ERNST & YOUNG
Quality In Everything We Do

From Compliance to Competitive Edge

New Thinking on Internal Control

Contents

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Ernst & Young, a global leader in professional services, is committed to restoring the public's trust in professional services firms and in the quality of financial reporting. Its 114,000 people in 140 countries pursue the highest levels of integrity, quality, and professionalism in providing a range of sophisticated services centered on our core competencies of auditing, accounting, tax, and transactions. Further information about Ernst & Young and its approach to a variety of business issues can be found at www.ey.com/perspectives. Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited does not provide services to clients.

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From Compliance to Competitive Edge: New Thinking on Internal Control

From a secure footing different strategies can be evaluated, new markets entered, new products brought to market.

Effective internal control means a company is working well. It performs reliably. It can communicate performance to the market and investors transparently and confidently. Management understand their major risks and have the tools in place to manage them effectively.

From a secure footing different strategies can be evaluated, new markets entered, new products brought to market. Good processes aid business decisions rather than simply measure them.

A business's internal control efforts are about much more than compliance. When implemented and working effectively they improve information reliability, improving decision making and driving competitive advantage. Yet controls seem to have gained a bad name for themselves as a burden – to budgets and management time – and are associated with unnecessary cost and inefficiency.

We have worked with many companies around the world, both public and private, with assessing, improving and monitoring controls across strategic, operational, financial reporting and compliance areas. In our experience, investment in internal control is a result of a variety of reasons but there is broad consensus in its importance to a business's success. In a previous report in our Risk Survey series, *'Investors on Risk'*[1], we highlighted that 69% of the major institutional investors we asked rated transparency as their number one consideration for making an initial investment in a company, over and above a long-term track record or business model. In addition, 85% of respondents to the Ernst & Young *"Emerging Trends in Internal Control"* Survey indicated that they anticipated benefiting from enhanced financial processes as a result of complying with Sarbanes-Oxley.

[1] *Investors on Risk. The need for transparency, Ernst & Young 2006*

With this in mind, we wanted to investigate whether companies not governed by the SEC and subject to Sarbanes-Oxley are investing in internal control and where this investment is being directed. We wanted to see whether there is similar reflection and future planning or agenda setting from organisations who have not had a compliance timetable and deadline imposed by regulations such as Sarbanes-Oxley S404. We know that companies across the board are spending more on controls – and most have further significant investment in the pipeline. But we wanted to explore how – and whether – the success of these investments is being considered and the justification for current and future investment decisions in particular business, reporting, strategic and compliance areas.

This report highlights the findings of an international survey of 140 companies in 20 industry sectors and draws together some high-level conclusions about the current status and future direction of thinking about controls. In particular, what arises from the survey is that this is a highly dynamic area, in which little is set in stone and management are exploring the ways that better internal control can make theirs a better business. The evidence from respondents suggests that they believe there is competitive advantage to be gained from taking a more professional approach to internal control.

Putting Internal Control in Context

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Complying with a multitude of regulations and a set of complex drivers across what is often a large number of locations and operations necessarily means that a company's internal control landscape is difficult to chart and navigate.

Companies who have not been subject to Sarbanes-Oxley are nevertheless subject to a diverse range of influences driving the focus of their internal controls.

Some of these are driven by compliance with local regulations, and yet an increasing number of companies are influenced by the demand from internal and external stakeholders for more transparency and certainty over risk and internal controls in strategic, operational and financial reporting areas.

Complying with a multitude of regulations and a set of complex drivers across what is often a large number of locations and operations necessarily means that a company's internal control landscape is difficult to chart and navigate. It is hard to get an 'aerial' view of the entire system of controls. So depending on particular contexts or concerns, attention tends to be drawn to specific areas for more detailed focus. This in turn means that it is very easy for inefficiencies, gaps and duplication to arise as some important areas get overlooked or form part of more than one process. Understanding where and how these may be happening is a major challenge. The experience of detailed controls assessment under Sarbanes-Oxley more than amply demonstrates the sheer complexity and volume of separate controls that have developed to cover financial reporting alone. The same holds true for other areas including operational and business functions that have a major impact on performance.

Survey Data – Who Took Part?[2]

140 companies participated in the survey, covering 17 countries around the world. 20 industry sectors were covered but we excluded businesses in the financial services sector due to the unique regulatory requirements pertaining to internal control in that industry. The individuals responding to the survey covered a number of roles, which could be described as the "control professionals" including Chief Financial Officer, Chief Risk Officer, Financial Controllers and Directors of Internal Audit.

[2] *Please note that that the survey and its results, statements and conclusions are based on the above as a representative sample of global non-SEC organisations only.*

Investment Drivers

Capital markets are paying closer attention to how companies manage risk and demonstrate control. Ratings agencies are expanding their assessments to include more qualitative factors around risk management. Their belief? Better management of risk can lead to more certainty around the achievement of business objectives, which, in turn, can increase return for stakeholders.

Corporate investors share a similar view. In *'Investors on Risk'*, covering 137 of the world's institutional investors, 61% said that evidence of poor risk management would mean that they would not invest, with 41% stating that they would disinvest if they perceived a lack of appropriate risk management.

Companies that are therefore able to actively demonstrate they are "in control" potentially create for themselves a genuine competitive edge. This is not simply theoretical: these enhancements in business control are qualities for which investors are increasingly prepared to pay a premium and to penalise those who cannot meet the standards they require.

To achieve this may require new thinking. The commercial gain from effective internal control is the ability to deliver promised performance reliably.

The ultimate prize from effective internal control is not simply a compliant business, it is a better business.

Key Findings

The survey covers many areas including the value drivers for investment, areas of investment focus, potential areas for improvement and information on where monitoring activities are focused.
In summary, some key findings include:

- Investments in internal control are seen as delivering business benefits with 89% of respondents citing enhancement in processes and underlying control structures, 86% better understanding of major risk areas and 50% “positive influence on investor confidence” as key business drivers for future investments
- 75% plan additional investments to strengthen internal control in the next 12-24 months, including key business/operational risk areas (51%); IT (49%); better alignment of internal controls to company strategy and key risks (44%); strengthen company-level controls (42%)
- Over 35% do not conduct an annual risk assessment
- Despite 72% assessing risks in strategic, compliance, operational and financial areas, only 57% have a monitoring programme focused on financial and operational controls, with 21% focusing monitoring on financial controls only
- Areas where respondents perceive controls need strengthening are primarily operational:
  - Expanding into new international markets (59%)
  - Post-acquisition integration (58%)
  - Real estate and construction projects (55%)
  - IT implementations and upgrades (51%)

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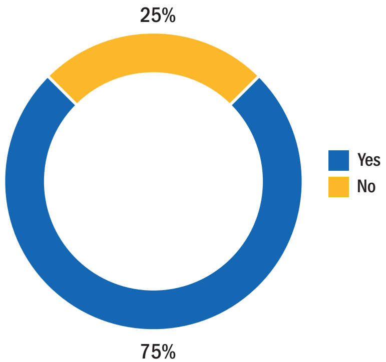
Investing in Internal Control for Competitive Advantage

Figure 1: ***Are additional investments to strengthen controls planned for the next 12 to 24 months?***



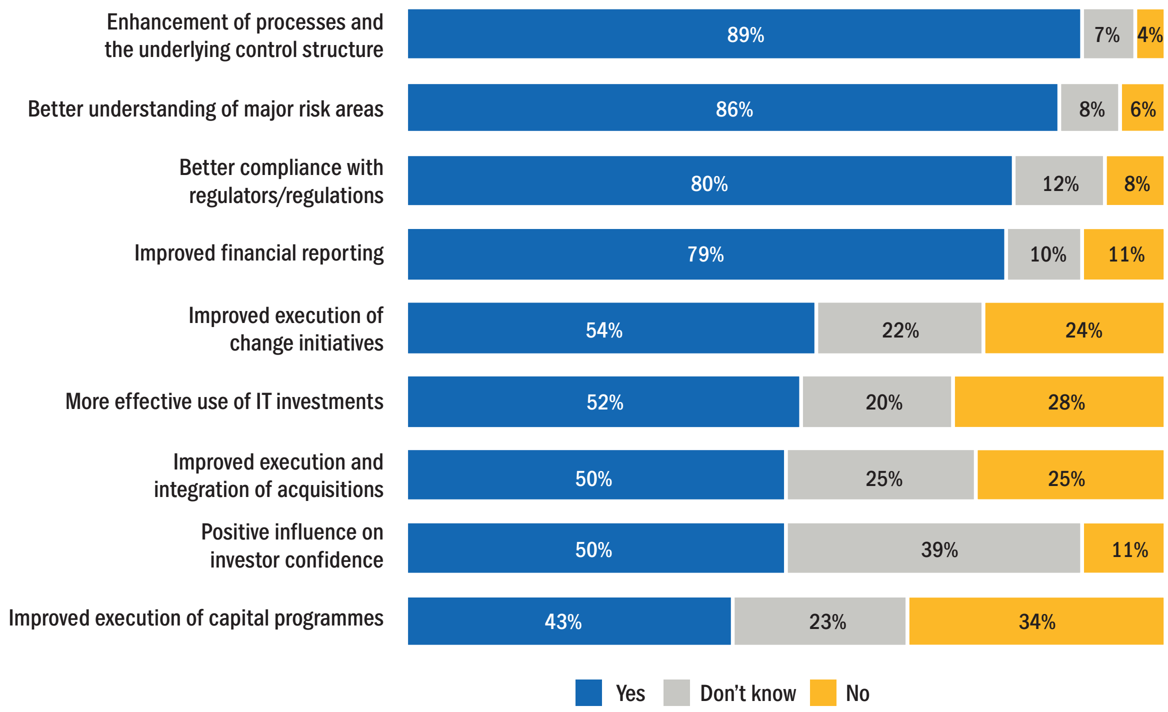
Key Areas of Focus	
Strengthen controls over key business/operational risks	51%
Strengthen IT controls	49%
Strategy & risks	44%
Strengthen company-level controls	42%
Strengthen assessment and testing programme	34%
Strengthen controls over financial reporting	33%
Other	6%

Companies continue to make considerable investment in internal control. We asked respondents to outline their expected future investments and the overwhelming majority, 75%, confirmed that they were expecting to make large investments in internal control over the next 12 to 24 months.

