

# 2017 NORTH AMERICAN PULSE OF INTERNAL AUDIT

Courageous Leadership: Instilling Confidence From Within



AUDIT EXECUTIVE  
CENTER®

# About the Pulse of Internal Audit

Number of Responses	
CAEs	460
Director/senior managers	78
Total	538

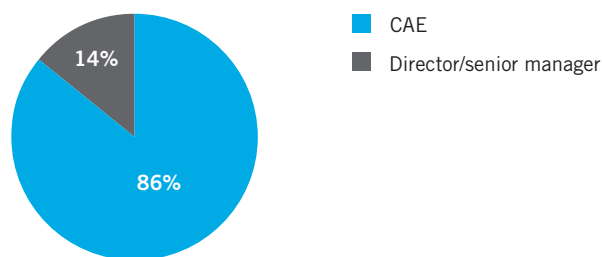
The IIA's Audit Executive Center® (AEC®) has gathered insight from leaders in the profession through the annual Pulse of Internal Audit survey since 2009. Each survey collects information about both established and emerging issues that are important to the profession as well as information about internal audit management (such as areas of focus, staff, and budget levels).

The 2017 North American Pulse of Internal Audit survey (Pulse) was conducted online from Oct. 20, 2016, to Nov. 11, 2016, with survey invitations distributed through the AEC, The IIA, and social media. The IIA collected data from 538 respondents, including 460 CAEs and 78 director/senior managers. In Pulse reports, CAEs and director/senior managers are collectively referred to as CAEs.

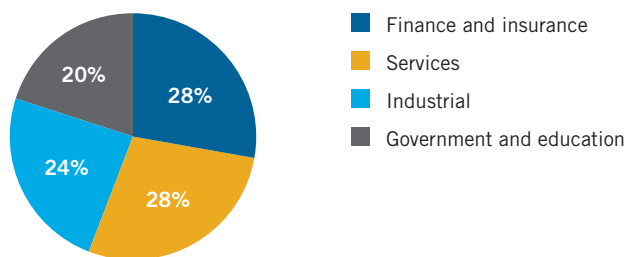
The survey results are analyzed and presented in multiple reports of which this is one. Complimentary high-level reports are made available to the public through The IIA's Pulse of Internal Audit resource page (visit [www.theiia.org/pulse](http://www.theiia.org/pulse)). More in-depth reports for internal audit management are available exclusively to members of the AEC. For more information about joining the AEC, visit [www.theiia.org/aec](http://www.theiia.org/aec).

## RESPONDENT DEMOGRAPHICS

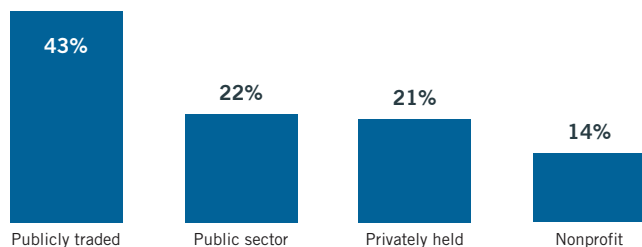
### Internal Audit Position



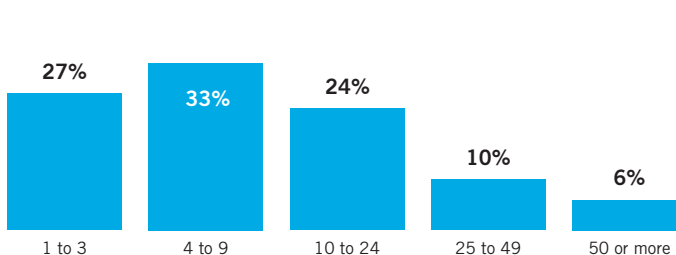
### Industry Groupings<sup>1</sup>



### Organization Type



### Internal Audit Function Size (FTEs)



<sup>1</sup> Industry groupings were defined as follows: Industrial — manufacturing; construction; utilities; mining, quarrying, and oil and gas extraction; transportation and warehousing; waste management/remediation services. Services — health care; retail trade; real estate; accommodation and food; wholesale trade; entertainment; information; professional; agriculture. Government and education — public administration and educational services. Finance and insurance — financial institutions, insurance, asset management, broker-dealers.

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## ABOUT THE AUDIT EXECUTIVE CENTER

The IIA’s Audit Executive Center<sup>®</sup> 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/aec](http://www.theiia.org/aec).

## DISCLAIMER

The information included in this report is general in nature and is not intended to address any particular individual, internal audit function, or organization. The objective of this document is to share information and other internal audit practices, trends, and issues. However, no individual, internal audit function, or organization should act on the information provided in this document without appropriate consultation or examination.

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## RESOURCES

Key internal audit management metrics on staffing, reporting lines, and more are compiled in the appendix. An additional report about management metrics will be provided to members of the Audit Executive Center.

# Introduction

In last year's Pulse of Internal Audit report, The IIA challenged internal auditors to "move out of their comfort zone" beyond annual planning and typical audit areas to audit at the speed of risk. Today, with increasing pressure on organizational governance and additional burdens placed on audit committees and boards, it is critical that chief audit executives (CAEs) lead with courage and take actions that could instill:

- Internal auditor's self-confidence.
- Management and the board's confidence in internal audit.
- Stakeholders' confidence in the organization.

Improving the effectiveness of risk management is a defining characteristic of internal auditing, yet even experienced CAEs may overlook some risks. This report looks at four areas where internal audit should take a closer look — both for the organization as a whole and for the internal audit function in particular.

Not all risks are new or emerging. In fact, many critical risks have been around for a long time and perhaps have fallen just below or somehow dropped off the radar. CAEs need to have the courage to revisit these areas while ensuring their audit coverage aligns with what is important and top-of-mind to key stakeholders. In this report, we address two such areas:

- Company communications not traditionally subject to independent assurance (e.g., analyst presentations, sustainability reporting, some operational reporting).
- Environmental, health and safety risks.

According to The IIA's International Professional Practices Framework, internal audit's mission is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. To do this effectively, leaders must have the courage to look inward with the same objective, professional skepticism used when assessing others. This report covers two areas where internal audit leaders have identified ongoing challenges:

- Internal audit's use of data analytics.
- Interpersonal dynamics between internal audit and others in the organization.

Using survey results, this report shows how CAEs in North America are currently looking at these areas, and where there are reasons for concern. The report also provides insights on how CAEs can instill confidence by "evaluating and improving the effectiveness of risk management, internal control, and governance processes."<sup>2</sup>

<sup>2</sup> Definition of Internal Auditing, The IIA's International Professional Practices Framework, 2017.

# Section 1: Communications Not Traditionally Subject to Assurance

In addition to formal financial statements,<sup>3</sup> organizations have several vehicles for communicating financial and nonfinancial information to investors, customers, and other stakeholders. Internal audit has not always provided assurance on information communicated through means other than financial statements.

