Top Priorities for Internal Audit in Manufacturing

Assessing Manufacturing Industry Results from the 2012 Internal Audit Capabilities and Needs Survey

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LEADERSHIP TEAMS IN MANUFACTURING COMPANIES ARE LOOKING TO DRAW LESSONS FROM THEIR RESPONSES TO THE RECESSION, ADDRESS MORE RECENT SUPPLY CHAIN DISTURBANCES IN THE FAR EAST AND THE MIDDLE EAST, EXAMINE WAYS TO DEVELOP OR STRENGTHEN ERM CAPABILITIES, AND CONTEND WITH EVER-INCREASING REGULATORY COMPLIANCE DEMANDS.

INTRODUCTION

As the effects of a bruising recession continue to recede slowly, U.S. manufacturing companies find themselves contending with a new normal. Although manufacturers no longer have an all-consuming focus on how to address plummeting demand, they still confront smaller (yet formidable) pressures along with a growing number of threats and opportunities. Global expansion, rising healthcare costs, supply chain disruptions, and increasing customer demand for product and service differentiation rank as key issues in the C-suites of many manufacturers.

Most, if not all, of these forces pose new pressures and opportunities for internal audit functions. The manufacturing industry findings of Protiviti's 2012 Internal Audit Capabilities and Needs Survey indicate that internal audit functions and their leaders are striving to respond to this new terrain by striking a balance between more strategic contributions to the business and ongoing – and steadily rising – tactical and compliance-related work.

Leadership teams in manufacturing companies are looking to draw lessons from their responses to the recession, address more recent supply chain disturbances in the Far East and the Middle East, examine ways to develop or strengthen enterprise risk management (ERM) capabilities, and contend with ever-increasing regulatory compliance demands. For example, many manufacturers are striving to understand and comply with the more recently enacted California Transparency in Supply Chains Act.[1]

The economic recovery continues to feel unsteady in most industries, including manufacturing. The Institute for Supply Management's national Purchasing Manager's Index (PMI) posted its second consecutive month of contraction (albeit a slight contraction) in July following 34 consecutive months of growth.[2] This information suggests that manufacturing leaders will continue to deal with uncertainties in the coming months.

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[1] "California Law Requires Companies to Disclose Efforts to Ensure Supply Chains Are Free of Slavery and Human Trafficking," *Protiviti Flash Report*, February 6, 2012, http://www.protiviti.it/en-US/Documents/Regulatory-Reports/General-Business/Protiviti-Flash-Report-California-Supply-Chain-Transparency-Law-020612.pdf.

About the Survey

Each year, Protiviti conducts its Internal Audit Capabilities and Needs Survey to assess current skill levels of internal audit executives and professionals, identify areas in need of improvement and help stimulate the sharing of leading practices throughout the profession. This year, survey respondents answered close to 200 questions in the following categories: General Technical Knowledge, Audit Process Knowledge, Use of Technology in Auditing Business Process Controls, and Personal Skills and Capabilities. Manufacturing industry respondents also were asked to address a fifth category of questions: Manufacturing-Specific General Technical Knowledge. The results, which are based on information provided by all respondents (who numbered more than 800), are contained within the overall survey report (available at **www.protiviti.com/IAsurvey**).

In each category, respondents were asked to assess, on a scale of one to five, their competency in different skills and areas of knowledge, with one being the lowest level of competency and five being the highest. They were then asked to indicate whether they believe they possess an adequate level of competency or if there is need for improvement, taking into account the circumstances of their organization and the nature of their industry.

Executive teams and their boards want to understand how certain risks, such as the financial viability of suppliers and/or customers during the credit crunch, caught their organizations off guard. Additionally, the historic economic crisis forced the vast majority of U.S. companies, including manufacturers, to retrench operations in a predominantly reactive manner: Capital expenditures were halted, IT projects were shelved and many people, including top talent, were laid off. These high-level inquiries commonly lead to discussions about emerging risks: *We have a pretty good handle on our internal risks, but what about external risks on the horizon? What emerging risks should we be aware of, and how can we monitor these through the windshield rather than in the rearview mirror?*

These questions lead top decision-makers to ERM: *How can we manage our risks in a more comprehensive, unified and systematic manner?* The most recent global supply chain problems – created by the earthquake, tsunami and ensuing nuclear disaster in Japan, along with widespread political unrest in the Middle East – as well as new regulatory risks and requirements reinforce ERM's importance.

