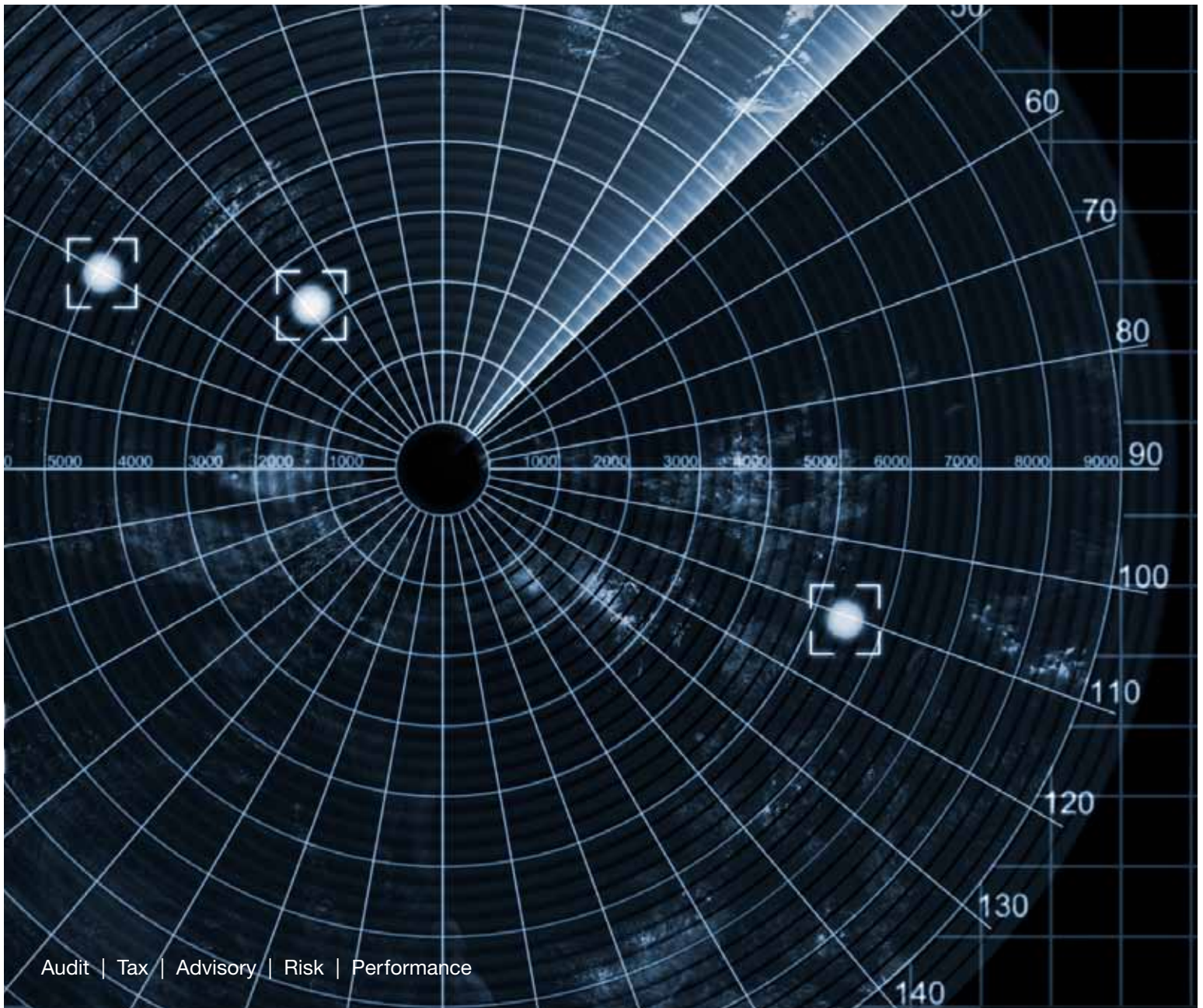


Taking Internal Audit to a Strategic Level

Identifying, Assessing, and Managing Risk

A Crowe White Paper by William C. Watts and Bart W. Kimmel



The new internal audit model, as outlined in “A New Decade, a New Internal Audit Model,”¹ leverages existing activities to continuously monitor, manage, and improve business performance based on four key auditing principles: assurance,² performance improvement,³ compliance,⁴ and risk identification and assessment. This white paper addresses the opportunity for internal audit to take its role in risk identification and assessment to a strategic level.

