

Risk Insights

Developing a Continual Internal Audit Presence



THE INTERNAL AUDIT STRATEGY provides the foundation for development of an organization's internal audit function. That strategy acknowledges unique factors affecting the organization and aligns with its business strategies. The internal audit strategy is articulated in the internal audit charter, which provides a framework of principles and objectives that guide all activity.

With the development of the audit function, the organization builds and maintains an in-house presence for continually monitoring risks associated with asset protection, loss prevention and compliance efforts throughout the organization. Through the execution of individual internal audits, controls and processes in place to mitigate risks are evaluated, enabling the organization to determine the effectiveness of those oversight efforts. Development of the internal audit function also gives the organization the necessary expertise for devising and implementing annual internal audit plans.

The internal audit department serves the organization in a broad monitoring capacity. While external financial audits focus exclusively on risks related to financial reporting, internal audit evaluations identify and assess potential operational risks throughout the organization, as well as risks associated with financial reporting and information technology activities. Based on those evaluations, the board of directors and management can determine whether those risks align with the organization's risk appetite and what responses are needed to mitigate any risks deemed unacceptable.

Principles for Developing the Internal Audit Function

TO ENSURE THAT internal audit assessments cover any relevant potential risks and related controls, all areas of the organization must be open for internal audit, and all areas must receive attention by the internal audit department. Assessments gleaned from those expansive evaluations allow management to make more informed decisions—decisions that enable the organization to identify and mitigate unacceptable risks, decisions that promote long-term growth. By exercising such oversight, the internal audit department also provides assurance to employees, investors and other stakeholders.

Applying Risk Assessment Evaluations to the Internal Audit Universe

USING RESULTS FROM an organization's risk assessment offers a basis for developing the internal audit universe, which provides a structure for rating and organizing items to be addressed in internal audits. The internal audit universe focuses on risk factors that influence the organization, such as inherent, financial, fraud, operational, compliance, technology, reputational and regulatory risks relevant to the specific organization.

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Risks differ from one entity to another, and the internal audit universe must reflect the organization's business and internal audit strategies. Within that perspective, the internal audit objectives must address entity-level and process-level risks. A metal-plating company, for example, may face an array of entity-level risks, including changing customer preferences, cost increases for materials, potential liability exposure or the possibility of more stringent regulatory requirements. While all of those risks need to be considered as part of the company's overall risk assessment and enterprise risk management efforts, only certain ones may be effectively addressed by the internal audit function.

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The internal audit department would monitor related process-level risks, including the operational risks associated with properly storing, handling, treating and disposing of the various chemicals used in metal-plating operations. Such an assessment addresses whether or not actual practices conform to internal policies and whether or not those policies are effective in mitigating risks. That evaluation also monitors whether those activities are conducted in compliance with current workplace safety, environmental protection and other regulatory standards.

Risk assessments for internal auditing purposes consider the potential impact of a risk, the likelihood of it occurring, as well as the quantitative or qualitative nature of each risk. Those assessments also consider the effectiveness of related internal controls. In a manufacturing facility, for example, the collapse of an overhead crane during production hours would be catastrophic. Evaluations might reveal, however, that regular, prescribed schedules for inspections and preventative maintenance are followed, with detailed documentation archived for each inspection and maintenance activity. With such efforts, the risks associated with a crane collapse are effectively mitigated.

An assessment of the various IT elements used throughout the company may yield different results. Incompatibilities between legacy hardware or software and newer technology may require manual intervention to transfer data from one system to another. Such manual intervention presents inherent risk for errors. Some of the controls surrounding those IT-driven processes may rely on manual activities, too. Manual processes may be used, for example, to reconcile operational metrics or balances for some accounts. That activity presents further inherent risks to data integrity across systems. Some of the data affected by those manual interventions and reconciliations may also support significant accounts—those that have a material impact on the company's financial reports.



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Based on risk assessments conducted throughout the organization, the internal audit department develops the risk-rated internal audit universe. That universe includes all items that require monitoring and that should be audited. Each item is rated on a risk scale, such as a scale of one to three, with three representing the highest level of risk, two indicating a moderate level of risk, and one signifying a low level of risk.

Using the Risk-Rated Universe to Plan Annual Audits

THE RISK RATING ASSIGNED to each item in the internal audit universe will provide prioritization in the risk response plan. The risk response plan will include the efforts in place across the organization to mitigate or monitor the risk for that process area. This includes internal audit activities and will be used to determine the frequency of auditing for the process area. The risk response plan commonly uses a three-year rotation for internal audit and may range from once a year to once every three years, or for very low risk areas, never. Reviewing such ratings enables the internal audit department to devise annual audit plans that include items requiring examination that year.

Processes with the highest risk ratings merit more attention on the risk response plan and by the internal audit department. Such processes include crucial financial reporting functions, as well as pervasive operational processes that present considerable potential risks to the organization. Certain moderate risk processes may not be routinely monitored and therefore would have an increased effort of internal audit over those processes that have recurring monitoring.