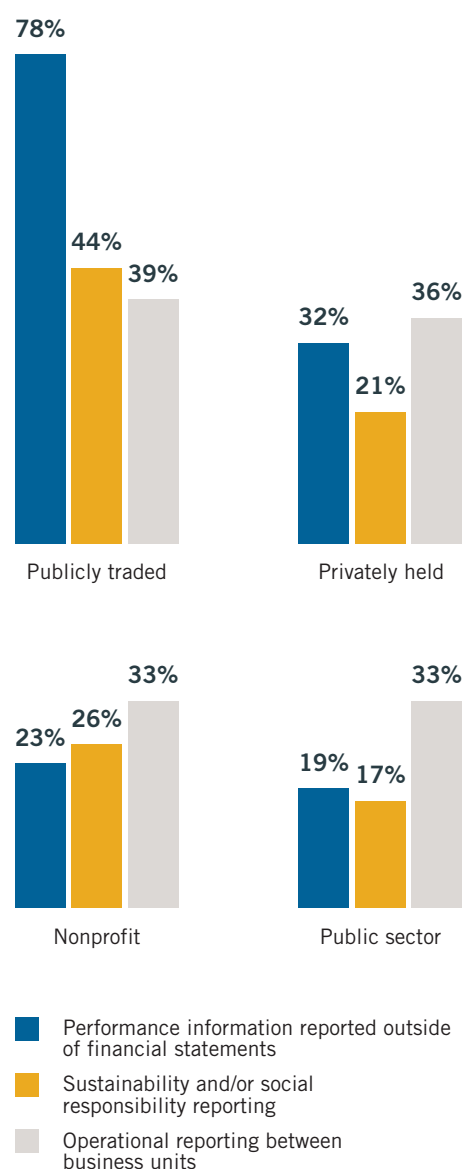
One of the key findings from the National Association of Corporate Directors' (NACD) 2016–2017 Public Company Governance Survey was that boards express concerns about the quality of information they receive in areas such as finance, strategy, and talent. The key driver of the dissatisfaction was that the “information doesn’t provide sufficient transparency into performance issues. In other words, boards find it difficult to identify the bad news.”<sup>4</sup> Clearly this type of information is critical to the board’s ability to effectively fulfill its duties. And it represents an opportunity for internal audit to align with the board’s objectives. By identifying, assessing, and prioritizing key information reported to the board, internal audit demonstrates its value and instills the board’s confidence in internal audit.

The Pulse explored three important types of communications that are often NOT subject to assurance by any independent assurance provider (Exhibit 1):

1. Performance information communicated outside of financial statements (for example, analyst presentations and other communications providing performance information to investors).
2. Sustainability and social responsibility reporting.
3. Operational reporting between business units (reporting within an organization on risk management, business continuity, etc.).

Publicly traded organizations are most likely to issue communications in these areas, with 78 percent communicating information about company performance outside of the financial statements and 44 percent engaging in sustainability and/or social responsibility reporting. While non-publicly traded organizations are less likely to issue these types of reports, a notable percentage of all types of organizations engage in communications other than through financial statements, especially operational reporting between business units (Exhibit 1).

**Exhibit 1: Communications  
Not Traditionally Subject  
to Assurance**



*Note: Q17: Does your organization issue the following types of communication that contain any data or information not included in the financial statements? (Select all that apply.)  
n = 512.*

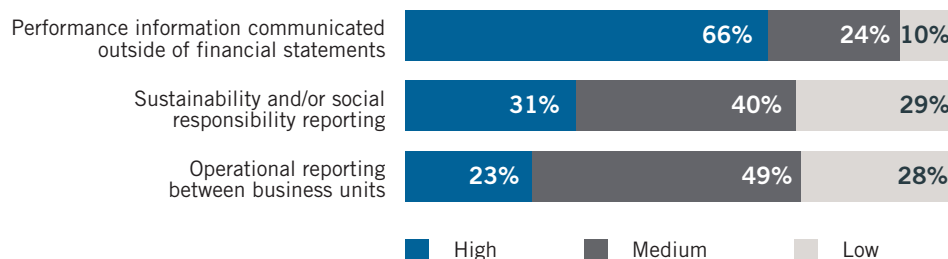
<sup>3</sup> Formal financial statements refers to financial statements and related disclosures that are prepared in accordance with generally accepted accounting principles and/or applicable regulations, frequently audited by an independent certified auditor.

<sup>4</sup> 2016–2017 NACD Public Company Governance Survey, National Association of Corporate Directors, November 2016.

## COMMUNICATION RISKS

Management, investors, and other stakeholders make strategic decisions based on information communicated outside of financial statements. Survey respondents perceive substantial risk to organizational reputation if these communications are inaccurate, incomplete, misleading, or confusing. Among respondents whose organizations issue performance information outside of financial statements, 66 percent have high concern regarding the risk to organizational reputation if communicated information is inaccurate, incomplete, misleading, or confusing. Concern is not as high for sustainability and/or social responsibility reporting or operational reporting between business units, but these areas are still considered important by the majority of respondents (Exhibit 2).

### Exhibit 2: Perceived Reputation Risk Due to Communication of Inaccurate, Incomplete, Misleading, or Confusing Information



*Note:* Q19: Rate the level of reputational risk your organization faces should the data and/or information in the following reports be inaccurate, incomplete, or misleading. Responses filtered to include only those who reported the activities in their organizations.  $n = 74$  to 190.

## PROVIDING INDEPENDENT ASSURANCE

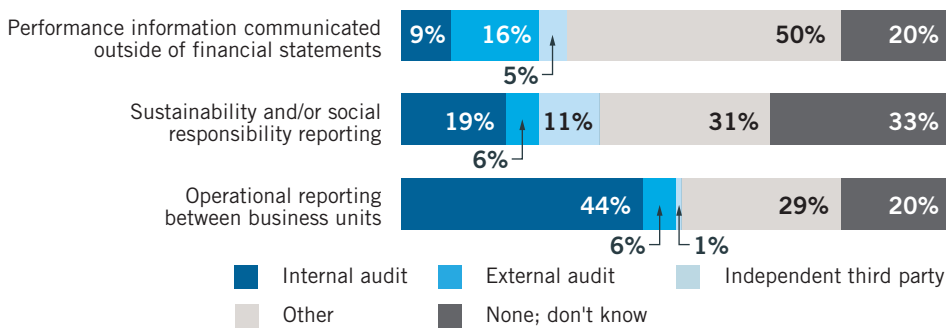
Organizations need to be assured that all information used in decision-making is accurate, complete, truthful, and clear — whether communicated via formal financial statements or other means. While external audit provides assurance over formal financial statements, this does not include all the communications important to the organization, nor the related processes and controls. Independent assurance can come from internal audit, external audit, or an independent third party.<sup>5</sup>

Surprisingly low levels of independent assurance were indicated for performance information reported outside of financial statements (Exhibit 3). In particular:

- Only 9 percent say internal audit provides assurance in this area.
- 50 percent say assurance is provided by other parties who are likely not independent (e.g., second line of defense, investor relations, accounting).
- 20 percent say that they are not aware of any assurance in place.

<sup>5</sup> Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner, *International Standards for the Professional Practice of Internal Auditing*, The IIA, 2017.

### Exhibit 3: Sources of Assurance



Note: Q20: Who provides assurance over the accuracy, completeness, and/or coherence for each of the following? Responses filtered to include only those who reported the activities in their organizations. *n* = 74 to 190.

These are seemingly low levels of independent assurance, considering a majority of CAEs (66 percent) perceive high reputation risk associated with information about performance communicated outside of financial statements (Exhibit 2). Internal audit needs to ensure that its efforts to provide independent assurance align with areas of highest perceived risk.

### ADDRESSING COMMUNICATION RISKS

In considering communications outside of financial statements, CAEs should address the following:

- **Identify the organization's communication tools and processes.** What modes of communication are used by the organization? Have audiences been identified and prioritized? Is an effective communication process in place?
- **Determine what types of information are important.** To determine importance, consider what information gets a lot of attention either internally or externally. If certain information gets a high level of interest, the presumption should be that it is important.
- **Assess the risks of communicating important information that is inaccurate, incomplete, misleading, or confusing.** What is the impact to the organization if important information, as communicated, is inaccurate, incomplete, misleading, or confusing?
- **Incorporate communication(s) of important information into the internal audit universe and planned audits.** Processes supporting communication of important information should safeguard the information's accuracy, completeness, truthfulness, and clarity.

## CASE IN POINT

Consider a retail organization that reports year-over-year sales per store (same-store sales) in its annual financial filings. The organization also may include same-store sales data in an analyst presentation, along with a discussion of opportunities and risks associated with same-store sales growth.

Has the same-store sales data included in the analyst presentation been verified against the same information used to prepare the financial statements? Has the definition of “same stores” been consistent? Has the process through which management identified opportunities and risks associated with same-store sales growth been assessed?

These questions represent a few concerns that internal audit might consider when looking for hidden risks associated with communications not traditionally subject to assurance.

