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A WORLD IN ECONOMIC CRISIS:

KEY THEMES FOR REFOCUSING INTERNAL AUDIT STRATEGY

The Institute of Internal Auditors

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A WORLD IN ECONOMIC CRISIS: KEY THEMES FOR REFOCUSING INTERNAL AUDIT STRATEGY

A major reshaping of internal auditing's risk priorities and resulting audit coverage is underway as chief audit executives (CAEs) respond to changing stakeholder expectations in the current economic crisis. These observations were overwhelmingly shared by the 28 CAEs, service providers, and regulators who convened in Washington, D.C., by invitation of The Institute of Internal Auditors (IIA) with the goal of gaining insight on the impact of the economy on internal auditing. This exceptional opportunity to discuss among peers what internal auditors can do to help their organizations through these turbulent times — in particular, what they should do differently — provided valuable insight for moving forward with a more meaningful and proactive approach to understanding and addressing risk.

Attendees of the March 2009 roundtable primarily comprised CAEs from Fortune 100 companies, as well as several from the Fortune 250. The session also included representatives from the U.S. Public Company Accounting Oversight Board, the U.S. Securities and Exchange Commission, and The IIA's Principal Partners that provide internal audit services to Fortune 100 Companies. In navigating through the current economic uncertainties, the CAEs indicated that they are taking a more proactive and strategic role in working with stakeholders to improve the risk and governance cultures of their organizations. Participants candidly offered their insight and strategies for redirecting the focus of internal audit activities to meet the challenges. Key questions discussed throughout the four-hour roundtable included:

- What is the biggest impact the economic crisis has had on internal auditing?
- How has the internal auditor's role changed in the last 12 months?
- What issues are different now, and how have they changed the internal audit strategy?
- What are the lessons learned and the main focus going forward?

To supplement the roundtable participants' views, The IIA gathered feedback from 34 Fortune 100 company CAEs and audit directors who responded to a pre-roundtable survey conducted by The IIA's Global Audit Information Network (GAIN). The results showed a high degree of correlation between the survey and the concerns of the roundtable participants. While the wide-ranging discussions touched on numerous topic areas, they centered around four key themes:

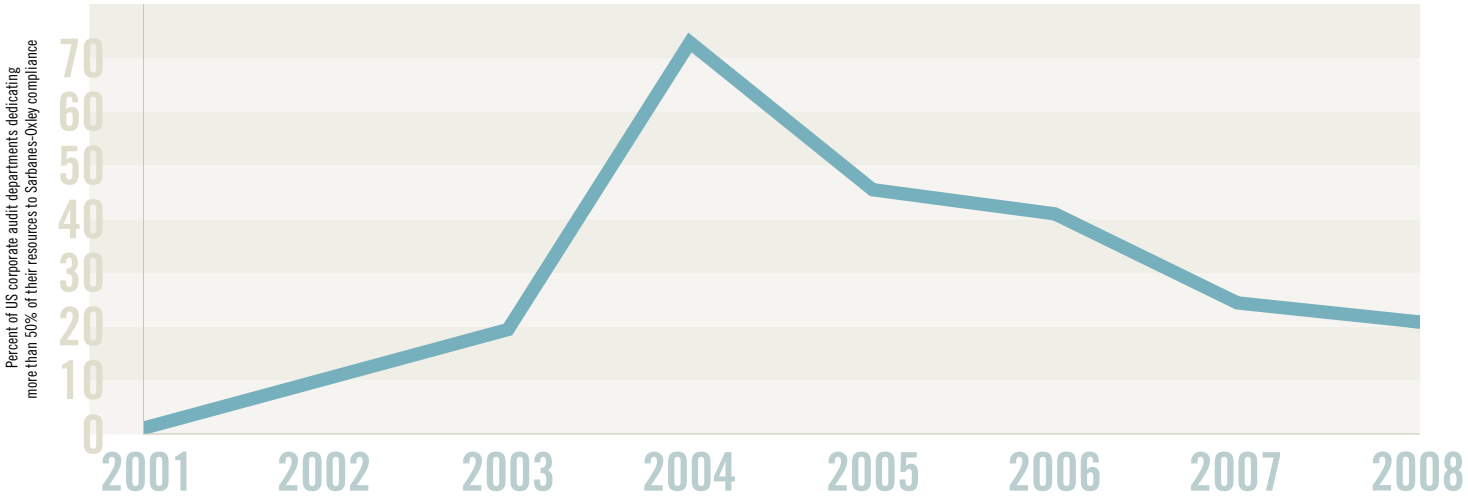
- Changing expectations from internal auditing's stakeholders are resulting in revisions to internal audit strategies.
- A broader, more strategic focus on risk and risk management is developing.
- Major shifts in the focus of internal auditing's coverage are already taking place.
- CAEs have been undertaking various initiatives within internal auditing to do more with less.

These themes were not exclusive in their focus but overlapped in several areas. For example, risk and risk management were topics that came up in virtually every area of discussion. These overriding themes also represent a comprehensive strategic framework for CAEs to consider in responding to the current economic crisis.

