

July
August
2007

INTERNAL Auditing



Risk Intelligence:
Internal Auditing in a World of Risk
The SEC's Guidance on Internal Control
Continuous Auditing and Digital Analysis

INTERNAL

Auditing

July/August 2007

Volume 22 Number 4

- 3** Risk Intelligence: Internal Auditing in a World of Risk
Eric Hespenheide, Sandy Pundmann, and Michael Corcoran
- 11** The Impact of the SEC's Guidance on Internal Control Over Financial Reporting
Brian Patrick Green, Michael Foran, and Bruce Bublitz
- 20** Five Years Out from Sarbanes-Oxley: The Flaws of the Dashboard Mentality on Ethics and Governance
Marianne M. Jennings
- 25** Continuous Auditing, Digital Analysis, and Benford's Law
Vinita Ramaswamy and John Leavins
- 32** The Effectiveness of Group Decision Support Systems for Internal Audits
Harold J. Lagroue III
- 40** **Corporate Governance and Internal Auditing**
COSO's Internal Control Guidance for Smaller Businesses
Audrey A. Gramling and Dana R. Hermanson
- 45** **Windows Audit Update**
Insight Into the Administrator Accounts
Derek Melber



RISK INTELLIGENCE:

Chief audit executives and internal auditors have an opportunity to add tremendous value to their organizations by taking a proactive approach to risk.

INTERNAL AUDITING IN A WORLD OF RISK

ERIC HESPENHEIDE, SANDY PUNDMANN, and MICHAEL CORCORAN, DELOITTE & TOUCHE LLP

Ask senior executives to identify their greatest concerns, and chances are risk management will rank high on the list—and with good reason. Debt-rating agencies, such as Standard & Poor's and Moody's, and many equity analysts now consider companies' enterprise risk management processes in their reviews. Shareholder activism and high expectations placed on the CEO and CFO have also sharpened the focus on risk management. And, of course, the main driver of risk management has been an increase in the actual risk of doing business. Developing new products, expanding into new markets, using third-party production and sales channels, and acquiring companies all elevate risk and are all ongoing activities in large companies.

These developments present chief audit executives (CAEs) and internal audit functions with an opportunity to increase their value to, and profile in, their organizations. Companies need internal audit's expertise to attain transparency and to improve their ability to execute against their business plans and governance responsibilities. Risk Intelligence—an integrated, proactive approach to risk management—gives internal auditors the means to seize the opportunity and to apply their expertise to risk management.

Internal auditors are uniquely qualified to help management identify, assess, and address risk. But assisting in those tasks in ways that truly serve management and other stakeholders presents its own set of challenges. Although they understand that risk tak-

ERIC HESPENHEIDE is the global leader for internal audit services at Deloitte & Touche LLP. He can be reached at (313) 396-3163 or ehessenheide@deloitte.com.

SANDY PUNDMANN is a partner in the internal audit services practice at Deloitte & Touche LLP. She can be reached at (312) 486-3790 or spundmann@deloitte.com.

MICHAEL CORCORAN is a partner in the internal audit services practice at Deloitte & Touche LLP. He can be reached at (404) 220-1729 or micorcoran@deloitte.com.

ing is a part of business decisions, many internal auditors, by training, temperament, and tradition, see risk mainly as something to be avoided, even eliminated whenever possible.

Meanwhile, management teams willingly (and hopefully knowingly) take on risk as a condition of creating value, particularly in highly competitive, fast-moving industries. Given internal audit's traditional role of value preservation, most audit committees and management teams expect CAEs and internal auditors to talk in terms of risk avoidance and strong controls, and often hear internal auditors' opinions about risk through those expectations.

But CAEs can alter those expectations and can play an instrumental role in addressing risks, without compromising internal audit's mission. This requires an understanding of risk taking for reward and of how internal auditors can best assist management in assessing and managing risks. With that understanding, you can frame discussions about risk in terms of value creation as well as value preservation.

Advisors, not owners

Of course, internal audit does not own the risks being managed. That ownership goes to the managers of the functions associated with the risk, as delegated by the board of directors in the case of publicly traded companies. Internal audit's objective role positions it to advise management on acceptable risks as well as how to avoid unnecessary risks—a critical and oft-neglected distinction. Indeed, internal audit is uniquely positioned to discuss all dimensions of risk, and to act as a voice of reason as management addresses the myriad risks facing today's businesses.

Considering the perils inherent in today's business environment, management certainly needs an objective source of information, metrics, and judgments about the downside difficulties as well as the upside opportunities of a course of action. In most enter-

prises, an optimistic, if not blindly enthusiastic, mindset quickly attends a management decision after it is made. This is particularly true of decisions associated with value creation, such as pursuing a new market or developing a new product.