Respondents largely expect these investments to be in key operational and business risk areas as well as specifically in information technology controls. A high percentage of respondents – 44% – also suggested that they were seeking to achieve better alignment of their internal controls to company strategy and the key risks they face. A similar proportion – 42% – were planning to invest in strengthening their company-level controls (for example, activities conducted by senior management to set direction – policy, tone from the top etc). The role of strong controls at this level has been seen to have an effect within SEC-registrants in reducing the amount of documentation and testing required at transactional level.

The focus on these areas – away from the more traditional emphasis on core financial controls or compliance with regulation – suggests that businesses are seeking to apply a broader understanding of their major risk areas to the relevant areas of control and directing investments accordingly. And they expect these investments to drive business benefits. Nine out of ten respondents cited process improvement and enhanced control structures as a major driver of investment and 86% said that investing in internal control provided them with better understanding of major risk areas.

Figure 2: ***Do the current internal control investments provide the following business benefits?***



Nine out of ten respondents cited process improvement and enhanced control structures as a major driver of investment.

But to realise the benefits that can be achieved from these investments in internal control some major challenges have to be faced and difficult questions answered:

- How do companies know that the areas that they have selected for investment are the right ones?
- How will they monitor the success of their investment in internal control and what measures do they have in place to assess the benefits derived from strengthening their internal control infrastructure?
- If the focus is – as it should be – moving towards 'investing' for improvement rather than just compliance – how are companies able to express the benefits they generate through commercial measures such as improved profits, reduced losses and positive impacts on share price as well as regulatory compliance?

To try and assess how far along this road companies have already travelled, we broadened the scope of the survey to find out about current risk management, and how favourably this compared to the aspiration for a value-driving and commercially beneficial approach to internal control.

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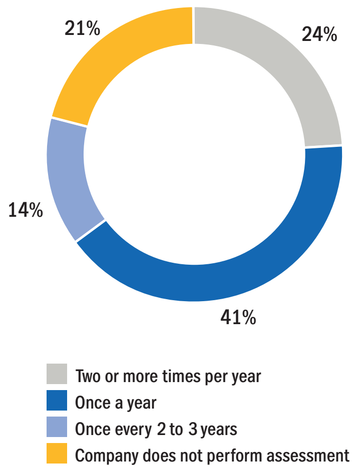
Aligning Internal Control Investment with Risk Assessment

Figure 3: ***How frequently does the company conduct an enterprise risk assessment?***

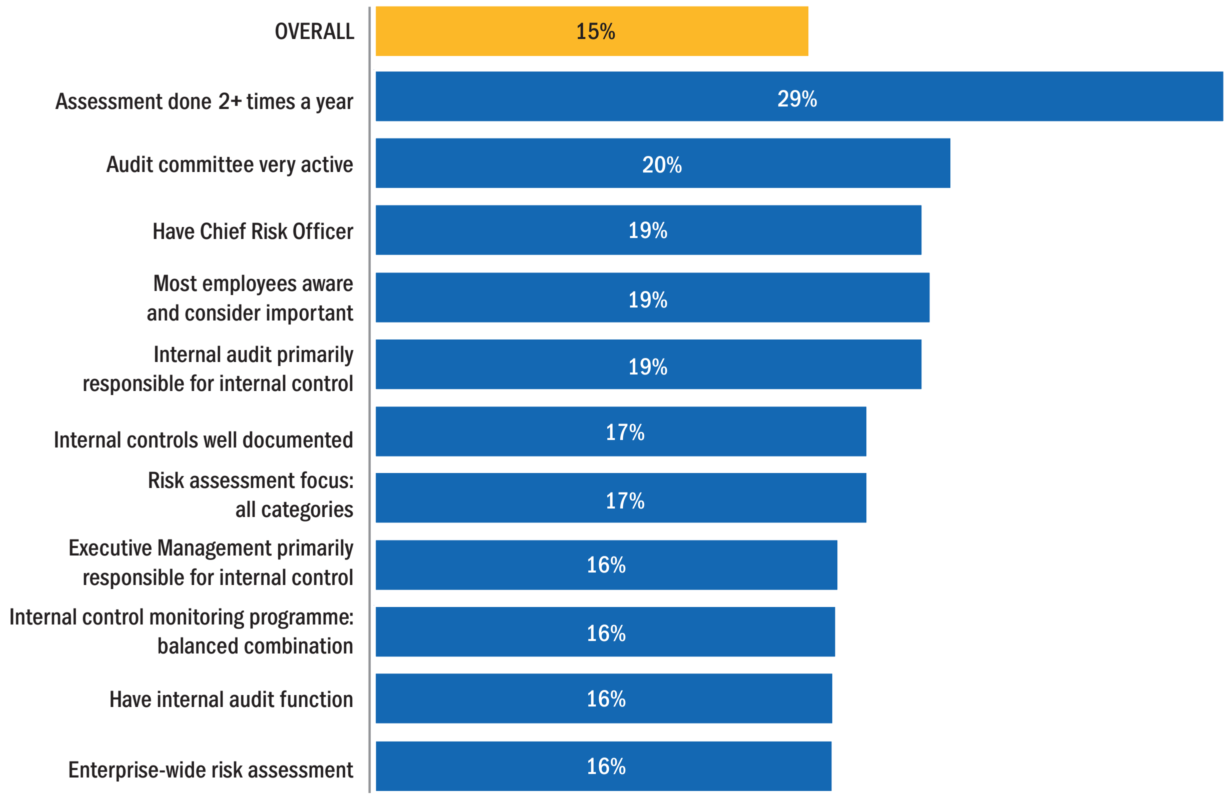


The survey reveals considerable differences in risk assessment practices. While 65% of respondents perform an annual enterprise risk assessment examining their key internal and external risks, and 24% perform this assessment twice or more each year, some 21% perform no enterprise risk assessment at all.

Taken together, this means that one-third of the companies we surveyed are potentially exposed to unnoticed changes to their risk profile arising from both internal and external market influences and developments. Overlooking the necessity to perform a risk assessment means that companies will find it difficult to direct their internal control investment appropriately – or allocate it efficiently – as they are not aligning the controls required to address their most significant areas of risk as these develop. Where organisations rated themselves as 'very effective' in more than three operational and business control areas, the most decisive factor was seen as having a risk assessment carried out more than twice a year. It is clear that there are benefits from ensuring that risk assessment moves away from being a centrally led stand alone activity to being a strategic tool embraced by the organisation.

21% of companies focus monitoring activity on financial controls only

Figure 4: ***Factors influencing 3 or more operational controls being rated 'very effective'***



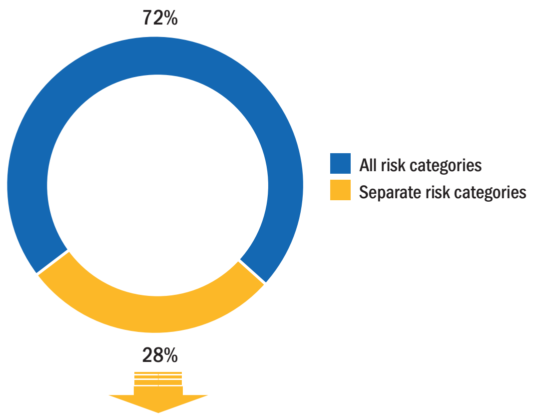
Functional Points of View

Analysis of respondents' specific roles suggests that perception of control differs according to the role occupied. For example, 36% of CFOs say that risk assessment covers operational and business areas compared to only 19% of Heads of Internal Audit that responded to the survey. Similarly, a greater majority of CFO's responding to the survey (41%) compared to Heads of Internal Audit questioned (11%) believe that internal control monitoring covers operational areas in their organisation.

Identifying the Internal Control Blind Spots

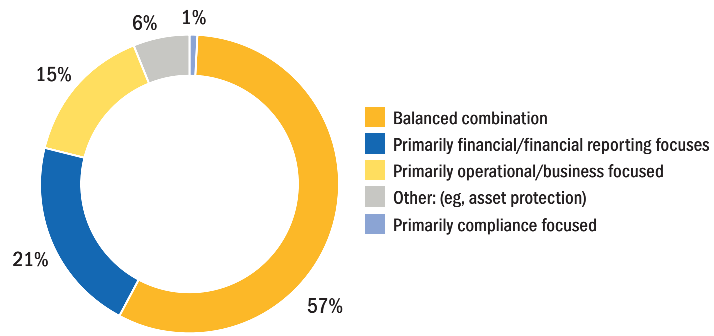
We asked companies to identify the areas of risk on which their assessments focused. Nearly three-quarters (72%) focus on all major areas of risk (business/operational, financial/financial reporting, compliance, strategic) with the remainder looking only at specific areas. However, only 57% of companies conduct balanced monitoring across all major areas of risk and 21% of the total sample look only at financial reporting. This imbalance means that the effectiveness of the controls in some of the areas identified as major risks may not be receiving any real scrutiny and ongoing assessment, at least not within formal internal control monitoring and reporting processes.

Figure 5: ***What is the focus of the risk assessment?***



Focus of Risk Assessment	
Operational/business risks	22%
Financial/financial reporting risks	20%
Compliance risks	14%
Strategic risks	7%

Figure 6: ***Where is your internal control monitoring programme primarily focused?***



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Room for Improvement?

The results show that there are some significant gaps that should prompt senior management to think about their own organisation, and the degree of certainty that they possess in the assurance they receive over controls in some of these critical areas.

To deepen our understanding of where respondents thought they had particular potential opportunities to improve control, we asked them to gauge the effectiveness of specific areas and functions within financial reporting, business and operations and information technology.

Financial Controls

In general, the majority of financial reporting activities were seen as areas over which most respondents felt that they had effective controls. Responses attesting that controls were either 'very effective' or 'effective' ranged from a high of 79% for revenue recognition, to 52% for contract accounting. However in all cases the proportion of respondents claiming that controls were 'very effective' was relatively small.

Other areas that require more judgement and specialist technical knowledge, such as tax and contract accounting, saw a larger proportion of respondents admit to weaknesses or a lack of knowledge about the controls in those areas. This may have implications for the required audit skills in these areas that are able to provide adequate assurance over these complex operations.

This is supported by our recently published *"Global Tax Risk Survey"*[3] where only 37% of respondents had internal audit carry out reviews and testing of tax processes and controls, with 23% having no tax audit programme in place.

The factor with the greatest correlation with whether an organisation rated itself "very effective" in 3 or more areas of financial control was the active involvement of the audit committee.

[3] *Global Tax Risk Survey. Tax Risk: External Change, Internal Challenge, Ernst & Young 2006*

Moving further away from the financial reporting comfort zone decreases the confidence that respondents have over the effectiveness of the relevant internal controls.

