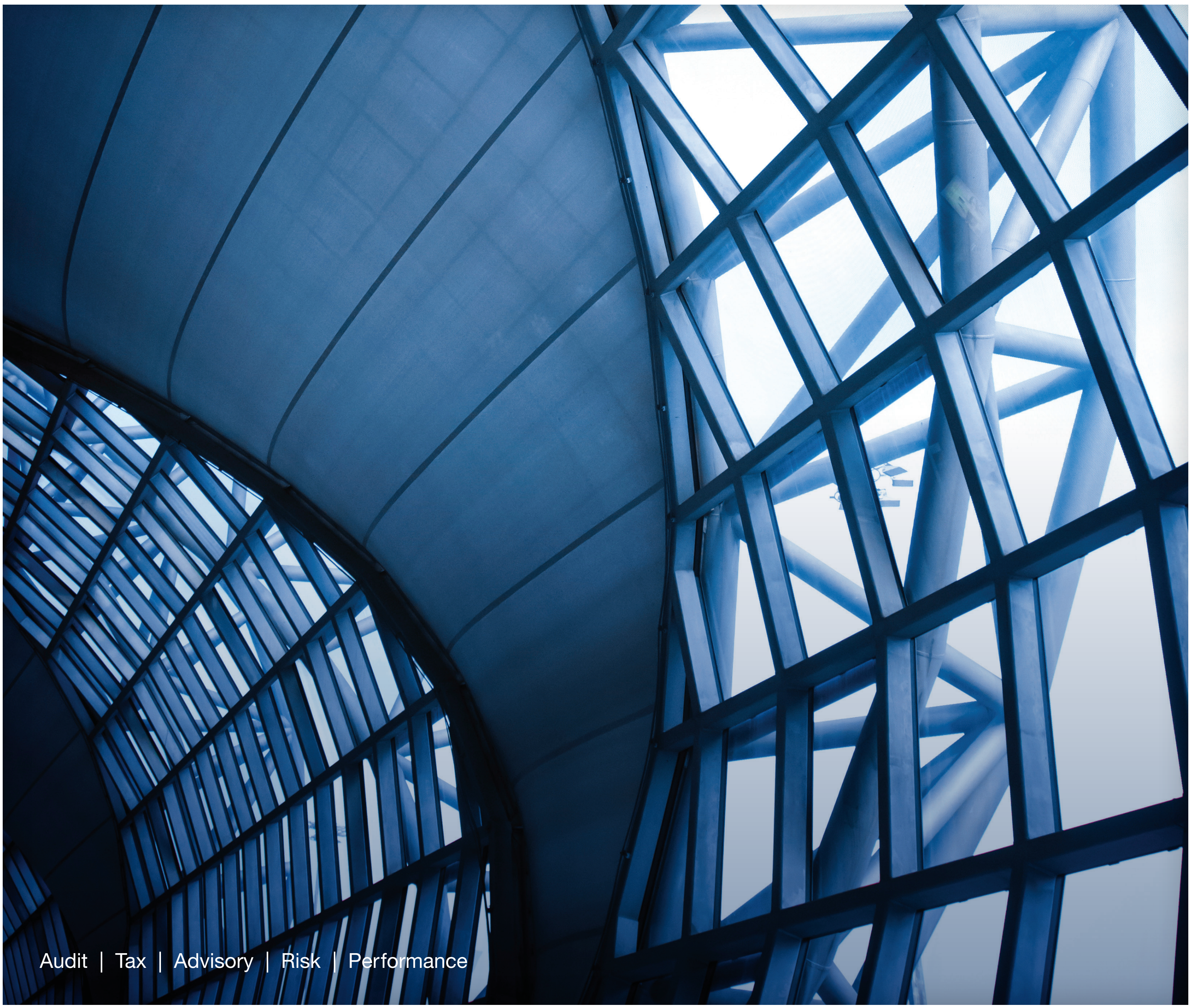
September 2014

Making Internal Audit More Strategic

How Changing Its Role Makes It More Valuable to the Organization

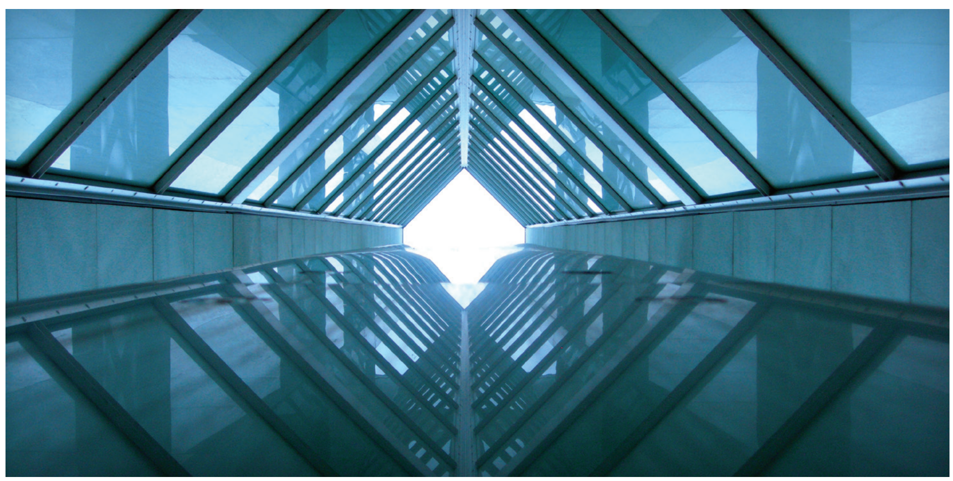
A White Paper by William C. Watts



Internal audit departments these days rarely participate in setting and executing their organizations' strategic objectives. To be perceived as an important strategic player, internal audit must find ways to expand its role and align its contributions with organizational objectives.

Risk assessment and risk management are becoming both more complex and more critical to organizations. External market forces, volatility, and regulatory expectations have prompted executive management and audit committees to be more concerned than ever about identifying and managing risks that could undermine strategic and operational objectives. Risk activities, therefore, are now integrated across organizations, leading to multiple risk assessments performed by multiple functions – such as compliance, legal, and finance – with varying agendas. This fragmentation makes it difficult for leadership and other stakeholders to obtain the comprehensive view of assurance they need to have when forming and pursuing strategic plans.

