

Embracing Change:

Real world examples of internal audit disruption

IIA – The Atlanta Conference

SEPTEMBER 2019



Session Overview

Details

Title: Embracing Change: Real world examples of internal audit disruption

Duration: 50 Minutes

Facilitator: Presented by KPMG

Audience: Most Audit Professionals

Session Overview

- The convergence of emerging technologies across all industries and business functions is creating <u>new market value</u> and rapidly displacing existing products and services.
- The demonstrations presented will explore <u>specific examples</u> of how internal auditors are leveraging emerging technologies to execute audits more efficiently, expand audit coverage, and deliver higher-value business insight and results to their stakeholders.
- The examples presented compare the results achieved through the use of emerging technologies verses using more antiquated audit procedures to further illustrate the value that disruption offers to internal auditors.

Session Objectives

- Session participants will gain insight into how emerging technologies are currently being leveraged by internal auditors, including the <u>opportunities</u> that they present.
- Participants will learn, through tangible demonstrations, how emerging technologies are both enabling and disrupting the internal audit profession and how emerging technologies can be used to transform their respective organizations.

Proposed Agenda

00 - 05:

Speaker introductions and participant instructions

05 - 10:

Session introduction and overview of objectives

10 - 40:

Demonstrations of emerging technologies:

Illustrated through an engaging walkthrough of a selection of internal audit projects comparing the approach and results using emerging technologies compared to the same project executed using more antiquated methods

40 - 50:

Q&A discussion and session close





The Premise of this Session

If the audit function is bogged down with immediate compliance concerns, the CAE can't necessarily devote enough time to pondering disruption

> - Anna Cristina Zambrano, IIA Member

the Age of Disruption – IIA Publication 2018

"

and becoming a

trusted advisor.



First you need to make your audit department work strategically, for example with better analytics and smarter use of technology. Then you can start lifting up your head to look at the horizon, to see what disruptions are coming. ""

- Hans Nieuwlands. IIA Member



GET STARTED!



- DISCOVER.
- Initiate activities within your IA function to identify, validate, and select innovation ideas

PLAN.

- Create the business case for the ideas to outline what the team will do and the resources required to realize the full potential and maximize outcomes for the function
- DEVELOP.
- Design, prototype, build, test and pilot of the idea to validate and refine early planning assumptions. Develop activities are iterative in nature and can vary significantly in formality

- DEPLOY.
- Publish and communicate new capabilities across the IA team, Establish standards and guidelines for using the new capability, support adoption

EVOLVE.

Assess how new innovation capabilities are progressing against their expected commitments to the business. Monitor, maintain & continuously improve capabilities



"Is this real life"

- David DeVore Jr. (After going to the dentist)

Case study examples of tangible "real-world" IA innovation efforts



Data-driven Audit

Case-study #1

Traditional Approach

SCENARIO DETAILS

- The Internal Audit plan includes site-visit audits for a selection of the company's operating units (i.e. branches, stores, facilities, plants, etc.)
- The IA team is resource constrained and follows a tight timeline to execute each site-audit with the objective of demonstrating full coverage of all locations over a 36 month timeframe
- Historically, very few audit findings/ observations result from the sitevisit audits performed

TRADITIONAL APPROACH

- The selection of site-visit locations are determined solely by revenue materiality and achieving full-coverage of all locations within 36 months
- The IA function maintains standard audit programs for similar operating units that are executed during each site-visit audit
- IA leveraged their risk assessment results to design the standard sitevisit audit programs, which they reevaluate annually and update as they deem necessary
- The auditors follow a well-defined schedule across all phases of the site-visit audit (planning, fieldwork, post-fieldwork, & reporting)

OUTCOME

- Internal audit risk assessment and site visit selection process, entirely driven by total revenue contribution, resulted in the company's largest locations being selected for site visits every year
- Internal audit struggles to achieve their stated goal of visiting all locations over the 36-month timeline and consistently defers audits planned for "lower-risk" locations to the following year
- Key management and AC stakeholders seem accepting of IA's messaging that the real value for performing the site visit audits is the IA presence in the field that reinforces the importance of sound corporate governance





AC Messaging: "No material issues to report from site visit audits...continue to experience challenges meeting 36 month rotation coverage. Currently scheduled to achieve 90% coverage of planned locations.

