

Focus of IA departments on strategic risks of listed companies

L Foxcroft

Department of Auditing
University of Pretoria

H de Jager

Department of Auditing
University of Pretoria

ABSTRACT

Since 2000 various companies including Enron and Tyco, have ended up throwing in the proverbial towel as major accounting fraud has led to their downfall. A diversity of other companies has followed suit due to the global financial crisis since 2008, and the escalating U.S. federal debt and deficit. This has merely intensified global pressure for the adoption of a risk focussed approach to internal audit (IA), especially when reviewing strategic risks. Strategic decision making and the implementation of those decisions during the still stuttering economic recovery is vital and will determine any firm's success or failure for many years to come. The global pressure for a risk focussed approach to IA has highlighted the fact that some of the most important risks that a company faces are strategic risks.

In this paper, the involvement of IA functions in the context of strategic risk management is explored. The alignment of the IA function's strategy with the business's strategy is investigated, including the extent of IA's participation in strategic risk identification and management. The results of the research reported in this paper suggest that IA departments of Johannesburg Stock Exchange Limited (JSE) listed entities, whose chief audit executives (CAE) are members of the Institute of Internal Auditors, exclude strategic risk from their audit scope.

Key words

Assurance; audit; focus; intern audit; process; questionnaires; risk; scope; strategic risk

1 INTRODUCTION

Since 2000 various companies, including Enron and Tyco, have ended up throwing in the proverbial towel as major accounting fraud has led to their downfall. A diversity of other companies have followed suit due to the global financial crises since 2008, and the escalating U.S. federal debt and deficit (Basioudis 2010; Grambling & Myers 2006:53). This has merely intensified global pressure for the adoption of a risk focussed approach to IA, especially when reviewing strategic risks. According to Anderson and Schroder (2010:16), strategic decision making and the implementation of those decisions during the still stuttering economic recovery is vital and will determine any firm's success or failure for many years to come. The global pressure for a risk focussed approach to IA has highlighted the fact that the most important risks that a company faces are strategic risks (Andersen & Schroder 2010:18; Beasley & Frigo 2007:26; Bloomberg Business Week 2010:12).

There are many reasons for a company to fail: the mismanaging of risk (including the construction of and assumptions in its risk model,) and the IA function not coping with the complexity of the current economic environmental chaos, being the most important (Williams 2008:473). Studies by Mardjono (2005:282),

Markham (2006:596), and Williams (2008:472), amongst others, have indicated that many of the organisations that were the subjects of public humiliation had well-established IA departments. These companies were even (nominally) practicing high-quality governance principles.

IA departments apparently often exclude strategic risks from their audit scope (Basioudis 2010). More concerning is the lack of new and creative practices that could assist IA to successfully review strategic risks (Fitzmaurice 2010; IIA 2010). As Fitzmaurice (2010) points out elsewhere, IA needs to seize every opportunity to enhance its alignment with the firm's strategies and vision, as this need for congruence is often disregarded. This can be achieved by IA positioning itself outside the "premeditated" compliance department and by siding with management to integrate "strategic risk" as an audit priority (Fitzmaurice 2010; Wells 2010).

2 BACKGROUND AND OVERVIEW

2.1 Research Problem

As has been described in the introductory sections of this article, strategic risk has been identified as an area of fundamental concern to business (Andersen &

Schroder 2010:18; Beasley & Frigo 2007:26; Bloomberg Business Week 2010:12). Although many organisations are content to rely on their IA departments to report on identified risks and gaps in controls, for other organisations the area of reviewing and reporting on strategic risk is inadequate.

IA needs to add value beyond mere compliance auditing, but a significant obstacle facing them is the perception that strategic risk activities are beyond their scope and capabilities. Although IA may currently lack knowledge of strategic risk practices and techniques, it is not difficult to achieve competence. The key skill required to assess strategic risk effectively and efficiently is knowledge of the business and of the industry it operates in (IIA 2009:11a).

2.2 Purpose of the Research

The purpose of this paper is to report on research conducted to determine if the IA departments of various JSE listed companies, whose CAEs are members of the Institute of Internal Auditors, do in fact focus on the strategic risk.