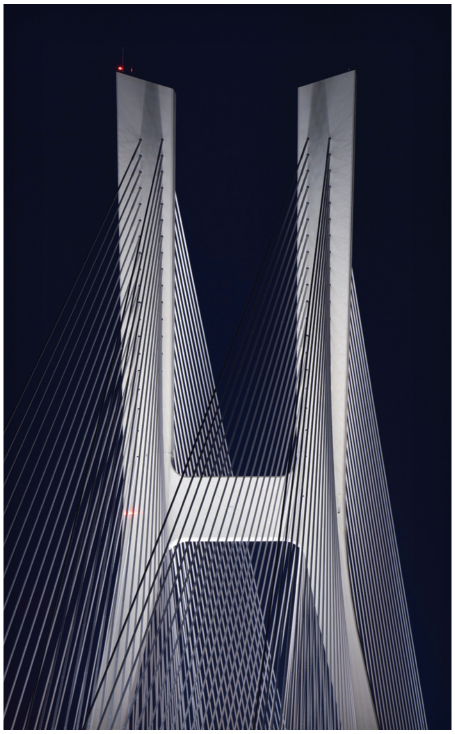
In discussions of the need for companies to develop more integrated strategic initiatives, professional organizations and thought leaders are not mentioning the valuable role internal audit could play. Internal audit rarely has a seat at the strategic table, in part because the function is perceived (often accurately) as lacking the capabilities or technical skills requisite for playing a role beyond risk assessment and mitigation. Internal audit must take steps to expand, measure, and communicate its strategic value to the organization as a whole.



Trends

One reason internal audit is regularly left out of strategic considerations is that stakeholders lack confidence that the department is aligned with the organization's objectives. Although stakeholder reviews indicate the performance of internal audit has been improving, the progress has not been enough to keep pace with the increasingly complex and risky business landscape. Moreover, a majority of the senior executives we encounter say that they still don't believe internal audit adds significant value to their organizations, and many of the board members believe internal audit adds less than significant value.

