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The Evolving Role of the Internal Auditor

Value Creation and Preservation from an Internal Audit Perspective

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Introduction

Internal audit's existing organization-wide perspective and mandate uniquely position it to expand its role.

Changing stakeholder expectations and a new view of risk management are prompting an important shift in the role of internal audit (IA) in many organizations. New demands from the board, senior organizational leaders, and regulators are requiring internal audit groups to refocus their efforts beyond regulatory compliance issues.

What's more, as regulatory compliance responsibilities have expanded and the New York Stock Exchange and various rating agencies, among others, have adopted evaluation criteria including enterprise risk management (ERM), the need for enhanced rigor and transparency and a consolidated view of risk management capabilities has become paramount.

In this environment, many leaders have recognized the need for internal audit to play a larger role—one that expands on its historic focus on value preservation (a control focus) to encompass activities related to value creation (a performance focus). Such a shift could enable internal audit—with the objectivity of its perspective and the rigor of its processes—to bring value to the business in new ways. Internal audit's existing organization-wide perspective and mandate—and its access to all areas of the business, personnel, and resources—uniquely position it to expand its role.

This white paper will discuss the new challenges internal audit departments face in the context of their evolving role and responsibilities. It will consider how IA can begin to address these challenges and thereby create value for organizations—thus reasserting its traditional role as an independent adviser.

The Changing Role of Internal Audit

The Changing IA Environment

- Focus on the C-level agenda
- Impact on value creation
- Evolving skill sets to meet a new role
- Participation in strategy development
- Integrated versus siloed risk management
- New focus on fraud

Accelerating change has characterized the business landscape for many years and can be expected to continue. New competitors, technologies, and financial instruments; changing cost structures and regulations; increasingly integrated global economies; and other developments are creating new risks and opportunities for organizations to consider. As these developments evolve, they will open new doors for internal audit to regain its historic influence as an independent adviser to management—in supporting top management's goals, monitoring enterprise risk, and enhancing regulatory compliance efforts—as discussed next.

Supporting the C-Level Agenda

Internal audit's new opportunities and challenges are analogous to those that are evolving for chief financial officers (CFOs) at many leading organizations.

Traditionally, the CFO has been responsible for areas such as risk, financial reporting, compliance with capital market regulations, and infrastructure—the "value preservation" roles. Today, CFOs are being asked to take on additional responsibilities, and they are increasingly at the center of leadership decision-making and influence. Organizations are increasingly expecting their CFOs to play a strategic, consultative role in leading the business—one that is driven by the needs of the business rather than traditional accounting responsibilities. In many

leading organizations, the CFO owns, participates in, or influences "value creation" activities including finance transformation and mergers and acquisitions as well as post-merger integration, strategic sourcing, operations improvement, and the technology enablers needed to achieve change. CFOs are focused on activities that add value, and their functions are driven by an awareness of the organization's key risks. Increasingly, CFOs focus on how to apply their organizations' analytical and financial skills to manage those risks.

Similarly, internal audit has new opportunities to both expand its traditional value preservation activities and leverage its skills in new ways to support value creation. Leading organizations increasingly expect internal audit to use its quantitative skills and risk knowledge to support improvements in risk management. Internal audit personnel can bring their core skills of risk and control analysis to these increasingly important activities. Over time, IA will need to continue expanding its skills as its role encompasses activities at the top of the C-level agenda.

Managing Risk Across the Enterprise

Throughout organizations, leaders are focused more fully than ever on managing risk enterprise-wide. Their agendas have the support of their boards as well as their regulators, a few of which are including ERM as a scorecard component. As practical uses of ERM have evolved, they have been widely embraced and deployed as a means of bringing new discipline to the process of risk management.

