Making a Difference through Internal Audit Leadership and Enterprise Risk Management

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Abstract: The classical view of the internal audit practices has to be rejuvenated. It is not about only to perform the traditional audit, but in addition, it has a broader view and a farer role in making a difference to organizations’ strategic objectives. Moreover, it is differentiated than what everyone knows about external auditors (CPA’s) who perform financial and accounting audit, despite their indispensable important roles in monitoring towards compliance, efficiency and effectiveness. The internal auditing is an independent, objective assurance and a consulting activity designed to add value and improve an organization’s operations. Internal audit has many types such as compliance audit, operational audit, financial audit, information system audit, economy and efficiency audit, environmental audit and so forth. The manner is like the case of the evolution and the transformation from the classical view of the human resource management to the new perspective of the important role of human resource professionals as strategic partners, the internal audit has to be transformed into a strategic advisor and demonstrating its leadership and expanded vision thoroughly within the enterprise risk management, corporate governance and internal control. Accordingly, the research will delve into evidences and analytical facts and theories that should deliver a better understanding and add changes to stakeholders’ expectations.

Key Words: Internal Audit, Leadership, Strategy, Risk Management, Corporate Governance, Internal Control.

I. Introduction

Statement Of The Problem

Internal auditing role is rarely participating in setting and executing strategies. In a fast-changing business environment and as organizations are facing more risks than ever, stakeholders should be more aware and well educated on emerging risks and how to manage risks in order to protect the business from downfalls that might impede its strategic objectives. Thus, CEO’s are becoming more concerned about the wide range of risks and the overregulation threats, in addition to uncertainties derived from geopolitical factors. Furthermore, CEO’s are facing tremendous challenges in managing their businesses due to the fact that today’s customers and stakeholders are increasingly demanding from them to tackle more complex future problems especially in a complex global marketplace.

Senior organizational leaders and regulators are strongly endorsing internal audit leaders to refocus their efforts on regulatory compliance issues. The expansion of globalization, capital markets, the evolving regulatory environment, and technology are forcing companies to undertake strategies incorporated with entering new markets, expanding into new industries, launching new product lines, new business models, and cost reduction strategies. Nevertheless, this issue conveys new and more-complex risks that companies’ risk management functions and internal audit, must understand and proactively address and therefore, companies must capitalize on new opportunities.

Senior leaders and directors for organizations of all sizes are debating about enterprise risk management and how to make it more involved. “This new-found interest in abandoning traditional risk management and embracing an enterprise-wide risk management approach has naturally led to several questions regarding who are supposed to be the architects, implementers, managers and overseers of the entire process.” (J. Hall, 2007). A risk-based approach is used by internal auditors which easily provide an interest in the enterprise risk management (ERM) process. Professional organizations and thought leaders are controverting the role of the internal audit in integrated strategic initiatives and thus internal auditors barely have a seat at the strategic table because the function is blurred as a lack of capabilities or technical skills as a major role beyond risk assessment and mitigation. Therefore, the internal audit and ERM roles must be advocated to expand, assess, and communicate its strategic value to organizations.
II. Research Objectives

The research intends to refresh the strategic foundation of senior leaders and organizations and to persuade them that their strategies can be more efficient if they involve internal audit leaders, in addition to the value creation of the enterprise risk management (ERM) in formulating a more professional risk based view in order to overcoming future threats and to sustain the organizations’ governance and control processes, and nevertheless to achieving strategic objectives. Therefore, the study will answer the following questions:

Why senior leaders and professional organizations should involve internal audit leadership in their strategies?
How internal audit leadership and enterprise risk management can optimize the roadmap of the organization?

The questions will generate a research hypothesis as the outcome is expected to revitalize the role of internal auditing and ERM in the contribution of changing stakeholders’ expectations.

III. Limitations

Due to the time constrain, the thesis is not supported with surveys and interviews by Lebanese internal audit practitioners and business leaders about the internal audit leadership especially in the Lebanese organizations. However, the internal audit function in Lebanon is still in the evolving process and it is rarely applied with professionalism except in the banking sector. Therefore, the surveys and statistical data are collected from various case studies and publications performed by some of the big four known audit companies.

The enterprise risk management has a more traditional ways of managing risks. “ERM calls for high-level oversight of the company’s entire risk portfolio, rather than having many different individual managers overseeing specific risks in isolation” (J. Hall, 2007). Furthermore, the internal audit is expected to support more strategic business objectives and therefore the efforts in ERM activities are more diligently through risk identification and prioritization, alignment of people, processes, systems with business strategy, defining the critical KPI’s, analyzing and quantifying risk factors in new ventures and strategies and understanding these risks among different projects.

IV. Risk-Based Internal Auditing

Risk based internal auditing (RBIA) is a methodology that links the risk management framework of an organization to the internal auditing in order to provide assurance to the board that risk management processes are effective, in relation to the risk appetite.

