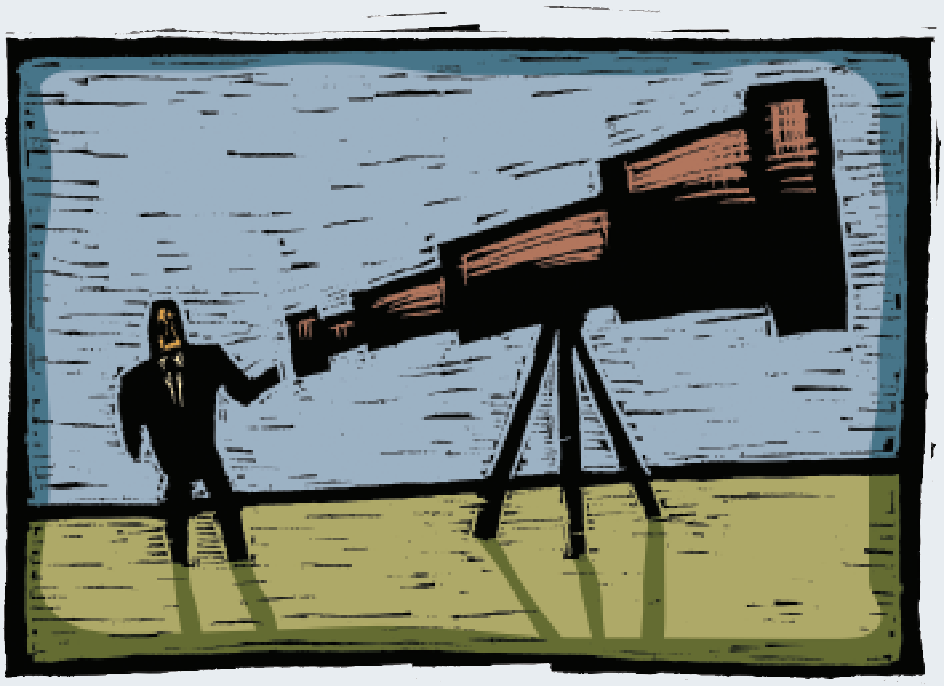
What's Ahead for



Three reports offer a look into the FUTURE.

By Robert Bloom, Chris Luchs, and Mark Myring

The role of the internal auditor has evolved dramatically over the past century. Prior to the 1940s, internal auditors had a very limited function in an organization. Members of the controller's department, they were concerned strictly with accounting verification within the firm as part of providing assistance to external auditors. Since that time and up to 2002, internal auditors gradually assumed a larger role in terms of serving management, not just from an accounting perspective but also from an operations orientation. Internal auditors, for all intents and purposes, became internal management consultants, examining not only accounting but also nonaccounting functions such as human resources and purchasing. (For an analysis of the history of internal auditing, see Robert Moeller's 2005 book, *Brink's Modern Internal Auditing*, especially pages 4-7.)

Then came the Enron scandal. Management was criticized for failing to maintain adequate internal controls, to staff the internal audit function properly, and to allow internal auditors to report to an independent audit committee. To help mitigate these deficiencies, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 (SOX).

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Internal Auditors?

Section 404 of SOX requires management to assert its responsibility for maintaining effective internal controls and to perform an annual evaluation of the controls.

The enactment of SOX elevated the importance of internal audit in many corporations. No longer are internal auditors only concerned with examining the suitability of internal financial and operating controls, safeguarding assets, and promoting effectiveness and efficiency of the organization. Today, through their chief audit executive (CAE), internal auditors are involved in the overall process of corporate governance, moving into a broader role of enterprise risk management (ERM). Now they assess a vast array of uncertainties the entity faces (including capital and product markets as well as legal and regulatory) and recommend courses of action to deal with those uncertainties. Internal auditors are playing an ever-expanding role in advising management, the audit committee, and independent auditors on many issues concerning their organization's performance.

