Challenges in a changing internal audit environment

On June 18, 2013, the Canadian Audit Committee Network (CACN) met in Toronto to discuss the challenges inherent in a dynamic and changing internal audit environment. This document summarizes the key points raised during the meeting, with selected perspectives that members shared both before and after the meeting.¹ For a full list of participants, please see Appendix 1, on page 11.

Executive summary

Members discussed the changes and challenges in the current internal audit environment, focusing on four broad issue areas:

- **The evolving role of internal audit** *(page 2)*

  As the role of internal audit evolves to keep pace with the risks that companies face, its purview is changing. Members noted that internal audit is well suited to the tasks of coordinating enterprise risk management (ERM) process, ensuring that cybersecurity issues are addressed, aiding in anti-corruption compliance, and identifying opportunities for increased operational efficiencies. Members agreed that organizations must work to ensure that internal audit has the right people with the right technical skills to undertake assessments in areas that may constitute new territory for the department.

- **Recruiting and retaining highly qualified internal audit staff and leaders** *(page 3)*

  Internal audit’s staffing structure presents both challenges and opportunities for success when it comes to recruiting and retention. Members agreed that the head of internal audit should possess several key attributes, including excellent communication and interpersonal skills, good judgment, and an ability to secure respect for the internal audit function from the rest of the organization.

- **Supporting the internal audit function and staff** *(page 6)*

  The audit committee benefits from a strong relationship with the head of internal audit and the audit staff. Members discussed a variety of ways in which they support internal audit, including regular meetings outside of the audit committee meeting setting, candid communication in all interactions, and the establishment of clear expectations. In addition, members discussed the advantages and disadvantages of the various possible lines of reporting for the head of internal audit. They noted that a good relationship between the head of internal audit and the person to whom he or she reports is more important than the title at the end of the administrative reporting line and that regardless of reporting lines, some form of access to the CEO is essential.

¹ *VantagePoint reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.*
Assessing internal audit’s effectiveness and overall value (page 8)

Members discussed the challenges of defining the characteristics of an effective internal audit function and of determining whether and how internal audit adds value to the organization. While several members indicated that they take an informal approach to assessing internal audit, at least one member described a formal approach that includes questionnaires completed by others in the company, including members of senior management, and an in-camera session with the audit committee to discuss internal audit’s contributions. For a list of questions for audit committee members, see Appendix 2 on page 12.

The evolving role of internal audit

Respondents to a recent survey by EY ranked pricing pressure and cost cutting and profit pressure as the top two risks companies currently face. These risks create new demands and challenges for internal audit, and they can influence how the function is structured and the extent to which it relies on cosourcing external expertise.

However, some chief audit executives (CAEs) insist that the focus on these risks is nothing new. Responding to the EY survey, Christophe Babule, head of internal audit at L’Oreal Group, noted, “Ever since the beginning of the financial crisis, everyone has felt rising pressure from cost cutting and related profit pressure. But within our group, we were acting on these risk pressures even before the crisis. It is deeply in our roots to consider these risks every single day, even when the sun is shining.”

Certainly the situation has changed from the overwhelming initial period after the passage of the Sarbanes-Oxley Act in 2002. One member recalled, “When [Sarbanes-Oxley] came out, it almost took over the internal audit function until things got rationalized so that operations people took over some controls and internal audit could move on.” Members observed that although the scope of internal audit continues to expand beyond the controls review mandated by Sarbanes-Oxley, internal audit must not exceed the limits of its skills and expertise. For example, as the function becomes involved in ERM and information technology (IT) security assessment, its work should be confined to activities for which it has competence.

Enterprise risk management

Meeting participants described different approaches to oversight of the ERM process, but all agreed that internal audit has an important role to play. One member described the value of internal audit, especially in non-financial institutions that lack a designated independent risk function: “Identifying risk and risk mitigation should be done by management, but someone has to coordinate it, and internal audit is very good at ensuring that the process of risk identification is done properly and reviewed regularly.” Internal audit can tell the board and executives whether “risk mitigation measures are being well implemented.” Another member said, “Internal audit can act as a coordinator. It is not in the same position as heads of business units to identify risks, but the CAE can be the secretariat for the process.”