All of these pressures influence internal audit functions in the manufacturing industry. Internal auditors are expected to address new and familiar risks and opportunities in a more efficient manner. Specifically, the manufacturing industry survey findings suggest that internal audit's activities in the coming year will center on five overarching priority areas:

1. Fostering greater supply chain transparency

2. Increasing the use of technology to audit key business process controls (e.g., supplier management) more effectively

3. Addressing and managing existing and emerging risks

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2 "July 2012 Manufacturing ISM *Report On Business*®," Institute for Supply Management (ISM), August 1, 2012.

4. Enhancing efficiency through technology-enabled auditing

5. Nurturing internal collaboration and networking externally

In all, the results from manufacturing respondents in the 2012 Internal Audit Capabilities and Needs Survey present a picture of manufacturing industry internal audit functions that remain vigilant regarding familiar and known risks while also carving out time and resources to concentrate on emerging risks and ongoing uncertainty.

RESULTS AND ANALYSIS

Providing support in these areas, especially when it comes to areas of emerging risk, creates two notable challenges for internal audit functions in the manufacturing industry.

First, since most of the functions currently invest much of their time on compliance-related audits and operational audits, addressing emerging risks and supporting ERM activities may require a new mindset within the internal audit function, as well as at the audit committee level and among executive leadership. Second, if they are to provide new and/or additional ERM and related risk management support, most internal audit functions will need to find practical ways to balance these objectives with their already bulging workloads.

The priorities that manufacturing industry respondents identified in the 2012 Internal Audit Capabilities and Needs Survey suggest that internal audit leadership and functions already are addressing these challenges as they seek to enhance the strategic value of their contributions.

1. Fostering Greater Supply Chain Transparency

Respondents were asked to assess, on a scale of one to five, their competency in 17 areas of manufacturing industry-specific technical knowledge important to internal audit, with one being the lowest level of competency and five being the highest. For each area, they were then asked to indicate whether they believe their level of knowledge is adequate or requires improvement.

The responses show that nearly all of the improvement needs cited in this category relate to operations or the supply chain.

Table 1: Manufacturing Industry-Specific Technical Knowledge

"Need to Improve" Rank	Areas Evaluated by Respondents	Competency (5-pt. scale)
1	California Transparency in Supply Chains Act	2.1
2	Customs/export	2.6
3	OSHA/employee safety	2.4
4	Managing third-party arrangements (e.g., resellers, wholesalers, contract manufacturers, licensees, etc.)	3.0
5	Valuation (e.g., LIFO, E&O)	3.3

With regard to supply chain management improvement priorities, the newly enacted California Transparency in Supply Chains Act, which took effect on January 1, 2012, figures as a top focal point.

The objective of this social policy-driven legislation is to eliminate slavery and human trafficking from product supply chains of companies operating in California. Its focus centers on increasing transparency by requiring companies to disclose their efforts to ensure their supply chains are free of these illegal activities. The Act applies to approximately 3,200 major companies that conduct at least some business within the state.

Given that the act is so new, it is not surprising that it represents a top priority among internal auditors in the manufacturing industry; nor is it surprising that survey respondents rate their competency in complying with the new law relatively low.

Although that competency can be expected to increase in the coming year, other supply chain management areas, such as customs/export and managing third-party arrangements, continue to rate as top priorities among internal auditors within the manufacturing industry. Customs/export and managing third-party arrangements were also identified as top priorities by 2011 industry respondents.

OSHA/employee safety and valuation are other top priorities for internal auditors in the industry. Also of note, chief audit executives (CAEs) in the manufacturing industry identified these areas – as well as the new California law and customs/export – among their top priorities.

2. Increasing the Use of Technology to Audit Key Business Process Controls (e.g., Supplier Management) More Effectively

Respondents were asked to assess, on a scale of one to five, the degree to which their organizations use technology to audit 36 different business process controls, with one indicating no use and five representing extensive use. For each area, they were then asked to indicate whether they believe their level of technology use is adequate or needs to be increased.

The results suggest that internal auditors within the manufacturing industry are concerned about the potential for fraud in the organization and are also committed to increasing the use of supporting technology across a broad spectrum of business process controls auditing areas.