- **Determine the quality of assurance being provided.** Who is providing assurance over the communication of important information? Is it someone other than the preparer of the communication? Evaluate the assurance provider’s level of independence, subject matter expertise, and competency in providing assurance; and the assurance process used.



## Section 2: Environmental, Health and Safety Risks

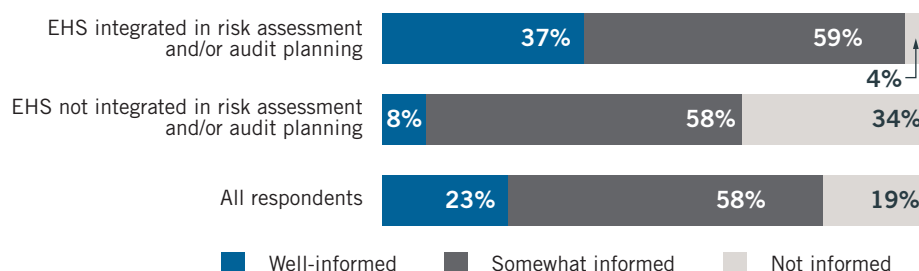
Environmental, health and safety (EHS) risks are pervasive in organizations, yet the majority of Pulse respondents indicate that EHS risks are not part of internal audit's risk assessment or audit planning. Examples of EHS risks include the release of toxic materials, contaminated food, dangerous working conditions, and ergonomics that hamper worker health or efficiency. One only needs to consider that in 2015, U.S. organizations spent over US\$13 billion for EPA and OSHA fines<sup>6</sup> (not including corrective measures), and it becomes obvious that no organization should ignore EHS risks.

Similar to the way they approach IT and fraud, internal auditors should obtain sufficient knowledge to evaluate EHS risks and the organization's EHS management processes, but they are not expected to have the expertise of a person whose primary responsibility is managing EHS activities. For many, this is unfamiliar territory and it will take courage to challenge existing beliefs as to internal audit's role in EHS. However, a lack of adequate, independent assurance over EHS risks could have a disastrous financial and reputational impact on an organization. Addressing EHS risks will instill confidence that internal audit is considering all types of risk across the organization.

### EHS RISK ASSESSMENT AND AWARENESS

Only 23 percent of all respondents reported they were well-informed regarding EHS risks (Exhibit 4). It is not surprising, then, that less than half of all respondents included EHS risks in their audit planning (Exhibit 5). Those in finance and insurance were least likely (31 percent) while those in industrial organizations were more likely (59 percent). Those who include EHS in their audit planning and risk assessment indicate much higher levels of awareness about the EHS risks in their organizations compared to those who don't include EHS (37 percent vs. 8 percent) (Exhibit 4).

#### Exhibit 4: Internal Audit Awareness About EHS Risks (Compared to EHS Integration into Risk Assessment and/or Audit Planning)



Note: Q5: How informed do you feel about environmental, health and safety risks in your organization? *n* = 503.

### RESOURCE

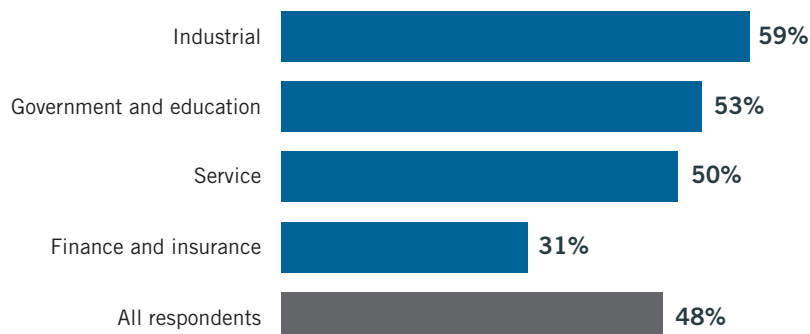
The IIA launched the Environmental, Health & Safety Audit Center in 2016 to help auditors keep abreast of changing regulations and requirements, and to provide learning and networking opportunities. Find out more at [www.theiia.org/EHSAC](http://www.theiia.org/EHSAC).

<sup>6</sup> Sources: United States Environmental Protection Agency (EPA) Enforcement Annual Results for Fiscal Year 2015 and [www.safetynewsalert.com](http://www.safetynewsalert.com) article, "10 Largest OSHA Fines of 2015."

## RESOURCE

For more information about the importance of independence and the three lines of defense, see The IIA Position Paper “The Three Lines of Defense in Effective Risk Management and Control,” available at [www.theiia.org](http://www.theiia.org).

## Exhibit 5: EHS Risks Integrated into Risk Assessment and/or Audit Planning



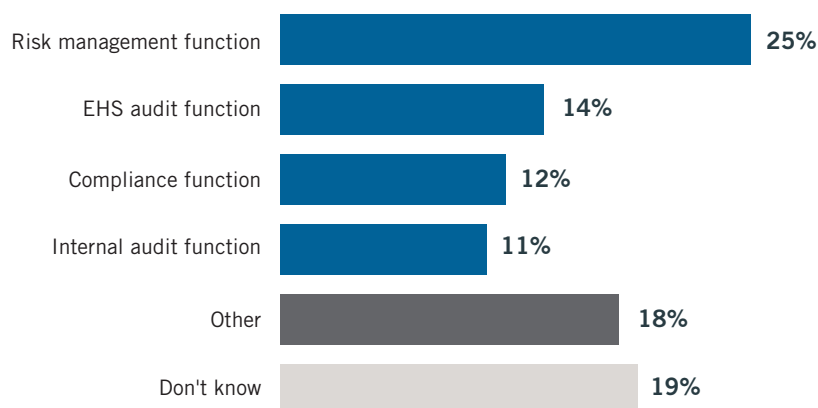
Note: Q9: Are EHS risks integrated into your risk assessment and/or audit planning?  $n = 492$ .

## ASSURANCE OVER EHS RISKS

When it comes to providing assurance over EHS risk management and controls, most organizations do not look to an independent, standards-based function such as internal audit. Instead, organizations generally rely on second line of defense functions (risk management and compliance) and first line of defense functions to provide assurance on EHS risks. Only 11 percent rely on internal audit (Exhibit 6).

Nearly 1 of 5 survey respondents did not know who, if anyone, provides assurance to the board regarding EHS risk management and controls (Exhibit 6). A closer look showed this percentage was higher for organizations in financial services and other service industries; however, even among respondents from industrial organizations, 1 of 10 did not know who provided EHS assurance.

## Exhibit 6: Providers of Assurance over EHS Risks to the Audit Committee or Board



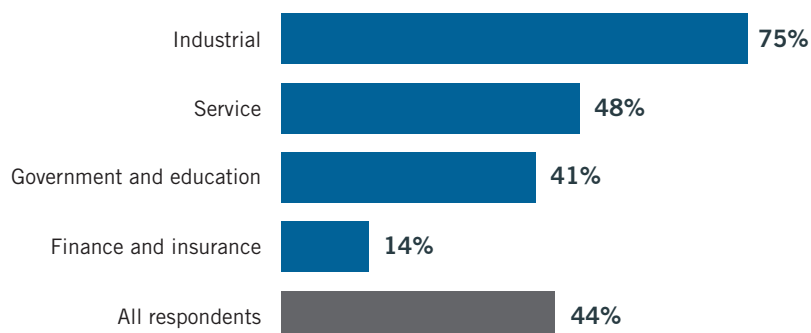
Note: Q11: Who provides assurance on the adequate management of EHS risks to your audit committee or board?  $n = 455$ .

## EHS AUDIT FUNCTIONS AND REPORTING LINES

Just under half of all CAEs surveyed said their organizations have a separate EHS audit function. This percentage varied significantly across industry type ranging from 75 percent in industrial organizations to 14 percent in finance and insurance organizations (Exhibit 7).