3 Ibid., 13.
Cybersecurity and IT risks
In a recent EY survey, 68% of respondent organizations reported using internal audit to assess the efficiency or effectiveness of information security. Members said they do wonder, however, whether internal audit has the technical skills necessary to review and assess cybersecurity or IT risks: “When it comes to new issues, I am not so sure our talent is good enough. It is hard to judge as an audit committee chair. Our internal audit people say they have the talent, but do we really?” One member downplayed internal audit’s input: “First, we need comfort from the CIO and CEO. Then, to the extent internal audit can help, that would be okay. But chances are, because of the technical skills required, you have to go outside the organization [and cosource for this issue].” However, at another member’s organization, “while the CIO identifies deficiencies or issues related to cybersecurity, it is up to internal audit to ensure that someone is actually addressing and fixing those issues.”

Anti-corruption risks
Internal audit may have several duties associated with compliance with anti-bribery statutes such as the US Foreign Corrupt Practices Act (FCPA) and UK Bribery Act, including investigating potential breaches, auditing the company’s compliance policy for operating effectiveness, and handling annual compliance certification. One member described the value that internal audit can add to anti-corruption compliance: “Internal audit can be very helpful because they set the tone, and people know that internal audit can come flying in at any time to check the cash box or anything else.” Not all companies delegate anti-corruption matters to internal audit, however. At several members’ companies, compliance departments handle those issues. As one member observed during a pre-meeting conversation, “Most of the time, if we suspect anything has gone wrong, we hire an attorney because we want the attorney-client privilege, and the attorney may hire someone [to keep the protection of privilege]. Internal audit is not taking the lead.”

Operational efficiencies
During pre-meeting conversations, members observed that internal audit has become a resource for identifying or proposing new operational efficiencies. One member said that management now sees internal audit “as a resource that can bring about some efficiencies and add more value.” Another member said, “Internal audit gets requests from operations groups asking for assistance not just when something is wrong, but when they think something could be done better.” A third member characterized the increase in “consulting assignments” as “a sign of confidence in the internal audit staff.”

Recruiting and retaining highly qualified internal audit staff and leaders
Members discussed the challenges of properly staffing and organizing the internal audit function, touching on the characteristics of an excellent CAE.

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Striking the right balance between services provided in-house and by an external provider

Members weighed the benefits of different organizational approaches to internal audit: house-only staffing, cosourcing, and fully outsourcing the function. Many members agreed with one who said, “I am a proponent of the cosourcing model. You get the skills you need when you need them, and it is up to the head of internal audit to put up a hand and request resources when needed.” Another member noted that cosourcing allows internal audit functions to use “very specialized people,” which is an advantage when the skills need to change so quickly. One member pointed out that cosourcing can be economical: “If you need someone for a three-week project, why would you keep them for the other 49 weeks?” However, during a pre-meeting conversation, one member expressed concern about external providers’ initial lack of familiarity with the organization: “You have to try to keep the same team on for a while so that they become used to the company.”

The Institute of Internal Auditors has said that the head of internal audit “should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts.”6 These considerations affect not only decisions regarding cosourcing and outsourcing, but also the nature and frequency of interactions with the external auditor, how much time internal audit spends on assurance and compliance work, and how much it spends on operational and other work.

Recruiting, motivating, and retaining talent

Talent is a top concern for any corporate function, and internal audit is no exception. According to one member, when it is not perceived as a promising career path, internal audit has historically risked becoming “an elephant burial ground.” Another member said, “Turnover is a problem, and as the scope of internal audit changes, it is harder still to get good people into the function.” But one member acknowledged that regardless of the challenges staffing presents, “it is the audit committee’s responsibility to ensure the function has the right people with the right skills to execute the plan.” Members focused on the advantages and disadvantages of treating internal audit as one part of a larger career-training model and on the human-resource challenge posed by recent advances in technology.

Using the rotational model

One way to increase the desirability of a position within internal audit is to provide a pathway for advancement from internal audit to other parts of the company. Members highlighted the potential benefits of this approach: it provides a way to train young people interested in finance, gives internal audit an infusion of business knowledge from other parts of the business, and helps the rest of the organization understand the importance of internal audit. Furthermore, if employees throughout the organization have prior experience in internal audit, they may be more likely to answer the department’s call for

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reinforcements in the future. As one member remarked during a pre-meeting conversation, “Sometimes, when internal audit needs additional resources temporarily to do pressing audits or investigations, people around the organization who previously spent time within internal audit are available to help.”

While the model has proponents, some still question the trade-offs. One member said, “The ideal head of internal audit is in their last job. I would be concerned if that person were on a career path because they might not be solely focused on internal audit but also on the next step to another point in the organization.” Others question the viability of the model in smaller companies with relatively small internal audit staffs in light of the added cost of high turnover among internal audit personnel.

