

Reaching greater heights: Are you prepared for the journey?

2013

*State of the internal audit
profession study*



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The heart of the matter

Executive summary

“Everyone in an organization is responsible for helping to move forward with the mission, but in addition, every single employee/teammate/person must realize it is also their responsibility to look out for the people on either side of them and help them move in the right direction as well.”¹

—Alison Levine, adventurer, explorer, mountaineer and team captain of the first American women’s Everest expedition

Much like explorers in extreme conditions who must continually manage through risk and uncertainty, companies have come to accept that market volatility and complexity, along with political and regulatory change, are here to stay. Yet, in this greater risk context, many internal audit functions are not keeping pace, and companies face a major challenge in determining their strategy for internal audit and realizing value from their investment.

Are audit committees and management requiring enough of internal audit? Are they satisfied with the status quo? Or, given the rapid increase in the number and types of risks organizations face, should they encourage internal audit to reach for new heights and play a more valuable role? And, if they require internal audit to reach for greater heights, is internal audit prepared with the right capabilities to take this journey?

The overwhelming opinion of 1,700 executives participating in the 9th annual PwC State of the Internal Audit Profession Research is that internal audit needs to reach for new heights and contribute to the organization in a more meaningful way. Our research clearly indicates that internal audit must continue to evolve in its focus and significantly improve its performance—or risk losing relevance as other risk functions become more vital contributors to the organization’s risk management.

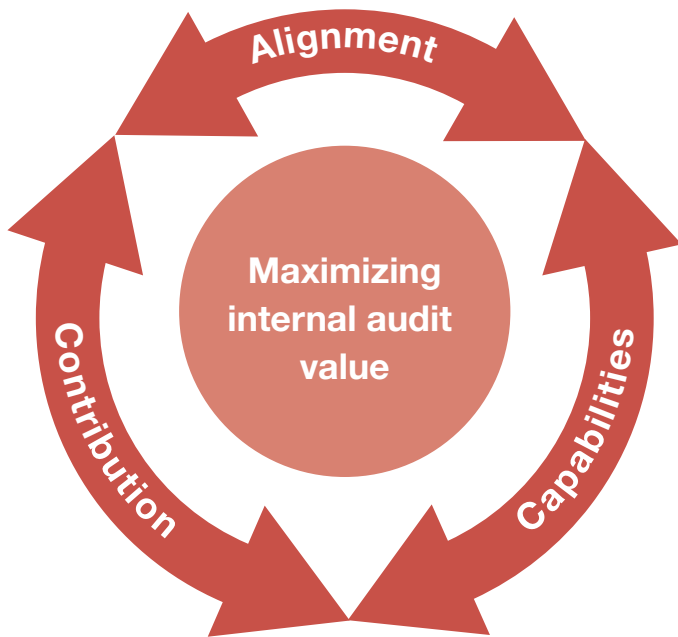
In this time of increasing risk, our research identified three significant issues affecting many internal audit departments’ ability to deliver more value.

- **Management and board members are not aligned on their perception of internal audit’s value and performance, and it appears as if board members may be settling for too little.** A far greater percentage of board members than management believe internal audit contributes significant value—by a 35-point margin. While board members rated internal audit’s value contribution as high, they rated the function’s performance in core attributes, such as promoting quality improvement, much lower, indicating they have relatively low expectations of their internal audit function.

- **The foundational capabilities of internal audit may not be strong enough to deliver today’s work nor secure enough to build upon to generate greater value.** As companies raise the bar on their own performance to contend with the ever-changing risk landscape and the greater regulatory and stakeholder expectations placed on them, they’re not raising the bar on internal audit at the same pace. Our data indicates that as functions struggle to excel at eight core attributes (see Figure 4, page 9), their ability to deliver the appropriate level of value to their organizations is limited.
- **Internal audit continues to struggle in maximizing the impact of its contribution, particularly in areas outside of its more traditional focus.** Stakeholders are least satisfied with internal audit’s contribution in emerging risk areas, such as large program assessment, new product introductions, capital project management, and mergers and acquisitions. While internal audit had actually increased its focus in many of these areas over the past 12 months, it has not always met expectations.

1 <http://www.alisonlevine.com/Leadership/>

Figure 1: The circular nature of internal audit's challenges



The issues of stakeholder misalignment, a challenged capability foundation and sub-optimal internal audit contribution are tightly interwoven. Each affects and is affected by the others (Figure 1). When taken in aggregate, these challenges identify the need for internal audit to embark on an aggressive journey to break the cycle of inaction, increase its capabilities and add true value in risk areas most critical to the organization. Without preparing a plan and climbing to new heights, internal audit runs the risk of becoming a marginalized function without the ability to play a significant role in the organization's overall risk management infrastructure.

Preparing for the journey

Our research shows that high-performing internal audit functions have journeyed to new heights and are perceived by their stakeholders as extremely relevant. These audit functions perform significantly stronger on core attributes and exhibit different behaviors from their peer group—notable differences that are necessary for achieving a level of performance that keeps them relevant and valued by their enterprise. Specifically, high-performing internal audit functions stand out in four areas. They:

- **Demonstrate significantly stronger foundational capabilities** that far exceed others' performance on core internal audit performance attributes. With strong capabilities, they have a solid foundation on which to take incremental steps up the value chain.

- **Coordinate with their organization's governance, risk and compliance activities**, improving the likelihood that risks are well covered across the lines of defense and resulting in greater satisfaction with how well risks are managed.
- **Incorporate emerging risk more effectively into audit areas**, enabling internal audit to see problems sooner, add value early and stay engaged to add value throughout.
- **Partner with those they serve** by providing proactive advice and insights and actively engaging with management in organizational initiatives.

In essence, high-performing internal audit functions have strong capabilities that form their foundation as assurance providers, enabling them to deliver more value and providing them the solid ground from which to move toward a trusted advisor role.

Audit committee members and management must think hard about what they require from internal audit, while chief audit executives (CAEs) must determine the appropriate internal audit strategy to

deliver against those requirements. Organizations that expect internal audit to play a more expansive role must be confident the function has the right capabilities and approach to succeed in the journey. Conversely, organizations that maintain more traditional expectations for internal audit should reflect on whether that's a purposeful decision based on the needs of the business, or one made by default or lack of options. But even in the latter case, internal audit functions must add value beyond just reporting audit findings.

At some level, all constituents must do their part to help internal audit break the cycle of responding to multiple and often competing expectations; auditing to their capabilities versus the risk profile of the company, and struggling to build the capabilities required to keep pace with the growing and changing risk environment. Audit committee members must ask more questions and reevaluate their criteria for satisfaction with the value internal audit is delivering. Management must expect more. And CAEs must step up and deliver more. Only then will internal audit be able to reach greater heights and help their organizations move toward more effective management of risks.

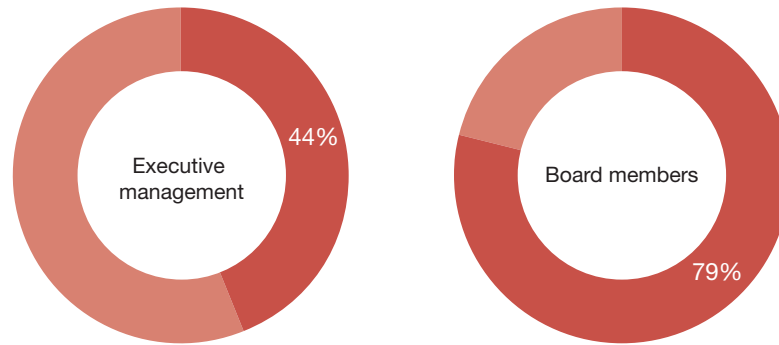
Our research shows that high-performing internal audit functions are demonstrating attributes and behaviors that are distinctly different than those of their peer group.