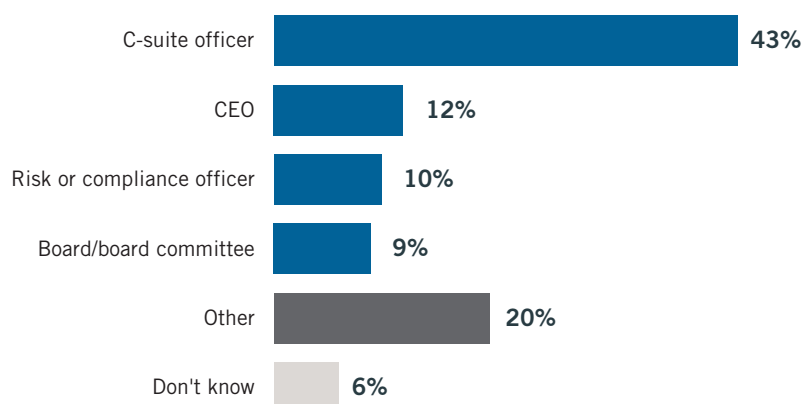
EHS audit functions can have varying levels of independence from management. At one extreme, some operate very similarly to internal audit with separate functional reporting to a board committee. At the other extreme, some are merely groups directed and controlled by line management that confirm compliance with select laws and regulations. Based on the survey responses, for those organizations that have an EHS audit function, the majority are part of the first or second lines of defense, reporting functionally to management and not the board (Exhibit 8).

### Exhibit 7: Existence of EHS Functions



Note: Q15: What is the relationship between EHS audit and internal audit in your organization? Filtered to exclude those who selected, "We don't have an EHS department."  $n = 235$ .

### Exhibit 8: Functional Reporting Line for EHS Audit



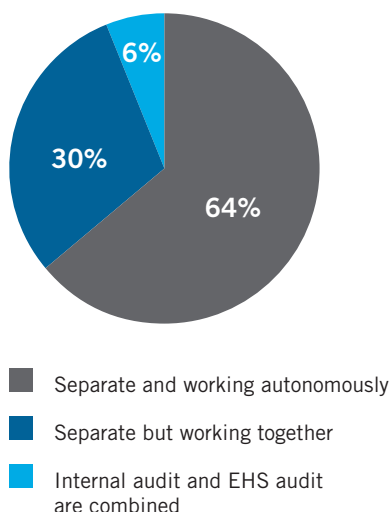
Note: Q16: What is the primary functional reporting line for EHS in your organization?  $n = 164$ .

## CASE IN POINT

EHS risks, from office building health and safety hazards to environmental toxins used in manufacturing, are commonplace. Consider the organization in which EHS and internal audit operate autonomously. Which function provides assurance over EHS findings? Does internal audit know how a specific risk might affect the organization? At what point would such a risk impede the organization achieving its strategic objectives?

When EHS operates autonomously, EHS risks might not be obvious to internal audit. The optimal relationship between EHS and internal audit depends on the organization, but internal audit should have clear visibility and understanding of EHS risks. At a minimum, the CAE should confirm that the board is aware of the potential impact of EHS risks and there is appropriate assurance over EHS risk management and control processes.

## Exhibit 9: EHS Audit and Internal Audit Relationship



*Note:* Q15: What is the relationship between EHS audit and internal audit in your organization? Filtered to exclude those who selected, "We don't have an EHS department."  $n = 235$ .

## COORDINATION BETWEEN INTERNAL AUDIT AND EHS AUDITING

As noted in The IIA's CBOK Stakeholder Report: Voice of the Customer, internal audit stakeholders expect internal audit to work closely with other functions that provide assurance, with appropriate safeguards. However, Pulse findings indicate that collaboration between internal audit and EHS audit is not common. For organizations that have an EHS audit function, almost two-thirds of respondents report that EHS and internal audit operate autonomously. EHS and internal audit work together in only one-third of organizations, and EHS is part of internal audit in 6 percent of organizations (Exhibit 9).

This provides internal audit with the opportunity to step up and take a leadership role in coordinating efforts to explore providing the organization with combined assurance regarding EHS risks, while also providing independent assurance over the manner in which the first and second lines of defense achieve their risk management and control objectives.

## ADDRESSING EHS RISK

EHS risks can affect almost any organization, and should be evaluated by internal audit.

- **Understand the full breadth of the potential impact of EHS risks.** As with other technical or specialty areas, CAEs should ensure that internal audit has adequate competencies in this area.
- **Open lines of communication with other parties that provide assurance over the management of EHS risks to explore the best options to leverage knowledge and coordinate activities.** Stakeholders expect internal auditors to work with other assurance providers and coordinate assurance activities where appropriate.
- **Consider who provides assurance over EHS risk management and control processes.** Ensure the level of assurance — and especially the independence of the assurance provider — is appropriate for the level of the risk to the organization.

## Section 3: Internal Audit's Use of Data Analytics

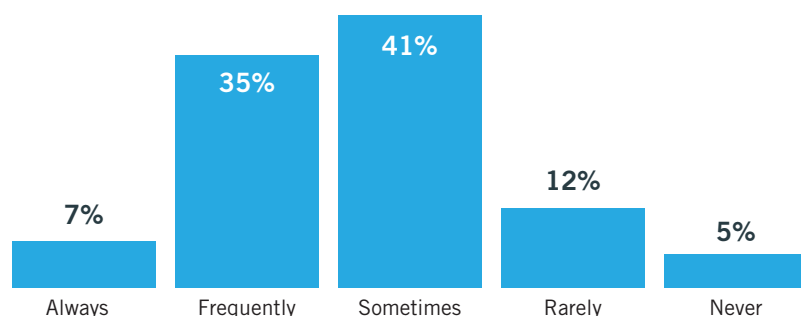
CAEs are often eager to use data analytics because it enables them to look at large volumes of data and quickly identify nonconforming activities or outliers. Leveraging the vast amount of data available in most organizations can enhance the capacity and impact of internal audit, instilling confidence in internal audit among our key stakeholders. These potential benefits may compel CAEs to implement data analytics, even when the needed structures and processes are not fully in place. Pulse results suggest that if CAEs were to audit their own data analytics practices, many would not have positive results.

### FREQUENCY OF DATA ANALYTICS USAGE

Data analytics have become a part of the audit process for almost all survey respondents (Exhibit 10). At the same time, it is a developing process, with the largest group of respondents indicating that data analytics is only used sometimes.

In addition, there is a direct correlation between audit department size and frequent use of data analytics. The larger the department, the more likely data analytics are used frequently (Exhibit 11). Survey results did not reveal significant differences in use among industries.

**Exhibit 10: Internal Audit Use of Data Analytics During Audits**

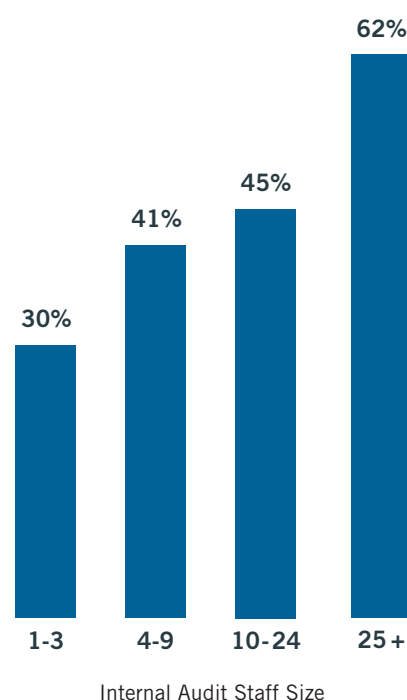


Note: Q4: How frequently does internal audit use data analytics during audits?  $n = 531$ .

### RESOURCE

The IIA offers in-depth learning on data analytics in various formats, including in-person seminars, online self-directed courses, and onsite group seminars. For more information, contact [teamdevelopment@theiia.org](mailto:teamdevelopment@theiia.org).

**Exhibit 11: Always or Frequently Use Data Analytics During Audits**



Note: Q4: How frequently does internal audit use data analytics during audits?  $n = 530$ .

