Adding Value:

How Modern Internal Auditing Assists Organizations in Achieving Strategic Objectives

By Emily Ray

University of Texas at Dallas

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About the Author

Emily Ray is a graduate student at the University of Texas at Dallas, where she is studying Accounting and completing the IAEP curriculum. She recently graduated Magna Cum Laude with a Bachelor's degree in Accounting. She plans to sit for the CIA exam in 2009.

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Introduction

2008 was a roller coaster year for the world economy. Some of the most established, best-known firms either were bought up by competing firms at fire sale prices (as in Bear Stearns' acquisition by J.P. Morgan in March, 2008), or have sought assistance from the government in the form of an emergency bailout (examples include AIG and automobile manufacturers in the United States).

Where did these firms go wrong? Some experts argue that these companies mismanaged their risks. Others have argued that governance was lacking. And we should consider the control environment in these organizations. Were controls not being followed, or were they ineffective? Ultimately, all of these concepts – risk management, governance, and effective controls – impact a firm's overall health as well as its ability to implement strategy and meet performance targets. As professionals charged with evaluating risk management, governance and control processes, internal auditors fulfill a critical supporting role in gauging the firm's ability to achieve strategic objectives. As such, they have become an indispensable resource to many companies.

The purpose of this paper is to illustrate how internal auditing helps firms more fully achieve strategic objectives. I decided that the best way to approach this topic was to analyze a firm that failed to achieve its objectives, and investigate how internal auditing might have been able to make a difference in its success or failure. In light of the current economic crisis, Bear Stearns is a relevant and compelling example. Accordingly, I will use vignettes from characters in the Bear Stearns story to show how internal auditing can bring organizations closer to their goals. I will then use data published by the Institute of Internal Auditors in its 2006 Common Body of Knowledge (CBOK) study to illustrate some of the ways internal auditors are currently

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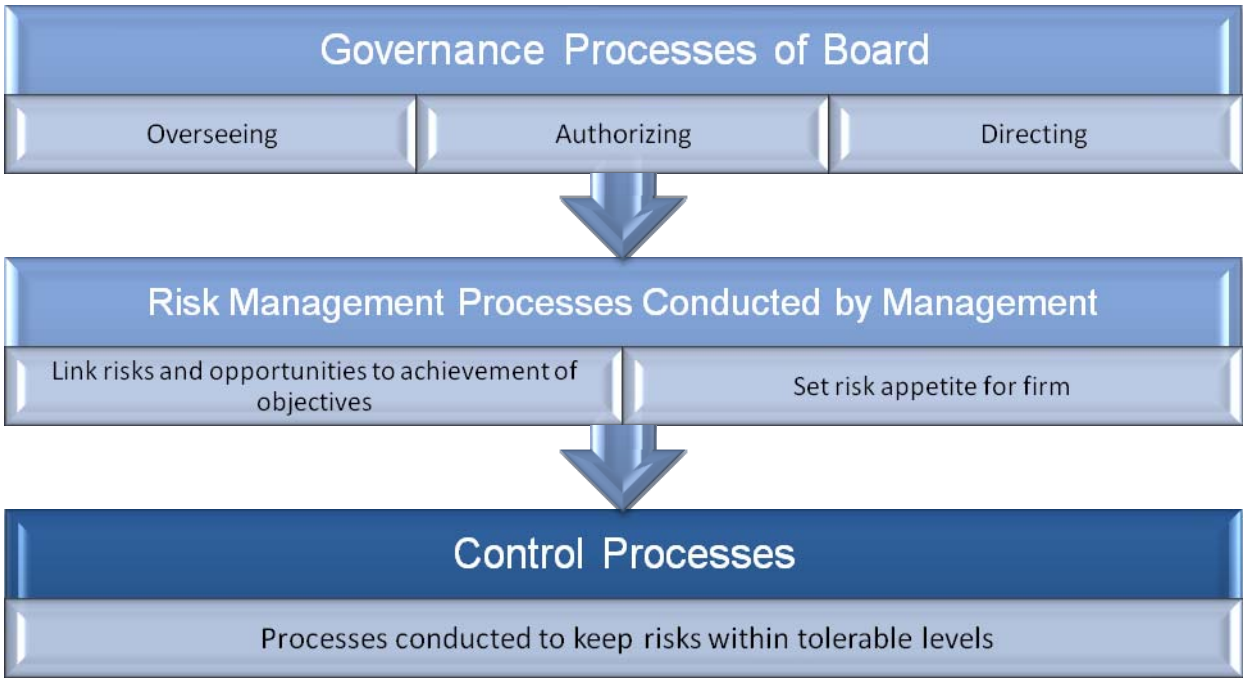
adding value and helping firms achieve objectives. I also plan to use the CBOK data to illuminate some of the areas in which our profession has room for growth. My hope is that the reader will gain an appreciation of how internal auditors make a positive contribution to their audit clients' success, as well as an understanding of some of the areas in which our profession can continue to grow. To begin, I will give a brief overview of internal auditing and how it adds value to organizations.

