CONTINUALLY EVOLVING TO ACHIEVE STAKEHOLDER EXPECTATIONS

NORTH AMERICAN REPORT – MARCH 2014
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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.

ABOUT THE PULSE OF THE PROFESSION STUDY

Since 2009, The IIA’s Audit Executive Center has conducted annual Pulse of the Profession surveys to assess the state of the internal audit profession and identify trends and emerging issues in the profession and with its stakeholders. The IIA has published analyses of the survey results for North America since the first survey was issued. And in 2012, The IIA began publishing analyses of the global results annually.
INTRODUCTION

Annually, The IIA’s Audit Executive Center conducts a global Pulse of the Profession study to assess the state of the internal audit profession. The study includes a survey looking at current trends and emerging issues in the profession around the world. From the global survey, two reports are produced — one focusing on North American results and the other focusing on global results. As in previous years, the North American report examines survey responses from chief audit executives (CAEs) within the United States, Canada, and the Caribbean. In addition to analyzing the responses from 367 North American CAEs who participated in the survey, this year the Audit Executive Center spoke with 24 CAEs from the United States and Canada to gain insight from the CAE perspective on the survey results.

A portion of the survey focused on three critical topics that are affecting the profession of internal auditing. Those topics are:

- The Application of the Three Lines of Defense Model.
- The Career Path to CAE.
- Information Security and the Board.

This Pulse of the Profession report looks at both current trends and emerging issues to consider the implications they have on the realization of internal audit’s value — that value being tied inextricably to stakeholder perceptions. As these expectations continue to evolve, “internal auditors must continuously assess the risks facing the organization and align their assessment with stakeholder expectations,” IIA President and CEO Richard Chambers says. “Our success as a profession is contingent upon not only securing the resources and talent needed to address key risk areas, but also gaining the trust from stakeholders that our contribution is focused at the right areas and is valued by them.”
KEY FINDINGS

The IIA Audit Executive Center’s 2014 Pulse of the Profession study surveyed 1,935 audit professionals around the world. In North America, 367 CAEs participated in the survey. An analysis of their responses alongside interviews with CAEs brought to light the following key findings surrounding emerging issues and current trends:

• The Three Lines of Defense Model is gaining acceptance; however, the majority of respondent organizations have not clearly defined the three lines.
• Risk-based planning may bridge the perceived misalignment between stakeholder top risks and internal audit priorities.
• Essential competencies and career paths are continuing to evolve for internal auditors and CAEs.
• Among the board, concern about information security risks are on the rise.
• Sustained levels of resources suggest continued stakeholder support.
THREE LINES OF DEFENSE GAINING TRACTION, BUT DISTINCTIONS ARE STILL BLURRED

The IIA’s position paper on the three lines of defense articulated the division of responsibilities within an organization’s risk and control structure with the goal of providing a model that offers “a simple and effective way to enhance communications on risk management and control by clarifying essential roles and duties.” The Pulse survey results offer a first glimpse into how widely accepted the model is as an illustration of internal audit’s role within an organization’s risk and control structure. Thirty-four percent of CAE respondents in North America indicate that their organization has very clearly defined distinctions between the different lines of defense, leaving a full 66 percent of CAEs who indicate their organization has only moderately, somewhat, or not clearly defined lines of defense (Figure 1 and 2). This appears to present a significant opportunity for CAEs of organizations who have not clearly defined their lines of defense to serve as catalysts to prompt that definition process in their organizations.

Figure 1. Percentage of North American CAE respondents who report that their organization has only moderately, somewhat, or not clearly defined lines of defense.


Regarding the clarity between your organization’s various “lines of defense,” how clear are the distinctions between the roles of internal audit and your organization’s management, risk, compliance, and control functions?

Based on CAE interviews, most organizations appear to have a clear understanding of management responsibilities, but distinctions become less clear between the second and third lines of defense. The concern that arises when these lines get blurred is that “without a cohesive, coordinated approach, limited risk and control resources may not be deployed effectively, and significant risks may not be identified or managed appropriately,” as noted in The IIA’s position paper. An uncoordinated structure can also lead to organizational silos, which was also noted in the paper as being detrimental to organizations’ performance during turmoil. Furthermore, should stakeholders not understand the distinction between functions, this may lead to the presumption that one or the other function is dispensable.