Recruiting and retaining staff with IT skills

A significant new recruiting challenge has arisen from recent rapid advances in technology. Big data – “high-volume, -velocity and -variety information assets that demand cost-effective, innovative forms of information processing for enhanced insight and decision making” – has the potential to revolutionize the work of internal audit. According to the IIA, “Data analysis technologies can benefit internal audit departments and the organization as a whole. For instance, data analytics can create the opportunity to test up to 100 percent of a particular data population, continuously monitor and audit a particular area, standardize the use of repeatable procedures, and enhance audit reports by providing trend and statistical analyses on financial and other data.”

However, this is only possible if the function can attract employees who are proficient in data mining and analysis. At one member’s company, the risk of fraud is very high, and an internal audit fraud team “spends 100% of their time mining data to assess whether a fraud has taken place.” But very few other members feel their internal audit functions are well equipped to exploit technological advances such as big data. One member observed, “Recently, we were looking for an IT-capable internal auditor and had no luck. We ended up having to pull someone out of retirement from abroad.” One meeting participant reported an IT talent scarcity among auditors, even in technology centers like Vancouver. As IT risk and the demand for analytics increases, so too will the pressure to fill the talent gap.

Requirements for the head of internal audit

As the scope of the internal audit function expands, a broader set of skills and experience may be necessary for successful CAEs. When asked to describe a superlative head of internal audit, members highlighted the following qualities:

- **Excellent communication and interpersonal skills.** The head of internal audit needs good communication skills and the ability to give “straight talk,” one member said. Another member described communication skills as “critical” for the head of internal audit, who “has to have the ability to build consensus and get buy-in.” During a pre-meeting conversation, one member stressed the

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*Svetlana Sicular, “Gartner’s Big Data Definition Consists of Three Parts, Not to Be Confused with Three ‘V’s,” Forbes, March 27, 2013.*

importance of relationships: “It all goes back to relationships. The head of internal audit has to be able to develop relationships with staff, with the audit committee and the board, and with management.”

- **Good judgment.** “The head of internal audit has to have good judgment – that is the most important quality.”

- **Deep understanding of the business.** One member said that the head of internal audit “has to know the business and where the bodies are buried,” in order to understand potential weak spots and focus the audit on key risk areas.

- **Audit and controls background.** “The head of internal audit has to know the name of the game: what an internal auditor is, how internal audit should work, and what tools are at internal audit’s disposal to offer maximum efficiency.”

- **Ability to secure respect for the internal audit organization.** In a discussion before the meeting, one member said, “Ideally, the person should command the respect of all of senior management and thus be a go-to person in any number of situations.”

One member said that ultimately, a successful CAE will “modernize the function, establish a proper risk-based audit approach, and gain the confidence of top management and business unit leaders.”

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**Improving compensation for heads of internal audit**

Members wondered whether better compensation plans might be needed to recruit and retain highly qualified people. One member observed, “We want one who walks on water, but how can we keep that person if we’re not paying them the money that other key executives receive?” Another member described the practical benefit of increasing the pay for the head of internal audit: “It could be cheaper to pay them well than to go to a head hunter every two years. After one head of internal audit got great reviews, I went to senior management, saying we need to keep her. I argued for a higher salary and a healthy bonus so that we could keep her.” Another member summarized what could lie at the root of the problem: “The point is, it’s challenging to find fair and reasonable compensation for the head of internal audit when they don’t get compensation based on the profitability of the company as with the rest of senior management.”

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**Supporting the internal audit function and staff**

At the vast majority of companies in North America, the internal audit group reports functionally to the audit committee,\(^9\) which makes a strong relationship between the two an imperative. The audit committee’s support of internal audit can help the relationship flourish. One member observed during a pre-meeting conversation, “It is absolutely critical that the internal auditor feels strong support from the audit committee and the audit committee chair.”

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Ways in which the audit committee can support the internal audit function and staff

Members said that open communication and frequent interactions are the keys to nurturing the relationship with internal audit, and they mentioned several ways in which the audit committee can help strengthen the function:

- **Emphasize to the CAE the importance of candid communication.** One member said, “Talk to the internal auditor and make sure they know that if they have something to say, they [should] feel safe doing so.” Another member observed, “It is incumbent on the audit committee to meet in camera with the head of internal audit. It should not be at the tail end of the audit committee meeting. It should be front and center, or the person won’t understand how important the audit committee thinks internal audit is.”

- **Include the relevant business unit head in the audit committee meeting.** Occasionally management may lag in its response to a problem identified in an audit report. One member described a face-to-face approach that can get the right message across: “I make sure the presentation of the audit report is done in the presence of the business unit that is in question. That has had the necessary effect.” Other members agreed that it can be very effective to bring in the relevant business head to answer questions about an identified deficiency that has gone uncorrected for a significant period of time.