1. CHANGING STAKEHOLDER EXPECTATIONS ARE PROMPTING AUDIT STRATEGY REVISIONS

A shift in stakeholder expectations is requiring that internal auditors take on a more strategic role, with risk management activities taking precedence over U.S. Sarbanes-Oxley Act of 2002 and other controls compliance auditing. Roundtable participants said that their audit activities are shifting to focus more on enterprise risk management (ERM) processes and recession-related risks. Another developing focus is responding to stakeholder requests for assistance and assurances from internal auditing that line businesses are accurately reporting their activities, risks, and results. One roundtable CAE said that executive management has asked internal auditors to be more critical: "Tell us when we're not getting the big picture; look and dive into the business; let us know if a business unit is being too optimistic." Participants agreed that asking internal auditing for this type of assistance and focus is highly positive for the profession and an indication of its evolving role relative to strategic business risks.

CHASING THE LAST RISK: THE SARBANES-OXLEY "PHENOMENON"



Source for 2004 – 2008 data: PricewaterhouseCoopers' State of the Profession white papers, © 2005, 2006, 2007, 2008, and 2009

RAMPING UP AUDIT COMMITTEE COMMUNICATION

The audit committee is now relying more heavily on internal auditing to keep stakeholders informed of ERM strategies and changes in the audit plan. The majority of roundtable participants said they are spending more resources on audit committee preparation and communication. Many noted that the audit committee is requesting more time with internal auditing on the audit committee agenda, requiring the CAE to prepare more thoroughly for committee meetings and private sessions. Auditors have recognized that while audit committees increase their focus on risk and the organization's ERM processes, they can provide value-added services to these stakeholders by:

- Offering audit committee members risk management education during regular meetings or in special sessions, helping them to become familiar with ERM terminology and risk prioritization methodologies.
- Expanding ERM discussions with the board, including an assessment of strategic risks — short-term and long-term — not just a heat map or checklist.
- Including a list of the organization's top 10 risks in every audit committee package and showing the linkage to the audit plan.
- Actively coordinating with the other risk and control functions to identify the next 10 developing or emerging risk priorities.
- Increasing informal communication through phone calls and e-mail, outside of the regular face-to-face meetings.
- Identifying and reporting pervasive recessionary issues, such as risks related to liquidity, staffing reduction, and fraud.

GOVERNANCE

Internal auditing is also being asked to play a more strategic role in the oversight and governance of the organization, as governance is another area receiving an increased focus by audit committees. The current economic crisis points clearly to the governance failures of many organizations. And because governance incorporates the organization's strategic response to risk, CAEs are increasing their focus on this area. Several participants indicated that their audit plans now include governance audits.

One roundtable participant observed that although management and boards are navigating as well as they can, they are all still a bit nervous. Management has

learned the hard way that "they don't know what they don't know," and that those charged with corporate oversight need to gain a better understanding of the holistic ERM process and what the term *governance* really entails. One participant suggested that internal auditing and management need to be able to talk about the organization's governance process — they need to be able to define it and understand the overall governance structure.

While governance (or lack thereof) may be one of the causes for the deterioration of the conduct of business in certain corporations or industries, many at the roundtable still rated the governance structure in their organization as strong. Principal success factors identified include a strong board, a strong ERM process with active risk champions, and a strong ethics culture.

PROMOTING GOVERNANCE OPPORTUNITIES

Despite the changing economy, CAEs at the roundtable indicated that they did not notice a significant change in the governance of their organizations. However, the participants did recognize that there are opportunities for internal auditing to help enhance the organization's governance processes. Suggestions that came out of the discussion included:

- Assisting the audit committee in strengthening its activities around understanding and enhancing the organization's governance processes, moving governance from form to substance.
- Providing educational sessions to further develop the audit committee's understanding of best practices in governance and risk management.
- Ensuring that the CAE reports administratively to the chief executive officer (CEO), strengthening internal auditing's stature and authority.
- Improving CAE skills and competencies necessary to earn credibility at the governance table.
- Enhancing the internal audit role to include coverage of strategic business risks and governance.
- Helping increase transparency among all levels — auditing to management and management to auditing.
- Fighting against forces that push internal auditing into the compliance corner, implementing the full extent of activities as described in The IIA's definition of internal auditing.

Risk management is a key responsibility of senior management and the board. To achieve its business objectives, management ensures that sound risk management processes are in place and functioning. Boards have an oversight role to determine that appropriate risk management processes are in place and that these processes are adequate and effective. In this role, they may direct the internal audit activity to assist them by examining, evaluating, reporting, and/or recommending improvements to the adequacy and effectiveness of management's risk processes.

IIA Practice Advisory 2120-1

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The IIA's International Professional Practices Framework

While the definition has included coverage of risk management and governance, the focus in recent years has been heavily weighted toward controls, as a result of Sarbanes-Oxley. What was apparent from both roundtable participants and the survey results is that the balance is shifting away from an almost exclusive focus on controls, as internal auditing's stakeholders are similarly shifting their focus. With the increased attention to risk, risk management, and governance, CAEs are transitioning their audit plans and coverage to place increased attention on risk management and governance. While coverage of controls still outweighs these areas, a more healthy balance is developing that is bringing internal audit coverage more in line with the broad definition of internal auditing.

Roundtable participants also had a robust discussion on how their organizations are identifying and addressing potentially catastrophic risks, particularity those with very low probabilities. Roundtable CAEs suggested that those responsible for governance and risk management should be challenged to answer the question: What is the contingency plan if a catastrophic risk event does happen, even if it has a low probability of occurrence? Although external events may be difficult to foresee (e.g., the impact to liquidity and credit caused by bank lending restrictions), it is important to consolidate and quantify the impact of interrelated risk possibilities that may bring about a catastrophic impact.

