The Internal Auditors: How to maintain their relevance?

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INTRODUCTION

I am grateful for the opportunity to speak at your National Annual General Meeting on a subject that is of particular interest not only to all auditors but also to Chief Executive Officers (CEOs), management generally and to corporate Boards.

Earlier this year the Institute of Internal Auditors called for comments on a proposed ‘Definition of Internal Auditing’ to replace that contained in the Statement of Responsibilities of Internal Auditing Institute of Internal Auditors 1990. ‘Statement of Responsibilities of Internal Auditing’. A comparison of the current and proposed definitions highlights a significant shift in emphasis and approach.

For example, internal audit has been redefined from an ‘appraisal function’ to an ‘objective assurance and consulting activity guided by a philosophy of adding value’. Institute of Internal Auditors 1999. Proposed ‘Statement of Responsibilities of Internal Auditing’, January.. The proposed statement also explicitly refers to risk management and governance processes.

The proposed changes are not just cosmetic or window dressing. They are powerful indicators of the emerging and future role for internal audit and go directly to the issue of relevance.

The basic test of relevance is ensuring internal audit is meeting the needs of its key stakeholders. Such needs may be expressed in terms of the scope and nature internal audit activity, the cost-effectiveness of the internal audit function and the efficacy of internal audit procedures.
Issues for consideration under the general test of relevance include identification of the key stakeholders; the extent to which these stakeholders have given sufficient consideration to their own needs; and whether these needs have been effectively articulated to internal audit.

One matter of particular interest to me is the role of the public versus that of the private sector internal auditor. This question can be examined largely from the perspective of the differences and similarities between the public and private sectors. The first part of my address focuses on the growing convergence of the two sectors and the growing commonality of interests. The second part looks at some useful strategic responses by internal audit to the changing environment and the third examines some of the important relationships between internal and external audit.

I thought it might be of interest to start by considering some of the broad implications of the growing convergence of both sectors. This convergence naturally results in areas of interest common to internal auditors in both sectors (and might I say to external auditors as well). However, it also makes clearer the differences between the two sectors.

And there continue to be real differences, as witnessed by the frustration of many private sector suppliers of public services subject to constraints that do not apply in the private sector. This has been a factor in the ongoing debate about a trade-off between public interest and accountability issues and private interest and efficiency concerns. Inevitably such questions have to be resolved in the political arena by government and/or Parliament.

II. THE GROWING CONVERGENCE OF THE PUBLIC AND PRIVATE SECTORS

The Australian Public Sector (APS) has steadily evolved to a more private sector orientation over the past decade. The evolutionary pressure arising in part from National Competition Policy reforms Independent Commission of Industry Commission 1996. ‘Competitive Tendering and Contracting by Public Sector Agencies’, Melbourne.
The report from that latter Inquiry resulted in the Government deciding that ministers should require their agency managers to systematically review activities to ensure that agencies focus on those activities that are the prime responsibility of the Commonwealth.

A methodology to undertake these reviews has been provided in the publication ‘The Performance Improvement Cycle: Guidance for managers’ issued by the Department of Finance and Administration in March 1998. In summary, this requires agency managers to:

- review all of their agency’s responsibilities;

- assess their activities cost and effectiveness to determine how to improve performance; and

- consider whether tools, such as competitive tendering and contracting, will provide improvement opportunities.

To quote from that publication:

‘The cycle encourages managers to actively question the relevance [my underlining] of their activities in meeting the Government’s objectives and to test whether the current arrangements for their activities use resources in the most effective and efficient way. It also encourages managers to actively search for new ways to meet client needs’ Department of Finance and Administration, 1998. ‘The Performance Improvement Cycle: Guidance for managers’, Canberra, March (page 7).

As in the United States and other western democracies, the increased emphasis on performance based management, including the supportive legislative framework, is a response to citizen demands for improved government services at lower cost and better stewardship of public resources. United States General
One outcome of the reform processes has been an increased focus on privatisation, market testing, competition, and outsourcing of services and activities. The private sector is steadily providing more goods and services to the public sector and, more significantly, is delivering an increasing range of ‘traditional’ public services directly to the community, often in competition with the public sector. The Job Network arrangements are a prime example of this trend.

