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The Bulletin

The Future Auditor: The Chief Audit Executive's Endgame

According to The Institute of Internal Auditors (IIA), "internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations." Internal auditing "helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."[1]

This definition of internal auditing captures a vision concerning the endgame to which a chief audit executive (CAE) should aspire. The term *future auditor* describes a CAE who takes definitive steps toward making this vision a reality within the organization he or she serves. This issue of *The Bulletin* provides observations regarding our view of the future auditor and its implications to internal audit's value proposition.

The Future Auditor Defined

Positioned to be objective with regard to operating units, business processes and shared functions, and vested with a direct reporting line to the board of directors, the future auditor:

- Establishes relevance by understanding the organization's business objectives and strategy and identifying risks that create barriers to the organization achieving its objectives and executing its strategy successfully;
- Is authorized to evaluate and challenge the design and operating effectiveness of the organization's governance, risk management and internal control processes that address its critical risks, and creates value by making recommendations to strengthen those processes and keeping the appropriate parties informed regarding open matters;
- Uses a lines-of-defense perspective to ensure that risk management and internal control are functioning effectively;
- Articulates the value a risk-based audit plan contributes to the organization, providing an assurance perspective that the board and executive management can understand;
- Maximizes the use of technology to achieve efficiencies in assessing risk, expanding audit coverage, automating critical internal controls, tracking issues, providing exception reports, and mining and analyzing data to draw meaningful insights regarding emerging risks and process and control performance; and
- Possesses escalation authority and proactively exercises that authority to bring important matters to executive management and the board for resolution on a timely basis.

12 Ways the Future Auditor Can Contribute Value

1. Think more strategically when analyzing risk and framing audit plans
2. Provide early warning on emerging risks
3. Broaden the focus on operations, compliance and non-financial reporting issues
4. Strengthen the lines of defense that make risk management work
5. Improve information for decision-making across the organization
6. Watch for signs of a deteriorating risk culture
7. Expand the emphasis on assurance through effective communications with management and the board
8. Collaborate more effectively with other independent functions focused on managing risk and compliance
9. Leverage technology-enabled auditing
10. Improve the control structure, including the use of automated controls
11. Advise on improving and streamlining compliance management
12. Remain vigilant with respect to fraud

With these responsibilities and independent positioning in place, the future auditor is recognized throughout the organization as a positive change agent and provides a valued sounding board to executive management and the board in safeguarding the adequacy and effectiveness of activities that really matter to the organization's success.

[1] See The Institute's definition of internal auditing at the following site: www.theiia.org/guidance/standards-and-guidance/ippf/definition-of-internal-auditing/?search%C2%BCdefinition.

To some, the aforementioned responsibilities may be nothing new and merely depict what CAEs are, or what they should be, doing now. We agree some CAEs, particularly in financial services, actively embrace the future auditor vision. Every CAE has the opportunity to self-assess his/her value contributed against the future auditor vision and determine whether gaps exist and, if so, whether such gaps are due to the function's positioning, scope or skill sets.

While operating the internal audit function in accordance with the profession's standards[2] is important, the future auditor's primary focus is on value contributed in the eyes of the board and executive management. To that end, we have suggested 12 ways the future auditor contributes demonstrable value. While not intended to be all inclusive, we think enough of these suggestions to recommend that if significant gaps exist between the expectations of the board and management and the CAE's performance on any of them, they should be carefully considered and addressed by the CAE.

Think More Strategically When Analyzing Risk and Framing Audit Plans

Internal auditors have traditionally focused on operational, compliance and reporting issues. Though these matters have always been important and will never cease to be important, they usually don't end up on the C-suite floor unless there's a problem worth escalating to that level. To gain access to the C-suite more frequently, the future auditor thinks more strategically when evaluating risk and formulating audit plans. Following are suggestions:

