

PULSE OF INTERNAL AUDIT

Navigating an Increasingly
Volatile Risk Environment

MARCH 2015



AUDIT EXECUTIVE
CENTER®



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ABOUT THE AUDIT EXECUTIVE CENTER

The IIA's Audit Executive Center™ is the essential resource to empower CAEs to be more successful. The Center's suite of information, products, and services enables CAEs to respond to the unique challenges and emerging risks of the profession. For more information on the Center, visit www.theiia.org/cae.

INTRODUCTION

At a time when geopolitical, macroeconomic, and cyber-related incidents border on the routine, the volatility of such risks is placing enormous pressure on internal audit functions to have the foresight needed to address these and other emerging risks and avoid damaging surprises.

Internal auditors are well aware of many of the challenges, according to The IIA Audit Executive Center's North American Pulse of Internal Audit survey. However, there are a number of areas that warrant closer attention:

- On one hand, nearly 7 in 10 respondents to the survey, conducted in October 2014, viewed cyberattacks and other security threats as a high or critical priority. At the same time, respondents as a whole did not express significant concern about major geopolitical developments, global health threats, or the impact of social media, perhaps because of a failure to see how such factors could have much of an impact on their organizations.
- More than half of the chief audit executives (CAEs) and directors who responded consider the identification of emerging risks to be their biggest challenge. Yet only about one-third expressed a high degree of confidence in their ability to identify such concerns.
- Four in 10 respondents put a high priority on attracting and retaining talent, and 54 percent of respondents cited competition for a limited pool of skilled auditors as a reason for skill gaps on their audit teams. The growing talent shortage may blindside some in the profession.

In today's operating environment, internal auditors have a clear mandate to identify and address major risks on a continual basis. They also need to find the talent to do so and to allocate their resources in response to those risks.

Through the North American Pulse of Internal Audit survey and the insights we can draw from the results, we hope to strengthen your ability to address these and related challenges now and in the future.

Richard F. Chambers, CIA, QIAL, CGAP, CCSA, CRMA
President and CEO
The Institute of Internal Auditors

DEMOGRAPHICS

The IIA Audit Executive Center's Pulse of Internal Audit survey, conducted in October 2014, garnered responses from 444 CAEs and others in internal audit management roles. The 2015 North American Pulse of Internal Audit report is based on 311 responses from CAEs and directors in North America.

The survey respondents represented a diversity of organizations. Publicly traded organizations accounted for the largest group (44 percent). Public sector entities and privately held organizations also represented significant portions — 22 percent and 19 percent, respectively. In addition to the 22% and 19% discussed above, 18 percent of all respondents work in Fortune 500 companies.

Participants represented 19 industries, with the highest representation from finance and insurance (28 percent). Other industries that participated at notable rates include manufacturing (14 percent), education (10 percent), health services (7 percent), and public administration (6 percent).

Risks in Focus



CONTINUOUSLY ASSESSING EMERGING AND EVOLVING RISKS

To conduct business in the 21st century, internal audit leaders must contend with an extraordinarily broad array of challenges, ranging from the identification and management of risks related to globalization and interdependency to the proliferation of global communication channels. At a time when the world has instantaneous access to information, risks capable of destroying decades of accumulated value can materialize overnight and without warning.

Annual internal audit plans for global companies based on risk assessments conducted in late 2013 likely did not envision the rapid spread of the Ebola virus in Western Africa, instability stemming from conflict in Eastern Europe, territorial disputes between China and Japan, the rising threat of Islamic militant groups, or the potential collapse of Iraq and Yemen. What’s more, cybersecurity risks were likely not seen as potentially lethal threats by large national retailers or global multimedia companies.

How things have changed: According to the 2014 North American Pulse of Internal Audit survey results, nearly 7 in 10 internal auditors view cyberattacks and other security threats as a *high* (43 percent) or *critical* (26 percent) priority. In addition, more than half (52 percent) of survey respondents consider the identification of emerging risks to be their biggest challenge in 2015.

Connecting the Dots to Identify Emerging Risks

The survey results concerning audit-planning priorities were somewhat surprising. Nearly half (45 percent) consider the **sustainability** of the organization and its business partners, supply chain, revenue change, and product development to be a *high* (36 percent) or *critical* (9 percent) priority, a clear reflection that people care strongly about these issues. At the same time, however — perhaps owing to the fact that many internal auditors do not “connect the dots” between emerging global or technology risks and threats to their organizations — survey respondents did not express significant concern about *major geopolitical developments*, *global health threats*, or the *impact of social media*. To this point:

- 6 percent of our respondents consider **major geopolitical developments** such as economic sanctions on Russia to be either a *high* (less than 5 percent) or *critical* (less than 2 percent) priority. By contrast, 40 percent do not place any priority on such factors.
- Less than 10 percent of Pulse respondents consider **global health threats** such as the Ebola outbreak to be either a *high* (less than 6 percent) or *critical* (less than 4 percent) priority — and 32 percent do not consider them to be a priority at all.

- Slightly more than a quarter (26 percent) of respondents view reputational risk and other potential **impacts of social media** to be either a *high* (22 percent) or *critical* (4 percent) priority. By comparison, 30 percent view them as a *low* priority, and 7 percent do not prioritize such impacts.

In examining survey responses by organizational size and type, we noted that companies with a major global presence exhibited higher degrees of concern with geopolitical instability, global health risks, and similar issues than did small to medium-sized companies with a limited global footprint. Yet in a world of interconnected risks, threats originating from outside of North America often manifest themselves as risks to North American businesses and other organizations at some point.

It is noteworthy that although nearly half of the Pulse survey respondents see disruption of their supply chain as a high risk, relatively few of them view recent geopolitical developments in the same light. One explanation is that respondents have a keen understanding of the reach of their organizations' supply chains. Alternatively, their relative lack of concern about emerging global instability could reflect a lack of appreciation for the extent to which their supply chains could be affected by such instability in remote regions of the globe. We believe the detection of emerging risks requires a thorough awareness of the macro-environment, a deep understanding of the business, and the ability to anticipate what happens when the two converge.

Recognizing the challenges associated with the identification of emerging risks, only about one-third of our respondents expressed a high degree of confidence in their ability to identify emerging risks. Roughly the same percentage expressed a high degree of confidence in the ability of their organizations to respond to emerging risks.



