties in meaningful co-sourcing relationships;
- Continuous monitoring and auditing;
- Developing guest and virtual auditor programs; and
- Effective personnel deployment and proactive management of staff utilization.

Today's internal auditors must strive for ongoing improvement to meet increasing demands while managing expenditures in order to contribute positively to the organization's value equation.

BUILD Talent – Attract, Develop and Retain the Best

Amid the changing regulatory climate and increasing demands for performance and efficiency, internal audit leaders are challenged in attracting, developing and retaining the resources they require to deliver on their new mandate.

Our era of regulatory reform has highlighted resource and experience shortages in accounting, finance and auditing. In many cases, compliance activities were delegated to already lean departments, which had been targeted for cost-cutting measures during the downturn that preceded corporate reform. With the reform-driven spike in demand for talent, along with emerging business growth opportunities, more companies have realized the need to step up their recruiting efforts and offer more competitive compensation and benefits packages for internal audit as well as accounting personnel.

The overall demand for accounting, finance and audit professionals is unlikely to lessen significantly, as there will be an ongoing need for companies to meet regulatory requirements and emphasize governance. Demographic forces also will keep demand high. As baby boomers begin leaving the workplace, the enrollment in university accounting programs is now rising after years of decline, but it will take some time for graduates to gain the experience needed to fill certain positions.

A more complex business environment also has created the need for specialized expertise to assess new risks and address areas of complex business auditing. The complement requirements of internal audit functions are changing. Internal audit leaders need to perform a comprehensive skills assessment to identify gaps to be filled by additional talent or flexible staffing arrangements such as strategic co-sourcing relationships.

Continuous education and staff development are also critical to enhance capabilities. While not required or mandated specifically, it is now considered best practice for internal auditors to possess and maintain professional designations that are directly relevant to the practice of internal audit. Leading internal audit practices are encouraging and rewarding personnel to attain specialized designations and accreditations including Certified Internal Auditor (CIA), Certified Information Systems Auditor (CISA), Certified Fraud Examiner (CFE), Certified Public Accountant (CPA), Chartered Accountant (CA), Certified Management Accountant (CMA), Certified General Accountant (CGA) and others. Supplemental training is also required to meet requirements for Continuing Professional Education (CPE) and further professional development.

Most important, effective leadership is critical to high-performing internal audit functions – starting at the top with the chief audit executive to set the tone, elevate the stature of the functions and preserve the independence and objectivity required to effectively fulfill the internal audit mandate. The chief audit executive must not only “mind the store” and manage the function, but also possess the vision, foresight and drive to lead the function in raising the bar and moving to the next level in a world of constant change.

To effectively deliver on their mandate, internal auditors need to ensure they have both the quantity and quality of resources they require. The success of internal audit functions will be driven, in large part, by its people and their capabilities.

PARTICIPATE in the Profession – Embrace The IIA Standards

Internal audit is a self-governed profession through The Institute of Internal Auditors promulgating a Professional Practices Framework that includes mandatory guidance in the form of a Code of Ethics and International Standards for the Professional Practice of Internal Auditing (IIA Standards). As a fundamental requirement, internal auditors should comply with The IIA Standards. In addition, they should be active in the profession at the international and local chapter levels, and contribute to the development of the practice of internal audit.

Internal audit is evolving as a respected profession separate and distinct from external audit, bringing added opportunity to demonstrate its fullest potential to add value to the organization.

STRENGTHEN Quality Processes – Focus on Continuous Improvement

Internal auditors should practice what they preach to the company. The IIA Standards require ongoing and periodic assessment of the entire spectrum of audit and consulting work performed by internal audit, including an ongoing internal quality assurance process with periodic reviews and an external quality assessment by a qualified independent reviewer every five years. In other words, internal audit should take steps to ensure its activities undergo quality assessment.

Assessments of quality programs should include evaluation of the following:

- Compliance with The IIA Standards and Code of Ethics;
- Adequacy of the internal audit activity's charter, goals, objectives, policies and procedures;
- Contribution to the organization's governance, risk management and control processes;
- Compliance with applicable laws, regulations, and government or industry standards;
- Effectiveness of continuous improvement activities and adoption of best practices; and
- Whether the auditing activity adds value and improves the organization's operations.

Many internal audit departments already comply or are in the process of complying with these requirements and are now looking beyond mere compliance to benchmark themselves against leading practices to foster continuous improvement within the function. Other internal audit functions realize that, for whatever reason, the function needs to change substantially from its current structure. In these cases, internal audit functions and their audit committees take a “transformational” approach, working with outside advisors to redirect and reorganize to meet current reality, expectations and needs.

Quality also is highly relevant to the external auditors. Internal audit operates as a key element of the organization's control system. In addition, auditing standards specifically acknowledge the ability of external auditors to rely on the work of others, such as a competent and objective internal audit function. Senior management and the audit committee should seek feedback from the external auditors and their viewpoint on the performance, competency and objectivity of the company's internal audit function, including the level of coordination with the external audit firm and the degree of reliance the firm places on internal audit's work.