Organizations that embrace clear lines of responsibility benefit from collaboration between assurance functions, so as The IIA’s position paper states “there are neither

2. Ibid.
‘gaps’ in controls nor unnecessary duplications of coverage.” Effective communication is essential to this goal and can be attested to by Vice President of Audit Services Carol Gordon from Ontario Teachers’ Pension Plan who was offered the opportunity to take over internal control, but instead “built a partnership with the internal controls team, the compliance team, and the risk management team, which now regularly shares information, frameworks, and risk definitions so that together, the second and third lines of defense can have the same language and leverage each other’s work while providing different layers of assurance to the board.”

RECOMMENDED PRACTICES

• Seek a balance between the desire to do business and the appetite for risk as reflected in the tone set for developing or enforcing controls on the resulting risks.
• Identify organizational structures that tend to delay, divert, or distort the flow of information up the management chain of the organization.
• Engage in cross-disciplinary discussions and communication of insight into relevant risks across the organization.


3. Ibid.
RISK-BASED PLANNING: A VEHICLE TOWARD BETTER ALIGNMENT WITH STAKEHOLDER TOP RISKS

Table 1. Ranking of priorities for audit committees and executive management.

<table>
<thead>
<tr>
<th>AUDIT COMMITTEES</th>
<th>EXECUTIVE MANAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Strategic Business Risk</td>
<td>Strategic Business Risk</td>
</tr>
<tr>
<td>2 Operational</td>
<td>Operational</td>
</tr>
<tr>
<td>3 Compliance/Regulatory</td>
<td>Compliance/Regulatory</td>
</tr>
<tr>
<td>4 Information Technology</td>
<td>Information Technology</td>
</tr>
<tr>
<td>5 Risk Management Effectiveness</td>
<td>Cost/Expense Reduction</td>
</tr>
</tbody>
</table>


As shown in Table 1, CAEs believe strategic business risk is the top concern among stakeholders. More specifically, 28 percent of CAE respondents rate strategic business risk as the top priority for audit committees and 46 percent rate it as the top priority for executive management. While business strategy remains a relatively small area (six percent) of the overall audit plan (Figure 3), discussions with CAEs indicate that internal audit’s approach to audit planning can bridge a perception of misalignment.
A successful internal audit function takes into account stakeholder priorities and addresses them throughout their audit plan. As stated by Larry Abston, Anadarko Petroleum’s vice president of corporate audit, “In viewing the audit plan, I don’t see strategic business risk as a discrete ‘slice of the pie’ as it often can’t be tangibly audited in isolation. Instead, strategic business risk, including how it is identified, managed, and mitigated in the operating and governance culture of the business, is an influencer to each audit focus area. Stakeholder relevance and value is enhanced by our considering in each audit project the higher-risk items that could impact the company achieving its business objectives. This challenges us to stay current on business activities and emerging issues, while maintaining the requisite business acumen and stature to recognize and effectively communicate matters of a strategic nature.”

Taking inspiration from Abston and other interviewed CAEs, Figure 4 illustrates how the priorities of executive management and the audit committee drive a risk-based audit approach. Beginning with effective risk assessment that combines input from stakeholders with the CAE’s knowledge of the business, internal audit functions can better determine what business risks threaten their organization’s strategic objectives.
With this view of audit planning, internal audit’s coverage of strategic business risk cannot be measured as a “slice of the pie”; and therefore requires significant effort to resolve any perceived gap between the priority given by stakeholders to strategic business risk and the portion of the audit plan devoted to business strategy. Richard Anderson, Clinical Professor at DePaul University, observed that this apparent gap might be indicative of a communication issue between some CAEs and their stakeholders. He notes, “Given the focus of stakeholders on strategic and business risks, it becomes incumbent on CAEs to communicate clearly where within their audit plans they have identified and addressed the organization’s key strategic and business risks. Explicit rather than implicit communication with full transparency is needed to avoid any misunderstanding of this critical risk coverage.”
Stakeholders are placing business leaders in CAE seats in high numbers just as the demand for business skills drives internal audit recruiting efforts. The Pulse survey indicates that 42 percent of CAEs in North America held a position outside of internal audit immediately prior to becoming CAE (Figure 5). This supports other recent evidence that CAEs are being sourced from other areas of business — a trend that is likely to continue.

Strong opinions surround the question of what experiences best serve the role of CAE. Without internal audit experience, a CAE coming from the business may not have an aptitude for governance, risk, and controls or an appreciation for the possibilities of internal audit. On the other hand, understanding the business is also vital, and can be significantly enhanced by having actually served in a hands-on role as a business executive. As Vice President of Internal Audit and Corporate Compliance at The Home Depot Kelly Barrett notes, “The bottom line is that internal audit needs people in the CAE chair who understand the business and speak like business leaders.”