Figure 7: ***How effective are internal controls over the following financial reporting areas?***

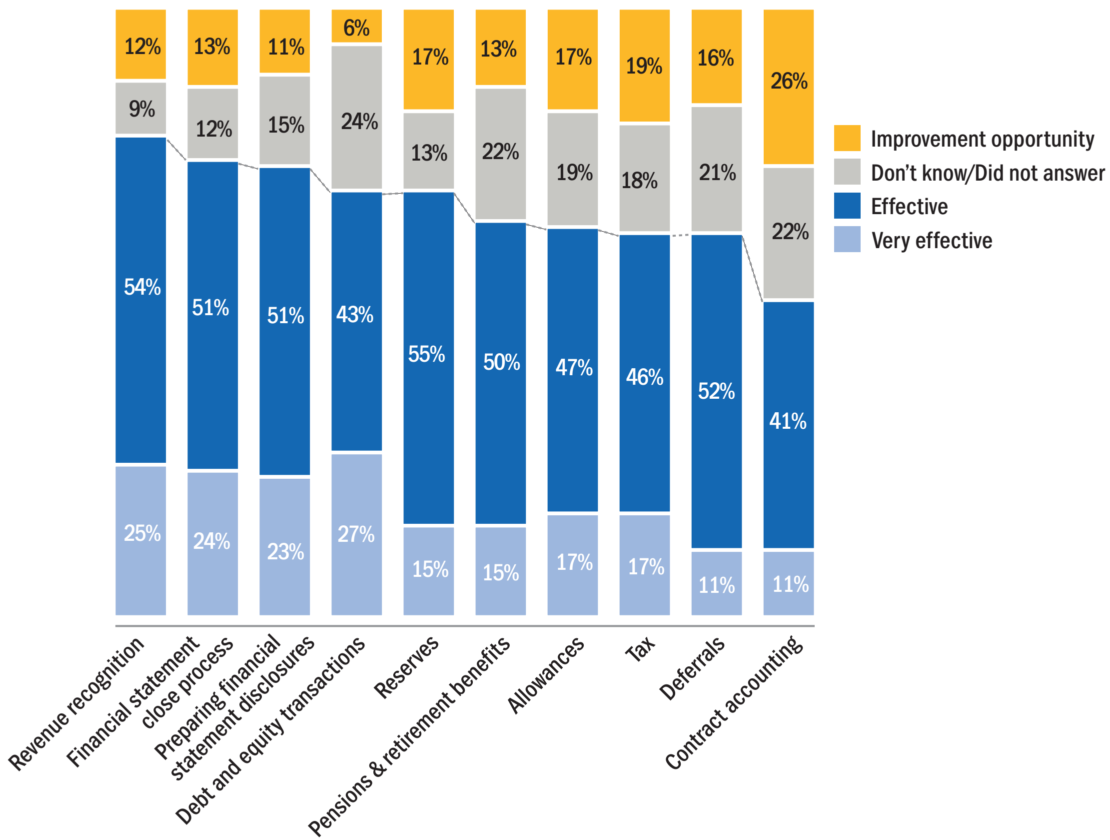
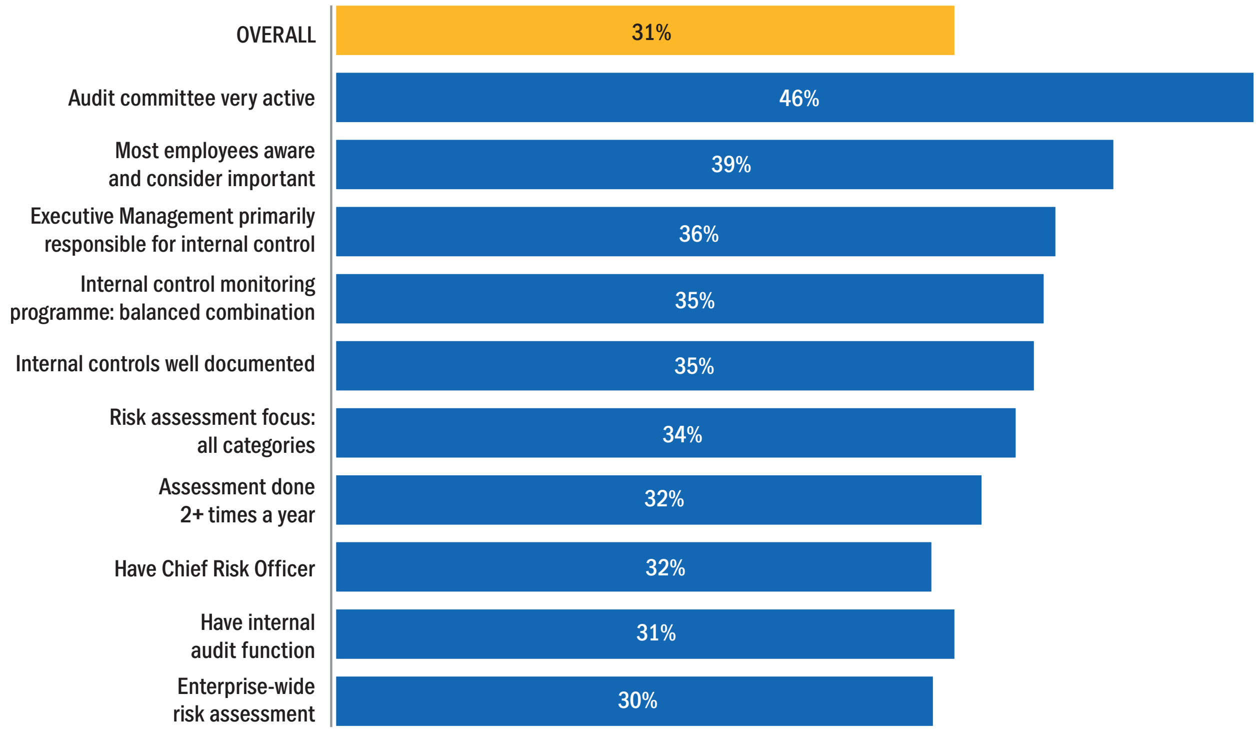


Figure 8: ***Factors influencing 3 or more financial controls being rated 'very effective'***

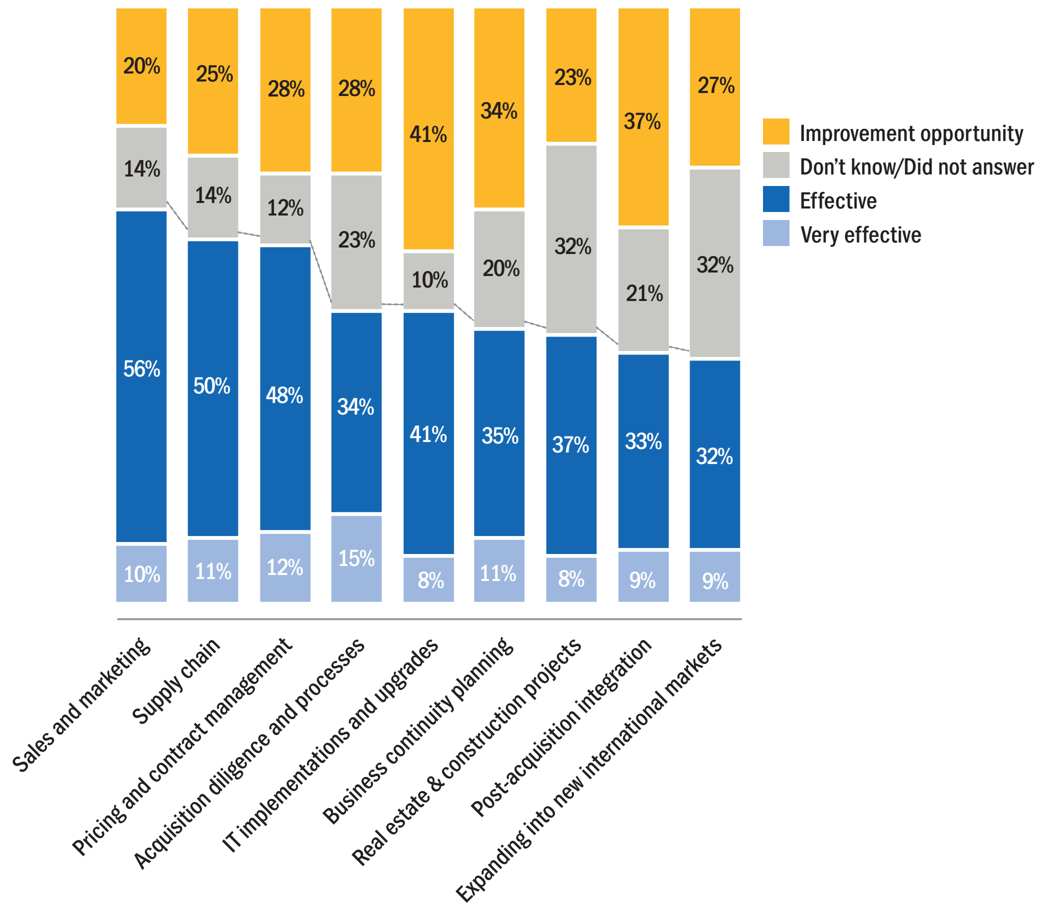


Business and Operations

There is clearly far less comfort and familiarity among respondents about the effectiveness of controls governing business and operational areas. The degree of confidence expressed about controls in areas such as expanding into new markets, and post-acquisition integration saw less than half of all respondents state that controls were either effective or very effective. Given that these activities are strategic in nature and therefore fundamental to business success, it is concerning that survey respondents query the effectiveness or, worse, are unaware of controls. This suggests a mismatch between risk priorities and the controls structures and accountabilities to support them. It is possible that capabilities and knowledge required to assess control in certain business areas may not be available to the functional area – likely to be internal audit – charged with this role and may reveal some 'blind spots' beyond the scope of controls professionals who are generally tasked with providing an opinion of the overall internal control environment. Though there is obviously an awareness of the need to invest further in controls in many of these areas, it is critical that senior management take as broad a 'risk and control' view as possible of all the business and operational functions that have an impact on bottom-line performance.