In order to draw valid conclusions regarding the research aim, a number of sub-questions were also examined:

- The degree of integration of strategic risk management into individual companies' IA universes;
- the extent to which the strategic risk management process was being reviewed, and
- if IA departments of companies listed on the JSE, whose CAE's are members of the Institute of Internal Auditors, include strategic risk within their audit scopes.

3 LITERATURE REVIEW

As the corporate landscape changes from its current focus on recession survival tactics to growth strategies for economic recovery, the roles of IA and the CAE continue to grow (Chambers, Eldridge & Park 2010; Ernest & Young 2010a; Fitzmaurice 2010), and risk identification and assessment acumen is at the core of IA's transformation. CAEs and their teams are now being asked to expand their more traditional assurance and consulting roles and to apply their business insights and audit expertise to key organisation-wide initiatives, particularly those pertaining to risk management (Chambers *et al* 2010; Ernest & Young 2010a; Fitzmaurice 2010; IIA 2010a). According to the report published by The Institute of Internal Auditors entitled *IA in 2010: Shifting Priorities for a Changing Environment*, risk management is the number one strategic priority for CAEs, and the key area of focus for IA activities now and into the future (IIA 2010b).

IA is already stepping into a risk identification function, providing increasingly beneficial insights to support strategic transformational initiatives (Chambers *et al* 2010; Ernest & Young 2010b). Successfully addressing these demands requires a combination of

insightful leadership, savvy processes and effective tools. Most prominently, IA should be offering a stronger role in boosting the organisation's overall risk management capabilities as well as promoting the greater use of automation and analytics, such as continuous auditing, to deliver greater efficiency and effectiveness (Chamber *et al* 2010; Ernest & Young 2010b; IIA 2010a).

Through risk based auditing, IA can be involved in a variety of risk areas within an organisation. The various risk categories consistently identified across academic literature as those that IA should focus on in order to increase their ability to add immense value, were strategic risk, compliance risk, financial risk, reputational risk and operational risk (Basil II 2009; Compliance Executive Board 2010; Compliance Institute 2010; Ernest & Young 2010b; Fitzmaurice 2010; IIA 2010a; IIA 2009b; Jacka & Scott 2011; Jackson 2008; PwC 2012; Steelhammer 2011).

Within all five of the risk categories identified in the previous paragraph, IA has an important role to play. By aligning the IA function's strategy with the business's strategy, IA can meet stakeholder expectations. IA functions should also increase their skill set in order to provide business with specific outcomes, thereby ensuring that IA continues to add value.

The regulatory requirements for listed companies were identified by reviewing the JSE's (JSE) listing requirements, which revealed that compliance with King III (IoD 2009).

King III should be seen as a significant set of guidelines, and not prescriptive rules, especially since it is not a "one size fits all" document. IA can add major value to business by monitoring and ensuring compliance with King III, especially since compliance (or an explanation for non-compliance) is mandatory under the JSE Limited's listing rules.

The reason companies are looking to IA for risk management assurance is that they do not feel that this aspect of business, and especially strategic risk, is being adequately addressed within their organisations. While this is a great obstacle for business, it is also a tremendous opportunity for forward-thinking IA departments.

In business today, stakeholders' needs and expectations are at an all-time high, and fulfilment of these rests with IA. Many IA functions suffer from a performance gap due to lack of innovative thinking and unclear stakeholder expectations. IA functions that do not regularly rethink and redefine their capabilities are at risk of losing the stature gained through King III's effective enforcement of their leadership role, particularly in risk assessment and management.

CAEs have to provide the leadership needed to balance the demands for compliance and value in audit plans. At the same time, they must continue to develop future leaders. Each CAE has an opportunity to shape the future of the profession. IA functions

must therefore make use of the models created to enhance the value of their roles where strategic risks are involved. IA has the opportunity to define its place in the business hierarchy, and to emerge as the “game-changers” that this business environment demands, by assisting business to manage their strategic risk. Those who demonstrate the best capabilities of the profession of IA will succeed spectacularly under this harsh spotlight.