Table 2: Use of Technology in Auditing Business Process Controls

"Need to Increase Use of Technology" Rank	Areas Evaluated by Respondents	Degree of Technology Use (5-pt. scale)
1	Supplier management	2.8
2 (tie)	Compensation and benefits management	2.8
	Time off/vacation tracking	2.2
3	Purchasing/purchase orders	3.1
4 (tie)	Cash receipts/applications	2.9
	Credit collection/bad debt	2.7
	Revenue recognition	2.8
5 (tie)	Billing	2.9
	HR records management	2.6
	Obsolete/expired inventory	2.9

These results also suggest that internal auditors within manufacturing companies plan to do a better job of capitalizing on technology-enabled auditing to monitor controls over areas more prone to fraudulent activity,

including purchasing/purchase orders, cash receipts/applications, and billing. Revenue recognition, which is a common source of financial reporting errors, also marks an area that manufacturing industry respondents believe would benefit from an increase in supporting technology.

To avoid these issues – and to increase the effectiveness and efficiency of auditing many other business process controls – it behooves internal audit leaders to ensure that their functions possess the appropriate technology tools to audit effectively.

3. Addressing and Managing Existing and Emerging Risks

Respondents were asked to assess, on a scale of one to five, their competency in 57 areas of technical knowledge important to internal audit, with one being the lowest level of competency and five being the highest. For each area, they were then asked to indicate whether they believe their level of knowledge is adequate or requires improvement.

The responses to this line of questioning suggest that internal auditors within the manufacturing industry plan to:

1. Enhance their ability to understand and manage new and emerging risks, including those related to social media, in particular

2. Improve their management of more traditional risks, including regulatory risks

3. Continue to assess and improve their overall effectiveness

Table 3: General Technical Knowledge

"Need to Improve" Rank	Areas Evaluated by Respondents	Competency (5-pt. scale)
1	GTAG 13: Fraud Prevention and Detection in an Automated World	2.8
2	International Financial Reporting Standards (IFRS)	2.5
3	GTAG 16: Data Analysis Technologies	2.8
4	Social media applications	2.5
5	Practice Guide: Measuring Internal Audit Effectiveness and Efficiency	2.8

Like virtually every other department and function in organizations today, internal audit must understand and address the risk implications of social media. As with any new process or activity that introduces significant elements of change, social media applications and cloud computing create substantial new risks that internal audit must – in partnership with executive management and business owners – identify, assess, monitor and mitigate appropriately.

Social media and other new technologies, including cloud-based business software, are frequently being used throughout the enterprise, from human resources and IT to sales, marketing and legal. There are numerous security, privacy, legal and reputation risks related to social media to consider. It is incumbent upon the internal audit function to work with management, the board of directors, department leaders and business process owners to develop clear social media use policies and standards, and to ensure there is ongoing compliance with these standards throughout the organization. More broadly, internal audit should partner with these executive and leadership groups to assess the risks of the organization's social media capabilities, and ensure that this risk profile fits the corporate culture and overall control environment.

As the use of new technology increases, so, too, does the likelihood of fraud. Although technology can be exploited to commit fraud, it can also be used to prevent and detect fraud. This helps explain why manufacturing industry survey respondents identified GTAG 13: Fraud Prevention and Detection in an Automated World as the top improvement priority in this General Technical Knowledge area. GTAG 13 focuses on IT-related fraud risks and risk assessments and how the use of technology can help internal auditors and other key stakeholders within the organization address fraud and fraud risks.

Technology can also be used more broadly to strengthen the effectiveness and efficiency of the internal audit function's work (a prevailing theme throughout most areas of the survey results, as the following section illustrates). GTAG 16: Data Analysis Technologies, another General Technical Knowledge improvement priority, is designed to help internal auditors improve their use of data analysis.

In addition to addressing emerging risks like social media and leveraging technology to prevent and detect fraud, internal auditors within manufacturing companies also identified IFRS as a knowledge area they will target for improvement in 2012 and beyond.

4. Enhancing Efficiency Through Technology-Enabled Auditing

Respondents were asked to assess, on a scale of one to five, their competency in 52 areas of audit process knowledge, with one being the lowest level of competency and five being the highest. For each area, they were then asked to indicate whether they believe their level of knowledge is adequate or requires improvement.

Consistent with findings from the past several years of the Internal Audit Capabilities and Needs Survey, continuous auditing, continuous monitoring and computer-assisted audit tools (CAATs) figure as top priorities for CAEs and their internal audit functions within all industries, including manufacturing companies. Although a widespread desire to expand internal audit coverage has traditionally driven interest in auditing technology, the need to devote more time to perform higher-value work likely will also drive greater adoption of these tools moving forward.