Internal auditing's position in the organization's governance structure was also debated. Responding to the question, "Is internal auditing properly positioned in the organization's governance process?" roundtable CAEs agreed that a one-size-fits-all approach does not work. Although all confirmed that they report directly to the audit committee, administrative reporting lines among the participants vary greatly. While a few report to the CEO, others have a "dotted line" to the chief financial officer (CFO), president, and chief risk officer (CRO). The CAEs emphasized, however, that the substance of the administrative reporting line and relationship is key. Regardless of the specific administrative reporting line, the roundtable participants felt that they have a "seat at the table" and are aware of and involved in strategic business initiatives and issues. They also agreed that it is important to get in writing a description of what the administrative and functional reporting lines mean.

While roundtable attendees said that they feel they are an integral element of their organization's governance structure, they acknowledged that they could do more to embed the internal audit activity into the heart of their organization's governance and risk management strategies. Yet according to some, executive management has questioned the CAE's operational expertise in the past, citing the benefit of business knowledge over internal audit skills. While some audit groups hoped to resolve this issue by using a rotational audit program, it has not worked as well as intended and is being used less frequently. Despite these challenges, relationships with senior management are good, the majority of CAEs reported, and management is reaching out more to gain internal auditing's responses and opinions.

> The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.
> **IIA Standard 1110, Organizational Independence**

OPPORTUNITIES FOR PARTNERING

As normal benchmarks failed executives and risk management experts in predicting the scope of the financial meltdown, internal auditors can take a leading role by working with management and other risk management groups to brainstorm emerging risks. Participants described several approaches they use to help identify such risks. For example, some use scenario analysis, similar to those used to identify fraud risks, to identify emerging issues. By strategizing what could go wrong, adding a reputational risk element in every scenario, and involving finance to quantify the impact, internal auditing can bring a progressive aspect to the organization's risk management strategy.

It was also noted that this type of information, namely emerging risks and events, is highly valued by senior management and audit committees and viewed as a value-added internal audit activity. CAEs are increasingly taking a proactive role in risk management. One roundtable CAE offered that their internal audit activity surveys management on upcoming and emerging risks and then reports the top 10 risks each quarter to management and the audit committee. Potential high-risk issues, including major equipment deterioration and replacement, aging

workforce, and diminishing supply of raw materials, are kept on management's radar. By meeting with management regularly to discuss the velocity of such emerging risks and making sure someone is assigned to study, understand, and own the risk, governance overseers can remain acutely aware of the potential risks that the organization may face.

Roundtable participants also agreed that now more than ever, it is important to maintain a good relationship with other risk and control functions within the organization. Most agreed that communication sharing across lines seems to be better during these difficult times. Internal auditors who can build this relationship and ensure that every angle is covered by someone, with no overlaps or gaps, will find that they also build their knowledge base of the business and become more rooted in the organization's risk management strategies.

When asked if their relationship with their external auditor has changed, most CAEs had not seen a marked difference. Some roundtable participants expected that the external auditors' scope, which focuses primarily on financial risk, may soon shift attention to operational risk but said it is too early to tell. Recession-related risks such as liquidity and credit risk, may also become higher on the external auditors' radar, and CAEs who keep their finger on the pulse of the external auditors' activity can help reduce scope overlap and contain external audit fees.

Leading practice suggests that CAEs can build their relationship with the external auditors by partnering in lessons-learned and emerging risk sessions, focusing on external rather than internal risks. For example, brainstorming topics could include emerging accounting, legal, or risk events; current or evolving regulatory issues; and comparisons of risk disclosures for peer companies.

2. A BROADER, MORE STRATEGIC FOCUS ON RISK IS DEVELOPING

Risk and risk management were recurring themes that permeated virtually every topic area in the roundtable discussions. Participants agreed that the economic crisis underscores the need for greatly enhanced and more focused risk management. CAEs are being asked to take the lead in ensuring that risk management processes are working effectively across the organization, allowing internal auditing to play a key role as strategic partners and champions of risk management. While not all of the organizations represented in the roundtable have formal ERM functions, almost all acknowledged an increased interest in risk management in general. Additionally, the focus of ERM is increasingly transitioning from a tactical level to a strategic level. Participants indicated that the transition presents opportunities and challenges for internal auditors and risk managers alike. As one audit leader remarked, "If ERM is going to work, organizations have to react quickly and proactively."

With the events of the current economic meltdown, however, even CAEs more experienced in risk management at the roundtable candidly admitted that predicting and reacting to something of this magnitude would be difficult, even though most agreed that some warning signs existed. "We have great ERM processes, but we were too slow to react," said one internal audit leader. Another observed that risk management can be a very bureaucratic process, making it difficult to respond effectively to an onslaught of risk events. Several also commented that the current crisis involved both external risks and systemic risks that significantly impacted their organizations and that these types of risks are even more difficult to identify and assess.

Participants also identified numerous risk management areas that could be improved. (See the "What Can Internal Auditors Do?" sidebar on page 14.) Many indicated that several key risks involved in the onset of the economic crisis were identified in their risk matrix but needed a different focus, suggesting that velocity, preparedness, and resilience should also be considered when assessing risk impact and probability.