4 RESEARCH METHODOLOGY

4.1 Questionnaire

A questionnaire was developed to address the objectives of the research being reported in this paper. The self-administered questionnaires were electronically distributed to the various listed companies' CAEs, to determine what role IA fills regarding strategic risk in JSE listed companies, if any. The information that was used in this paper was limited to information that had a direct impact on the status of IA's focus on strategic risk. It was directed to the CAEs (or the equivalent) of JSE listed companies.

4.2 Response

A total of 245 questionnaires were distributed electronically to all CAEs who were members of the Institute of Internal Auditors, and 30 completed and usable questionnaires were received back, a response rate of 12%. The data gathered from the research instrument was immediately summarised after being received through electronic mail. After all the questionnaires had been received all the responses were captured onto an excel spread-sheet to enable the initial analysis of the data to be performed. Thereafter, the results of the survey were subjected to further analysis using descriptive statistics contained in the Statistical Package for the Social Sciences (SPSS) software application for Windows.

4.3 Limitations

The literature review was essentially restricted to the disciplines of strategic risk management within the IA environment, of risk based auditing, and of IA. Literature from related disciplines such as enterprise wide risk management, and strategic planning to avoid risks, was also consulted when needed. Thus this research topic can be expanded to investigate the situation in the enterprise wide risk management and strategic planning to avoid risks areas of business, for example, thus placing them on equal terms with analysis of the strategic risk management process, in order to gain better insight into the fullest extent of the management of risk in companies.

5 RESEARCH RESULTS

Although IA might be seen as being somewhat 'out of its league' when it comes to providing assurance on strategic risks, 47% of the CAEs responded that their Audit Committees still wanted to hear from their IA functions about these risks. This then means that CAEs need to ensure that their departments' skill sets and experience is continuously improved so that they

can give meaningful opinions on these issues when required.

The research responses indicate that the majority of the research population are aligned to their organisations' strategic objectives. However, it can be concluded from the responses that the strategic risk areas being audited have been identified by and are being audited at the request of audit committees and process analysis, instead of emerging from the organisations' strategic risk workshops. Consequently, IA functions are auditing areas that are subject to influences other than, or in addition to risk.

The results can be summarised under the research sub-questions that were presented at the beginning of the paper.

5.1 To determine how strategic risk management is integrated into the individual companies' IA universes

The research instrument (questionnaire) was designed specifically to determine how strategic risk management was being integrated into the individual companies' IA universes. These responses indicated that only 43% of the population planned their audits to address the specific strategic risks faced by their organisations, and only 40% presented their completed audits in a form that addressed these risks. Furthermore, 53% of the respondents were not involved in their organisations' strategy-setting process, and only 40% of respondents reviewed the supporting information these strategic decisions were based on. A reading of these results leads to the conclusion that a minority of IA functions within JSE listed companies, where the CAE is a member of the Institute of Internal Auditors, have strategic risk management formally and effectively integrated into their IA universes.

5.2 To establish the extent to which the strategic risk management process was reviewed

Only 37% of the population are effectively involved in the pursuit of the organisation's strategic objectives, and 13% are not involved at all, as this area had been out-sourced. These results demonstrate that IA departments play a less-than-optimal part in the review of the strategic risk management process, and questions whether the strategic risk processes are even subjected to a review. It was noted that organisations with fully fledged IA departments were more involved in the business, as there was a positive correlation between the type of IA department and the extent to which the strategic risk management process was reviewed.

5.3 To determine if IA departments of companies listed on the JSE, whose CAEs are members of the Institute of Internal Auditors, include strategic risk management within their audit scope

In order for strategic risk management to be part of the IA department's audit scope that scope needs to be aligned with the organisation's policies and processes intended to achieve the organisation's overall strategic objectives. The survey results

indicated that 60% of the respondents' audit scope was not aligned with the organisation's strategy to achieve the overall corporate objectives, signifying that only the minority included strategic risk management in their audit scope. In addition, only 47% of the audit departments have the strategic risk management process as an agenda item at their audit committee meetings.