Process Efficiency: Highly standardized site selection and site visit audit program, Significant travel expense

Analysis & Decisioning: Limited to site selection process

Stakeholder Perception: Minimal value, limited to perception of IA presence in the field



Innovative Approach

DISRUPTION OBJECTIVES

- Enhance site selection and audit schedule to prioritize risk coverage over location coverage
- Enhance site visit audit programs to produce more valuable results

INNOVATIVE APPROACH

- Proactively engaging the AC and key management stakeholders in "questioning the norm" to gain buyin/approval to innovate and drive change
- Establish a more comprehensive riskbased site selection methodology that prioritizes quantitative data attributes
- Assess and rationalize the existing site visit audit program to establish the minimum set of mandatory audit requirements
- Expand audit planning and coordinating efforts to other corporate governance functions/ stakeholders

VALUE THROUGH DISRUPTION

KPI DRIVEN INSIGHT:

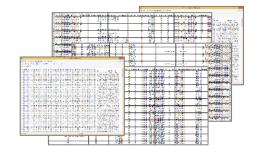
Established KPIs across key risk areas related to site operations

WORKFLOW AUTOMATION:

Collect, normalize, and process internal data to monitor KPIs

DATA-DRIVEN AUDITING:

Collectively analyze KPIs to customize site visit audit plans



Revenue Contribution

Procurement Spend

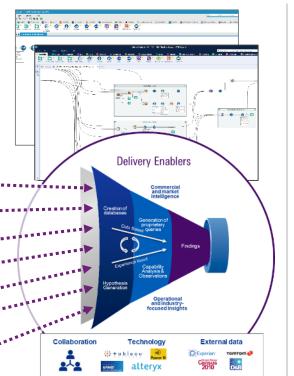
Payroll Spend/ Overtime

• Employee Turnover

Inventory Balances

Inventory Shrink

• Ethics Hotline Reports







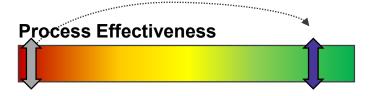


Comparing Results

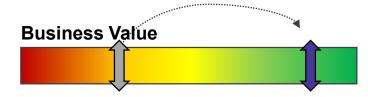
TRADITIONAL

Process Efficiency

- Standardized and highly efficient "scratch the surface" audit programs focused on covering all locations within timeline
- Significant travel expenses and travel time
- Reduced number of site visit audits from 30 per year to 12, significantly reduced travel expense, improved the audit reporting cycle, and allowed IA to expand the amount of time allocated to fieldwork
- Automation enabled workflows simplified the collection and ETL process to drive KPI data for routine monitoring
- Data obtained to support KPI metrics leveraged for audit sample selections prior to fieldwork significantly reducing time and effort related to the previous manual data and documentation request process



- Standardized audit program approach with limited ability to target specific risk areas
- · Limited historical audit findings identified
- Poor coordination and limited connectivity across different stakeholders
- Automation incorporated data integrity tests to ensure data completeness
- Automated KPI monitoring facilitated broader discussion and collaboration within the IA function and with other key stakeholder across the business
- Data-driven semi-customized site-visit audit programs allowed IA to continue performing the required standard audit procedures, but select targeted areas for each site visit based on data specific to each individual location



 Even keel perception of value, value viewed as the act of just showing up and not the actual audit results

- Refocused the value proposition to focus on targeting specific risks unique to each location and the results/ audit outcomes
- Improved business acumen of the entire IA team helping to shift from task-focused execution to a strategic-thinking mindset
- Improved coordination with other corporate governance functions and elevated IA brand awareness across the senior and executive management functions
- Increase in the number of audit findings/observations and quality/impact to improving operations





