Auditing Strategic Risks: Turning Risk into Opportunity

Experis™ Finance
ManpowerGroup

Over the past decade of corporate governance reforms, internal control compliance programs such as Sarbanes-Oxley, Model Audit Rule, and FDICIA have matured to become embedded into daily operations, while most operational and compliance "low hanging fruit" have been addressed through greater investment in the internal audit function. As a result, many organizations perceive internal audit findings to be trending as less significant and less numerous over time, and therefore the value delivered by the traditional internal audit organization may be considered by several organizations as providing ongoing validation that internal controls are still working as intended.

To remain relevant beyond an ongoing assurance function, internal audit departments that transform their focus more heavily toward value creation as opposed to risk aversion will be viewed by their executive counterparts as equal contributors in the business, rather than a necessary corporate governance function that is a "cost of doing business."

From risk aversion to value creation

Traditional internal audit functions focus on assurance over internal controls over financial reporting, regulatory compliance and back office operations. Various studies performed over the past decade have determined that internal audit's traditional focus in these three areas addresses less than one-third of the market capitalization losses that account for the erasure of one-half or greater portion of company value. Therefore, approximately 70 percent of the root causes of such catastrophic losses stem from strategic risks, which are largely unaddressed by traditional internal audit functions outside of specific management requests.

With its intricate cross-functional subject matter knowledge about processes, policies and procedures and its strong foothold within the organization as a trusted advisor, internal audit can build a compelling case to position itself with the C-suite as a strategic partner. As Figure 1 on page two reflects, the internal audit function realizes its full potential by evolving its focus from risk aversion toward value creation.

For internal audit to be effective in auditing strategic risk, there are a number of critical success factors:

- Clearly define the role of internal audit, assess the process and not the plan
- Understand the strategic planning process
- Deepen knowledge of the business, industry and competitive threats
- Leverage relationships to broaden understanding
- Link knowledge of risks and controls to strategy
- Promote a dialogue - develop a series of open-ended questions rather than audit programs and questionnaires
- Share knowledge and facilitate discussion
- Communicate effectively

Internal Audit's role in the strategic planning process

Starting with the strategic planning process, internal audit can be a key contributor. Strategic planning determines where an organization is going over the next year or more, how it's going to get there and how it will know if it is there or not. During strategic planning, the organization evaluates alternative strategies to achieve the goals while understanding key issues and constraints to be addressed through an internal and external environmental scan. Once the strategy is agreed upon, it will entail action planning (task owners and assigned action steps) and a commitment of resources.

As depicted in the strategic planning lifecycle illustration (Figure 2) on page 3, management typically follows a formal process during strategic planning:

1. Start with the goals linked to vision and mission
2. Examine strategic alternatives against assumptions
    a. Internal and external issues
    b. SWOT analysis
    c. Forecasting
3. Formulate strategy
4. Execute strategy
5. Sustain strategy

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Managing Compliance, Managing Crisis	Minimizing Business Uncertainty	Exploring Opportunity
Complying with corporate governance standards (fiduciary responsibility)	Achieving global best practices	Improving returns through value-based management
Avoiding personal liability failure (the personal fear factor)	Understanding and evaluating business risks	Enhancing capital allocation
Owning company crises	Understanding full range of risks facing business today	Protecting corporate reputation

Figure 1: Value Protection to Creation

During strategic planning, internal audit may focus on the following areas:

- **Existence of a formal process and level of compliance with the process** - Does strategic planning follow a formal, documented process? Consider benchmarking the strategic planning process against proven frameworks used by other leading companies.
- **Cross-functional involvement and vetting process -** Are the right participants involved in the right roles at the right time throughout the process? Is Marketing (with the sales forecasts) and the Controller (with production and cash flow forecasts) brought in to provide the supporting assumptions as the top executives identify alternatives and weigh the merits of each?
- **Documentation of the strategic objectives and underlying assumptions** - Are assumptions validated, and to what extent are the various internal and external risk elements being considered?
- **Review and approval process** - Are review and approval points identified and to what extent are the supporting assumptions and alternatives vetted in this group?
- **Measurability of strategic objectives** - Are metrics established for measuring success over time, and will these metrics be relevant and reliably accurate? Are projections being set during interim key decision making points to provide a basis to continue or abandon the initiative?
- Communication of strategic objectives - It is commonplace to see a disparity in staff's understanding of the organization's strategy and how each department supports it. Internal audit can focus an advisory engagement centered on the quality of information and communication activities supporting the organizational strategy. Articulating organizational strategy and how each division contributes to that strategy increases the likelihood that various silos in the organization work toward the vision as a cohesive team, and there is upward communication of risks that might otherwise not surface while staff manages through day-to-day duties.
- Organizational readiness - Identify gaps between current state and required capabilities to achieve the strategic objectives (process, people, systems).