An in-depth discussion

Examining the issues

Figure 2: Stakeholders are not aligned on the value of internal audit

Considering your investment in internal audit resources and funding, please rate the value you receive from your internal audit function.



Percent of respondents indicating internal audit contributes significant value

For nine consecutive years, PwC has conducted a comprehensive research study examining the state of the internal audit profession to help organizations address common challenges and keep pace with the escalating demands on the profession. Recognizing the increased need for internal audit functions to contribute more meaningfully to their organizations' risk management capabilities, we felt it was critical to include board members and executive management in our research yet again for our 2013 study.

Nearly 1,100 CAEs and more than 630 stakeholders (CEOs, audit committee chairs, other board members, and senior finance and risk managers) representing 18 industries and 60 countries participated in PwC's 2013 State of the Internal Audit Profession study. These individuals contributed their views on today's critical risks, the role they expect internal audit to play in addressing them, and the performance of their enterprise's internal audit function. Building on our prior research, this year we pinpointed the specific attributes and behaviors of the internal audit functions that contribute the most significant value to their organizations. This data produced substantial insight into what specific actions these organizations are taking to increase internal audit's performance and contribution. To gain even deeper

insights on stakeholder expectations and internal audit's response, PwC's teams also conducted one-on-one interviews with more than 140 stakeholders and CAEs across North America, Europe, Australia and Asia (see Appendix: Research Demographics).

Any organization reaching for new internal audit heights must study the data, chart a course, and prepare in advance of taking action. In this section of the report, we begin that process by examining three significant issues that are affecting internal audit's ability to maximize its performance. We first discuss the lack of alignment between two stakeholder groups—executive management (including CEOs, CFOs and senior finance and risk managers) and board members (primarily audit committee chairs and members)—on their perceptions of internal audit value and performance. We then examine the strength of internal audit capabilities to make the journey to new heights. Finally, we explore the contributions internal audit makes to the enterprise's efforts to manage critical and emerging risks.

Stakeholder misalignment

Our comprehensive outside-in look at the internal audit profession reveals that different stakeholders hold vastly different opinions on internal audit as well as on their organization's risk management capabilities. This misalignment is especially evident in their views of internal audit value and performance, and of which risks are most critical for internal audit coverage.

Internal audit value and performance

Management and board members have different perceptions of internal audit value and performance. As illustrated in Figure 2, PwC's research found a far greater percentage of board members than management believes internal audit contributes significant value—by a 35-point margin.

Our discussions with stakeholders and CAEs, coupled with our years of experience working with a variety of internal audit functions, have consistently identified eight core attributes that are critical to internal audit establishing the right foundation to deliver value, regardless of scope or size (Figure 3). These eight attributes, introduced by PwC three years ago, are the foundation of the new floor from which internal audit must build. This year's

Our study produced significant information beyond what is presented in this report. To view additional data and sector perspectives, please visit www.pwc.com/us/2013internalauditstudy

Figure 3: Stakeholders are not aligned on how well internal audit is performing

How well is internal audit performing in each of the following areas?



On average, 56 percent of board members rated internal audit's performance as strong, compared with 37 percent of management

research confirmed not only that these attributes remain the core of the foundation, but that strong performance against the attributes in fact resulted in stakeholders receiving greater value from internal audit.

On average, across all eight of the attributes, 56 percent of board members and 37 percent of management rated internal audit's performance as strong. These figures suggest internal audit's performance is far from stellar and must be addressed to improve the function's standing and relevance within organizations.

An equally critical insight here lies in the correlation between value and performance. Less than 50 percent of management saw internal audit as contributing significant value or performing well on any of the eight core attributes that are the necessary foundation of an internal audit function. While this management view is far from positive, at least there is a relationship between perceived value and

performance. That is not the case with board members, who rated internal audit's value contribution high yet rated its performance in core capabilities much lower, indicating they appear satisfied with average performance. If this disconnect persists, internal audit's value to the organization may very well be minimized in the eyes of the board.

Management, who are closer to internal audit's day-to-day activities, clearly want more from internal audit than the function is currently delivering. Interestingly, across most attributes, CAE responses fall between management and board members in their assessment of their own performance—an acknowledgement of the cracks in the function's foundation. On average, 48 percent of CAEs rated internal audit performance as strong. As we will discuss later in the report, some stakeholders with high expectations are gaining value from internal audit, and those internal audit functions have strong foundations from which to deliver.

Managing the most critical risks

According to our research, organizations have much work to do to align stakeholders' thinking on coverage of critical risks. Overall, compared with management, board members consider the risks we surveyed them about to be more critical to the organization, and to pose an increasing level of threat. (See Appendix: Critical risks). Furthermore, board members view the effectiveness of their organization's risk management more favorably than management or CAEs do.

The significant difference in views on the criticality and management of risks is a symptom of a lack of alignment on how risks are assessed, monitored and managed. Misalignment creates potential exposure if some risks receive too little or the wrong focus, and creates inefficiency if other risks receive too much focus. It also creates confusion for internal audit, making it more likely their efforts are not properly addressing the risks most critical to the organization.

Figure 4: Internal audit performance on three core capabilities is particularly lagging

How well is internal audit performing in each of the following areas?



Considering both stakeholder misalignment on value and performance and the increasing risk landscape, we believe a key message our research delivers is this: Companies' management, board and internal audit should have candid conversations about the value internal audit is delivering, the areas on which it should be focusing and the specific contributions it should be making to help monitor the organization's risk profile. Clearly laying out and agreeing on how value is defined and what expectations for value stakeholders have is essential to setting the foundation for an effective internal audit function and a more holistic and effective risk management approach.

Internal audit capabilities

Despite misalignment between the board and management, stakeholders agree there are crevices to navigate and cracks in the internal audit foundation that must be fixed for internal audit to truly deliver value. We believe eight core attributes are the foundation of

the rising floor that will allow internal audit to provide assurance on a broader range of critical risks and clearly communicate deeper insights. Rising with the new floor takes deliberate action, yet our survey this year showed most internal audit functions have significant opportunity to fortify their core capabilities: As shown in Figure 4, fewer than 60% of respondents rated their internal audit functions as performing well or very well on any of the eight core attributes.

In particular, three aspects of internal audit's performance showed the greatest opportunity of improvement, even in organizations that reported internal audit contributed significant value (Figure 4):

- Promoting quality improvement and innovation
- Leveraging technology such as automation, data and advanced analytics
- Obtaining, training and sourcing the right talent to match the organization's risk profile

"A board has different objectives than management and should have different objectives. What does a CAE do about it? Make sure you have good enough relationships with both to understand those expectations. All perspectives must be understood. A confident, courageous CAE who spends the time building the relationships can negotiate a middle ground that will meet the goals of both board and management in the long run."

— Paul Sobel, CAE,
Georgia-Pacific

“It is critical that every audit observation is clear about the business impact. The difficulty, from a leadership standpoint, is to develop less experienced staff members’ business acumen.”

—Keith Tandowsky,
Vice President Internal
Audit, Clorox

Promoting quality improvement and innovation

Our data shows that more CAEs than board members and management believe their internal audit functions promote quality improvement and innovation. Forty-five percent of CAEs, compared with only 28 percent of management and 42 percent of board members, believe they are doing well in this area (Figure 3). What is remarkable about this data is the inverse of these findings: 55 percent of CAEs, 58 percent of audit committee members and 72 percent of management do not believe that internal audit is promoting quality improvement and innovation. These findings further illustrate the questions surrounding the board’s expectations of internal audit. How can almost 80 percent of board members report that internal audit contributes significant value, yet more than half indicate internal audit does not perform well on something as fundamental as promoting quality improvements?

