Transforming Internal Audit to Drive Business Performance

21 June, 2011
Agenda

• Stakeholder Needs from Survey Data
• Linking Business Performance to Internal Audit
• The Role of Risk Management
• Becoming a “Strategic and Valued Advisor”
• Unlocking the Value of Internal Audit Examples
• Value Charter/Value Scorecard Considerations
• Steps to Transformation
• Self Diagnostic
Insights on internal audit

96% of companies believe strong risk management has a positive impact on their long-term earnings performance

94% of companies believe that their internal audit function has an important role in their overall risk management efforts

94% of companies have been asked to improve their risk coverage through internal audit

77% of companies have been asked to improve internal audit with the same or reduced cost/budget

44% of companies believe internal audit helps their organization achieve its business objectives

38% of organizations believe their internal audit function is consistently strong across all geographic locations

37% of organizations involve internal audit in key business decisions and strategy

32% of organizations believe their internal audit function attracts future leaders and high-potential talent from within the business

74% of organizations believe there is a need to improve their internal audit function

Of these organizations, 96% of companies believe they should make improvements within the next 24 months

Source – VERSION 11 May: Ernst & Young Risk Survey conducted in April and May 2010 with Global Audit Committee Members, CEOs and CFOs

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Executives are asking

- Does my internal audit function understand their key stakeholder expectations?
- Is my internal audit function contributing to address our key business objectives?
- How do I know I am getting value from my internal audit function?
- How can internal audit help to get better risk coverage for less cost?
- Should my Internal audit function be responsible to help add value and improve my business?
- Does my IA function have the appropriate influence on my overall control environment?
- Does my internal audit function have the right skills in the right places?
- How can information technology help internal audit do a better job?
- Do I know I have an effective internal audit function based on objective performance and cost benchmarks?
- What does internal audit do to help increase the competitiveness of my business?
Internal audit addressing stakeholder needs

The ‘value gap’ represents the opportunity for long term improvement.
## Linking business performance to internal audit

Internal audit enables improvement to business performance

### Implications for Internal Audit

Focus on high risk areas while driving value and reducing costs

### Governance and risk management

Co-ordination with all other risk and assurance activities

### Internal Audit capabilities

<table>
<thead>
<tr>
<th>Stakeholder expectations</th>
<th>Business objectives/ Business value agenda</th>
<th>Internal audit enabled business performance</th>
</tr>
</thead>
</table>

- **Stakeholder expectations**
  - Focus on high risk areas while driving value and reducing costs

- **Business objectives/ Business value agenda**
  - Co-ordination with all other risk and assurance activities

- **Internal audit enabled business performance**
  - **Value Charter**
  - Mandate: Alignment with stakeholder expectations and support of business objectives
  - People: Highly skilled and experienced people
  - Methods: Dynamic approach
  - Technology enablement: Advanced tools and techniques
Aligned and integrated risk management activities can lead to improved business performance

Future State

Board oversight
- Audit committee
- Compensation committee
- Risk committees
- Other committee

Executive management
- CEO
- CFO
- CRO
- General Counsel

Aligned mandate and scope
- Coordinated infrastructure and people
- Consistent methods and practices
- Common information and technology

Integrated risk functions increase value, reduce costs, and improve business performance
Risk Coverage – Mapping accountabilities for key risks

**Representative Example – Risk Coverage Map**

Aligning the key risks to the organizational roles and responsibilities is ultimately critical to determining opportunities for enhancement.

<table>
<thead>
<tr>
<th>Significant Risks</th>
<th>Business Operations</th>
<th>Support Functions</th>
<th>Monitoring</th>
<th>Oversight</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>New Product Development</td>
<td>Gain New Business</td>
<td>Procurement</td>
<td>Production</td>
</tr>
<tr>
<td>International Expansion</td>
<td></td>
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<tr>
<td>New Product Development</td>
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<td>Raw Material Price Volatility</td>
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<td>Foreign Exchange Rates</td>
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<td>Interest Rate Volatility</td>
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<tr>
<td>Contract Terms/Conditions</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Recruitment &amp; Retention</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Regulatory Compliance</td>
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<tr>
<td>Health/Privacy</td>
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Enhancing and sustaining business performance – Unlocking the value of internal audit | Page 7
Calendar Overview - “Rhythm Of The Business”

Key points of integration for incremental enhancements

<table>
<thead>
<tr>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
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</thead>
<tbody>
<tr>
<td>JAN</td>
<td>FEB</td>
<td>MAR</td>
<td>APR</td>
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</table>