## CASE IN POINT

When using data analytics to audit purchasing activities, internal audit should not rush into pulling data and creating visuals. First, internal audit needs to thoroughly understand the purchasing process, the types of purchases made, the data that is captured and reported, and the risks associated with different types of purchases.

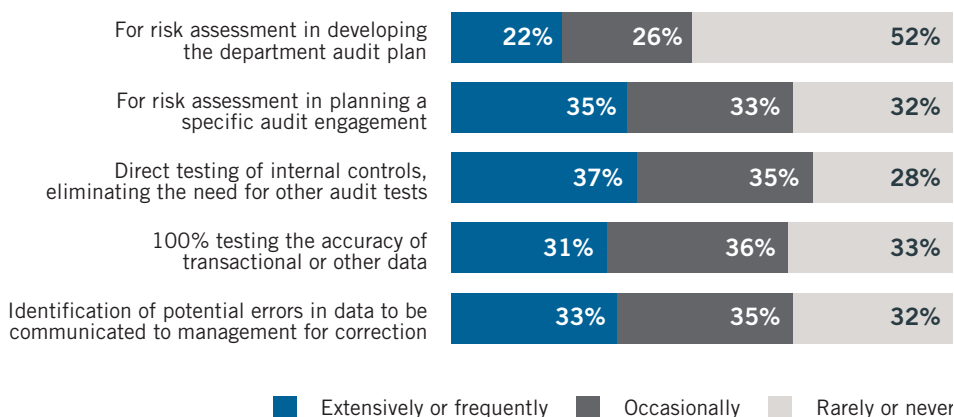
For example, purchases of commodity raw materials have a very different risk profile than purchases of consultant services. Commodity raw materials are market-priced, high dollar volume, and result in the delivery of physical goods. Consulting services have fewer transactions, hard to verify quality and quantity, and less recognizable suppliers.

The risk profiles for these two types of purchasing activities are very different and related data analytics must reflect these differences.

## HOW INTERNAL AUDIT USES DATA ANALYTICS

Internal audit functions use data analytics in a number of ways, but no single use was dominant among the survey respondents. The most common uses of data analytics was at the detailed specific audit level. Fewer than half indicate that data analytics is used for risk assessment in developing the department audit plan (Exhibit 12).

### Exhibit 12: Ways Internal Audit Uses Data Analytics



Note: Q7: In what ways does your internal audit department use data analytics?  $n = 537$ .

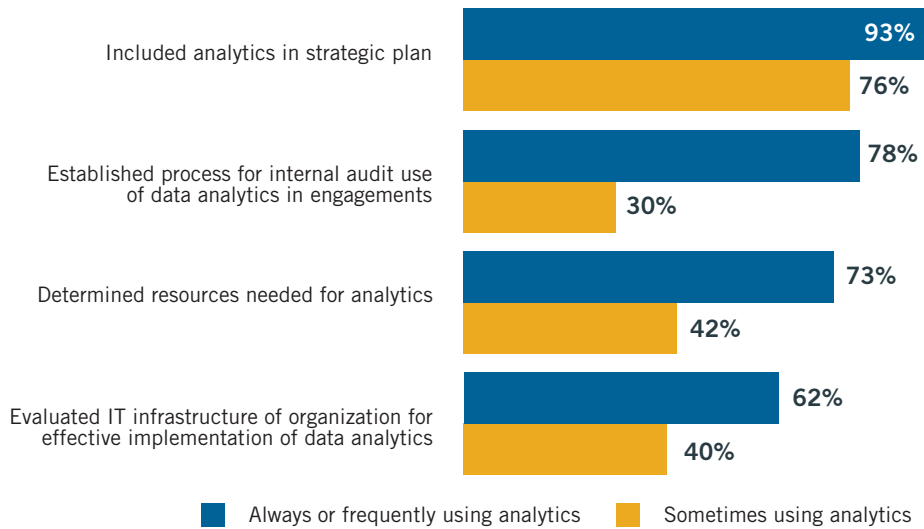
## IMPLEMENTING A DATA ANALYTICS PROGRAM

Planning and structure are important precursors to internal audit's effective use of data analytics. To properly implement a data analytics program, CAEs should:

- Include data analytics in the internal audit strategic plan to help ensure the activities are properly positioned, coordinated, and resourced.
- Establish a process for incorporating data analytics into department planning and specific audits to promote consistent, efficient, and focused use.
- Determine the resources needed to successfully implement data analytics. Consider the quantity (time) and quality (competency) of human resources, as well as the tools needed.
- Consider whether the organization's IT infrastructure can support internal audit's data analytics activities. This includes the data storage capacity, availability of data, and internal audit's ability to segment and protect data from unauthorized access (as necessary).

Many survey respondents reported they had not performed all of these tasks (Exhibit 13). Those who use data analytics regularly are more likely to have performed these tasks than less frequent users. For example, 78 percent of frequent data analytics users have established a process for using data analytics in engagements, compared to only 30 percent of less frequent users. The pattern is the same for the other implementation metrics. This may indicate that as organizations gain more experience with data analytics, they understand the value of having the right planning and structure in place. However, even the most frequent users of data analytics have not always completed these tasks, increasing the likelihood of inefficient or ineffective data analytics activities.

### Exhibit 13: Key Metrics for Internal Audit Data Analytics Implementation (Compared to Frequency of Data Analytics Usage)



Note: Q1, Q6, Q3 and Q2 compared to Q4: How frequently does internal audit use data analytics during audits?  $n = 488$  to  $497$ .

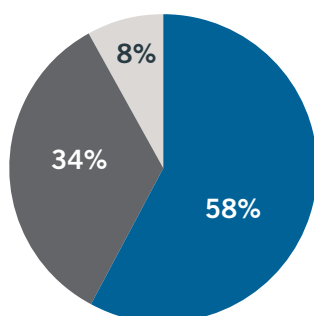
## RESOURCE

*Data Analytics: Evaluating Internal Audit's Value*, a recent release from the Internal Audit Foundation, presents a structured framework that offers ways internal audit departments can more fully develop and integrate data analytics (available at [www.theiia.org/bookstore](http://www.theiia.org/bookstore)).

## ONGOING TECHNICAL TRAINING

Ongoing technical training in data analytics is particularly essential. Two-thirds of survey respondents report that their staff needs more training in data mining and analytics. This training need was similar across all organization sizes. Training in data mining and analytics builds competencies and instills self-confidence in internal auditors.

## Exhibit 14: Poor Data Analytics Design Caused Extra Work



■ Yes  
■ No  
■ Don't know

*Note:* Q5: Has your use of data analytics ever resulted in extra work due to faulty design of the analysis parameters? Filtered to include only those who use analytics at least "sometimes."  $n = 431$ .

## PLANNING RISKS

More than half of survey respondents who regularly use data analytics reported poor data analytics design had caused extra work (Exhibit 14). This was more common in the larger internal audit functions. However, for any size audit function, poorly planned data analytics can easily result in extra, wasted, and ineffective work. Many organizations using data analytics take a bottom-up approach, starting "in the trenches," when more focus on top-down planning and structure might provide for a less haphazard and more successful implementation. It is important for internal audit to plan strategically and ensure that a sound IT infrastructure, established processes, and ample trained resources are in place before moving forward.

## ADDRESSING INTERNAL AUDIT'S DATA ANALYTICS RISKS

Data analytics can be of great value to internal audit, but its use must be planned, structured, and executed properly.

- **Consider all the possible ways that internal audit can use data analytics.** Avoid focusing only on detailed analysis to supplement routine audit approaches. Consider using data analytics more fully in developing the department audit plan and as a replacement for traditional audit methods.
- **Identify the components needed for a data analytics programs.** Such components likely include a clear objective, defined processes, skilled practitioners, quality data, and adequate IT platforms.
- **Fill the gaps that could derail a data analytics program before fully implementing.** Everything does not need to be perfectly in place to start a data analytics program, but some fundamental aspects are critical. Start experimenting in data analytics to establish the scope, methods, processes, and talent needed, but don't consider a pilot program complete without filling the gaps.
- **Establish stakeholder relationships necessary to build an effective data analytics program.** Work with IT, risk management, compliance, human resources, and other internal stakeholders to address IT infrastructure, processes, and resources. Work with internal and external stakeholders (including management and the board) to understand how internal audit can leverage data analytics to serve stakeholder needs.
- **Document the approach to data analytics in the internal audit strategic plan.** A data analytics program can provide tremendous benefits. Ensure the efforts are not only well planned and documented, but also communicated to key stakeholders through the internal audit strategic plan.