Protecting business from the aftereffects of the 2008 financial meltdown is topmost in the minds of business leaders, political leaders, regulators, and investors. New threats and vulnerabilities emerge daily that can put organizations' mission-critical objectives at risk.

Companies that spend time understanding, managing, and navigating risk – from a business-unit level to an enterprisewide view – benefit from critical insights into risk that influence sound strategic decision-making. To capture the nuances of today's broad and complex risk environments, however, organizations' executives must adopt a new approach to risk management.

The Four Principles of the New Internal Audit Model



Internal audit can play an essential role in the shift to a proactive risk management model by integrating the identification and assessment of enterprisewide risk into the audit plan. The insight internal audit gains from these activities and communicates to senior management and the board of directors can make risk management efforts more relevant, reliable, and resilient. It can also move internal audit into a strategic advisory role through dialogue that helps management better understand risk in relation to the vision and objectives of the organization.

Trends

In today's global business environment, organizations are increasingly vulnerable to social, political, and economic forces. An organization unable to identify change as it unfolds in the business environment – and react to the potential consequences of that change – is at risk of missing opportunities or taking on more risk than the organization can bear.

Internal audit will benefit from willingly and proactively taking on a leadership role and helping the organization move toward an enterprisewide risk management model.

Excessive risk-taking fueled the worst financial crisis since the Great Depression, pushing AIG, Lehman Brothers, and many other companies to falter. The struggles of these companies to survive clearly demonstrate how fundamental risk management is to preserving the long-term viability of business. The rapid progress of globalization, changes in industries and markets, and advances in technology, among other trends, require that business leaders and supporting functions move toward an enterprisewide, risk-based management model that is capable of continuously capturing and responding to significant risks on a day-to-day basis.

By willingly and proactively taking on a leadership role in shifting the organization to an enterprisewide risk management model, internal audit:

- Becomes fundamental to business operations;
- Adds value to the organization through broad-based, ongoing risk oversight;
- Moves into a strategic-level position; and
- Further integrates risk management considerations into leaders' decision-making.



Challenges

Most organizations recognize the need to understand risk better, and many boards of directors and CEOs are already turning to internal audit as the department best suited for the job. By conducting traditional internal audit activities, most auditors have experience with quantifying and analyzing business-unit risks. However, in taking on enterprisewide risk identification and assessment at the strategic level, internal audit faces several challenges.

Enterprisewide View

Internal auditors' traditional focus on the financial processes and procedures of individual business units needs to be broadened to uncover and assess risks that threaten the organization as a whole. For example, many audit plans do not include an assessment of risks associated with cloud computing or social media, although their use is widespread and could pose significant threats to an organization.

Senior-Level Advising

As the demand increases for auditors who can provide effective forward-looking advice, not all internal audit departments will be prepared to take on a new role. The transition from financial auditor to risk adviser and leader requires a sophisticated set of skills and an understanding of financial, environmental, economic, systemic, and often global underpinnings of the organization that might go beyond the general expertise of the traditional internal auditor. Additional training may be necessary to increase internal audit's business acumen and create a higher level of comfort among company leaders that internal audit is capable of, and committed to, stepping into a role as a risk adviser at a strategic level.

Culture of Enterprisewide Risk Awareness

Internal audit efforts to identify and assess risk should open management's eyes to the link between managing risk and achieving strategic initiatives. For example, water damage to highly sensitive equipment at a manufacturing plant could cause a production shutdown. The production shutdown might be a strategic risk that could negatively affect sales goals and customer retention. As such, the threat of water damage is a strategic-level risk that should receive a high priority in risk mitigation efforts.

Principal Benefits of an Enterprisewide Risk Identification and Assessment Project

1. Links risk management to important business initiatives.
2. Fosters a culture of risk awareness that begins with leadership's tone from the top.
3. Accurately identifies the risks that are critical to the company.
4. Provides a road map for internal audit planning that focuses on areas critical to leadership.
5. Validates risk, reveals hidden risks, assesses control gaps, and generates insight into better ways to manage risk.

Solutions

The time has come for all companies and the audit profession to shift to a more proactive role in identifying and managing risk across the enterprise. Making this shift starts with completing an enterprise risk identification and assessment project.