The increasing prospect of direct competition and/or the wholesale replacement of service activities previously considered to be the exclusive domain of the public sector, requires public sector managers to think and act more ‘commercially’. In concert with this ‘external’ pressure for change, the Government has continued its internal management reform program. The trend to increased devolution of authority to agency management, and to provide greater flexibility (and accountability) for decision-making, continues. There is a greater focus on performance, exemplified in the new accrual-based outputs and outcomes framework. At the same time, there has been heightened concerns for the exercise of public service values and ethical conduct. In part, this is a recognition of the rights (and responsibilities) of citizens as opposed to their treatment as clients or customers.

Whereas the public sector can therefore be seen to be moving toward the private sector in regard to its business environment and the way it does business, there has also been some movement of the private sector toward aspects of administration that have traditionally been viewed as the province of the public sector. Nevertheless, that is not the same as constraints that apply when actually operating in the public sector even where public sector agencies are operating more commercially.

The accountability of boards to their shareholders, while perhaps always ultimately sourced in the ‘bottom line’, is beginning to be framed in less familiar non-financial terms such as ‘values and ethics’; ‘fair and equitable treatment’; ‘access and transparency’; ‘the environment’; and ‘community welfare’. These elements are becoming important considerations of boards and executives in their business strategies to be seen, and accepted, as good
corporate citizens. And this is, increasingly, not simply a matter of ‘image’ or a good marketing technique. An interesting concept is the so-called ‘triple bottom line’ reporting requiring the disclosure of information about an entity’s economic, social and environmental performance. Deegan Craig, 1999. ‘Implementing Triple Bottom Line Performance and Reporting Mechanisms’. Charter, Vol.70, No.4, May (page 40).

One area of accountability that has created particular problems for Parliament, and associated concerns for private sector contractors, is access to information, particularly that identified as ‘commercial-in-confidence’ Barrett Pat, 1999. ‘Commercial Confidentiality - A Matter of Public Interest’. Presentation to the 1999 ACPAC Conference, Perth, 21-23 February. A related issue has been audit access to private sector premises, as well as to records and information. As with so many other public policy debates, the issue is fundamentally about ‘balance’. Converging interests might assist in breaking down some of the ‘traditional’ barriers to achieve the ‘right balance’. But we need to keep in mind that the major element of public sector accountability is ‘transparency’.

Common issues

The convergence of the public and private sectors in the delivery of public services, and in the underlying management structures and approaches adopted, inevitably also leads to a convergence of significant business risks and common management issues. However, it has to be said that the political dimension will always loom large in the public sector. The most obvious focus of shared interests is on contract management which traditionally has been a source of much irritation and frustration between the public and private sectors. In today’s world, the management imperative is for genuine and effective partnerships to ensure that the contract meets the objectives of both parties without the need for frequent, and often costly, resort to legal disputation.

Both the public and private sectors have as a key business objective the need to minimise costs through greater economy and efficiency. Both are looking at what constitutes their ‘core’ business activities and to the formation of strategic alliances for delivery of non-core functions. Both sectors have been, and continue to be, subject to significant episodes of ‘down-sizing’ and outsourcing.
The issue of effective corporate governance is as much a concern for the Chief Executive Officer (CEO) of a public sector agency, many of whose responsibilities in this regard are enshrined in legislation, as, indeed, it is for the Board of Directors of a listed company. In particular, the importance of the Audit Committee and its relations with internal and external audit is increasingly being recognised in both sectors.

Effective risk management and control are cornerstones of good governance and need to be adequately addressed by the governing body of all organisations. The governing bodies of public and private sector organisations are increasingly seeking to obtain assurance from a variety of sources that appropriate arrangements are in place to manage risk and that the controls designed by management are operating as intended.

Managers in both sectors need to understand their critical business risks, which are increasingly common. The processes needed to manage these risks are receiving greater attention as part of the realisation that ‘good processes mean good outcomes’. Both sectors are now more fully focused not only on ‘results’ but also how they are being achieved.

For example, the risks from outsourcing an activity or function are essentially the same in either sector. The need for effective project management and contract management skills; the potential loss of ‘corporate memory’; unnecessary and often expensive recourse to litigation; and the often practical inability to bring the outsourced function in-house at a future date where it has not achieved its objectives; are of as much concern to a private sector manager as to one in the public sector.

