Unlocking the strategic value of Internal Audit
Three steps to transformation
Questions to consider

• Does your Internal Audit function know the expectations of its stakeholders?

• Are the goals of your Internal Audit function aligned with those of your business?

• Does your Internal Audit function have a reasonable balance between assurance and advisory work?

• Does your Internal Audit function have the right staffing mix to provide the advice and expertise your business seeks?

• Do you need to redefine the mandate for your Internal Audit function? If yes, what is your time frame for achieving it?

• Is your Internal Audit function a pipeline for organizational leadership?
Internal Audit’s evolving role

Ernst & Young commissioned Forbes Insights to conduct a global survey about the evolving role of Internal Audit. The 547 respondents included CEOs (40%), CFOs (27%), Audit Committee Chairs (17%) and Audit Committee members (16%) and represented 101 companies, spanning 19 industries. Headquartered in Europe, the Middle East and Africa (40%); the Americas (39%); and Asia-Pacific (22%), the organizations represented generated revenues ranging from US$1b (38%) to more than US$20b (9%).

In the survey, 96% of respondents indicate that their Internal Audit function has an important role to play in their overall risk management efforts. And yet, 74% believe that there is room for improvement, and nearly every respondent believes that improvements should be undertaken within the next 12 to 24 months. Only 44% of respondents believe that Internal Audit is helping their organization achieve its business objectives. And fewer —37%— say they involve Internal Audit in key business decisions and strategy.

Do you believe there is an opportunity to improve your company’s Internal Audit function?

- Yes: 74%
- No: 21%
- Don’t know: 5%

How pressing is your need to improve your Internal Audit function?

- We need to make improvements within the next 12 months: 60%
- We need to make improvements within the next 12-24 months: 36%
- There is no urgency to our need to make improvements: 5%

Only 44% of respondents believe that Internal Audit is helping their organization achieve its business objectives. And fewer —37%— say they involve Internal Audit in key business decisions and strategy.

Source: Ernst & Young/Forbes Insight, Internal Audit survey, 2010.

Note: Some percentages noted may not equal 100% due to rounding.
Transforming Internal Audit into a strategic advisor

By looking beyond processes and controls, Internal Audit can play an essential advisory role within the organization. It can identify enterprise-wide cost efficiencies, provide strategic insights that improve business performance and provide key insights that focus on the risks that matter. This kind of support reaps multiple benefits for the organization, including enhanced efficiency, and the ability to move more quickly and take advantage of opportunities.

For Internal Audit to realize this transformation, it needs to:

• Align itself with the organization's key business objectives
• Improve audit efficiency and effectiveness, and streamline processes to drive cost savings
• Offer broader risk coverage and be proactive about current and emerging risks
• Enable cost efficiencies across all business units
• Identify and employ the right internal and external skills
• Create competitive advantage by contributing to sustainable business improvements

Given that a majority of corporate leaders will be pushing for enhancement to their audit function in the next two years or less, Internal Audit has the opportunity to move quickly in driving competitive value across the enterprise.
Three steps to Internal Audit transformation

There are three key steps Internal Audit can take to enhance the function and become a value-driven strategic player for the organization.

1. **Link Internal Audit to the business value agenda**

   Businesses are constantly shifting and evolving – and never more so than now. Internal Audit needs to continually change with it. One way Internal Audit can transform its role within the organization is to align its activities with the organization’s business strategy and objectives. With the right capabilities, Internal Audit can directly help the company achieve its business objectives by identifying weaknesses – as well as improvement opportunities – in the design and operating effectiveness of processes and controls.

   The business value agenda offers examples of business objectives to which Internal Audit can align.

   Opportunities for improvement can include:
   - Playing a key role in maintaining a strong control environment and supporting initiatives that improve performance
   - Focusing on the risks that matter most in the context of the organization’s risk appetite, including strategic risks, risks associated with major program changes, operational risk and any other areas that pose major risks for the organization
   - Coordinating with other risk functions to provide efficient assurance on risk and governance activities across the organization
   - Developing leading capabilities in terms of resources, methodology and technology
An effective Internal Audit function has to find the balance between risk, cost and value. Not having that balance results in sub-optimization, which creates a value gap. Issues could lie in the areas of enablement or competency, or both. From an enablement perspective, Internal Audit may not be aligned with the business risks, may be using out-of-date technology or may not know how to prioritize effectively. In terms of capabilities, the Internal Audit function may not have the industry insight and functional insight it needs. It may have inflexible staffing models. Or it may lack skills in specific areas, such as tax or IT.