The Internal Audit Activity's Role in Helping Firms Achieve Strategic Objectives

Internal auditing helps the firm achieve strategic objectives through its "evaluation of governance, risk management and control processes" (Reding, Sobel and Anderson 1-4). The visual model below portrays the relationship of these process areas to one another.



Governance, risk management and control processes exist to ensure the company is adequately positioned to control risks that threaten achievement of objectives. Internal auditing supports these processes by evaluating them, communicating recommendations to management, and reporting deficiencies to the audit committee.

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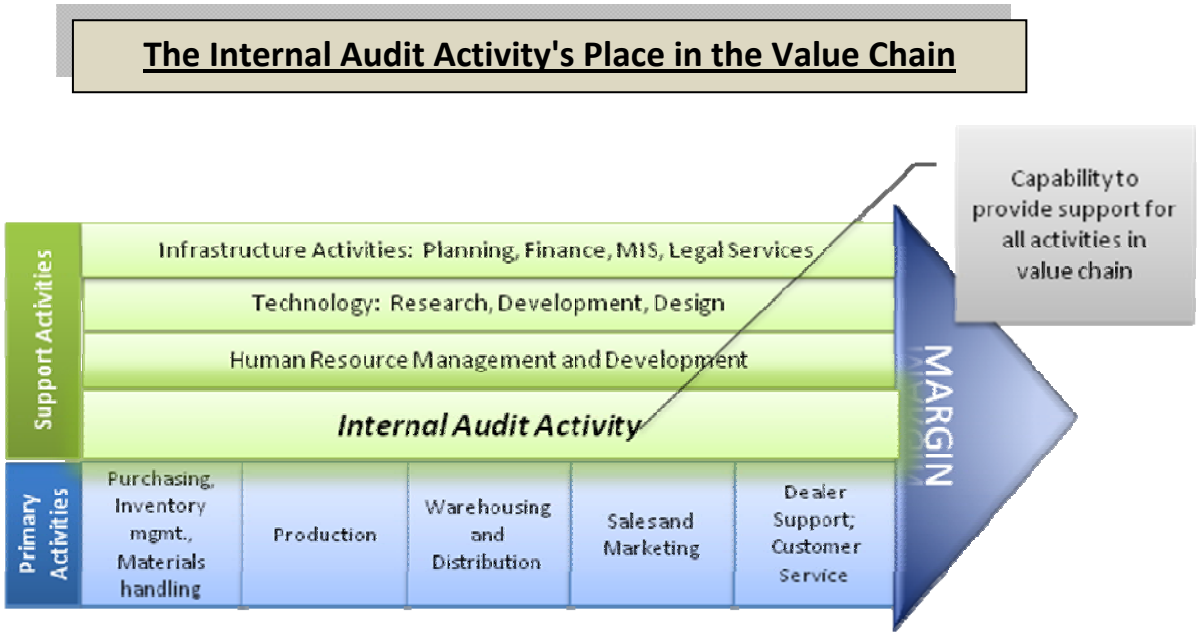
Value-Creation Choices

In order to show how internal auditing truly enhances the organization's ability to achieve strategic objectives, I thought it would be beneficial to envision how the activity fits into the organization's value chain, as diagrammed below.



This diagram, which was adapted from Michael Porter's generic value chain model in his classic work *Competitive Advantage* (Porter), shows that a firm has two essential categories of activities that create value – primary and secondary activities. The primary activities involve the firm's operations and day-to-day management. The support activities typically encompass three main categories of activities: Infrastructure activities, which relate to strategic planning, finance decisions and legal services; Technology, which includes R & D efforts; and Human resource management and development (Porter).

