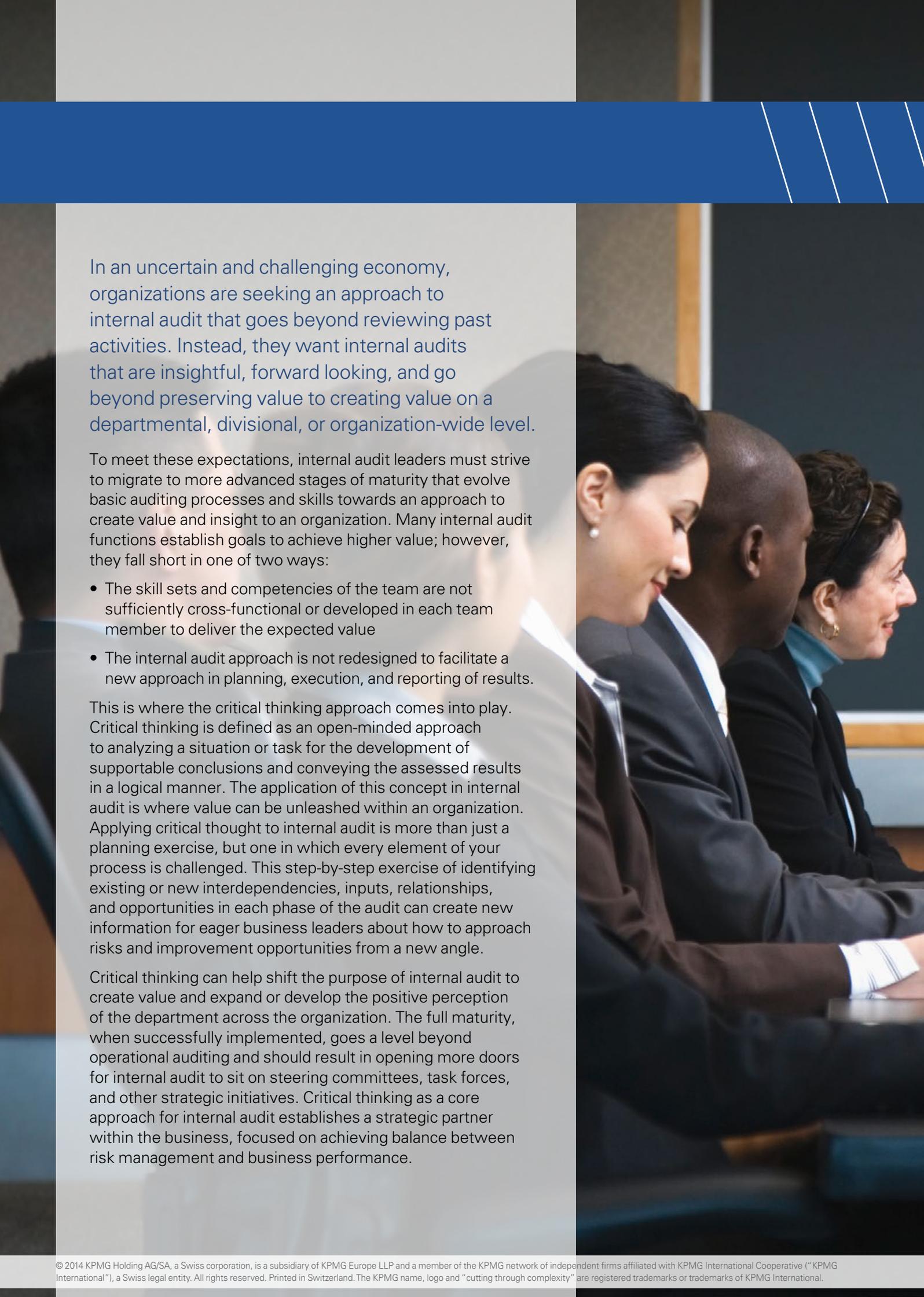




Transforming Internal Audit Through Critical Thinking





In an uncertain and challenging economy, organizations are seeking an approach to internal audit that goes beyond reviewing past activities. Instead, they want internal audits that are insightful, forward looking, and go beyond preserving value to creating value on a departmental, divisional, or organization-wide level.