Assessments and feedback promote continuous improvement to strengthen quality within the function. The chief audit executive should share the results of external and internal quality program assessments with their various stakeholders, including senior management, the audit committee and external auditors.

MEASURE Performance – Add Value

Gone are the days of internal audit as a forgotten sleepy place. The reality of today's business environment is that internal audit, like others in the organization, is responsible for contributing to the success and performance of the enterprise and will be held accountable for results.

What gets measured gets done. Appropriately developed performance measures help to drive results, performance, quality and continuous improvement. Strong internal audit functions have processes for measuring their own performance with a balanced scorecard of measurements focusing on cost, quality and timeliness.

To be effective, performance measures should be aligned directly to stakeholder value drivers. These will vary among organizations but could include measures such as audit plan accomplishment, cycle time, recommendations accepted, control breakdowns or deficiencies in areas recently reviewed by internal audit and customer satisfaction.

Example performance measures for internal audit could include:

Quality

- Customer/process-owner satisfaction scores from auditees
- Audit committee and management evaluation scores
- External audit evaluation score from company's external auditor
- Upward feedback scores on chief audit executive and internal audit managers from internal audit staff
- Percentage of internal audit staff with CIA or other relevant certifications
- Performance evaluation scores on internal audit staff
- Control breakdowns/deficiencies in areas recently reviewed by internal audit
- Internal control scorecard results by major area within the company
- Results of internal and independent quality assurance reviews

Cost

- Percentage of fully loaded internal audit cost as a percentage of company revenues and assets
- Actual and average cost per internal audit project
- Average cost per internal auditor
- Cost per audit hour in total
- Cost per audit hour based upon actual audit work only, excluding administration
- Travel costs of the internal audit function and average cost per trip
- Training costs and training cost per auditor
- Technology licensing costs and other outside costs
- Costs related to use of outside resources

Timeliness

- Report cycle time from completion of fieldwork to issuance and finalization of report
- Budgeted hours versus actual hours by individual audit
- Percentage of audits called for in the audit plan that are not yet complete
- Unresolved/incomplete recommendations from prior audit reports
- Average length of audit assignment in person hours or weeks
- Major risk areas not audited in the last year
- Aging/status of open, unresolved audit findings (especially those beyond their due date)

Other

- Degree of reliance on internal audit work by external auditor
- Turnover rates
- Percentage change rate in the annual audit plan
- Percentage of assets, revenues, locations, business units, etc., covered by the internal audit plan
- Linkage of key risks to specific skills of the internal audit team
- Degree of IT-related audit work to total audit effort

Leading internal audit functions have well-developed scorecards of selected measures that are agreed-upon with senior management and the audit committee. They measure their success and constantly re-evaluate their effectiveness. Top performing internal audit functions are committed to quality, value and satisfaction, using balanced scorecards to assess their contribution in quantifiable and measurable terms.

Conclusion

Given current regulatory reform and the changing business environment, the future for internal auditors has never been brighter. As the expectations of stakeholders rise with regard to internal audit's performance, internal auditors will benefit greatly by employing the 10 strategies detailed in this publication. In addition, as the role of internal audit continues to evolve, the opportunity exists to take internal audit functions to the next level to improve the effectiveness of governance, risk management and control in the organization, which will create true value enterprisewide.

About Protiviti

Protiviti (www.protiviti.com) is a leading provider of independent risk consulting and internal audit services. We provide consulting and advisory services to help clients identify, assess, measure and manage financial, operational and technology-related risks encountered in their industries, and assist in the implementation of the processes and controls to enable their continued monitoring. We also offer a full spectrum of internal audit services to assist management and directors with their internal audit functions, including full outsourcing, co-sourcing, technology and tool implementation, and quality assessment and readiness reviews.

Protiviti, which has more than 50 locations in North America, Latin America, Europe, Asia and Australia, is a wholly owned subsidiary of Robert Half International Inc. (NYSE symbol: RHI). Founded in 1948, Robert Half International is a member of the S&P 500 index.

Internal Audit Services

Protiviti provides a full spectrum of services, technologies and skills to management, directors and the internal audit community. We provide world-class professionals and state-of-the-art methodologies and tools. Our network allows us to offer the right resources at the right time and in the right place to meet your needs.

Among the services Protiviti's internal audit practice provides are:

- Audit committee advisory
- Co-sourcing and specialized resource enhancement
- Full outsourcing
- Internal audit technology and tool implementation
- Internal audit quality assessments and readiness reviews
- Internal audit transformation
- Information technology audit services
- Start-up and development advice

Other relevant publications and resources from Protiviti

- *Guide to Internal Audit: Frequently Asked Questions About the NYSE Requirements and Developing an Effective Internal Audit Function*
- *Internal Auditing Around the World*
- *Guide to Enterprise Risk Management: Frequently Asked Questions*
- *Guide to the Sarbanes-Oxley Act: Internal Control Reporting Requirements*
- Supply-chain white paper series from Protiviti and APICS
- KnowledgeLeader (www.knowledgeleader.com)

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