As you can see from the above model, the internal audit activity fits under the umbrella of support activities as its own category in my adaptation of the generic value chain. This is because internal auditing touches all of the primary activities in the value chain, and, in addition, can streamline support activities through compliance audits and process evaluation.

When executed effectively, the audit plan should flow from goals related to all of these activities. When the support and primary activities are conducted more efficiently and effectively, margin can be increased and a firm can gain competitive advantage. This supports the idea that internal auditing adds value to the organization and helps it better execute its strategy, putting it in a better position to achieve its objectives. In the next section, we will examine how one firm failed to do this, and how an effective, properly supported internal audit activity may have been able to help right its course.

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Bear Stearns

Bear Stearns was widely known to be the "maverick" among all the investment banks, and had a reputation as a risk-taker. The firm, known for dabbling in anything that would make money, also loaded up on securitized mortgage-backed securities just as many others did in the heyday of the housing market (Morgenson).

However, Bear appears to have made two very large mistakes that made the downfall of the housing market more painful for itself than for some of its competitors. For one thing, two of Bear Stearns Asset Management's prominent hedge funds invested heavily in mortgage-backed securities, did not diversify, and then increased their leverage, resulting in the first fateful mistake: Bear Stearns made a massive losing bet on an ill-fated investment vehicle (Burrough). If the market had continued to rise, Bear would have made its investors impressive returns instead of losing their money. But that's not what happened, which led to the second mistake – which, the SEC alleges, was not a mistake at all but in fact was fraud: When the hedge funds started to fail, the fund managers allegedly withdrew their own money and never told investors or creditors about the woes facing the funds. In fact, they misrepresented the expected performance of the funds to the investors, according to the Department of Justice indictment of the hedge fund managers (Department of Justice).

The collapse of these hedge funds was the beginning of the end for Bear Stearns. The question is: Could internal audit have helped prevent the failure of the hedge funds in some way?

To answer this question, we can think of these hedge funds in terms of some of the control objectives that might have been in place to ensure proper oversight. If the control objectives were to maintain adequate liquidity, ensure achievement of performance targets and instill effective risk management practices in accordance with the firm's risk appetite, then the firm could have implemented key controls based on those objectives. Internal auditors could have tested and reported on the adequacy of the controls, which might include measures such as the following:

- ✓ Test for proper valuation of securities.
- ✓ Ensure fund managers' assertions about the fund were accurate.
- ✓ Determine whether or not the mix of securities represents the stated diversification strategy. Even though the fund manager's strategy is proprietary, internal auditors should have access to it to confirm that the firm is not exposed to unknown risks.
- ✓ Evaluate whether or not risk is being measured objectively. Is the hedge fund manager in charge of determining the true risk of the investment? If so, this could represent a lack of segregation of duties. According to Schmerken, it is standard industry practice to have a separate "risk czar" to determine the true risk of the investment when dealing with hedge funds (Schmerken). The SEC's Office of the Inspector General also reported that risk managers at Bear Stearns may have lacked independence (Office of the Inspector General).
- ✓ Analyze liquidity and solvency ratios to test for financial health.

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- ✓ If not in place already, recommend that managers implement an automated system that alerts risk managers of inappropriately high leverage and requires a review or approval from the independent risk manager before a fund manager can borrow excessively. This at least triggers review of the hedge fund managers' strategy for soundness. This is also a preventive control that can deter bad judgment calls. Implementation of such a system is ultimately management's responsibility.
- ✓ Analyze fund P&L statements to measure performance.
- ✓ Report any exceptions or findings to the audit committee immediately.

If these tests were being conducted by internal auditors, then management and the board must not have been listening. However, if these tests were performed, and if management and the board had taken action, Bear Stearns might still be an independent investment bank today. This story exemplifies that a firm's attitude towards risk, governance and control defines its ability to adapt and shift when the market experiences a massive downturn. Even if Bear Stearns had "won" its bet that the housing market would continue to rise, the fact that the firm was exposed to so much risk is troubling. The long-term health of a firm relies on the ability of managers to assess risk realistically, and make judgments based on a pragmatic approach to achieving strategic objectives. Internal auditors can facilitate this approach by evaluating and communicating the results of testing to management.