To meet these expectations, internal audit leaders must strive to migrate to more advanced stages of maturity that evolve basic auditing processes and skills towards an approach to create value and insight to an organization. Many internal audit functions establish goals to achieve higher value; however, they fall short in one of two ways:

- The skill sets and competencies of the team are not sufficiently cross-functional or developed in each team member to deliver the expected value
- The internal audit approach is not redesigned to facilitate a new approach in planning, execution, and reporting of results.

This is where the critical thinking approach comes into play. Critical thinking is defined as an open-minded approach to analyzing a situation or task for the development of supportable conclusions and conveying the assessed results in a logical manner. The application of this concept in internal audit is where value can be unleashed within an organization. Applying critical thought to internal audit is more than just a planning exercise, but one in which every element of your process is challenged. This step-by-step exercise of identifying existing or new interdependencies, inputs, relationships, and opportunities in each phase of the audit can create new information for eager business leaders about how to approach risks and improvement opportunities from a new angle.

Critical thinking can help shift the purpose of internal audit to create value and expand or develop the positive perception of the department across the organization. The full maturity, when successfully implemented, goes a level beyond operational auditing and should result in opening more doors for internal audit to sit on steering committees, task forces, and other strategic initiatives. Critical thinking as a core approach for internal audit establishes a strategic partner within the business, focused on achieving balance between risk management and business performance.



Contents

- Understanding the Need to Evolve Internal Audit 3
- The Drive Towards Value Creation – Is It Measurable? 5
- Embedding Critical Thinking in the Audit Cycle 13
- Taking the Audit to the Next Level..... 15
- Summary.....21

Understanding the Need to Evolve Internal Audit

Accelerated changes in response to challenging economic and competitive market conditions over the past five years have redefined organizational structures, business processes, and ultimately the risks. This environment has created an opportunity and a need to evolve internal audit beyond the traditional approach.

Emerging markets, new product entrants, challenging cost structures, and evolving regulations are categories of risk in which we are seeing significant strategic responses by management to monitor these risks. The resulting initiatives require internal audit teams to be more broad based and adopt a holistic approach to their planning and execution methodology in order to be effective business partners.

In response to this shift from compliance and routine validation of controls to creating business value, the profile of the internal auditor is starting to change. The Institute of Internal Auditors (IIA) 2013 Pulse of the Profession Survey captures the top five skills desired for internal auditors:

1. **Analytical and critical thinking (77%)**
2. Communication skills (66%)
3. Data mining and analytics (47%)
4. Business acumen (41%)
5. General IT knowledge (39%).

These results do not necessarily imply a movement away from auditors with financial and compliance backgrounds, but rather the importance of enhancing the capabilities of the core internal audit team with critical thinking skills. These skills may come from searching for internal auditors from varying backgrounds, or looking to source those capabilities. No matter the auditor's background, critical thinking is a skill set that should be considered one of the core competencies to be developed.

Critical Thinking vs. Thinking Critically

In many instances, the term "critical" takes on negative connotations such as stubborn, judgmental, or opinionated; therefore, it is imperative that we do not desire a critical "result", but rather apply a critical "approach" to thinking that is holistic, skeptical, analytical, and evaluative to develop well-rounded conclusions.

Importance of Stakeholder Alignment

A foundational element of internal audit is to achieve proper positioning in the organization. This includes aligning multiple stakeholders within the overall charter of the department. As part of moving towards a critical thinking approach to internal audit, it is important to ensure the stakeholders are supportive of this potentially transformational change in approach. The audit plan should be reflective of stakeholder expectations, a risk-based prioritization, and the appropriate coverage of financial, compliance, and operational needs of the business.



The Drive Towards Value Creation – Is It Measurable?

Many internal audit functions have observed organizational transformations across multiple global functions within their companies over the past five years. This change creates tension, increases risk, changes audit requirements, and creates difficulties for internal audit to stay on top of business expectations. During this period, certain audit functions have chosen to assume a similar challenge to transform their department based on the results of leading-practice maturity assessments, or quality assessment reviews. To ensure the department is meeting the new challenges of the organization and expectations of stakeholders, the internal audit function must move beyond keeping pace with organizational change, and lead the way through critical thinking audits.

