Elevating Internal Audit on the Boardroom Agenda

Generally, it is perceived that internal auditors do not add value to business as internal audit is a tick in the box exercise. This expectation gap can be bridged through annual strategic risk assurance exercise conducted by the internal auditors. Assessing or not assessing these strategic risks brings its own costs in the form of missed business opportunities and a high cost of failure. The results of risk assurance exercises can form part of the Board's Agenda when the business plans and strategies are approved annually. Internal audit function can play a major role in transforming the business landscape by an independent review of the strategic risk portfolio of the company. An internal audit function which is independent of other business functions is best placed to question the resources being consumed by each business process, thereby creating value for the stakeholders. Read on to know more...

CA. Huzeifa I. Unwala

(The author is a member of the Institute. He can be reached at huzeifa.unwala@verita.co.in)

Independent Annual Strategic Risk Assurance (ASRA)

We live in volatile times with no control over events outside the organisation's boundary. External forces have the potential to destroy the business model with no forewarning to prepare. The list of business threats are expanding by the day, business failures and corporate insolvencies are rising around the globe. A research report by Euler Hermes predicts a rise of 3% in business failures globally. In the Euro zone and Mediterranean economies, they are estimated to rise by 12% and 19% respectively. In India, going concerns are slipping into debt and growth traps on account of a variety of reasons such as desires to grow at an aggressive rate, lack of a defined profit model for each product/service line, not keeping pace with competition, sticking to old business models, lack of knowledge of the changing customer needs, inability to learn and adapt to new technologies, and lack of desire to discover blue oceans.

In the last few years, we have witnessed high profile cases of business failures in India and the consequential lessons learnt from them. The obvious consequence of not managing strategic risks effectively is business closure. In recognition of this fact, the Companies Act, 2013 has introduced a new provision that casts a responsibility on the Board of Directors to make a statement on the development and implementation of risk management policy of the company including identification therein of elements of risk, if any, which in the opinion of the Board may threaten the existence of the company.

The OECD principles on Corporate Governance state that the board should fulfil certain key functions, including: reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives…." Therefore, formulating and implementing strategy and business plans is essentially the Board's business; however, internal auditors can play a vital role in monitoring, evaluating and reporting the effectiveness of strategy implementation and strategic risk action plans in addition to the regular internal audit activities. Such monitoring and appraisal are referred to as Strategic Risk Assurance (SRA) exercises. The King III ground breaking Code of Governance describes an outline on the need and scope of risk assurance under clause 4.9 of the code. The Code prescribes that the internal auditor should provide a written assessment of the effectiveness of the system of internal controls and risk management to the Board. Refer exhibit 1 for illustrative key strategic risk factors that could potentially impact the going concern status of the company.

Exhibit 1 – Key Strategic Risks

- Economic environment
- Competition behaviour
- Technology developments
- Customer demand
- Intellectual property
- M & activities
- Innovation/ R & D activities
- Brand and public perception
- Board composition
- Product recall and quality
- Supply chain constraints
- Natural disasters
- Financial stability
- Regulatory enforcement
- Litigation

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Economic uncertainty and fast changing market dynamics can significantly dent business confidence, while in economic booms, businesses develop tendencies to disregard the obvious strategic risks and may be carried away in decision making process. In either case, an independent review of the strategic risks by the internal audit function can play the crucial role of providing a safety net on the "greed" and "fear" factor thereby bringing in the much required balance. The result of risk assurance is confirmation of the existence and effectiveness of the risk management procedures. The ASRA results in a renewed scope and focus for risk, including the company's preparedness for recognising and managing risk when it occurs.

Linking Internal Auditing to Annual Strategic Risk Assurance

The demands from internal audit functions in a volatile business environment increase many fold. Where there is volatility in virtually all business functions especially in input costs, an organisation frequently changes business strategies to respond to the external environment. To meet the business needs, organisations may make new strategic and tactical choices like outsourcing of business functions, employee lay-offs, differentiated pricing strategies for customer segments, frequent changes in organisation structures, mergers, investments in new markets/ locations, etc. In such a business environment, the gap between the internal audit expectation and actual internal audit performance can widen, as the internal audit function may continue to operate on a design which is outdated. Thus it leads us to a fundamental

question - Is the internal audit function tuned to the new business realities or is it operating in its comfort zone of only finding faults and errors?

The internal audit expectation gap can be bridged through delivery of ASRA (Annual Strategic Risk Assurance). While conducting the risk assurance exercise, the internal auditor will develop a reasonable understanding of the business challenges and proposed responses thereby bringing him closer to the business realities.

It is relevant to note that the non-executive Directors are not trained on the subject of risk management and also lack a fair understanding of how the various business functions interact in the company's overall risk portfolio. In such a scenario, the internal auditor's knowledge of the business processes, functions and segments makes him/her the most suited for carrying out the independent strategic risk assurance. The objectives of internal audit activities and strategic risk review exercise are compatible. Internal audit and strategic risk assurance activities can be more effective when they are closely integrated. Refer exhibit 2 to understand the scope and coverage of the ASRA.