1. Risk Review
   - 1/XX
   - 4/XX
   - 7/XX
   - 10/XX

2. Business Risk Assessment
   - Quarter Review
   - Quarterly ECC

3. QBR Risk Review
   - Quarterly Review
   - Quarterly ECC

4. Quarterly Close
   - 1/xx
   - 2/xx
   - 3/xx
   - 4/xx
   - 5/xx
   - 6/xx
   - 7/xx
   - 8/xx
   - 9/xx
   - 10/xx
   - 11/xx
   - 12/xx
Internal Audit as a valued business advisor

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

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

Control and Compliance Monitoring Structure
Internal Audit function focused on evaluating the design and the effectiveness of internal controls in those areas outlined in their charter or mandate. Also includes focusing on compliance with key regulations and policies.
Closing the gaps

The transformation gap keeps many IA functions from becoming a strategic and valued advisor to executive management and their boards of directors. Targeting approaches that help fill the gap will allow for enhanced performance.

What drives the gap?

**Competency gap**
- Rotational resource model
- Lack of scale to adequately staff certain areas
  - IT, international, treasury, taxes, supply chain
  - Fraud prevention and detection
- Audit activity = available resources
- Traditional role of internal audit function limits scope
- Alignment with strategic plan and initiatives to support
- Industry/competitive insight

**Enablement gap**
- Traditional risk assessment and audit planning approach
- Not driven by business risk
- Heavy focus on auditable units and locations
- Limited use of data analysis and modeling
- Limited training and development
- Lack of effective prioritization
- Unwillingness to change
- Not focused on key business process improvements

Filling in the gaps can help improve IA performance and client service.
Stakeholder expectations of internal audit

**Risk**
- Effective management of risk
- Strong corporate governance
- Fraud risk
- Regulatory compliance
- Reliable assurance

**Value**
- Business performance improvement
- Support M&A
- Meet Strategic business objectives
- Advisor on major change initiatives

**Cost**
- Business process improvement
- Cost reduction or recovery
- Efficiency and effectiveness
Unlocking the value
Aligning internal audit with business objectives

Example value objectives
- Improve overall skills and personnel in the internal audit function
- Increase business performance capabilities
- Improve results on major change programs
- Advise on entering new markets
- Benchmark against peer organizations

Example risk objectives
- Improve risk assessment
- Enhance coverage of key and emerging risks
- Improve coordination with other risk functions
- Improve overall control awareness and control behavior

Example cost objectives
- Improve efficiency and effectiveness of the control environment
- Leverage technology to reduce internal audit costs
- Improve staffing flexibility to manage through peak/trough capacity demands
Case study - Internal audit and major capital programs
A seat at the table prior to and during implementation

The business objective(s):

► Return maximum on investment in major capital program
► Achieve ROI/ROC as quickly as possible while minimizing disruption to existing business operations

The focus of Internal Audit:

► Participate in pre-implementation and ongoing program execution by providing controls consultation, efficiency monitoring and test of intended new controls
► Help management reduce the overall risk of failure by monitoring key risks to the program as well as long-term risks to the business process(es) affected by the major change

<table>
<thead>
<tr>
<th>The results (benefits/impacts):</th>
<th>Value added</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. IA helps to reduce the risk of failure (cost overruns, program milestones not achieved), failure to meet stakeholder expectations) by monitoring “program risk”, that is, those risks that are inherent in large capital projects.</td>
<td>✔</td>
</tr>
<tr>
<td>2. IA, by monitoring risks that would otherwise cause major delays in program execution and benefits realization, actually enables speed-to-ROI/ROC.</td>
<td>✔</td>
</tr>
<tr>
<td>3. IA is a true “partner” with the business, seen as a true consultant skilled in leveraging internal leading practices across the enterprise.</td>
<td>✔</td>
</tr>
</tbody>
</table>

True story ...

Objective - Execute a major rollout of SAP on a worldwide basis across 5 waves and 3 years. Do so with maximum efficiency and little disruption to the business.

IA’s role - Dedicated five (of 40) Internal Audit team members (two IT) and a Program Risk SMR. Participated in company program (including PMO) from very start. Consult on controls and test new risk profile.

Bottom Line - Not only did IA and the SMR help the company achieve the intended results/benefits of the rollout, it established itself as a value-added contributor (and consultant) of leading practices and key skills.
M&A Risk Assessment Process

Corporate M&A Strategy (8-10 deals/year)

Deal profiles and characteristics are assessed based on established risk criteria.