By dividing the research objective into the three sub-questions, the researcher was able to analyse the data and reach the conclusion that the majority of audit departments listed on the JSE Limited have excluded strategic risk management from their audit focus. Even though the population did not all have fully fledged in-house IA functions, there is nothing in legislation or the JSE's listing regulations to suggest that strategic risk management could not still be included in the scope of the out-sourced or co-sourced IA contracts.

5.4 Interpretation of the results within the limitations of the paper

In this particular research paper, the researcher has focused on whether or not the IA departments review the strategic risk management process (and if so, to what extent it was reviewed), and whether the strategic risks that have been identified have subsequently been incorporated into the audit universe.

The literature reviewed was limited primarily to the disciplines of strategic risk management within the IA environment, of risk based auditing, and of IA. Literature from related disciplines such as enterprise wide risk management and strategic planning to avoid risks was also consulted when needed. Thus this research topic can be expanded to include enterprise wide risk management and strategic planning to avoid risks, for example, on equal terms with analysis of the strategic risk management process, in order to gain better insight into the fullest extent of the management of risk in companies.

The distinction made between the types of IA departments was shown to be necessary as organisations with fully fledged (in-house) IA departments were more actively involved in the strategic risk management process than those with co-sourced or entirely out-sourced departments. The reason for this difference in involvement is probably because fully fledged IA departments are more involved in the business' daily activities. Therefore, should a concern be brought to management's attention, IA is conveniently on hand to assist in addressing it, and to enhance their knowledge of the business along the way. Although it is management's responsibility to design and implement the necessary controls in order to mitigate operational risks and other risk, IA's part is to focus on whether those controls are working. By being onsite and readily available fosters a good business relationship between the IA department and management. When IA is out-sourced or co-sourced, the IA department's ability to assist management with strategic initiatives is diminished, both by physical distance, and because

the business knowledge is not specifically retained within the company.

Strategic risk is not a common risk. Not all members of management are aware of the negative impact being oblivious to the impact such risks carries, until it is almost too late. Although it is common knowledge that organisations need a strategy to bridge the gap between the reality of today and their vision, the risks associated with such a strategy are usually forgotten, if they were ever fully identified. This is where the IA department plays a vital role. The profession of IA has evolved in such a way that strategic risk can be incorporated within its universe. The IA function is able to provide information to management regarding the progress of the implementation of strategic actions and plans, and to be made aware of any strategic risks that are identified prior to and during the strategy implementation process. IA is also able to provide the necessary assurance that the correct strategic risk identification and management processes have been followed. Audit committees and stakeholders need to obtain assurance that management is implementing the strategy agreed upon, and that adequate reviews are being performed. Should IA functions not be aligned with the organisation's strategy, this type of assurance will not be possible.

It is recommended that strategic risk should be a part of the audit universe to ensure that IA does include the strategic risk and the management thereof in their wider review process. IA should research strategic risk and the business environment to be able to assist management.

6 CONCLUSION

By analysing the research data collected and reported on in this paper it can be concluded that strategic risk and the review thereof is not part of the respondents' audit scope. Strategic risks pose real threats to organisations, especially if the original strategy was not a well-designed one, and management needs the assistance of insightful specialists who hold the "going-concern" interests of the organisation in high regard. IA practitioners are not necessarily experts on strategy-setting or on how to address company-specific risks, but they can assist management implement and manage appropriate risk-mitigating efforts. Not only will management and stakeholders then gain from such reviews, IA will also increase the respect and status it has within the business as they are increasingly seen as a value adding management tool, and not just the company "watchdog". It is recommended that IA guidelines should be developed to assist IA in its efforts to provide assurance on strategic risk and the management thereof. These guidelines should be developed by the Institute of Internal Auditors Inc., with the assistance of IA professionals who are actively involved in the issue of strategic risk management.

IA can play a pivotal role in the shift to a proactive strategic risk management process by integrating the identification and assessment of risk (including strategic risk) into the audit plan. The insight IA gains from these activities and by communicating these to

senior management and the board of directors can make strategic risk management efforts more relevant, reliable, and resilient. It can also add a

strategic advisory role to the IA skills bouquet through dialogue that helps management manage more effectively and efficiently.

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