Considerations besides risk ratings also determine what areas require inclusion in the internal audit universe. Some items must be evaluated annually to meet various compliance requirements. A review of the past year's audit may also highlight vulnerabilities, exposures of misstatement, or errors in the process to identify the audit objectives. Those issues need to be addressed in the annual audit plan, as well.

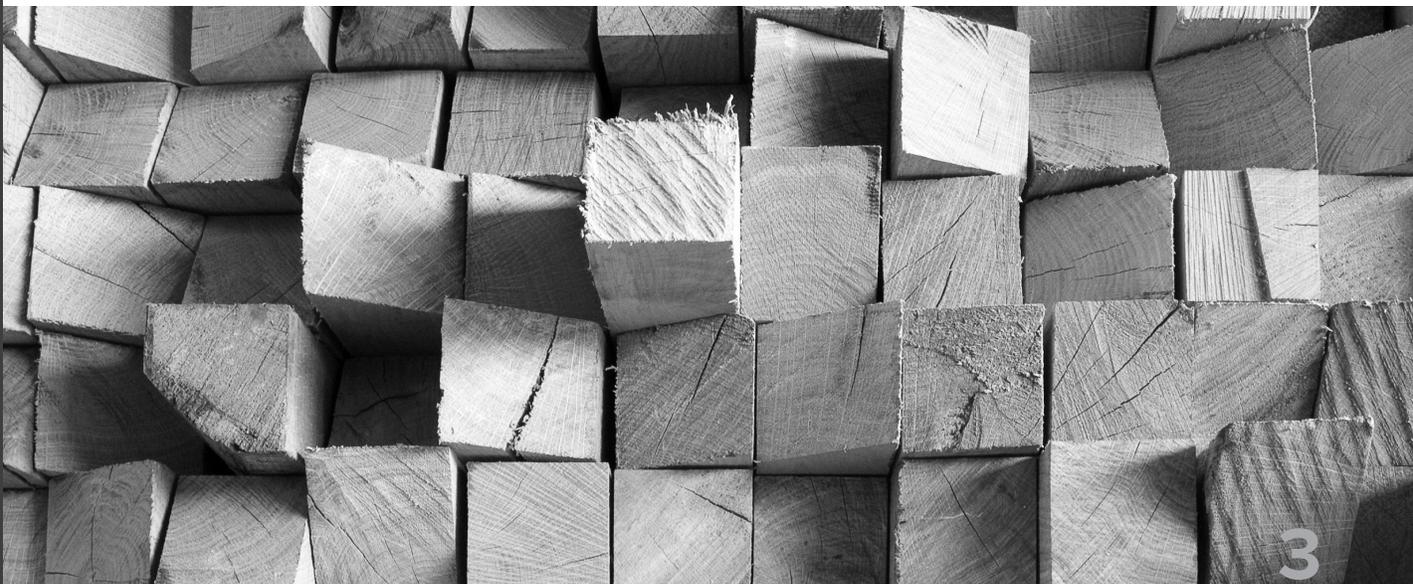
Such evaluation promotes continuous improvement and helps ensure that all items requiring attention receive the appropriate amount of monitoring in each annual audit.

Staffing the Internal Audit Function

ORGANIZATIONS VARY IMMENSELY with respect to specific internal audit needs. Variances may include company size, business strategies and risk appetite influencing the volume of necessary internal audit monitoring activity. Such factors help determine the proper size and staffing requirements of the internal audit function.

To properly address specific needs, the internal audit department should be staffed with individuals whose skill sets include management planning and review, financial reporting and IT operations. The internal audit function may also need to deploy specific industry expertise or regulatory knowledge based on the industry that the organization operates within.

The volume of audit work defined by the internal audit plan based on the risk-rated universe determines the appropriate staffing level for the organization. That volume of annual work may not equate to an exact number of staff members. Organizations vary, too, in the number of staff members they need for each skill set. To address either scenario, organizations may outsource some internal audit work to attain optimal staffing and skill set levels.



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Residual Benefits of Developing the Internal Audit Function

THE INTERNAL AUDIT STRATEGY provides a foundation for development of the internal audit function. That development gives the organization a means for continually monitoring the risks associated with asset protection, loss prevention and compliance efforts.

The internal audit department and the internal audit universe can then be expanded to accommodate organizational growth and any changes facing the entity. That provides the means for conducting individual annual audits. Depending upon the organization and its circumstances, internal audit findings may also be applicable to external financial audits.

By continually identifying and assessing risks, the internal audit function provides the board of directors and management with the information they need to determine whether or not risks align with the organization's risk appetite. Through applying enterprise risk management principles, unacceptable risks can be mitigated. That safeguards the organization, nurtures its growth and provides ongoing assurance to all stakeholders.

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- Business process improvement
- Contract monitoring and compliance
- Enterprise risk management
- Internal audit
- Internal control evaluation
- Integrated financial and IT audit
- Performance audit and measurement
- Regulatory compliance
- Risk assessment
- Sarbanes-Oxley compliance

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