Internal audit has a multifaceted role to play in the ERM arena. The Institute of Internal Auditors notes that internal audit's core role with regard to ERM is "to provide objective assurance to the board on the effectiveness of an organization's ERM activities to help ensure key business risks are being managed appropriately and that the system of internal control is operating effectively."[1] In addition, many companies are looking to internal audit to support strategic business objectives. That effort extends to ERM activities such as:

- Risk identification and prioritization
- Alignment of people, processes, and systems with business strategy
- Definition of key performance indicators
- Analysis and quantification of risk factors in new business ventures and strategies
- Understanding of shared risks among various projects and initiatives.

Internal audit's discipline, its knowledge of the organization's key risks, its enterprise-wide view, and its familiarity with the COSO framework[2] enable it (unlike any other group) to bring an important perspective and discipline to an ERM effort.

Developing a Consolidated "Single View" of Risk

Along with efforts to manage risk across the enterprise, many organizations are struggling with overlapping and often burdensome compliance requirements. The tendency has been to employ multiple approaches to risk identification, measurement, and monitoring, depending on the purpose of the effort (e.g., Sarbanes-Oxley [S-O]) or the perspective of the department involved (e.g., compliance, internal audit, operations). Each framework or department tends to have its own views of risk and "risk focus." For example,

- **S-O** – Financial statement risks
- **Compliance** – Reputation and regulatory risks
- **Internal Audit** – Process- and control-level risks (inclusive of reputation, regulatory, and operational risk)
- **Operations** – Market, credit, currency, and other operational risks

In addition, how risk is measured and rated also differs across departments. For example, those focused on S-O may use a system of high/medium/low, while internal audit may use a number-based system.

[1] The Institute of Internal Auditors' Web site, FAQs, "What is Enterprise Risk Management (ERM) and what role in it does internal auditing play?"
[2] The Committee of Sponsoring Organizations of the Treadway Commission.

Often, regulators, compliance departments, operational risk departments, and external auditors ask for similar (and sometimes identical) information about the state of internal risk management. In addition, multinational companies have to cope with differences in "home" and "host" risk management standards and regulatory requirements in multiple jurisdictions.

To address these issues, many leading organizations are moving away from a "siloed" or geographic approach to a more consolidated risk assessment, management, and monitoring perspective. This effort involves formulating, at the board level, a "single view" of what organizational risk is and how it can be measured and rated.

The efforts to integrate numerous compliance and risk management requirements into one process (or at least fewer processes) while continuing to meet the needs of various constituencies can be challenging for organizations. The goal is an enterprise-wide approach to compliance and governance that minimizes the overlap in management structure and the duplication of existing processes, systems, controls, and data flows. The single view of risk focus and identification, measurement, and monitoring allows senior management to identify and "slice" top risks that face the organization as a whole across all business lines. IA can support the business with development of related metrics.

Complying with Regulations

Organizations' evolving desire for a single view of risk is increasingly reflected in external stakeholders' demand for something similar. In recent years, the need to comply with new and evolving regulations and business requirements has prompted many public companies to develop "bolt-on" risk management processes. In many cases, these efforts to address a single issue have resulted in processes that are largely disconnected from existing oversight functions.

In an environment in which regulatory change can be expected to continue, organizations need to determine how to improve the efficiency and effectiveness of such efforts. For example, as organizations move into year four of compliance with the Sarbanes-Oxley Act of 2002, and address the new SEC guidance and PCAOB Auditing Standard No. 5 (AS 5), many of them are seeking ways to make these efforts less costly and time-consuming as well as yield greater value.