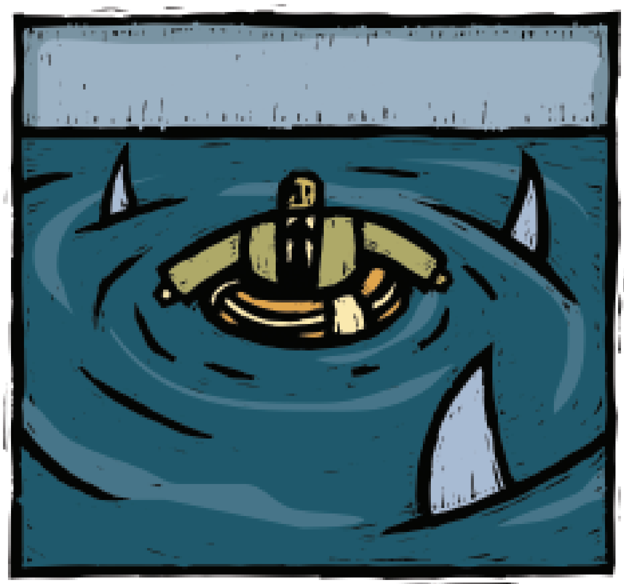
Here we analyze three new reports on the current and evolving role of internal auditing that were published by PricewaterhouseCoopers (PWC), the Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC), and the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The three reports accentuate the importance of viewing controls as part of the evolving organizational governance, stressing the need for frequent and meaningful communication among all the parties affected. The reports also call for continuous improvement in the management of risk throughout the organization.

The PWC report, *Internal Audit 2012*, which focuses on trends that are expected to have a significant impact on the role of internal auditing, recommends that internal auditors adopt a risk-centric mind-set to maintain their role as key players in assurance and risk management. IFAC's *Internal Control from a Risk-Based Perspective* consists of interviews with 10 accountants from various organizations about their internal control experiences, reflecting a consensus that risk management, in view of its association with appropriate corporate governance, is the key to internal audit. COSO's *Guidance on Monitoring Internal Control Systems*, which is part of an extensive monitoring project, advocates that monitoring internal controls is critical to achieving organizational goals. This report calls for a risk-based approach to such monitoring. See Table 1 for an overview of the reports.

Internal Audit 2012

Based on the results of a survey of the chief audit executives of *Fortune* 250 companies, PricewaterhouseCoopers projected the trends likely to characterize internal auditing by 2012. The CAEs of *Fortune* 250 companies and 25 academics and other prominent individuals in "stakeholder arenas" were asked to respond to surveys. PWC received a total of 82 responses: 72 from CAEs and 10 from other stakeholders. The firm also conducted personal interviews with 19 CAEs, among others. According to the survey, in the next five years the value of a controls approach to internal auditing is expected to decline as experience with SOX takes hold. Internal audit functions have already begun to shift to a risk-centric orientation where emphasis is on the effectiveness of comprehensive risk management. This study points to five identifiable trends: globalization, changing internal audit roles, changes in risk management, talent and organizational issues, and advances in technology. PWC offers a number of general conclusions about the future of internal audit.

The first trend—globalization—influences how companies view assurance and risk management. For exam-



Internal auditors are expected to assume responsibility for a broader spectrum of risks.

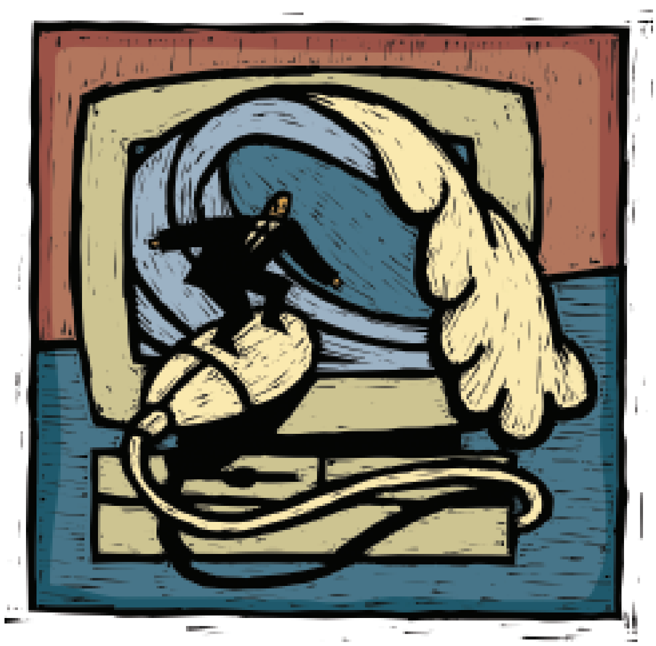
ple, the complexity of global operations makes it difficult for management to identify and evaluate new risks. In addition, although respondents generally anticipate internal audit structures for U.S. companies to remain U.S. focused, increased globalization along with advances in technology should have a direct impact on talent. There are notable ties between what participants said about the role of internal audit and the changes they expect to see in organizational approaches to risk management. For instance, the growth of outsourcing and the upsurge in offshoring services and manufacturing have made global supply chains more interconnected and risk laden, thus increasing financial market volatility. Companies operating abroad are exposed to new risks in regulatory and compliance changes such as new accounting standards (e.g., International Financial Reporting Standards (IFRS) convergence) to adhere to, often requiring changes in the enterprise's information system.