- **Identify and anticipate barriers to successful execution of the strategy –** Grounded in a solid understanding of the organization's strategy and business model, the future auditor focuses on the risks that matter and ascertains whether someone in the organization is monitoring the vital internal and external signs that indicate whether critical assumptions underlying the strategy remain valid.
- **Facilitate the risk appetite dialogue –** The future auditor facilitates dialogue at the highest levels in formulating assertions around (1) acceptable or on-strategy risks that the organization intends to take because the risks taken are sufficiently compensated, (2) undesirable or off-strategy risks that should be avoided and for which zero/minimal tolerances should be set, and (3) strategic, financial and operating parameters within which management runs the business. Taken together, these assertions frame the organization's risk appetite statement. The future auditor ensures that the risk appetite is operationalized effectively using actionable risk tolerances and limit structures in critical areas.
- **Update the company's risk profile to reflect changing conditions –** Organizations should assess their risks at least annually and consider refreshing their risk appetite statement for changing markets and conditions. The future auditor plays a significant facilitation role in these activities, ensuring a quality enterprisewide risk assessment process is in place along with appropriate action plans to manage the most significant risks.
- **Understand how new technological trends are impacting the company –** Mindful of the disruptive effects of technological innovation and related implications to security/privacy, financial reporting processes and business model viability, the future auditor recognizes that ignoring tomorrow's technology while implementing today's can position the organization on the wrong side of the change curve. The future auditor has access to the necessary capabilities to evaluate the ongoing effectiveness of the overall information technology (IT) control environment and IT process-level controls (both general IT processes and application-specific processes).
- **Maintain healthy tension between value creation and protection –** Organizations operate every day with the notion of managing residual risk. The future auditor pays attention to the organization's decision-making processes, particularly around risk acceptance, and whether the right risks are accepted by the right people at acceptable levels. Of particular interest is entrepreneurial opportunity-seeking behavior driving revenue growth and whether such activities give appropriate consideration to identifying, mitigating and monitoring the resulting risks. The future auditor escalates to management and the board any dysfunctional situations giving rise to unacceptable risks.

The value of the internal audit function is enhanced by the future auditor's consideration of the validity of strategic assumptions, the organization's strategic alignment, and progress toward executing the strategy. The above suggestions may help internal auditors see the big picture more clearly when interpreting audit results.[3]

Provide Early Warning on Emerging Risks

Effective risk management requires understanding more about what we don't know than what we do know. While it is universally accepted that risk assessments must be refreshed periodically, the future auditor's line of sight is directed to recognizing emerging risks in a timely manner. For example, strategic uncertainties arise when critical assumptions underlying the strategy become invalid and management and the board are unaware they are playing out what could be a "losing hand" in the marketplace. Contrarian analysis can be used to think outside the box to identify emerging strategic

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[2] See https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx for The Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing, effective January 1, 2013.

[3] "Five Things the Audit Committee Won't Tell Internal Audit," Richard Chambers, *Internal Auditor,* March 10, 2014.

risks and scenarios that could bring the company down, e.g., actions competitors may take, changing customer preferences, the threat of substitute products, or the implications of losing a major supplier, channel partner or customer.

Emerging risks can lie hidden within the organization's processes until they appear without warning, triggering embarrassing surprises. Often a result of behaviors and deficiencies deeply embedded within the organization's culture, they expose executive management to losing touch with what is really happening in the business. To illustrate, deferred maintenance over the course of several years due to budgetary pressures can ultimately lead to a significant environmental and/or safety disaster. Today's shortcuts on quality can trigger tomorrow's product recalls, regulatory sanctions, challenges from the plaintiff's bar and brand-eroding headlines. A culture permitting cost and schedule considerations to carry priority over prudent health and safety standards creates an unsustainable environment that will ultimately pay the price. Management's acceptance of a lack of segregation of authorization, execution and settlement activities creates exposure to unauthorized dealings by a rogue employee. The future auditor provides a line of defense against these deficiencies.

Broaden Focus on Operations, Compliance and Non-Financial Reporting

The focus on financial controls is not enough and is unsustainable in terms of meeting stakeholder expectations over the long term. The profession needs to acquire and retain the skills necessary to address a broader portfolio of risks. The future auditor can lead the way.[4]

Last year, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its update of the *Internal Control – Integrated Framework*. The new framework is likely to be used by many (if not most) public companies as a suitable framework for evaluating the effectiveness of internal control over financial reporting in accordance with the Sarbanes-Oxley Act in the United States. However, the future auditor's role should touch significant aspects of business operations, including IT security, business continuity and crisis management, supply chain management, operating expenditures, talent management, compliance management, and more.

Protiviti's *2014 Internal Audit Capabilities and Needs Survey*[5] assessed competency levels and areas of improvement for CAEs and internal audit professionals, and revealed a number of notable trends and priorities that are shaping the internal audit landscape. Among the key takeaways are observations that run beyond the reliability of financial reporting: social media remains a top concern; changes from regulatory and rulemaking bodies are garnering attention; the nature of fraud risk is changing – as are the ways internal auditors address it; there is continued interest in leveraging technology-enabled auditing; and internal auditors aim to collaborate with the rest of the organization more effectively.