Assume a Role in Risk Management

Internal audit must decide on its role in the organizational transition to enterprisewide risk management. This role will vary from organization to organization, depending on the degree of senior-level involvement in risk management efforts. When no senior-level executives have championed a formal enterprisewide risk management program, internal audit's role might be to create awareness and buy-in at the senior level. When a chief risk officer, treasurer, general counsel, or other senior member of a company's leadership team is assigned the responsibility for implementing a risk management program, internal audit's role should be more focused on two primary areas: 1) participation in the identification and assessment of enterprise risk; and 2) the assessment of the effectiveness of the company's enterprise risk management program.

Initiate and Execute a Risk Identification and Assessment Project

Regardless of the extent of its role in risk management, internal audit might need to gain senior-level support for its changing role. By conducting an enterprisewide risk identification and assessment project, internal audit can demonstrate the relevant value and actionable results that the function can bring to risk management efforts.

An enterprisewide risk identification and assessment project entails taking four primary steps:

- 1. Create a comprehensive risk inventory.** Internal audit can use ongoing monitoring and review methods to identify and assess risk throughout the organization. A number of different groups in a company are likely to be performing risk management activities already – for compliance or safety purposes, for example. Internal auditors can use the existing assessments of each group to begin to build a comprehensive risk inventory of critical risks and concerns that the company faces. One-on-one interviews with company leaders can provide internal audit with an additional layer of understanding. Each individual might identify different critical risks, depending on his or her role, responsibilities, and point of view. Using the information from existing assessments, interviews, and continuous monitoring of controls and the outside environment, internal audit can create a comprehensive inventory of risk.



Use the results of the risk identification and assessment project to foster conversation around the leadership table.

- 2. Assess and prioritize the risk inventory to develop an understanding of the company's risk landscape.** A risk landscape is a snapshot of risks, by priority, that a company faces. Internal audit must help define an organization's risk landscape by bringing together company leaders to form a consensus about the prioritization of identified risks. Priorities are based on the potential impact, likelihood, and control effectiveness of each item in the risk inventory. Management's top-of-mind issues – such as financial strategy, business imperatives, product quality, and market share – also factor into the risk prioritization process and therefore the risk landscape. By helping to define a leadership-approved risk landscape, internal audit focuses attention on opportunities that could be leveraged and exposures that might negatively affect a company's strategy. The critical risks – those that matter most to stakeholders – are kept in the sharpest focus.
- 3. Analyze the risk landscape to focus audit efforts.** Internal audit has been in the business of risk quantification and analysis for years. Now these techniques can be applied to enterprisewide risks and summarized in concise, relevant, and actionable reports for senior management, audit committees, and the board of directors. Based on the results of the risk assessment, internal audit can create an audit plan that is aligned to management's objectives and goals for the company.
- 4. Assume an advisory role at the leadership table.** Use the results of the risk identification and assessment project to foster conversation around the leadership table. Ongoing dialogue can serve to highlight changes in the risk landscape, including emerging or previously overlooked risks. It also can lead to a better alignment of risk mitigation strategies with business initiatives.

By developing an approach to identifying and assessing risk that fits the size and complexity of the organization, internal audit can effectively contribute to enterprisewide risk management efforts and help point the way to better risk management practices.

Conclusion

Internal audit's move to embrace a leading role or play a supporting role in a company's risk management effort has far-reaching consequences. Audit teams that do not extend their role to include enterprisewide risk identification and assessment are in danger of becoming obsolete. Only by moving toward an enterprisewide risk management model can internal audit remain relevant, current, and valuable to the organization.

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¹ Lawrence A. Rieger and Rick Julien, "A New Decade, a New Internal Audit Model," a Crowe white paper, 2010; <http://www.crowehorwath.com/folio-pdf/Internal-Audit-Model-RISK9122.pdf>

² William C. Watts and R. Michael Varney, "Six Steps to Systemic Assurance That Increase the Value of Internal Audit," a Crowe white paper, January 2011; <http://www.crowehorwath.com/ContentDetails.aspx?id=1854&terms=six%20steps>

³ Patrick D. Warren, James Hannan, and Craig P. Youngberg, "Internal Audit Leads the Way to Performance Improvement," a Crowe white paper, 2011; <http://www.crowehorwath.com/ContentDetails.aspx?id=2182&terms=internal%20audit%20leads%20the%20way>

⁴ Gregory B. Hahn and Eric Durham, "Internal Audit Raises the Bar on Compliance," a Crowe white paper, 2011; <http://www.crowehorwath.com/ContentDetails.aspx?id=2791&terms=internal%20audit%20raises%20the%20bar>