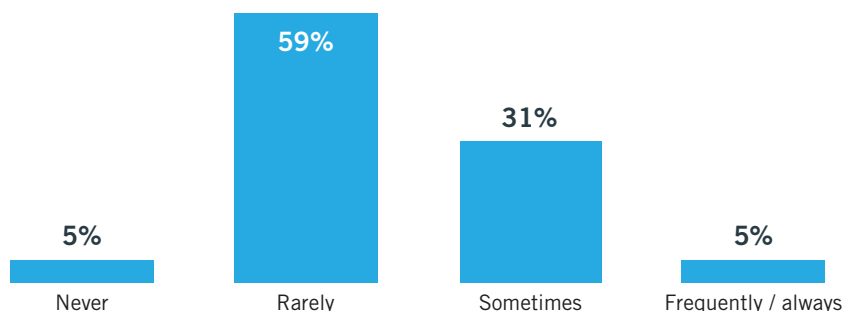
## Section 4: Interpersonal Dynamics

Internal audit engagements by their nature are interpersonal, and the quality of interpersonal dynamics — how internal auditors communicate and establish relationships with others in the organization — is likely to have an effect on audit outcomes. Understanding interpersonal dynamics is essential to effective auditing.

During an audit engagement, the auditor is tasked with understanding and evaluating an activity as an objective, independent observer. Internal auditors' effectiveness centers on the ability to navigate personal interactions and potentially contentious issues, while still fostering trust — no easy task.

About one-third of survey respondents indicated they sometimes experience negative interpersonal exchanges that they attribute to their roles as internal auditors. A small percentage say they frequently or always have these negative exchanges (Exhibit 15).

### Exhibit 15: Negative Interpersonal Exchanges Attributed to Role as an Internal Auditor



*Note:* Q23: How frequently do you or your team experience negative interpersonal exchanges that you attribute to your role as an internal auditor?  $n = 534$ .

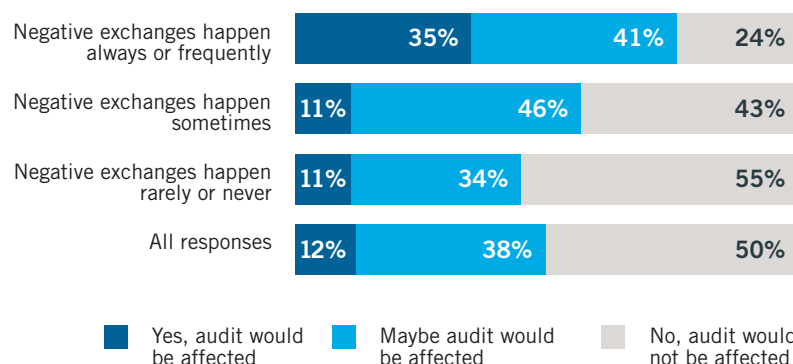
The quality of the interpersonal interactions between auditors and others in the organization is likely to impact audit efficiency and effectiveness. After a negative exchange with internal audit, management may be less forthcoming with information and also less likely to implement audit recommendations. This weakens internal audit's ability to carry out the audit and contribute to positive change in the organization.

Half of all Pulse respondents reported they believe a negative interpersonal exchange might or would adversely affect internal audit's ability to conduct an audit (Exhibit 16). Interestingly, those who most frequently experience negative exchanges more strongly believe that such an exchange would negatively impact the ability to conduct an audit (76 percent said yes or maybe).

### RESOURCE

The IIA offers in-depth learning on interpersonal and soft skills development in various formats, including in-person seminars, online self-directed courses, and onsite group seminars. For more information, contact [teamdevelopment@theiia.org](mailto:teamdevelopment@theiia.org).

## Exhibit 16: Expectation that a Negative Exchange Would Affect the Ability to Conduct an Audit (Compared to Frequency of Negative Exchanges)



*Note:* Q24: In your opinion, would a negative interpersonal exchange adversely affect your or your team's ability to conduct an audit? *n* = 532.

## BRINGING EMPATHY INTO THE AUDIT

Most auditors have had experiences where a member of management tried to blame their own poor performance on the auditor or tried to challenge the auditor as a mechanism to divert attention away from their own failings. After a negative interpersonal exchange, it may be tempting for an internal auditor to blame the other person. However, some of these negative interactions may have been avoided through better use of soft skills. It takes courage to look back and ask, "Could I have handled that differently?"

In particular, empathy can improve the tone of an interaction. Bringing empathy into the audit means understanding the audit process from management's perspective. For example, auditors should reiterate that they want to help management improve processes and provide assurance to key stakeholders. This collaborative approach can encourage management to take ownership of audit results and help the audit to be more successful.

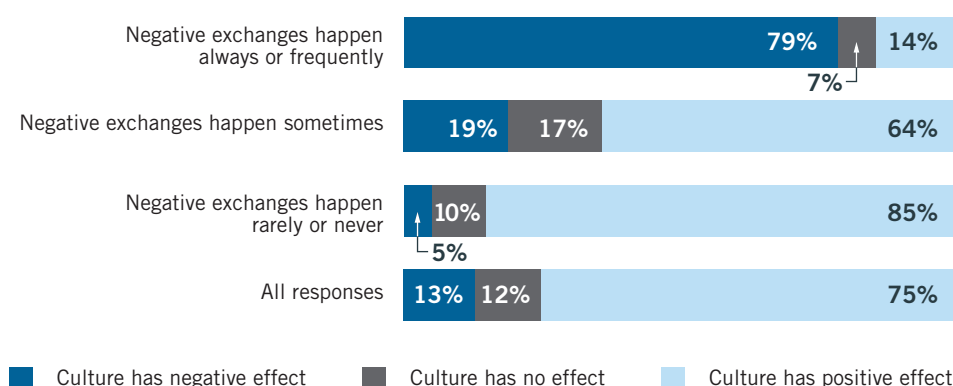
In addition, internal auditors should make it clear that they respect management's expertise. This can be an issue when internal auditors feel pressure to be experts in every area and thereby discount the experience or perspectives of others. But if auditors position themselves as experts in understanding risks and controls while recognizing others' expertise, audit experiences may be more positive.

Internal audit managers are recognizing the importance of soft skills. When asked which skills are most essential for internal auditors, they gave high ratings to communication (4.4 out of 5) and persuasion/collaboration (4 out of 5).

## IMPACT OF A NEGATIVE ORGANIZATIONAL CULTURE

Auditors' soft skills are not the only variable affecting interpersonal dynamics. Based on survey responses, negative organizational culture also has a strong connection with negative interpersonal exchanges (Exhibit 17). Among those who reported that negative exchanges happen always or frequently, 79 percent say their organizational culture has a negative effect on their professional interactions. This compares to only 19 percent among those who only sometimes experience negative interpersonal interactions.

### Exhibit 17: Effect of Organizational Culture on Professional Interactions (Compared to Frequency of Negative Interactions)



Note: Q25: In your opinion, what effect does your organization's culture have on the quality of professional interactions you and your team experience? *n* = 511.

## ADDRESSING INTERPERSONAL DYNAMICS RISK

Given the negative impact interpersonal exchanges can have on internal audit's work, it is important for CAEs to take action to reduce this risk.