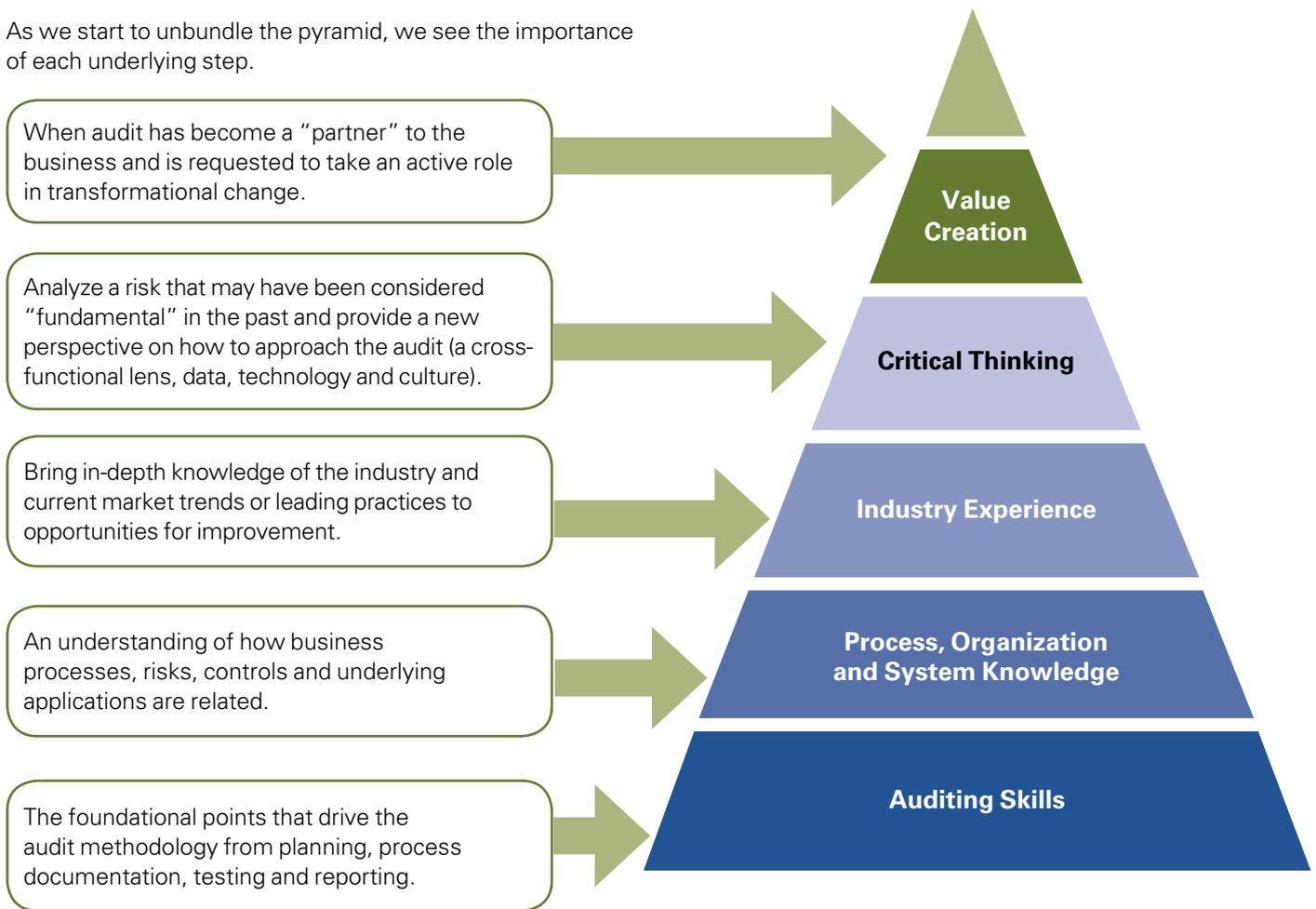
Critical thinking audits cannot be basic finding, observation, and recommendation reports that are too general and not actionable. Rather, these audit results must create measurable value to an organization, through highly effective data analytics, and cost-benefit considerations. The audits need to be geared toward identifying revenue opportunities, cost recovery, discovering cost avoidance opportunities, measuring hours of efficiency opportunity and direct redeployed dollar savings, quantified or untapped growth opportunity, or determinable risk reduction. Further, internal audit should challenge its approaches to compliance activities, and examine the potential for embedding value creation opportunities into those required audits. Overall, in order to create value to the organization, internal audit must apply a critical thinking approach to internal audit, a level beyond basic operational audits.