Survey participants were asked to rate their levels of confidence in the ability of *their organization* to identify emerging risks and respond to emerging risks in a timely manner.

The Urgency for Continuous Risk Assessment

Internal audit stakeholders are notably risk-averse when it comes to unforeseen events posing significant operational, reputational, or brand risks. “No surprises” is one of the most commonly articulated audit committee expectations of internal audit. Yet, as noted earlier, geopolitical, macroeconomic, and cyber-related surprises have become almost routine. We believe the volatility of such risks will put enormous pressure on many internal audit functions to raise their game.

Given the threat, scope, and significance of emerging risks, it is imperative that internal audit functions and the organizations they serve be able to assess risk on a continuous basis. In today’s fast-paced operating environments, internal auditors need to audit at the speed of risk. That means developing the capability to continuously align or realign their audit coverage to address emerging risks and avoid damaging surprises. Global companies in particular need to constantly recalibrate their audit plans based on what is happening within their organizations, their industries, and geopolitically, and take appropriate steps to realign their audit priorities accordingly.

Risk Assessment Methodologies

Based on our experience, internal audit departments that continuously assess risks tend to employ a limited portfolio of strategies that they and other organizations have seen work effectively. These include monitoring key risk indicators (KRIs), interviewing management to identify changes in the organization's risk profile, and monitoring key industry and economic trends.

We asked a number of questions related to continuous risk assessment in the Pulse survey. The responses help to quantify the extent to which internal auditors are employing various approaches to the continuous assessment of risk and the updating of audit plans.

- **Periodically Monitor Key Risk Indicators** – A majority (61 percent) of Pulse survey respondents manually monitor KRIs throughout the year. Specifically, 33 percent described their utilization of manual KRI monitoring as *moderate*, 19 percent as *very utilized*, and 9 percent as *extensively utilized*.
- **Use Technology to Continuously Monitor Key Risk Indicators** – Only 10 percent of respondents describe their utilization of technology to monitor KRIs as *very* or *extensive*, 22 percent rate their use as *moderate*, and 29 percent describe their use as *slight*. Surprisingly, nearly 40 percent of respondents do not employ technology at all in the KRI-monitoring process. The bottom line: *9 in 10 respondents appear to be underutilizing the ability of technology to enhance and streamline the risk-monitoring process.*
- **Periodically Interview Management to Identify Changes in the Organization's Risk Profile** – More than 7 in 10 respondents make widespread use of this practice, with 38 percent describing their use of management interviews to identify changes in the organization's risk profile as *very utilized* and 33 percent as *extensively utilized*.
- **Initiate Formal Updates of the Internal Audit Risk Assessment and Audit Plan** – Sixty percent of respondents take a formal approach to updating their risk assessments and audit plans, with 31 percent describing their use as *very utilized* and 29 percent as *extensively utilized*.
- **Initiate Informal or Ad Hoc Updates of the Internal Audit Risk Assessment and Audit Plan** – Thirty five percent of respondents describe their use of informal or ad hoc means to update their internal audit risk assessments and audit plans as *very utilized*, and 26 percent as *extensively utilized*.
- **Periodically Update Risk Assessment Based on Changes to Risk Ratings Identified During Ongoing Audit Operations** – Nearly 80 percent of respondents indicate that they periodically update their risk assessments based on changes identified during ongoing audits, with 22 percent describing their use of this technique as *extensive*, 32 percent as *very utilized*, and 25 percent as *moderate*.

“Our approach to continuous risk assessment is to engage in formal and informal dialogues with management to qualify risk.”

—Hakan Olofsson, CRMA
Vice President Internal Audit,
Ball Corporation

52% of respondents agreed or strongly agreed that internal audit's biggest challenge in continuously assessing risks is its ability to identify emerging risks and incorporate these risks into the audit plan.

Internal Auditors' Confidence in Risk-Assessment Capabilities

In contrast to the inconsistency in utilization of continuous risk assessments and the relative lack of Pulse survey respondents' reliance on technology, the respondents' expressed level of confidence in their ability to continuously assess risks was surprisingly high. When asked to **rate** internal audit's ability **to assess risk continuously**:

- 54 percent of respondents expressed significant confidence in their abilities to do so, with 45 percent saying they have a *very high* level of confidence in the ability of their internal audit functions to assess risk continuously and 9 percent described themselves as extremely confident in this regard.
- Another 37 percent said they were *moderately* confident in their ability to assess risk on an ongoing basis.

When asked to **rate** the **ability of their internal audit functions** with regard to **skills specific to continuous risk assessment**, here's what survey respondents had to say:

- 50 percent *agreed* that internal audit has the **resources and expertise to assess risks continuously and analyze their potential impact to the business model**; another 11 percent *agreed strongly* with this statement.
- 50 percent *agreed* that internal audit **encourages contrarian thinking and questioning of strategic assumptions**; another 14 percent *agreed strongly* with this statement.
- 60 percent *agreed* that their **audit planning is designed to be responsive to changes in the organization's risk profile**; another 28 percent *agreed strongly* with this statement.
- 43 percent *agreed* that internal audit's **biggest challenge** in continuously assessing risks is its **ability to identify emerging risks and incorporate these risks into the audit plan**; another 9 percent *agreed strongly* with this statement.

Key Imperatives to Audit at the Speed of Risk

The mandate to address emerging and evolving risks is clear. Risks are emerging with unprecedented speed, and stakeholders' impatience with surprises is evident. Internal audit departments must deploy effective techniques to continuously assess risks and update dynamic audit plans accordingly.

Imperatives for Change: The IIA's Global Internal Audit Survey in Action, which highlights the findings of The IIA's 2010 Global Internal Audit Survey, includes a series of 10 imperatives for the internal audit profession, each of which is accompanied by a number of recommendations¹. What follows are the "Key Action Steps for CAEs" for Imperative 2, **Conduct a More Responsive and Flexible Risk-Based Audit Plan**, which is particularly relevant to a discussion on monitoring risk in a fast-changing environment.