- **Meet with the CAE outside of audit committee meetings.** In a conversation before the meeting, one member said, “The audit committee chair and the CAE have to meet routinely – usually before an audit committee meeting.”

- **Present to the internal audit function.** One member said it can be beneficial to have the audit committee chair make a presentation to the internal audit team: “I actually made a presentation to the whole audit team about what we expect of them, including the types of questions we will ask and the materials we expect. Then I threw it open for questions.”

- **Connect CAEs for peer-to-peer information exchange.** Because many audit committee members also serve on other boards, they are uniquely positioned to facilitate engagement among audit executives across companies. “I try to get the heads of internal audit together,” one member said. “I introduced an experienced CAE to a newer one so that the experienced CAE could share what a head of internal audit needs to be thinking about. It was very helpful.”

Structuring administrative reporting lines to support the internal audit function and leader

Although internal audit organizations in most companies report functionally to the audit committee, internal audit can report administratively to any one of several executives. The CFO is the most common candidate for the role. In a recent IIA survey, 27% of Fortune 500 respondents said they reported administratively to
the CEO, while 48% said they reported to the CFO.\textsuperscript{10} Members shared their experience and views on the various reporting options:

- **Reporting to the CEO.** Citing a focus on objectivity, the Federal Reserve recently issued guidance encouraging large US banks to have their CAE report to the CEO.\textsuperscript{11} The IIA considers that arrangement to be ideal, but stops short of making it a requirement.\textsuperscript{12} As the IIA survey revealed, however, not many Fortune 500 CAEs currently report to the CEO,\textsuperscript{13} and very few CACN members have had experience with that arrangement. One member expressed a view held by most members, saying, “There has to be a reporting line to the CEO so that the head of internal audit can go to the CEO any time, but that reporting line is not realistic.” Members agreed that regardless of the reporting line, “the head of internal audit has to have easy and regular access to the CEO.”

- **Reporting to the CFO.** Many members said that their CAEs report administratively to the CFO, and that this is a good arrangement. One member explained in a pre-meeting conversation, “I am comfortable with the CAE reporting to the CFO because internal audit, at its core, ensures accuracy of the financial statements – and even improvements in process and controls ultimately end up reflected in the financial statements.”

- **Reporting to a different member of senior management.** Several members suggested that there is no single right answer when it comes to the CAE’s line of administrative reporting. One member said, “The key is the individual. Whether the head of internal audit reports administratively to the CEO, CFO, or general counsel is no matter. What matters is the chemistry between the two.” Members noted examples of positive experiences with administrative reporting lines to the general counsel, to a senior vice president of strategy, to the head of human resources, and to the corporate secretary.

### Assessing internal audit’s effectiveness and overall value

Assessing the effectiveness of internal audit requires a standard of effectiveness against which to make the assessment. Members discussed what characterizes an effective audit function and how internal audit adds value to the business.

#### Understanding what makes an internal audit function effective

What are the characteristics of an effective internal audit function? One member asked, “Is it enough that the company has not been in any trouble? Can that really mean that the function has been effective?” Another member asked, “If internal audit is doing compliance, advisory work, what does ‘effectiveness’ mean?” A third member suggested, “Effectiveness depends on two things – one, a clear definition of expectations, and two, the people you hire.” One member mused on the use of key performance indicators to assess internal audit’s performance: “I am beginning to think through what key performance indicators can

\textsuperscript{10} Ibid.


\textsuperscript{12} Ibid.

\textsuperscript{13} Ibid.

\textsuperscript{14} Institute of Internal Auditors, *2013: Time To Seize The Opportunity*, 5.
be used for internal audit – aside from whether they just completed the audit plan. What KPI means the most for this function?"

Another member observed that “the effectiveness and the value of internal audit are tied.” As members addressed the challenge of defining effectiveness, they also discussed the corollary issue of determining internal audit’s value relative to its cost. Although one member questioned whether internal audit “is worth the money,” several members agreed that the value of internal audit varies according to industry: “In a cash business, internal audit is very important because the next generation is very creative about how they steal money.” Another member noted the link between the skills of the internal audit group and its ability to add value: “It is a question of core competency. For example, in financial services, internal audit is a core competency and adds great value. But there may be organizations where internal audit does not add value because it does not know what it is doing.”

Assessing the internal audit function

In a 2012 survey that EY commissioned by Forbes Insights, 41% of respondents reported that they focus on internal audit’s productivity when assessing the function’s performance. The function is also often evaluated on the basis of whether high-risk areas were addressed, what recommendations were made, whether the recommendations were implemented, and the number and type of interactions the function had with business unit executives.