Another example are the risks associated with rapid advances in the use of technology and the growth of electronic commerce. These include not just the obvious operational, fraud and security risks of deliberate or unintentional loss or corruption of electronic information; but also the perhaps less apparent business risks such as the potential for loss of market share to ‘virtual’ businesses delivering their services exclusively through the Internet.
In short, the opportunities provided by technology are demonstrating that we all basically need to re-think what we do and how we do it, if we are to remain contestable, or continue to be able to compete and/or to cope with the growth and complexity of information and communication systems. The latter provide both opportunities and risks. I was interested to read a recent report of the Australian Institute of Criminology which indicates that the increased use of information technology will lead to a major rise in white collar crime against governments. Smith Russell G. 1999. ‘Defrauding Governments in the Twenty-first Century’. Australian Institute of Criminology, Trends and Issues in Crime and Criminal Justice, Canberra. April (page 6).

III. STRATEGIC RESPONSES BY INTERNAL AUDIT

Where does internal audit fit into, and how should it respond to, this rapidly changing and increasingly globalised environment which includes the convergence of the public and private sectors? Not meaning to be over-dramatic, we might take notice of the recent advice by the Gartner Group to Internet service providers - ‘Add value or die’.

The profession

Foremost, it is important the profession is seen to take a leading role in relation to maintaining its relevance. The proposed changes to the definition for internal auditing referred to previously are a key step along this path. A practical application of the common exhortation to ‘think globally and act locally’ is for internal audit departments to devote some energy and resources to providing comments to the Institute on exposure drafts and generally contribute to the debate on future directions, their role in corporate governance and on accounting and auditing standards. I would also add considerations of independence and a professional code of conduct which are essential to the credibility of all auditors.

The more pro-active internal audit departments would seek to engage their key stakeholders, the audit committee and line management, in such a debate as users and decision-makers. These latter groups need to understand, and appreciate, the value that can be added by a professional independent and analytical group that knows and understands the organisation’s functions and/or business and the environment in which it operates.
My colleague, Denis Desautels, the Canadian Auditor-General, has observed that:

‘... probably no single factor is more important to effective internal audit than the attitude and expectations of executive management’. Report of the Auditor-General of Canada on Internal Audit, Ottawa May 1996 (Chapter 4).

His report on internal audit found a high correlation between those departments with strong senior management support and direction and the effectiveness of the internal audit function.

Dialogue with key stakeholders

To maintain its relevance the internal audit department needs to engage its stakeholders on a range of issues. Perhaps the central issue is the role of internal audit in the organisational context. Where does internal audit fit within the existing assurance and business process improvement frameworks within an organisation? To what extent should internal audit attempt to influence these frameworks and the composition of associated management structures? One departmental Secretary in an address to Heads of Internal Audit placed the responsibility squarely on them:

‘It is your role to make internal audit relevant and operate as part of the organisation.’ Beale Roger AM 1997. ‘A Secretary’s Expectations of Internal Audit’. Presentation to the 1997 Heads of Internal Audit Forum, Canberra, 28 October (page 3).

From the perspective of the governing body and the audit committee, internal audit can be a major source of assurance in relation to the effectiveness of organisational management in managing business risks, which includes consideration of the appropriateness of management’s design and operation of the control structure. However, internal audit need not be the sole source of assurance, and in one or two notable cases, has been replaced altogether in this role.
For example, the growth in use of control and risk self-assessment and co-assessment techniques, provides an opportunity for the governing body to consider the appropriate balance of ‘independent’ assurance, obtained through internal and external audit, and ‘self’ assurance activities undertaken by management. However, a recent Ernst & Young research project of more than 260 of Australia’s top 2000 organisations (measured by market capitalisation) indicated that management’s stated level of concern for operational, compliance and financial risk:

‘... is not mirrored by the extent to which those risks are being identified, assessed, quantified and managed.’ Ernst & Young 1998. ‘An Australian View of Risk Management’. Benchmark Survey, Melbourne (page 5).

To a great extent, the capacity to place a high degree of reliance on control and risk self-assessment activities, in place of independent assurance, requires a relatively mature control structure and a strong culture of control consciousness within a committed management. Internal audit will typically find itself in an ideal position to assess the ‘readiness’ of an organisation for introduction of self-assessment techniques given its ‘traditional’ emphasis on compliance and financial regularity auditing. It should have a clear picture of the control ‘culture’ and a deep appreciation of the adequacy of design and operation of existing controls. To this extent it should take a leadership role in the introduction of such techniques; and also in the broader consideration of the effectiveness of an organisation’s overall governance arrangements.