Assurance and advisory perspective through the project lifecycle

Once the strategy is established, internal audit can contribute in an ongoing assurance and advisory capacity on the individual initiatives. In order to provide greater assurance that the strategy will succeed, it is imperative that a roadmap is established and localized at the departmental level to coordinate the efforts between executive management and organizational departments to attain and sustain the strategy.

Any strategic initiative (e.g., due diligence for acquisition, new facility or plant, system deployment, new product development, consolidation of operations) should follow a project lifecycle through the following phases with key focal points upon which internal audit can focus its engagement:

- **Inception** - Existence and adequacy of project governance and risk management
  - Is there a formal, documented project management methodology for overseeing the project?
  - Has a project risk assessment been performed, identifying risks to achieving project objectives, with a mitigation plan?
  - Do risks appear to be reasonably mitigated within the budget and timeframe constraints set by the project?
  - Is there a charter documenting project governance and oversight, roles and responsibilities, timeline, communication plan, deliverables and success metrics?

- **Planning** - Quality and thoroughness of planning and how realistic the plan may be
  - Are the planned tasks, milestones, assigned resources, and timelines documented and do they appear realistic?
  - What resources must each area contribute to the initiative and when? While participating in this initiative, will service levels be maintained in their current roles?
  - Have the adequate internal and/or external resources with sufficient skillsets been procured and scheduled?
  - Are there any contingencies in what must be provided? Have those contingencies been addressed with mitigation plans?
  - What about task dependencies? Which tasks can indefinitely delay the initiative as a whole? Are the risks of task completion being actively monitored and addressed with mitigation plans?
  - What controls are in place to monitor that the right things are accomplished at the right time and within budget?

Figure 2: Strategic Planning Lifecycle

- **Execution** - Effectiveness of controls to monitor progress against scope, budget, schedule, and quality standards
  - Are milestone dates being met or are they on track to being met?
  - Are there review points or decision making gates between phases to obtain approval to move forward?
  - Are there quality assurance and oversight controls over work in process and the end product? Have sufficient resources been budgeted for quality assurance?
  - When changes to schedule, budget, or scope occur, is a formal change order process being followed?
  - What information and communication controls are in place to ensure management is apprised of status and can intervene in a timely manner as risks emerge to cost effectively influence outcomes?
- **Wrap-up** - Project readiness for stakeholder acceptance and organizational readiness to own and sustain the project outcomes
  - Are the criteria satisfied in the final decision gate to consider the initiative “live”? Can the information supporting this decision be audited?
  - Has a readiness assessment been completed? Will the organization structure sustain the implementation going forward?
  - Has change management occurred to ensure that the organization accepts the changes, has been sufficiently prepared and trained, and is willingly accountable for the results?
- **Post Mortem** - Post mortem review to determine if the expected outcomes were achieved and sustainable
  - Post implementation – were the expected outcomes achieved (expected vs. actual results)? Are they sustainable long term?
  - Are recommendations and lessons learned documented and followed through?

Becoming a trusted advisor

To incorporate strategic risk into the audit plan, internal audit should obtain a seat at the table during strategic decision making. During the risk assessment process, internal audit should also obtain the budgets (including capital budget), forecasts, and underlying support and, as necessary, facilitate a cross-functional discussion among leadership in areas such as: Finance, Operations, Information Technology, Sales/Marketing, Human Resources, Compliance, Legal, Research and Development. The agenda for this discussion is to open lines of communication between areas that have both a stake and a role in bringing the strategy to reality. The agenda for this meeting should address the known and emerging risks to strategic plans and metrics business by business and address the following:

- What must each function contribute to achieve the strategic plan?
- Which contributions are most at risk for success?
- What are the cause and effect issues and interdependencies among risks?

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Despite the strong business case for internal audit's contributions to facilitate the achievement of strategic objectives, it may be an uphill climb for internal audit to be included in strategic dialogue. To foster greater collaboration on strategic risk, internal audit should continually elevate its stature within the organization through:

- Reporting performance metrics, including its contribution to the bottom line through cost recoveries, process improvements, reduced cycle times, etc.
- Anticipating needs of management and the board before being asked
- Leveraging the audit committee relationship to intercede, if necessary, with management
- Retaining and sustaining the right skillsets (e.g., understanding the business, keeping current with industry changes and professional standards, and soft skills such as communications, problem solving, critical thinking) and continually recalibrating to meet the need through training, hiring, rotation programs, and outsourcing activities.

In doing so, management will increasingly become an advocate for internal audit's role as a trusted advisor on strategic risk.

If you have any questions regarding Auditing Strategic Risks, contact us at Knowledge@experis.com.

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