PwC Advisory
Internal Audit

An opportunity for transformation*

How internal audit helps contribute to shareholder value

*connectedthinking

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Rapidly accelerating pressures fuel the need for internal audit to transform its thinking from financial controls-centric to shareholder value-centric—and to drive efficiency into traditional internal audit processes.

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The heart of the matter

It's time to question the internal audit status quo

In June 2008, one of the world's largest banks held what must have been an uncomfortable call with investors. The topic of discussion: more writedowns and additional losses on consumer loans.

The bank had plenty of companionship in its discomfort, both in and outside the financial industry. While the mortgage crisis has grabbed headlines, risk-related turmoil can be found across every industry and sector, and examples abound of the troubles companies face when things go wrong.

A lawsuit accused a major retail pharmacy chain of defrauding the US government by switching Medicaid patients' prescriptions to more expensive forms of anti-ulcer and antacid drugs. A pharmaceutical maker was charged with manufacturing and distributing a heart medication said to have exceeded not only the dosage reflected on the label, but also that approved for human medical treatment. And a recent $20 million product recall dampened the brand reputation of a major fertilizer manufacturer.

No doubt many companies need a fresh approach to protecting shareholder value. Evident from the recent onslaught of litigation and losses is the fact that many risk-measurement models have failed. As journalist Christine Harper asserted in a Bloomberg special report, "Everyone…is coming to the realization that no algorithm or triple-A rating can substitute for old-fashioned due diligence."[1]

But with big-company risk management functions already struggling to fill key roles, where is such old-fashioned due diligence to come from?

One source, often overlooked, may be internal audit.

While at times otherwise focused, and not always as cost effective as it could be, internal audit has great potential to help organizations evaluate the risks that impact shareholder value. Why? Because no matter how grand the strategic risk vision or how extensive the automation involved, risk management ultimately comes down to people monitoring the assumptions and actions of other people.

And in that, internal audit has a natural competency and years of experience.

For internal audit to live up to this potential, it must undergo both a value and cost transformation. First, it must do more of the higher-value work that comes from a focus on risks that can significantly impact shareholder value. Second, it must lower operational costs by driving radical levels of efficiency into its traditional work. With the right approach, both can be done simultaneously.

The time has come to question the internal audit status quo. As management's search for cost reduction becomes more inclusive and stakeholders demand improved risk management, internal audit needs to examine its role in the organization, retool its teams, and prepare for a new level of involvement in governance and risk as well as compliance.[2]

1 Harper, Christine. "Death of VaR Evoked as Risk-Taking Vim Meets Taleb's Black Swan," January 28, 2008. Bloomberg.com. http://www.bloomberg.com/apps/news?pid=20601109&sid=axo1oswvqx4s&refer=home

2 "Internal Audit 2012," PricewaterhouseCoopers, August 2007 whitepaper.


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An in-depth discussion

The shareholder value challenge

Yale University economics professor Robert J. Shiller has a theory about the recent market downturn: “Speculative bubbles,” he wrote in his aptly titled article, *Infectious Exuberance*, “are fueled by the social contagion of boom thinking.”[3] He points out that in an environment characterized by rampant optimism, “skeptics have a hard time of it.”[4]

Indeed, few skeptics were heard arguing for shareholder value protection during the boom years, although every major company had a risk program in place. But for many organizations, conventional risk management strategies and methods for testing them were not enough. As upheaval in one industry sector spilled into the wider economy, investors and other stakeholders wondered what went wrong.

One company acknowledged about its own multibillion-dollar loss that VaR (value at risk), stress tests, and other risk measures significantly underestimated the magnitude of actual loss from the unprecedented credit market environment. Another suggested that its practices should be viewed in the context of wider industry practices pursued during the period.