68% do not have a fraud prevention programme in place

Figure 9: ***How effective are internal controls over the following business and operational areas?***



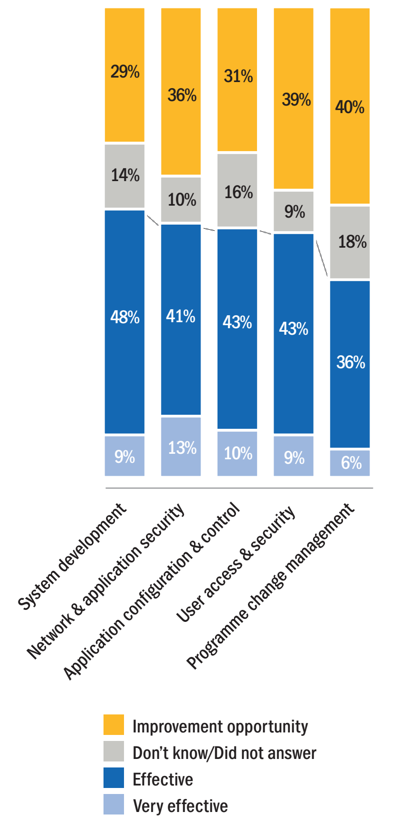


Figure 10: ***How effective are internal controls over the following information technology areas?***

Information Technology

Awareness and assessment of controls around information technology functions covered in the survey also point to a degree of discomfort. Again, a lack of relevant skill sets and knowledge has a part to play and many companies may be working with third-parties to fill the gaps accordingly. However, critical issues such as user access and security – where 39% believed their controls to be less than effective and 9% did not know or failed to answer the question – are again a source of potentially major risk for all businesses. The criticality of information technology systems across the business and the considerable investments required in information technology are obvious drivers of the need to make sure that controls are effective. The results of the survey show that there is a pressing need to assess risk and establish greater control in these areas and to make sure that once established, that control is maintained, particularly given the role that effective information technology plays in improving processes and efficiencies.

Fraud

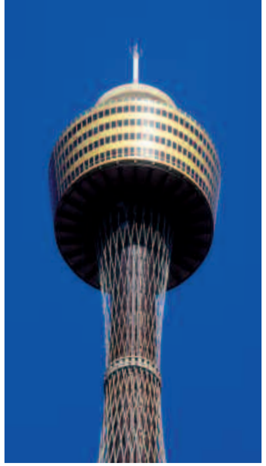
One notable absence for companies in the survey is the existence of a formal fraud prevention programme – nearly three quarters of respondents do not have such a programme (68%) and over one third of respondents rated this as important or very important to have in place. With one in five of the companies that took part in our *"9th Global Fraud Survey"*[4] experiencing a significant fraudulent activity in the last 2 years, fraud and its associated reputational risk continues to be a focus for businesses – organisations should be looking for ways in which they can make anti-fraud measures more comprehensive and integral to business operations.

Controls Documentation

A high number of respondents indicated that controls were documented at their organisation (76%). Given that such documentation will cover a wide range of controls such as policies, procedures, codes of conduct, organisational charts and job descriptions to provide clarity for employees about their roles, a question to be asked is whether the standard of documentation would stand up to external scrutiny and be deemed fit for purpose. With documentation providing the basis to assess and monitor the effectiveness of controls as well as supporting business continuity, its absence or being sub-standard will have serious implications for the organisation's ability to set and monitor expectations for internal control performance.

[4] 9th Global Fraud Survey. Fraud Risk in Emerging Markets, Ernst & Young 2006

Managing Internal Control Across the Enterprise – Getting a View from the Top



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For many companies, it's unlikely that there has to date been any one holistic, overarching view of the entire controls landscape.

Who, ultimately, should be taking responsibility for making sure that the control gaps and opportunities are spotted and addressed effectively?

For many companies, it's unlikely that there has to date been any one holistic, overarching view of the entire controls landscape. But to align major risks with an effective and responsive internal control infrastructure, gaining the right vantage point is essential. Those with responsibility for the overall governance and risk management of the organisation, be they the Board and/or executive management, are often unaware of potential internal control deficiencies and only find out when a problem arises as a consequence of ineffective controls. In other words, unless Boards consider and evaluate their knowledge of internal control, they run the very real risk of major problems developing that can threaten the business in a number of ways. So where should they begin? This becomes even more difficult when Boards or Audit Committees are expected to have oversight across complex business unit operations, joint ventures and geographically spread subsidiaries.

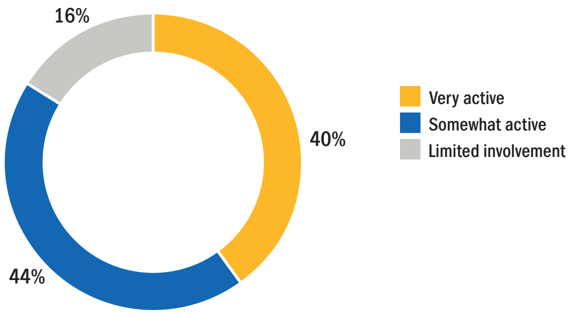
We would suggest that before embarking on a journey it helps to know where you are starting from. To that end, Boards and executive management need to become used to asking difficult questions to which there may not be easy answers, for example:

- Where, based on an awareness of the risks across the enterprise, are the internal control priorities?
- What are the internal control investments and where are resources currently being allocated?
- How can the company determine if it is getting the right return from its investment in internal control and who can provide the assurance this is the case?
- Has the company reviewed company-level controls to ensure that they are working to their fullest extent?

The market is asking more and deeper questions about internal control. The awareness of controls brought sharply into focus by Sarbanes-Oxley and other internal control legislation means that ignorance is no longer a reasonable excuse, regardless of whether a company is SEC-registered or not. And if the Board is not challenging the state of internal control then who should be?

Our research shows that the active involvement of the Audit Committee/Supervisory Board in making sure effective internal controls exist and are operating varies across companies; and yet this is the factor that, combined, has the greatest influence over whether an organisation rated itself “very effective” in more than 3 financial or operational controls. This raises the question – what does leading practice audit committee involvement look like? The answer will vary for each company, however it is clear that boundaries need to be set to ensure that their objectivity is maintained.

Figure 11: ***How active is the Audit Committee in making sure effective internal controls exist and are operating effectively at the company?***



Views of Accountability and Responsibility

Getting a view from the top correctly implies that management at those positions in the organisation accept and exercise their accountability for overseeing internal control across the enterprise. This accountability is in many countries built into existing or proposed rules and regulations – either specifically for CEO/CFO or collectively across an organisation's Board.

A strong set of company-level controls (CLCs) indicates a degree of internal control maturity, and in this case most respondents claim to have the requisite controls in place. When it comes to ranking the perceived importance of these controls, respondents firmly believe that a strong management 'tone at the top' and a strong Board are the most important.

The responsibility for monitoring and assessing controls in the majority of respondent companies falls to internal audit. Though some companies operate with a legal obligation to test their controls, others do so on a voluntary basis, and more are expecting that future regulation will require them to monitor and test their internal controls. More than half of all respondents rely on internal audit to test and monitor controls effectiveness across the business, with others turning to a mix of internal audit, business process owners and third-party providers.

Examples of Global & Emerging Regulations

Australia: CLERP 9
Basel II
Brazil: Governanca Corporativa
China: SASAC Directive
EU: 4th, 7th, 8th Directives
France: LSF
India: Clause 49
Italy: 231 & 262
Japan: J-SOX
Russia: Order No. 04-1245
Sweden: Corporate Code
Switzerland: Swiss Code
UK: Combined Code
USA: SOX

Nearly all respondents indicate that they have a competent internal audit function. However, given the range and scope of many of the internal control areas that the survey covers – particularly in the business/operations and information technology areas – questions are being asked about the knowledge and capabilities that internal audit functions need to possess to provide effective assurance over these risk areas. The results of the survey show that capabilities are being particularly challenged in areas such as contract management, M&A, major construction processes, capital programmes as well as information technology processes and projects.

By definition, senior management's involvement is key in a 'top-down' approach to ensure that controls are properly aligned to risks. Leaving it to a 'bottom up' identification of risks and where internal control investment is required creates the potential for gaps and overlaps. The use of company-level controls among survey respondents as a means of exercising this responsibility – and the indications for further investments – suggests that management and Boards are taking an increasingly pro-active approach. It is increasingly in their interests – voluntarily or as a result of the continuing evolution of the regulatory environment, to make sure that they align these efforts to the appropriate monitoring mechanisms to ensure that effective assurance is created.

Where are Leading Companies Investing?

Kaknästornet – Stockholm, Sweden

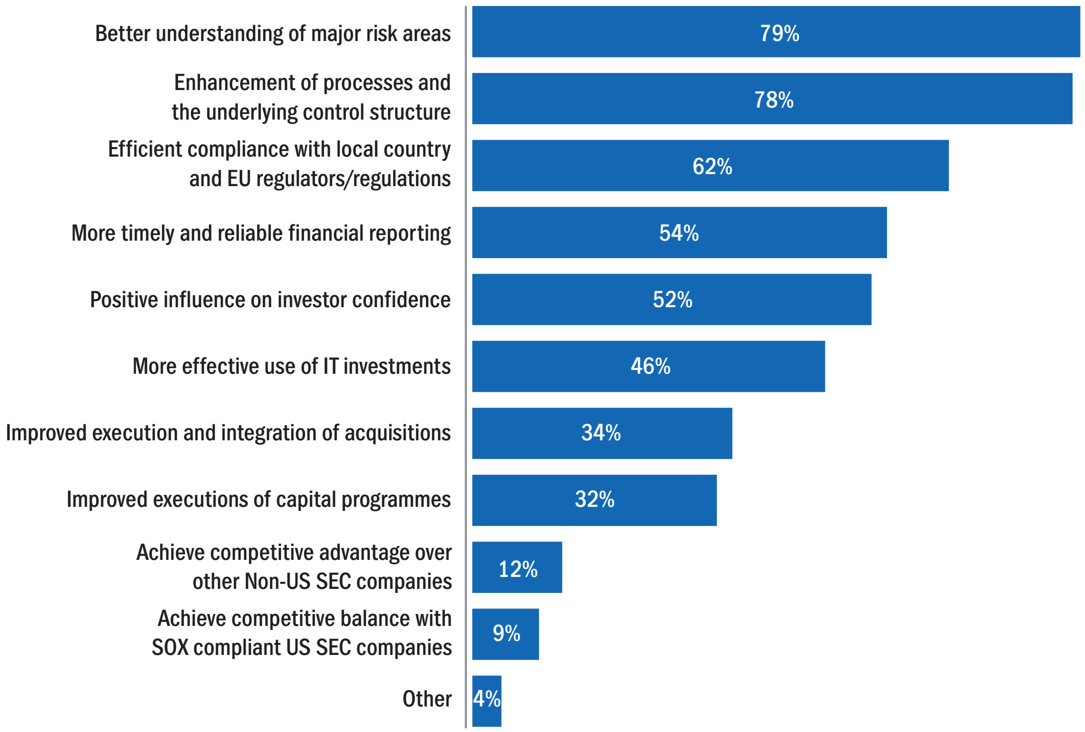
The survey shows that the two major drivers of future spending intentions for internal control are directly related to improving performance.