Procure-to-Pay Audit Project

Case-study #2

Traditional Approach

SCENARIO DETAILS

- As part of a growth strategy involving multiple acquisitions, IA was requested to perform multiple operational audits of the company's centralized procurement function
- Internal audit designed the audit work plan to address both ICFR key control testing along with a risk-based selection of operational audit activities
- IA maintains a strong relationship with P2P stakeholders, who requested feedback on improvement opportunities IA identifies

TRADITIONAL APPROACH

- IA developed a standard audit program previously used for P2P audits for historical acquisitions, which they reviewed and revise as required for the following P2P audit project
- The IA function utilizes statically-valid sampling for transaction testing
- For efficiency, IA conducts ICFR testing first and leverages these results where possible for the operational audit effort

OUTCOME

Audit Report Executive Summary:

Internal Audit conducted an audit of the company's Procurement Process. None of the audit findings identified meet the criteria defined to require escalation to the Audit Committee. However, IA identified the following areas where internal controls could be strengthened to further improve the overall procurement function

Improvement Recommendations:

- 1. The organization maintains standard operating procedures, but does not maintain a corporate procurement policy
- 2. Opportunities exist to further update SOPs to reflect current processes and clarify best practices for purchase requisitions including approvals over matching variances, requisition & PO requirements, and negotiated payment discounts

Detailed Observations & Recommendations:

Sample-based Testing of 25 Disbursement Transactions:

- For 1 of 25 samples, the invoice did not include evidence of approval from the project manager as stated in the SOP
- For 1 of 25 samples, the earned payment discount was not taken resulting in an overpayment of \$128
- For 3 of 25 samples, the Purchase Order was created after the invoice date indicating that the POs were created to process the payment for transactions that did not follow the process defined in the SOP
- Monitoring procedures over past-due orders are not performed consistently across the Procurement team. 2 of 12 procurement leads did not maintain evidence of their weekly monitoring procedures as stated in the SOP

Sample-based Testing of 25 New/Modified Vendor Records:

- 1 of 25 new vendors added to the VMF did not include evidence that background/credit checks were performed
- 2 of 25 VMF modifications did not include evidence of approval for 1. Modifying vendor address, and 2. Modifying vendor phone number
- Management does not review the VMF to identify and deactivate dormant vendors or rationalize VMF records



Innovative Approach

DISRUPTION OBJECTIVES

- Enhance procurement audit procedures to deliver higher-value audit results
- Improve stakeholder participation in audit planning

INNOVATIVE APPROACH

- Proactively engage key management stakeholders to play an active role in planning and scoping the audit
- Leverage the full population for selected datasets to guide audit planning & scoping
- Use analytic tools and techniques to review complete data populations to decrease the level of sample-based testing procedures
- Conduct interim cross-functional review workshops to explore and discuss preliminary observations and/or data anomalies

VALUE THROUGH DISRUPTION

Data-driven
Audit
Planning &
Scoping



Preliminary Observation Working Sessions

Analytics
Over Full
Data
Populations

Detailed Observations & Recommendations:

Early Payment Discounts:

Over the entire Q1 & Q2 period, the company received invoices totaling \$590.13M and issued disbursements totaling \$588.02M. The total early payment discounts taken equaled \$2.11 M. The total amount of discounts lost equaled \$264K and discounts earned, but not taken equaled \$47K

<u>Discounts Lost</u>: **\$98K** in Lost Discounts resulted in invoices being received by AP after the discount period had expired. **\$102K** in discounts were lost as a result of delays in the invoice approval workflow cycle

<u>Discounts Earned/ Not Taken</u>: **\$42K**, **or 90%**, of the total balance was associated with a single vendor

Vendor Masterfile Management:

The Vendor Masterfile contains **14,386** vendor records comprised of **9,832** active vendors and **4,554** inactive vendors. For an 18 month period, IA identified actual activity for **4,387** vendors, or **only 45%** of the total active vendors in the VMF. IA identified and **confirmed 25 duplicated vendor** records from an initial population of **387 suspected duplicates**. Upon confirming 25 duplicates audit work was stopped