The sooner internal audit is engaged with management on such decisions, the better. Ideally, entry should occur in the analytical stages of decision making or during implementation planning. After-the-fact involvement leaves internal audit in a defensive posture or relegated to rubber-stamp status, too late to the party to exert any meaningful influence on the outcome.

For instance, significant risks attend most acquisitions, despite a good amount of due diligence conducted by multidisciplinary teams. Those risks arise around strategy; intangible assets; contingent liabilities; and integration of legal, financial, reporting, and operational systems. An acquisition potentially puts a company's brand and reputation, as well as customer, supplier, and competitor relations, at risk.

One cannot expect legal counsel (let alone the investment bankers) to identify all downside risks posed by an acquisition. However, these must be identified, and internal audit should stand ready to help ensure that all risks are properly evaluated prior to management pulling the trigger on any deal. Of course, internal audit does not approve or veto decisions. Rather, internal audit advises management on the completeness of their risk assessment and the processes and controls required to address these risks and achieve the goals of the acquisition.

A mindset of managing risk, as opposed to avoiding all risks, enables internal audit to speak management's language, align with management's goals, and support management's activities in useful ways. To be sure, some risks must be avoided. But most business risks—governance and compliance risks, strategy and execution risks, operational and financial risks, infrastructure and external risks—can be addressed according to their nature, severity, and probabil-

INTERNAL AUDIT'S OBJECTIVE ROLE POSITIONS IT TO ADVISE MANAGEMENT ON ACCEPTABLE RISKS AS WELL AS HOW TO AVOID UNNECESSARY RISKS—A CRITICAL AND OFT-NEGLECTED DISTINCTION.

**INTERNAL
AUDIT CAN
DEVELOP A
"PORTFOLIO"
VIEW OF RISK
THAT
ENCOMPASSES
THE ENTIRE
ORGANIZATION.
FEW OTHERS IN
THE CORPORATE
HIERARCHY
HAVE THIS
CAPABILITY.**

ity, as well as the organization's vulnerability to them.

A risk management framework

What we call a Risk Intelligent approach accepts risk as a necessary condition of doing business and engages in proactively addressing it. This approach recognizes that risk cannot be fully mitigated, that risk avoidance is not a growth strategy, and that risk taking for reward is integral to creating value.

Essentially, an organization taking a Risk Intelligent approach:

- recognizes and manages the full spectrum of risks that the enterprise faces;
- creates connections between organizational "silos" that may be evaluating risks from a single dimension;
- allocates more risk-management resources to the more important risks;
- anticipates and prepares integrated responses to risks; and
- manages risk to maximize the upside of decisions while minimizing the downside.

That final point warrants emphasis: a Risk Intelligent approach values the ability to anticipate and respond to market opportunities as highly as it does readiness for potential disruptions. Thus it defines risk as the potential for loss or the diminished opportunity for gain caused by events that can adversely affect the achievement of a company's objectives. A Risk Intelligent approach protects existing assets and business models and enhances growth opportunities. It focuses on avoiding negative outcomes and on achieving positive outcomes.

Operating managers—and most internal auditors—might view this approach to risk as alien to internal audit, given the function's traditional value-preservation role and above-noted orientation toward eliminating risk. We are not suggesting that internal auditors abandon value preservation. Controls, compliance, reporting, and value preservation represent the foundation for value-creating activities, and cannot be abandoned. Rather we are suggesting that, in

order to increase their professional worth in an environment characterized by risk taking, internal auditors expand their focus on, and proficiency in, risk management by taking a holistic view of risk.

For example, internal audit can encourage management to build Risk Intelligent processes for assessing and mitigating risks and advise management on the structure, effectiveness, and efficiency of those processes. The goal for internal audit is active involvement as management puts the processes in place. This dramatically increases the chances that processes will function as intended. When the processes are in place, internal audit monitors the quality of the processes, as well as the levels of risk.

It is a worthwhile effort because, although enterprises have intensified their control, compliance, and governance efforts, business remains as risky as ever. Drivers of risk include:

- aggressive product development and market expansion;
- creative financial strategies;
- continual acquisition and foreign investment activity; and
- greater use of outsourcing, joint ventures, and third-party production and sales channels.

Although management assumes these risks in anticipation of increased growth and profitability, risks are rising. In October 2006, a study in *Fortune* of S&P 500 companies showed that overall risk levels more than doubled between 1985 and 2006.