The second trend concerns the changing role of internal audit, including continuous auditing and auditing both the enterprise-wide risk management process and outsourced operations. The PWC report suggests that risk assessments and monitoring will be conducted real time, primarily when triggered by changes in the organizational risk profile. Examples include higher probability of computer infringement, potential fraud, and terrorism.

Third, internal auditors are expected to assume responsibility for a broader spectrum of risks—i.e., in enterprise risk management, defined as the consideration of the risks the firm faces, an evaluation of these individual risks and an attempt to deal with them so as not to jeopardize the main goals of the enterprise. Internal auditors will probably play a greater role in assessing fraud risk, prevention, and detection and perhaps in considering macro trends such as health and wellness, workforce issues, and product safety.

Accordingly, internal auditors will be expected to provide a more focused strategic value, taking a risk-based approach to auditing based on ongoing risk assessments. They should expand assurance activities to cover overlooked areas of risk, anticipating the needs of the audit committee and senior management. Additionally, internal auditors should strengthen risk coverage of technology, fraud, and strategy areas of high priority to appropriately control and manage such risks. This can be accomplished by enhancing existing internal controls or setting up new controls to protect technology and to guard against fraud and misappropriation of assets.

The fourth trend affecting internal auditing relates to talent and organizational issues. The PWC survey predicts



With new technology comes the need for a different set of skills in order to be effective in the field.

Table 1: *An Overview of the Three Reports*

	INTERNAL AUDIT 2012	INTERNAL CONTROL FROM A RISK-BASED PERSPECTIVE	GUIDANCE ON MONITORING INTERNAL CONTROL SYSTEMS
OBJECTIVE	To provide a consensus projection of the trends shaping internal audit by 2012.	To provide an assessment from 10 global professional accountants on current issues related to internal control.	To enhance an understanding of the building blocks of effective monitoring,
OBSERVATION(S)	A perspective on trends, including globalization, changing internal audit roles, changes in risk management, talent and organizational issues, and technological advancement.	Thoughts on issues such as risk management, communication, integration of internal controls, the importance of hiring qualified people, and documentation.	A framework for effective and efficient monitoring analysis.
KEY OUTCOME	An understanding of the trends that should assist internal auditors in the identification and management of risk, thereby providing added value to the internal audit function.	Internal auditors' role in enterprise risk management will likely increase in the future.	Implementation of effective and efficient monitoring to improve the quality of the internal control system.

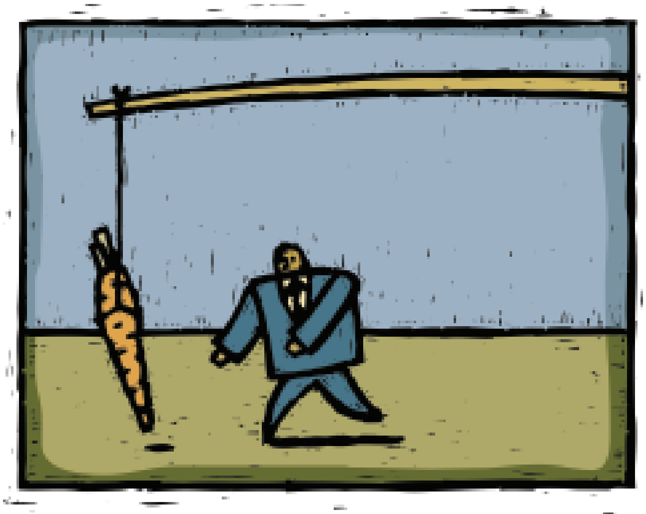
an increase in internal audit positions available, but these positions will require a broad array of skills, including the ability to assess and analyze risk data and to prevent fraud. Individuals assuming these positions should possess strong technical skills so as to be able to conduct data analysis and to address both enterprise-wide risk and governance issues. These technical skills would include an expanded knowledge of statistical applications, the mechanics of management information systems, and forensic audit procedures.

The final trend expected to affect internal auditing is technological advancement. With new technology comes the need for a different set of skills in order to be effective in the field. The PWC study offers particular strategies to address human resources (HR) in order to attract staff with the technological skills needed for success in this environment. The most significant proposals include increasing the core skills of the general internal audit staff to understand the risks of auditing technology, to acquire more sophisticated technology tools to address technology risks, and to increase reliance on third-party experts.