- Assess the maturity of the existing risk assessment process and develop plans to extend its application across the enterprise.
- Develop processes within internal audit to identify and report on emerging risks:
 - Make the identification of emerging issues a key performance responsibility of the CAE and direct reports.
 - Coordinate with the organization's other risk and control units to share information and views on emerging issues.
 - Identify and use external sources of relevant data, knowledge, and business issues to assist in the identification of external emerging issues.
- Assess the existing process for making periodic updates and revisions to internal audit's annual audit plan; develop steps to enable internal auditing to move faster and make more frequent changes to the audit plan as the organization's risks change.
- Communicate with key stakeholders (executive management and the audit committee) about the need to make more frequent updates to the audit plan; seek agreement on an appropriate balance between the need for internal audit to "complete the annual plan" and their desire for internal audit to make changes in response to emerging and changing risks:
 - Consider implementation of a "rolling" audit plan — for example, a plan that is rolled forward to cover the next six months.
 - Conduct regular, frank discussions with both senior management and the audit committee about the nature, scope, and severity of the organization's risk profile.
- Develop or refine audit reporting to demonstrate a more direct link between changes to the organization's risk profile and associated changes to the audit plan.

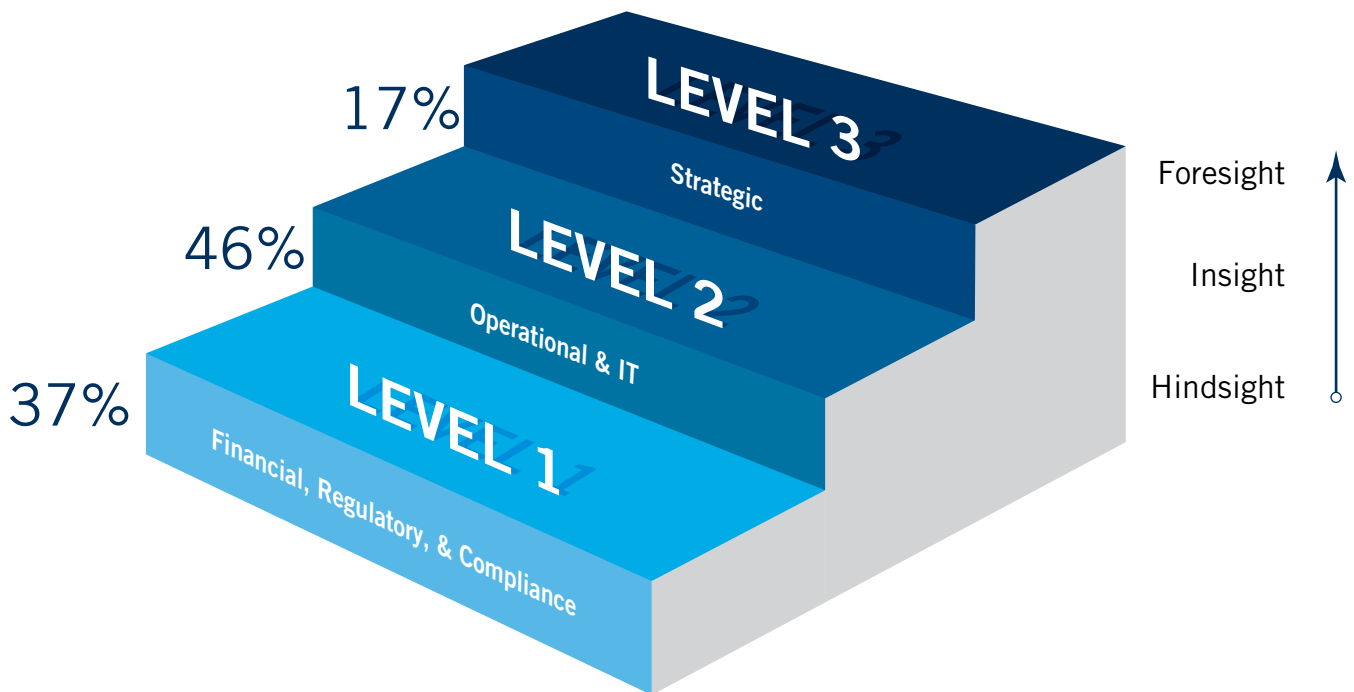
1. Richard J. Anderson and J. Christopher Svare, *Imperatives for Change: The IIA's Global Internal Audit Survey in Action* (Altamonte Springs, FL: The Institute of Internal Auditors Research Foundation, 2011).

LINKING RISKS AND AUDIT COVERAGE

Internal audit stakeholders have a core set of expectations that internal audit needs to address. These expectations have been built up over time based on stakeholder needs and the extent to which internal audit has delivered against those needs. As organizations become more complex, and internal audit functions enhance their competencies and resource levels, in kind, internal auditors can be expected to take on and address a more complex set of organizational risks.

The areas of risk addressed by internal audit can be portrayed as a three-level continuum:

The Audit Risk Coverage Continuum



Pulse survey respondents expect Level 1 risks to account for an average of 37 percent of their 2015 audit plan. Level 2 and Level 3 risks are projected to account for 46 percent and 17 percent, respectively.

- **Level 1** includes the foundational risks that internal audit has traditionally addressed and has developed competencies to handle. These risks include financial reporting and accounting (including compliance with Sarbanes-Oxley financial control provisions), compliance and regulatory issues, fraud, and IT-support activities. In many respects, internal audit provides “hindsight” as part of its Level 1-type assurance work.
- **Level 2** includes significantly broader types of risks, including operational and IT considerations (not directly supporting Level 1 or operational risks). Operational risks include areas such as purchasing, supply chain, pricing, and management of financial instruments. IT considerations in this level include aspects of IT governance, program management, security over intellectual property, and website maintenance. Level 2 audit coverage affords internal auditors the opportunity to complement hindsight with insight on matters such as the efficiency and effectiveness of key operations or enterprise processes.
- **Level 3** includes strategic and business risks, corporate governance, and the effectiveness of risk management. A 2014 study² estimates that 86 percent of significant declines in market capitalization in the past decade were linked to strategic risks. Level 3 coverage affords internal auditors the opportunity to provide not only hindsight and insight, but foresight, as well. For example, internal audit might share its perspectives on threat scenarios for the future based on key risks and mitigation strategies today.

The specific risks included in each level will vary from one organization to another. Irrespective of level and organization, however, the following is true: As the risks facing an organization become more complex and internal audit competencies mature, an internal audit function will generally devote more resources to higher levels.

2. CEB, *Executive Guidance: Reducing Risk Management's Organizational Drag*, <http://ceb.uberflip.com/i/366476/6>, (2014).

“Disclosing the gaps in risk coverage and discussing the resources needed to address the gaps is essential.”