Both types of gaps can limit Internal Audit’s ability to operate at higher levels. Identifying these challenges — and establishing solutions to address them — will form the foundation of the business case for change.

Building a business case means reinforcing the need for — and benefits of — an appropriately sized transformation. Internal Audit aims to develop a cost model, identify the options for transformation, create scenarios and identify both savings and benefits.

What if the gaps were closed?

The transformation gap keeps many Internal Audit functions from becoming strategic and valued advisors to executive management and their boards of directors. Targeting approaches that help fill the gap will allow for enhanced performance.

What drives the gap?

**Enablement gap**
- Traditional risk assessment and audit-planning approach
- Not driven by business risk
- Heavy focus on auditable units and locations
- Limited use of data analysis and modeling
- Limited training and development
- Lack of effective prioritization
- Unwillingness to change
- Not focused on key business process improvements

**Competency gap**
- Rotational resource model
- Lack of scale to adequately staff certain areas
- IT, international, treasury, taxes, supply chain
- Fraud prevention and detection
- Audit activity = available resources
- Limited scope of traditional role of Internal Audit function
- Alignment with strategic plan and initiatives to support
- Industry/competitive insight
Risk, cost and value: it’s a balancing act

For Internal Audit, like other risk-related business units, one of the keys to improving performance comes from finding the balance among risk, cost and value.

Risk
As the recent economic downturn demonstrated, in a worst-case scenario, an organization’s risks can proliferate at a far faster rate than its ability to provide coverage. Internal Audit functions need to have the ability and agility to quickly close the gaps by:

• Performing regular rolling risk assessments (more than the annual, semi-annual or even quarterly frequency for which many Internal Audit functions currently plan)
• Improving risk assessments to focus on the highest-priority risks
• Enhancing coverage of key and emerging risks
• Coordinating and collaborating with other risk functions
• Improving overall control awareness and control behavior

Cost
In the past two years, for many organizations, finding cost efficiencies in every facet of the organization has been critical to survival. Internal Audit has not been immune. Nearly 48% of survey respondents listed increasing the efficiency and effectiveness of the control environment and raising the efficiency and effectiveness of the Internal Audit function as their top cost-related reasons for improving the Internal Audit function.

Even as the economy improves, Internal Audit needs to remain vigilant in seeking opportunities for improved efficiencies. Opportunities may include:

• Better managing the cost of controls (by focusing on the right risks and deploying the appropriate audit approach or technique, e.g., data analytics versus field review
• Maximizing the use of technology to streamline processes
• Making sure that efforts are cost-proportionate to the level of risk
• Creating flexible staffing models to manage through peak and trough capacity demands as well as costs

However, Internal Audit should not only be focused on finding cost savings within its own function. As part of its audit process, Internal Audit should also be looking at how to drive cost efficiencies across the organization. An enhanced understanding of business processes and objectives (including, but not limited to, business-specific accounting treatments, business-unique systems and the like) will allow Internal Audit to help identify these enterprise-focused cost efficiencies.

Value
Many organizations already have an idea of their potential to be effective in managing financial and compliance risks, as well as costs. But to maximize the organization’s return on investment, executives are increasingly leaning on their Internal Audit function to be proficient at more than providing reliable assurance and highly efficient audit services. They also want ideas for process and control improvements. Opportunities may include:

• Improving overall skills and personnel in the Internal Audit function
• Increasing business performance capabilities
• Improving results on major change programs
• Advising on entering new markets
• Benchmarking against peer organizations

Without the right risk-cost-value balance, an organization cannot achieve its full potential for enhanced and sustained business performance.
Demonstrating leadership at General Dynamics
Internal Audit’s expanded vision
Wayne Maiers, Staff Vice President, Internal Audit, General Dynamics

Enhancing independence and objectivity

Our Internal Audit transformation began in 2006, when the Audit Committee began taking a series of actions to strengthen the department. Our Audit Committee changed the functional reporting relationship of the Chief Audit Executive (CAE) from the CFO to the Audit Committee. Administratively, the CAE reports to the Chairman and CEO, with strong support from the CFO.