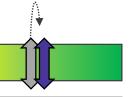
Payment Terms:

The company's procurement strategy defines a > 60-day payment term objective. IA identified 5,113 of the 9,832 active vendors, or 52%, reflect terms > 60 days and 559 vendors, or 5%, with Upon Receipt terms



Comparing Results

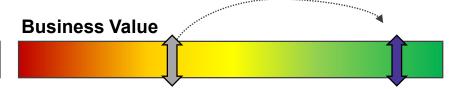
Process Efficiency



- Combined ICFR and Operational audit to drive efficiency
- Sample-based testing approach
- Leveraged prior audit programs to perform audit procedures
- Separated ICFR testing from operational audit work, which slightly increased the level of effort for the two audit objectives
- Obtained full data populations in advance of planning resulting in front-loading additional effort into planning & coordination, but decreased sample-based testing efforts resulting in slightly lower overall effort
- Cross-functional review workshops over preliminary observations significantly decreased audit reporting cycle



- Limited historical audit findings identified
- Limited coordination and limited connectivity across different stakeholders
- Audit issues not quantified to illustrate the magnitude of the impact to the business
- Data-driven approach to planning & scoping using full data populations optimized audit focus
- Including stakeholders in the data-driven audit planning & scoping process provided a more holistic understanding of risks to the organization that helped to improved the audit procedures performed
- Performing analytics over full data populations vs. only sample-based testing significantly improved IA's precision in quantifying the magnitude and severity of observations/ findings



 Stakeholders expressed that the audits were valuable, but very little response or action taken based on the audit results

- Including stakeholders in the data-driven audit planning process increased management's perception of value
- Executive leadership took immediate measures to improve collection of early payment discount by implementing procedures that resulted in:
- Retroactively collecting 85% of the identified "Earned, Not Taken" amount and enhancing controls over the process to limit future reoccurrences
- Decreasing "Lost Discounts" in the following two quarter periods by 65%.
- Management enhanced VMF management & Paymentterm negotiations procedures & requested IA to participate in new on-going monitoring procedures





Ethics Hotline Reporting

Case-study #3

Traditional Approach

SCENARIO DETAILS

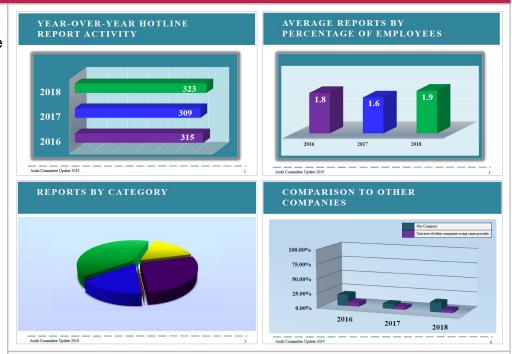
- The organization's Corporate Compliance function is responsible for operating their ethics reporting program
- The organization uses a leading technology platform and service provider to administer their ethics hotline reporting program
- The compliance function coordinates with internal audit to assess hotline reports and delivers an update to the Audit Committee (AC) on an annual basis

TRADITIONAL APPROACH

- Corporate Compliance reviews hotline reports at the end of each period to determine response activities and subjectively determines whether to escalate a report to internal audit
- Prior to the annual AC update, Corporate Compliance meets with Internal Audit to perform a high-level review of the reporting materials and high-risk cases reported
- The AC reporting materials heavily leverage the reporting information provided by their platform service provider and only call out the reports subjectively defined as "high-risk"

OUTCOME

- Corporate Compliance
 effectively monitors hotline
 activity at the case level,
 but the manual and time intensive review process
 limits the function's ability
 to identify and evaluate
 the broader issue themes
 across the organization
- The effort to prepare the AC reporting materials is manually intensive and requires a substantial amount of re-work as the reporting materials pass through the review and approval process
- The AC criticized the presentation stating that the report only provided data and insufficiently translated the data into actionable information



Process Efficiency: Highly manual, Excel driven, Reporting process required 3 weeks, multiple participants and iterations