When asked if the current financial situation could have been prevented by better risk management processes, more that half (56 percent) of the Fortune 100 survey participants indicated that their organization's risk management processes are functioning adequately. And while a little more than a quarter of the respondents remained neutral in their opinion, more than 17 percent agreed that improvement is needed. On the other hand, 44 percent of respondents indicated that there are things internal auditing could have done to help their organization identify key risks to mitigate some of the current economic impacts their organizations are facing.

Another factor affecting the handling of the economic crisis is the lack of a centralized risk management plan — a major obstacle for most organizations represented at the roundtable. A few participants shared that their organizations have risk departments scattered throughout the various business processes, yet no centralized or integrated process to bring it all together. And although risk management at the business unit and process levels is working fairly well, silos have developed. The majority agreed that risk oversight must be more connected enterprisewide, enabling the organization to act quickly in times of crisis. As a result, several participants indicated that they are spending more time on and sharing more information with other risk and control functions in their organizations.

Participants also agreed that someone with adequate stature must be in charge of organizational risk management so that an effective action plan can be carried out timely and systematically. Should this be the CEO, CFO, or CRO? Depending on the organization, participants agreed that it must be someone — or an authoritative team — who has a finger on the economic pulse to react with speed to emerging risks, the depth to look at systemic risk, and the leadership to promote accountability and transparency at all levels.

Risk interaction among low probability risks can compound the severity of impact. What happens if they all occur or have a domino effect? By "connecting the dots" and assessing the cascading effect of risk interaction, possibly through scenario analysis, auditors and risk managers can be better prepared for the "perfect storm."

VARYING PERCEPTIONS

As part of the strategic shift in risk management, internal auditors are increasingly being called upon to evaluate business processes, strategies, and the resultant risks. Internal auditors should do what they can to make sure management has made prudent risk decisions and has appropriate risk monitoring processes in place. While a strategic decision may rest with management, internal auditing can review strategies to see that they are aligned with the organization's ethics, culture, and risk appetite. This calls into question whether internal auditors possess the expertise and knowledge to accurately assess all potential risk events. Probably not, one CAE observed, but internal auditors should have an in-depth knowledge of the business. If a significant business discussion or decision arises, internal auditing needs to "step out of the audit box" and demonstrate its value by working with management to understand the implications.

Internal auditors should prompt management to ask: Are we staying true to our ethics, culture, and policies? Are our assessments of risk accurate, and do they align with the organization's risk appetite? Do we have the appropriate risk monitoring processes and triggers?

Furthermore, as noted earlier, audit committees are also asking questions about business strategies and risk, and they're asking internal auditing for help in answering them. Participants agreed that this situation presents an opportunity for internal auditing to demonstrate value at the highest levels. A positive outcome of internal auditing's evolving role as a strategic partner in risk management is that its communications with senior management and the audit committee are gaining credibility.

Because risk management is imperative in today's environment, internal auditors have an opportunity to help management and audit committees understand where they fall on the risk management maturity curve. By raising tough questions about practices, oversight strategies, and the organization's risk appetite, auditors can help ensure that a well-thought-out risk management process exists.

HOW CAN INTERNAL AUDITING EFFECT CHANGE?

Roundtable participants agreed that internal auditing can best assist in the transition toward strategic risk management by offering results. The first call to order should be the performance of an audit of organizational risk management processes. Is the organizational structure effective and productive? Are all risk areas covered? Has the organization defined its risk appetite? Is there accountability and transparency? Is the organization at an appropriate point on the risk management maturity curve for its complexity and risk profile? Without the support, guidance, implementation, and monitoring by corporate overseers, a formal risk management process cannot be effective.

With limited resources and shifting stakeholder expectations, maintaining a current understanding of the organization's strategic plans and major business changes can be a challenge for internal auditors. To keep abreast of new developments, several Fortune 100 CAEs said that they meet regularly with the organization's risk champions — those accountable for identifying and prioritizing risks in their respective business processes. CAEs who work through changing operations and emerging risks proactively will not only gain a current understanding of the organization's business and strategic plans, but also add value to the process by offering insight into the risk and control process. With this strategic information, internal auditors can update their risk assessment more often, link changing business strategies to the audit plan, and shift audit activities to cover the most critical risks.

Because the fundamental flow in risk management is people, auditors also need to determine whether risk management is embedded within all processes and understood by all employees. Roundtable participants suggested that auditors look for holistic processes when reviewing the ERM structure, such as assessing the following:

- Reviewing the structure, roles, reporting lines, and communication across the organization's risk management processes.
- Ensuring that the organization has defined its risk appetite appropriately and communicated it across the organization.
- Evaluating the processes used to assess risk, including the impact of cascading events that could lead to a higher risk priority and catastrophic risks.
- Assessing the accountability of management for overall risk management as well as the assignment of responsibility for individual risks. Providing evidence of cross-functionality within the risk management strategy, including the integration of individual risks into an aggregate.

- Ensuring risk management processes are embedded within each business unit and its strategies and plans.
- Appraising the effectiveness and alignment of compensation and incentive plans with the organization's risk appetite.
- Using a risk framework and common enterprise "risk language" to clarify risk transparency, accountability, and focus.
- Ensuring that the risk assessment process is dynamic and includes periodic updates to ensure that the organization's risk profile is current.
- Assessing the impact of reputational risk in all processes, activities, and functions.