—Joe N. Steakley, CPA, CRMA
Senior Vice President, HCA
(Hospital Corporation of America)

The Internal Audit Conundrum

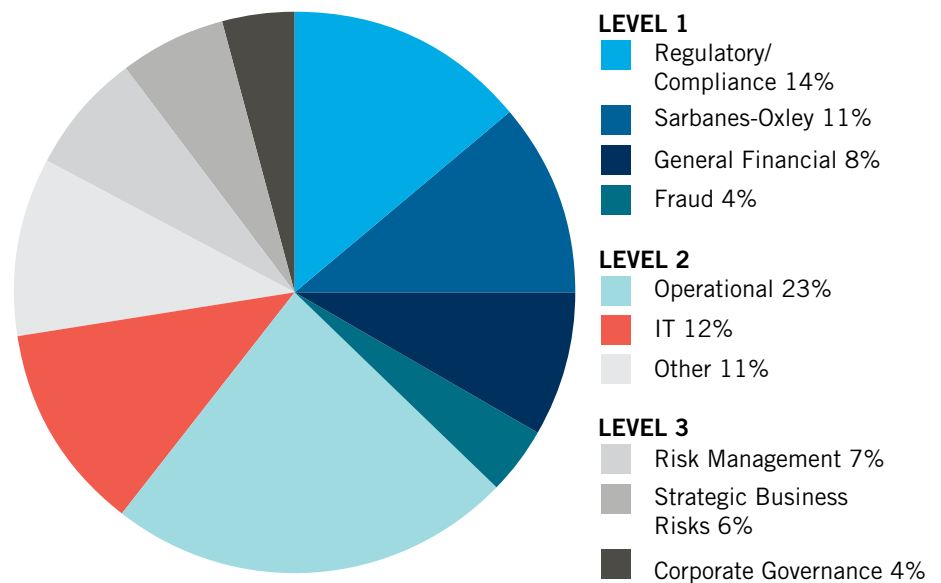
When an internal audit function successfully operates on Level 3 of the Audit Risk Coverage Continuum, it is providing value to the organization that would otherwise be lacking if internal audit were focusing solely on Level 1. This is not to say, however, that internal audit’s work on Levels 1 and 2 do not bring tremendous value to the organization. Indeed, the function’s key stakeholders have historically expected their internal audit groups to address Level 1 risks. As risks to organizations have grown, and internal audit functions have matured, internal auditors have been able to devote more time to addressing risks on Level 2 and, to varying extents, Level 3.

The challenge for internal audit is threefold: first, address Level 1 risks before moving up to higher levels; second, make sure the right resources and competencies are in place to address Levels 2 and 3 risks effectively; and third, ensure key stakeholders support internal audit’s increased attention to higher-level activities. Some stakeholders may believe internal audit should focus solely on Level 1 risks. In part, such a viewpoint could be reflecting the traditional role of internal audit in the organization or the perception that internal audit lacks the requisite competencies to add value at higher levels.

What is paramount is that internal audit understands and assesses all the major risks of an organization and allocates its resources in response to those risks. As an organization’s risks become more complex and internal audit enhances its competencies and resource levels, we should expect internal audit to increase its focus on higher levels of risk. Pulse survey responses support this direction.

Pulse survey respondents were asked to estimate the distribution of their audit plan coverage. This figure reflects a summary of the data.

Audit Plan Coverage in 2015



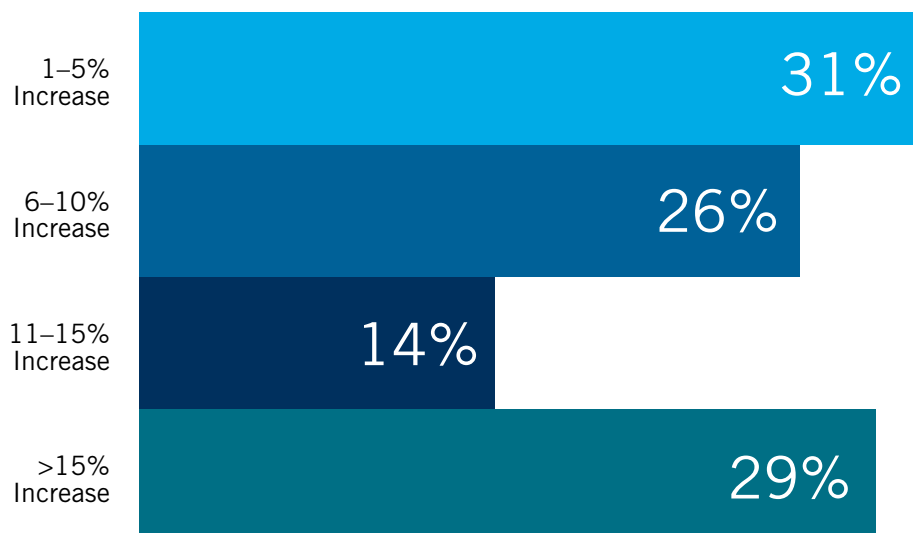
Additional Insights From the Pulse Survey:

- Nearly all survey response segments reported an increased focus on Level 3 risks.
- An increased focus on audits of operational risks was more prevalent among smaller organizations operating outside of financial services.
- Increased Level 1 activity stemmed primarily from an uptake in regulatory/ compliance audits on the part of financial services companies.
- The increased focus on IT risks, although driven primarily by larger financial services organizations, is also being spurred by large organizations, in general.
- Roughly half of all survey respondents devote no resources to risks related to Sarbanes-Oxley; those that do focus on Sarbanes-Oxley tend to be larger manufacturing organizations.
- Smaller organizations focusing on Sarbanes-Oxley risks tend to devote a higher percentage of their resources to this area than do larger organizations.
- Smaller organizations expect to devote more effort to general financial risks in 2015.

Resource Allocations

Pulse survey participants project increases in budgets and staffing in 2015. On the financial side, nearly 42 percent of survey respondents expect their budgets to increase, nearly 50 percent expect their budgets to remain level, and only 9 percent anticipate a decrease in budget. Looking at their human resources, 29 percent of respondents anticipate an increase in their staffing levels, 68 percent expect staffing levels to stay the same, and only 3 percent project a decrease in staffing.

Range of Projected Budget Increase for 2015



Among respondents projecting an increase in budget, the majority projected an increase of 10 percent or less.

