

# Risk Insights

## Refocusing the Internal Audit Function



### Adding value across the organization

**THE BUSINESS CLIMATE HAS CHANGED** amidst the recent economic difficulties most organizations have experienced. New risks that influence business success have arisen. These challenges illustrate the importance of identifying and assessing strategic risks. Strategic plans focused on introducing new products, entering new markets, changes in the sales model, outsourcing functions or undertaking other substantial change also expose organizations to new vulnerabilities. Internal audit can play a vital role in identifying and monitoring strategic risks across the organization.

Organization leaders increasingly view recognizing and responding to strategic risks as having higher value than addressing process level risks related to assurance or compliance needs. They also periodically reevaluate the cost and incremental value of many established functions, including the internal audit function. The internal audit function in every organization should be devised to provide insight, objectivity and assurance to senior management.

Emphasis on addressing strategic risk and justifying costs presents opportunities to refocus the internal audit function — one that enables the organization to take a more proactive approach toward addressing strategic vulnerabilities and process level risks within various business units and departments.

By becoming a partner in identifying exposures and potential enhancements throughout the organization, the internal audit function becomes a catalyst for continuous improvement.

### Initial Steps in Refocusing the Internal Audit Function

**AT THE CORE OF THE DEFINITION OF INTERNAL AUDIT** is “independent, objective assurance and consulting activity designed to add value and improve an organization’s operation.” The internal audit function is designed to accomplish this through a systematic, disciplined approach to evaluating and improving risk management, control and governance. Further, internal audit has the vantage point to provide independent and objective insight across the organization. As such, internal audit leaders need to consider the organization’s key stakeholders and their expectations, as well as the organization’s business objectives and business model.

## Refocusing the Internal Audit Function

Audit committee members and senior management concern themselves with an organization's business strategies and the risks accompanying those strategies. External auditors need assurance that information presented in financial reports is complete and accurate. Regulators place various compliance requirements on certain industries and public companies.

Identifying the strategic initiatives of senior management and mapping those to the internal audit contribution is an initial step for enhancing the value of the internal audit function.

Every organization is unique in its strategies and the vulnerabilities it faces based on its specific operations and initiatives. Global economic integration of business units, product expansion, sales model changes and reliance on outsourcing partners are examples of such initiatives. While senior management is concerned with risks surrounding those strategies, business unit managers are concerned with operational aspects and potential opportunities for improvement.

Understanding business initiatives and related strategic and process level risks allows the internal audit function to modify its overall approach, serve as a partner to business unit leaders and meet the core requirements of all stakeholders.

### Aligning the Internal Audit Function with Key Business Objectives and a Business Model

**ALIGNING THE INTERNAL AUDIT FUNCTION** with the organization's strategic objectives requires recognizing potential vulnerabilities that may arise within 12, 24 or 36 months of pursuing those strategies.

Key performance indicators (KPI) throughout the business operation measure the effectiveness of performance and the implementation of key strategies. As a partner to the business, internal audit should then identify the complementary key risk indicators (KRI) to the identified KPIs to monitor the risks that may signify potential future declines.

KRIs serve as leading indicators of organizational performance; whereas KPIs are based on events that have already occurred, such as changes in sales volume or inventory levels. Determining what KRIs will reliably predict a KPI decline provides an organization with early alerts for potential adverse events.



## Refocusing the Internal Audit Function

A retailer's strategic plan, for example, might include opening stores in regions where automotive industry companies are large employers. A slowdown in new car sales might serve as a KRI, an indicator that those companies will reduce overtime costs or institute layoffs within 12 to 24 months. Those actions would cause a drop in local consumer income. Based on that KRI, the retailer could then scale back or delay its expansion plans.

“Fraud is a **substantial vulnerability** for all organizations, and the internal audit function should still maintain a leadership role in initiating **fraud prevention and detection measures.**”

In determining KRIs, internal audit leaders can work with the business unit to review historical adverse events and identify factors that preceded those events. Industry-specific insight also helps in identifying the most appropriate KRIs and in identifying risk factors in general. Knowledge of KPI, KRI and industry-specific vulnerabilities enables internal audit leaders to identify and focus on mitigating strategic business risks. That focus then extends to related entity and process level risks.

Addressing the risks related to strategic vulnerabilities ensures that the internal audit function focuses most of its attention on the most crucial exposures. That emphasis provides direction for developing the internal audit plan and its specific examinations and metrics.

Fully realigning an internal audit function requires time. Attaining significant early success nurtures support and patience. Early efforts should focus on demonstrating the value the internal audit group provides throughout the organization.