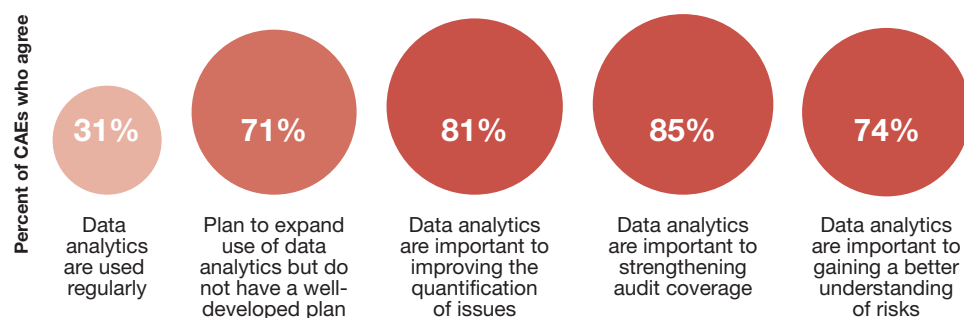
A major concern senior executives expressed during our interviews is that internal audit does not understand

the root causes when making quality improvement recommendations. Too often, they say, internal audit staff develop recommendations but do not have the experience to bring a perspective of proven and leading practices. We found that higher-performing internal audit functions have navigated through this problem by embracing sourcing options and leveraging external subject matter expertise. By bringing in specialized resources with deeper experience, they have improved the insights they provide and have more consistently delivered innovative solutions to address the business issues at hand. This approach has also enabled these internal audit functions to audit to the organizations’ risk profiles rather than to their own capabilities, delivering the value stakeholders expect.

Leveraging technology

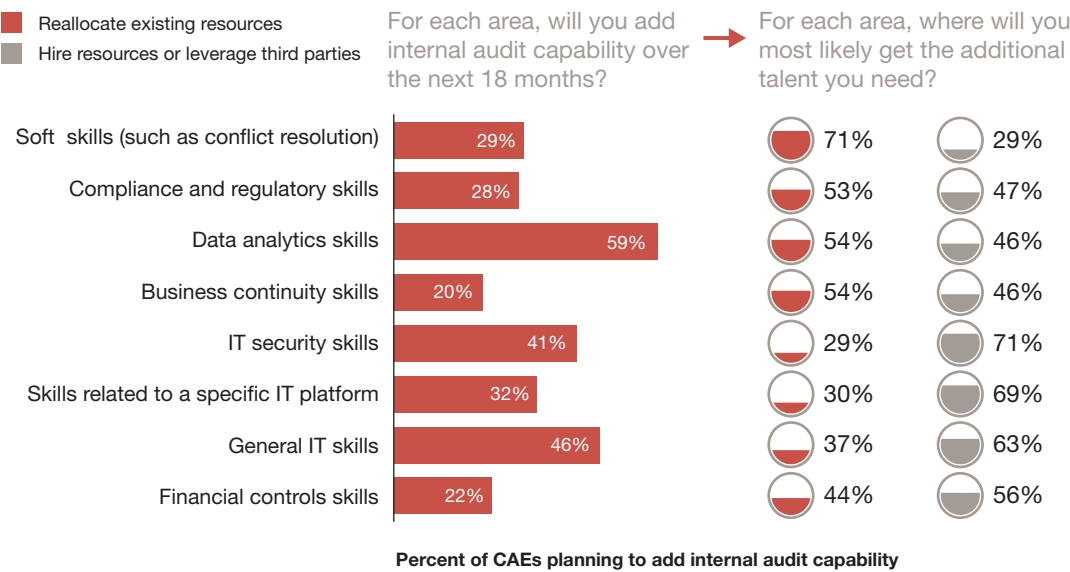
Technology has emerged as a key enabler for internal audit to improve audit quality and value while remaining cost-effective. One of the fundamental ways internal audit can leverage technology is through data analytics.

Figure 5: CAE thoughts on use of analytics by internal audit



The continued evolution of data analytics provides auditors the opportunity to look at trends or patterns in the business and highlight unseen risks, areas of control effectiveness or possible areas of control weakness. Analytics are increasingly helping auditors align their internal audit effort with riskier business areas, while also providing efficiency in testing through automation. When properly

Figure 6: Where internal audit functions will get the talent they need



implemented, data analytics can provide deep and persuasive intelligence on business issues and provide a powerful means for presenting audit observations and recommendations using impactful visualizations and supporting metrics. As appropriate, the analytics can be refreshed to evaluate improvement and remediation efforts over time.

As illustrated in Figure 5, companies in our survey appear to recognize the importance of analytics to the internal audit function. However, the findings also illustrate that companies appear thus far to be lagging in the use of these valuable tools. Only 31 percent use data analytics regularly, and among those who intend to expand the use of analytics, 71 percent lack a well-developed plan to do so. CAEs reported that the biggest barriers to the integration of analytics are an inefficient data collection process (cited by 48 percent) and finding the capabilities and resources to support their vision and desired future state (46 percent).

Obtaining, training and sourcing the right talent

Promoting quality improvement and leveraging technology to make audits more robust are steps internal audit functions must take to improve their contribution to the organization. To do this, as well as to raise performance in all of the other attributes, internal audit must have the right people. The right resources are critical to the strength of internal audit’s foundation, and are prerequisites for improving internal audit’s performance and expanding its scope to provide assurance on a broader range of critical risks.

The low performance scores in the area of obtaining talent indicate that resourcing must be addressed first, as functions cannot build upon their foundation and take on greater challenges without the right people. Just one-third of overall respondents said internal audit was doing well in sourcing and training the right level of talent. Furthermore, stakeholders cited lack of expertise, lack of enough talent and lack of the right kind of talent among the top barriers to improving internal audit performance. CAEs see the need to add talent and many/most plan to do so (Figure 6).

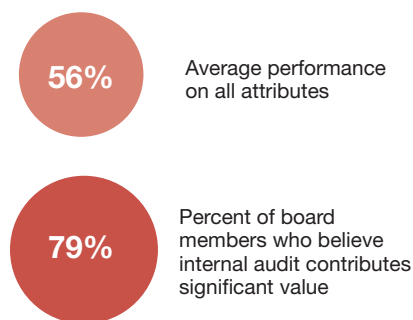
“We should be asking internal audit how to more effectively use our resources, how to make internal audit the right size and optimized, and how to create the most value leveraging technology. Leveraging technology is a key area of focus.”

—CFO, a North American utility company

“Internal Audit no longer just means mere interpretation of past existing data. The actual required skill is when auditors go beyond the existing data available and seek out ‘hypothetical’ data for analysis in anticipation of emerging trends, which delights the internal customers we work with and makes them appreciate our work.”

—S. Bhaskar, CAE, TATA Capital

Figure 7: The gap between performance and value perception



The question to stakeholders is whether that plan aligns to the organization's risk areas. The low assessment of internal audit's ability to promote quality improvement and innovation indicates the need to add resources with industry and technical expertise to deliver quality in both traditional areas as well as more emerging areas.

In summary, across the core internal audit attributes, our data indicates the foundational capabilities of many internal audit functions are not strong enough to add sufficient value in all of today's areas of risk. And, if the gap between stakeholders' perceptions of value and performance is not closed, internal audit risks becoming marginalized (Figure 7).

Internal audit contribution

For internal audit to be most effective, it must build capabilities to meet higher expectations. Our data also revealed a closely related issue: Internal audit continues to struggle to maximize its impact, particularly in areas outside of the function's traditional focus.