Figure 5. Percentage of North American CAE respondents who entered the role of CAE from outside the internal audit profession.

42% of CAEs in North America held a position outside of internal audit immediately prior to becoming CAE

As with the emerging CAE career path, competencies for internal auditors are evolving. For example, the Pulse reports that only 25 percent of CAE respondents in North America recruit for the traditional auditing skills of accounting, while 43 percent recruit for business acumen, and 40 percent recruit for industry-specific knowledge (Figure 6). In fact, among the top six skill areas, only data mining and IT could be classified as traditional internal auditing skills.

In similar research, results from KPMG’s 2014 Global Audit Survey, which polled nearly 1,500 audit committee members, suggest that a gap exists between stakeholder expectations and their perception of internal audit competencies. Based on responses from the United States and Canada, more than 62 percent of KPMG’s North American survey respondents reported that internal audit’s role should extend beyond the adequacy of financial reporting and controls to include other key risks facing the business. As it pertains to competencies, only 40 percent of KPMG’s North American respondents believe that internal audit currently has the skills and resources to be effective in the role they envision.4


Both the high number of business leaders in CAE roles and the trend toward recruitment of a diverse set of skills that fosters more versatility in the internal audit staff are a natural response to the changing expectations of internal auditing. However, as the KPMG study suggests, a substantial percentage of stakeholders do not perceive internal audit professionals as having the business knowledge and business acumen to meet those expectations. There are indicators that some organizations seek skills in their CAEs that are not already apparent in their existing internal audit departments.

While the practice of rotating business leaders into the CAE role continues to gain popularity, organizations need to understand the risks as well as the benefits of this trend. Those interviewed for the Pulse of the Profession described CAEs coming from outside internal audit as providing new energy and perspective to the role, possessing deep business knowledge, having strong internal relationships, and maintaining a business perspective. On the other side of the discussion, most CAEs interviewed readily acknowledged that the lack of internal audit experience and inadequate aptitude for governance, risks, and controls could present significant challenges.

**RISKS**

- **Potential exposure to the company** due to inadequate understanding of risk and control structures.
- **Disruption to the continuity** of internal audit activity during the learning curve.
- **Limited receptivity to the value** internal audit can deliver.
- **Impaired objectivity** pertaining to any business area from which the CAE might have come or to which they may eventually be assigned.

**BENEFITS**

- Business experience brings a **greater return-on-investment mindset**.
- Strong pre-existing internal relationships facilitate **more credibility with the business**.
- A business perspective may result in **greater receptivity to recommendations**.
An observation worth considering is the relationship between the benefits noted from having business leaders in the role of CAE and the preceding discussion about skills recruitment. The skill gap at the center of both trends and at the core of stakeholder perceptions may well revolve around business understanding. Accordingly, internal audit staff that aspire to the CAE role must have a clear understanding of the skill expectations of their stakeholders to ensure that they are taking steps to build those skills. This may entail a rotation or assignment outside internal audit into a business unit.
Everyone operating in today’s business environment is increasingly aware of cybersecurity concerns and other IT risks. While internal audit has long since considered technology risk part of the audit universe, board members have recently increased interest in these concerns, especially cybersecurity. The Pulse survey addressed this subject with a series of questions about information security and the board. Figure 7 shows that 64 percent of North American CAEs surveyed indicate their boards have increased or significantly increased concern over cybersecurity in the last 1–2 years. Should the information security risk profile increase markedly, the Pulse survey also suggests that the board’s involvement would likely increase — illustrated by the 59 percent of CAEs that represent the majority in Figure 8.

Figure 7. Board’s concern over cybersecurity.

How would you characterize the board’s perception of cybersecurity risks over the last one to two years?

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Has Been At A High Level</td>
<td>13%</td>
</tr>
<tr>
<td>Increased or Increased Significantly</td>
<td>64%</td>
</tr>
<tr>
<td>Decreased or Decreased Significantly</td>
<td>&lt;1%</td>
</tr>
<tr>
<td>No Change</td>
<td>22%</td>
</tr>
</tbody>
</table>

If your information security risk profile were to increase markedly, how involved would the board expect to be when it comes to information security matters?