Generally, every organization is different and each has its structure, processes and even different language, therefore the attitude toward risks would be different and internal auditors need to adapt accordingly in order to efficiently implement the risk-based approach. The aim of every stage is to underpin management responsibilities and the board for managing risks. The risk management framework must be existed and strong, otherwise the organization will not be able to implement the RBIA.

The RBIA is a dynamic process that empower the practice of the internal audit, and more difficult to manage than traditional methods of risk management. However, its advantages are various. According the Chartered Institute if Internal Auditors (2014), through RBIA an internal auditor could reap the following:
Management has identified, assessed and responded to risks above and below the risk appetite.
The responses to risks are effective but not excessive in managing inherent risks within the risk appetite.
Where residual risks are not in line with the risk appetite, action is being taken to remedy that.
Risk management processes, including the effectiveness of responses and the completion of actions, are being monitored by management to ensure they continue to operate effectively.
Risks, responses and actions are being properly classified and reported.

Assurance provided by RBIA
(Chartered Institute of Internal Auditors, 2014, "Risk based internal auditing")

The methodology of developing the risk assessment and annual audit plan has seven steps designed by PWC for the Oxford City Council.

The first step is about understanding the corporate objectives and risks. The internal auditor review the corporate strategic plan and strategic risk register with compliance to local government and communicated with a number of senior management and members.

The second step is about to define the Audit Universe. According to the organizational chart and process flow of each business unit, the internal auditor can reflects the management structure in order to identify the auditable units which include functions, processes, systems, products and locations.

The third step concerns the assessment of the inherent risk in the most risky area of the business and these risks are allocated and rated depending on the importance of those risks and the likelihood to be associated. The inherent risk is then determined by mapping the corporate risks to the appropriate auditable units and discussed further with the management.

The fourth step is about to assess how strong the environment is controlled wherefore it facilitates the allocation of the internal audit resources. Nevertheless, the internal auditor must understand the controlled environment and must have enough knowledge about its internal control, information provided from external parties and previous results of an internal audit if existed.

The fifth step is about rating the inherent risk and the control environment and to ensure that the audit work is focused also on areas which have high reliance on controls or a high residual risk.

The sixth step involves the audit plan. The risk appetite are tolerable risks and helps in determining the frequency of internal audit work at each level of audit requirement, however the audit plan should consider an annual review of the auditable units in order to ensure that these units are operating efficiently and in compliance.

The last step involves other considerations in addition to the above, such as undertaking regulatory driven audits, value enhancement or consulting reviews.

The path of good to great of an organization is not limited to the above steps in maximizing the internal audit role, despite that the above insures the value protection of an organization which assures its core systems. The figure below depicts the real need of the value enhancement risk based methodology. The top of the pyramid involves the important role of the internal auditor as an effective player as a strategic partner by
delivering future value through assessing future governance, risk management and control and improving business performance and thus enhancing value.

Value Enhancement and Value protection Diagram

Maximizing internal audit role (PWC, 2009, “Maximizing Internal Audit”)

Directing internal audit efforts in these areas involves the focus on more broadly key areas of risk related to directly contributing to enterprise talent development and by providing consulting services. The communication with stakeholders in such case permit internal auditors to assess assurance needs and make sure that internal talent and other resources are available to address those needs, and thus internal auditors can play a role in developing talent for the organization, wherefore talent management becomes an essential issue to expanding the scope and responsibilities of the internal audit. Furthermore, in order to effectively apply the internal auditing according to the institute of internal auditors, a charter must be established and stakeholders have to understand that the internal audit charter is about purpose, authority, responsibilities, and applicable professional standards, and more aspirational elements, such as vision and strategic themes and imperatives, because it defines the mission statement and how it will be achieved with regard also to reporting relationships, access and independency in the organization. Nevertheless, the internal audit play a role in SarbanesOxly Act and enterprise risk management, therefore their scope should be clearly defined as it is considered a critical tool for internal and external communication.
Ten steps of strategic planning
(PWC, 2009, “Building a Strategic Internal Audit Function”)

V. Organizational Strategy Overview

Generally, organizational strategies can be deliberate or realized and intended and can be emergent, unrealized and imposed by other external factors. Despite the various types of strategies that are overwhelmed under the umbrella of these two, the deliberate and the emergent, organization’s environment is sometimes difficult to deal with if it is unstable and unpredictable, however, a strategic planning can provide enough tools to the organization in order to gain and maintain success. The formulation of the strategy is a mandatory issue if aiming for sustainability, therefore a strategic planning must be formulated in a way that risks might be associated are about to be expected as much as possible. The figure below depicts the strategy implementation from its preparation (input), execution (process) and outcome assessment (output).

Internal audit and strategy
(M. van Buul, 2010, “Successful Strategy Implementation A job for the Internal Auditor?”)