Facilitating Effective Enterprise Risk Management

Enterprise Risk Management (ERM) is defined as a continuous process in which an organization identifies, assesses and decides on responses to risks that threaten achievement of objectives (Institute of Internal Auditors). While internal auditors cannot take ownership of risks or design or implement the responses to risk (management must take accountability for those steps), internal auditors can champion the cause of ERM in the organization, and increase the organization's awareness of risk. Internal auditors are responsible for evaluating, reviewing and giving assurance on risk management processes (Institute of Internal Auditors). These key activities facilitate risk awareness and better governance by putting a much-needed focus on events that threaten achievement of objectives.

In addition to facilitating ERM, there are other ways in which internal audit can assist firms in achieving their objectives. I will explore this in the next section, with a vignette about another character in the Bear Stearns story: the Securities and Exchange Commission.

The Securities and Exchange Commission, Dynamic Risk Assessment and Proactive Auditing

When the SEC's Office of the Inspector General conducted an internal audit of the commission's Consolidated Supervised Entity (CSE) program after the Bear Stearns collapse, its chief purpose

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was to evaluate the program's effectiveness and efficiency. What the audit found was that the SEC failed to fulfill the mission of the CSE program, and the Office of the Inspector General made 26 recommendations to improve it. Of the 26 recommendations made, the responsible SEC managers agreed with 21 (Office of the Inspector General).

I will not enumerate all the Inspector General's findings and recommendations here, although I think the report does a great job of illustrating the value of the service that internal auditors provide. To summarize just a few of the findings, the audit concluded that the Division of Trading and Markets (the Division), which was responsible for oversight of Bear Stearns, ignored red flags that indicated that Bear had a dangerously high concentration of mortgage-backed securities. The audit also found that the Division knew about deficiencies in Bear Stearns' risk management processes, and failed to take action.

It is also worth noting that Bear Stearns was, technically, in compliance with the liquidity and capital ratio requirements of the CSE program. Consequently, the auditors issued a finding questioning whether the program's requirements truly were adequate to support its mission. Recommendations were then given regarding how the program could be improved. This kind of feedback helps managers and those charged with governance in determining what impedes achievement of objectives, and how those obstacles can be overcome.

If this audit had been conducted prior to the collapse of Bear Stearns' hedge funds (instead of in the aftermath of Bear Stearns' acquisition by J.P. Morgan), then the SEC may have been able to make essential changes to the CSE program, such as implementing more stringent credit or liquidity requirements. Whether this would have saved Bear Stearns is impossible to say for certain. However, it is clear from the Office of the Inspector General's audit report that Bear Stearns had serious risk management issues and would have benefitted from more appropriate oversight than the CSE program provided.

Audits are most helpful when they are able to help avert crisis, and in an ideal situation, the Office of the Inspector General would have performed this engagement before Bear Stearns collapsed. Perhaps the Office of the Inspector General could have been more proactive through dynamic risk assessment. According to Roth, dynamic risk assessment is a key method world-class audit shops use to design audit plans (Roth). Dynamic risk assessment allows auditors to modify the audit plan as risk factors change for the organization. With dynamic risk assessment and a flexible audit plan, the Office of the Inspector General may have been able to shift audit resources to higher-risk areas as conditions in the real estate market deteriorated. This might have triggered earlier review of the CSE program, causing auditors to pinpoint deficiencies earlier on.

In the next section, we explore how, through consulting engagements, internal auditing can help a firm limit its exposure to risk.

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J.P. Morgan

In the end, Bear Stearns ultimately failed because it ran out of cash. In the final days of the crisis at Bear Stearns, when the situation had spun out of control and it was clear that the legendary investment bank would not be able to operate through the next business day without an emergency loan, Bear Stearns' management and Federal Reserve regulators got to work. They decided that they couldn't let the firm fail, so they brought J.P. Morgan to the negotiating table to work out a deal. According to reports, J.P. Morgan CEO Jamie Dimon was called during his 52nd birthday party to begin talks to float Bear Stearns a $30 billion loan. That night, Jamie Dimon and his team of executives worked out the details to extend Bear Stearns a credit line that was backed by the federal government (Burrough).

Shortly thereafter, J.P. Morgan acquired Bear Stearns. In order to properly value the company and limit its exposure to the same risks Bear had incurred, J.P. Morgan had a team of 300 personnel to perform due diligence work prior to the acquisition. It was this important work that led J.P. Morgan to assess the value of Bear Stearns at $3 - $4 a share. (In the end, it was Treasury Secretary Hank Paulson's urging that prompted J.P. Morgan to make the offer at $2 a share; this figure was later increased to $10 a share by J.P. Morgan when Bear Stearns stockholders were understandably outraged at the $2 figure.) These stock prices are a far cry from the $32 price that Bear Stearns had boasted the previous business day (Burrough).