Future state questions in the survey show that leading companies are not happy to accept the status quo and are taking active management of their investments in internal control to achieve business benefits beyond compliance to give them a competitive edge.

They are challenging themselves in known risk areas to make sure that investment is directed to creating effective controls in some of the major blind-spots and areas that have a significant impact on performance.

To achieve a better business, these investments in internal control need to be on a sustained basis. They are not one off events. So there has to be a willingness to remain continuously aware of change. Will, for example, the internal audit function remain competent to deal with a changing business risk profile? Will management continue to provide a strong tone from the top even when the market takes a downturn? It does appear though that a strong set of company-level controls is a fundamental indicator of control maturity, common across businesses. Other elements have more limited recognition (although still attract a high level of positive responses). It will be interesting to see if these elements (eg a fraud prevention programme) become accepted as 'core' company-level controls in the way a competent IA function has been.

Figure 12: ***What are the key business drivers justifying future investments to strengthen internal controls?***



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The Look and Feel of Internal Control Success

The results of the survey show that companies are aware of the need to ensure their internal control infrastructure delivers more than compliance. But how will they know what internal control success feels like?

It's clearly more than satisfying regulatory compliance criteria, although this remains a key consideration. But if a business is not able to reliably meet the commercial performance it promises – even if it is regulatory compliant – can it be said to be in control? If it is not able to report with confidence and transparency to the market, can it be said to be in control? If it is failing to achieve the predicted benefits and synergies from mergers can it be said to be in control? What we find is that high performing companies are likely to have an internal control infrastructure underpinning the successful execution of their business processes and risk management. There are clear accountabilities and responsibilities regarding internal control ownership. Senior management and the Board feel confident and comfortable that the major risks they face are being addressed and managed effectively, and the information and intelligence they receive is accurate and reliable.

The Pendulum is Swinging Back

Our findings and wider observation of the market suggest that the commercial elements of internal control are coming more to the fore in a balanced view that combines keeping the business 'out of trouble' with a drive towards 'making it better'. Effective controls are instrumental in achieving both goals simultaneously. Perhaps the focus on regulatory compliance has swung the pendulum in recent years, but that pendulum is swinging back. Leading companies understand this balance is critical to achieving the goal of ongoing reliable performance. Accordingly, they are investing in the tools, structures and processes that ensure they are addressing not simply the risks that financial performance will be incorrectly reported but the risks to the performance itself.

In addition, Control Self Assessment (CSA) – where management, process and control owners review and evaluate the controls under their responsibility – is emerging as an established practice among respondents. Larger companies are more likely to have CSA programmes in place, with 39% of respondents already operating them, and a further 28% planning to introduce a programme in the future. At face value, CSA and similar techniques such as continuous controls monitoring becoming a component of a mature control environment looks to be a positive trend. However, as it involves a degree of investment to get it right, decisions need to be taken carefully, with a clear understanding of the benefits CSA is expected to deliver within the overall internal control agenda.

Conclusion

Businesses need to ask whether they have an agenda for internal control within their organisation. If not, they need to question why. Establishing an agenda requires them to assess their priorities for the next six to nine months and to work out how they can create an internal control agenda that provides a platform for sustainable and continuous improvement that will propel them towards the goal of making their business better.

About Ernst & Young

As the survey demonstrates, companies are at different stages along the evolutionary path to achieving highly effective internal control in all areas. Our services and solutions are therefore highly flexible. We don't seek to impose a solution. Our priority is to assess where a company is and where it needs to go. Our knowledge of internal control derives from broad experience across geographies and industries. Ernst & Young helps organisations achieve their business objectives by delivering a wide range of risk advisory services that are designed to help enhance risk management activities and improve business processes. From our network of member firms around the world, Ernst & Young's 10,000 risk advisory professionals provide services that help clients assess, improve, and monitor their business risks.We can complement existing resources, as well as augment existing skill-sets and provide specialist advice and insights. Specifically, we can help companies to assess whether the controls environment they have is meeting its objectives.

Next Steps

If you would like to discuss any of the issues raised in this report, or investigate any of the implications for your organisation, please contact:

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What the Internal Control Survey tells us about the role of…

Finance Director

For finance directors, the results of the Internal Control Survey confirm perceptions that many already have from experiences within their own organizations.

Broadly speaking, the survey shows that controls over financial reporting areas are generally thought of as effective but that controls are seen as less effective in many business and operational areas and IT.

Particular blind-spots and gaps in control arise in areas outside 'business-as usual' such as capital programs, integrating acquisitions and major change programs. The survey also shows that three-quarters of all businesses are planning to make considerable investments in control. The finance director has a pivotal role to play in overseeing that controls investments achieve the value that is expected from them.

Finance directors, perhaps more than anyone else, are engaged in creating internal controls that deliver not simply a compliant business, but a better business. In many ways, the finance director is seen as the custodian of the 'risk and control' mindset required to achieve that objective. This mindset needs to be applied in a number of ways. For instance it should guide the analysis of 'non-organic' change so that when undergoing its strategic review, the board is able to consider not only the business case for a particular change, but the risks arising from that course of action and the control mechanisms that need to be put in place to manage and mitigate those risks.

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A further application of the risk and controls mindset is in the identification of particular areas of complexity that may create risk in other functional areas. The finance director is able to use his or her understanding of risk and control to help senior management in functions such as marketing, HR and so on to address the complex aspects of their functions and design and implement controls to manage them effectively.

All businesses face common drivers for a better controls environment. These include the need to respond to both external and internal stakeholders' expectations, achieving improved governance whilst reducing the cost of compliance and the need to improve business processes in order to maintain and enhance competitiveness. The finance director is likely to be best-placed to drive a risk-based approach and to help others use the same approach to build effective controls in their area of responsibility.

A further indication from the survey is the importance of entity or company level controls. Establishing rules that cascade from group to divisional and then company level is vital so that people across the organisation know what is expected of them. But putting these rules in place and communicating them is only one half of establishing control. Equally important is creating the appropriate mechanisms for feedback so that senior management is able to gain assurance that what has been requested has been done.

Gaining confidence and comfort through a properly established feedback loop allows finance directors to decide how much detail they need in the processes underlying particular controls. So adopting a risk-based approach to challenge why processes and monitoring controls are executed in a particular way makes it possible to achieve efficiencies and streamline controls so that they are cost-effective. And with the levels of investment already committed to internal control and the planned future spend indicated by the survey, it is essential that the efficiency of controls and their ability to deliver value to the business are an integral part of the approach. As is the case with all investments, there needs to be a sound business case for creating the appropriate controls infrastructure.

Questions to Ask

Finance directors assessing their own organization's control infrastructure need to ask a number of questions about how they can achieve the appropriate balance between compliance and competitiveness in making sure that their approach to internal controls delivers value.

They need to question the resources they and the organization have at their disposal. What is the level of understanding about risk and the approach to its management and mitigation? Who are the controls specialists? Within their own finance function and in the wider organization it is likely that these resources will be fairly scarce; a finding that was highlighted for some by the experience of implementing the Sarbanes-Oxley Act and the pressure this placed on identifying suitably qualified and experienced personnel to carry out that work.

Finance directors also need to identify how control within their organization is managed at a practical level in order to find areas for improvement. They need to understand what the cost of operating their present system of internal control is and how new thinking may help to achieve greater efficiency and deliver a system that is fit for purpose.

How Ernst & Young can help

Ernst & Young works with finance directors and their teams to help them answer these questions and to develop their own risk-based approach that can help create a fit for purpose system of controls that will help make the overall business better.

Our insight and experience comes from across a range of industries and organizations and we can apply these insights in a way that is uniquely relevant to every individual organization. For example, we can help finance directors to identify blind-spots and gaps across different parts of the organization in different locations and align multiple processes in order to eradicate unnecessary duplication. We can conduct workshops to help apply risk-based analysis to create effective controls in parts of the business subject to particularly high level of complexity such as supply chain and logistics.

Our work with finance directors is above all aimed at helping them to achieve the controls environment for their organization that responds to the concerns and requirements of all internal and external stakeholders.

Kyoto Observation Tower – Kyoto, Japan

What the Internal Control Survey tells us about…

Contract Risks

Nearly half of all the respondents to the Internal Control Survey highlight contract accounting as an area over which they perceive their organization to have less than effective controls.

This finding concurs with our observations of the market and our discussions with clients, many of whom are beginning to look closely at the area of contract risks and the need to develop better controls to manage the risks arising from commercial relationships with third parties.

Many of those relationships involve third parties acting for companies as custodians of significant financial value. For example, a consumer goods company that has a large global advertising spend may be entrusting a number of agencies and media buyers with a substantial budget for creative, production and media requirements. Companies need to gain comfort that the strict formula laid down in the contract is being adhered to. This applies across a whole range of external service providers, from IT support contracts, facilities management, distributors, customer service functions, outsourcing back office and so on. In all these relationships considerable business is at stake. With the increased focus on internal controls and governance, companies have realized that they need to obtain a greater understanding of their contractual risks and how they manage these. Additionally, they must obtain greater insight into the various activities to comply with these contracts.

Whilst there may be adequate internal controls over who within the organization can authorize expenditure there has often been little in the way of comparable scrutiny of how that money is spent once the procurement relationship is established. Understanding the risks in contractual relationships and putting the appropriate controls and monitoring practices in place to address these risks can lead to efficiency and effectiveness that may result in improved profits.

Questions to Ask

To create a starting point, it is helpful to consider how contracts are seen in the general organizational context and during the process of risk assessment.

Relevant questions might include:

- How many contracts does the company have? How many different types of contract does the company use? (e.g. licensing, royalty, distributor, supplier, agency, etc.)
- What is the income, or cost, associated with these contracts?
  How many of these contracts (or contract groupings) would be considered financially material?
- When conducting a risk assessment, are contract risks considered in designing the internal audit plan?
- Have the complexity and risks of different contracts been categorized? Is the review process tailored on this basis of those categories?
- Who monitors the service level agreements for contractual terms?