On a more promising note, we are hearing from more stakeholders who value internal audit more when it's seen as a "trusted adviser," as opposed to simply an "assurance provider" delivering objective evaluations of the effectiveness of an organization's internal controls. Many of the stakeholders who regard internal audit as a trusted adviser report that the function does provide significant value.



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Gaps

Several factors could be responsible for the poor impressions some organizational leaders have of internal audit. For example, legal and regulatory requirements, the growing use of technology, and intensified profit pressures mean that internal audit departments are being asked to do more with less. It is expected to mitigate existing risks while also anticipating the needs of the organization in relation to the changing environment it must operate in. Internal audit must respond to changes in the organization's strategic objectives and evolving external factors, which requires it to understand more complicated risks as well as the complexity of identifying and mitigating them within the constraints of the changing environment.

Internal audit departments are trying to find the right balance between meeting their compliance responsibilities and accomplishing their business improvement duties. Unfortunately, management and the audit committee persist in the perception that internal audit tips the scales much more to the compliance side; they don't expect internal audit to play a role in developing and executing the organization's strategic vision.

This perception isn't necessarily misplaced. Over the past decade or so, in the wake of the *Sarbanes-Oxley Act of 2002* (SOX), internal audit has concentrated largely on financial controls. This focus has resulted in a narrower competency, one that doesn't fully satisfy most organizations' current needs. In the 1980s and 1990s, internal audit departments primarily served as a business-operational, value-added consultative function for their organizations. The regulatory explosion following the financial crisis and recession of 2007-2009, however, provoked a dramatic shift as internal audit was directed to focus mostly on financial controls and less on being a leader in the organization. Internal audit departments understandably hired staff members armed with formidable accounting and financial skills but little knowledge of the broader spectrum of business management and value.

In the current environment, however, internal audit needs to bring a "triple threat" to risk mitigation. It must possess the skills to audit and mitigate risks and a thorough knowledge of the specific industry (including competition, market volatilities, and applicable regulations), while also being adept with the technology that can render those skills and that knowledge more effective, strategic, and valuable.

Many internal audit departments today are strong in audit and financial controls but not as strong in industry knowledge and even weaker in technology. Experience and anecdotal evidence indicate that investments in technology are consistent markers of highly effective internal audit departments. The best departments go beyond just using the technology to finding the points where their people's skills and knowledge intersect with the technology. As a result, they offer unique business acumen that can solve organizational problems.

The current tight market for talent makes it difficult for many internal audit departments to rebalance their areas of expertise as necessary. Departments are competing against internal audit shops and professional services firms around the globe, as well as other business units in their own organization, for individuals with new and diverse skills.

Challenges

Internal audit departments looking to participate in strategic matters face challenges (and, in turn, opportunities) in four particular areas.

1. The Internal Audit Mandate

The expectations for internal audit – its mandate – are not only changing but also expanding. The internal audit function has long been expected to assume a role in the assessment and coordination of enterprisewide risk coverage, but internal auditors haven't been seen as thought leaders in the organization.

Going forward, internal auditors will be asked to offer more in terms of the skills, experience, and risk management-related vision required for meeting growing demands. Rather than just following orders, internal audit will need to be a proactive force behind risk management – providing a vision for how the organization should focus on internal audit.

Internal audit departments also will need to change their mandate for SOX Section 404 testing. Most organizations still expect internal audit to bear the primary burden for SOX testing or similar low-end compliance testing. Internal audit needs to limit its responsibility for such compliance testing and mainly support the testing of higher-risk or more complex areas. This approach will help free internal audit to respond to specific events that bring new, expanded, or unique risk as well as opportunities. Events might include acquisitions, divestitures, joint ventures, new regulations, globalization, or an increase in outsourcing.

In addition, with internal audit under mounting pressure to provide additional value to the organization, the mandate will need to better align audit coverage with the organization's major business and operational initiatives and risks. Because internal audit's current mandate calls for it to be part of the team looking at areas like system implementations, complexity of transactions, and major change initiatives, it must advance to deal with extended enterprise risk (for example, risk related to vendors' vendors), quantum analytics that assess "big data" and interpret results, the move from internal systems to the cloud, and issues resulting from global expansion of the enterprise.

2. Internal Audit Staff

Perhaps the top challenge for internal audit is the "war for talent." How can a department recruit and retain the type of talent that will close gaps in audit coverage, meet new requirements in the audit plan, and make strategic contributions?