Our research indicates stakeholders are *most* satisfied with internal audit's contribution in traditional coverage areas such as financial controls and fraud and ethics. They are *least* satisfied

with internal audit's contribution in less-traditional areas such as large program assessment, new product introductions, capital project management, and mergers and acquisitions. One of the most concerning findings from our survey was that for three of the top four areas where stakeholders are least satisfied, internal audit had substantially increased its focus in the past 12 months, from which it can be concluded that internal audit tried but is not fully delivering (Figure 8).

Consider new product introductions, for example. In our 2012 study, stakeholders said this was an area receiving too little attention from internal audit and one where the function should add capacity. Many internal audit functions responded: Our current study showed that, among those organizations that see new product introductions as an increasing threat, half increased internal audit involvement in the past 12 months. Nonetheless, new product introductions still ranks as an area in which stakeholders are least satisfied with internal audit's contribution. This same scenario holds true for mergers and acquisitions support and large program assessments, indicating that stakeholders' expectations of internal audit involvement or anticipated value were not met.

Figure 8: Areas of greater involvement but least satisfaction

Survey respondents were asked to rank their top three areas of least satisfaction with internal audit



* Respondents = subset of total who reported the risk presented more of a threat in the next year than in the past year

While some of these areas are slightly outside of the traditional audit scope, they are nonetheless tangible, auditable and important areas for internal audit's involvement. But internal audit must seize the opportunity and get it right. With low performance in promoting quality improvement and talent sourcing, internal audit will find it difficult to move into new and emerging risk areas and perform well. Internal audit can break this cycle by acquiring and leveraging the appropriate talent to add quality and value, one audit at a time.

Our interviews demonstrated many cases where internal audit had successfully created the capacity to move into new risk areas. For example, Michelle Stillman, Vice-President, Internal Audit of Hewlett-Packard, said her internal audit team is "moving away from a historical coverage model with a heavy emphasis on validating mature controls and processes to a risk-based model that gives us the ability to consider emerging risks and processes, which may be a more valuable use of our time."

The combination of the board's overly optimistic perception of internal audit value, a shortfall in internal audit capabilities and limited internal audit contribution should serve as a wake-up call for all constituents. These three issues are tightly interwoven, each affecting the success of the other. In most organizations, internal audit must substantially improve its performance or risk evolving into irrelevance as other risk functions contribute more to the organization's risk management. However, internal audit functions that are perceived by stakeholders as high performing have successfully broken the cycle and are able to contribute more effectively to their organization's ability to manage risk—which in turn delivers greater value.

"The business sees internal audit's value in assurance over protecting company assets. There are now opportunities to go up the value chain. We have started and are making steady progress."

—Per-Olof Ahlstrom, Group Head of Risk and Assurance, TT Electronics Plc

“The environment will remain challenging. Internal audit needs to step up and come out of the compliance mode. Internal audit needs to be strong, ask difficult questions from management and seek answers.”

—Vali Nijhawan, Audit Committee Chair, Aircel Limited

The opportunity

Internal audit functions have a tremendous opportunity to reach new heights and increase the value they bring to their organizations. Our interviews and survey data indicate that audit committees and management are asking more from internal audit, and CAEs have the responsibility to respond. Our data shows that high-performing internal audit functions behave differently, exhibit markedly stronger performance on eight core attributes and deliver distinctly different levels of service. This demonstrates these attributes and behaviors are not “nice to have.” Instead, they are necessary to ensure internal audit achieves a level of performance that keeps the function relevant and in a valued position. For these organizations, their relevance is earned through consistent contribution. These high-performing internal audit functions provide a benchmark for others, showing how they can address the opportunity in their own organizations and close the gap between what stakeholders want and what internal audit is delivering.

Defining the new height

In our research, a subset of organizations represented by 5 percent of the respondent base stood out as “high performing” in that they manage risks extremely well and have internal audit functions that deliver significant value. High-performing internal audit functions stood out from others on a

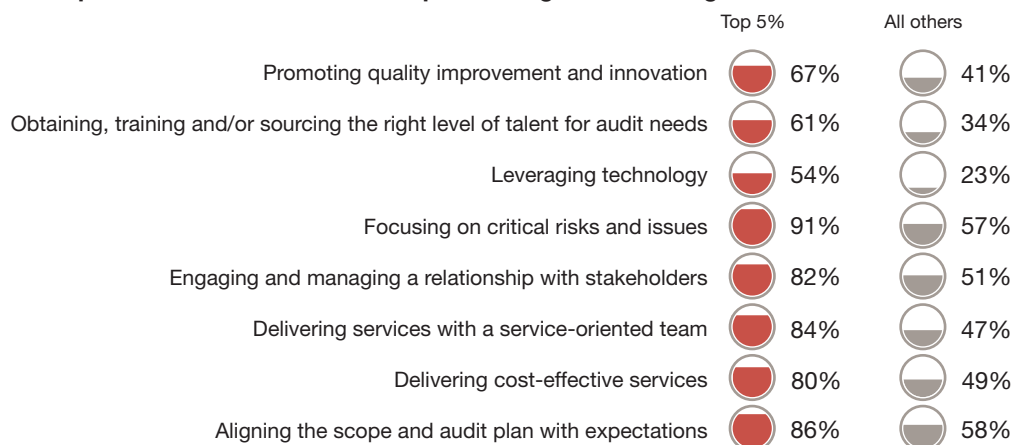
number of fronts, from the services they offer to the risks they address to the capabilities that enable their strong performance. (See Figure 9: Profile of the top 5 percent.) In particular, the internal audit functions performing at a high level are different in four important areas:

- **Stronger foundational capabilities**—High-performing internal audit departments get the fundamentals right and far exceed others’ performance on the eight core attributes discussed earlier. With strong capabilities, they have a solid foundation on which to take incremental steps up the value chain. Getting the fundamentals right gives internal audit the credibility and bandwidth to keep pace with a greater risk landscape and rising stakeholder expectations.
- **Coordination with ERM and other risk functions**—High-performing internal audit functions also have a far greater level of integration with enterprise risk management and other risk functions—by a 25-point margin. This integration helps internal audit see problems sooner as they engage in emerging risks, add value early and stay engaged to add value throughout.
- **Coverage of emerging risk**—High-performing internal audit functions also more often incorporate emerging risk into audit areas. In fact, our survey found notable differences between these and other types of internal audit functions in how extensively they were involved in risks such as cyber security, environmental regulations, talent reviews and industry-specific risks.

- **Higher level of service**—Finally, high-performing internal audit functions provide a distinctly different level of service by going beyond just providing assurance or validating the known. They provide proactive advice and insights, and actively engage management in traditional areas. Proactive advice can come in the form of advice to improve financial controls or it may simply be about when they deliver the advice, such as earlier in the process when it is easier and less costly to make improvements and adjustments. Many also provide these same services in more strategic and operational areas—but they are doing so with deeper skills, use of analytics, stronger alignment, and a more informed perspective on risk. Microsoft follows this proactive approach to auditing according to CAE Melvin Flowers. “We have taken a proactive approach to auditing, he commented. “The quicker we can get in and identify risks and concerns the quicker the business can respond. We spend a lot of time looking at future P&Ls, not just current ones.”