In addition to the needs of the governing body (and audit committee) there is a general recognition that the requirements of internal audit’s clients, that is, line management must also be considered. Here the emphasis is on process improvement and adding value to organisation performance. The internal auditor has been taking on more of a ‘consulting’ role to management. There is a discernible shift towards operational auditing away from compliance and financial auditing.
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It is in this latter regard that internal audit has perhaps the greatest opportunity to directly add value to the organisation by examining processes and activities from the perspective of their cost-effectiveness. That is, whether they are achieving the business objectives established by management in the most economical and efficient manner. This is akin to my performance or value-for-money audits.

A key point for engagement with line management, by internal audit, is in the audit planning process. It is here that a major strategic shift in emphasis is required and has been observed in many organisations in both sectors. While the ‘independence’ of internal audit has to be preserved, it is necessary to seek a degree of ‘ownership’ in audit planning by management as well as by the Audit Committee. With ‘ownership’ should come commitment, including to the audit results and their implementation.

Organisation’s themselves are applying greater discipline and rigor in their own business planning, particularly through the adoption of a risk management methodology. There is a growing appreciation that, to be effective, business planning must consider all of the risks to the achievement of organisational objectives, be they financial, legal, operational or compliance.

The internal audit department must respond in kind to these changes in approach. Its own planning should reflect the organisation’s business planning and align their audit effort with the key business objectives and the critical business risks. Internal audit should be demonstrating the necessity and effectiveness of a systematic approach to risk management.

More advanced internal audit departments will not just respond to the business risks identified by management, but will engage management in a debate as to what the key business risks are and encourage their involvement in assessment, prioritisation, treatment and review of identified risk for better performance. An Institute of Internal Auditors Research Foundation research project noted the major role being played by internal audit in the operation of risk management systems:
Incorporating the organisation’s view of strategic risk in developing the audit universe.

Developing a risk-based audit selection process (model) for the annual schedule of audits.

Monitoring the annual business plan and the annual audit plan for changes in risk priorities.

Using risk-based internal auditing techniques in performing the audits.

Reporting back to management and the board the results of audits using the language of risk frameworks rather than control frameworks (see page 15).

**Getting the product mix right**

An important consideration for internal audit when planning its program of coverage is the appropriate ‘product’ vehicle for delivery of its service.

There is a continuum of client needs ranging for assurance to process improvement, which can be matched to a range of products—from the traditional audit through to ‘consulting’ activities. Matching the product to best meet the needs and getting the mix of products right is very much an issue for my own organisation at the moment in terms of our own business.

There is a recognition in the public sector that the Parliament expects, and I suggest the same applies to private sector boards, some attention must always be paid to legal adherence, financial control, fraud awareness, prevention and detection, privacy and security. In these regards the traditional, compliance-based audit has its obvious place. The extent to which it can be replaced by, or complemented by, self-assessment activities is, as discussed previously, a question of balance based on proper risk assessment and establishment of priorities in relation to business objectives and resource availability.
By way of contrast, assisting line management to improve productivity, cut costs or increase profitability would not be the normal consequence of a compliance-based audit, particularly one undertaken under the traditional approach of reviewing past activities and events.

To be responsive and timely, internal audit needs to consider how it can actively participate in problem solving projects; the possibility of pre-auditing; real-time auditing, say on systems implementation; and the extent and nature of its participation in an organisation's benchmarking, business process reengineering and quality management initiatives.

It needs also to address the composition of its audit teams if it is to undertake these activities—in terms of the range of skills experience and relevant background required of its internal auditors; and in terms of the use of operational staff on its teams. A particular, and growing, requirement of internal audit management, at least in the APS, is to oversight effectively outsourced internal audit activities. In particular, we need to have the capacity to do so.

Integrated audits examining financial, operational and compliance issues, using multi-disciplinary teams, reflect one approach that is growing in popularity for internal audit. But this has severe limitations, in my view, for external audit particularly given the critical legal and other obligations associated with auditing of financial statements. Nevertheless, in whatever manner audit teams are organised, there is a clear requirement for integrated planning and delivery of audit services to maximise their impact on management decision-making and be clearly seen to add value.