Pyramid of Internal Audit Maturity

The pyramid of internal audit maturity captures the movement through each stage that must be achieved before focusing on critical thinking to add value. We will examine each of these stages, and detail how critical thinking is a maturation process. This approach will first require establishing foundational aspects of auditing skills, process, technology, and industry experience.

As we start to unbundle the pyramid, we see the importance of each underlying step.



The Drive Towards Value Creation – Is It Measurable?

Auditing Skills

Internal audit is structured to enable the maintenance of independence and objectivity, as well as proximity to the business to maintain relationships and depth of understanding of business drivers. At the core of any audit are the foundational auditor traits, which in turn serve as the basis for inserting critical thought in audits:

- **Professional skepticism** – the drive to go deeper through displaying auditor instinct and asking questions: what, why, who, when and how
- **Communication** – being able to efficiently express written and verbal ideas to stakeholders
- **Listening** – understanding the auditee’s departmental goals, time lines, and barriers, thus increasing their confidence and trust in internal audit
- **Handle the unexpected** – being resourceful, agile, and able to quickly react in creative ways to develop a solution
- **Preparation** – ensuring a resourceful approach to being fully aware, and analyzing readily available information.



Audit Administration – Foundational

For an internal audit function to be effective, basic administration skills have to permeate each audit. The following are foundational requirements for internal auditors:

- Organization and detail oriented
- Ease of communication
- Persistence in obtaining information
- Efficient and clear documentation
- People management skills
- Working as a team and independently
- Constructive questioning
- Able to use technology effectively as an audit and reporting tool
- Use of the 80:20 rule on audit completion (last 20 percent may extend the audit, but not value).

Project Management – Tools and Templates

A defined and efficient structure to perform audits must be in place to avoid value leakage in the audit process through completing nonessential administrative tasks. Key considerations include:

- Streamlined set of required standard documents
- Assess and eliminate bottlenecks
- Right-sizing timekeeping or budget efforts
- Insightful and valuable planning procedures rather than routine and extensive documentation
- Ensuring the reporting cycle time is not excessive – multiple validation points or closing meetings
- Appropriate level of findings or observations (positive change versus late or not implemented)
- Clearing observations efficiently through appropriate timing of follow-up testing.

Process, Organization and System Knowledge

Internal audit needs to be structured to address key risks and meet stakeholder expectations. This includes deep organizational and business understanding to apply judgment, and challenge the business on a broad range of topics. In addition, internal audit must invest the time to understand the business strategy and transformational changes occurring throughout the organization. A key expectation for internal audit is to challenge the control environment and risk management supporting the strategy across the organization’s functional areas and business units.

Key points of necessary knowledge include:

- Business processes including significant inputs, outputs, and key performance indicators
- Company knowledge beyond the basics: key influencers, cultural dynamics, top strategic initiatives and projects, transformational change events, and perception of internal audit
- Clarity in roles and responsibilities including delegation of authority
- Key application systems or tools – knowing what data resources are available to leverage.



The Drive Towards Value Creation – Is It Measurable?