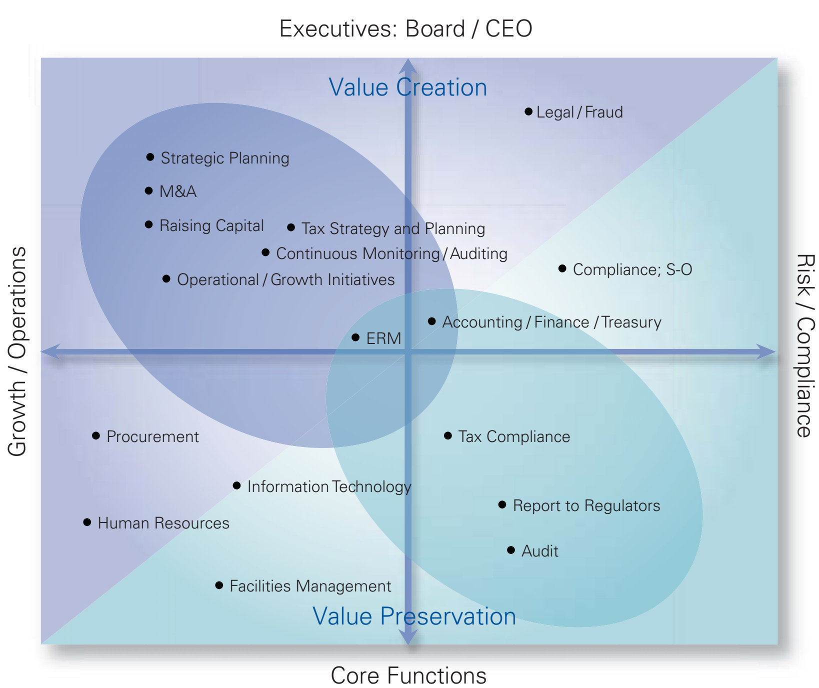
In many cases, organizations are looking to internal audit to help refine risk management processes and to help leverage newly gathered information about organizational risks. Internal audit is particularly suited to assist in a number of areas: risk identification, the application of quantitative and qualitative analysis, control design and effectiveness evaluation, continuous monitoring and auditing techniques, and regulatory compliance are among its core competencies, and regular contacts with the external auditor make it well-suited to assess and interpret changes.

Moreover, ERM and S-O 404 should evolve into a combined effort, and the risk-based approach now endorsed by the SEC is allowing the integration of S-O efforts into the "single view" model for ERM. Internal audit is positioned to become a valuable leader in linking ERM risk monitoring and compliance activities, the integration of continuing regulatory changes, and the C-level agenda. All of these changes are prompting internal audit groups to consider how they can expand their risk-monitoring responsibilities and thereby help their organizations create as well as preserve value.

Internal Audit: Uniting Efforts to Preserve and Create Value

Enhancing Value Preservation, Expanding Value Creation

Internal audit needs to maintain and strengthen its value preservation activities (lower right oval) and move more fully into activities that create value (upper left oval). Adding new skill sets that are in keeping with these goals will become increasingly important.



Source: KPMG LLP (U.S.) 2007

Originally developed as a means of assisting organizations with safeguarding corporate assets and enforcing corporate policies to preserve value, internal audit is expanding its traditional role with a new focus on value creation activities (see the graph at left).

Leading internal audit organizations are taking a risk-based approach to their role as independent advisers. With a view toward value creation, internal audit can expand both its perspective and its skill base, using an ERM approach to develop and reallocate resources in a risk-based manner. Essentially, internal audit can expand its view beyond finance and across the other aspects of the COSO framework. In this way, IA can once again serve as an independent, internal adviser—as it was historically before so many of its efforts became compliance- and finance-focused.

Value Preservation

As internal audit broadens its view, it will not forego value preservation. Rather, it will want to maintain and strengthen these activities. As the graph on page 5 indicates, internal audit will seek to move from value preservation to value creation (lower right to upper left) by developing strengths in new areas of focus. At the same time, it will focus on the key preservation activities and improve its capabilities in this arena, potentially by leveraging continuous auditing, assisting in the automation of controls, and emphasizing more preventive controls.

For example, historically, when internal audit focused on monitoring business operations, processes, and governance functions, it would examine whether a control was being performed or procedures were being followed and report either "yes" or "no." Now, internal audit's focus is not on whether a control is being performed but on whether it is the right control and if it is being performed correctly and cost effectively (e.g., movement from manual/detective controls to automated/preventive controls). Automation can enhance the efficiency and effectiveness of the control environment so that costs can be lowered and limited resources used strategically. Within leading organizations, internal audit will review the organization's portfolio of controls and consider whether opportunities exist to improve the overall portfolio while reducing the organization's cost of control performance.