The work of the due diligence personnel was extremely beneficial to J.P. Morgan in that it gave an accurate picture of the worth of Bear Stearns and allowed J.P. Morgan to truly ascertain what it was getting with the acquisition. In any acquisition, due diligence provides a wealth of knowledge about the company being acquired. The resulting information serves to significantly impact the risk of the acquisition. Through the work of those involved in due diligence, the firm's strategic objectives in the M&A process can be met.

Internal auditing assists in the effort to provide due diligence in a variety of ways. Through documenting and evaluating the new acquisition's processes, controls, policies and systems, internal auditors can provide recommendations that serve to identify strengths, weaknesses and risks in the acquisition of a company. In J.P. Morgan's case, due diligence was critical to minimizing the risk associated with buying the illiquid assets on Bear Stearns' books.

I've identified some real-life scenarios in which internal auditing can and has provided value-adding services to help firms achieve their business objectives. Next, I will use the Common Body of Knowledge study to gain an understanding of how we perceive ourselves as a profession, where we are going and what positions our profession to continue to add value.

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The Common Body of Knowledge: Summarizing the State of the Profession

Based on the research I conducted in preparation for this paper, which includes reading the articles I've cited as well as the Standards, I believe that well-run audit shops ought to have, at minimum, the following qualities:

- Independence and Objectivity. This is the internal audit activity's primary value-adding quality. Auditing and assurance functions don't mean much if they aren't conducted by an independent and objective audit team.
- In-depth understanding of a firm's core value proposition, strategy, vision and values.
- Competent audit staff.
- An effective quality review process.
- An effective way to measure value-added.

To determine whether or not audit shops possess these qualities, I read the Institute of Internal Auditors' 2006 Common Body of Knowledge study. I used this data to attempt to determine how members evaluate themselves on the above criteria. I also identified several areas on which we as a profession can focus to create more value.

Independence and Objectivity

The 2006 CBOK survey data shows that most internal auditors think that their organizations do a good job of complying with independence requirements. 47.3 percent of Chief Audit Executives report directly to the audit committee and 43.4 percent report to the executive level of management, indicating that, in general, internal audit activities have appropriate organizational independence. In addition, 91.3 percent of Chief Audit Executives in organizations with audit committees believe that they have appropriate access to the audit committee (IIARF "CBOK"). These results are summarized in the below table (ratings were on a scale of 1-5, 5 being the most favorable).

Mean Rankings of Internal Audit Departments by CBOK Respondents

Quality	CAE	Audit Managers	Audit Seniors	Audit Staff
Independent and objective	4.45	4.34	4.25	4.1
Adds value	4.41	4.32	4.26	4.2
Sufficient status to be effective	4.07	3.97	3.86	3.75
Independence is key factor	4.46	4.4	4.32	4.29
Objectivity is key factor	4.58	4.47	4.42	4.36
Credibility of IAA	4.3	4.17	4.08	3.99

Experience and Composition of Internal Audit Team

According to Roth, one characteristic of world-class audit teams is experience level and degree of expertise (Roth). One indicator of expertise is education. 36.1 percent of all respondents have a bachelor's degree in a business-related field, while 32.8 percent have master's degrees in business fields. 12.1 percent of respondents have bachelor's degrees in non-business related fields (IIARF "CBOK"). This seems to indicate that IIA members currently come from a wide variety of educational backgrounds, and the majority have, at minimum, a bachelor's degree.

Aside from university degrees, internal auditors should obtain certifications to demonstrate specialized expertise. According to the CBOK, the professional certification obtained by the largest percentage of members of the IIA is a public accountancy certification such as the CPA. 35 percent of members hold a CPA or other public accountancy certification, so internal auditors are more likely to have a CPA certification than a CIA certification. While having other certifications is certainly a sign of proficiency in specialized areas, professional internal auditors should strive for CIA certification as a priority.

Not only does being a CIA signify a level of professional expertise as an internal auditor, but the educational requirements that go along with being certified would ensure that the auditor is completing CPE coursework and therefore staying up-to-date on the latest Standards, Practice Advisories, and Guidance. This is critical, both in demonstrating proficiency and in maintaining auditors' skillsets. Currently, less than half of IIA members have completed the recommended amount of CPE coursework over the previous 3-year period, so this appears to be an area where we have room for improvement.