The future auditor ensures that the function (including any co-source partners) has the resources, skill sets and tools it needs to address the above trends and priorities as well as the company's key risks. Internal audit must be attuned to changes in the organization if it is to be a value-added player in the eyes of executive management and the board, and that includes appropriate emphasis on operations, compliance and non-financial reporting issues. The 2013 COSO *Internal Control – Integrated Framework* provides guidance on how to sharpen the future auditor's focus on these areas.

Strengthen Lines of Defense That Make Risk Management Work

The future auditor uses the multiple lines-of-defense model as a lens for evaluating how the organization establishes the necessary discipline to ensure risks are reduced to a manageable level as dictated by the organization's risk appetite. Much more than "segregation of incompatible duties" and "checks and balances," the lines-of-defense model provides an effective lens through which to evaluate risk management.

There are three traditional lines of defense – the primary risk owners, independent risk management and compliance functions, and internal audit. Using the vantage point of the shareholders, we see a broader view – five lines of defense that support the execution of the organization's risk management and compliance management capabilities:

1. **Tone of the organization –** Senior management, under the board's oversight, must set and reinforce the organization's risk culture by positioning each of the lines of defense to function effectively. The other lines of defense reinforce this tone of the organization.
2. **Primary risk owners –** Those responsible for units and processes that create risks must accept the responsibility to own and manage the risks their units and processes create as well as establish the proper tone for managing these risks consistent with the tone at the top.
3. **Independent risk management and compliance functions –** Effective risk management requires an independent, authoritative voice to ensure that an enterprisewide framework exists for managing risk, risk owners are doing their jobs in accordance with that framework, risks are measured appropriately, risk limits are adhered to, and risk reporting and escalation protocols are working as intended.
4. **Internal audit –** The future auditor provides assurance that other lines of defense are functioning effectively and uses the lines-of-defense framework to focus assurance activities more broadly on risk management.
5. **Executive management and the board of directors –** Under the board's oversight, executive management arbitrates the inevitable tension between market-making

[4] Ibid.

[5] Protiviti's *2014 Internal Audit Capabilities and Needs Survey* is available at www.protiviti.com/IAsurvey.

activities and control activities by (a) ensuring these activities are appropriately balanced such that neither one is too disproportionately strong relative to the other, (b) acting on risk information on a timely basis when significant matters are escalated, and (c) involving the board in a timely manner when necessary.

The five lines-of-defense model is an integrated approach through which an organization responds to risk. It provides direction to executive management and the board as to how the organization should approach risk management. The future auditor watches for the warning signs that these lines of defense are not functioning effectively.[6]

Improve Information for Decision-Making Across the Organization

The future auditor helps the organization identify and manage supply chain and business interruption exposures, commodity risk, third-party liability risk, human resources management challenges and other risks through:

1. Using performance indicators, metrics and monitoring systems the organization already has in place;
2. Combining the use of analytic tools and techniques with the performance indicators, metrics and monitoring in place to create a balanced family of lead and lag performance indicators and trending metrics to signal when risk events might be approaching or occurring; and
3. Automating key controls or selected business processes to enable continuous monitoring by primary risk owners, independent risk management functions and internal audit.

The future auditor's emphasis on improving risk information across the organization can lead to better information for decision-making used in the business. Importantly, it enables internal audit to be in tune with the right issues at or before the time they hit the screens of executive management and the board as significant problems.

Watch for Signs of a Deteriorating Risk Culture

Risk culture is the "set of encouraged and acceptable behaviors, discussions, decisions and attitudes toward taking and managing risk within an institution." Developed in conjunction with research Protiviti conducted with The Risk Management Association (RMA), this definition applies to all organizations, whether public or private, for-profit or not-for-profit, or domiciledin one country or another.[7]

The emphasis on ethical and responsible business behavior in any organization is only as strong as its weakest link. The organization's tone at the top must be translated into an effective tone in the middle before it can reach the rest of the organization. An integral part of this alignment, risk culture is the glue that binds all elements of risk management infrastructure together. It reflects the shared values, goals, practices and reinforcement mechanisms that embed risk into an organization's decision-making processes and risk management into its operating processes. In effect, it is a look into the soul of an organization to ascertain whether risk/reward trade-offs really matter.

The future auditor understands that a deteriorating risk culture presents a formidable hurdle to improving risk management performance. Because risk culture often evolves as the organization itself evolves, from time to time the future auditor may use self-assessment techniques, internal surveys, focus groups and other techniques to understand the current state of the organization's risk culture. Once this assessment is completed, the future auditor works with executive management and the board to ascertain whether any gaps against the desired risk culture exist, organizational changes are needed to rectify those gaps and specific steps are necessary to implement those changes.