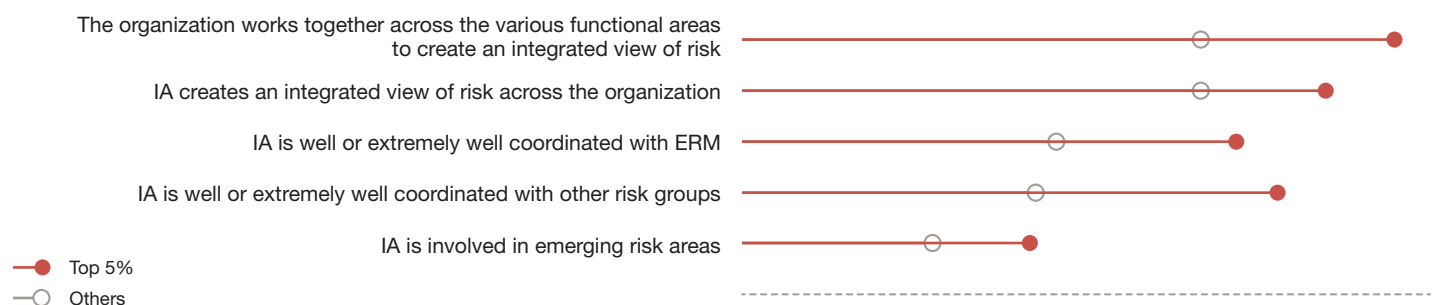
Figure 9: Profile of the top 5 percent

The top internal audit functions are performing at a much higher level on core attributes

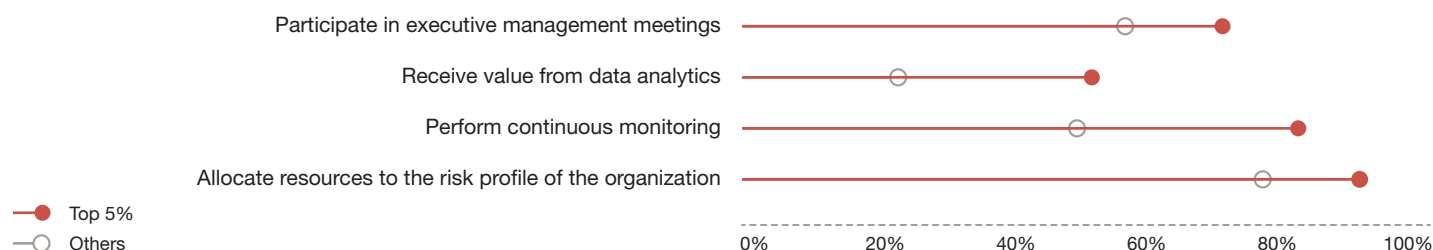


Percentage of respondents who responded that internal audit was performing well

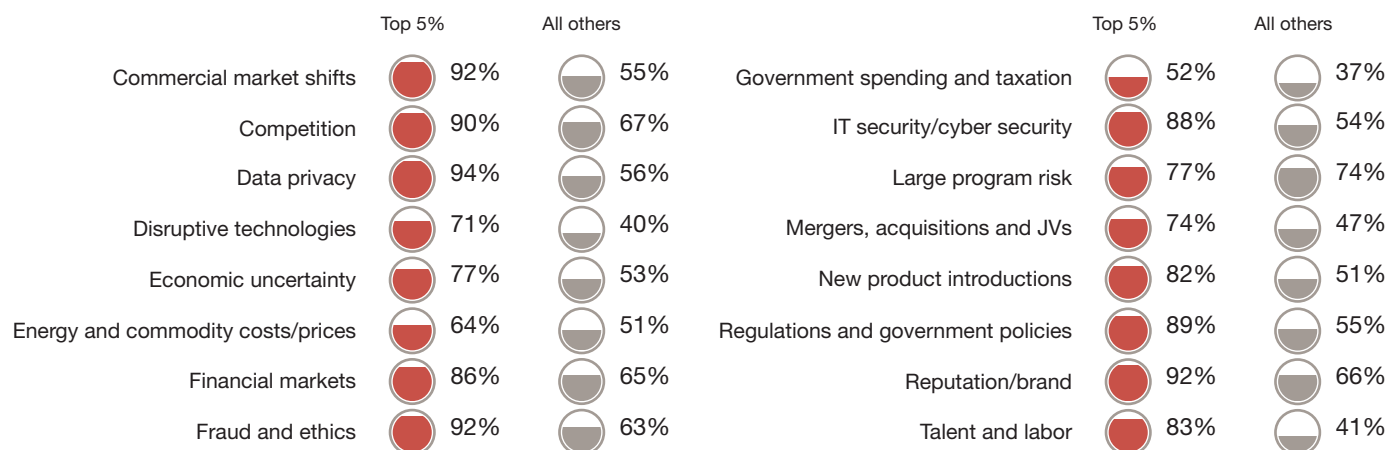
Organizations with high-performing internal audit functions are better aligned on risks



The top internal audit functions are doing more for their organizations



Organizations with high-performing internal audit functions manage risk better than others



Percentage of respondents who responded that each risk area is well managed.

“Stakeholders don’t understand that they can expect more. There’s an education of boards and audit committees needed. At the end of the day, basic blocking and tackling has to happen and run efficiently, but there is a lot more that audit can and should do to help you sleep better at night. As a profession we can’t afford to perform audits in a vacuum anymore. Even in companies that only value the traditional internal audit you can change the tide a bit—be more proactive, more courageous and help change the perception of internal audit across the business. CAEs have to have the courage to say what needs to be said. Having an audit committee that recognizes that more can be done is a win-win.”

—Randal Earley, Vice President–Audit Services, Cox Enterprises

Preparing for the journey

There are many paths to reaching greater heights and the journey will be unique to each company. Stakeholders participating in our research each have different risk profiles and expectations for their internal audit functions; however, regardless of expectations, there was consistency in what stakeholders viewed as a high-performing function that delivers value to the organization.

Through our research and first-hand experience, we know that internal audit functions can provide value across a spectrum of delivery approaches—from assurance provider to trusted advisor (Figure 10). Stakeholders can find value from internal audit functions across this continuum, but our research indicates that there is unrealized value to be obtained by moving up the continuum—provided stakeholders are aligned on this expectation and internal audit has the capabilities to deliver.

- **Assurance provider**—A fundamental role of internal audit is to be an assurance provider, delivering objective assurance of the effectiveness of organizations’ internal controls.
- **Problem solver**—Problem-solving internal audit functions are leveraging expertise and technology-enabled analysis to identify root causes to help management understand and solve specific issues. They also are more integrated with

other risk management functions in the organization to ensure risks are well managed.

- **Insight generator**—Insight generators take things a step further by developing deeper perspectives and options for how to solve problems, being more proactive about suggesting meaningful improvements, leveraging more subject matter expertise and considering other implications outside of the problem.
- **Trusted advisor**—Functions considered trusted advisors leverage their consistently strong delivery and resulting brand strength to provide a higher level of engagement and timely, proactive advice on both current and future problems. They are an advisor to executives and others early in initiatives and partner with the business throughout the course of projects by providing relevant, timely advice. At organizations where internal audit has achieved this status, executives rarely make critical decisions without considering the function’s input.

In every case, internal audit functions must deliver world-class assurance over all areas of critical risk management and control. The role of assurance provider is mandatory, but leading-class functions build on the assurance foundation and grow into roles that allow them to add value beyond audit observations, without impairing their objectivity. Regardless of where internal audit is focused, they

“Findings from internal audits should be commercial, strategic and make business sense. Good internal auditors can join the dots and express their intuition without “hard facts” and “all the evidence.”

—Peter Marriott, Chair of the Audit and Risk Committee, Australian Stock Exchange (ASX)

must present a point of view on how the company can improve. They also must be able to provide insight into related risks and emerging risks, as well as tangible, implementable recommendations on how to address the same risk in the future. This is a baseline expectation, but one that not all functions are meeting.