Analysis & Decisioning: Limited to Case-level review & Annual Reporting, Limited focus on themes and broader business impact

Stakeholder Perception: Poor, Limited value to the business



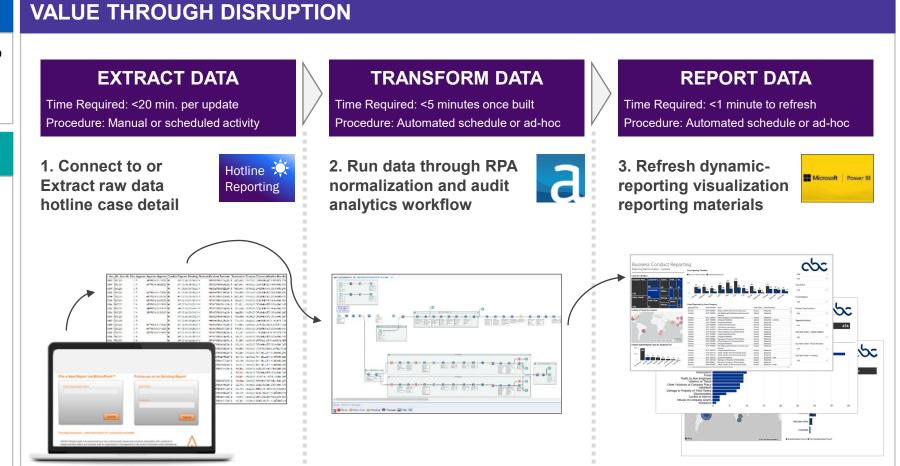
Innovative Approach

DISRUPTION OBJECTIVES

- Enhance reporting to translate "data" into valuable information
- Eliminate process inefficiency

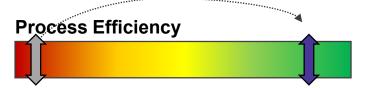
INNOVATIVE APPROACH

- Define case-level decisioning guidance that includes evaluation criteria to limit subjectivity in the evaluation
- Leverage automation technology to enhance the effectiveness of the case reviews, enables dynamic reporting, and clearly connect activity at the case-level to the attributes that provide broader perspective across business operations
- Transition reporting from static to dynamic using data visualization technology and implement crossfunctional review and analysis working sessions to identify and understand the broader picture across the business.
 (i.e. forest vs. only the trees)





Comparing Results



TRADITIONAL

INNOVATIVE

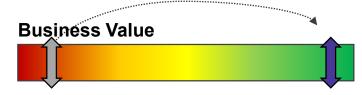
Approach

Manually-intensive execution focused on "getting through the work"

- Limited unstructured review and analysis of impacts to the business
- Reporting not sufficient in meeting AC expectations/ needs
- Automation design and build effort equal to executing one cycle of the traditional approach. Resulting in:
 - Data extraction and normalization reduced from 3 weeks to > 30 minutes
 - Reporting material refresh reduced from to > 1 minute
 - Dynamic reporting supported crossfunctional senior management discussion & analysis meetings on a quarterly basis



- Individual hotline case focused
- Isolated focus on monthly activity
- Static "data focused" reporting
- Poor coordination and limited connectivity across different stakeholders
- Automation incorporated data integrity tests to ensure data completeness
- Automated key text/ phrase functionality identified "higher-risk" hotline reports requiring additional review
- Data visualization provided stakeholders to view both the case-level reports (i.e. "trees") along with the broader issue trends and themes across the business (i.e. "forest")



- Perceived value to AC considered poor
- Minimal, Enough to meet basic compliance requirements, Allowed company to identify and respond to specific risks on a case-bycase basis, but left the company exposed to broader risk themes
- Data visualization structure designed to connect hotline "data" to the company's operating structure allowing stakeholders to translate "data" into valuable "information" for action
- Updated AC reporting materials commended by the AC leading to these being included in each quarterly package for reference in addition to the annual agenda update
- Location specific activities incorporated into IA audit programs based on hotline themes



Q&A



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