### Determining Internal Audit Function Objectives

**BY PRIORITIZING STRATEGIC** and related entity and process level risks, the refocused internal audit function can drive value through sharing knowledge and insights with the business units to assist them in meeting their objectives. The internal audit function should deploy an integrated approach of risk mitigation and control assurance activities to each audit area.

Investors and other stakeholders value financial reporting assurance, and the internal audit function should continue to work with operational managers to design and then monitor internal controls to ensure completeness and accuracy in financial reporting. Among other items, such controls could include establishing uniform credit approval provisions and accounts receivable management practices across all business units. Subsequent monitoring would then center on adherence to those standards.

Fraud is a substantial vulnerability for all organizations, and the internal audit function should still maintain a leadership role in initiating fraud prevention and detection measures. IT reporting tools, for example, can capture and call out smaller, suspicious transactions that might have escaped scrutiny in previous transaction sampling practices. Implementing and using such capabilities is time efficient for the internal audit and provides a means for detecting suspicious activity much earlier and reducing revenue leakage.

Organizations face an array of compliance requirements, which are most efficiently met when required activities are embedded into job descriptions and everyday processes. Worksite safety inspections could be integrated within various individuals' routine duties. In another organization, someone's work responsibilities could include secure disposal of any paper documentation containing customer account numbers or other nonpublic information.

While addressing concerns specifically related to financial reporting assurance and compliance requirements, the internal audit function serves as a partner to business unit managers in promoting continuous improvement.

## Refocusing the Internal Audit Function

A manufacturer may face difficulties with inventory being misplaced. Those difficulties affect operational efficiency as well as accounting accuracy. The internal audit function might suggest a color coding or lot location system that enables individuals to easily identify where particular inventory items should be stored.

Individuals from different locations may be working together on a new product development project. Difficulties in locating current documentation may lead to costly delays, duplication of effort and overlooked errors. The internal audit function might recommend an online collaborative program that allows team members to more easily share and view each other's work and archive vital documentation.

Such efforts enable the internal audit function to focus on activities that mitigate vulnerabilities and enhance performance throughout the organization. The objectives of the internal audit function can then be incorporated in a purpose statement that defines the internal audit function's role in enterprise risk management, financial and operational assurance, compliance and operational improvement.

### Establishing the Internal Audit Function as a Valued Business Partner Across the Organization

**THE INTERNAL AUDIT FUNCTION'S TOP PRIORITY** should be assessing and mitigating risks related to business strategies. That priority should be documented in the internal audit charter and purpose statement. Updating and communicating the revised internal audit purpose is a starting point for creating a new value-added expectation to provide insight along with assurance when working with the business units across the organization. Once that priority is established, related assurance, compliance, fraud prevention, financial reporting and operational expertise coverage should be assessed as part of the staffing and deployment plan.

Identifying where greater efficiencies may be attained enables the internal audit function to make an effective transformation. Some current low-value audits may be eliminated. Other audits that address low or moderate-level risks may be conducted less frequently.

Compliance-related activities can rely on the work performed as part of business operations and can be streamlined. Within any organization, human resources,

legal, information technology and other functions have responsibilities for assessing risks throughout the organization. Building upon such existing efforts enables the internal audit function to more effectively address crucial vulnerabilities.

A particular control, such as an IT access restriction pertaining to credit card account security might address payment card industry (PCI) compliance, as well as other regulatory requirements. Identifying instances where one control addresses multiple risks further enables the internal audit function to focus its resources in a more efficient manner.

Technology also reduces the amount of resources needed to identify and monitor vulnerabilities. Data mining and related reporting tools, for example, address entire data populations. Various analytics also provide context to activity reports.

“Beyond taking measures to **improve efficiencies**, the internal audit function can also take additional relatively easy measures to more fully understand **industry-specific factors** that affect the organization.”

Beyond taking measures to improve efficiencies, the internal audit function can also take additional relatively easy measures to more fully understand industry-specific factors that affect the organization.

Internal audit team members can join industry groups to provide opportunities to gain insight into particular risks facing the industry. Such involvement allows internal audit team members to develop a network of peers who face similar challenges. Becoming familiar with competitors or similar organizations also helps in learning best practices and with setting benchmarks for what constitutes acceptable and exemplary performance.

Overall, enhanced industry knowledge enables the internal audit function to direct its activities and measure itself in ways that directly link to organizational strategies and concerns.