If you expect internal audit to journey towards trusted advisor status

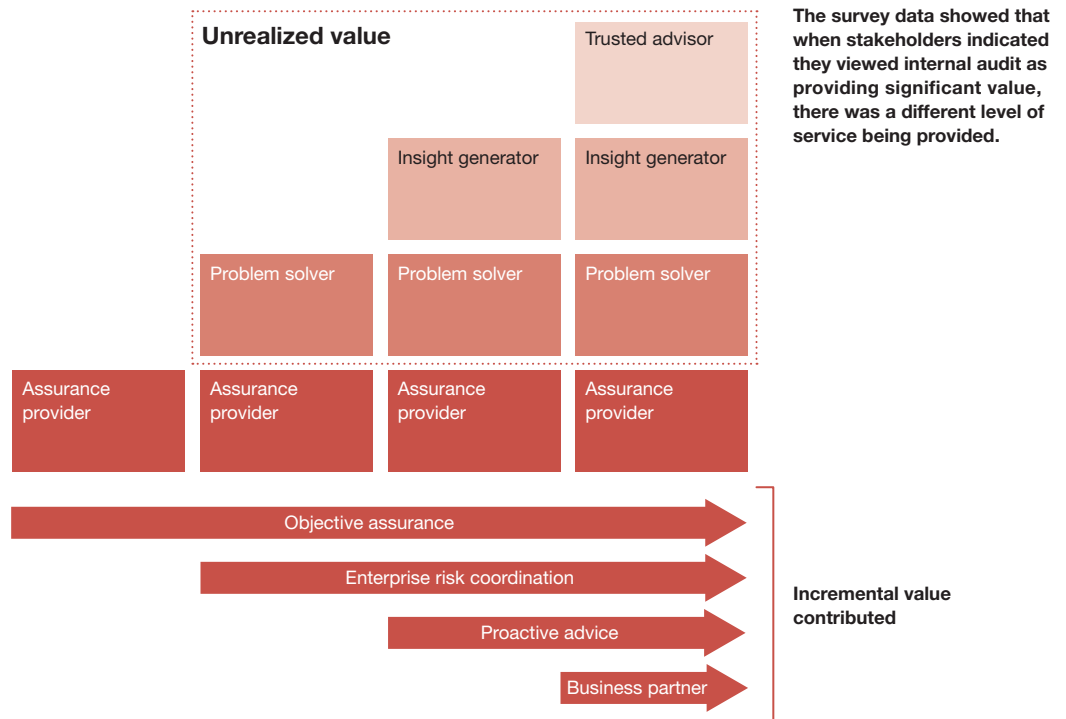
Organizations that expect more from internal audit than the function is currently delivering should recognize that the path to reach greater heights

is challenging and requires preparation, but the journey is meaningful. It requires thoughtful consideration of how internal audit is equipped and resourced and how it delivers its services. We know from our research that with the right capabilities and approach, internal audit can deliver and be viewed by stakeholders as highly relevant and a trusted advisor. Clare Brady, Vice President and Auditor General of the World Bank, affirmed the importance of being a trusted advisor. “I believe being a trusted advisor is a role internal audit should play,” she said. “It should not just be the CAE though; it needs to

happen at all levels within internal audit which is sometimes difficult. You need to be both assurance provider and trusted advisor and you can’t become a trusted advisor without the knowledge gained from the assurance provider role. The new generation can help make this trusted advisor role happen if we don’t stifle the innovation within internal audit.”

In these organizations, internal audit has earned the role of trusted advisor by first bringing the right people and abilities to provide quality and value, and as a result, becoming more valued. It is a planned progression. Each effort

Figure 10: Unrealized value for internal audit to claim



“Audit committees and management expect more from internal audit, providing a huge opportunity for internal audit functions to be a relevant contributor to protecting stakeholder value and the business from the most critical risks.”

—Jason Pett, PwC Partner and US Internal Audit Leader

must be done well to take the next step, and the previous steps should serve as a foundation on which internal audit can ascend. Internal audit must be aligned with the audit committee and management on where its role is headed, but it also must start with the most relevant, specific actions, in the proper sequence, to make a difference. Having the appropriate talent to take each step is a prerequisite, and leading companies are not deterred if required skills do not exist within internal audit. Like their business counterparts, internal audit leaders find the resources they need to achieve the expectations set by their stakeholders.

If you expect internal audit to deliver greater value in a more traditional role

Our research also shows us that not all organizations have set their sights on moving internal audit to trusted advisor status. Some are just expecting greater value from the more traditional assurance provider role. It is critical that organizations are intentional in their planned and desired scope of internal audit focus and that organizations are not simply comfortable with the status quo based on only moderate expectations of internal audit or acceptance of the current state of capabilities.

Consider the service currently being delivered by internal audit. Our research shows that high-performing internal audit functions provide a higher level of service in the traditional areas in which they are involved—promoting quality improvement ideas and proactive advice as a foundational prerequisite in every area of focus. The point is, an internal audit function does not necessarily have to expand outside its traditional areas to be more valuable. Even one that is focused on traditional areas can deliver much greater value by expanding the nature of its contribution—providing recommendations that move beyond the observation, providing root cause analysis and forward-looking recommendations and, in many cases, leveraging data to drive efficiency in execution and generate insights beyond assessing control effectiveness.

If internal audit is indeed maximizing its contribution in traditional areas, consider if it makes sense to begin the journey toward problem solver and possibly even insight generator. Internal audit functions that are providing distinctive service in traditional areas have built the foundation necessary to expand to provide the same service delivery model to new areas, thus generating even more value. This requires a realization by stakeholders that other organizations are getting value by using internal audit in these expanded ways, and that they, too, can ask for more.

Challenges that will arise

As companies look to protect themselves from an expanded risk landscape, internal audit can provide a much more meaningful contribution. The good news is that companies want internal audit to be an important team member—and are maintaining or even increasing their commitment to the internal audit function. Indeed, 8 in 10 CAEs in our survey said their budgets in the next 12 months will be the same as or greater than their budgets in 2012. Of course, stakeholders want a superior return on that investment, and that means internal audit must find ways to increase the value they deliver to the enterprise.

The challenge for CAEs is to boost the benefits internal audit generates by breaking out of the cycle of misaligned expectations, challenged internal audit capabilities and sub-optimal contribution that keeps them from furthering their journey. For example, stakeholders’ lack of alignment on internal audit’s role, expectations and value generated creates challenges for internal audit as regards planning their audit focus areas. If stakeholders aren’t aligned in their expectations, internal audit will find it challenging to build the right capabilities and contribute positively. Similarly, an internal audit function without the appropriate skills and capabilities will struggle to contribute to new risk areas and maximize its value to the organization. And if internal audit lacks

the right capabilities and history of valued contribution, management and the board may not agree on where the function should be positioned within the organization.

CAEs who do “more of the same” won’t increase their value or that of their internal audit functions. Our research shows that internal audit functions that target their investment toward improving performance along the eight core attributes and in the most relevant areas of risk facing their organizations can break the cycle.

As CAEs spend wisely, they must also communicate well and work toward alignment on goals. The vice president of internal audit at a global technology company relayed his recent experience moving out of the internal audit “box,” and confirmed that the journey isn’t easy. His internal audit based its audit plan on the enterprise’s global risk assessment, which included areas such as strategic planning, product quality and product Research and Development (R&D). Because audit committee members were unfamiliar with seeing enterprise risks on the audit plan, they raised concerns that internal audit would overstep its bounds and take on risk management responsibilities beyond its mandate. The CAE reflected on his original presentation of his planned change in course for internal audit and recognized that better communication regarding the path forward was needed to gain alignment on expectations from the board. Once he stepped back and considered the board’s concerns, he improved his

communication by providing more details about the steps he had taken to develop this planned path forward. An example of this improved communication related to product R&D, which was a critical enterprise risk. The organization had identified a risk that cost estimates for investments were not rigorous enough to support decisions. The CAE felt this was an ideal area for internal audit to include in its plan, evaluating the costing models used and the organization’s overall compliance to its costing processes. Once he clarified the scope of what internal audit planned to cover, he was able to gain alignment on his overall approach.