When I took the role of CAE in 2008, we decided as a function to focus on three main areas:

1. Filling the talent gap. We began by reviewing the skill sets we had, determined where we were short and then set about to fill those gaps. We wanted our direct reports to have a broad, business-focused skill set. Team members needed to think like the owners of the business so that they could react faster and provide stronger recommendations for improvement.

2. Communicating with leadership teams at all levels of the business. We developed a simple, consistent approach that could be used to communicate with everyone, from the business process owner to the Audit Committee. Our approach focused on keeping everyone informed on the activities Internal Audit was undertaking, how we were evaluating their controls and how we were reporting our findings to the executive leadership and the Audit Committee. It also focused on making sure that any communiqué we created was concise and could be understood in a few minutes.

3. Reporting to the Audit Committee. Reports generally cover three areas: results of the processes that we tested, key focus areas for the Audit Committee and management’s attention, and areas of recommended improvements – this really highlights the value we are providing.

What we do

Over the past two and a half years, we’ve been shifting more toward the operational and business process areas – strategic areas – and spending less time on compliance activities. Some of the operational and business processes we focus on include program management, supply chain management, cash management, significant information systems implementations and cyber security.

Ultimately, I think Internal Audit has three clear goals:

1. Fulfill our governance obligations. Our job, first and foremost, is to provide an appropriate level of assurance based on stakeholder and regulatory expectations.

2. Improve the overall operations of the business. We do this by developing recommendations that will fine-tune value-driven processes. We focus on tightening the controls, improving the throughputs of areas like cash and order management, and sharing leading practices.

3. Groom future leaders. Our team leaders spend a period of time within the Internal Audit function and then rotate to opportunities with broader responsibilities within the corporation. We tend to groom our in-house staff a little bit longer so that they get a wide view of what is going on in the company. For them to experience various aspects of the business, they need to stay in the role for a period of three to five years.

What the future holds

We see the future as one of continuing to promote the corporate culture of continuous improvement and principled performance. We’re going to keep expanding the awareness of leading practices and how we integrate those leading practices into our reporting process. In addition, we will continue to leverage use of technologies to increase our efficiency and effectiveness.

“[Our approach] focused on making sure that any communiqué we created was concise and could be understood in a few minutes.”
With an understanding of where Internal Audit fits into the organization’s rhythm and a business case for change developed, it’s time to develop a plan that gets Internal Audit from where it is now to where it wants to be. Internal Audit will need to identify the business objectives, the actions, roles and responsibilities of each of the parties involved, and the timing of implementation. As leader of the Internal Audit function, it is the role of the CAE to ensure that the transformation plan is appropriately “owned” and that its respective owners are held accountable for meeting the plan’s objectives and targets.

By routinely using a value scorecard, leading Internal Audit functions are open and transparent with their transformation plans and frequently report on their progress and contributions in helping the company meet its business objectives. A value scorecard, defined in collaboration with stakeholders, forms part of a larger value charter (see below), which serves as a means to qualitatively measure Internal Audit performance and the value delivered to the organization.

These goals should include a commitment for Internal Audit to:
- Deliver consistent, seamless and high-quality service to the organization
- Be recognized as the catalyst for strengthening the organization’s control performance
- Serve as a catalyst for the enhanced efficiency of the organization’s control environment

### Sample value charter

**Value statement**

- Business value agenda/objectives
  - People
  - Highly engaged workforce
  - World-class safety
- Performance product and process
  - No. 1 in quality
  - Market leadership
  - Market-leading availability
- Profitable growth
  - Revenue
  - EPS growth
- Critical success factors
  - People
  - Quality
  - Product
  - Velocity
  - Distribution
  - Emerging markets
  - Macroeconomics

