Annual Audit Planning

Perspectives from Chief Audit Executives
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Introduction

Most Chief Audit Executives face challenges every year while preparing and drafting their Annual Audit Plan. The Annual Audit Plan should address the audit needs of an organization and should be designed to provide the most effective and efficient deployment of Internal Audit resources to meet those needs.

► What are current leading and emerging practices for developing an Annual Audit Plan?
► How does Internal Audit deal with the changing economic environment?
► Are the expectations from the Audit Committee still the same?

These questions have been discussed with Chief Audit Executives (‘CAE’) representing various industries during a recent round table in Rotterdam hosted by Ernst & Young.

The Internal Audit Roundtable is part of a series of recurring events and aims to provide a platform for companies to collaborate with peers. The goal is to identify, through deliberations, practical step change solutions that can contribute towards maximizing the value that organizations can derive from their investments in managing risks.
Aligning to company strategy and key business risks

As the economy remains fragile, executives and supervisory board members continue to challenge their organizations' risk management processes. They are looking to their internal auditors to help deliver a more sustainable, efficient and effective audit function – one that fully aligns with the company’s needs and expectations.

A leading global company in the chemicals industry follows a robust audit planning process which is designed to align to the overall strategy of the company as well as the related key business risks. Their audit planning process starts with the identification of audit objects (business entities, Global functions, risks and processes) across the organization which is reflected in an “Audit Universe”. This is followed by a risk assessment for each global function and business unit (BU) where the internal audit function leverages the business enterprise risk assessment, which is aligned to the company strategy, as well as control self assessments. As part of this, internal audit considers the control environment, the business and operational environment, control history, mandatory audits, organizational change, context and materiality. Based on the BU risk assessment a risk assessment is performed on the objects in the audit universe for that BU and hours are allocated in a top down and risk based manner. This results in a five year rolling plan with focus on the year ahead.

One CAE states that the most important element of the planning and scoping process is to ensure that there is sufficient coverage of the audit universe and that no material items/locations are missed. Other participants of the round table add that you should also look back to see whether the expected coverage has been achieved. A significant challenge recognized by all CAE’s is that in practice the expected coverage has not been achieved as a result of rapid changes in the business environment. It is critical for CAE’s to identify potential gaps in expected coverage at an early stage and communicate these together with implications and suggestions to the Audit Committee.
Ernst & Young Point of View

A Strategy-Based, Entity Level Risk Assessment

Management is constantly assessing risks to the organization through both formal and informal methods. Not only should internal audit leverage management’s process, but it also may assist management with this endeavor in case the organization has not reached the desired level of maturity in this area.

A strategy-based, entity-level risk assessment driving the audit plan involves:
- Understanding the businesses strategies and objectives.
- Understanding key business risks and processes which align to the organization’s strategies and objectives.
- Creating a customized risk universe - a framework for categorizing key business risks - that reflects the risks facing the organization.
- Determining current risk monitoring activities outside of internal audit.

Furthermore, internal auditors should shift their focus from their own (audit) perspective to the business perspective. A business manager constantly thinks about and acts on the question how he can achieve his business objectives. Therefore, internal auditors should start asking management “what should go right?” to achieve his/her business objectives. It is a simple reversion of the classical (what could go wrong) question but the response from management will be more insightful.

The answer to this question delivers the inherent risk areas the auditors are looking for without having a technical audit discussion. At the same time the business manager feels connected as he experiences a more valuable discussion around the drivers of his business success, i.e. “what should go right” to achieve business objectives.
Ernst & Young Point of View

Considering internal control maturity when defining an audit response

Traditional audit plans are often driven by the overall inherent levels of risk exposure without considering the perceived level of maturity of internal control. As a result, audit findings often highlight issues which management was already aware of. In these cases management often considers internal audits a non-value adding activity.