- **Invest in soft skills professional development for all internal audit staff.** Poor soft skills will negatively impact audit work. Investment in training, mentoring, and targeted talent acquisition will be worthwhile.
- **Recognize the impact of organizational culture on auditors' interpersonal interactions.** When assessing organizational culture in performing audit work, also consider how culture can potentially impact internal audit's effectiveness.
- **Seize opportunities to improve organizational culture.** Organizational culture is determined in large part by variables beyond the CAE's control — such as tone at the top — and may be difficult to change. However, internal auditors have some ability to be a catalyst for cultural change by bringing transparency to issues, taking positions on issues, and operating with integrity. Organizational culture is impacted by the values of the individuals in the organization. An internal auditor with effective soft skills can have a positive influence on organizational culture.

## IN-GROUP–OUT-GROUP DYNAMICS: THE PSYCHOLOGY BEHIND INTERNAL AUDIT ENGAGEMENTS

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The resentment internal auditors often feel when they begin working with a new department is a normal cognitive process known in psychology as the Social Identity Theory.

The theory, also called “in-group bias,” states that people naturally hold a preference and affinity for their own group over anyone viewed as an outsider. Individuals will find any reason, no matter how minor, to prove why their “in-group” is superior to an “out-group.”

Social psychologist Henri Tajfel, who put forth the theory with John Turner in 1979, explains that people have the tendency to group things together — stereotype — and in doing so they tend to exaggerate the differences between the groups and the similarities within their group.

Thus, the internal auditor is walking into a world naturally divided into “us” versus “them” before he or she even utters a word.

As a result of in-group bias, the in-group feels threatened if their beliefs are challenged and may express aggression to the out-group. The aggression is justified by dehumanizing the out-group. The in-group will demean the out-group to enhance their own self-image.

How should internal auditors overcome this social categorization process? A key to understanding in-group–out-group biases is determining the psychological mechanism that drives the bias, according to *Boundless Sociology*. One of the key determinants of group biases is the need to improve self-esteem.

Recognizing and respecting management’s expertise will help do that. Fully embracing a collaborative approach, expressing honest empathy in tone, and brushing up on communication and persuasion soft skills will also help break down the in-group–out-group dynamics.

# Conclusion

It takes courageous leadership to enhance and protect organizational value. CAEs must have the courage to look both outward at the organization, and inward at the internal audit function. We must consider risks that likely have been given little attention, and make changes. This 2017 report identifies four areas where action is needed:

- Communications not traditionally subject to assurance.
- Environmental, health and safety risks.
- Internal audit's use of data analytics.
- Interpersonal dynamics.

Have the courage to peel back the layers of prior practice, old expectations, and a lack of awareness in these areas to reveal and address risks that could materialize into bigger problems. By addressing these risks and aligning with the expectations of key stakeholders, CAEs can instill stakeholder confidence in the value of internal audit and in the value of the organization overall. To get started:

- Gain a full understanding of the risks outlined in this report.
- Gather information needed to assess the importance of these risks to your organization.
- Determine how best to address these risks, including training for internal auditors where needed.

Taking these steps, CAEs can begin to instill confidence from within.

# Appendix: Internal Audit Management Metrics

CAEs need to have strong management skills — and the ability to efficiently use resources to achieve the internal audit function’s objectives. Annually, The IIA collects information on key internal audit management metrics, as illustrated in this appendix. A more in-depth report on internal audit management will be available exclusively to members of the Audit Executive Center. For more information about joining the AEC, visit [www.theiia.org/cae](http://www.theiia.org/cae).

## Methodology

Internal audit management metrics are provided for five organization types: financial services, nonprofit, publicly traded, public sector, and privately held. Financial services was created by extracting financial services respondents from the other four organization types.

The top industries represented include:

### Publicly Traded

- Manufacturing (33%)
- Utilities (10%)
- Mining, quarrying, and oil and gas extraction (10%)
- Retail trade (9%)
- Other services (7%)

### Public Sector

- Public administration (48%)
- Educational services (30%)
- Health care and social assistance (7%)

### Financial Services

- Finance and insurance (includes financial institutions, insurance asset management, and broker dealer) (100%)

### Privately Held

- Manufacturing (28%)
- Retail trade (14%)
- Other services (8%)
- Health care and social assistance (8%)
- Arts, entertainment, and recreation (8%)

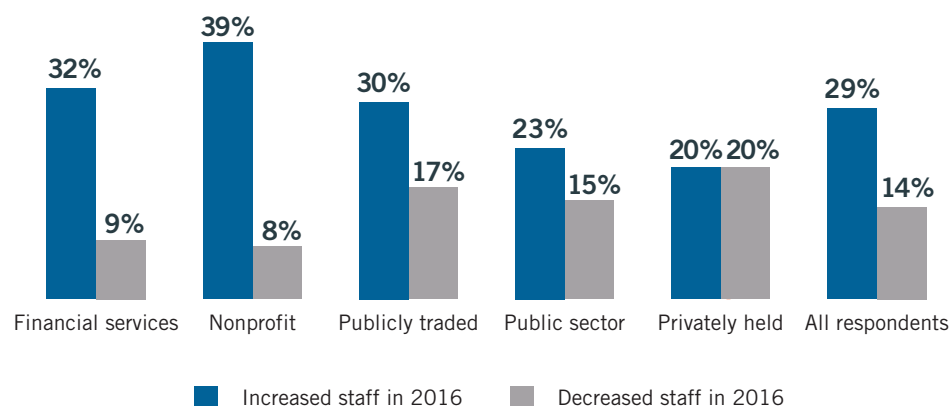
### Nonprofit

- Health care and social assistance (51%)
- Educational services (25%)
- Other services (12%)

## STAFFING

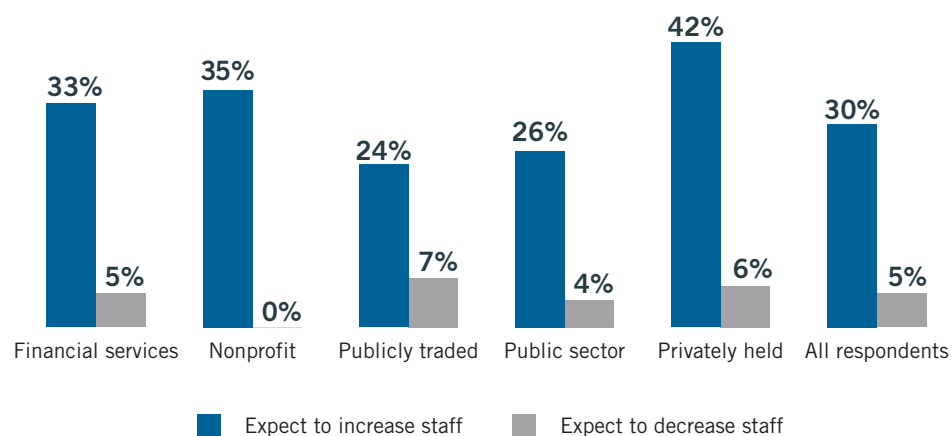
For most organization types, more internal audit functions increased staff in 2016 than decreased staff. The same is expected for 2017.

### Exhibit A: Percentage of Internal Audit Functions with Staff Increases or Decreases in 2016



*Note:* Q36: Looking back over the past 12 months, the number of full-time equivalent staff within your internal audit department has increased, decreased, remained the same, don't know, not applicable (choose one).  $n = 519$ .