Internal Control from a Risk-Based Perspective

IFAC's PAIB Committee conducted interviews with 10 leading accounting executives about their internal control experiences. The internal control discipline has long been in a state of continual adaptation, whether such adaptation occurs in response to the evolving nature of the organization or to external forces engendering changes in the regulatory environment. The executives represent a diverse group of worldwide organizations, including insurance, oil and gas, supermarkets, manufacturers, and even a municipal government, among others.

The interviews yielded common themes that reflect the changing role of internal control within organizations. Though not all of the changes apply to each organization, they illustrate trends. Taken together, such themes reflect a more integrative internal control function to support problem solving rather than isolating internal control as a



If a company recruits appropriate human resources, the cost of maintaining controls will decline.

security measure.

The most consistent themes in the interviews dealt with appropriate risk management. One participant advocated the use of continuous risk management, which is consistent with the PWC report, suggesting that a broad spectrum of risks be covered. He also said that the key to successful risk management is to be proactive. A second participant suggested that internal control is but one element of enterprise risk management, based on the conviction that corporate governance is also very important. Another participant asserted that ERM processes would be more effective if they were implemented from the bottom up rather than the top down, involving appropriate lines of communication. Also consistent with the PWC report, a fourth participant noted that risk management on a continuous basis is particularly important in a dynamic environment for the enterprise to adapt to constant change. Additional participants echoed similar views, contending that risk management systems are evolutionary and must react to changes in the environment. In their case, a recent change in banking regulation led them to reevaluate their systems and procedures. Another participant contended that an optimal balance of risk management and effective internal control is needed without creating unnecessary bureaucracy.

Regarding integration of internal controls, one participant argued that risk management should be considered as early as the product development stage. Another participant emphasized the importance of staying close to management and allowing those at the operating level to choose the scope of internal control that best fits the operating conditions. Another participant stressed the importance of integrated support from senior management and education as critical to the successful implementation of controls. A final participant argued that strong internal controls are important for maintaining a well-managed enterprise. For example, the internal control and risk management functions are critical in an organization's ability to respond to a variety of crises, including a flood.

Consistent with the COSO report, the interviewees repeatedly raised the theme of the importance of qualified people in internal auditing. Internal control functions are as effective as the people involved, who must communicate with one another. One participant maintained that the key to internal control is "having good people who know what they are doing." According to another participant, if a company recruits appropriate human resources, the cost of maintaining controls will decline.

The interviewees also discussed the importance of documentation to successful internal control. One participant argued that, without proper documentation, management has no grounds to assure system integrity. Another participant contended that it's difficult to improve processes and controls without sufficient documentation. Others believed that documentation of responsibilities furnishes a proper mapping of how the business processes deal with various risks.

Guidance on Monitoring Internal Control Systems

COSO's *Guidance on Monitoring Internal Control Systems*, released this year, is the first phase of a comprehensive monitoring project undertaken to assist organizations in implementing effective monitoring systems so controls operate as intended. COSO's *Internal Control—Integrated Framework*, issued in 1992, is concerned with effectiveness and efficiency in operations, reliability in financial reporting, and legal and regulatory compliance. Monitoring internal controls is critical to providing reasonable assurance regarding achievement of organizational goals.

According to COSO, effective monitoring consists of several objectives that should be built into normal operating activities, offering an objective consideration of internal control effectiveness. The objectives of effective monitoring include the integration of its routines into normal operating activities wherever this is practicable, providing objective assessments, use of knowledgeable personnel in the process, providing management and the board of directors feedback on the effectiveness of internal controls, and to be flexible and adaptable regarding its scope and frequency. Additionally, evaluators should understand the components being evaluated and how the components relate to the objectives of the organization. Management should vary the scope and frequency of evaluations, depending on the importance of the underlying controls in mitigating risks to the objectives of the organization.

To achieve the foregoing objectives, COSO sets forth two components of effective monitoring of internal controls: (1) monitoring of internal controls performed on an ongoing basis so that controls continue to function over time and (2) communicating weaknesses identified in the monitoring process in a timely manner to the responsible parties along with management and/or the board. Successful implementation of these two components is likely to improve the effectiveness and efficiency of controls.

An effective control environment includes the proper tone at the top of the organization, which requires management to communicate the importance of monitoring internal controls throughout the enterprise. Management must support the conclusions of evaluators about the effectiveness of the company's internal controls. When weaknesses are identified, they must be corrected before they materially affect the organization's objectives.

It's difficult to improve processes and controls without sufficient documentation.