How Ernst & Young can help

We can help organizations understand the risks in their contractual relationships and assist them to put the appropriate controls and monitoring practices in place to address these risks.

We can review existing contracts across the whole portfolio for the regulatory and business risks they create, and identify appropriate areas for monitoring procedures, effectively creating a third party audit plan. Given the nature of contracts and third party relationships will vary according to industry, we also have teams with specific sector knowledge in areas such as pharmaceuticals, consumer products, telecommunications, technology and automotives. We can augment the skills of in-house controls professionals with our in-depth knowledge of contractual arrangements and subject matter resources in areas such as IT licensing, sales and marketing, outsourcing, real estate and construction. We also assist supply chain functions to analyze and manage their contractual relationships with suppliers and to achieve costs savings and recoveries, based on industry knowledge and process excellence.

We deliver tangible findings and provide valuable insights into contract terms, processes and controls.

Who to Contact

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What the Internal Control Survey tells us about…

IT Controls

Our recent survey suggests IT is one area where many businesses still believe they could improve their controls. Nearly half of all respondents believe their controls are less than effective in addressing the critical issues of security, user access, application control, and program change management.

Systems are now at the heart of every business. More than just a support function and a business enabler, IT systems are now completely intertwined with what and how a business operates. Businesses have – and continue to make – significant investments in their systems and it is increasingly important they understand the associated risks and establish greater control in this area.

Change is a constant when it comes to most IT environments and our survey found that only 49% of businesses believe their internal controls for IT implementations and upgrades were effective. Contributing to this challenge is the fact that many IT systems have developed organically on a piecemeal basis, making it difficult for the organization to have complete global oversight of their IT systems. This means increased vulnerabilities and gaps in coverage, threatening not only the security of the systems, but their efficiency and effectiveness. The proliferation of different systems within one organization creates considerable complexity which in turn leads to greater risks and the need for effective IT controls.

As part of their changing IT environment, many businesses are engaged in automating controls particularly within their Enterprise Resource Planning (ERP) systems. As they do so, they are looking to generate a return on their IT investments and make improvements with sustainable benefits. They want to simplify and streamline their systems so that they are not only compliant and in control, but are also able to reduce the cost and effort required to support current and future compliance efforts. Of our survey respondents, 46% considered a more effective use of their IT investments to be a key driver to strengthen their internal controls. To do this effectively, management must consider several key areas often overlooked and ask the pertinent questions prior to implementation and “go live”.

Key Considerations for Management

Though there has been a tendency for many IT organizations to operate independently, the importance of IT is such that it should command the attention of senior management. They need to challenge and test the effectiveness of their IT and risk controls to increase confidence and demonstrate to their stakeholders that appropriate risk management measures are in place. Similarly, major IT programs need to be tested and assessed to identify critical risks and increase the likelihood benefits will be realized. If the internal audit function is the major source of assurance for the organization, management must consider whether they possess the skills, capabilities and knowledge to challenge the IT organization and any third-party IT providers.

Another area that should have the attention of senior management is security with only 54% of businesses reporting their controls in this area are effective. This is a growing area of risk with threats from viruses, malicious hackers, and insiders targeting the systems and business information on those systems. In many cases it is simple procedures and policies that can be the difference in preventing a major security breach with costly consequences.

How Ernst & Young can help

We can help organizations to establish an IT control environment that will meet their objectives and enhance their risk management activities. We provide insight and an approach designed to increase confidence that IT strategies, processes, and controls are both appropriate and effective. We help clients identify critical IT risks in time to make informed decisions, avoid costly overruns, and reduce unwanted surprises. We help clients reduce costs and eliminate overly burdensome or redundant IT controls whilst improving the operational efficiencies of the organization.

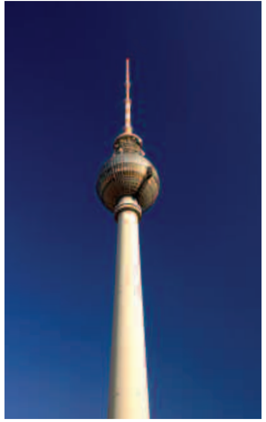
In addition, we work closely with our clients to improve the effectiveness and efficiencies of their business and technical processes in ERP environments. Whether an organization is implementing, upgrading, optimizing or integrating an ERP environment, our professionals can help identify and verify that controls are in place to mitigate the risks associated with these activities. We can also help clients better leverage their ERP investments to meet regulatory compliance requirements.

Our experienced professionals also help clients assess their security environment – including their ability to identify critical security weaknesses, vulnerabilities, and risks to the business – so that gaps in security can be addressed and effective policies and procedures implemented to protect business systems.

We can also help improve the effectiveness of the overall IT organization by measuring performance against leading practices and peers, identifying the root causes of performance issues and developing actionable roadmaps for improvement. We help manage and execute the steps required to realize intended benefits and additional value from the IT organization.

What the Internal Control Survey tells us about…

Transactions



TV Tower – Alexanderplatz in Berlin, Germany

Despite the strategic importance of acquisitions and post-acquisition integration, historical evidence suggests that a significant proportion of acquisitions do not deliver their projected benefits. Minimizing this value leakage requires the ability to both identify and address risk during the acquisition and during any subsequent integration activities.

Against this background, current trends are also often leading to increased inherent risk around acquisitions:

- A trend towards competitive auctions. This is increasingly the case also for larger, complex businesses,
- Increasing competition due to private equity bidding alongside corporates for businesses of all sizes,
- Acquisitions in high-growth emerging markets with different business cultures and approaches, as well as less predictable local regulatory and political environments (see bullet point below also). This impacts upon both the ease of due diligence and also the ability to effectively integrate these acquisitions,
- Increased bribery and corruption, regulation and enforcement with a global impact, leading to an objective that key issues in target companies will be identified pre-signing and resolved post acquisition.

A robust and controlled approach to transactions and post-acquisition integration is key to address these and other risks, and maximize benefits.

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Ernst & Young's Internal Control Survey asked companies in a range of sectors and across 17 countries, to identify the relative effectiveness of their current internal control in a number of business and operational areas. The general area of transactions featured in a number of these questions, and the responses given suggest some concern about the perceived effectiveness of control over this area.

In particular, when asked about the effectiveness of controls over acquisition due diligence and processes, 28 per cent of respondents said that there was opportunity for improvement and 23 per cent either said they did not know how effective their controls were, or did not answer the question.

An even higher proportion, 37 per cent, identified controls over post-acquisition integration as an area for improvement and 21 per cent did not know or did not answer the question. Finally, 27 per cent of respondents said that controls over expanding into new international markets offered room for improvement, with 32 per cent saying that they either did not know, or could not answer the question.

50 per cent of respondents indicated that improved execution and integration of acquisitions was a business benefit arising from their current internal control investments. In addition, more than one-third of respondents indicated that improved execution and integration of acquisitions was a driver of future investment to strengthen controls.

Given the strategic criticality of executing transactions and integrating acquisitions effectively, these findings suggest that, although some companies are obtaining business benefits from existing internal control investments, a significant proportion of respondents either have a 'blind spot' in this area or see this as an opportunity for improvement. Importantly they also see this area as one that will justify future investment in internal controls.

One of the reasons that a relatively high proportion of survey respondents did not know how effective their controls were, or did not answer transaction-related questions, may well be due to in-house 'controls professionals' having limited involvement either in undertaking these transactional processes, or reviewing their effectiveness.

Involvement of key in-house or external specialists at appropriate points is critical to a successful approach.

In certain cases there may be valid reasons for the limited involvement of in-house controls professionals. Transactions and post-acquisition integration demand specific skill sets, and in-house controls professionals (such as internal audit) may have skill sets focused more around 'business as usual' processes.

These results suggest that companies could often benefit from reviewing control over their transactional processes. This could include:

- Involving all relevant stakeholders in a review of transactional processes to ensure an effective process, including the involvement of appropriate experts on a timely basis. For example, should controls professionals (including those in IT related controls) be involved earlier in the process to assess the implications of integrating control frameworks post-acquisition?
- Formal internal audit reviews to evaluate the effectiveness of transactional processes post each transaction and highlight areas for process and control improvement in future transactions.

Questions to Ask

The example questions below may help to identify businesses that can benefit from a review of internal control around transactional processes:

- Is the business plan to grow by acquisition in the future?
- How successful have previous acquisitions been for the business?
- Does the business formally measure transaction success? If so, how? If not, how is success assessed?
- What have been the reasons behind the key successes and failures?
- Does the business have a formal process in place for acquisitions and post acquisition integration?
- How effective is this process? What are the key areas for improvement? How effectively have key risks been identified during due diligence? How effectively have they been addressed during due diligence/post acquisition integration?

- Does the business carry out a formal evaluation of the effectiveness of transactional processes post each transaction? Has the business learnt from previous areas of weakness?
- Are appropriate people within the business involved in each stage of the transactions process?
- When are "control professionals" within the business involved? Is their involvement early enough/sufficient? If not, why are they not involved?
- Does the business have sufficient in-house skills to deal with all aspects of acquisitions and post acquisition integration? If not, where are the gaps?
- Does the business use external support? If so, in which areas? How well have these external relationships worked? Are there any areas you would like to improve?

How Ernst & Young can help

Increasing value from transactions and post-acquisition integration requires a robust and controlled approach to all transactional processes. Ernst & Young is able to provide support and advice across all these areas including due diligence (Financial, Taxation, Operational, HR, Commercial, Systems and Controls), valuations and modeling, tax structuring, and post-acquisition integration.

As well as providing on the ground support in execution, our broad knowledge and experience also allows us to provide insights and advice to our clients to help them improve their transactional processes.

Our transactions focused team has knowledge and experience in reviewing the control environment during due diligence, and in reviewing and improving internal controls post-acquisition and in readiness for a sale or listing.

Kaknästornet – Stockholm, Sweden

What the Internal Control Survey tells us about…

Tax Risk

In Ernst & Young's Internal Control Survey, 37 per cent of respondents expressed reservations about the effectiveness of their internal controls over tax.

This finding concurs with other recent research we have carried out which suggests that tax is an area that has been somewhat excluded from the general approach to assessing and managing the major risks that an organization faces and verifying that the relevant control framework is in place and operating effectively. This has arisen for a number of reasons, not least of which is the way that tax has been perceived as a relatively discrete function within the business, away from the scrutiny of internal audit and other 'controls professionals'.