### Developing the Internal Audit Plan

**THE INTERNAL AUDIT PLAN** should be revised based on the priority to cover strategic risks through various audit activities. Past audit plans may have been based upon a process level universe and shown to cover the financial and regulatory compliance activities first. With a refocused internal audit function, the plan should be linked to:

- Risks related to organizational strategic initiatives
- Risks at the entity and process levels that relate to those strategic risks
- Operational risks based on business unit feedback
- KPIs and KRIs to validate business unit performance
- Supporting assurance, compliance, fraud prevention, financial reporting and operations risks

A risk register should be maintained with critical risks mapped to the audit plan. Internal audit leaders then need to determine the appropriate methodologies, processes and infrastructure needed to execute the plan. Those methodologies include determining how to identify and evaluate risks and plans for executing the audit examinations. Utilizing the necessary software and IT tools enables auditors to automate many evaluations and thus accomplish more with the same resources.

Implementing the plan also requires staff that possesses the appropriate skills. These skills may include industry knowledge, ERP system and database expertise, data analytics, understanding of operational challenges and issues, accounting/financial reporting compliance requirements and IT security.

For organizations whose business relationships encompass foreign countries, internal audit staff should also be able to address international concerns, including compliance with the Foreign Corrupt Practices Act.

After evaluating current skills and training needs, internal audit leaders may determine that additional staff or training may be needed, or that some skills need to be attained through outsourcing.

Internal audit leaders then need to determine appropriate communications and reporting practices. Presenting the proposed plan to key stakeholders generates valuable feedback and support for risk and strategic goals coverage.

### Evaluating Current Staff Capabilities and Needs

**TRANSFORMING THE INTERNAL AUDIT FUNCTION** requires sufficient resource expertise and capabilities. Internal audit staff should include individuals with industry-specific knowledge and insight. Additional skills may be needed to address financial reporting, IT security or other vital concerns. Hiring decisions can be based on how well a candidate's background aligns with that skills inventory.

In some instances, those skills may be outsourced on an as-needed basis. When the skills are required consistently throughout the plan, they may need to be developed through training.



## Refocusing the Internal Audit Function

Additional full-time staff may be required. Hiring decisions should be based on the skills sets most needed. To attain other expertise that is not needed as frequently, internal audit leaders should consider outsourcing certain audits or compliance challenges that require particular insights and experience, such as the use of analytical tools or the review of documentation compiled for a specific regulatory standard.

### Establishing Measurement Standards for a Refocused Internal Audit Function

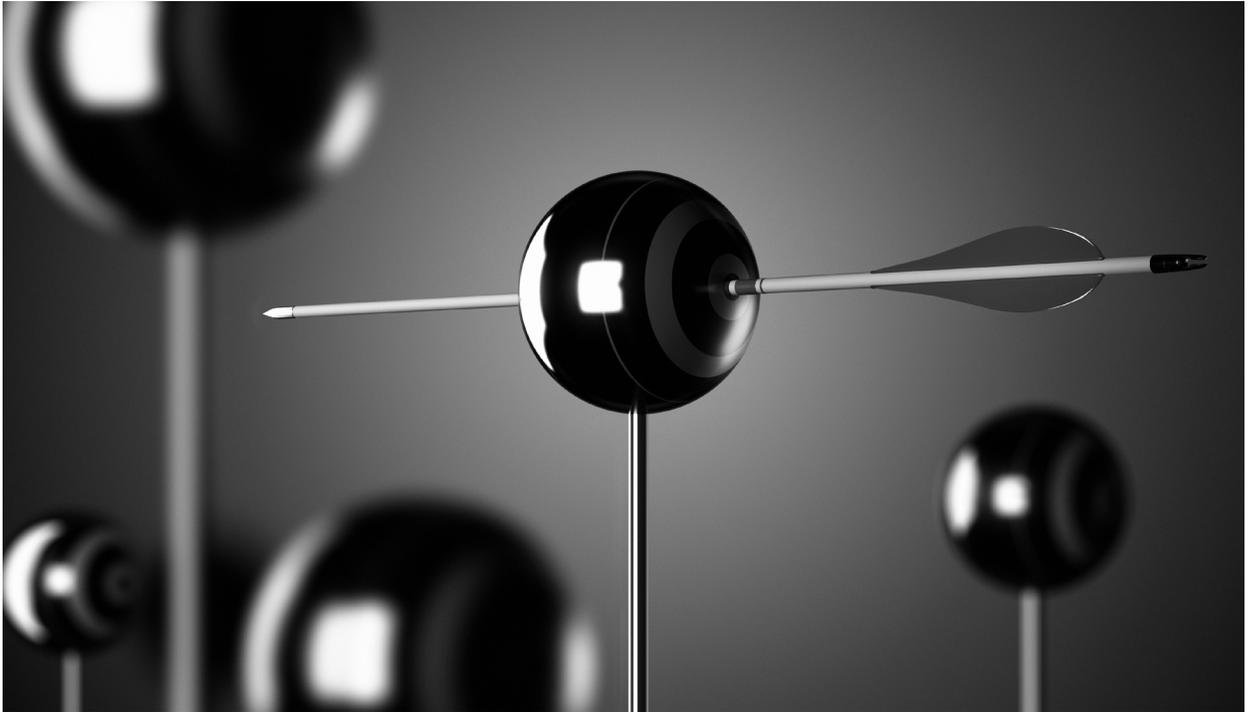
**KEY METRICS OF ACHIEVEMENT** of the plan are needed to measure the effectiveness of the internal audit function. Those metrics can include a listing of strategic/high risk areas addressed and documentation of examinations and reports completed.