How is internal audit planning to invest these increased resources? As reflected by the pie chart on page 11 (see Audit Plan Coverage in 2015), survey respondents are focusing their plan on Levels 1 and 2 as opposed to Level 3.

Why isn't internal audit focusing more aggressively on Level 3? The most likely reasons center on stakeholder expectations, internal audit competencies (what they have and don't have), and the need to maintain a strong focus on Level 1. It can take time for stakeholders to recognize that internal audit should be devoting greater resources to higher-level risks. In addition, internal audit needs to build the competencies and skill sets to tackle higher-level risks effectively. Finally, there are some Level 1 risks that simply cannot be dismissed.

Key Imperatives for Internal Audit

What does this all mean? Stakeholders have differing expectations and internal auditors have differing levels of competencies. Although risks to organizations are changing, the attention given by internal audit to Level 3 risks remains modest while the need to keep a sharp focus on some Level 1 risks remains critical. Given this scenario, here are four important points for internal auditors to consider:

1. Ensure a risk-based level of effort across the Audit Risk Coverage Continuum. Do not rely too heavily on what has been the traditional scope of internal auditing on page 11.
2. Give Level 3 concerns the attention they deserve while ensuring that risks on Levels 1 and 2 are addressed appropriately.
3. Foster awareness among stakeholders about how internal audit can address higher-level risks. This may require challenging historical patterns and long-standing attitudes toward internal audit, building on the excellence of internal audit capabilities and proven work.
4. Look for significant risks lurking on the lower-risk levels. No one wants their organization to be the next in line to suffer from restated financial results or regulatory penalties.

PCAOB CREATING DOWNSTREAM IMPACT ON INTERNAL AUDIT

When the Public Company Accounting Oversight Board (PCAOB) issued Staff Audit Practice Alert No. 11 (PA 11) in the fall of 2013, it raised questions about the extent to which external auditors would rely on the work of others (including internal audit) when assessing Internal Control over Financial Reporting (ICFR). The PCAOB, a nonprofit corporation established by Congress to oversee external audits of public companies, expressed particular concern about the amount of unsupported reliance being placed by external audit when evaluating higher-risk areas involving significant judgment, such as the valuation of complex, hard-to-value investment securities.

The PCAOB issued Staff Audit PA 11 on October 24, 2013, in response to "...significant auditing practice issues observed" relating to audits of ICFR. In practice, ICFR has, in the post-Sarbanes-Oxley era, become a major area of emphasis during the annual external audit cycle for U.S. publicly traded companies. Today, the evaluation, assessment, and documentation of ICFR consumes countless hours of time from executive management, financial staff, internal audit, and external audit on an annual basis.

PCAOB activities, while directed at U.S. firms and individuals performing external audits, also have a significant downstream impact on public company boards and audit committees as well as financial management and internal audit. In many respects, such activities have become symbolic of the increasingly heavy regulatory burden being placed on the internal audit community in the United States — a burden that can be expected to have an increasing impact on audit planning and risk assessment going forward.

Documentation Takes Center Stage

During a series of roundtable discussions hosted by The IIA's Audit Executive Center and the Center for Audit Quality in the latter half of 2014, internal and external auditors alike reported stepped-up demands for more complete documentation from the PCAOB. Underpinning the dual push for enhanced documentation and completion of work related to ICFR assessments is the determination of how much reliance external audit can place on the work of others, namely management and internal audit. In addressing the determination issue, PA 11 makes two key points: first, the extent to which external audit can rely on the work of others diminishes as the risk associated with the particular control being tested increases; and second, the extent to which external audit can rely on the work of others diminishes as the evaluated competence and objectivity of the persons whose work the (external) auditor plans to use decreases.

In the past year, a number of CAEs have reported that the issuance of PA 11 has led to less external audit reliance being placed on the work of internal audit when conducting ICFR evaluations — regardless of the risk, competence, or objectivity assessed. This could be the result of the external audit firm adopting a risk management practice to minimize its reliance on the work of others under all circumstances. At the same time, however, other CAEs have reported little to no impact from PA 11. This disparity in anecdotal evidence prompted The IIA to survey its members about the true impact of PA 11.

In the Pulse survey, we posed a number of questions seeking to assess the impact of PCAOB PA 11 on the internal audit community. The results are decidedly mixed.

On the positive side, 94 percent of the Pulse survey respondents from publicly traded companies indicated that external audit does rely on work produced by internal audit. At the same time, however, 35 percent of such respondents reported that, with respect to higher-risk areas, external audit’s reliance on the work of internal audit had decreased since the issuance of PA 11, with nearly 8 percent indicating that such reliance had decreased greatly. Conversely, 48 percent reported that such reliance had remained level and, notably, 17 percent of respondents reported an *increase* in such reliance.

Documentation and Testing Experience Greater Scrutiny

When asked to what degree external audit’s review of internal audit’s work had changed from 2013, survey respondents reported that such analysis had increased sharply in the areas of documentation and testing and significantly across all areas examined, including risk evaluation, internal auditor competence, and the objectivity of internal audit functions.

Change in Level of Scrutiny by External Audit of Internal Audit’s Work Since 2013

FOCUS AREA	% INCREASED	% UNCHANGED
Risk Evaluation	36%	63%
Testing Scope	56%	43%
Internal Auditor Competence	27%	72%
Internal Audit’s Objectivity	22%	78%
Internal Audit’s Workpaper Documentation	55%	43%
Management’s Documentation of Controls	65%	35%

Pulse survey respondents also provided some insights on what to expect in 2015 and beyond:

- 95 percent of respondents from publicly traded companies report assisting management to some degree with its documentation of ICFR, with 51 percent being either *very* or *extremely* involved.
- 65 percent of respondents from publicly traded companies experiencing increased scrutiny from external audit since 2013 expect an increase in external audit fees as a direct consequence of PA 11.
- 55 percent of respondents from publicly traded companies experiencing increased scrutiny expect an increase in the hours devoted by internal audit to providing direct assistance to external audit. (When providing direct assistance, internal auditors function as part of the external audit team and are directly supervised by the external auditors.)

Clearly, internal audit, external audit, and the audit committee will need to continue to collaborate going forward to strike the most appropriate balance for the company, taking into account three key factors — reliance, external audit fees, and the highest and best use of internal audit resources.