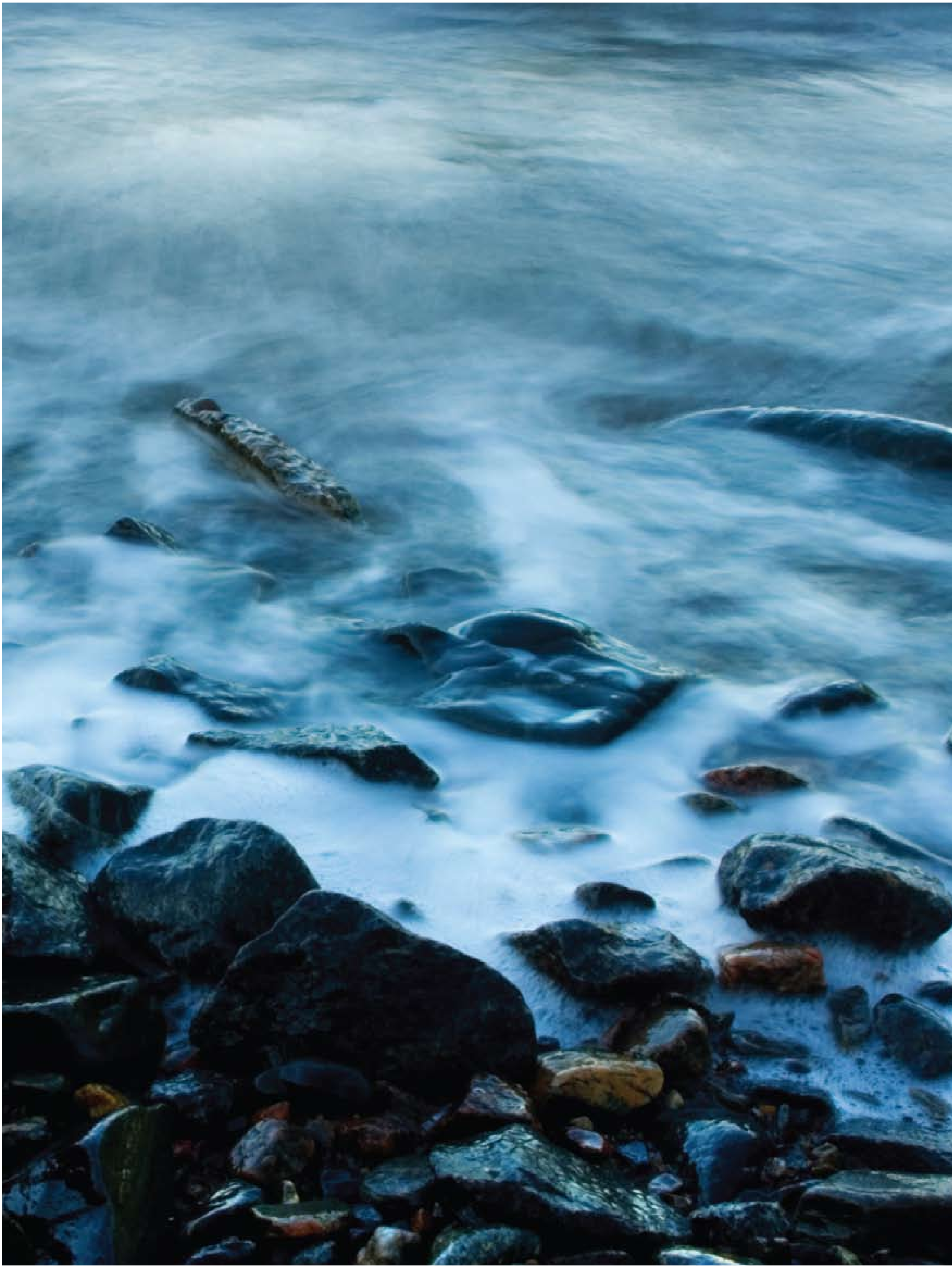
In other words, a strategy that may have strained risk boundaries in other circumstances seemed comfortable at the time because everyone was doing it.

Could a shareholder value-centric internal audit function have helped assess these kinds of risks before it was too late?