Industry Experience

Internal audit has an important responsibility each year to identify skills and competencies required to deliver the annual internal audit plan. Business risks change rapidly, and the audit plan should be adjusted accordingly, which can create changing skill-set needs. Industry experience is a constant in this changing environment and must include:

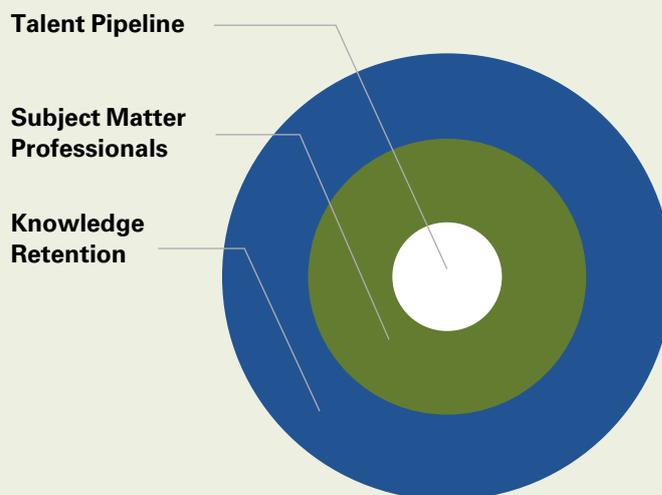
- Knowledge of the industry, business trends, and current events to enable effective stakeholder discussions
- Anticipating emerging trends with organizational impact and potential internal audit impact
- Increasing and changing regulatory and compliance landscape within the industry
- Pulse of the competitive marketplace (consolidation, expansion, inorganic or organic growth)
- Brand awareness and the company’s position with customers.

Internal audit must critically assess its departmental skill sets and identify strengths and weaknesses to ensure gaps are filled to deliver insightful internal audits.



Importing Industry Experience

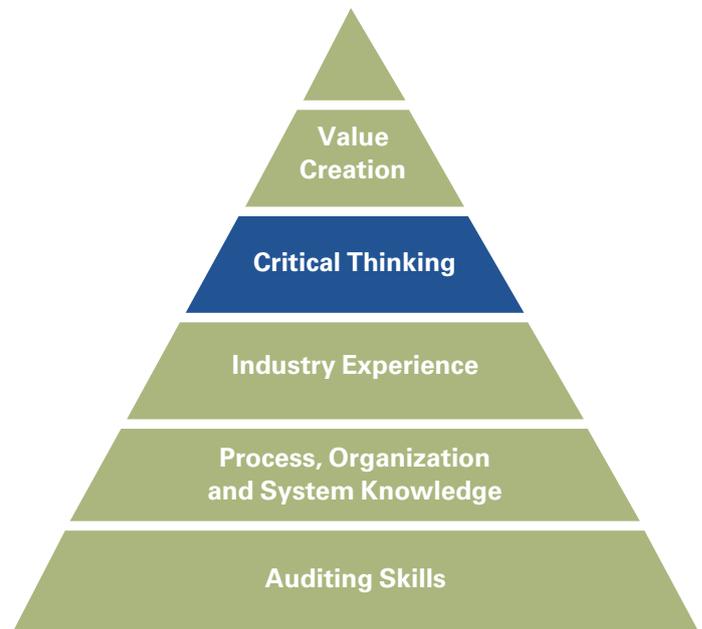
An internal audit team is only as good as the talent available. Internal audit in many companies is not seen as a career destination, but rather a “feeder” system for growing businesses or functions. As a feeder system, internal audit can face periods of experience limitations as transfers out of the department are replaced. This can create a need to call upon subject matter professionals to provide a broader perspective. These professionals can come internally from the business (e.g., guest or rotational auditors), or externally from consultants with the needed skills and experience. The key to creating value from subject matter professionals is to ensure there is an effective process to utilize the resources efficiently, and begin to transfer the knowledge where practical. This can occur through deeper planning sessions, shadowing on the audits, and “full hindsighting” at the completion of the audit.



Critical Thinking

At this maturity level, internal audit is characterized by a culture of challenge, probing, and continuous improvement. Auditors must remain solution focused; investigative in scenarios or solutions for issue resolution; and persistent in having a seat at the table for the key discussions. The following are foundational essentials to a critical thinking approach to internal audit:

- **Open minded** – recognition of alternatives, and assessment of assumptions and reasonable consequences
- **Situation analysis** – ability to break down the problem to the factually supported components to provide a deeper understanding and clarity of the challenges
- **Provide context** – identification of what is known, what is not known, and what comparatives provide context
- **Brainstorm** – funneling practical ideas into further analysis or detailed solutions
- **Conclude** – creatively putting it all together in a complete form that provides the best recommendation.