The CIA certification should be encouraged for internal auditors in all organizations. Currently, only 28.6 percent have it (IIARF "CBOK"). Below is a table summarizing the certifications held by IIA members at the time the CBOK study was conducted.

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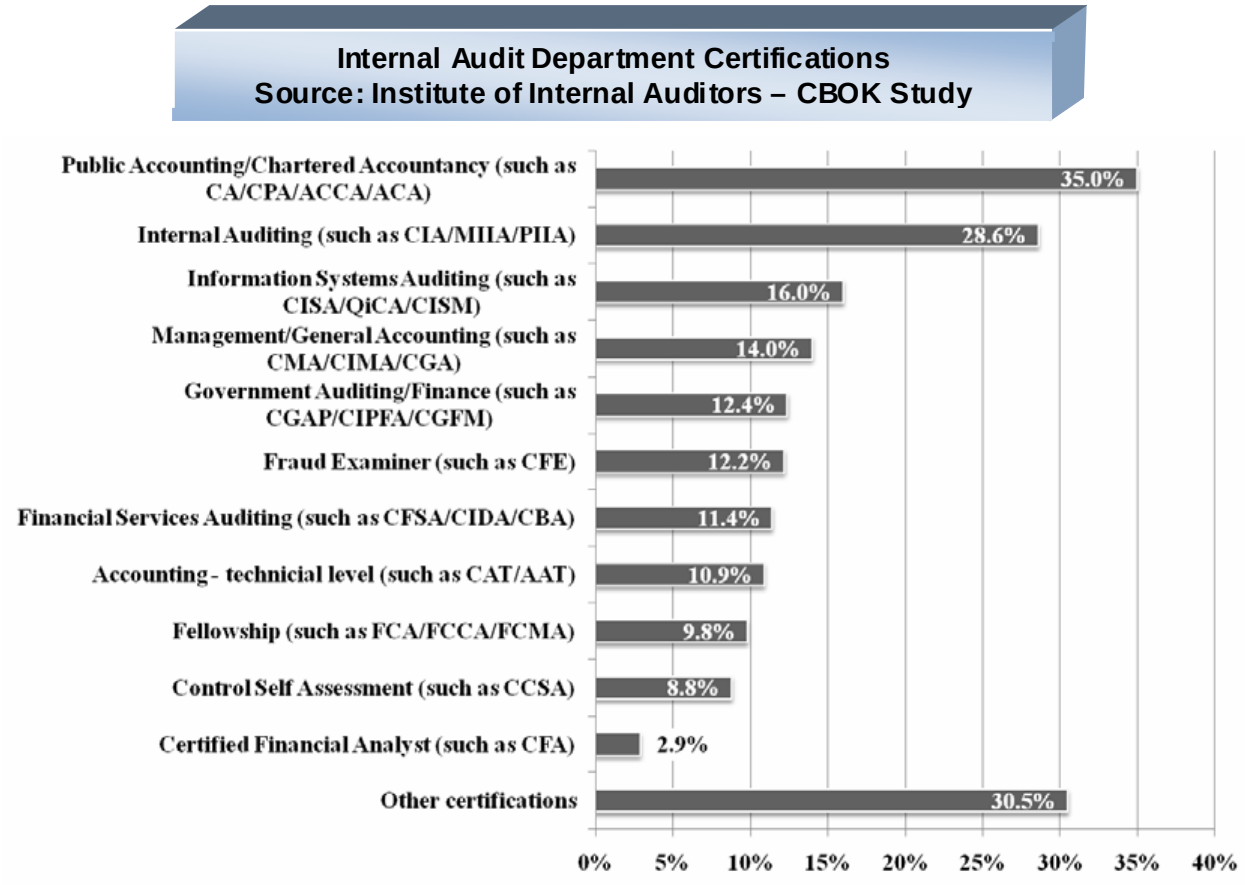


Quality Reviews

Quality reviews are essential to appropriate development of the internal audit activity. However, according to the CBOK study, less than 50 percent of respondents have activities in place to monitor the effectiveness of the internal audit function in their organizations. Chief Audit Executives that were surveyed responded that 47.4 percent of their teams have never had an internal assessment, and 39.7 percent have never had an external assessment (although, 28.4 percent of the respondents had internal audit departments less than 5 years old and were not subject to external reviews yet under the Standards) (IIARF "CBOK").