To increase the soundness of risk management at their organizations, internal auditors must develop certain skills and overcome formidable barriers.

A risk management skill set

Let's return to the practices of a Risk Intelligent organization, and look at what internal audit can do to help implement such practices:

- Recognize the full spectrum of risks. Internal audit has access to every area of the organization and can identify risks wherever they lurk. Thus internal audit can

develop a "portfolio" view of risk that encompasses the entire organization. Few others in the corporate hierarchy have this capability.

- Create connections between "silos." When internal audit identifies a risk, it must identify potential effects on other areas. What other functions might be affected or put at risk? What other types of risk might arise due to a specific risk?
- Advise on optimal resource allocation. Internal audit can identify or confirm and assist management with prioritizing risks and advise management on optimal resource allocations, particularly in value-creation activities.
- Anticipate and suggest integrated responses to risk. Internal audit can advise management regarding the composition of an integrated response to risks. Internal audit should also assess the appropriateness and efficacy of any new processes and metrics in management's response to risk.
- Provide risk management advice to maximize the upside as well as minimize the downside. When internal audit fully appreciates the need for management to assume risk taking for reward, the function can partner more effectively as a risk management advisor.

These activities demand a shift in perspective. Historically, internal audit's purview has been limited to the controls associated with operational, financial, and compliance risks. That role must now be extended to include strategy and execution risks (those associated with new products, markets, acquisitions, alliances, and other initiatives) and infrastructure risks (those relating to intellectual property, legal liability, safety, and business continuity), among others.

In other words, it's time to move beyond evaluating the effectiveness and efficiency of payroll, accounts payable, and similar controls. For example, internal auditors can educate management about risk identification and evaluation, particularly in such difficult areas as reputational risk and extended enter-

prise arrangements. In addition, internal audit can review its approach to risk assessment for internal audit planning to help ensure that resources are allocated to higher-priority risk activities.

Internal audit as catalyst

Internal audit can act as catalyst in many areas of Risk Intelligence. Examples of areas where internal audit can lead or contribute to management's improved approach to embedding risk understanding into all decisions include:

- assisting in the development of a uniform governance, risk, and compliance framework that will promote an integrated view of risk and responses to risk;
- coordinating the gathering and analysis of risk information and establishing systems for monitoring ongoing risk;
- establishing common risk terminology and harmonizing the way risk is identified, measured, assessed, and addressed;
- synchronizing cross-functional preparedness, response, and recovery plans;
- rationalizing the amount of effort, money, management attention, and other resources allocated to various risks; and
- eliminating duplication of assessment, testing, and reporting efforts.

Most organizations remain in the early stages of Risk Intelligence. For instance, few distinguish between various kinds of risk at detailed enough levels. While finance recognizes financial risk in its various forms—credit risk, foreign currency risk, inflation risk, and so on—few organizations make fine distinctions among governance risk, strategy and execution risk, operational risk, infrastructure risk, and external risk. In addition, few have a disciplined approach to evaluating and addressing these various risks.

Fine distinctions and disciplined approaches help managers deal with risk in more sophisticated and useful ways, and internal auditors can help

MOST ORGANIZATIONS REMAIN IN THE EARLY STAGES OF RISK INTELLIGENCE. FOR INSTANCE, FEW DISTINGUISH BETWEEN VARIOUS KINDS OF RISK AT DETAILED ENOUGH LEVELS.

promulgate such distinctions and approaches.

Barriers to risk intelligence

The internal audit function seeking a role in risk management may encounter barriers, some internal to the function and some in the larger organization.

Internal barriers may include lack of expertise and confidence. Most internal auditors, even CAEs, must challenge themselves to think beyond risks related to reporting, compliance, and governance. Also, some CAEs have been conditioned to see risk management solely as management's job or to await directives from management. Others may feel they are encroaching on operational management's role.

To overcome such barriers, CAEs must recognize that risk evaluation lies at the heart of the internal audit function's mission, as emphasized in the Professional Practices Framework promulgated by the Institute of Internal Auditors. At a minimum, this means dealing with operational risk. A mainstream approach, practiced by most internal audit functions, would also include financial and perhaps IT risks. At the leading edge—Risk Intelligence—it means addressing all significant risks faced by the enterprise. Rigorous risk evaluation and understanding risk exposure after considering management's controls can ensure that time and money devoted to responding to the risks have been optimally allocated.