**Value attributes for Internal Audit**

- Leadership development
- Subject-matter knowledge
- Training and certification
- Utilization
- Audit relevance to risks that matter most
- Efficiency and effectiveness of audit process
- Value impact on the business (process improvement)
- Business relationships, insights and advisory focus
- Six Sigma-principled
- Risk coverage

**Value charter**

- Value scorecard measures
  - Staff placement/attraction to/from business
  - SMRs leveraged in the audit project(s)
  - Training hours, CPEs and certification attained
  - Team head count and utilization
  - High-risk areas addressed
  - Issues monitored and closed (H/M/L)
  - Recommendations made and implemented
  - BU executive interactions and key initiative inclusion
  - Costs contained/recovered and revenue enhancements identified/implemented
  - Emerging-markets insights and red flags monitored and reported
## Internal Audit transformation in action

In becoming a more essential advisor to the C-suite and the Audit Committee, Internal Audit should be involved in any strategic business investment to grow or improve the organization where a missed risk could hurt share price, market capitalization or earnings. The following represent large-scale change programs where the Internal Audit function can play a significant role:

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
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<tbody>
<tr>
<td><strong>Mergers and acquisitions</strong></td>
<td>This is one of the most risk-heavy initiatives any organization can undertake, and Internal Audit should be involved in all the key steps throughout the M&amp;A process. It can conduct a review of the company’s readiness to go through a merger or an acquisition. It can also make sure that the value is being preserved. If the company sets a stock price in a merger or acquisition, how does it know that it is getting the right value for the price that it is paying? If the Internal Audit function understands the process, it can alert the business to potential risks and monitor associated controls. Furthermore, Internal Audit may assist in the assimilation of the newly acquired or merged entity by ensuring proper control monitoring of new or changed processes, systems and policies. Finally, Internal Audit can monitor the process employed to realize synergies from the combination.</td>
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<td><strong>Technology implementation</strong></td>
<td>There is a tremendous amount of risk associated with an enterprise-wide systems implementation. Internal Audit should have a seat at the table from the beginning to help identify the risks and to provide controls consultation. A common role for Internal Audit in such implementations is as an active, full-time member of the Program Management Office (PMO).</td>
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<tr>
<td><strong>Climate change and sustainability</strong></td>
<td>Companies face myriad strategic climate change and sustainability risks, such as market positioning and changing consumer preferences, as well as strategic investments (e.g., in cleantech and renewable energy). Stakeholder communications and investor relations create another challenge, given that companies are now being valued based on their climate change performance. Internal Audit needs to have a seat at the table when climate change and sustainability strategies are being determined. This will help ensure that key risks are identified, prioritized and are a recognized part of the Internal Audit plan and overall risk management.</td>
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<tr>
<td><strong>Process improvement</strong></td>
<td>Any major process transformation (supply chain, procurement, finance) requires evaluation of the current state, determination of the future state, a plan for implementation and a means of measuring success. Internal Audit can provide risk and controls consultation to determine the readiness for the process improvement, levels of progress, and measurements for success and overall value to the organization. In the case of many such transformations, a subsequent Internal Audit transformation project (or transformation plan update) is warranted.</td>
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<td><strong>Business process outsourcing</strong></td>
<td>The outsourcing of any major process, from payroll to IT, holds a number of inherent risks. How does an organization know that it has the right arrangement in place at the front end? Is the business ready to enter into the arrangement? Does the organization have the right processes in place to measure whether it is getting all of the benefits it is seeking from the arrangement? Internal Audit can play a role in responding to all of these issues. For business process outsourcing, Internal Audit also has the option to consider using third-party resources (internal or external) to execute its work processes in a more cost-efficient and effective manner (e.g., guest auditor programs, offshore talent hubs).</td>
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<tr>
<td><strong>Real estate and construction</strong></td>
<td>While risk management is a key consideration for organizations undertaking real estate or construction projects, few have complete visibility into the risks across every element of the construction lifecycle. Internal Audit can provide valuable input to help the organization avoid such issues as scope creep, design flaws, unrealistic timelines, cost overruns, vendor mismanagement and change management concerns.</td>
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<tr>
<td><strong>New product development</strong></td>
<td>A company has placed a big bet on a market-changing product, but has it done enough planning and due diligence to know that it is going to be a success? Has it prepared for all possible risks and contingencies? Internal Audit can provide the right risk and controls analysis to help the company avoid recurring product delays and cost overruns that could damage the company’s reputation and hurt its share price.</td>
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<tr>
<td><strong>Expanding footprint</strong></td>
<td>Expanding a company’s footprint isn’t only about moving into new geographies that may present language, cultural or statutory requirement issues. It’s also about understanding the impacts on distribution channels and supply chains. Internal Audit has already likely had to deal with these issues and can play an important role in using existing risk methodology to review the company’s readiness for expansion. Internal Audit can also share leading practices that can help the company avoid the pitfalls of previous expansion efforts.</td>
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</tbody>
</table>
Internal Audit can neither identify nor develop the necessary proficiencies and skills to play a more strategic role overnight. This is where an external teaming or cosourcing arrangement will help. A third-party provider can cost-effectively help build a business case, develop an improvement plan, and accelerate the timeline of the Internal Audit transformation. But it is also one of the best ways to hire key talent and build a more robust Internal Audit function.