The answer is yes. A very well-functioning internal audit department using a proven value approach would have identified some or perhaps many of the general issues, particularly with respect to governance and risk management. Internal audit would not have identified all of the issues—particularly as some were very complex while others were clearly operational—but many of the key factors would have been identified.

3 Shiller, Robert J., “Infectious Exuberance,” July-August, 2008. *The Atlantic*, Ideas Issue.

4 Ibid.



Why the effort to manage strategic risk and other key risks needs a force on the ground

A correctly aligned approach to risk management focuses on those risks with the greatest opportunity to reduce shareholder value. Given that definition, two factors may be to blame when management is unable to effectively identify and respond to risks that can damage shareholder value: the absence of a correctly aligned approach to risk management coupled with the lack of a sufficient engine to power the company's risk management strategy.

A transformed internal audit function has the potential to become that engine—a potent force of old-fashioned due diligence that could help manage the increasingly sophisticated risk factors today's businesses face.

Shareholder value, risk, and the internal audit plan

Throughout the past several decades, corporations have made fundamental changes in their business models with the goal of increasing shareholder value. A greater emphasis on financial management has set the tone for doing business, and several factors are evident from this trend. The rise of brand marketing has helped fuel worldwide demand for goods and services, while process changes, technology implementations, outsourcing, and offshoring have eliminated, reduced, or shifted the burden of labor-intensive processes to lower-cost areas. Shareholders have seen value rise accordingly, while management faces greater complexity and new types of risks.

Yet the resources dedicated to evaluating and monitoring those risks have not increased commensurately and, in some cases, have actually decreased. This has meant limited resources available to address an increasingly sticky set of problems. Experienced functional areas such as internal audit that have either gained resources or stayed constant have vast potential to help. But in many cases, internal audit resources are focused on tasks that, while important, have a lesser impact on shareholder value. And internal auditors may lack specific training in monitoring other types of risk. Moreover, the connection between shareholder value, risk, and the internal audit plan has not always been clear.

Recent studies indicate that strategic and business risks pose greater threats to shareholder value than operational, compliance, or financial risks. These studies, which examined the factors behind rapid losses in shareholder value, focused on “large cap” companies such as those ranked in the Fortune 500 and FTSE 100 index. The results of the studies were remarkably similar. As shown in the chart on page 12, strategic and business issues are the most common means by which company value is destroyed—responsible for 60% of value loss—with operational issues driving another 20% of the loss.

But when one looks at a typical internal audit plan, the overwhelming majority of internal auditor time and attention is spent on financial risks and related controls. Such heavy emphasis on financial controls may have been appropriate to achieve Sarbanes-Oxley compliance. Now that Sarbanes-Oxley risks are generally well controlled, internal audit needs to realign itself toward other shareholder-value risks and perform its financial and compliance monitoring activities more cost effectively.

Importantly, internal audit must expand its focus beyond risks that infrequently contribute to significant reductions in shareholder value.

For example, some areas of risk that have significantly impacted shareholder value but have been left out of the internal audit plan include the identification or evaluation of the following:

- Extended supply chain and the assessment of risks pertaining to the safety, quality, or reliability associated with suppliers.
- Process to receive and act on regulatory comments or findings in a timely, appropriate manner.
- Process to ensure advertising meets appropriate regulatory and consumer requirements.
- Pricing process for considerations of collusion with competitors, and whether pricing strategies are consistent with regulatory requirements.
- Processes to detect and avoid discrimination with customers, suppliers, and employees.

In addition to these examples, internal audit should also be prepared to evaluate the processes that support a company's strategic and business objectives. Shareholder value protection stems from careful observation of many factors, including how objectives such as revenue growth, people development, new product introduction, and strategic cost reduction are identified and implemented. While often overlooked by internal audit, the processes that support these objectives could be made more efficient and effective; both aspects help guard value over the long term.

Are you focused on the right risks?

How value is destroyed in companies—reasons for decreases in shareholder value

Strategic & Business 60%	Operational 20%
Financial 15%	Compliance 5%

However, a significant percentage of internal audit resources are focused on financial controls in most organizations.