Leading internal audit functions consider internal control maturity when determining an appropriate response for the significant risks to the business. The picture below summarizes four response strategies:

- High inherent risk exposures with low levels of control require an audit response focused on improving internal controls through e.g. internal audit advice and/or assessment of improvement plans.
- High inherent risk exposures where controls are asserted by management to be adequate, require a response focused on gaining assurance that controls continue to operate as designed and that risk is properly managed.
- Low inherent risk exposures that also have a low level of control may be consciously accepted by management but the development of the risk level must be monitored.
- Low inherent risk exposures with a high level of control are consciously accepted by the organization and in some instances may generate opportunities to increase process efficiencies.

![Diagram showing the relationship between risk level and internal control maturity]

Internal Control Maturity

Risk Level (Impact x Likelihood / 5)

- Improve: Advise and assess improvement plans
- Audit: Gain assurance of risk management and internal controls
- Monitor: The development of risk levels
- Accept: Risk management capabilities with limited amount of assurance
Responding to changes in the business environment

Some CAE’s argue: ‘Why we should plan a year in advance while we know that the business environment will change significantly?’ Other participants state that the audit plan is based on the expectation that everything remains constant during the year. The Audit Committee should reconcile the audit plan against its collective knowledge of the organization from their supervisory role to ensure there are no significant areas missing in the plan. Following the annual formal approval process, ongoing discussions on the audit plan with executive management and the Audit Committee should take place to determine if and when changes to the Audit Plan are in order.

A leading global company in the chemicals industry is addressing the issue of continuous changes in the business environment through the introduction of a rolling audit planning process. The audit plan is updated on an ongoing basis and audits are scheduled on a rolling 6+6 months basis, with room for ad hoc projects and business requests. In the long run the internal audit function aims for a rolling 3+9 audit planning process. In this case there might be multiple Audit Committee approvals throughout the year but the CAE could also rely on the continuous communication process rather than on formal approvals. During the first pilot of this approach approximately 25% of the audit plan has actually changed. The changes were driven by valid business reasons such as changing project timelines in a global ERP-system implementation. The main challenge for this global company is to keep up with new initiatives and changes resulting from the execution of the business strategy and to adapt to the different requirements of growth versus mature markets. As a response, they have developed a different audit approach for these two markets. For mature markets the audit function focuses more on higher level management monitoring of smaller entities rather than visiting them and it deploys remote audit techniques using data mining capability. For growth markets there is more focus on soft controls and detailed audits on site.
Ernst & Young Point of View

Moving to a more dynamic audit planning process

Today’s complex and rapidly changing environment requires a more dynamic planning approach. Many leading Internal Audit functions are moving away from multi-year cyclical plans and the concept of the rigid annual audit plan.

The planning process is transforming from a discrete (once or twice a year) activity to an on-going process. As a matter of good practice the Audit Plan is developed on a 3 + 9 basis, whereby the next three months work is firmly planned and subsequent nine months is indicative. The production of a longer term, 12 months forward plan, facilitates the management of financial budgets and the identification and sourcing of skills needed for delivery.

Statistical models (containing risk factors, materiality, time since last audit, complexity, degree of change) are no longer the main driver for the audit planning process. Instead, business intelligence and continuous monitoring provide pipelines of information constantly being assessed for audit planning implications.

The key criteria used to measure importance or significance of a potential audit area are the risk tolerances contained in the Risk Strategy of the company, approved by the Board. Those business areas with the capacity to breach group wide risk tolerance are prioritised reflecting the potential risk exposures.
Responding to changing expectations

All CAE’s participating in this roundtable agree that the key customers of internal audit are Business Unit Management, the Executive Committee and the Audit Committee. Between them there is some disagreement with respect to who the most important customer is as some participants argue that Business Unit Management might be even more important for internal audit than the Audit Committee. This is driven by the fact that in some companies the role of the Audit Committee is still perceived as being a formal one, while value delivered to Business Unit Management is more visible when insights from internal audit are actually leading to process improvements.

Other participants experience changing expectations from Audit Committees and Senior Management. The role of the Audit Committee especially seems to change. They are becoming more proactive and demand items to be added to the audit plan. CAE’s indicate that there is an increasing demand for ad hoc audits relating to special projects, fraud and follow-up audits. To be able to respond to ad hoc audits or special projects many CAE’s leave a contingency in their audit plan to facilitate these requests.