As we consider this example, an important lesson can be learned by all: CAEs must meet the audit committee where they are in their thinking and take them along on the journey by communicating clearly, assuring them that internal audit can deliver, and then executing with the right capabilities to add value.

Study the data, chart the course, prepare in advance and take action

Internal audit functions that take the right specific actions supported by the right resources and capabilities, and are aligned with what stakeholders expect, will be recognized for their contribution. They will see increased access within the organization, and increased opportunities to demonstrate value and move toward trusted advisor status. As a result, they will reach greater heights and multiply the value internal audit delivers.

“The number of requests we get from people asking internal audit to do special projects and provide insights is a barometer of how much management is trusting the information we give them and values what we are doing.”

—Jayne Donahue, Executive Vice President and General Auditor of State Street Corporation

What this means for your business

The path forward

“There are risks and costs to a program of action, but they are far less than the long-range risks and costs of comfortable inaction.”

— John F. Kennedy

Scaling new heights takes a well-thought-out plan and a well-charted route. To help you prepare for the journey, we have outlined suggested approaches for each stakeholder—audit committee member, management and the chief audit executives—to enhance the value that internal audit can and should deliver to the organization.

Audit committee: Ask more questions

Most board audit committees consider oversight of risk management to be a primary responsibility. To ensure their management teams and internal auditors are engaged effectively to meet this objective, audit committee members have to challenge themselves to ask more and often tougher questions.

- **Ask yourself if the expectations you have set for internal audit are clear enough and high enough.**

Most audit committee members see value in internal audit yet do not consider the function’s performance to be strong in several critical performance areas, including the fundamental area of promoting quality improvements and innovation. Board members see internal audit lagging in the use of technology, which enables much greater coverage and provides significant insights. Additionally, internal audit’s ability to acquire and use the right talent is not seen as particularly strong. Considering these factors, along with management’s generally much lower opinion of internal audit’s value, ask yourself if you and the rest of the board are

expecting enough of internal audit and if you are taking the right steps to hold the function accountable to those expectations.

- **Ask if critical business risk coverage is aligned with your views on risk.** You should ensure that internal audit’s actions are aligned against the most critical risks, that its resources are allocated effectively and that gaps in coverage are closed. Ask how key business risks are addressed by internal audit in the context of the organization’s aggregate risk coverage. Ask this of internal audit from two perspectives: To what extent is the function addressing this in its current internal audit plans, and are the function’s short- and long-term strategies contemplating this. Consider whether there may be an area of exposure the audit committee wants internal audit to investigate or an area that already has multiple resources involved and does not need as much internal audit coverage.
- **Ask if internal audit has a strategic plan and the resources it needs to deliver value.** Further reflection is necessary regarding whether internal audit has the ability to plan and the capabilities to deliver. Consider whether expecting more from your organization’s internal audit function is warranted and, if so, what internal audit must do to meet those higher expectations. Ask how internal audit performs against leading practices. The three most common underperforming attributes are (1) having the

right talent, (2) leveraging technology and (3) promoting quality improvements and innovation. Start there.

- **Ask if the audit committee is enabling internal audit to be what it should be.** Consider if you are holding internal audit (and management to the extent needed) accountable for progress. Establish criteria to evaluate and monitor progress through key performance indicators. Incremental investment should not be used to do more of the same; internal audit should focus on the areas our research has identified as attributes of value-adding functions.

Management: Expect more

Because management consists of many constituents with very different roles and responsibilities (CROs, CFOs, COOs, Controllers, etc.), you are the hardest group in which to build consensus on internal audit expectations and performance. Though you may lack the direct ability to influence internal audit’s plan or performance, each of you is likely to have a perspective on what the function should be doing. Are you comfortable with the contribution internal audit is making to the enterprise? If not—and clearly many of you are not—are you taking action to address this? The challenge to management is this:

- **Expect internal audit to perform at a higher level to bring more meaningful value to the organization.** Make sure you understand why your perceptions of internal audit’s performance differ from those of the board. Have you gone on record

“Internal audit has to be seen to be adding value. It is not a cost of compliance anymore. Internal audit has to get that mindset changed.”

—Mervyn King, Chairman of the King Committee on Corporate Governance

“This profession has a lot of upside potential but is vulnerable to the downside as well. We need thought leaders to continue to challenge the status quo and re-create what the profession can be. If we can avoid complacency and have enough creative thinkers on-board, the value internal audit can deliver and recognition that can be achieved can be far greater than it is today.”

—Paul Sobel, CAE, Georgia-Pacific

with internal audit and the audit committee about your expectations, to shed light on the clear gap that exists?

- **Expect your organization to have a strong enterprise-wide risk assessment process.** The survey results show there is work to do here. The process should consider the organization’s strategy and objectives, integrate the views of all relevant parties, and be reflective of the true risk to the organization. To that end, management should take steps to coordinate risk assessments so that management, internal audit and the board can have productive, transparent discussions on the true risks to the organization and clearly demonstrate how the company manages it. This truer view of risk will set the foundation and serve as the “North Star” to ensure there is a clear starting point from which all parties can begin to set expectations and regularly communicate with each other on where internal audit should and should not play, and on how the function is performing.
- **Expect internal audit to deliver value for investment, but also recognize the need to invest to realize value.** Internal audit must extend beyond its comfort zone, and you can help by setting expectations that demand more from the function. But you also need to ensure internal audit has the opportunity to do so. Management must make a conscious decision on whether the organization’s investment in internal audit should provide greater value and, if so, commit to a plan

that internal audit must execute. Investments of your time and financial resources are needed, as internal audit cannot do it alone. We have shown areas that internal audit must get right, so make sure the investment you provide is not spent on more of the same, but invested wisely to provide the greatest return.

- **Expect an ongoing, robust dialog with internal audit and provide candid feedback on how the function is performing.** Once expectations are set and criteria to evaluate performance are established, management must consistently provide candid feedback on how internal audit is performing. Management knows well that you are more likely to get what you measure, so to realize your investment, you need to define criteria and measure what you expect to be achieved.

Chief audit executives: Deliver more

CAEs have a significant opportunity to strengthen their foundation and take steps to climb to greater relevance and value. While stakeholders may not express greater needs, many recognize and value greater performance and contribution from internal audit. It requires knowing what you want to be and starting the journey by delivering value one step at a time. To make sure that internal audit is prepared to begin the journey, you must close performance gaps, and raise the bar on yourself—even if that means taking a risk and bringing stakeholders along.

- **Deliver high quality on the foundational areas.** Internal audit must strengthen the foundational performance areas to secure the “floor” and perform at a higher level. We continue to see that stakeholder expectations and the ever-changing risk landscape are raising the floor from which internal audit must perform; however, our data also shows that many internal audit functions need to improve their performance on the eight core attributes that are foundational to delivering effective internal audit services, before they can effectively rise to this new floor. In Figure 4 (p. 9), we’ve highlighted the three top attributes in which stakeholders consider internal audit to be underperforming. Start there, but consider the other five attributes as equally likely opportunities to improve your delivery.
- **Deliver a strategic vision that aligns to stakeholder expectations.** Make it clear to your stakeholders that you aspire to be high performing and show them how you are going to do it. Show more than an audit plan; show them the guiding principles you aspire to and will deliver against to provide the high level of performance that your stakeholders are not necessarily seeing today.
- **Deliver value for the investment.** There are very different characteristics between internal audit functions that are performing at a high level and those that are not. Make sure your investments are targeted at these proven practices. If you deploy the resources you are

given in a manner that will result in same, and in a way that’s not aligned with a clear strategy to provide a meaningful contribution, you risk losing that investment and more. A wise investment strategy includes investing in the resources you have and getting the right resources you need, whether through hiring or sourcing with third parties.