Internal audit's role in the extended global corporation

"Globalization," say the authors of a working paper on corporate social responsibility, "entails a paradox: the more interdependent we become, the more we seem to require order and yet foment change."[5] Doing business in a shrinking world includes multiple risk factors that should be on internal audit's radar:

- Large extended enterprises, often made up of independent organizations but with tremendous pressures to grow and perform as a unit.
- Rapid rates of change in technology and information flows as a result of globalization.
- Problems in managing large-scale operations using methods rooted in controlling decisions centrally.[6]

A recent PwC study agrees, suggesting that the "pursuit of international growth via new or expanded markets and the hunt for lower-cost suppliers abroad create a unique set of issues for multinationals."[7] For example, those surveyed expressed a strong belief that auditing of outsourced or offshored operations would continue to increase over the next five years.

Few robust techniques available to oversee risk

Information flows in and among organizations have risen in importance, volume, and speed in recent years, to the extent that they can almost be viewed as the exclusive domain of technology experts. Although intuition might suggest otherwise—after all, we can record every email and click now—transparency is actually much harder to achieve in the information age.

Imagine, by contrast, a mid-19th century Dickensian world in which a company's incoming sales orders were hand-copied by rows of clerks seated at high desks. Checking their work was as simple as walking the rows, glancing at the originals and looking to see if the copies the clerks made were accurate. It didn't require a technical degree, only the ability to read. But fast-forward a century and a half to the present day. What could most executives observe now by walking around the corporate campus? The muted sounds of telephones ringing and visitors at

5 Kytle, Beth and John Gerard Ruggie. 2005. "Corporate Social Responsibility as Risk Management: A Model for Multinationals." Corporate Social Responsibility Initiative Working Paper No. 10. Cambridge, MA: John F. Kennedy School of Government, Harvard University.

6 Ibid.

7 "Internal Audit 2012," PricewaterhouseCoopers, 2007, p. 13.

reception. The murmur of ongoing meetings. The sight of staffers talking or tapping lightly on laptop keyboards—but doing precisely what, an observer may never know.

Controls and the notion of assurance over controls began to gain importance as regulatory pressures increased and the realities of operating a large or multinational business became more complicated. Depending on management's wishes, internal audit often became the central authority for assurance over financial controls. In many cases, internal audit has been quietly toiling there for decades—certainly since the height of Sarbanes-Oxley and other reform measures in the early 2000s.

But as companies that needed to strengthen their financial controls began to do so, and to expand their ability to monitor those controls, the cost/benefit ratio of the type of labor-intensive, controls-focused assurance provided by internal audit has decreased. Pressures have mounted to reduce the overall cost of compliance.

Not only are management and the audit committee examining the cost side of internal audit, they are also questioning its value, looking hard at day-to-day value contribution.

Rethinking internal audit

Internal audit organizations facing this kind of tension need to look hard at change—or risk consequences that include flat or declining budgets and a diminished role within the company.

The need to pitch their merits in the wake of the unprecedented stakeholder support of the early Sarbanes-Oxley years will come as a shock to many internal audit executives. But in uncertain economic times, organizations pay close attention to every cost element—certainly anything that has an expense budget attached to it. Management is more inclined than ever to evaluate internal audit the same as it does other important functions, i.e., measuring performance against strategic value and operational cost metrics. In other words, no more sacred cows, and no more free pass for internal audit.

It is not surprising that when organizations have met existing financial-control compliance requirements, they soon turn their attention to doing it more cost effectively. They also become more attuned to another resource need: someone to help manage the non-financial risks that can adversely affect shareholder value. However, few resources have the knowledge, experience, and training to fill this role.

Internal auditors happen to be among them. But to succeed, the traditional internal audit function will have to prepare for a whole new battlefield.

Professor Mervyn King, Chairman of the Global Reporting Initiative and King Committee on Corporate Governance, told internal auditors at a recent global internal audit conference, “In the next five years, your profession will be revolutionized…a compliance-based approach is something of the past.”