One CAE states that approximately 30% of the hours in his plan are spend on special topics such as implementations of IT systems and other project audits.

He expects this percentage to increase even further in the following years. The main challenge with these type of audits is that in some organizations they cannot be planned far in advance as the projects are either not known or it is not clear when a project phase will finish. In fact, these may be indicators of weaknesses in the control environment.
There is a clear shift in stakeholders' expectations who demand more ad hoc audits or special projects at the expense of traditional cycle-based audits. This is a strong sign that audit functions are expected to become a strategic advisor in addition to their traditional role related to the evaluation of the effectiveness of internal controls. The picture below visualizes these changes in stakeholder expectations.

**Changing expectations from Internal Audit**

- **Audit committee and management expectations**
- **Company initiatives and business initiatives**
- **Mandate for internal audit**

**Strategic and valued advisor**
Internal audit function serves as a subject matter specialist to business management around strategic initiatives, challenges, and changes in the organization. The function has the people, knowledge, and experiences to effectively provide this level of service.

**Business insight**
In addition to covering the “basics”, the internal audit function is designed to provide high quality, relevant business insight as an integral part of its activities. Business insight is not a by-product, but an explicit outcome from the function’s activities.

**Control and compliance monitoring structure**
Internal audit function focused on evaluating the design and the effectiveness of internal controls in those areas outlined in their charter or mandate. Also includes focusing on compliance with key regulations and policies.

Audit Committees especially insist on quick follow-up on audit findings. Some participants question that Audit Committees are exposed from a personal liability perspective when audit issues have not been adequately resolved and closed by management. Several CAE’s mention the following current practices regarding the follow-up of audit issues:

- Requesting management confirmation on the follow-up of audit issues through a Letter of Representation process. In case items have not been followed up Internal Audit issues a report with high audit rating.
- Capturing audit issues in a central IT system with a monitoring process in place on missing explanations or changes in due dates.
Internal audit working together with others

As in most companies, the internal audit function is not the only risk function within a company. Given the increased expectations with respect to value and risk many CAE’s are trying to liaise with other functions.

Participants of the round table mention the following current practices in this respect:
► Using the risk assessments from specialized departments (e.g. tax) to obtain deeper insights in particular risks.
► Performing joint audits with other risk functions to increase the quality of audits.
► Using guest auditors from the business to add business knowledge to the audit team which increases credibility and the acceptance of findings.
► Coordinating and leveraging the effort of third party assurance providers such as so-called notified bodies and certification institutes in areas such as health and safety, quality, information security, etc.

Some CAE’s express concerns with respect to potential conflicts of interest when working together with other functions as they might have been closely involved in the design of internal controls with the business. Other participants agree and emphasize that Internal Audit should always be in the lead of internal audits.

Closing remarks

It is clear that most CAE’s experience challenges with respect to the alignment with the changing company strategy and business environment when drafting the audit plan. At the same time CAE’s need to respond to changing or emerging expectations. Throughout the discussions various emerging topics have been mentioned, such as:
► Auditing soft controls considering cultural differences.
► The role of Internal Audit with respect to Corporate Social Responsibility.
► New IT-challenges like cloud computing and protection of intellectual capital.

The latter topic is especially expected to have a huge impact on Internal Audit functions as external data storage and cloud data is becoming a very important risk. Internal Audit has difficulty with the emerging knowledge sharing cultures in companies and the move ‘into the cloud’. Internal control frameworks with respect to cloud computing environments are emerging. Therefore this might be a good discussion topic during a next round table.

For more information, please contact:
► Maurice van der Sanden
  Internal Audit solution leader
  +31 6 21251636
  maurice.van.der.sanden@nl.ey.com
► Tonny Dekker
  Risk Leader Belgium and The Netherlands
  +31 88 4071004
  tonny.dekker@nl.ey.com
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