Auditors should make sure management has included the eight elements of The Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) Enterprise Risk Management – Integrated Framework in the organization's ERM model to provide a framework for completeness and consistency.

As mentioned earlier, roundtable CAEs suggested that organizations consider expanding their heat map models by adding other aspects such as risk velocity, preparedness, and resilience elements. Assessing risk probability and impact — the core elements of a risk model — is crucial, but without quick reaction time and the possibility of cascading risks, the risk assessment is incomplete.

Another leading practice offered by roundtable CAEs is evaluating ERM preparation throughout the organization with a focus on scenario planning. A fundamental flaw in risk management is that people often get trapped in the checklist approach. Internal auditors should start with a blank slate and reassess events, and then tackle related risks. A key question to keep in mind: What would make the organization vulnerable? One CAE leads a quarterly risk scenario workshop. By presenting potential risk events and brainstorming possible outcomes with management for each key operating area, the CAE is able to capture information that is not included in the current risk assessment. Documenting these key action plans, with periodic review and updates, enables internal auditing to stay connected with the most current business strategies.

Are there any significant risk exposures in your organization that management has not or will not address? Almost half of the roundtable participants admitted there is little to no emphasis in addressing pandemic risks in their organization's risk management process.

WHAT CAN INTERNAL AUDITORS DO?

Internal auditors can take several actions to help the organization adopt a more strategic risk management focus.

- Increase the quality, frequency, and reporting of risk assessments.
- Facilitate risk management discussions across the organization.
- View risk management as a core competency and ensure that auditors receive appropriate training on risk and risk management practices.
- Review business plans to determine if they assess the risks embedded in their strategies appropriately and have risk monitoring and trigger points. Use the COSO ERM Framework to help position the organization higher on the risk management maturity curve.
- Review the annual report. Ask the question: Did we disclose and discuss the organization's risks appropriately?
- Continuously monitor and assess stakeholder expectations relative to risk and risk management; assist in the education of these stakeholders.
- Build a stronger relationship with the organization's other risk and control functions to drive an enhanced process to identify emerging risks.
- Identify and share best practices in risk management.

3. THE FOCUS OF INTERNAL AUDITING'S COVERAGE IS SHIFTING DRAMATICALLY

Roundtable participants confirmed that they are proactively shifting the focus of their audit plan in recognition of their organization's changing risk profile. Some of this shift is directly related to actions the organization is taking to streamline for economic reasons. This trend was also validated by the Fortune 100 GAIN survey, which reflected the most pronounced increase in coverage noted in operational risks and cost reduction/containment. More than 60 percent of respondents reported an increase in these areas.

A second area of shifting risk profiles is the increased risk presented by areas such as credit and liquidity and exposure to third parties in financial distress. These risks reflect the external impact of the economic crisis on the organization, with increased audit coverage reported by more than 50 percent of respondents. The only area in which CAEs noted a significant decrease in their audit activities was in testing and supporting compliance with Sarbanes-Oxley.

Participants from the GAIN Fortune 100 survey reported increased audit activity in several areas:

61.8% Operational risks	**52.9%** Liquidity and credit risk	**35.3%** Effectiveness of risk management
60.6% Cost/expense reduction/ containment	**48.5%** Financial risk	**26.5%** Compliance risks
58.8% Exposure to third parties in financial stress	**38.2%** Off-shoring/vendor risk	

The increased focus on operational auditing requires that CAEs have a thorough understanding of the business, suggested one roundtable participant. By coupling internal audit methodology with a deeper understanding of business processes, internal auditors can continue to prove their value to stakeholders. A key role is to help management answer questions about whether corporate overseers are analyzing the current business environment appropriately.

The increased focus on operational auditing requires that CAEs have a thorough understanding of the business, one roundtable participant suggested. By coupling internal audit methodology with a deeper understanding of business processes, internal auditors can continue to prove their value to stakeholders. A key role is to help management answer questions about whether corporate overseers are analyzing the current business environment appropriately.

REVISIT THE ANNUAL AUDIT PLAN

Current financial circumstances present opportunities for internal auditors to reassess their own audit strategies by stepping back and taking a fresh look at how the organization's changing business goals and resulting risks line up with the audit plan. Because the economic outlook is uncertain, CAEs need to be ready to change direction quickly, while keeping an eye on the actions management is taking to cope with today's economy.

CAEs are rapidly reprioritizing to identify potential cost savings and efficiencies and devoting more coverage to operational risks. There is a renewed need to provide objective analysis so that those charged with governance and oversight can use the information to improve program performance and operations, reduce costs, and facilitate decision making to oversee or initiate corrective action and contribute to public accountability.

Because of the changing business environment, many CAEs said that they are reviewing and updating their risk assessment more frequently than in the past. They also meet with the audit committee more often to review the changes. With limited resources and changing priorities, roundtable attendees agreed that the audit plan needs to remain dynamic and is no longer a tool that is planned annually and implemented on a regular audit cycle. The attitude, "This is the way we have always done it" no longer applies. In fact, with the renewed emphasis on auditing the organization's ERM processes, low impact/low probability functions may fall off the audit plan altogether. Participants agreed that these adjustments to the audit plan should stay on the radar, however, because risk in these activities may increase as operational and control processes change — thus the need for a frequent risk assessment.