Interviewed CAEs repeatedly noted cybersecurity and technology among the top risk areas discussed with the board. In some cases, recent concern was attributed to media headlines as boards seek assurance that internal audit has addressed technology risks. When asked to consider how a marked increase in their information security risk profile would affect the board’s involvement in security matters, interview responses varied depending on how proactive they perceived their current efforts to be. In some instances the organization assumes high vulnerability and acts accordingly; therefore, CAEs expect the same (high) level of involvement from their board.

Organizations that are actively protecting their information are doing so through prevention, detection, and reporting processes in addition to annual attack and penetration studies. Internal audit’s role in relation to information security revolves around ensuring that the tools used in these efforts are working effectively. In organizations that proactively manage these risks, confidence in their controls and
CAEs need to ensure they have appropriate support and resources for this fast changing area of risk. Note Figure 6 regarding skills indicates that cybersecurity and privacy skills are one of the top 10 skills areas being recruited. Turnover is a challenge when recruiting for cybersecurity skills because these skills are in such high demand, noted one CAE. To manage this, many organizations find creative ways to augment their IT skill set, such as:

- Using guest auditors.
- Leveraging a co-sourcing relationship.
- Outsourcing IT functions under the direction of the CAE.

In support of this, note a recent benchmarking study by Protiviti where respondents reportedly used guest auditors (20 percent), co-sourced providers (40 percent), and outsourced IT functions (14 percent).5

Another important perspective concerning the board's perception of information security risk revolves around communication and education. As one CAE shared in an interview, technology is perceived both as a real and unknown risk. As such, the board relies on internal audit to educate them on the changing nature of the risk and the actions being taken to mitigate such risk. When it comes to internal audit interaction with the board in this area, Keith McDonagh, senior vice president & general auditor at Mass-Mutual, noted that "internal audit needs to be proactive in assessing information security risks, incorporating those risks in the audit plan, and communicating the condition of the risk environment. The nature of this risk requires active communication with the board to help them understand internal audit's approach and views on the company's information security controls." In practical terms, meeting regularly with the board to reassess the top risks promotes the kind of transparency needed to ensure alignment with their expectations. Other factors that point toward successful management of information security risks, as described in CAE interviews, include strong relationships with the organization's IT department, having a board member meet directly with the CIO, and auditing the IT infrastructure as well as its operations.

Every organization has something to protect in the technology space. The media latches onto breaches that affect consumer data, but other information, including employee records and intellectual property, is equally susceptible. During CAE

interviews, Anadarko’s Abston discussed the technological advances that have rapidly transformed the operating capabilities in the oil and gas industry, commenting that “Oil and gas companies are actually technology companies. We collaborate with operations, supporting functional groups, IT, security, and other parties to assess that management has identified the high-risk, high-value data targets; designed appropriate segregation and technical protection of that data; and monitors the risk associated with loss of or inappropriate access to information.”
SUSTAINED LEVELS OF RESOURCES INDICATE STAKEHOLDER SUPPORT

Since 2011, the Pulse survey has reported an optimistic forecast for internal auditing budgets and staffing year after year. Internal auditing continues to sustain pre-recession resource levels in most organizations, indicating sustained levels of stakeholder support in terms of overall performance. As shown in Table 2, 41 percent of CAEs in North America predict an increase in the internal audit budget from 2013 to 2014, 44 percent believe budgets will remain stable in 2014, and only 15 percent are anticipating decreased budgets. In terms of staffing, 26 percent of survey participants project staffing increases for 2014, 66 percent anticipate that staffing will remain stable, and only 8 percent are predicting a decrease in staffing. Fortune 500 participants report a similar outlook — 46 percent of Fortune 500 respondents project that budgets will increase in 2014, and 33 percent anticipate the addition of more internal audit staff. As a slower than expected financial recovery plagues businesses with uncertainty and unrelenting pressures on the bottom line, the sustained levels of budget and staffing for internal audit suggest that organizations consider internal audit as a critical resource for assurance on risk management and internal controls.