Exhibit 2 – Scope and Coverage of Strategic Risk Assurance Program

- Assumptions at business planning stage
- Look back for review of business performance over the last 2-3 years
- Key strategic risk scenario and mitigation plans
- Financial stability, solvency and liability stress-testing
- Product line expansion feasibility
- Adequacy of Capital Structure
- New regulations

Assessing the Implementation Risks

Strategy and business planning is about understanding the available strategic choices and judiciously exercising them to sustain business in the long run. Exercising choices consume resources which are factors of production. The strategic risk assurance program should focus on "how the best choice is being implemented and what if something goes wrong or an opportunity remains unexploited". It is relevant that the internal auditor allocates adequate time to the implementation or execution risks. Exhibit 3 highlights the components for evaluating the quality of implementation.

Quick strategy shifts are common place as most businesses tend to be short-sighted. Annual strategic risk appraisals may restrict businesses from exercising the easier and tempting short term options. The independent strategic risk reviews may trigger Board's to re-assess their core and unique strengths thereby deepening the knowledge of customer needs and market place. The impact shall be profound and we may have lesser business failures.

Exhibit 3 - Evaluating Execution Risks

- Management's commitment levels to the strategy/ plans
- Sufficient allocation of resources to fulfil the strategy/ plans
- Regular progress reporting processes to the Board
- Missed milestones and remediation plans
- Risks that may prevent or slow down the realisation of strategic goals
- Opportunities that will promote realisation of strategic goals
- New regulations

As businesses evolve over time, their desire to grow often leads them to undertake activities that are not aligned to their core strategy and perhaps costlier as compared to their near competitors. Companies continuously hunt for growth opportunities but they rarely take a step back and reflect on the chosen

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path. Well-governed companies know how to use a calculated risk to their best advantage. Within their organisation they have those who monitor and even seek risky opportunities with the purpose of driving innovation and seeking competitive advantage. Well-governed companies also recognise that resources are drained and wasted when there are inappropriate levels of risk. Perhaps the difference is evident in their sustainable profits and track records.

The primary objective of the ASRA is to provide assurance to the Board that the company is on its intended direction. The ASRA exercise can be combined with the internal audit function so as to re-vitalise the organisational focus, re-align resources and refresh the vision of any organisation. The internal audit team shall annually report to the Board of Directors the results of the ASRA. Such communication when made would provide added confidence to the Board that the company is on the right path while pursuing its strategic goals and business objectives. To make the review process effective, it is advisable to follow a set of questions or points of focus. Refer exhibit 4 to see the illustrative strategic risk assurance questions.

The King Code for Governance aptly states that *"A compliance-based approach to internal audit adds little value to the governance of a company as it merely assesses compliance with existing procedures and processes without an evaluation of whether or not the procedure or process is an adequate control. A risk-based approach is more effective as it allows internal audit to determine whether controls are effective in managing the risks which arise from the strategic direction that a company, through its board, has decided to adopt."*

The role of Internal Audit is likely to differ from one organisation to another. However, by expanding the role of Internal Audit to include activities such as providing ASRA or assurance on the management of risk, Internal Audit shall be strategically positioned to achieve its objectives and the role shall be truly elevated.

Exhibit 4 - ASRA Points of Focus

S. No.	Point of Focus
1.	Whether the company has analysed the strategic risks and their impact on the various stakeholders of the company? Whether the execution risks have been assessed?
2.	Whether the company has developed a fine understanding of the industry which depicts the products, players, potential entrants, geographies, supplier groups and customer target segments?
3.	Whether the company has used any models like PESTLE (Political, Economic, Social, Technological, Legal, and Environment) or SWOT (Strengths, Weaknesses, and Opportunities, Threats) to undertake strategic analysis?
4.	Whether the company has clearly defined product/service features that are offered in the market place?
5.	Whether the company has recently surveyed their customer needs?
6.	Whether the company has recently measured which of their product or services, customer segments and procurement channels are most profitable?
7.	Is the company analysing which business activities in the value chain are most suited for their purpose?
8.	Whether the company has developed a process to map competition product features and pricing?
9.	Whether the company has surveyed the technology changes taking shape in the industry?
10.	Whether the company has conducted an employee survey on what they believe is the value position of the company, attitudes and commitment levels of employees?
11.	Whether the company has embarked on a research or development initiative which will allow it to find and develop new markets where there is little or no competition?
12.	Whether the company has developed a key result areas system that is aligned to the business objectives?
13.	Whether the company has assessed all key dependencies and concentration of risks?
14.	Whether the company has developed an appropriate succession planning system?
15.	Whether the company has a crisis management plan in place?

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