For some in the profession, this call to action was heard with pleasure—for others, with reluctance. PwC’s forward-looking “Internal Audit 2012” study found that internal audit leaders tended to fall equally into two camps: those who envisioned internal audit most successful when focused on strategic and operational risk, and those who saw internal audit’s strength in continuing its financial controls focus.

There are signs that such sentiment is shifting. A PwC 2008 “State of the Profession” study cited that 86% of internal auditors believe audit committees and other stakeholders would gain value from a focus on strategic and business risks, and 70% of internal audit functions expect their budgets to decline or stay flat in 2008—a signal that the value of purely financial-controls assurance has stagnated.

From an internal audit perspective, there is plenty to be gained from a transformative overhaul of its basic mission. For one thing, it offers internal auditors the chance to be part of a department that is energized, organized, and properly supported through skill sets, automation, and technology to better contribute to shareholder value.

Still, knowing that internal audit faces a shift from a financial controls-centric to a shareholder value-centric mode of thinking and then doing it are two different matters.

For many internal audit departments, the people currently on staff—from the director level on down—have skill sets that are primarily focused on financial controls. So to say that the focus should change from financial controls to shareholder value is logical, but the people who are being asked to change often don't have the necessary expertise to assess the different types of risks this focus requires.

However, methodologies do exist for helping internal audit organizations undergo the successful transformation that comes from a focus on both value and cost. For example, the PwC approach to adding value is centered on risks that impact shareholder value, providing an anchor to identify and prioritize risk. An added dimension stresses cost reduction and efficiency gains, using lean principles to streamline internal audit processes.

Clearly, the opportunity and impetus for transformation is in place. Internal audit is poised to contribute more value to the organization than ever before. Its professionals need new skills and new tools, but the fundamentals are there. What remains is for management, audit committees, and internal auditors to agree on a way forward.

Are you satisfied with your internal audit function?

Five essential questions every CAE and executive should ask.

- Is internal audit aligned with 1) enterprise strategy and 2) stakeholder expectations?
- Is internal audit focused on areas and activities that impact shareholder value?
- Are your internal auditors perceived as trusted business advisors or policemen?
- Is internal audit effective in its communications with you, with other members of management, and with the audit committee? Do they identify the key issues facing the organization?
- Does internal audit effectively utilize technology in its processes and take advantage of your company's existing systems and data?

What this means for your business

How to unleash the power of internal audit

PwC believes that internal audit must focus on improving its value-to-cost ratio, and that the right way to do it is to add value and simultaneously reduce cost.

Why both aspects at once? Though it may seem formidable, this twofold strategy sets the stage for true internal audit transformation. As a former advertising executive once philosophized about why successful campaigns inevitably start with a bang: "A strong brand should trigger the buyer's mind..."[8] The same idea goes for wholesale organizational change. By letting the organization know that executives are serious and committed to tackling internal audit's two major strategic dimensions, transformative power can emerge.

Changing the value side of the value/cost equation involves developing a new focus on risk: what it means to the enterprise, how it promotes or reduces shareholder value, and what internal audit can do about it. Driving down costs and enhancing efficiency typically involves streamlining processes; reassessing goals, tasks, and activities; tightening the focus on value-adding processes; and making greater use of technology.

Improvements in value and reductions in cost can have a broader impact on the company as a whole: internal audit can demonstrate greater value by aligning audit strategy with value-creating processes and, at the same time, streamlining operations to drive efficiency.

8 Kotler, Philip, *Kotler on Marketing: How to Create, Win, and Dominate Markets*. p. 65, April 21, 1999. Free Press.

Transformation includes demonstrable results in the short term

Many companies have begun their internal audit transformation projects with pilot efforts to demonstrate the concept. With overall transformation as the goal, these early efforts are designed to enhance internal audit's cost-effectiveness and adjust its risk-assessment focus to become more strategic. A side benefit: gaining rapid and visible value encourages the organizational support and energy needed for the long haul.