Several recommended practices emerged from the roundtable participants' discussion of key areas they intend to include in their upcoming audit plans:

- Ensure that you have a seat at the table when management discusses plans and initiatives to respond to economic conditions. Consider the risks and need for immediate or continuous audit coverage during implementation.
- Ensure reputational risk is considered in economic-related plans and initiatives. Ensure that operational audits are appropriately structured and staffed if cost savings and business process improvements are objectives.
- Consider how you can use technology to enhance audit coverage and results.
- Consider a quarterly summary to the audit committee of recent events, management initiatives, cost programs, and the resulting risk and changes being made to the audit plan.
- Increase the scope of review on recession-related risks such as liquidity, credit, third-party contracts, service agreements, inventory valuation, and controls.
- Continue to shift resources to operational audits.

Several cost containment and revenue enhancement opportunities could be considered "low hanging fruit":

- Construction and capital projects.
- Contract performance.
- Corporate credit card transactions and fees.
- Equipment leasing vs. purchase costs.
- Licensing and royalty revenue.
- Vendor performance metrics, discounts, and rebates.

TESTING THE WATER FOR FRAUD

As the financial crisis deepens, new suspicions of fraud have emerged. When asked if their audit plan includes new activities to identify control or fraud weaknesses, most CAEs reported that they have increased their focus on fraud, particularly in areas with recession-related risks. While many have embedded additional fraud testing in their audit plans, others are expanding their scope using automated data mining tools. One CAE said that his organization uses a fraud framework to help clarify its focus.

A few Fortune 100 company CAEs indicated that they are advocating self-assessment activities within the organization's business units, pushing control and fraud monitoring accountability to operational management. This process, which serves as a continuous monitoring tool, can help shift audit resources from compliance testing to reviewing trends and the effectiveness of the self-assessment process. By reviewing the results of self-assessment questionnaires, surveys, and checklists, internal auditors can gain valuable information on control weakness trends that could lead to fraudulent activity.

Recession-related areas susceptible to fraud:

- Corporate procurement cards.
- Sales commissions and bonuses.
- Payroll.
- Overtime.
- Expense reports.
- Inventory.
- Accounts payable.

CONTROL ADEQUACY

The adequacy of controls in light of decreasing organizational budgets and staffing was another key theme throughout the roundtable discussions. Many employees are worried about losing their jobs and paying their bills, while others are doing more work because of staff reductions and may feel the need to cut corners just to get the job done. Areas that are especially vulnerable to recessionary risk, such as payroll, accounts payable, inventory management, and expense reports, should now have a renewed focus in a risk-based audit plan. One CAE recently put payroll on the audit plan for the first time in five years and has identified an extraordinary number of control weaknesses. Inventory shrinkage and segregation of duties are areas that the CAE of a major retail chain is focusing on due to increased economic pressure and reductions in retail staff.

Other CAEs at the roundtable indicated that as they facilitate ERM workshops to brainstorm risks, they also try to identify operational inefficiencies and controls. This technique serves not only to update the risk assessment but also to identify cost-containment ideas that can bring added value to the organization's bottom line. Using a facilitated workshop approach with anonymous voting technology can also offer a cost-effective way to identify and prioritize the most critical risks and inefficiencies.

TARP OVERSIGHT: INTERNAL AUDITING'S ROLE

Reputational risk was the overwhelming focus when the roundtable discussion turned to challenges in those organizations that received funds from the U.S. Troubled Asset and Relief Program (TARP). Reputational risks should be at the forefront of all risk scenarios, but those associated with TARP can have an even greater residual effect, if not monitored closely. The public scrutiny of TARP funds — who receives them, how they are used, when they are repaid — and the media coverage associated with the funds are a constant threat to vulnerable companies. By pulling internal auditing and management together as a team to satisfy regulator demands, public perception can be managed so that the organization can concentrate on salvaging its fragile balance sheet.

How can companies further manage reputational risk if serious damage has already been done? Leading practices suggested by roundtable attendees included the following:

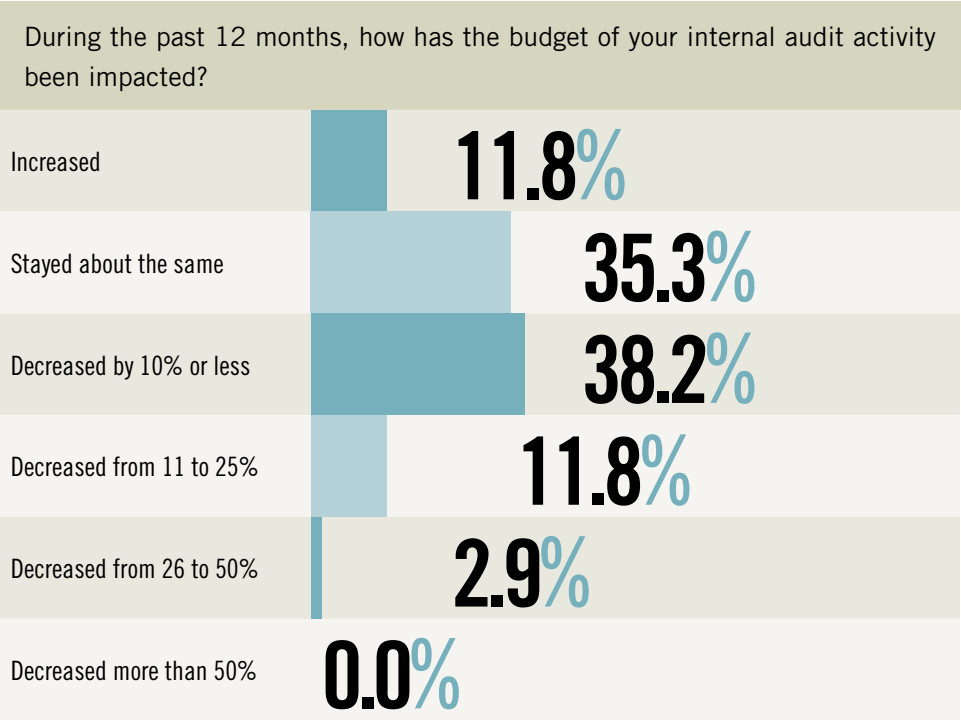
- Designate one area to "own" reputational risk and manage the media.
- Be transparent. Track negative press and circulate it to management and the audit committee.
- Don't over-react to negative press. Ask if it is worth addressing or just annoying. If necessary, move quickly with an action plan.
- Centralize all regulator correspondence and communication, national and global, within one area for consistency of messaging.
- Contact the regulators before every press release, alerting them to what will be announced.
- Incorporate reputational risk throughout every event in the risk assessment process.

