Internal Auditors Eyeing Operational Risks

By Lindsay Frost
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Internal auditors are pivoting their main areas of focus from finance and compliance risks to operational business risks, as audit committees shoulder heavier — and more complex — workloads.

Audit committees are growing increasingly reliant on the internal audit function to help them navigate external business risks that affect operations, including reputational risks from social media as well as cyber-security risks. As a result, the internal audit function at many companies has effectively been given a seat at the boardroom table as a trusted consigliere to the audit committee.

“Audit committees, right out of the gate, are asking for a more robust [operational] risk assessment, which is something internal auditors have been involved with more in the last two years than in the previous eight,” says Jerry Ravi, partner at consulting services group EisnerAmper. “Internal auditors got lost in financial reporting risk for quite a while, but there are so many other risks out there.”

Boards identified various operational risks as among the most critical areas of concern in a recent survey published by EisnerAmper in late January and conducted in 2015. Among 300 public, private and nonprofit board respondents, the most pressing business concerns identified were operational risks, including reputational risks (75%), cyber-security/IT risk (61%) and regulatory compliance risk (53%). About one third (32%) of all respondents were from public company boards, with 56% of all respondents representing members of the audit committee on their respective boards. Respondents could choose more than one answer.

The shift from identifying and mitigating finance and compliance risks reflects the way many organizations view risk currently, observers say.

“We went through a period in the aftermath of Enron and Worldcom where a lot of companies perceived the biggest risks to be in financial reporting controls, so a lot of internal auditors focused on financial reporting for a period of time,” says Richard Chambers, president and CEO of the Institute of Internal Auditors (IIA). “But, we’ve recently seen internal audit rebalance its workload to mirror risk [committees’ workloads], [including] whether operations are efficient and effective — areas not traditionally a part of their work.”

In the same vein, the largest area of focus of internal auditors’ 2016 audit plans will be operational risks, which are expected to encompass 24% of the plan. General financial risks are likely to encompass only 7% of the audit plan, according to a survey of 486 chief audit executives, directors and senior managers in the 2016 North American Pulse of Internal Audit. The survey was released by the IIA last week.

By comparison, survey participants in 2015 expected 23% of their audit plans to cover operational risks and 8% to cover general financial risks.

Dan Tessoni, audit committee member at several privately held companies and professor of accounting at the Rochester Institute of Technology, says the internal audit function is an integral piece of the audit committee puzzle as the risk environment changes and operational risk emerges as a main priority.

“Compliance with operational expectations is so critical to the optimal performance of the company,” Tessoni says. “Internal audit has always been the most important protection for the board.”
Several sources interviewed said the internal audit function acts as the “eyes and ears” of the audit committee as audit committees’ workloads have grown less manageable. Plus, members of the audit committee are only around the company a certain percentage of the year.

“Audit committees recognize it’s difficult for them to actually stay on pace with what’s going on [with operational risks], especially with technology,” Ravi says. “Internal audit never really had a seat at the table, but now they are being asked to come in before major decisions are made for insight and foresight.”

Historically, the internal audit team took a “check the box” approach to annual audit committee reports and would deliver written reports in boilerplate language, says Brian Christensen, executive vice president of global internal audit for risk consultancy firm Protiviti. Now, there is increased dialogue with the board and frequent meetings.

For example, Denise Dickins, associate professor at East Carolina University and audit committee chair of Watsco Inc., says she has monthly conference calls with her internal audit team and completes a yearly evaluation of them as well.

“It’s very important to keep in touch and take an active role to set their agendas annually,” Dickins adds.

A weak relationship between internal audit and the audit committee on operational and reputational risk can lead to major problems, the EisnerAmper survey indicates.

Last July, Toshiba was investigated for an accounting scandal in which the company overinflated profits from 2008 to 2014. The investigation determined that the company’s internal audit department did not report directly to the audit committee, which led to confusion and convolution of numbers.

Additionally, the internal audit department lacked routine access to the board, according to a blog post on the scandal written by Chambers.

Chambers also highlighted FIFA as an example of a “toxic” corporate culture with an ineffective internal audit team in a separate blog post.

“One of the most glaring weaknesses in FIFA’s governance and control structure for me, has been the lack of an internal audit function dedicated exclusively to an internal audit mission on behalf of the audit committee and executive management,” Chambers writes. “A unit that includes ‘compliance management tasks’ alongside ‘internal audit tasks’ falls vastly short of a 21st-century model that organizations like FIFA should be embracing.”

Seven of the organization’s top-ranking officials were charged by the U.S. Department of Justice under the Foreign Corrupt Practices Act (FCPA) for 47 counts of corruption last summer, including bribes and racketeering.

‘Ideal’ Internal Audit Skills

The demands on internal audit have grown so great that the IIA announced early this month that it would be adopting changes to its professional standards. This includes enhancing existing standards on communications with management and the board and quality assurance. It also will encompass new standards addressing objectivity in assurance, consulting and other roles the function is taking on.
Specifically, one key addition includes requiring an overall opinion issued by the internal audit function that would take into account the strategies, objectives and risks of the company.

Coinciding with the proposed framework is the push for more diverse skills and training of internal auditors, Christensen says.

The ideal internal audit candidate possesses comprehension of big-data analytics, strong industry expertise and good communication skills. The candidate is also culturally adept in an international marketplace with custom business techniques to assess the impacts of fraud, he says.

The IIA is currently taking comments on the change.

“The proposed framework provides a pathway for the chief audit executive to refocus the internal audit agenda in an environment with ever increasing and changing expectations,” Christensen says.

“Boards and audit committees [are expected] to understand the comprehensive risks to the business, and this framework is really putting forth the expectation that this is an area internal audit can and should assist with.”

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