Chief Audit Executives should focus on establishing and implementing effective quality programs, as required by the Standards. Quality reviews are essential to developing an understanding of weaknesses and how to address them.

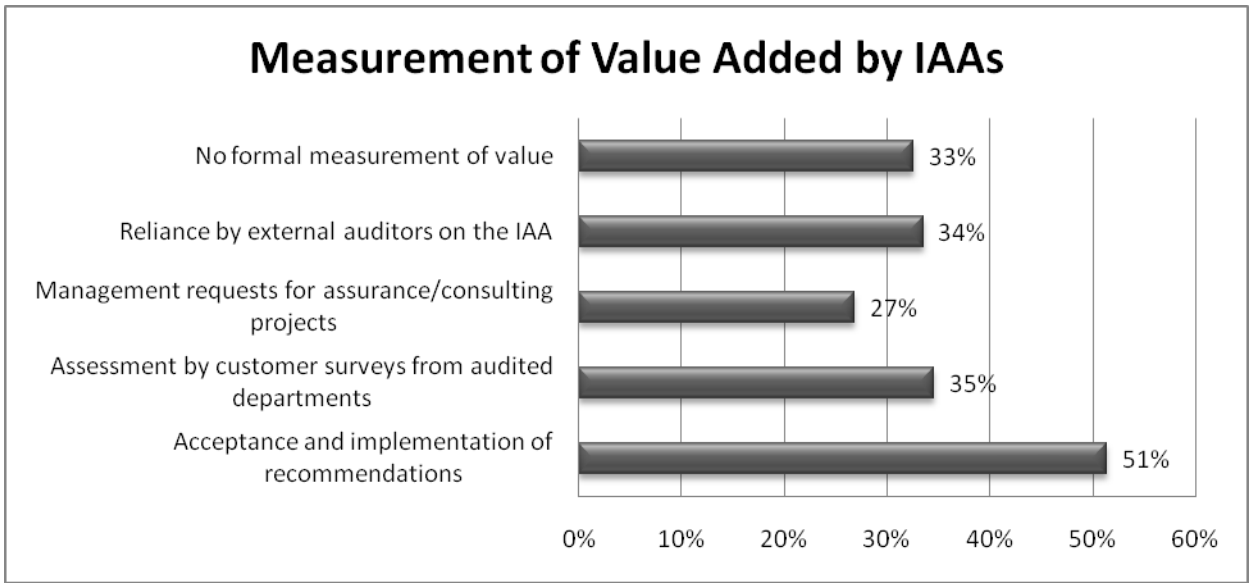
Understanding of the Firm's Strategy

According to the CBOK study, only 66.3 percent of members surveyed indicated that there was a long-term strategic plan for their organizations that they were aware of (IIARF "CBOK"). In order to help an organization achieve its objectives, auditors first have to know what the objectives are. In cases where this communication is lacking, internal auditors need to be

proactive in working with management to develop a solid understanding of firm strategy. This step is critical if the IAA is to enhance the organization's ability to achieve its goals.

Measurements of Value Added

How do internal auditors measure whether or not their departments have added value? There are many ways used to determine this, and some organizations use more than one formal method. The top four methods, according to the CBOK study, are as follows. First, most internal audit departments look at the cost savings associated with acceptance and implementation of auditors' recommendations. Many also administer surveys to audited departments. They may also look at the degree to which external auditors can rely on the work performed by the internal audit activity, because this can significantly reduce the amount of billable hours charged by external auditors. Additionally, many internal audit activities use the number of management requests for consulting and internal audit assurance projects to measure value added. The percentages of IAAs that use these methods are depicted in the below chart (IIARF "CBOK").



As the chart demonstrates, the overwhelmingly majority (51 percent) measure value added in terms of cost savings derived from implementation of recommendations. Following in popularity at 35 percent and 34 percent (respectively) are surveys of audited departments and reliance on IAA's work by external auditors. (CBOK, Chapter 5)

However, the fourth-highest percentage of answers in the survey (33 percent) is from internal auditors responding that their department had no formal method of measuring value added (IIARF "CBOK"). Since adding value is a fundamental concept to internal auditing, it is notable that so many internal audit activities don't have a way of formally measuring it, and this represents an opportunity for improvement. Internal audit activities should have formal review processes in place to determine objectively whether or not they are adding value to the

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organization. Choosing one or some combination of the above methods allows auditors to determine if stakeholders to the profession are deriving value from its existence.