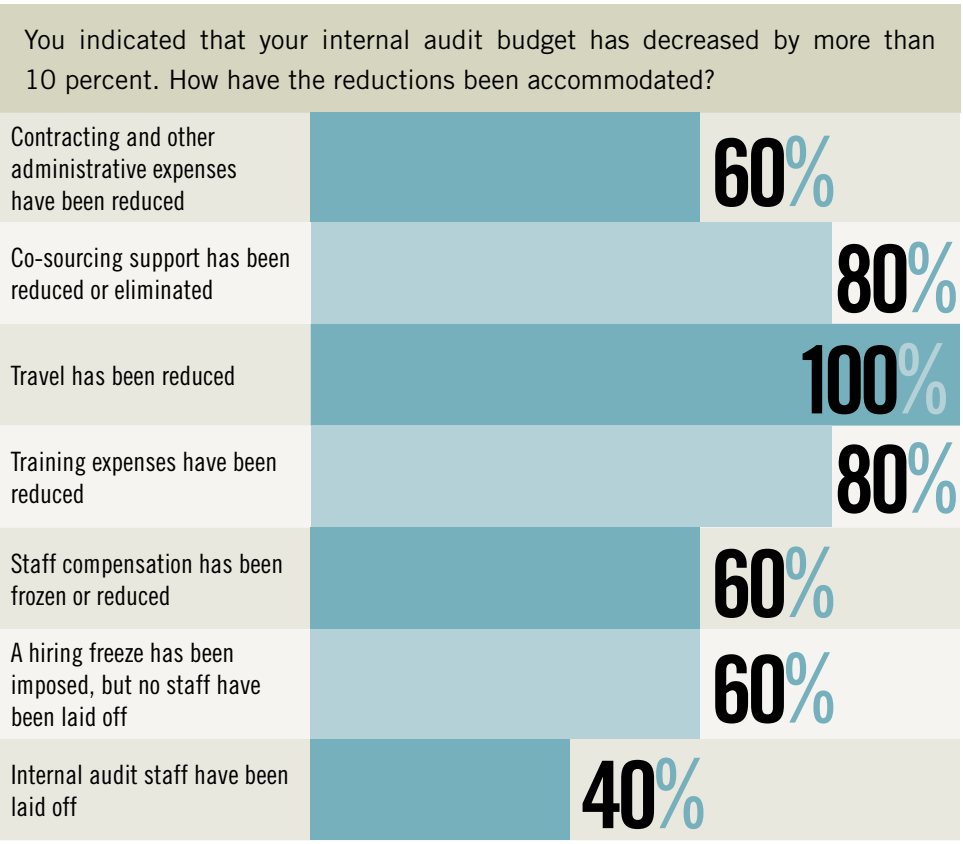
One roundtable participant indicated that internal auditing held almost daily communications with the company's CEO in regard to mitigating reputational risks surrounding the subprime mortgage crisis. And because regulators have already started asking about TARP assurance work, internal auditors need to have an audit plan in place. Most financial institution CAEs said that they are just starting to work on their TARP audit strategies because there are no defined expectations from regulators on what to do. But all agreed that if the regulators are going to review TARP compliance, internal auditors should be prepared.

4. CAEs ARE ENDEAVORING TO DO MORE WITH LESS

CAEs who participated in The IIA's roundtable discussion and GAIN survey agreed that there are budgetary challenges ahead for internal auditing. Reflective of the economy in general, almost 53 percent of survey respondents have experienced budget decreases during the past 12 months. Roundtable participants see a continuing need for internal auditing to become even more cost conscious and creative. Keeping an eye on risks and audit coverage, while focusing on efficiencies and operational effectiveness to drive down costs, remains a key focus for CAEs.

CAEs are using a variety of cost-cutting measures to accommodate these budget challenges. According to the GAIN survey, managing travel costs is at the top of the list, affecting almost every Fortune 100 audit department. Eighty percent of survey respondents reduced or eliminated co-sourcing support as well as training expenses, whereas 60 percent cut back on contract and other administrative costs. While not all have experienced budget reductions, most have been asked to freeze hiring and compensation.