The demand for individuals who bring the triple threat significantly exceeds the supply and will likely continue to do so in the near and short-term future due to the heavy emphasis on risk coming from industry, market, and business. Many candidates boast impressive financial and compliance skills but are deficient in the specialized skills required to deal with an organization's developing risk profile. Internal audit must find a way to attract people who might not have a traditional background in audit and finance but are business-minded and can solve problems.

Technological advancements and global interaction add to the challenge of providing effective audit coverage. These conditions produce an immediate need for internal audit to have unprecedented breadth and depth. Internal auditors must be familiar with remote locations' languages, cultures, business practices, local laws and regulations, accounting standards, quality standards, and more – and be able to understand, identify, and mitigate the related risks. Internal audit also must have staff members qualified to provide expertise in the new and changing risks like cybersecurity[1] and third-party risk[2] as well as the risks that will emerge in the future.

Training internal audit talent presents an additional hurdle. It's clear that training providers are not keeping up with the level and types of training required in the ever-evolving risk arena.

3. Internal Audit Operations

To keep up with dynamic and ever-changing business environments that create new risks and increase exposure to existing risks, the internal audit department needs to take a small-speedboat approach that allows it to alter course quickly rather than a battleship approach that can't shift direction in a timely fashion. Many internal audit departments already use the small-speedboat approach, refreshing their annual risk assessments and audit plans repeatedly throughout the year.

Completing an audit plan has always been a challenge, with stakeholders and events redirecting and straining resources. Internal audit now also must deal with strict and expansive regulations around the world, such as the *U.S. Foreign Corrupt Practices Act of 1977* (FCPA) and the *U.K. Bribery Act*, which require greater vigilance from organizations doing business abroad on matters of fraud, bribery, and other crimes.[3]

Leading internal audit departments are investing in proactive approaches to fraud prevention, such as automated real-time fraud risk assessments and monitoring, data analytics for early fraud detection, and fraud awareness training throughout the organization.[4] Most departments, though, need to make better use of specialized technological tools that compress manual efforts and provide real-time data analysis to facilitate work streams, collaborative efforts, knowledge exchange, and work mobility. Many governance, risk, and compliance (GRC) tools are not up to date, and new niche solutions usually don't integrate well with other solutions.

4. Measuring Internal Audit Value

To secure a place at the strategy table, internal audit must add value, measure and communicate that value to management, and determine how to provide even more value by, for example, focusing on different or additional areas. To demonstrate its value, internal audit tends to look only to the basic metrics such as the amount of time to issue reports or resolve audit findings. To gain the attention of stakeholders, internal audit must instead highlight its impact on the bottom line (for example, cost recoveries, process improvements, and reduced cycle times). To further reinforce its relevance, the internal audit function should align audit plans and performance metrics with the business strategy and initiatives of the organization.

Solutions

Internal audit is unlikely to become part of the organization's strategic leadership unless it takes steps to address the previously described challenges. The steps begin with updating the internal audit mandate – management and the board's expectations and perceptions of what internal audit is – to clearly position the department as a critical risk management player that responds to event-triggered risks with a process aligned with the organization's strategic objectives.

Internal audit won't be able to reposition itself, though, without staff members who are equipped with the requisite skills. With the market for internal audit staff so competitive, it could be necessary to shelve the old talent model and transform the internal audit department through not only traditional recruiting but also training, cross-functional or rotational programs, and relationships with seemingly nontraditional professional service providers. For example, converting engineers or IT programmers to auditors should be considered.

The department also could recruit people from the organization's business units, reversing the usual career progression in which employees are plucked out of internal audit for employment in various business units. To be considered a career destination rather than a rest stop or steppingstone on the way to something else, internal audit must emphasize the career development opportunities and challenges it offers.

Exhibit: Elevating Internal Audit

To foster greater collaboration on strategic risk, internal audit should continually elevate its stature in the organization through:

Response	Percentage of respondents selecting this answer
Retaining and sustaining the right skills and continually recalibrating to meet the need through training, hiring, cross-functional/rotational programs and outsourcing activities	64.7
Meeting the needs of management and the board before being asked	48.8
Reporting performance metrics, including its contribution to the bottom line through cost recoveries, process improvements, reduced cycle times, etc.	43.4
Leveraging the audit committee relationship so the committee will intercede, if necessary, with management	26.9

Source: Question put to participants in a Crowe-sponsored webinar for members of The Institute of Internal Auditors in July 2014. Respondents could select multiple answers, and they provided a total of 990 responses.