What Positions the Profession to Continue to Add Value?

"Progress through Sharing"

Anyone who has worked in a collaborative environment can understand that when it comes to being part of a group, contribution and knowledge sharing are valuable. When people feel free to share knowledge, ideas, and best practices, the group becomes stronger and its collective value increases. Fortunately, the Institute of Internal Auditors values the concepts of knowledge sharing and collaboration, and promotes the continuous evolution of the profession as a whole. This positions the profession to continue to add value for organizations.

"Progress through sharing" is the slogan of the IIA. It is this principle that enables the profession to advance through collaboration and information-sharing. This concept is pervasive throughout the IIA's website, where internal auditors have access to multiple resources providing assistance on a vast range of topics, from establishing a brand new audit shop to viewing information about how to establish quality assessment and review programs.

Conclusions and the Road Ahead

Internal auditing has come a long way since the inception of the Institute of Internal Auditors in 1941. Over time, it has evolved into a profession that brings a systematic approach to evaluating the effectiveness and efficiency of the firm's operations. It helps organizations achieve strategic objectives and adds value to the firm by aligning audit objectives with the firm's objectives. When developed and supported properly, the internal audit activity can actually help the firm gain competitive advantage by improving all activities in the value chain, which in turn helps the firm better execute its strategy.

In addition, the profession is supported by the Institute of Internal Auditors, an association that promotes knowledge-sharing and continuous improvement. Internal auditors around the world have access to standards, practice advisories, research papers, and studies through the IIA website. Internal auditors can also add to the common body of knowledge by submitting their own research. The profession is truly promoted and supported by "progress through sharing."

However, there are areas in which the profession can improve significantly. As we move forward and strive to better ourselves and our organizations, we should focus on a few activities that are pivotal in our progress. These activities are critical in measuring our success, and data from the CBOK study indicates there are still improvements that can be made in all of the following areas:

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Suggested Areas for Improvement

CIA Certification

- Denotes professional expertise
- CPE compliance helps develop/maintain skillsets
- Only 28.6% of members are CIA-certified (CBOK)

Quality and Performance Measurement Programs

- Quality Assessment Reviews
  - <50% of members have quality programs in place (CBOK)
- Measurements of Value Added
  - 33% of respondents have no formal measurement of value
- Solution: Define objective performance measurements, and monitor compliance.

Understand Business Strategy, Objectives and Risks

- A prerequisite to helping companies achieve goals
- 66.3% of IIA members indicate awareness of long-term strategy (CBOK)
- Room for improvement

Global Considerations: IFRS

In addition to those areas noted above, we should also consider how global standardization is having an impact on our profession. Today's global economy has made business more rewarding and profitable, but has also increased the complexity of transactions. In addition to differing currencies, standards and cultural values, there are different accounting standards. Now that countries are standardizing on the new International Financial Reporting Standard, reporting should become more transparent to the global business community. Comparability of financial statements will be increased if we all comply with one standard.

On the other hand, those of us in the United States (and in other nations converting to IFRS) will have to convert our accounting systems as well. We will all have to learn the new standard and will have to go through the initial pain of implementing the changes before we can enjoy the reduced complexity and increased transparency that IFRS should bring.

As internal auditors, we can help our organizations through our efficient review and evaluation of new systems and policies. We should familiarize ourselves with the project timelines our companies have in place for IFRS convergence, so that we can monitor progress. In performing all of these tasks, we can help streamline the transition to IFRS for our firms (Ernst and Young).

In closing, as the role of the internal audit activity in the organization has expanded, internal auditors have been able to help their organizations become more efficient and effective at

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improving operations and controlling risks. But this role requires proper support in order to function properly. People around the world are seeing what can happen when risks are ignored in pursuit of high returns. As we've seen from the Bear Stearns story, firms that fail to accurately predict or mitigate risk may see disastrous results. Risk management, governance and controls will continue to be key topics in the years ahead, as more people understand how these concepts are tied to the achievement of objectives in the long term. This makes internal auditing an indispensable activity to firms attempting to compete in today's challenging economic climate. As such, we should continue to learn, grow and adapt so that we can maximize our contribution to the business world in the years to come.

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