For example, one of PwC's clients found opportunities to save 20% of a $20 million internal audit function budget by zeroing in on travel costs and redeploying resources toward more value-added activities. Another found that optimizing core internal audit processes and increasing reliance on technologies and automation, along with travel reduction and selected redeployments, achieved significant cost savings.

Early-phase projects have also demonstrated the ability to increase value as well as cut costs. One company discovered entirely new risks to be audited, and in doing so, improved the department's understanding and coverage of strategic risk. Another was able to more effectively balance the alignment of its internal audit resources between traditional compliance needs and areas with significant impact to shareholder value.

Making the transition from current to future state

Transformation begins with an understanding of an organization's current operations, and a model that breaks the company's operational elements into separate categories can make it easier to plan change. As shown in the table on page 23, each category has actions associated with it that companies may want to use as a guide when planning a transformational project.

Strategy	• Based on the company's strategy, identify those risks at the process level that have the greatest impact on the company's ability to execute the strategy • Align internal audit’s plan to the risks identified above
Organization	• Evaluate internal audit’s organizational model (e.g., territory or business-unit alignment, rotational model) against the company’s current and future structure based on the company’s strategy
People	• Identify resource needs based on internal audit strategy (ERP skills, data analysis skills, etc.) • Determine approach to supplement missing skill sets (hiring needed skill sets, guest auditor programs, sourcing, etc.)
Process	• Improve the audit process through the use of lean principles, standardization, offshoring, etc., to lower cost without adversely impacting quality • Implement internal audit performance metrics focused on both strategic alignment as well as internal audit operational efficiency
Technology	• Increase the use of tools to streamline internal audit processes (electronic workpapers, reporting, scheduling, etc.) • Introduce tools to automate auditing, including greater use of data mining/evaluation, greater leverage of investments in ERP systems, etc.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Most importantly, companies considering this type of change should think strategically. Ask what would be the greatest strategic value internal audit could and should contribute to the organization. How would a transformed internal audit function deliver insights into the significant strategic and operational risks that could impact shareholder value? How would a transformed internal audit function provide this increased value at the same or lower cost as the current function? How would management define and measure the outcome of such a program?

When thinking about a major overhaul to internal audit, it is helpful to find a change-management protocol to follow; then adjust it to the company's individual needs. For example, PwC's 10-step plan for transforming the audit function outlines major steps in conducting long-term sustainable change.

A 10-step plan for transforming the internal audit function

1. Identify stakeholder expectations of internal audit; ask what management, the board, and the audit committee value.
2. Gather data to assess current state.
3. Link the company's strategic objectives and shareholder value drivers to internal audit's scope.
4. Consider how previously unaudited areas might be audited, then align auditable risks to the audit plan.
5. Eliminate routine, low-value audits.
6. Based on the updated audit plan, consider transformational ideas to reduce cost.
7. Identify inefficient processes.
8. Develop implementation plans for transformational concepts as well as anticipated process efficiencies.
9. Review updated internal audit plan, along with cost-reduction ideas, with key stakeholders to gain support.
10. Implement (add measurement, feedback, and adjustment processes for continuous improvement).

The concept of transformational audit, while progressive, has already begun to prove its merit as companies seek to better manage the risks to shareholder value in a complex global marketplace. As volatile markets create anxiety among investors, management, and other stakeholders, more companies have begun to examine the causes of value destruction and look for new ways to help identify and address them.

Balancing the need for cost-containment and efficiency with increased sophistication and attention to risk, PwC sees organizations taking a second look at internal audit, an underutilized resource whose efforts have been focused for years on a small part of the overall risk picture. No other single internal organization has more potential to become as powerful an internal element helping companies manage risk.

PwC practitioners are dedicated to the idea that the time for change is now. As credit markets tighten, commodity prices increase, and businesses hunker down to ride out the softening economy, no resource can go overlooked—especially an internal audit function that has this much potential to help companies protect shareholder value.

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