Expand the Emphasis on Assurance Through Effective Communications

In 2009, The IIA released a practice advisory asserting that the board of directors seeks assurance that processes are operating within parameters established around achieving specified objectives. This point of view spotlights the organization's assurance activities to determine whether risk management processes are working effectively and whether critical enterprise risks are being managed to an acceptable level, prompting the CAE to 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.[8]

The premise of the advisory is that there are three classes of assurance providers, differentiated by the stakeholders they serve, their level of independence from the activities over which they provide assurance and the robustness of the assurance they provide:

1. Those who report to management and/or are part of management;
2. Those who report to the board (including internal audit); and
3. Those whose reports are of interest to external stakeholders (e.g., the external auditor).

[6] There are myriad published versions of the three lines-of-defense model, e.g., IIA, ISACA, Solvency II and perhaps others. So far as we have been able to determine, Sean Lyons is the first author to have broadened the focus of the lines-of-defense concept in a Conference Board paper dated October 2011. Mr. Lyons' stakeholder-oriented approach is different from the one we outline in this issue of *The Bulletin*. Our view on the five lines of defense is discussed further in Issue 4 of Volume 5 of *The Bulletin,* "Applying the Five Lines of Defense in Managing Risk," available at www.protiviti.com.

[7] "Risk Culture: From Theory to Evolving Practice," *The RMA Journal,* December 2013-January 2014.

[8] "Assurance Maps," Institute of Internal Audit Practice Advisory 2050-2, July 2009.

In this context, there are many assurance providers internally within a company – line management, functional management, independent risk management, compliance management, internal audit, and senior management. The assurance these providers offer can be linked to specific business objectives.

This IIA advisory was ahead of its time in 2009 and still is today. It is interrelated with the multiple lines-of-defense model.

The future auditor uses an assurance map to clarify “who does what” at the different levels of assurance, and identifies gaps and overlaps against the various risk-based expectations and objectives set by the board and executive management. The assurance map provides the basis for evaluating whether the assurance process is functioning effectively. Therefore, as the board requests “assurance” from internal audit, not really knowing what that request entails, the future auditor uses the assurance map to educate directors as to where the accountability lies and focus the audit plan to assess the quality of the organization’s internal assurance processes.

Collaborate More Effectively with Other Independent Functions

Collaboration is a vital skill on many fronts in any discipline, and especially for internal audit. Of necessity, the future auditor undertakes a collaborative approach with independent risk management and compliance functions to coordinate roles, responsibilities and assurance plans as well as share risk information and available resources. Good things happen when strong alliances between the risk management and internal audit functions are formed – efficiencies, better decision-making and improved results.[9]

Leverage Technology-Enabled Auditing

The future auditor seeks to leverage technology-enabled auditing on multiple fronts. For example, self-assessment tools are used to gain a broader picture of the organization’s processes and controls and identify opportunities to improve process effectiveness and efficiencies than can be gained solely through individual audits. Intelligent use of continuous auditing and computer-assisted auditing techniques is another important area that increases the future auditor’s reach and broadens audit and risk coverage through the use of data mining and analysis tools. Technology can help automate ongoing monitoring of certain internal controls, track issues, and provide customized dashboards and exception-reporting capability.

By using technology, the future auditor is able to devote more time and effort to building relationships with process and functional owners and providing expertise in high-impact areas. A technology-focused audit approach facilitates the future auditor’s shift of emphasis to strategic issues and critical enterprise risks by leveraging technology and continuous monitoring approaches to the day-to-day financial, compliance and operational risks to provide timely notification of control issues and anomalies to management.

All told, technology enables the internal audit function to gain more coverage with less effort, provide more analytic insight and offer early warning capability. The future auditor knows that specialized skills may be needed from time to time that may be unavailable in-house, requiring the use of outside resources to improve the use of technology, increase service levels and reduce costs.

Improve Internal Control Structure, Including Use of Automated Controls

The future auditor evaluates the control structure and identifies opportunities to eliminate, simplify, focus and automate controls. For example, the future auditor:

- Rationalizes the overall control environment, including the number of overall key controls, the extent of reliance on manual controls and opportunities to increase the use of automated controls across the organization;
- Designs and implements custom automated tests that examine configurable data, master data and transaction data to address high-priority control issues; and
- Implements continuous monitoring tools such as detective controls that alert management to changes or activities that warrant further investigation.