Value Creation

In a changing regulatory and business environment, internal audit needs to find new ways to deploy its risk- and control-based skills to help the organization achieve its strategic objectives and thereby enable value creation. IA can help increase shareholder value through efforts to manage risk, prioritize goals and activities, promote behavioral change, improve processes, reduce costs, eliminate complexity and redundancy, and enhance the organization's recognition in the marketplace for its leading compliance programs.

Expanding Internal Audit's Horizons

Focusing on a number of areas internal audit has not traditionally covered can help it augment the organization's value creation efforts. Discussed below are examples of areas to consider in the development of a risk-based internal audit plan.

(1) Data Analytics and Continuous Auditing. Part of IA's value preservation work is to be capable of early-warning analytics that enable identification of issues before they become problems. This concept is not new, but its efficient and effective application can enable internal audit to allocate resources to value creation efforts. For example, a focus on the "big picture" in an array of reports or a population of transactions can highlight the most useful information. Identifying or creating key performance indicators (KPIs) can lead to the effective and efficient deployment of resources in a risk-based manner.

"Continuous auditing" (CA) techniques and use of a "digital dashboard" can help IA customize KPIs and then monitor and report on them. CA techniques—which IA may use and management may adopt to support continuous monitoring--refer to the automation of an audit routine achieved by leveraging technology with specific content filters, resulting in an automated examination of an organization's data. When properly implemented, CA can allow internal audit to detect control gaps and transaction anomalies as well as variances from agreed upon performance parameters or KPIs. For example, a digital agent (set of automated logic tests) performing an analytical review of accounts receivable could identify exceptions where the past-due or credit limit on a particular account exceeds the organization's normal parameters as defined in the digital agent.

While the benefits offered by CA may be substantial, several issues need to be addressed by IA. Two potential issues, aside from the obvious technical requirements, are organization acceptance and auditor training. The challenges of implementing CA, however, can be worth the investment. Shorter audit cycles, greater coverage, continuous real-time feedback for critical transactions and controls, and exception-based performance evaluations can create the time and cost savings that allow limited audit resources to increase focus on value creation activities.

(2) Strategic Initiatives and Planning. Organizations typically have four to five strategic goals each year. In many cases, however, leaders assign to various levels of management the task of interpreting and developing specific implementation plans for these goals—creating the potentially expensive execution risk of goal misalignment.

Management needs to be sure the organization's strategic objectives are communicated and that ongoing monitoring of the strategy implementation is occurring. Communication of the strategy, goals, and the "how to" thus becomes part of corporate culture and enables all levels within an organization to understand the goals and ensure their efforts contribute to achievement of the goals. For its part, internal audit can help the organization ensure that, several levels down from leadership, activities carried out in pursuit of management's agenda are actually aligned with management's intention.

When IA performs an audit of these initiatives, it would look at whether the business/functional and strategic objectives are aligned. It would consider the strategic objectives of a particular group, identify its priority projects, and determine which of them are aligned with the organization's strategic objectives. In this way, IA has a direct role in advancing the C-level agenda, making sure that resources are allocated appropriately.

(3) Tone at the Top/Corporate Culture. Internal audit can help support and monitor important efforts to enhance "tone at the top" and strengthen corporate culture. It can, for example, review areas such as:

- **Employee survey process**: Regular performance of employee surveys, and a structured process for responding to concerns, is an important activity requiring comparatively little investment of business time and resources for the benefits it can drive for leaders. Do employees know where the company is going? Do they feel comfortable communicating concerns and know management will take their concerns seriously, address them, and communicate the result? IA can help monitor these processes.
- **Compliance/ethics hotline**: Effective risk management depends on leaders being aware of all risks—and information about potential ethics violations is critical. Management needs to communicate its support of its own hotlines to ensure they are used when needed and then take seriously communicated concerns. IA can help ensure effective monitoring and follow up on issues and concerns noted. IA also can make a difference in the transparency of the process and help monitor the effectiveness of relevant employee communications.
- **Promote and develop fraud awareness at all levels**—from the application of company policies and procedures to the identification of waste, corruption, and mismanagement.