Tax is a highly technical area and for many heads of internal audit and finance directors one of which they are likely to have little direct experience or knowledge. Allied to this is the fact that many tax managers and directors often have limited experience and knowledge of risk assessment and controls. In addition, tax information is likely to come from a number of sources within the business and so it is critical to look along the chain of processes and functions that have an impact on the tax numbers.

In consequence, it is likely that there could be some significant gaps in awareness of potential tax risks. And these risks extend beyond uncertainty about a tax position or vulnerabilities in the financial controls. Tax risks could include any action (or lack of action) related to tax strategy, operations, financial reporting or compliance that could have an impact on tax or business objectives or result in unexpected or unacceptable levels of monetary, financial statement or reputational exposure.

EYG No. DZ0021

In light of these challenges there are clear signs that more companies are now addressing the tax risks they face and taking a proactive approach to understanding the extent and nature of the tax risks to which they may be exposed.

Questions to Ask

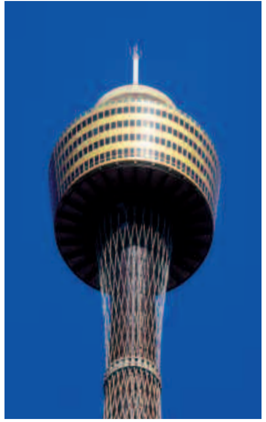
Addressing tax risks and the appropriate controls means that audit committees are able to identify the nature and extent of the risk that they may face. Even if a tax risk assessment reveals a high degree of exposure, this is preferable to not knowing what those risks are. In addition, assessing tax risks provides an opportunity to look at the effectiveness and efficiency of the tax function which may well reveal opportunities for process improvement. This can enable the tax function to improve both its reliability and its ability to react to opportunities arising from changing regulations or developments in company structures and operations.

There are also a number of external risks arising from the way that the revenue authorities are approaching this area. Revenue authorities are starting to look closely at tax from a risk, process and systems point of view, and are also intending to penalize errors more severely. Faced with these challenges it is also important that companies undertake post implementation reviews of transactions from a tax point of view and review tax related documentation to test its robustness.

How Ernst & Young can help

Our assessment of tax risks is performed using the same methodology and framework that we employ for other areas of risk assessment and management. We develop our approach in conjunction with controls professionals – such as internal audit – within the organization so that we deliver the appropriate level of support and so that the areas we focus on align with business priorities, risk policies and strategic objectives. This approach allows tax risks to be assessed and managed consistently with other key business risks.

Ernst & Young’s tax advisory and risk professionals (covering both direct and indirect taxes) focus on working with clients to assess, improve and monitor their tax processes and controls. Our services help organizations to embed a sustainable approach to consistently assessing tax risks and to improving processes and controls to mitigate those risks. This approach enables companies to manage their evolving tax risk profile in a cost-effective way while constantly looking for opportunities to improve their business.



AMP Centrepoint Tower – Sydney, Australia

What the Internal Control Survey tells us about…

Real Estate & Construction

Almost a quarter of respondents to Ernst & Young's Internal Control Survey agreed that real estate and construction are two areas where there are opportunities to improve controls and more effectively manage risk.

More importantly almost a third of respondents did not know the effectiveness of controls over real estate and construction projects. This finding is consistent with what we observe in terms of real estate's visibility within organizations. Often real estate is not adequately represented at the board level. Since real estate may only make up a small proportion of the balance sheet, the associated issues, risks and opportunities are not given enough consideration at a senior level.

However, real estate and construction are risk areas that organizations should consider. Property costs, including rent and facilities management services, often fall within the top three overall business costs. It is clear therefore, that effective controls over the financial aspects of property occupation should be a priority. Real estate also represents a significant business risk due to the complex nature of property tenure arrangements, facilities management agreements and statutory regulations. In addition real estate management often involves a large number of legal entities spread across multiple geographical locations and could involve potential lease issues with subsidiary operations. Therefore effective controls are critical to verify ongoing contractual and regulatory compliance.

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EYG No. DZ0020

Property occupation and ownership also needs to be managed effectively to verify that the risks associated with payments schedules (rent, rates and service charge), lease renewals and other events associated with property agreements are monitored and acted upon promptly. Companies that operate with a complex portfolio of sites distributed across a large number of locations need to make sure that there is an accurate and up to date understanding of all the property-related processes and related compliance and statutory requirements and to prevent, for example a breach of lease terms. It is also important to match property assets with their required business use, otherwise companies risk inefficiencies by paying for premises that they no longer need. The appropriate portfolio knowledge is key to help companies exploit commercial opportunities that generate acceptable returns and contribute to the overall business strategy and goals. In addition, it is critical that major construction projects are completed on time, within budget and that they meet or exceed the firm's quality standards.

Internal audit teams will often not have the appropriate skills and experience to comprehensively address property-related issues. Risks arising from property ownership and occupation may therefore go unnoticed until it is too late – opportunities may be missed and threats may materialize.

Effective property controls provide an early warning system which highlights areas that may warrant further investigation.

Questions to Ask

Asking the key or pertinent questions about the property portfolio and its management team will help senior executives better understand the risks, industry leading practices, the resources and the controls necessary to effectively manage property risk.

- Regulatory and contractual compliance: what are the controls and processes in place to make sure that all the company's regulatory and contractual obligations are being met?
- Procurement for property and facilities management services: what controls and processes exist to ensure that the company is actually receiving the levels of service that it contracted for originally?

- Management: what systems and processes are in place to manage the day to day operation of the portfolio, one off capital programs and property risk areas?
- Reporting: is relevant information being captured and reported to management on a timely basis in the right format? For example, this could include requirements under IFRS for assets to be valued and classified according to the appropriate methodology.

How Ernst & Young can help

Ernst & Young works alongside internal audit teams to augment their processes and approach with our industry knowledge and property and construction subject matter resources. We are able to identify key property-related risks and areas of improvement, working with the internal audit team's methodology and documentation.

We can help address all aspects of the property portfolio, examining processes and controls in relation to regulations, contracts, procurement, property management and reporting. Our approach helps organizations to identify the appropriate controls that make sure they both comply with their obligations and improve commercial benefits of property occupation, construction projects and ownership.

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Kyoto Observation Tower – Kyoto, Japan

What the Internal Control Survey tells us about…

Enterprise Risk Management

The overwhelming majority of respondents (79 per cent) to the Internal Control Survey perform an enterprise risk assessment, with 65 per cent performing this annually, and only a minority (14 per cent) performing no enterprise risk assessment at all.

Approaching risk assessment in a disciplined and proactive way is now generally accepted by businesses as a fundamental part of managing uncertainty better and improving business performance.

By identifying and evaluating the risks that they face, organizations are better able to:

- Avoid, or better prepare themselves for, undesirable surprises,
- Focus risk management efforts on the risks that matter,
- Improve the quality of their decision making,
- Prioritize investments in controls and management activities,
- Provide a degree of confidence to investors and other key stakeholders on the effectiveness of overall risk management and control efforts.

While the statistics from the survey are encouraging, many organizations still find it a challenge to achieve true incremental and sustainable benefit from a more formalized approach to risk assessment. Turning this exercise from a “required compliance” into a “recognized competence” requires thoughtful effort if it is to be integrated into the existing infrastructure and processes of the business. Often the success of delivering an enterprise risk assessment and a risk register or catalogue can build support for a broader effort to enhance overall risk management competencies. But greater insight into the key risks of the organization and the adequacy of existing risk management competencies can also lead to a range of difficult-to-answer questions; questions that need to be answered to validate that the right return is achieved on the overall investment in risk management.

Defining what is meant by “valuable” is a good starting point. Our experience of working with leading organizations indicates that the following are critical success factors in extracting benefits from performing a more comprehensive evaluation of risk across the enterprise.

Specifically, enterprise risk assessment should:

- Provide a completeness check to confirm that the most significant potential risks have been identified and that new and emerging risks can be identified more proactively,
- Focus management’s efforts on the risks that matter, ie, those risks that pose the greatest potential threat to the achievement of business objectives and stakeholder value,
- Generate proactive insight for decision makers, to support them in better informed decisions about risk,
- Be embedded into what the business does already, ie, into existing business processes and management activities on a sustainable basis,
- Coordinate control, monitoring and assurance activity, to optimize, rationalize and drive efficiency.

Completeness check

In the current environment the world is changing rapidly and businesses must respond to various threats and opportunities as they emerge in different business contexts. The seemingly never ending challenge remains, “how do we know, what we don’t know?” This underlying issue continues to concern many business leaders.

But leading organizations are beginning to find comfort through utilizing external sources of information and challenge to build an inventory of the possible risks the business faces. Leading organizations are starting with industry risk models and tailoring them to reflect the specific business objectives of the organization.

Focus on the risks that matter

To be truly beneficial to business leaders in support of making better decisions, risk information must actually help them take and manage risk better. It needs to focus on the risks that matter, and for these clearly define specific opportunities to improve controls and management activities, as well as define those risks that must be prioritized for ongoing monitoring. This would include a consideration of risks related to both “business as usual” activities (ie, risks to the successful operation of its core business processes), and risks to strategic initiatives and business objectives. Risk assessment and the resultant management of key risks must be anchored in relation to what the business is trying to achieve, not conducted in isolation.

Providing insights for the business

While most businesses agree that measuring their performance with sophisticated performance indicators (“KPIs”) is valuable, few measure the corresponding risks explicitly with Key Risk Indicators, “KRIs”. With a deeper insight into the causal drivers of the risks that matter and the appropriate measures and targets in place, it is possible to create a “risk dashboard”, like the cockpit of an airplane or the dashboard of a racing car, to provide management with real time indicators of the level of risk they are taking and advance warning of potential changes. The use of KRIs brings risk to the heart of decision making by integrating aspects of risk appetite and tolerance into considerations for the investment of capital and other resources.

Embedded

Integrating risk assessment as a core discipline in the existing management activities of the business is critical to protecting the business from downside risk and preserving the opportunity to enhance overall business performance. Practically, this means “baking in” risk assessment activities into existing business processes to develop, monitor and review the business plan, rather than “bolting on” these as a separate set of activities that take place outside the normal rhythm of the business and often after a plan of action has been formulated.

Coordinated

Finally, focused enterprise risk assessment should be used to coordinate controls and assurance activities and target the areas of greatest potential concern to management and stakeholders. Implemented well, risk assessment activities can challenge the network of controls that most businesses have developed as they have evolved, and the collection of assurance functions and mechanisms – be they management reporting, control self assessment, internal compliance/auditor or external bodies – they have in place to monitor these controls.