Table 4: Audit Process Knowledge

"Need to Improve" Rank	Areas Evaluated by Respondents	Competency (5-pt. scale)
1 (tie)	Computer-assisted audit tools (CAATs)	3.1
	Continuous auditing	3.4
	Continuous monitoring	3.5
	Data analysis tools: data manipulation	3.2
2	Data analysis tools: statistical analysis	3.2
3 (tie)	Auditing IT: change control	3.3
	Enterprise risk management	3.5
	Marketing internal audit internally	3.6
	Operational auditing: cost-effectiveness/ cost reduction	3.4

Many internal auditors within the manufacturing industry indicated that their functions need to increase the degree to which they leverage technology tools in their audit processes. The use of these and other technology-assisted auditing approaches (e.g., statistical analysis and data manipulation) enable manufacturing companies to perform millions of transactions and capture vast amounts of data on a daily basis.

5. Nurturing Internal Collaboration and Networking Externally

Respondents were asked to assess, on a scale of one to five, their competency in 24 areas of personal skills and capabilities. For each area, they were then asked to indicate whether they believe their level of knowledge is adequate or requires improvement.

The top priorities internal auditors from the manufacturing industry identified within the Personal Skills and Capabilities section of the survey indicate improvement is desired in the following areas:

1. Shaping interpersonal skills such as negotiating, managing high-pressure meetings, persuading, and dealing with confrontation

2. Leveraging personal skills to fortify internal relationships with senior executives and corporate directors (those who serve on the audit committee of the board, as well as with other board members)

3. Leveraging their personal skills to strengthen external networks that provide access to leading practices and related knowledge

Table 5: Personal Skills and Capabilities

"Need to Improve" Rank	Areas Evaluated by Respondents	Competency (5-pt. scale)
1	Developing outside contacts/networking	3.3
2	Presenting (public speaking)	3.6
3 (tie)	Developing other board committee relationships	3.2
	Negotiation	3.5
4 (tie)	Leadership (within your organization)	3.7
	Dealing with confrontation	3.5
	Persuasion	3.6
	Strategic thinking	3.6
	Using/mastering new technology and applications	3.5
5 (tie)	Developing audit committee relationships	3.4
	High-pressure meetings	3.5

To carve out more time and resources to conduct more risk-based and value-added activities, internal audit functions in manufacturing companies will need to work closely with their executive teams and audit committees to create a shared vision of the function's role within the organization. Many of the priorities identified in this category reflect the ongoing evolution of the internal audit function. Few, if any, effective internal audit departments operate in a silo today. A growing number of functions have embraced an "immersive role" as they work closely with business partners at all levels of the organization (including the board of directors) to address threats and opportunities throughout the enterprise.

From a personal perspective, it is no longer sufficient for internal auditors in the manufacturing industry to step out of the old silo mindset and into a new, more immersive role. Instead, internal auditors in manufacturing appear eager to ensure that their collaborations with all of the different parts of their organizations are as strong as possible so that they can thrive in their new roles.

Once again, the survey results depict an internal audit function that is striving to balance its increasingly strategic contributions (manufacturing respondents identified strategic thinking as a personal improvement priority) with the ongoing need to help their function become more efficient (in this case, by mastering new technology and applications).

IN CLOSING

For internal auditors in the manufacturing industry, balancing the priorities identified in this survey will not be easy, in large part because it requires the juggling of multiple priorities such as new and growing compliance needs, ERM activities, emerging risks, export issues, supplier performance management, the adoption of continuous auditing capabilities, and numerous IT auditing needs.

By focusing their efforts on the elements of this balancing act, internal audit leaders and professionals within manufacturing companies can help create sturdier footing for the organization, which will be extremely valuable regardless of the macroeconomic climate.

ABOUT PROTIVITI

Protiviti (**www.protiviti.com**) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE® 1000 and Global 500 companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

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About Our Industrial Products Practice

Protiviti's Industrial Products professionals can assist your company with strengthening compliance efforts, information for decision-making, and business processes to improve overall performance and lower costs.

Some of the many challenges management faces in the manufacturing environment include supply chain interruption, customer dissatisfaction, bottlenecks in the supply chain, forecasting issues, excess and obsolete inventory, quality concerns, work stoppages and inadequate enterprise resource planning systems. Industrial products companies understand these concerns because of their complex supply chains that deliver value to end customers. Combined with regulatory requirements, these companies need to manage an ever-challenging landscape of operating risks.

At Protiviti, our professionals understand the issues your organization is facing. Our solutions will help you deal with and overcome your issues and turn them into competitive advantages. We combine industry competency with internal audit, corporate governance, diagnostics, process design and cost-optimization to help you achieve a competitive advantage.

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