Typical Risk Assessment Criteria:
- Deal Size
- Deal Type
- Timing
- Speed of integration
- Synergy targets
- Geographical locations
- Resource experience
- Product/service offering
- Stakeholder expectations

Deals are categorized based on inherent degree of risk:
- Limited
- Partial Review
- Full Lifecycle Review

Internal Audit Participation

People

Process

Technology/Tools

Full Lifecycle Review

- End-to-End M&A lifecycle participation

Partial Review

- Participation at riskier stages in the deal lifecycle

Limited

- Participation in ad hoc or requested reviews

M & A Life Cycle

Strategy

Due Diligence

Deal Approval & Close

Integration

Outcome:
- Process Improvement
- Deal value confirmation/acceleration
- Link to strategy
- Measurement
- Mitigation of value leakage
- Stakeholder assurance
Corporate Audit M&A Role Framework

M & A Life Cycle

- Strategy
  - Assess corporate strategy process.
  - Assess the risks to the organization.
  - Assess business case process.

- Due Diligence
  - Assess valuation process.
  - Assess risks and internal control environment.
  - Assess synergy validation process.

- Deal Approval & Close
  - Assess deal approval process.
  - Assess monitoring of valuation process leading up to close.

- Integration
  - Assess integration planning process.
  - Assess integration project management.
  - Assess and monitor integration execution.
  - Transaction value assessment (post-integration).

Objective

Case Studies

1. Synergy Validation
2. Synergy Tracking
3. Synergy Quality
4. Look Back ROI
Implications for internal audit
Example value charter for internal audit

Vision Statement

Business Value Agenda / Objectives
- People
  - Highly Engaged Workforce
  - World-class Safety
- Performance Product & Process
  - #1 in Quality
- Market Leadership
- Market-leading Availability
- Profitable Growth
- Revenue
- EPS Growth

Critical Success Factors
- People
- Quality
- Product
- Velocity
- Distribution
- Emerging Markets
- Macro-economic

Value Charter

Value Attributes for Internal Audit:
- Leadership Development
- Subject Matter Knowledge
- Training and Certification
- Utilization
- Audit Relevance to Risk that Matter Most
- Efficiency and Effectiveness of Audit Process
- Value Impact on the Business (process improvement)
- Business Relationships, Insights and Advisory Focus
- Six Sigma Principled
- Risk Coverage

Value Scorecard Measures:
- Staff Placement/Attraction to/from Business
- SMR’s Leveraged in the Audit Project(s)
- Training Hours, CPE’s and Certifications attained
- Team Headcount and Utilization
- High Risk Areas Addressed
- Issues Monitored and Closed (H/M/L)
- Recommendations Made and Implemented
- BU Executive Interactions and Key Initiative Inclusion
- Costs Contained/Recovered and Revenue Enhancements Identified/Implemented
- Emerging Market Insights and Red Flags monitored and reported
Three steps to Internal Audit Transformation
“Continuous Improvement”

Link Internal Audit to the Business Value Agenda

Create a plan that focuses on value, measurement and accountability

Build the business case for change

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Value Charter

Results of self-assessment / scorecard
Risk based Internal Audit approach

Leverage the audit planning risk model to determine the appropriate means by which to staff and execute the detailed audit plan to drive a more efficient deployment of limited Internal Audit resources. The majority of Internal Audit resources should be deployed to address the most significant risks.
## Self-diagnostic – Ability to meet stakeholder needs

<table>
<thead>
<tr>
<th>Focus area</th>
<th>Basic</th>
<th>Evolving</th>
<th>Established</th>
<th>Advanced</th>
<th>Leading</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stakeholder expectations</strong></td>
<td>Internal audit stakeholders and expectations may be narrowly defined</td>
<td>•</td>
<td>•</td>
<td>•</td>
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</tr>
<tr>
<td><strong>Business objectives</strong></td>
<td>Internal audit activities may not be aligned to achievement of business objectives</td>
<td>•</td>
<td>•</td>
<td>•</td>
<td>•</td>
</tr>
<tr>
<td><strong>Internal Audit enabled business performance</strong></td>
<td>Internal audit activities are primarily focused on risk and compliance</td>
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<tr>
<td><strong>Enablers</strong></td>
<td>The internal audit operating model is functional but has known areas of weaknesses</td>
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</tbody>
</table>

### Enablers
- Mandate
- People
- Methods
- Technology

### Improved business performance
- Focus on risks that matter
- Alignment to business objectives
- Create competitive advantage
- Lower costs
- Greater efficiency
- Less complexity
- Broader risk coverage
- Improved coordination
- Proactive approach