(4) New Business Lines and Geographic Regions. IA plays a role in identifying whether necessary skill sets exist within the department and with existing management to operate effectively in newly identified business areas. ERM, interpersonal effectiveness skills, fraud awareness, and fraud skills are all important. New efforts should encompass IA's review of mission statements, business and integration plans, and objectives as well as the roll-out of training programs. IA would also consider support systems for new business lines and geographic regions—and, specifically, whether senior management has performed appropriate due diligence, research, or risk analysis of the viability of new initiatives.

Other considerations would include whether the company has the necessary skills, industry knowledge, and teaming protocols to succeed with new business lines (for example, a bank developing an insurance product line).

(5) Tax Strategy and Planning. To preserve value, IA can help the organization make sure tax compliance takes place appropriately—that controls are in place to ensure the correct calculation and filing of all necessary tax returns and that extensions occur. It can help make sure organizational tax structure is not an afterthought.

To create value, IA can help analyze existing tax structure to help determine the tax strategy the organization may want to pursue in light of new initiatives and their potential effects. It would consider whether the tax planning strategy aligns with strategic objectives. Have the tax implications of new initiatives in geographic regions or countries been fully investigated and understood, and are there any foreign tax regulations that may work to the organization's advantage or disadvantage?

Developing Internal Audit's New Skill Set

While internal audit was historically a training ground for developing corporate executives from various operations departments, recent compliance efforts have caused many IA departments to become heavily finance focused, both in perspective and skill base. The change in focus to a value creation approach requires a change in audit focus and a corresponding requirement for IA departments to acquire new skills through training, hiring new staff members, or sourcing talent from service providers. Some of the skills that would benefit IA in its transition include:

- Industry knowledge and functional expertise (strategic operational knowledge)
- Cross-culture training for global IA functions
- Improved interpersonal skills to allow for effective communication not only with process owners/line managers but also with C-level executives
- ERM – risk management and evaluation
- Continuous auditing capabilities
- Fraud skills
- IT – automation of internal control environment
- Specific certifications – Six Sigma, CFE, CFA, CIA, CFSA, CISA, and others should be considered in augmenting internal audit staff

Conclusion

With an ERM focus, internal audit can move beyond its monitoring role to help influence and improve how risks are managed before they become challenges.

The responsibilities of internal audit are expanding and, consequently, the required skill sets are changing. Board members and C-level executives should fully leverage internal audit's capabilities in ongoing analysis to help provide assurance that the organization's objectives and strategic goals are achieved. For its part, by reasserting its traditional role as an independent, objective adviser to management and the audit committee, internal audit can sustain its value preservation role and begin to develop a role in value creation. With an ERM focus, internal audit can move beyond its monitoring role to help influence and improve how risks are managed before they become challenges. What's more, in keeping with the C-level agenda, internal audit can look beyond compliance to helping the organization improve overall business performance.

Key Considerations for IA Leaders

- Focus on the future—take a proactive approach to risk identification (e.g., with a risk- and compliance-based audit plan)
- Integrate ERM to develop a mix of risk- and compliance-based audit efforts
- Augment skill sets (increasing the role of IT and subject matter professionals) and leverage resources
- Focus on fraud—control environment (tone at the top), hotline activities, fraud risk assessments
- Establish an adviser role—initiatives rationalization, ERM
- Build continuous audit capability and influence continuous monitoring techniques
- Maintain independence and objectivity
- Provide value-added assurance services beyond S-O compliance
- Leverage access to management

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