How Ernst & Young can help

Our risk and controls professionals help organizations to achieve a coordinated approach to assessing, improving and monitoring their risks, building an efficient and effective controls system and developing an assurance framework. By assisting organizations to better identify and assess risks, we can assist them in determining whether controls are in place that address the risks that matter and appropriate assurance is being provided that they are working as designed. An enterprise risk assessment and subsequent risk mapping exercise can help the organization see gaps in its coverage, as well as duplications and opportunities for improvement.

We provide a breadth of risk management and control experience combined with a depth of technical knowledge of risk on an industry specific basis. Our pragmatic approach assists organizations to create the necessary links between business objectives and risk assessment, control improvement plans and ongoing monitoring.

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Telecom Tower – London, England

What the Internal Control Survey tells us about the role of…

Internal Audit

Respondents to the Internal Control Survey show that internal audit is the area of the business most likely to be seen as responsible for independently evaluating and testing controls across the business.

Respondents also cite a ‘competent internal audit function’ as the third most important company-level control, with 95 per cent of respondents saying that they have such a function in place. Elsewhere in the survey though, there are some significant gaps in control coverage with respondents indicating particular business and operational areas such as major capital programs, business change events including acquisitions and reorganizations and expanding into new international markets as areas where control maybe less than effective.

What these findings suggest is that controls in certain business and operational areas are not receiving the audit coverage they need. This may be due to the fact that they are not included on the internal audit agenda. Companies who believe they may have significant gaps in audit coverage therefore need to address the way the internal audit plan is developed. And that means taking a risk-based approach that maps the major risks to the priority areas for internal audit scrutiny.

Inevitably, internal audit, like other functions within the business, is faced with constraints of resources and time that place clear limits on how broadly it can operate. However, it is vital that those limitations do not define the scope of the audit activity so that it becomes supply-driven, based on available in-department skills, rather than demand led. The audit plan has to be drawn up according to the demands of the business and the major risks. The need to address these demands places extra pressure on internal audit and calls for it to be agile and flexible in its approach to resourcing.

By taking the approach of first populating a plan designed to address the major risks and only then thinking about what it means for staffing requirements and capabilities, will any resource gaps become apparent. There are a number of creative responses for filling resource gaps that do not rely simply on enlarging the internal audit budget. Peer-reviews of particular functions and processes can be highly effective mechanisms as can the use of ‘guest’ auditors from other parts of the business. Similarly, external third parties, particularly in areas where specific technical experience is required in conjunction with auditing capabilities, can prove a cost-effective and efficient means to evaluate controls in particular parts of the business or specific business activities.

Rapid and pervasive change is a hallmark of business today. And the audit plan and the areas that internal audit covers need to reflect relevant business changes. New perspectives are required to verify that the areas of the business and the risks that matter most are accorded the highest priority and that internal audit can respond to and anticipate change in the wider business.

Questions to Ask

Asking a few fundamental questions can help to address the gaps in internal audit coverage that the survey suggests are common for many businesses.

- Is internal audit’s charter or scope clear and broad enough to address the risk areas that management are concerned about?
- Is the audit plan demand-driven or supply-led?

- How does internal audit validate that it is engaging effectively with the business? Are new perspectives sought to verify that change is monitored and responded to effectively?
- Are the same areas featured on the audit plan year after year?
- Is the plan built from scratch every year using a risk-driven process?

How Ernst & Young can help

We can help organizations to assess the drivers behind their audit plan and validate that a sufficiently broad view of risk is driving its formulation. We can assess the processes the internal audit department uses to arrive at their plan. Using our in-depth knowledge of leading practice we can also assist in the creation of a plan by engaging appropriately across the business and validating that internal audit's areas of focus align with the risks that matter most and verify that gaps and blind-spots in coverage are addressed.

We can also help internal audit teams by augmenting their resources with a wide range of subject matter resources and technical knowledge. We have experienced professionals that can help internal audit teams to assess controls in areas such as IT, treasury, capital projects and programs, real estate, contract risks and other business and operational areas where internal resources may lack in-depth knowledge. Our approach is flexible and explicitly driven by the culture and particular circumstances to which a business needs to respond. In addition, our global presence means that we can augment internal audit resources in a location where it is not cost-effective to have full-time staff deployed.

Who to Contact

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What the Internal Control Survey tells us about…

Fraud Prevention

Two-thirds of respondents to the Internal Control Survey said that their organization had no formal fraud prevention program in place.

Of course, the absence of a formal anti-fraud program does not mean that there are no checks and balances in place against fraud, nor that the organization tolerates fraud. They may rely on various controls and processes to detect and prevent fraud without formally connecting them in a coherent program. However, our experience suggests that for many organizations fraud incidents are much more common than senior management may be aware and the controls that are assumed to capture them may not be working effectively or are being circumvented.

The consequences of large-scale and high-profile frauds over the course of the last decade have created a regulatory push to implement effective anti-fraud programs. External auditors and directors are increasingly both asking management to present its anti-fraud program and considering the risk that management might override internal controls. What is clear from the wider observation of fraud is that often it is the culture and tone that is set by the organization, rather than the specific mechanisms in place that are likely to prove most effective in preventing or detecting fraud.

EYG No. DZ0016

Setting the right tone from the top is therefore critical, but it is also vitally important to assess how extensively the desired culture pervades throughout an organization. organizations operating across many locations and with many different entities are likely to have strong local cultures that may not reflect what central management, the audit committee or internal audit perceive to be the strength of the overall corporate culture. To identify where variations in the culture may be, it is critical to ask the key questions to identify whether the activities or circumstances of a particular part of the organization indicate that fraudulent activity is more likely.

Questions to Ask

By its very nature, fraud involves misrepresentation and concealment. Robust anti-fraud programs target three elements that are generally present for fraud to take place. There needs to be opportunity, a motive and the perpetrators need to have the ability to rationalize the fraud in order to 'justify' their actions. The focus of financial controls tends to be on the first of these, while the second and third conditions are often overlooked. Asking the appropriate questions can help to discern the extent to which opportunities align with motive and the ability to rationalism, or justify, a fraudulent act. For example, the degree and extent of incentives for success need to be examined in light of the pressure they may exert locally to achieve certain levels of performance. If a major component of remuneration – such as a bonus – depends on achieving particularly aggressive targets, local managers may be tempted to circumvent normal reporting controls to reach them. In a similar way, local employees with a grievance of one kind or another may have the motivation to commit fraud and to justify their actions in terms of their disenchantment with the organization.

Internal audit should identify the key controls in place to manage fraud risk, including the specific high impact fraud risk scenarios to which the business is most vulnerable. However, they are largely reliant on information that may pass through a series of filters before it reaches them. Identifying how this information compares to what is happening 'on the ground' can sometimes be a significant challenge.

How Ernst & Young can help

A formal anti-fraud program allows the organization to explicitly manage its fraud vulnerabilities. A typical anti-fraud program would include components such as a fraud risk assessment, specific controls to manage those risks and broader company-level controls, all embedded in an appropriate culture and reinforced with effective fraud response disciplines. Ernst & Young is able to help organizations to plan and execute such a program, including developing a picture of the potential fraud 'hot-spots' in the organization.

Our teams include investigators with direct experience in dealing with the consequences of fraudulent activity, internal control specialists and data analysts to support organizations through the implementation phases of anti-fraud programs.

With a consistent global methodology and insights into the industry-specific fraud risks of most concern to auditors, we understand the leading practice controls and processes most effective at managing and monitoring fraud risks. Our enabling tools allow us to automate and expedite the collection and reporting of information from the organization using leading e-mail survey tools and balloting software.

Who to Contact

Global Contact
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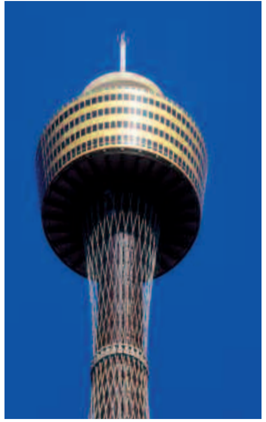

AMP Centrepoint Tower – Sydney, Australia

What the Internal Control Survey tells us about…

Capital Programs

Capital programs are shown in the Internal Control Survey as being one of the major areas over which respondents have concerns about the controls in place to manage the risks they face.

67 per cent of respondents in the Internal Control Survey say that their current control investments are not proving effective in the execution of capital projects. Yet successful execution of major programs and projects is critical to business success.

Understanding the controls and risks arising from capital programs requires different skills and knowledge to those that have traditionally been available to internal audit. As well as knowledge of effective program and project execution, auditors are likely to need to have specific technical knowledge across a wide array of areas driven by the focus of the program. These include knowledge and experience in engineering, construction, information technology, manufacturing, outsourcing, distribution or real estate. Identifying, recruiting and mobilizing these skills is a challenge for most internal audit departments.

Questions to Ask

Audit committees, the board and senior management need to understand the risks they face from major programs and the controls that need to be in place to manage them effectively. They need to know that programs are running on time, to budget and will deliver the intended benefits. They need to know if programs are aligned to strategic business objectives and whether funding is committed to the right projects.

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They need to measure the level of investment in current projects and programs and the level of investment likely to be required over the next few years. And they need to know how they currently obtain confidence over the programs underway.

Answering these questions can help develop some sense of where greater confidence is needed. Internal audit is maybe operating with limited resources so it will be impossible to cover all programs. Instead, a number of criteria need to be assessed that will create a sense of where control investments need to be made. These considerations should include the strategic importance of the program, the projected financial benefits, the major risks associated with the program, its cost, impact on day to day operations and how far it has progressed towards completion. Having answered these questions, it should be possible to create priorities for addressing program control.

Alongside focusing on the priorities, senior management also need to consider whether the resources they have available to provide confidence are suitably experienced and possess the appropriate knowledge and experience. The results of the survey suggest that for many organizations there is a need to invest in plugging the gap between current resources and required capabilities.

How Ernst & Young can help

Ernst & Young has developed considerable experience in helping organizations in the public and private sectors to address their risk and control needs for major capital programs. Our approach combines knowledge and experience in program advisory along with the specialized technical knowledge required to address particular aspects of major programs. This combination means that we can help organizations to align their internal audit resources to the major risks that their programs create. Ernst & Young can supply the appropriate knowledge and experience as and when it is required, validating the efficiency and effectiveness of program control.

Who to Contact

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