- **Deliver proactively.** We’ve encouraged the board and management to ask tougher questions and expect more of internal audit. Regardless of how and when this happens, CAEs must be prepared to respond—or even to force the conversations if they don’t arise. Many internal audit functions are in a position where average performance is valued. Someday, stakeholders will realize that average is not good enough. Get out in front of the issue so you are prepared and can show how you are raising performance or planning to do so.

There is a tremendous opportunity for internal audit to reach greater heights and contribute to the organization in a more meaningful way. Just as everyone in an expedition is responsible for helping the mission succeed, every stakeholder has a role in helping internal audit move in the right direction. Whether it is through internal audit contributing to the critical risks outside of its traditional coverage or delivering a greater level of service within those more traditional areas, the time is now for internal audit to take purposeful action to strengthen its core performance attributes and provide the valuable and relevant contributions organizations need.

“CAEs must be robust but pragmatic, have courage but diplomacy and have enough resources to do the job they are meant to do. They must come at things from a risk standpoint but have a reasonable amount within their plan for ad hoc and contingency efforts and consider what’s going on in the dynamic business environment in which they operate.”

—Jan Babiak, Audit Committee Chair, Walgreens and on other corporate boards

Appendix: Research demographics

To complete this study, PwC conducted an online survey in October and November 2012. The majority of respondents were chief audit executives, with the remainder encompassing audit committee chairs, other board members, CEOs, CFOs, chief risk officers, compliance officers and general counsel. Eighteen industries and 60 countries were represented in the survey, with no one sector representing more than 15 percent of the total sample. Participants work for companies across a distribution of company sizes; 66 percent work for public companies and 40 percent are subject to Sarbanes-Oxley regulations.

To understand the statistical trends and gain a qualitative perspective, we conducted in-depth case-study interviews with more than 140 executives

globally, comprising chief audit executives, senior executive management, audit committee chairs, board members and other stakeholders of internal audit. To further develop our qualitative perspectives, we leveraged our experience in performing internal audit services for a number of clients across a broad range of industry sectors and financial sizes.

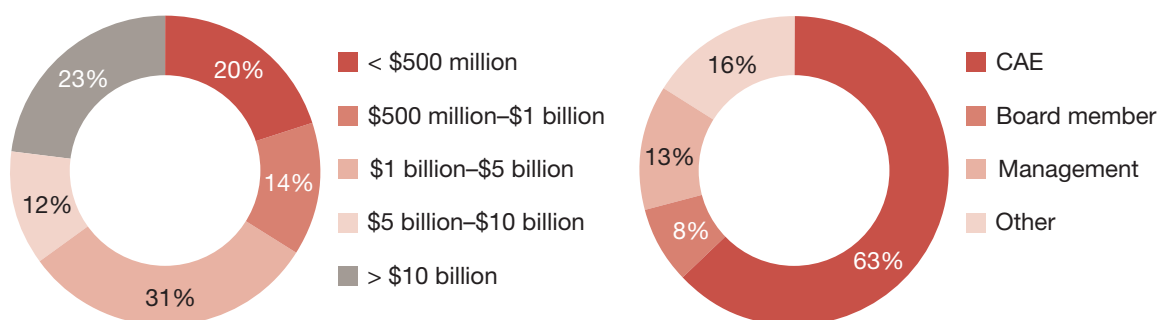
Within this report, we refer to differences between internal audit organizations that are and are not contributing significant value to their organizations. This analysis is based on stakeholder responses to the following question: “Considering your investment in internal audit resources and funding, please rate the value you receive from your internal audit function.” To develop our insights, we compared the

responses of those answering “significant value” to those answering some, little or no value.

We also reference in this report a subset of our survey respondents we deemed “high performing” or the “top 5 percent.” This is a subset of our respondents who reported they receive significant value from internal audit and believe their organization manages risk very well (on a five-point scale from very well to very poorly). This subset represents 5 percent of the total survey respondent base.

Finally, we would like to thank all of the executives who gave of their time to provide added insight to this year’s study. Their perspectives are extremely helpful and greatly appreciated.

Figure 11: Demographics



Appendix: Critical risks

Eighty percent of our survey respondents believe threats are increasing, yet only 12 percent think their organization manages risk extremely well. This is a call to action. Uncertainty, volatility and complexity are here to stay. As risks increase, internal audit's coverage of risk and performance in emerging areas is more critical. According to PwC's *Annual Corporate Directors Survey—Insights from the Boardroom 2012*, only 53 percent of directors are moderately comfortable with the board's understanding of emerging risks. Just over half of directors (51 percent) believe that the board is inadequately informed and involved in managing IT risks. This, along with our research, shows that enterprises have much more work ahead of them to align their thinking on the most critical risks to the organization, and to build a consensus view of how well they are managed.

Board members are more likely than management to consider the risks we asked about to be critical to the organization, as well as to believe the threat those risks pose is increasing. Board members see risks increasing more than management on 65 percent of the risks and consider 75 percent of the risks more critical than management.

Consistent with the preceding, stakeholders also do not fully agree on how well risk is managed in their organizations. Overall, board members view the effectiveness of their organization's risk management more favorably than management or CAEs. Hence, board members are more concerned about risk than management, yet they are more comfortable with how well

it is managed. On average, across the 20 risks we assessed, 60 percent of board members and 52 percent of management believe these risks are well managed. Exactly half of CAEs think risks are well managed in their organizations.

A likely root cause of the lack of alignment around risks lies with how well organizations are coordinating and integrating their risk management process. Half of respondents don't feel the risk management process is well coordinated and nearly one-fifth feel that within their organizations there is virtually no coordination with the ERM process or functional risk management groups. (There has been little to no change in these findings from our 2012 research.) We find that internal audit functions often discuss risk with the audit committee. Then management has a separate discussion on risk with the full board, and, in many cases, it is a different conversation. As a result, the risk assessment is less than complete or there may be multiple assessments, each created from the perspective of a subset of stakeholders. In contrast, 79 percent of respondents

who reported their organization's risks are well managed work together across the various functional areas to create an integrated view of risk.

The significantly different views on the criticality and management of risks increase the potential for greater risk exposure and raise the likelihood that internal audit's efforts are not aligned with the most critical risks. From a broader perspective, it also calls into question the overall effectiveness of risk management and resource allocation against risk. Our data confirms that many enterprise risk assessments should be more complete and more integrated. Companies must collectively confirm the organization's risk profile and internal audit's contribution to helping to monitor it. Open dialogue is an essential starting point to set the foundation for an effective internal audit function on a more holistic and effective risk management approach.

For industry perspectives and more information on the risks organizations consider most critical in our study, please visit www.pwc.com/us/2013internalauditstudy

Figure 12: Most threatening and best-managed risks

Risks seen as increasing the most in the last year

- Economic uncertainty
- Regulations and government policies
- IT security/cyber security
- Data privacy
- Government spending and taxation
- Competition
- Commercial market shifts
- Financial markets
- Large Programs (such as ERP)
- Talent and labor

Risks seen as most well managed in the last year

- Competition
- Reputation/brand
- Financial markets
- Fraud and ethics
- Government spending and taxation
- Data privacy
- Mergers, acquisitions and JVs
- Regulations and government policies
- IT security/cyber security
- Economic uncertainty

Most cited and most well-managed risks at the top

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

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