**Process improvement**

Opening and maintaining a constructive dialogue with its key stakeholders; aligning its audit effort with the key business risks of an organisation; and considering the design and mix of its audit products to best meet the needs of its clients; are all important strategic responses to the changing business environments in both the public and private sectors. They will undoubtedly have a major impact on whether internal audit is considered to be relevant and will remain relevant to its stakeholders.
These approaches are not, however, a guarantee of survival. Internal audit is, from one perspective, simply another business process. More importantly, as with many other support functions and activities, its contribution to the ‘value chain’ is at best indirect and often invisible. How, for example, do you value the ‘assurance’ role? How do you respond to the mantra ‘add value or die’?

In addition to looking outwards at the needs of its stakeholders, internal audit must introspect, and like any other business process, ensure that it is cost-effective—that it provides the ‘biggest bang for the buck’ and can be relied on. A particular challenge is the way we use, and interact with, information technology both as an audit and business tool. The ‘paperless office’ has created both efficiencies and areas of contention, for example, in relation to access to E-mail and the evidentiary nature of electronic data.

This requires a culture of continuous improvement. It demands the development of balanced indicators of performance, preferably with input from the audit committee and line management. Ideally these indicators should be benchmarked against other internal audit departments.

The discipline of the ‘process improvement cycle’ discussed earlier, can easily be applied to the internal audit function and readily translated to the private sector for this purpose. It commences with the most fundamental question, should we be undertaking this activity at all?

The ANAO is presently undertaking or planning a number of benchmarking studies in the areas of financial management covering the finance, human resources and internal audit functions. We are in our second year of examination of the internal audit function in the public sector and are due to publish the results of this study shortly.

It is an interesting, though not unexpected, result from such broader benchmarking studies that those organisations which benchmark themselves tend to outperform those that do not, in
terms of both cost and quality indicators. The clear implication is that measurement is a critical part of process improvement.

In the Internal Audit benchmarking study, ANAO Report No.46. 1997-98. ‘Internal Audit’, Canberra, May. The ANAO used an international database maintained by the Institute of Internal Auditors in the United states of America entitled the Global Audit Information Network (GAIN) to benchmark the audited organisations against international best practice. The ANAO report covered 49 respondents that expended $25.7 million on internal audit resources for the period ended 30 June 1997. The survey included organisations with in-house, contracted-out (outsourced) and mixed (co-sourced) internal audit resources. using data from the United States Global Audit Information Network (GAIN) for comparative purposes, we focused on the use of Key Performance Indicators (KPIs) by internal audit in the Commonwealth sector. It was a very positive sign that 68 per cent of the 49 organisations surveyed indicated they used KPIs to evaluate their own performance.

The KPIs regarded as most important by these organisations were (in order of priority):

_ percentage of tasks completed compared to approved audit plan;
_ percentage of audits completed within budget and agreed timeframe;
_ percentage of recommendations accepted and implemented;
_ audit client satisfaction rating; and
_ number of complaints received about internal audit.

It is pleasing to see that these indicators reflect a balance of cost, time and quality measures and emphasise outputs and to some extent outcomes, which are always difficult to measure. Qualitative assessment has become somewhat of a challenge particularly in terms of client satisfaction and the use of reliable survey methodology and analysis.
The candid reporting of such performance measures to the audit committee and other key stakeholders within the organisation is an effective way to complete the dialogue loop that commenced with the audit planning phase. It also demonstrates a commitment to process improvement. As in all management tasks good communication is essential. In that respect you may be interested in a U.S. study which outlined five basic elements of effective audit reporting - solid audit substance, sound logic, balanced tone, visual clarity and sound mechanics. Lessans Carol S. And Roslewicz Thomas D. 1999. ‘Effectively Communicating Audit Results - A Formula for Success’. The Government Accountants Journal Vol.48, No.1, Spring (page 25). The following is the checklist for report writers and reviewers:

Solid Substance: Does the report have all the attributes of a finding?  
Sound Logic: Does the report make sense, and is it easily readable?  
Balanced tone: Does the report present a balanced tone, one that is respectful of the auditee?  
Visual Clarity: Does the report’s appearance guide the busy reader through the logic of the material?  
Good Mechanics: Do the report’s words and sentences clearly and effectively communicate the message?