The future auditor recognizes that automated controls provide opportunities for improving the transparency of the control structure so that risk owners, independent risk management functions and internal auditors will have more insight as to how operating processes and critical controls are performing than when extensive manual controls are in place. Automated controls can reduce costs, mitigate risks, improve processes and streamline compliance, providing tangible value relative to required investments in hardware, software, implementation and training.

Advise on Improving and Streamlining Compliance Management

In many companies, there are challenges in compliance, including:

- Proliferation of operating silos;
- Gaps and overlaps in ownership of control responsibilities;
- Fragmented and diffused reporting of risk and control data leading to a lack of transparency and uninformed decision-making about the control structure; and

[9] “Risk Management and Internal Audit: Forging a Collaborative Alliance,” Risk and Insurance Management Society, Inc. (RIMS) and The Institute of Internal Auditors, April 2012, available at https://na.theiia.org/news/press-releases/Pages/Risk-Management-and-Internal-Audit-Forging-a-Collaborative-Alliance.aspx.

- Unaligned stakeholders' expectations as new policies, procedures and controls may be perceived by process owners as putting a drag on operational efficiency, resulting in failure to embed the new activities into day-to-day business processes.

The future auditor recognizes these challenges can result in a fragmented control environment, unnecessary infrastructure, excessive manual controls, redundant requests of process owners, high audit costs and other symptoms of a reactive compliance infrastructure, presenting opportunities for a collaborative partnership with compliance management to improve and streamline compliance.

To address these challenges, the future auditor applies a quality focus to managing compliance with the same fervor with which the organization often approaches the improvement of core operating processes. For example, the future auditor might recommend:

- Refining the compliance operating model, striving for lean central functions and pushing down compliance accountability to the front lines;
- Adopting risk governance principles around multiple lines of defense;
- Undertaking an enterprisewide approach to assessing compliance risks; and
- Rationalizing a more efficient controls design and driving a more focused internal control structure in specific compliance areas.

With one or more of the above pathways in mind, the future auditor collaborates with compliance management to forge a more streamlined, end-to-end view of compliance management, resulting in improved coordination across the organization of control requirements setting, alignment of management and control activities, streamlining and integrating reporting around compliance and other risks, reduced complexity and redundancy, and increased efficiency and effectiveness of entity-level compliance oversight processes.

Remain Vigilant with Respect to Fraud

The future auditor knows full well that the nature of fraud is ever-changing – as are the ways internal auditors address fraud and corruption. For example, the future auditor understands the importance of a comprehensive enterprisewide fraud and corruption risk assessment and evaluation of the robustness of the organization's anti-fraud and corruption program.

Consistent with the multiple lines-of-defense model discussed earlier, the future auditor places emphasis on the ability of primary risk owners to prevent, deter and detect fraud in their respective activities, especially in high-risk areas. In essence, internal audit is the final line of defense evaluating the effectiveness of, among other things, regular fraud-related communications to employees; fraud prevention, deterrence and detection measures; reporting and investigative processes; and the retribution mechanisms enforcing established policies. The future auditor deploys data mining and analytics techniques to analyze transactional data and activities involving third parties, obtain insights into the operating effectiveness of internal controls, and identify indicators of, or patterns signifying the possible existence of, fraudulent activity requiring further investigation.

Summary: Striking the Right Balance

We have suggested the vision of the "future auditor," our view of the CAE who takes definitive steps to apply the full scope of The IIA's definition of internal auditing. In taking these steps, how does the CAE balance it all? There are multiple priorities in an audit plan – "must do" activities (e.g., regulatory compliance and financial reporting controls compliance), risk-based activities linked to the organization's strategies and objectives, core assurance activities rotated over several audit periods, and management requests (e.g., investigations and special projects). The future auditor not only understands these various demands, but also optimizes the allocation of resources to each. Depending on the function's existing competencies, the CAE's approach to contributing value may likely result in gaps that must be filled over time to realize the future auditor vision we've articulated. While this path is not easy, the future auditor masters the art of applying due professional judgment in determining what's relevant to the company's leaders and board of directors, and knowing when to escalate critical matters to them.

Clearly, finding the appropriate balance is a challenge. The key takeaway is that CAEs embracing the future auditor vision are better positioned to demonstrate to executive management and the board the value contributed by internal audit through their comprehensive risk-focus and forward-looking, change-oriented and highly adaptive behavior. Now is the time to raise the bar for the profession. It is up to progressive CAEs to take the lead and show the way to reach the profession's full potential as a discipline.

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