The Drive Towards Value Creation – Is It Measurable?

Case Study #1 – Operational Call Center Internal Audit

The review was requested by management in order to assess operational processes, provide leading practices, and identify and quantify relevant recommendations to support continuous improvement in the call center.



Scope

- Determine root cause of call volume increases and provide recommendations for improvement
- Analyze customer feedback and operational tools and technology utilized compared to leading practices, and provide recommendations
- Identify revenue opportunities for the call center utilized by top-tier call center operations
- Review operational processes and provide recommendations for improvement



Approach

- Conduct in-depth planning session and data analysis including leading practice benchmarking, with use of subject matter professionals (25+ years of call center experience)
- Documenting and analyzing the current-state processes
- Conduct stakeholder interviews to identify strengths and opportunities
- Listen to multiple customer calls to validate root cause data through a customer perspective
- Facilitate validation sessions with stakeholders based on initial observations
- Perform analysis to quantify and rank opportunities and concerns



Results

- Identified call reduction and prevention opportunities that ranged conservatively between **\$400,000** and **\$900,000** annually, and mapped these out by opportunity and level of effort to help the business target high-return opportunities
- Identified an additional **\$900,000** to **\$1,100,000** of opportunity annually by implementing leading-practice recommendations



Embedding Critical Thinking in the Audit Cycle

In a critical thinking environment, the traditional audit cycle of planning, fieldwork, completion, reporting and follow up is enhanced by adding additional stages focused on strategic alignment, critical thinking scope and quantifying value drivers. The end result can be a more dynamic audit that not only focuses on the underlying risks and controls, but generates a mind-set of creating value to the organization.

Key Benefits to Critical Thinking

Strategic alignment: Alignment of the audit area with the strategic initiatives or long-term vision for the audit area. This focuses internal audit’s resources on timely reviews in areas critical to current key business initiatives and significant to the organization’s overall success.

Critical thinking scope: Planning step to look at the audit from multiple levels (function, geography, technology, and up/downstream processes). Brainstorming holistically with the best and brightest who have a perspective on this area (both internal and external resources should be considered).

Quantify value drivers: Filter the audit results in a value-driver method. This must match the strategic alignment phase; considerations include cost recovery, new growth opportunity, hour efficiency, redeployment savings, or risk reduction. The ultimate goal is to provide recommendations of significance, supported by an assessment of the tangible value being created.





Taking the Audit to the Next Level

To further embed a critical thinking perspective in the audit life cycle, consider the following:

- Step back to assess the internal audit team’s skills—do we have the “outside the box” perspective?
- Do we truly understand all the risks involved from a number of perspectives (strategic, operations, compliance, reporting, human capital, and reputation)?
- Do we have the industry leading practice perspective?
- Have we used data analytics information from a variety of sources (i.e., consider structured data available from systems and unstructured data available internally or externally)?
- Have we considered all functional and business intersections with the area we are auditing?

Case Study #2 – Visual Design and Floor Set Operational Internal Audit

Visual design (floor set and window changes) has long been a contentious issue with disagreement on where the cost should sit, impact (freshness versus return on investment), and operational control having caused significant concern at this Specialty Retailer. Internal audit’s risk assessment and planning process determined this was an ideal area for a critical thinking audit.