“**Being aware** of different needs and preferences allows internal audit leaders to provide **added value** by reporting in ways that best meet the needs of key stakeholders.”

Other key metrics include recommendations made and accepted by the audit group; recommendations implemented with follow-up performed to ensure the corrective action covered the exposure identified; costs contained or recovered; and revenue enhancements identified and implemented.

Some reports can illustrate the insight provided by internal audit, such as the value of establishing and monitoring KRIs. A KRI may have indicated that a manufacturer would be facing substantial price increases for petroleum-based products. Early awareness of those pending price increases enabled the manufacturer to slowly adjust its product prices. The success in responding to that KRI could be illustrated in reports presenting the manufacturer's comparable increase in cost of goods sold and its sales revenues.





Different stakeholders have differing expectations, and the manner in which reports are prepared and delivered should reflect those differences. The audit committee and senior management, for example, want to periodically know how strategic risks are being addressed.

Business unit managers are more concerned with operational vulnerabilities and value the completion of efficiency and effectiveness of recommendations implemented by their groups.

Such reports may address any variances between established standard costs and actual costs. Material scrap rates may be used to measure the efficiency of production and quality assurance processes.

Business partners should receive more frequent updates of achievement and open items from internal audit. Being aware of different needs and preferences allows internal audit leaders to provide added value by reporting in ways that best meet the needs of key stakeholders.

### Evaluating Internal Audit Plan Results

**ONCE THE INTERNAL AUDIT PLAN** has been completed, leaders can evaluate its effectiveness in assessing risks, promoting internal improvement and in delivering added value.

Effectiveness in evaluating risks may be evaluated by how well crucial risks are identified and assessed. How well did crucial internal controls perform? Did the internal audit function receive positive feedback from the audit committee, senior management and business unit managers? The answers to such questions provide a basis for improvement.

Added value may be measured in numerous ways. Enhanced responsiveness to risk and adverse events provides immense value, as do improvements throughout the organization in accuracy and efficiency. Reduced revenue leakage, enhanced cash flow and cost savings that can be specifically attributed to following internal audit recommendations for improvement illustrate ways the importance of the refocused internal audit function may be measured. The results will reinforce that the internal audit function has provided insight, objectivity and assurance to senior management.

## Refocusing the Internal Audit Function

### The Immense Benefits of Refocusing the Internal Audit Function

**REFOCUSING THE INTERNAL AUDIT FUNCTION** transforms what may have been regarded as a required cost into an investment. Through refocusing, the internal audit function concentrates first on identifying the most crucial risks. That enables the organization to become more adept at recognizing and responding to potential adverse events and to also take advantage of opportunities.

The internal audit function then devotes greater attention to helping the organization become more efficient. That function also helps promote continuous improvement throughout the organization. Meeting the objective of providing assurance and consulting activity designed to add value and improve the effectiveness of risk management allows the internal audit function to truly be a partner to senior management.

With the advantages it can deliver, such an internal audit function gives an organization a competitive advantage.

## CONTACT US

**Alyssa G. Martin, CPA, MBA**

Partner-in-Charge  
Risk Advisory Services  
alyssa.martin@weaver.com

Weaver's risk advisory services are strategic, executable and measurable—and our nimble process is designed to help companies remain optimally functional as they identify and manage risk. We work closely with our clients to customize services that fit their existing staff structure and operations. Integral to this sensitive work, we believe our communication skills are as valuable as our technical knowledge and professional insight. You will experience thoughtful, purposeful communication throughout the process. Specific services we provide include:

- Business continuity planning
- 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

*Disclaimer: This content is general in nature and is not intended to serve as accounting, legal or other professional services advice. Weaver assumes no responsibility for the reader's reliance on this information. Before implementing any of the ideas contained in this publication, readers should consult with a professional advisor to determine whether the ideas apply to their unique circumstances.*

© Copyright 2014, Weaver and Tidwell, L.L.P.