Barriers outside internal audit can emanate from management, the audit committee, or external auditors. Management may be most likely to resist. Some senior executives view internal audit as an after-the-fact function rather than one to be actively involved in strategic decisions or implementation plans. Similarly, some audit committees might resist an expanded internal audit role, perhaps fearing that compliance might suffer. While external auditors typically would not object to an expanded internal audit role, some might question internal audit's capabilities to address risk holistically.

CAEs seeking an expanded role in risk management may have work to do. This can take the form of:

- developing better interviewing and organizational skills of internal auditors;
- building a case for including internal audit early in the risk assessment leading to a decision;
- defining internal audit's role clearly as advisor rather than risk owner; and
- taking the stage in a gradual way (see below).


By such means, internal audit can, without reducing its traditional role, expand its charter to include risk advisory and assessment activities as a natural extension of that role.

Change from within

On the bright side, management has developed the habit of looking to internal audit for expertise. Many management teams have been chastened by the Sarbanes-Oxley Act and by losses incurred in financial engineering; acquisitions; divestitures; and joint ventures, outsourcing, and other third-party arrangements. Even developing and selling products and services and pursuing new markets has become riskier due to globalization, new technologies, and rapid change.

In this more receptive mood, senior executives will hear a well-made case for Risk Intelligence. In addition, CEOs and CFOs are painfully aware of the high turnover in their ranks and comprehend the consequences of failure. Given this, internal audit has an opportunity—arguably, an obligation—to take an active, and perhaps activist, role in risk management.

This effort should begin at home. Even the definition of an "effective" internal audit can change as risks, conditions, and management priorities change. Thus it makes sense to build dynamic risk assessment into the audit plan. For instance, many enterprises assess a risk related to an investment, a product, or an acquisition at the outset and leave it with that. However, most risks increase



A BUSINESS DOES NOT STAND STILL FOR A YEAR; THEREFORE, AN ANNUAL AUDIT WORK PLAN MAY WELL BE INADEQUATE, ESPECIALLY WITH REGARD TO THE MORE COMPLEX RISKS, SUCH AS THOSE RELATING TO STRATEGY AND EXECUTION.

or decrease over time, which can render risk assessment or mitigation measures outdated, ineffective, unnecessary, or too costly.

A business does not stand still for a year; therefore, an annual audit work plan may well be inadequate, especially with regard to the more complex risks, such as those relating to strategy and execution. Even though many CAEs build extra capacity (say, 25 percent) into their work plan in anticipation of the unknown, it is far more effective to search out the unknown, proactively evaluate emerging risks, and plan accordingly.

Indeed, internal audit can drive changes in the larger organization. For instance, a major company in the extractive industries recently initiated a dynamic risk assessment and planning process that was spearheaded by internal audit. When fully deployed, the process will include continuous risk assessment by management, augmented by assurance and consultative help from internal audit, as required. In many other companies, internal audit employs quarterly or rolling plans in which specific projects and areas of focus are identified based on risk. Thus, while it is management's job to continuously assess and address risk, it is internal audit's job to evaluate the effectiveness, efficiency, and completeness of that process.

Taking the stage

Moving from compliance and traditional controls into other high-value areas—and broadening the perspective to include value creation—requires a game plan. The following ten steps, to be adapted to your specific needs, provide the outlines of such a plan:

1. Prepare: Understand Risk Intelligence and the vital role internal audit plays in it.¹
2. Assess: Develop a clear and comprehensive picture of the risks your

organization faces and of its risk management practices.

3. Redirect: Set the new direction and goals for internal audit, and present the challenges as opportunities to the most competent, forward-thinking professionals in your shop.
4. Justify: Align the internal audit plan with the organization's risks and build the case for doing so.
5. Persuade: Present the case to the CEO, other senior executives, and the audit committee.
6. Adapt: Engage in dynamic risk assessment and audit planning, in which audit plans reflect the changing constellation of risks to the organization.
7. Phase: Begin with changes to the internal audit function, and with pilot plans and small experiments in the larger organization.
8. Implement: Move toward a more continual, flexible audit plan and process, rather than a periodic one, while keeping the audit committee informed.
9. Deploy: Put the right people with the right skills and training in place, given the management strategies being developed and executed.
10. Document: Prepare brief, relevant, readable internal audit reports on the risks of contemplated or existing strategies, types and measures of risk, potential methods for reducing and mitigating risks, and current risks facing the organization.

CAEs and internal auditors now have an opportunity to add tremendous value to their organizations. The current focus on risk management provides the means by which they can capitalize on that opportunity, but it won't last forever. Prescient CAEs will seize this opening offered to them. ■

NOTE

¹ Visit www.deloitte.com/riskintelligence for a full array of Risk Intelligence resources.