Scope

- Efficiency and effectiveness of visual design processes
- Data analysis on economic and traffic impact of floor/window/seasonal changes
- Stores use and compliance with guides issued for floor/window changes
- Inventory flow alignment with floor set execution



Approach

- In-depth planning session and data analysis
- Complete an end-to-end process map, capacity, and cost analysis with pain points
- Walk-through and validate process by observing and performing work involved from design concept to store execution of floor set
- Validate pain points with management, and complete a risk and gap assessment
- Survey stores and quantify how closely visual design plans are followed
- Quantify sales per day, transaction per day, and consumer per day compared to dates of floor-set/window display changes and identify sales and traffic impact
- Identify impact of localization or one-off/unique store designs that required additional visual design effort to manage
- Identify options for improving internal processes



Results

- Identified savings of approximately **\$500,000** annually in store labor by eliminating six negative impact floor sets that were not required to move out of major seasons
- Identified approximately **12,000 hours of process efficiency** in store by moving timing of markdowns in relation to floor sets to ensure product was only touched once
- Identified an additional **1,500 hours annually** of time saving at corporate via elimination of duplicate steps and more rigorous enforcement of deadlines
- Identified gaps in training needs for merchants, and helped design risk portion of training to minimize risk of on-time delivery of merchandise for floor set

Value Creation

In this environment, internal audit is more than a compliance function focused only as preserving value, and is recognized by business leaders as a strategic risk function providing long-term value creation and a key partner to the business.

Invitations are extended for audit to participate in key meetings and serve as a component to key decision making. For example:

- **System change** – serve as a consultant to the business to ensure information processes or controls are not lost when systems are transitioned
- **Administrative and operational improvement** – serve as a risk liaison to ensure risks are identified and assessed by the business, and controls are not eliminated or new risks generated when process improvement is attempted
- **Strategic initiatives** – real-time reviews of new products, innovations, and direction
- **Stakeholders request audit activity.**



Taking the Audit to the Next Level

Case Study #3 – Procure to Payment Business Cycle Optimization Internal Audit

Management requested internal audit to perform a consultative optimization of the procurement-to-payment business cycle, evaluate current controls, and perform an analysis on data accuracy of payments processed to direct material vendors at this Global Manufacturer.



Scope

- Recommend process optimization to the procurement-to-payment cycle
- Provide control design improvement recommendations as part of process optimization
- Analysis and identification of data accuracy of payments to direct material vendors



Approach

- Conducted in-depth planning session and data analysis
- Created process maps documenting the current-state flow, bottlenecks, and control gaps
- Performed data mining and further analysis on payments to direct material vendors to quantify volume and amount of payment inaccuracies
- Performed a further sorting of the identified purchase price variance (PPV) data for the top vendors to quantify the impact of potential overpayments
- Conducted interviews and further overpayments analysis to determine the root causes for process weaknesses, including vendor master file changes, operating complexities among business units and standing orders
- Provided recommendations related to control weaknesses, and identified areas to optimize the process and mitigate risk



Results

- Identified more than **\$1.3 million** in confirmed duplicate over-payments and seven root cause process issues related to these direct findings
- Each of the top 15 vendors had negative variances > \$100,000 in these direct overpayments, and further extrapolated an additional opportunity for recovery of **more than \$1 million**



Taking the Audit to the Next Level

Quantitative Measures and Qualitative Roadblocks

A critical thinking audit should bear the following hallmarks:

- Audit results will be set and measured in creating value for the company – either cost savings, capital realignment, hours saved or compliance improvements
- Audit results will be limited to the key tangible findings that the business should address as a matter of priority
- Minor issues are reported outside of the final report to the business leaders in order to focus attention on the critical issues
- The business actually makes meaningful improvements due to internal audit findings.