The mission, vision and major organizational objectives frame the premise for further vital strategic decisions on corporate, business, and practical level. To have the capacity to settle key decisions, the organization first needs to break down the external environment to recognize the opportunities and threats it is confronting, which may influence the accomplishment of its mission’s goals. Also, the organization ought to identify the strength and weaknesses through breaking down the internal operating environment. A SWOT analysis could be prepared to settle on the fundamental vital decisions, where it can utilize its strengths versus its weaknesses, and exploit its external opportunities in overcoming the pitfalls that could arise from the threats. Strategic choices for any business plan ought to be the foundation that should match the demand in markets with respect to resources and capabilities of the organization, and ought to spur acknowledgment that leads to achieve its objectives. Moreover, the selected strategies for the various levels in the organization have to be compatible and
together could delineate the proper business model, and thus a strategy formulation would fit the overall mission statement of the organization.

VI. The Role Of The Internal Audit In The Strategy Implementation

The involvement of the internal auditors in the implementation of organizations’ strategies is not being considered to be as an essential function when the management is planning for a strategy in the first place and thus there is a gap in the strategic table that should be filled. Internal auditors are not supposed to be experts in everything, however they are acknowledged in almost everything that might affect the company and they are proficient in internal control procedures and risk analysis. Moreover, internal auditors have independent position which report to the board of directors in addition to their unbiased and objectivity as assurance providers and consultancy. They can add value by assessing situations and decisions, they advise the management and they are known to be innovators and can help in designing new business models.

Generally, organizations have more than three strategic goals each year that should be achieved and thus leaders assign various level of management the task of developing and implementing the plans that should achieve these goals. Therefore, as depicted in the figure above in the first section of this chapter, the preparation of the strategy implementation is fundamental and internal auditors should be involved. As they can provide quality assurance, formulate the strategy, execute vision, values, goals, design organizational controls and structure and culture, strategy assessment and contingency plans. The strategy implementation needs a proficient communication and the “how to”; and nevertheless, all levels of the organization are part of the corporate culture and they are endorsed to understand the goals and ensure their contributions to achieve those goals. Therefore, the internal audit can ensure that several levels from leadership, the activities adopted by the management are tracked and affiliate the management’s intentions.

The execution phase of the strategy implementation involves the design of the corporate governance, organizational culture and ethics, the structure and internal control system. The internal auditor is tailored to add value to the execution of the strategy. The management will be looking for assurance on the implementation process, so internal auditors are the right people. Internal controls are at the heart of the corporate governance, and improving effectiveness in these areas is mentioned within the definition of internal auditing. They provide added-value services and proactive strategic advice beyond the effective and efficient execution of the organizational plan. As a proactive player, internal auditors can provide assurance around risk and bring the necessary analysis and perspective on root cause methodology which helps business units take corrective actions.

In assessing the strategy implementation, internal auditors can provide assessment based on the findings reaped from audit engagements. A review of the content, completeness of the implementation plan, whether the plan and strategy are consistent and business functions and strategic objectives are aligned, and assurance that organizational resource are allocated appropriately…etc. Therefore, internal audit plays an important role in advancing the C-level program. Furthermore, one of the major roles of the internal audit functions is to promote and develop fraud awareness at all levels. It is a very important issue in order to safeguard the application of the company’s policies and procedures and the ensure compliance with all kinds of regulations. After the post-implementation review, an internal audit report is provided to the board of directors, reporting on findings, providing recommendations for improvement and communicating the result. Certainly, this will allow management to proceed more effectively.

VII. Methodology

Based on a qualitative research method, the data collection is done through several articles and case studies used from several top big four audit firms and other professional organizations. The articles are supported by statistical data gathered from surveys made by Ernst & Young on the impact of the recession and financial crisis on internal auditing in the Irish companies and how pressing is the need to improve the internal audit functions, in addition to the strength of risk management’s impact on their long-term earnings performance. The topic is supported also by descriptive statistics and analysis that critically analyze the main subject, such as unlocking the strategic value of internal audit by Ernst & Young and the ultimate study of the 2016 study of PWC’s annual survey results concerning the internal audit professionals, “Leadership matters: Advancing toward true north as stakeholders expect more.” Furthermore, the multiple case studies have comparative examinations of different organizations. The comparative information could support the study and make it more valuable, whereas the information remains qualitative and extend boundaries of knowledge. “Yin (1989, 2003) does not differentiate between the use of single case studies, and the use of multiple case studies. He sees such research as a key way to discover answers to the questions; how and why.” (R. Wright, 2009 ; Yin 1989, 2003)