In a presentation he gave at the General Audit Management Conference in Orlando, FL, on 31 March 2010, Richard Chambers, CEO of The Institute of Internal Auditors, suggested that cosourcing isn’t just a good idea – it’s essential for most Internal Audit departments. “If you have a need as a CAE, if you have an expertise that you need to complete your audit mission, or if you have an audit area and you don’t have expertise, under the standards you have an obligation to procure that support.”

Do you consider cosourcing of your Internal Audit function to be viable business option?

- Yes: 41%
- Yes, but as a short-term solution: 36%
- No: 23%

Source: Ernst & Young/Forbes Insight, Internal Audit survey, 2010.
A third-party provider can offer:

- Organization-specific, sector-specific and international experience
- A fresh perspective and a wealth of experience gained from having helped other clients transform their Internal Audit functions
- Highly skilled talent who receive ongoing training to stay current on leading practices
- An array of technology solutions and audit tools that can be customized to meet specific Internal Audit needs

Assuming you would receive the same or better risk coverage and service that you currently receive from your Internal Audit function today, at what cost savings would you consider cosourcing your Internal Audit function?

<table>
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<tr>
<th>Cost Savings</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Less than 10%</td>
<td>10%</td>
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<tr>
<td>10% – 20%</td>
<td>41%</td>
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<tr>
<td>21% – 30%</td>
<td>22%</td>
</tr>
<tr>
<td>Greater than 30%</td>
<td>9%</td>
</tr>
<tr>
<td>Never would</td>
<td>19%</td>
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</tbody>
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Note: Some percentages noted may not equal 100% due to rounding.
Unlocking Internal Audit’s value as strategic business advisor

In recent years, Internal Audit has been focused on control and compliance efforts to address internal control requirements. Now senior executives and Audit Committees are looking for more.

As our survey suggests, companies want to broaden the role of Internal Audit. Executives want more than reliable assurance and efficient audits – they want to be able to turn to Internal Audit for subject-matter expertise and business insights into strategic initiatives, and for ideas that challenge existing practices and lead to ongoing business performance improvements.

It’s about finding the right balance among risk, cost and value. With it, Internal Audit can become an internal beacon for change across the organization.

As the economy continues to gain momentum toward a full recovery, there is no better time for Internal Audit to transform itself into a valued strategic asset that continues to rise in stature within the organization.
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Our point of view
Thought leadership at ey.com/internalaudit

Internal Audit global cosourcing: a case study with commentary
Looking at the issues surrounding cosourcing from the standpoints of a CEO, CFO, CAE and Audit Committee Chair, this study examines a myriad of pressing issues facing today’s C-suite as it grapples with the evolving strategic role of Internal Audit. A panel of four Ernst & Young professionals examines the differing viewpoints and comments on the hypothetical situations facing the officers of the global XYZ Technology Group.