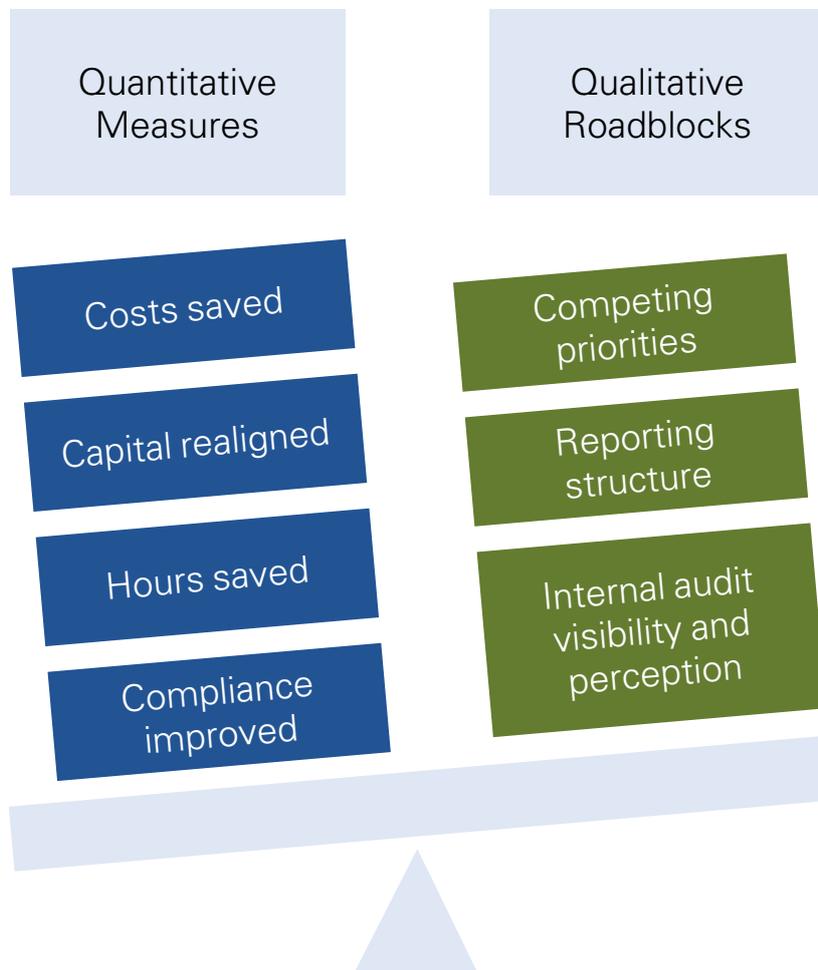
In performing the audit and producing the report, the internal audit function must keep in mind the qualitative roadblocks and work to minimize them:

Competing Priorities

- What are the critical initiatives the auditee is working on?
- Where do the findings fit with these initiatives?
- Does the auditee have the budget to remediate the findings?

Reporting Structure

- Who are the influencers in the business?
- What steps has internal audit taken to develop personal networks through the business?
- Has internal audit provided insights or invested in these key relationships outside of an internal audit in order to be viewed as a “team player?”



Internal audit success through critical thinking can achieve the desired state of:

- The business immediately adjusts to internal audits observations
- The business begins to implement continuous monitoring based on internal audit techniques used
- Business leaders recommend internal audit and actively seek to hire internal audit staff.

Internal Audit Visibility and Perception

- Is internal audit seen as the policy enforcer or as a business advisor?
- Which internal audits in the past have directly benefited the business?
- How experienced or inexperienced is the internal audit team collectively?
- Where has internal audit had challenges in the past within the organization?



Summary

Critical thinking is many times a cultural shift for internal audit. It can deliver the value creation being sought, and expand or develop the positive perception of the department across the organization. When implemented, full maturity should reach the point of internal audit being frequently invited to participate on steering committees, task forces, and strategic initiatives.

Critical thinking can be leveraged as a core approach for internal audit to establish itself as a strategic partner within the business, focused on achieving balance between risk management and business performance.

Embedding critical thinking in the audit process can produce the following results:

- Internal audit will be viewed as a valuable, forward-looking business partner
- Audit results will be set and measured in tangible returns for the company
- Stakeholders will frequently request internal audit involvement.



Contact

KPMG AG

Badenerstrasse 172
PO Box
8036 Zurich

kpmg.ch

Luka Zupan

Partner
Head Internal Audit,
Risk and Compliance Services
+41 58 249 36 61
lzupan@kpmg.com

François Rouiller

Partner
Head Global Assurance
+41 58 249 79 14
frouiller@kpmg.com

Ulrich Amberg

Partner
Head Consulting
+41 58 249 62 62
uamberg@kpmg.com

Matthias Kiener

Partner
Forensic
+41 58 249 21 35
mkiener@kpmg.com

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received, or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

©2014 KPMG AG is a subsidiary of KPMG Holding AG, which is a member of the KPMG network of independent firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss legal entity. All rights reserved.