RELATIONSHIP WITH EXTERNAL AUDIT

I would like now to turn to the relationship between internal and external audit. I have pointed to some of the important implications of the growing convergence of the public and private sectors. I also contend there is a similar growing convergence of interests between the external and internal auditor. The Auditing Standards have always assured a degree of complementarity but we are looking at more than this, for example, in audit approaches and initiatives; analytical techniques; interrelationships with various stakeholders, as well as reporting; and implementation of recommendations, including assessment of our own performance. A particular challenge is to provide assurance about the ‘ethical’ use of resources which is as much about the higher risk environment confronting us as it is about legislative requirements.

Much of any convergence is driven by the common needs of our audit clients in terms of their own corporate governance responsibilities. From an external audit perspective the governing
bodies and line management of our audit clients are asking us to add value by providing more comprehensive assurance about their financial management and control environments and by contributing to strategies for better performance. However, the audit community at large will need to become more skilled than we now are in assessing performance measures and results in particular in relation to concepts of outputs and outcomes in the public sector and their interrelationships. As well, we do not get together as much as we should to be more effective as the following GAIN survey data show.

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<th>Commonwealth Govt. Group</th>
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<td>% answering Yes</td>
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<td>Did Internal Audit conduct joint annual planning sessions with External Audit?</td>
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<td>Did Internal Audit and External Audit conduct joint risk or control sessions?</td>
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The above data indicate that around half Commonwealth Government Internal Audit Units do not conduct joint annual planning sessions and only a small percentage jointly consider risk and control issues with external audit. On both metrics we perform worse than the global benchmarks, particularly in relation to risk and control.

The ANAO is responding to these demands by also developing a business oriented, risk-based approach to our financial and other audit services. A key success factor in this respect is the imperative to know and understand the ‘business’ we are auditing. There is a clear corollary between the information needs of the external and internal auditor in this regard. It is this point, perhaps more than any other, the sharing of common information sets and the leverage to be made from this, that will ensure our approaches are compatible and directed toward meeting the needs of our clients in the most cost-effective manner.
In practical terms, this requires close interaction in the respective planning cycles of internal and external audit as well as with any other related evaluations and reviews.

As noted above, my own Office is also examining the nature and mix of its products. It is clearly important that our combined activities avoid duplication and where possible enhance and strengthen each other’s position. This requires a strong partnership forged again based on an open and effective dialogue and, dare I say, trust and mutual confidence. The focal point of this dialogue is in the Audit Committee in my view. In turn, the Committee should provide a pathway to the CEO and/or any Board.

As I have mentioned, the ANAO is embarking on a program of quantitative benchmarking studies in relation to resource and financial management. These studies complement our better practice guides which focus on qualitative benchmarks in these areas. It is our expectation that the results of these studies and content of these guides will be able to be used by internal audit to assist it, together with management, in diagnosing those functions and activities that require improvement.

In recent years we have prepared a number of Better Practice Guides of relevance to internal audit such as Audit Committees (July 1997), Controlling Performance and Outcomes (December 1997) and New Directions in Internal Audit (July 1998).

CONCLUSION

In closing, it is clear that many challenges are increasingly being shared by internal audit groups in both the public and private sectors, with their growing convergence, as well as by internal and external audit generally under the audit umbrella. The accent continues to be on our professionalism, independence and integrity.

Effectively integrating internal audit into the corporate governance framework of an organisation; and adopting a business risk approach which is responsive to changes in the internal and
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external environment, and which is predicated on ongoing communication with key stakeholders; should ensure that internal audit continues its evolution as a source of independent and trusted advice and assurance to key stakeholders and maintains its relevance to the successful management of an organisation, including its performance.

A strategic, forward-looking approach is called for. In this respect, it is pleasing to see the internal audit profession taking the lead. It is incumbent on us all, as professionals, to contribute positively to this debate. The future is very much in our own hands. The lesson from recent years is that there is no White Knight defending our cause or providing us with a place in the sun. Perhaps we have not ‘sold’ ourselves and the value we can add to an organisation as well as we might have. However, time is running out as others are quite willing to fill any gaps.