The human resources effort doesn't end after the right people have been hired – retention is as important as recruitment. To retain high-quality employees, the department must provide customized training in the right skills, tailored to the relevant industry, and the best implementation skills. The department also must provide challenges and growth opportunities. Attracting and employing the organization's top performers will naturally elevate perceptions in the organization of internal audit.

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Internal audit should also address its operations. It must understand and integrate the organization's strategic planning process, adjusting processes as necessary to assume a more business-oriented role and contribute valuable ideas. To do this, internal audit must deepen its knowledge of the business, industry, and competition.

Internal audit can supplement this knowledge by using its relationships with the audit committee, executive management, and business-unit leaders. Internal audit can promote conversation with these parties by abandoning audit programs and questionnaires in favor of posing a series of open-ended questions (Why are we doing this? How will we do this? What are the expected results?) that are likely to result in better understanding and a better alignment with the organization's strategic objectives. To be understood more easily and perceived more favorably, internal audit personnel should use the mode of communication and language of business managers. By linking its knowledge of risks and controls to strategy, internal audit can work as partners with stakeholders.

Some internal audit departments use an expanded annual quality assessment review to analyze the gap between the current state and the desired state and create a plan for improvement. The review goes beyond adherence to internal audit standards to consider knowledge, methodology, technology, and staff. Internal audit also could combine assurance in all aspects of the organization into a single comprehensive assurance report that incorporates assurance reports for the external audit, compliance, legal, regulatory, finance, and strategy functions. The report clearly communicates the value of internal audit.

Another tool for reinforcing internal audit's relevance is the value scorecard. The scorecard should be tied to the metrics the organization uses elsewhere so that the internal audit function is monitored according to the same performance indicators of other areas of the organization.

Thinking ahead and anticipating the needs of management and the board could raise internal audit's profile in the organization. In general, internal audit should be seen as a dynamic and proactive department that changes with the organization and environment.

Conclusion

The role of internal audit is just beginning to evolve; the transformation is in its infancy. To be seen as a relevant and valuable contributor to the organization, internal audit must continuously monitor and reassess the risks related to compliance and focus on those risks as they affect the organization's strategies and objectives – in other words, help the organization assume the right risk at the right time. Recognizing and remedying deficiencies in the mandate, staffing, operations, and value measurement is essential if internal audit is to take its proper place at the organization's strategic table.

Contact Information

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[1] The dynamic nature of technology risks requires particular vigilance. For additional information, see Raj Chaudhary and Michael Del Giudice, "Data Protection: A Practical Guide to Managing Your Data Risks," Crowe Horwath LLP white paper, December 2011, http://www.crowehorwath.com/ContentDetails.aspx?id=3678; and Raj Chaudhary, Angela Hipsher, and Michael Lucas, "IT Security: Seven Steps to Take in the Wake of Recent Breaches," Crowe, May 2014, http://www.crowehorwath.com/ContentDetails.aspx?id=8501

[2] See, for example, Rick Warren, "Closing Gaps in Third-Party Risk Management – Defining a Larger Role for Internal Audit," Crowe webinar presentation, Jan. 15, 2014, http://www.crowehorwath.com/ContentDetails.aspx?id=7751

[3] For additional information about the acts, as well as an FCPA compliance action plan, see Jonathan T. Marks, "Building and Enhancing FCPA Compliance," Crowe white paper, March 2011, http://www.crowehorwath.com/ContentDetails.aspx?id=1815; and Jonathan T. Marks, "FCPA: The Guide and Lessons Learned From 2012," Crowe webinar presentation, 2013, http://www.crowehorwath.com/ContentDetails.aspx?id=5888

[4] For a take on managing fraud risk, see Jonathan T. Marks, "Skepticism: A Primary Weapon in the Fight Against Fraud," Crowe white paper, May 2014, http://www.crowehorwath.com/ContentDetails.aspx?id=8683