Members mentioned several channels for evaluating internal audit:

- **By the audit committee.** In pre-meeting conversations, one member described three components to the audit committee’s evaluation of internal audit: “First, we have a bit of a formal evaluation with a questionnaire available from IIA. Second, we have a good set of metrics prepared quarterly, which includes the level of satisfaction of and reactions to internal audit by the rest of the organization. And third, we have a session with the audit committee only in camera – this provides us an opportunity to debate the value and contributions of internal audit on our own.” Another member seeks input from the external auditor: “I always find it interesting to know how much our external auditor relies on the internal audit function. I think it is a good sign to hear that they are relying on internal audit.”

- **Self-assessment by the CAE.** The IIA publishes a self-assessment guide for CAEs that asks the CAE to determine the degree to which the internal audit function has contributed to the organization’s strategic objectives, whether the function has the people it needs, and whether its processes enable achievement of objectives and the audit plan.

- **External quality assessment through peer review.** One way to meet the international standard for the professional practice of internal auditing is to submit to an external quality assessment. A peer
review performed by three or more organizations within the same industry, regional association, or other affinity group meets the IIA requirements.18

**Conclusion**

Members discussed common characteristics of highly effective internal audit functions and CAEs and common challenges companies and audit committees face in deploying, staffing, and retaining a quality internal audit function. Although members struggled to identify the metrics they should use to evaluate internal audit’s effectiveness, many agreed that internal audit functions succeed when the scope of work is clearly communicated, they have the right leadership, and they have “support from top management, especially the CEO.” As one member summarized, “Define what you want, pick the right person to lead, and give them the right profile within the organization.”

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Appendix 1: Participants

- John Caldwell, Audit Committee Chair, FARO Technologies and IAMGOLD
- Peter Case, Audit Committee Chair, Fortis
- Marc Courtois, Audit Committee Chair, TVA Group
- Denis Desautels, Audit Committee Chair, Bombardier and The Jean Coutu Group (PJC)
- Sheila Fraser, Audit Committee Chair, Manulife Financial
- Alan Horn, Audit Committee Chair, Fairfax
- Michel Labonté, Risk Management Committee Chair, The Laurentian Bank of Canada
- Eileen Mercier, Audit Committee Chair, Intact Financial and Teekay
- Ted Reevey, Audit Committee Chair, Bell Aliant
- Stuart Smith, Audit Committee Chair, TGS North American REIT
- Bob Steacy, Audit Committee Chair, Cineplex, Domtar, and Postmedia Network

The following audit committee chairs took part in pre- and/or post-meeting discussions:

- David Leslie, Audit Committee Chair, Crombie REIT, Enbridge, and IMRIS
- Tom O’Neill, Audit Committee Chair, Nexen and The Bank of Nova Scotia

EY participants included the following:

- Greg Boehner, Partner, Transaction Tax Advisory Services, EY
- Tom Kornya, Managing Partner, Assurance Services, EY Canada
- Eric Rawlinson, Managing Partner, Greater Toronto Area, EY Canada
Appendix 2: Questions for audit committee members

- How have the challenges confronting your internal audit team changed over the past several years?
- What do you believe the proper role of internal audit should be? As an audit committee chair, how have your demands on internal audit changed over the past few years?
- What specific challenges are associated with the heightened focus on risk, including risks associated with cybersecurity, compliance, and strategy?
- What is internal audit’s approach to identifying, assessing, communicating, and mitigating risks?
- What organizational approach is internal audit taking? Has it changed its structure in recent years?
- What approaches to resourcing have worked best? What pitfalls have emerged?
- What kind of analytic tools is internal audit using? How is it applying them? What have been the costs and benefits? Will more powerful tools raise expectations of internal audit?
- How does internal audit coordinate with the external auditor to ensure that, whatever the approach to staffing, there is proper and efficient coverage?
- Does internal audit serve as a training ground for other roles in the company? Why or why not?
- What are the characteristics of a highly effective CAE?
- How do you build a good relationship with the CAE and the internal audit team?
- How does your audit committee support the head of internal audit and the internal audit function generally?
- What are the reporting lines for internal audit? What are the benefits and challenges of those reporting lines?
- How does the audit committee assess the cost, performance, and capabilities of internal audit? What is the process?
- What are some specific areas of focus for the audit committee’s assessment?
- Does your internal audit organization perform a regular self-assessment? Does your internal audit organization participate in peer reviews? How are these results shared with the audit committee?