Successful monitoring depends on maintaining an organizational structure that places individuals with appropriate skills and authorities in monitoring roles. The evaluators must be competent in their knowledge of the processes and controls they evaluate, and they must be objective, performing suitable monitoring procedures irrespective of personal consequences.

Management must prioritize the importance of the company's monitoring procedures, determining which risks are most likely to inhibit the organization from reaching its objectives, an exercise ordinarily performed in the risk assessment component of the COSO Framework. COSO recommends considering several factors to determine the scope of monitoring, such as the size and complexity of the organization; the nature of its operations, including whether they are subject to frequent changes and high risks; the specific objective of the monitoring (e.g., regulatory); and the relative importance of the underlying controls in achieving the organization's objectives.

COSO delineates a monitoring process to ensure the effectiveness of internal controls in a changing environment. The first step, termed the "control baseline," is based on the conviction that the internal control system is designed and operating effectively. Once the benchmark is established, the organization enters the "change-identification process." Both environmental and internal factors may impact the effectiveness of internal controls. Also, previously effective controls may fail to work as designed. If either factor exists, a material increase in risk may escalate the probability of internal control failures.

Monitoring environmental changes also helps evaluate the effectiveness of the risk assessment component. Effective monitoring facilitates an assessment of the organization's response to changes in the environment. Identifying changes in the processes or risks may indicate that controls should change. The third component of the framework is the "change-management process" designed to verify the appropriate management of modified or new control features.

The second and third components of this process are particularly important. These steps provide information about changes that should be made in controls because of underlying process or risk changes and information about changes in controls that have already taken place. The report provides an example of these steps in the setting of a supervisor responsible for multiple order-entry personnel. Effective monitoring in this setting can bring attention to areas of heightened risk due to change. Assume that the organization adds a new sales channel with a different order-entry procedure. This results in a change in process, possibly impacting the design or operation of controls, so the scope of monitoring controls over this process may have to be increased.

The last component of the process is "control reconfirmation." In settings where routine monitoring only partially supports the effectiveness and efficiency of control operations, a periodic separate evaluation is necessary that utilizes persuasive information to confirm the adequacy of internal controls.

Effective monitoring depends on the quality of the information gathered. For a control to be judged effective, persuasive information about its operations must be obtained. Persuasive information is information suitable in sufficient quality to ensure the control is performing correctly. It is suitable if relevant, reliable, and timely. Sufficiency pertains to the quantity of information. A review of the résumé of an accountant may indicate a suitable background to perform a particular function, thus reflecting on the competence of the individual and representing an element of persuasive information concerning an internal control. The degree to which information is relevant depends largely on whether it is direct or indirect information. Direct information is acquired by observing controls in operation, reperforming them, or testing them. As such, this information clearly substantiates the operation of controls. Indirect information, by contrast, is secured by examining the outcomes of the control process. Examples include operating statistics and key risk indicators. Reliable information is accurate and verifiable and comes from an objective source. Timely information is information that is produced and used in a time frame that makes it possible to prevent or detect and correct a material weakness before it affects the organization significantly. Communication is critical to effective monitoring, which requires appropriate reporting of the results and corrective action taken. The reports should go to the individual operating the control and the individual one level higher or above. The frequency of communication depends on the significance of the control. A severity assessment of the weakness is also recommended.

A Quick Recap

The three reports we analyzed furnish interesting insights into the future of internal auditing. Though each report has a different focus, all complement one another and reflect consistent themes, especially the role of the internal auditor in enterprise risk management. Since 9/11 and the high-profile accounting scandals at the turn of the 21st Century that led to SOX, organizations have developed a greater sense of risk perception and evaluation. Internal auditors, in view of their background in assessing controls, are expected to play an expanded role in this process. The PWC report asserts that, by 2012, the internal auditor should provide both risk assurance and control assurance as part of an increased emphasis on risk and control management processes. A primary objective of the COSO Framework is the responsibility of internal audit to identify risks that are most likely to inhibit the organization from attaining its objectives. Executives interviewed in the IFAC study also discussed the importance of internal audits in enterprise risk management.

The importance of attracting and retaining high-quality employees in internal audit positions is a second theme common to the three reports. The PWC survey foresees an increase in demand for internal auditors who possess a broad array of skills. A number of interviewees in the IFAC survey expressed a similar view. The COSO report asserts that an appropriate skill set is necessary for effective and efficient monitoring of internal controls. A third theme emphasized in each of the three reports is the role of technological changes in internal auditing, and a fourth theme is the importance of maintaining documentation of internal controls. While appropriate documentation is necessary today, it will only grow in importance in the future. All members of the finance and accounting areas will need to be prepared. **SF**

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