### Table 2. Budget and Staffing Year Over Year Comparison

<table>
<thead>
<tr>
<th>Year</th>
<th>Budget</th>
<th></th>
<th></th>
<th>Staff</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Increased</td>
<td>Stable</td>
<td>Decreased</td>
<td>Increased</td>
<td>Stable</td>
<td>Decreased</td>
</tr>
<tr>
<td>2014</td>
<td>41%</td>
<td>44%</td>
<td>15%</td>
<td>26%</td>
<td>66%</td>
<td>8%</td>
</tr>
<tr>
<td>2013</td>
<td>37%</td>
<td>52%</td>
<td>12%</td>
<td>23%</td>
<td>70%</td>
<td>7%</td>
</tr>
<tr>
<td>2012</td>
<td>37%</td>
<td>46%</td>
<td>17%</td>
<td>21%</td>
<td>65%</td>
<td>14%</td>
</tr>
<tr>
<td>2011</td>
<td>33%</td>
<td>48%</td>
<td>19%</td>
<td>18%</td>
<td>69%</td>
<td>13%</td>
</tr>
<tr>
<td>2010</td>
<td>32%</td>
<td>40%</td>
<td>28%</td>
<td>17%</td>
<td>67%</td>
<td>17%</td>
</tr>
<tr>
<td>2009</td>
<td>27%</td>
<td>44%</td>
<td>29%</td>
<td>20%</td>
<td>61%</td>
<td>19%</td>
</tr>
<tr>
<td>2008</td>
<td>36%</td>
<td>50%</td>
<td>14%</td>
<td>22%</td>
<td>70%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Source: The IIA’s Emerging Trends and Global Pulse of the Profession surveys, 2008 – 2014. This chart reflects data from the North American CAE respondents of the global surveys. Totals may not equal 100 percent due to rounding.
CONCLUSION

Ongoing understanding and support from stakeholders sets the stage for internal audit to continue to evolve its approach and coverage. Demonstrating competence and coverage in new areas elevates the value delivered by internal audit as long as its focus is aligned with stakeholder expectations. Strategic business risks are a top concern for stakeholders. Therefore, an effective audit plan must consider the risks to the business objectives and the processes that create and protect value for the organization, and communicate clearly to stakeholders how those risks are covered in the plan. As this approach opens up areas to internal audit, success becomes contingent upon having the right talent in place.

The question of talent may well begin with the CAE. As many organizations seek CAEs from outside of internal audit, the concern over skills being sought by stakeholders comes to the forefront. Those working in internal auditing who aspire to the CAE role need to understand clearly the skills expected by stakeholders and take actions to build and demonstrate those skills. At the same time, every team should consider the expertise needed to address the specific strategic business risks for their organization.

While the role of internal audit changes, CAEs continue to look at models that allow for effective and efficient collaboration with other assurance functions. As the Three Lines of Defense Model gains traction, many internal audit functions are using this model to more clearly define their role and to assist their organizations in improving their overall risk management and control structures. The model also serves as an effective tool to help align stakeholder perceptions and understanding across all the organization’s lines of defense.

Ultimately, the approach a CAE takes when executing their role and managing the internal audit function depends on their understanding and alignment with the expectations of their stakeholders. The IIA’s Vice President of Professional Services Gina Eubanks suggests that “whether you come from within the profession or not, self-preservation as a CAE begins with understanding the business, applying diversity of experiences, and effectively communicating with your stakeholders.”

Learn more and download a copy of this report at www.theiia.org/goto/pulse.
The IIA Audit Executive Center’s 2014 Pulse of the Profession survey garnered responses from 1,935 CAEs and others in audit management roles globally. Among those, 477 internal audit professionals from North America (United States, Canada, and the Caribbean) participated, of which 367 were CAEs. The North American Pulse of the Profession report is based on these 367 responses from CAEs in North America.

The North American CAEs surveyed represent a diversity of organizations. Publicly traded organizations comprise the largest group represented by these respondents (43 percent). Privately held organizations and public sector entities also represent a significant portion — 26 percent and 22 percent, respectively. In addition, 17 percent of all respondents work in Fortune 500 companies.

Participants represent more than 26 industries, with the highest representation from the financial services industry (23 percent). Other industries that participated at notable rates include manufacturing (9 percent), insurance (7 percent), education (7 percent), energy (5 percent), and health services (5 percent).

To complement the survey, 24 CAEs participated in discussions on key topics emerging from the survey results. These CAEs represented a diversity of industries including energy, gaming, manufacturing, and insurance. CAEs from both the United States and Canada were interviewed, as were CAEs coming from traditional and nontraditional career paths.

Since 2009, The IIA’s Audit Executive Center has conducted annual Pulse of the Profession surveys to assess the state of the internal audit profession and identify trends and emerging issues in the profession and with its stakeholders. The IIA has published analyses of the survey results for North America since the first survey was issued. And in 2012, The IIA began publishing analyses of the global results annually.