### Exhibit B: Percentage of Internal Audit Functions Expecting Staff Increases or Decreases in 2017

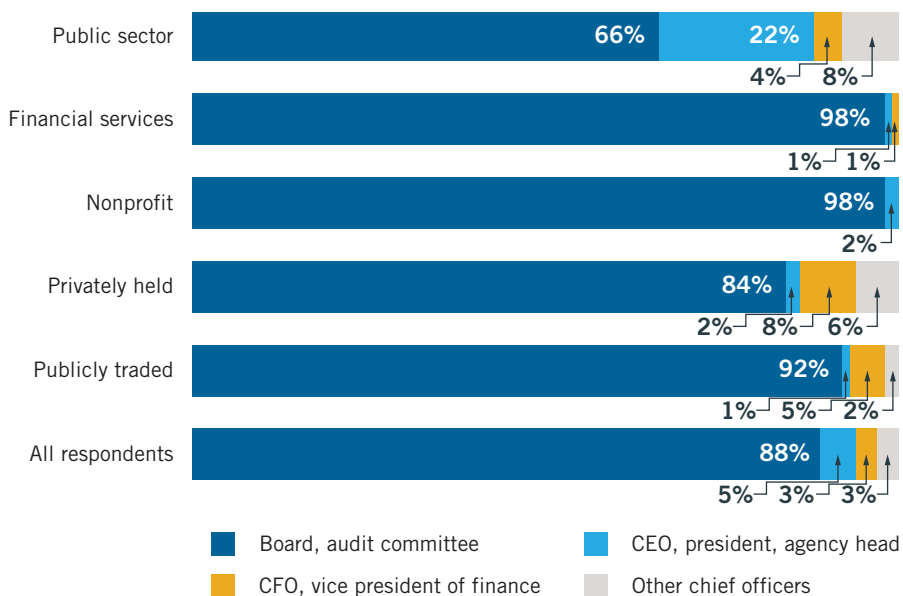


*Note:* Q37: Looking ahead at the next 12 months, do you expect the number of full-time equivalent staff within your internal audit function to increase, decrease, remain the same, don't know, not applicable (choose one).  $n = 512$ .

## REPORTING LINES

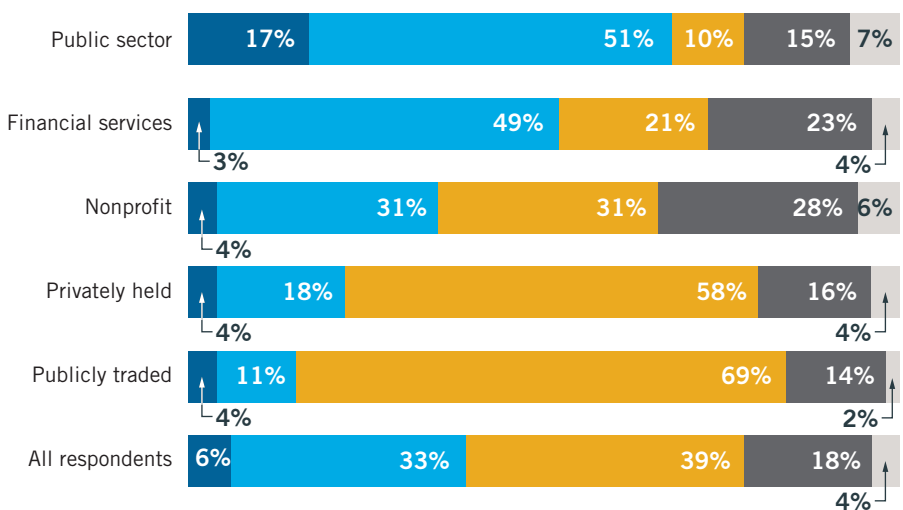
The vast majority of CAEs report functionally to the board (with some exception in the public sector). Administrative reporting lines vary, with privately held and publicly traded organizations generally reporting to CFOs or equivalent, while public sector and financial services generally report to CEOs or equivalent.

### Exhibit C: Functional Reporting Lines



Note: Q34: What is the primary functional reporting line for the chief audit executive (CAE) or head of internal audit in your organization?  $n = 520$ .

### Exhibit D: Administrative Reporting Lines



Note: Q33: What is the primary administrative reporting line for the chief audit executive (CAE) or head of internal audit in your organization?  $n = 520$ .

Board, audit committee   CEO, president, agency head   CFO, vice president of finance  
Other chief officers   Other



## ALLOCATION OF AUDIT EFFORT

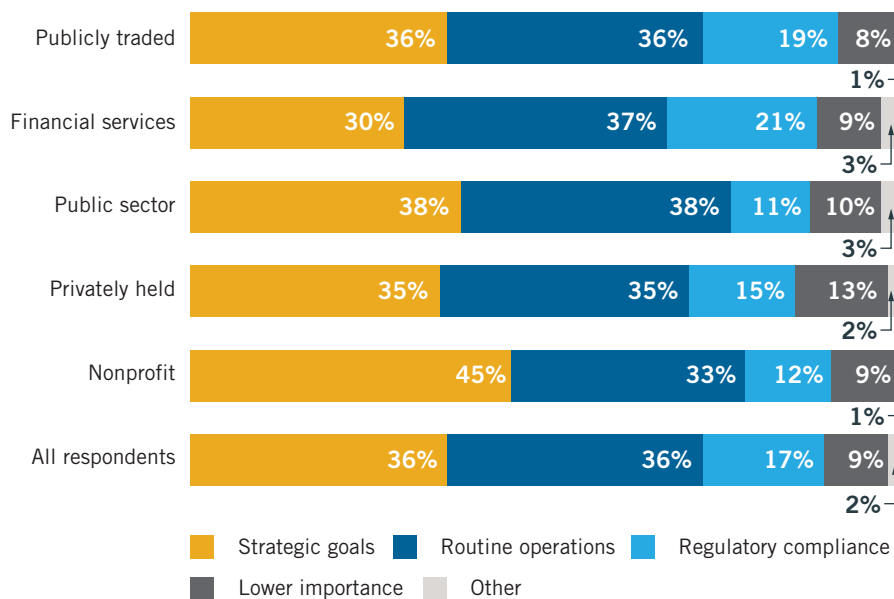
CAEs primarily allocate resources to operational, financial reporting, and compliance risks (Exhibit E). CAEs across all organization types direct roughly one-third of audit work to areas aligned with the organization's strategic goals and one-third to routine operations (Exhibit F).

### Exhibit E: Allocation of Audit Effort by Risk Area

Risk Areas	
Operational (not included elsewhere)	19%
Financial reporting (including Sarbanes-Oxley testing)	14%
Compliance/regulatory (not related to financial reporting)	13%
IT (not covered in other choices)	9%
Financial areas other than financial reporting	9%
Cyber (prevention and/or recovery)	6%
Fraud identification and investigation (not covered in other audits)	6%
Support for external audit	6%
Enterprise risk management programs and related processes	5%
Cost/expense reduction or containment	4%
Governance and culture	4%
Management of third-party relationships	3%
Sustainability or other nonfinancial reporting	1%
Other	1%
Total	100%

*Note:* Q43: Looking ahead over the next 12 months, please indicate what percentage of your audit plan you anticipate will be allocated to each of the risk categories listed.  $n = 535$ .

### Exhibit F: Allocation of Audit Effort to Strategic Goals



*Note:* Q47: What percentage of your total audit effort addresses your organization's activities grouped into the following categories?  $n = 535$ .

## SKILL IMPORTANCE AND TRAINING NEEDS

CAEs indicate that analytical/critical thinking and communication skills are the most important skills for internal auditors. Internal auditors most need additional training in cybersecurity and privacy, and data mining and analytics.

### Exhibit G: Skill Assessment for Internal Auditors

Internal Audit Skills	Importance of Skill*	Need More Training
Analytical/critical thinking	96%	49%
Communication skills	95%	45%
Understanding of professional ethics	79%	4%
Understanding the audit process	76%	9%
Persuasion and collaboration	79%	33%
Business acumen	76%	34%
Understanding of governance, risk and control	62%	23%
Understanding of the International Professional Practices Framework (IPPF)	51%	14%
Industry-specific knowledge	46%	36%
Process improvement and innovation	48%	33%
Accounting and finance	45%	11%
Risk management assurance	46%	18%
Basic IT knowledge	43%	24%
Cybersecurity and privacy	33%	52%
Data mining and analytics	35%	67%
Fraud auditing	20%	23%

*Note:* Q49: For each of the skills listed, please indicate to what degree it is essential to your audit function's ability to perform its responsibilities.  $n = 537$ . Q50: In which of the following areas do you feel your staff members need more training? (Select all that apply.)  $n = 536$ .

\*Percentage of those who chose very essential or extremely essential.



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