Strategic Considerations for Internal Audit

Addressing the fallout from PA 11 and its impact on audit planning and risk assessment will require an effective collaboration among internal and external audit functions, senior management, and the audit committee. Here is a starter list of questions for CAEs to pursue with their key stakeholders:

- When collaborating on annual planning activities, do external audit and internal audit have a common understanding of what areas are deemed most risky from an ICFR standpoint? Is there clear agreement on an acceptable level of external audit's reliance on the work of internal audit for these risky areas?
- Does the audit committee have an understanding of where external audit is, and is not, placing reliance on the work of internal audit, and the rationale behind the reliance parameters?
- Do internal audit and the audit committee clearly understand how external audit evaluates the competence and objectivity of internal audit?
- If there are opportunities to enhance the competence of internal audit, are those opportunities being pursued?
- If there are opportunities to enhance the perceived objectivity of internal audit, are those opportunities discussed?

- Does the external auditor have competence- and objectivity-related discussions with the audit committee? If not, does the audit committee know to initiate the conversation?
- To lay the groundwork for an informed cost/benefit decision about a potential increase in reliance work, is it clear how increased reliance on the work of internal audit might affect not only external audit fees, but also other internal audit priorities?

“Strategic risks and value-added opportunities should not be overlooked when planning activities with external audit.”

—Greg Kalin, CIA, CRMA
Director of Internal Audit, Morningstar, Inc.

NAVIGATING AN ESCALATING TALENT SHORTAGE

War for Talent Poses Challenge for Internal Audit

The war for talent is real, and it's heating up for organizations vying for the best and the brightest. According to Manpower Group's 9th Annual Talent Shortage survey³, which includes interviews with more than 37,000 employers in 42 countries and territories, 36 percent of employers reported talent shortages in 2014, the highest percentage in seven years. In the United States, that number is even higher, with 40 percent of employers finding it a challenge to fill jobs. Of the 10 most difficult types of jobs to fill, accounting and finance ranked sixth, ahead of IT, engineering, and nursing. What's more, the McKinsey Global Institute⁴ projects a shortfall of up to 18 million highly skilled workers in advanced economies, including the United States, by 2020.

What does this mean for internal audit functions? For starters, they will face tougher competition to recruit and retain the top talent needed to meet the increased complexity of regulatory changes, emerging risks around cybersecurity, IT, and the growing demands of stakeholders for more effective risk-based assurance and advisory services.

In the Pulse survey, 40 percent of respondents indicated that attracting and retaining talent was a *high* or *critical* priority for their audit plan. Furthermore, when survey participants were asked to describe the reasons for any skill gaps on their audit teams, 54 percent of respondents cited competition for a limited pool of skilled auditors. This suggests that although talent shortage remains a concern in the profession for some, others may be confident they have the right talent to perform audits or they may not be expanding their audit coverage to encompass emerging risks requiring more talent with varied, more specialized skills and competencies.

Findings from the Pulse survey along with perspectives from CAE interviews point to two drivers contributing to the growing talent shortage in the internal audit profession: first, internal audit functions continue to seek talent with skills and competencies in traditional areas such as accounting and finance despite shifting expectations from audit committees to address critical risks outside of these areas. Second, the profession is suffering from a brand identity crisis. On one level, internal audit functions have difficulty attracting and recruiting top talent when up against the perceived opportunities in fields such as banking and consulting, where higher

3. Manpower Group, *The Talent Shortage Continues: How the Ever Changing Role of HR Can Bridge the Gap*, http://www.manpowergroup.us/campaigns/talent-shortage-2014/assets/pdf/2014_Talent_Shortage_WP_US.pdf, (2014).

4. Richard Dobbs, "Talent tensions ahead: A CEO briefing," *McKinsey Quarterly*, http://www.mckinsey.com/insights/economic_studies/talent_tensions_ahead_a_ceo_briefing, (November 2012).

salaries are more appealing to today's in-demand candidates looking to fast-track their careers. On another level, the function has difficulty retaining top talent given its growing reputation as a breeding ground and pass-through source of talent for the business coupled with a lack of strong retention strategies.

Soft Skills Deemed Most Essential, But Challenging to Address

Gone are the days when a degree or experience in accounting was sufficient or desired for internal audit candidates. Instead, CAEs today are looking to acquire talent with a stronger mix of soft skills, such as critical thinking and communications, to navigate the increasing complexity of the internal audit profession and the organizations it supports as well as an uncertain business environment and changing stakeholder expectations. There is a growing mindset that talent can learn and expand technical skills, but that soft skills are more difficult to teach on the job. Not only is it important to have seasoned staff to assess risks and controls, but it is becoming increasingly important to infuse the department with fresh technology skills, analytical thinking, and other competencies that stretch beyond the accounting skills for which internal auditors traditionally have been known.

According to the Pulse survey results, **analytical/critical thinking** and **communication skills** are the top two skill categories, with 96 percent of respondents considering them to be either *very* or *extremely essential*; **business acumen** skills and **industry-specific knowledge** were also rated highly:

- **Analytical/critical thinking** skills, the top-ranked category, were considered to be *extremely essential* by more than 62 percent of respondents, with another 34 percent considering them to be *very essential* (96 percent on a combined basis).
- **Communication skills**, the second-ranked category, were deemed *extremely essential* by 56 percent of respondents, with another 40 percent considering them to be *very essential* (96 percent combined).
- **Business acumen** skills, the third-ranked category, were considered *extremely essential* by 30 percent of Pulse survey respondents and *very essential* by more than 50 percent (80 percent combined).
- A total of 69 percent of respondents considered **industry-specific knowledge**, the fourth-ranked category, to be either *very* or *extremely essential* (46 percent of respondents considering such skills to be *very essential* and another 23 percent perceive them to be *extremely essential*).

In an article entitled "The Search for Top Talent,"⁵ Tim Hird, executive director of Robert Half International Inc.'s Management Resources division, added perspective to the intense competition for highly qualified personnel: "It's not just a question of

5. Russell Jackson, "The Search for Top Talent," *Internal Auditor*, (Altamonte Springs, FL: The Institute of Internal Auditors, February 2015).

finding and acquiring talent. It’s a question of finding and acquiring the modern day internal auditor.”

As the scope of internal audit broadens to encompass skills in areas beyond the traditional areas of finance and accounting, the talent pool shrinks while competition increases for talent with a broader set of skills and competencies. As the Pulse survey results indicate, internal audit functions are having difficulty hiring across a significant number of areas where specialized or soft skills are considered essential (see table: **Areas of Hiring Difficulty**). Without question, internal auditors with the ideal mix of soft and hard skills are becoming more difficult to find. “Indeed,” adds Hird, “there’s a supply and demand imbalance that’s growing by the day.”