While many of the Fortune 100 company CAEs surveyed indicated they have not had to reduce their audit staff, most said that they have reallocated resources. A CAE for a major retail chain told the roundtable group that with limited audit resources and the need to decrease audit travel, their department now reviews a much smaller percentage of retail stores. To add value to the process, they present a quarterly report of operating risk and control trends to management, offering a lessons-learned approach that other store managers can use to monitor processes. Management and the audit committee support this flexibility in the audit plan, acknowledging that in today's economy, everyone in the organization is charged with working smarter to do more with less.

One area that roundtable participants discussed at length was the use of technology and newer technology tools to enhance both the efficiency and effectiveness of the audit process. On the whole, participants agreed that technology is under-utilized in internal auditing but represents an opportunity for significant cost savings. While new technology may require new investments, the discussion pointed to several ways in which these CAEs are using automation and analytics to reduce manual testing times and increase audit coverage.

FINAL THOUGHTS

Despite the pressures and challenges of the current economic crisis, the results of the roundtable discussions and supporting survey data point to unprecedented opportunities for internal auditing to expand its focus in several strategic areas. The resounding take-away from CAEs attending The IIA's economic crisis roundtable is that in the future, assessing the effectiveness of risk management will become an increasingly vital role for internal auditing. The declining economy signals a new era in the strategic and systemic approach to assessing risk. Connecting the organization's business strategies with identified risks will challenge internal auditors to remain at the top of their game.

Internal auditors also have the task of assisting stakeholders as they respond to these economic challenges. Expectations are changing, sometimes dramatically, and CAEs are at the forefront in meeting those expectations.

The current crisis has served to move internal auditing beyond its significant role in Sarbanes-Oxley control compliance to a more strategic role in enhancing the organization's risk management and governance processes. The roundtable participants recognize this opportunity and are using it to further enhance the stature and credibility of their internal audit activities.

10 TAKE-AWAYS

CAEs are helping their organizations navigate through the current crisis in a variety of ways. Most roundtable participants said that they are making their internal audit activities more flexible by adjusting to stakeholder expectations and changing risk priorities. By linking their audit plan to business strategies and current risks, internal auditors are shifting priorities from a financial and compliance focus to a more operational and ERM effectiveness strategy. Roundtable participants suggested several leading practices and strategies:

1. Ramp up communication with management and the audit committee. Know the expectations of the audit committee and management. Recognize the opportunity to advocate risk management and keep the audit committee informed of upcoming and emerging risks. Discuss and obtain agreement on any shifts in audit plan priority. Promote transparency at all levels.

2. Place renewed focus on risk management and governance processes. Audit the effectiveness of the organization's risk management and governance processes. Take a hard look at the organizational structure and business strategies, and ensure that there is a well-thought-out risk management process. Raise tough questions about oversight practices and strategies. Look at the board structure, reporting lines, and separation of duties.

3. Strengthen your risk assessment process. Reassess risks, including emerging external risks, and quantify the impact more frequently. Add a preparedness, velocity, and resilience factor to the risk assessment matrix, and subject every area of the risk assessment to a reputational risk litmus test. Assess the impact of compounded interrelated risks that if combined could snowball into a higher risk priority, and look toward the future to anticipate the next emerging risk.

4. Operate with a more flexible and adaptable audit plan. Reassess the audit universe regularly and change the audit plan to stay aligned with business objectives. Reprioritize resources to adapt to priority risks identified in the risk matrix, and shift assurance activities to risk management processes, operational controls, and cost containment/reduction and revenue enhancement activities. Keep an eye on what actions management is taking to cope with today's environment.

5. Serve as a risk management educator. Help management and the audit committee understand where they stand in the ERM curve and work together to fill in the gaps. Facilitate risk management workshops, and advocate a rigorous self-assessment process to provide broader risk review coverage. Facilitate risk discussions at every opportunity.

6. Focus on recession-related risks and activities. Incorporate cost containment and revenue enhancement reviews into the audit activity. Review risks around reputation, liquidity, workforce reductions, and third-party vendors. Look at going concern issues and off-balance-sheet transparency, and ensure internal controls mitigate reputational risk. Cultivate a cultural mind-set so that all activities are scrutinized with corporate reputation in mind. Invite management to surprise drills and discuss strategies if the unthinkable happens.

7. Expand fraud testing in the audit plan. Incorporate technology to review a broader transaction universe for anomalies. Focus on recession-related risks, inventory shrinkage, overtime abuse, unauthorized accounts payables, and expense report padding.

8. Strengthen business knowledge. Couple audit methodology with a deep understanding of the business; find out what you don't know and fill in the gaps. Focus on business objectives and strategies, and ensure that your audit plan considers and addresses the strategic risks to the organization. Partner with risk champions to improve organizational knowledge.

9. Strengthen your relationships and communications with the organization's other governance, risk, and control functions and meet with risk champions regularly. Build a strong relationship with management to stay abreast of business changes and strategies. Encourage open communication and sharing, facilitate risk discussion, and publish emerging risk lists.

10. Enhance the efficiency of your audit processes. As your businesses revamp and re-engineer their processes to enhance efficiency and cost effectiveness, put internal audit processes to the same test. Look for ways to shorten reporting time, increase the use of technology, and challenge internal audit teams to increase their efficiency.

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