Competition for Skilled Talent Creates Gaps

According to Robert Half’s Special Report: The Demand for Skilled Talent⁶, four factors in particular are contributing significantly to the talent shortage in specialized skills:

- An increase in companies hiring.
- An intensified war for talent globally.
- A decrease in the supply of college graduates.
- Persistent recruiting shortfalls and challenging skills gaps.

When asked to describe why they were experiencing skill gaps, 54 percent of Pulse survey respondents cited competition for a limited pool of skilled auditors as a concern, 33 percent mentioned changes in the field making it difficult for auditors to stay current, 28 percent cited insufficient compensation, and 25 percent mentioned lack of resources for skills development.

Assessing and Addressing Skills Gaps

When asked to describe the degree to which skills gaps have had an impact on their audit coverage, Pulse respondents cited strategic business risks and IT issues (not covered by other audits) as being of particular concern. That coupled with areas where respondents either pointed to skill deficiencies (see table: **Areas of Skill Deficiencies**) or difficulty in hiring (see table: **Areas of Hiring Difficulty**) reinforce concerns about how well internal audit functions understand the skills they have, the skills they need, and their ability to attract and retain the right talent (and skills) to provide assurance and advisory support for emerging risks impacting their organizations.

When asked to describe the tactics being used to address skill gaps, 56 percent of respondents said they were recruiting talent from outside of internal audit, which

Areas of Hiring Difficulty

Rank	Skill
1	IT-General
2	Cybersecurity & Privacy
3	Data Mining & Analytics
4	Industry-specific Knowledge
5	Analytical/Critical Thinking

Pulse respondents were asked to indicate where they are experiencing difficulty hiring candidates. In response, they pointed to general IT skills, cybersecurity skills, data mining, industry-specific knowledge, and analytical thinking.

Areas of Skill Deficiencies

Rank	Skill
1	Quality Controls, e.g. Six Sigma
2	Data Mining & Analytics
3	Cybersecurity & Privacy
4	Forensics & Investigations
5	IT General

Pulse respondents were asked to identify all areas of skill deficiency in their internal audit functions. Areas where skills are lacking include quality controls, data mining, cybersecurity skills, forensics, and IT.

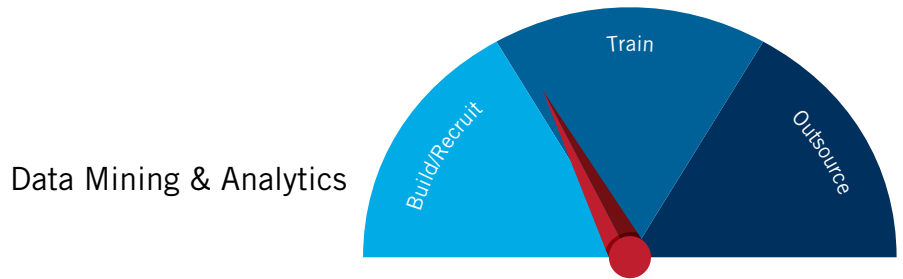
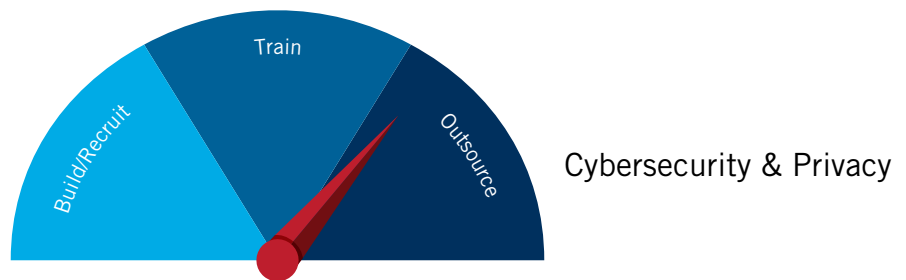
6. Robert Half, *Special Report: The Demand for Skilled Talent, Volume 7*, <http://www.roberthalf.com/demand-for-skilled-talent>, (2013).

“No surprise to anyone, IT risks are not decreasing. Our challenges are to balance the execution of the plan with team development and to assist management in building risk-and-controls capability within the IT function through the use of guest auditors.”

Amy Hamilton,
Vice President, Internal Audit
Marsh & McLennan
Companies Inc.

opens up a wider talent pool to select from, but one that is also targeted by tougher competition. In addition, 39 percent of respondents said they were offering on-site training, 23 percent said they were offering a more attractive salary, and 19 percent mentioned offering internal employee rotational programs. These tactics are positive steps that will help internal audit strengthen its brand as a preferred career destination in terms of opportunity, growth, and development. But will they be enough? As they look ahead, internal audit leaders will need to regularly assess, monitor, and enhance their talent strategies to maintain a competitive edge. In doing so, they will need to continually focus on recruitment, training, and assembling the right mix of staffing and skill sets to meet changing organizational needs.

Techniques Employed by Pulse Survey Participants to Address Skill Gaps



When asked to describe their tactics for addressing skill gaps, Pulse survey respondents pointed to recruiting staff from outside of internal audit, offering on-site training, and outsourcing as three effective approaches, with responses varying by skills area. For instance, 37 percent of respondents reported outsourcing cybersecurity and privacy skills, whereas only 9 percent reported outsourcing data mining and analytics. Conversely, 37 percent reported recruiting for data mining and analytic skills, but only 23 percent reported recruiting for cybersecurity and privacy.

ASSEMBLING THE EXPERTISE TO ADDRESS KEY RISKS

To address stakeholder concerns, internal audit functions need to build teams with the right sets of skills, competencies, and expertise to provide effective audit coverage to the organizations they serve. That means gaining a solid understanding of an organization's risk profile and developing a talent strategy designed to target key risks effectively. Given the stiff competition for top talent today, however, building such a team can be a major challenge.

In a 2014 review of quality assessments of internal audit conducted by IIA Quality Services, LLC, two common themes, in particular, stood out: first, the lack of talent strategies aligned with an organization's enterprise risk assessment; and second, the failure to track the competencies and professional development of internal audit team members.

Audit coverage and the need to address specific types of risk — including emerging risks associated with cybersecurity, IT, and data analytics — are key factors driving the demand for talent with specific skill sets. At the end of the day, internal auditors need to be more risk-centric in their efforts to understand the business, assess the perceived risks to the organization, and determine the appropriate skills needed to meet stakeholder expectations.

Too often, however, risk plans are driven more by the skill sets on hand or in line with a more traditional audit approach focused predominantly on financial or compliance risks as opposed to determining the ideal mix of skills needed to address a broad spectrum of risk challenges.

To this point, when Pulse survey respondents were asked about the degree to which skill gaps affect their audit coverage, the surprising answer was “none” — no impact! However, when asked about their level of agreement with the statement, “Internal audit has the resources and expertise necessary to continuously assess risks and analyze their potential impact to the business model,” 21 percent of respondents indicated that they lacked such resources and expertise and another 18 percent remained neutral (neither agreeing nor disagreeing with the statement). That would seem to run counter to claims that skill gaps are having no impact on audit coverage. Indeed, there seems to be a disturbing disconnect between perception and reality among internal audit functions when it comes to achieving effective audit coverage of enterprisewide risks with their current talent and skill sets.

The apparent belief among survey respondents that skill gaps are having no effect on their audit effectiveness is a clear reflection of internal audit coverage being driven more by skills on hand rather than by a comprehensive risk assessment and an audit plan with sufficient scope to address emerging risks in areas such as cybersecurity, IT, and data analytics. It's in these areas in particular where we are seeing a number of high-profile risk crises. What is troubling is that Pulse survey respondents do not place a high priority on their skills in these areas.

A Key Imperative for Internal Audit – Forge a Strong Talent Management Strategy

An effective talent management strategy can significantly enhance the ability of an internal audit function to address enterprisewide risks effectively. A successful talent strategy would typically reflect a **clear understanding** of the **anticipated key risks** facing an organization **over the next three-to five-year period**. It would provide an **evaluation of audit team competencies** with regard to providing target audit coverage and a **game plan** for growing, obtaining, and maintaining missing competencies.

Consider the following 4-step plan for developing a talent management strategy tailored to the needs of a particular organization:

Step 1: Create an Organizational Risk Profile

Start by conducting a comprehensive risk assessment of the organization in collaboration with your business partners and key stakeholders that includes emerging risks meriting close attention. Gain audit committee input through discussions and other means in order to convey a clear and documented understanding of the board's risk appetite and present an accurate picture of the organizational risk profile. Create a list of desired skills and competencies for the audit team.

Step 2: Assess Team Skills

Conduct a basic skills audit of the internal audit team. Leverage self-assessment and career-mapping tools to gain a solid understanding of team strengths, development opportunities, and perceived gaps across the department in terms of skills and competencies.

Many internal audit leaders follow the basic or generic performance evaluation program supplied by their organizations; however, this process typically does not truly evaluate the competencies for internal audit. And although a CAE might have a good sense of team skills, he or she might not fully understand the underlying behaviors that enable a person to do something successfully, effectively, or efficiently. What's more, informal assumptions about team competencies are not sustainable, particularly when it comes to large and growing teams.

Leverage The IIA's Global Internal Audit Competency Framework to supplement existing performance evaluations. Extend this data to include tracking of professional development.

Step 3: Identify Skills Gaps and Develop Strategies to Close Them

Study the correlations between the organizational risk profile (Step 1) and the skills

assessment (Step 2) to pinpoint skills gaps within the internal audit department that could impede meeting the risk assurance and advisory expectations of the organization. Consider adopting the following strategies and tactics:

- Partner with HR and recruiting colleagues to develop a talent-recruiting approach tailored to the organization; leverage internal and external learning development resources to develop a world-class talent recruitment program and retention strategy centered on assessment-based staff training and career-mapping input.
- Identify opportunities to coach and mentor staff with a variety of audit projects designed to stretch and develop skills.
- Employ a co-sourcing strategy in partnership with a service provider that has the right mix of specialized skills to balance those in the internal audit department.
- Consider if outsourcing alternatives could help address the organization's unique needs and circumstances.

Step 4: Address Strategic Business Risks and the Effectiveness of Risk Management

The fourth and final step in this comprehensive plan for developing a tailored talent management strategy is to develop a forward-looking strategic platform for internal audit that builds on the organizational risk profile developed in Step 1 and the Step 2 skills assessment. Incorporate a mindset for building and acquiring skills to address strategic and business risks as well as the effectiveness of risk management. Establish a balance between soft and technical skills resulting in a more nimble and diverse talent pool. And consider strategies and tactics to help reposition the internal audit brand in a more advisory and strategic context, such as guest auditor and rotational programs.

CONCLUSION

The volatility of the current risk environment for organizations requires a mature internal audit function. With geopolitical, macroeconomic, and cyber-related incidents becoming more common, internal audit must enhance its focus on emerging risks. To this end, the 2015 North American Pulse of Internal Audit report emphasizes the need for continuous risk assessment, properly aligned audit priorities, and a strong audit team.

The internal audit function that effectively addresses continuous risk assessment can guard against potential surprises. Specifically, CAEs should develop processes to identify and report on emerging risks, assess existing processes, and provide periodic updates and revisions to the annual audit plan. Communicating these efforts to stakeholders is essential — as is refining audit reporting to demonstrate a more direct link between changes to the organization's risk profile and associated changes to the audit plan.

In the current climate, internal audit must not only provide the assurance of hindsight, but also the perspective and prescience of *insight* and *foresight*. Internal auditors should take a risk-based approach to audit planning and address appropriate risks across all levels of the continuum. Additionally, CAEs can challenge historical patterns and attitudes toward internal audit by communicating the value internal audit can add.

Meeting the challenge of these complex risks requires a high-performing internal audit function. Build the right team. An effective talent management strategy will ensure the skills, competencies, and expertise needed to provide effective audit coverage. As the complexity of risks increases, a shortage of internal audit talent emerges. CAEs need to be strategic when approaching talent. A strategic approach facilitates internal audit coverage based on a comprehensive risk assessment as opposed to the skills on hand.

In short, as noted by Douglas Anderson, former CAE at Dow Chemical, “CAEs have a tough task and it’s not getting any easier. Risks are blowing up. Talent is getting scarce. The job has always been tough, and it’s getting tougher. We have many more opportunities to fail today than we did 10 years ago. It’s time to up our game.”



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