VIII. The Case Study In The Research Methodology

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A case study is one of the many methods used to do a research, which involves an investigation of an organization made by an external observer or a researcher. Depending on the type of the research question, the researchers or the investigators way of control over the actual events and their perspectives, case studies are adopted as an efficient research strategy to understand a complex phenomenon. However, one of its disadvantages is that the information available in the case are bounded to the case and findings become more difficult to justify them statistically even if the case contains statistical analysis such as those used in this thesis, the bias factor can never be dismissed. Despite, the data gathered from a case study is rich in general and has more details and focusable insight on the topic under analysis. In addition, multiple cases can add evidences and comparative examinations and an in depth critical analysis. Briefly, “The case study allows an investigation to retain the holistic and meaningful characteristics of real-life events-such as individual life cycles, organizational and managerial processes, neighborhood change, international relations, and the maturation of industries.” (R. Yin, 2003)

The Process:

According to Yen (2003), there are various forms of case studies that can be used as explorative, descriptive or explanatory tools. Therefore, the phenomena under investigation should answer questions of “what”, “how” and “why”, thus an effective design should depict the critical elements of the case, starting with the questions of the study, the propositions, its units analysis, data linkage and findings interpretation.

IX. The Evolving Role Of Internal Audit In The Irish Companies

A study made by Ernst & Young, one of the big four audit firms, in “staying relevant” which analyze the role of the internal audit effectiveness in the Irish companies. The study shows that 93% of the Irish chief audit executives (CAE) rated the internal audit function as effective or very effective. CAE’s are facing a more complex challenges in improving their contribution to the business and raising up higher standards. Moreover, the study shows that three quarters of Irish participants believe that the internal audit function need to be improved, as believed also in the global findings.

The study answers many questions posed to Irish participants and one of those key questions was how the internal audit function could be improved and make an important contribution to the organization. The results emerged four improvement priorities, involving the internal audit with the organizational strategic goals, driving efficiency through integration, talent management and data analytics, balancing the assurance with the advisory reviews and running the internal audit like a business. The study showed a very interesting statistics results which collected answers that overwhelm the key objectives of this thesis, embedded to prove the capabilities of the internal audit and enterprise risk management to push the theory into more tangible outcomes. CFO’s and CIO’s nowadays are key players in the organization’s strategy and visions for the future, so why should a CAE be different? However, there are lot of companies, not just in Ireland but in most of the organizations worldwide, have not a formal internal audit specific strategy designed for the business key elements that improve performance and add value. 56% of the Irish participants think that internal audit function have no documented decree aligned to business objectives and this correlates 61% of the international results.

As the evolving role of the internal audit function, it is having more attention in the recent years, and due to economic pressures, many organizations are realizing that the function could be a strategic advisor to the business. The EY study highlighted the gap existed in Ireland concerning the organizations’ understanding of the internal audit function. The study conduction involved 45 chief audit executives, including industry leaders, big manufacturing leaders and public service providers.

This case study aims to understanding the path of the internal audit, its structure and how it stood up in recessionary pressures in Ireland, as the internal audit has increased during the recession.

X. Analysis Based On The Irish Case Findings

Mitigating risks of fraud and corruption are essential elements that compliance programs are endorsing internal auditors to continuously improve. There is a pressure that is imposing emergent strategies on organizations, wherefore compliance departments are globally accountable to deliver more effective programs using efficient resources. Therefore internal audit leaders should be aware of these essential elements and must align their own strategy which embraces the organizational strategy. “To truly focus on the risks that matter, create value and help the organization achieve its objectives, Internal Audit needs to focus on aligning its own strategy to that of the overarching organizational strategy.” (Ernst & Young, 2014) Many internal audit leaders are not focusing on a long-term strategic plan for the internal audit, therefore in order to remain relevant, the alignment should embark risk assessment that mostly fit the organization’s strategic objectives. “Don’t gamble when it comes to addressing risk. Become more relevant by using the organization’s business strategy to identify the risks that matter most.” (Ernst & Young, 2014)
Intraudit leaders in Ireland have different perspectives, as the data in the previous section revealed, some believe that their strategy should align the business strategy, and others believe that it should be independent. In fact, an internal audit strategy should be designed for three to five years’ timeframe, delineate a road map that fit the overall organization’s strategy, considering stakeholders expectations and compliance, enterprise risk management, KPI’s, talent people, training, developing skills, processing new techniques, new technology requirements and so forth. It is obvious how much interesting the ERM for the Irish companies, quarter of them believe that it has a strong impact, however, there are larger organizations that have their ERM functions independent from the internal audit functions, whereas it should be aligned for a better convergence in managing risks as depicted in Thus, both functions complete each other and avoid gaps in governance, risk and compliance.

Furthermore, data analytics is a tool that permits the internal auditor to generate better insights to processes and thus a broader audit coverage which enhance skills in identifying inefficiencies, errors and risks. Data analytics is vital to meaningful communication with management and audit committee and it enhances the follow up of reported recommendations and findings by the internal audit. The below figure depicts the analytical basics on controls and its impact on the organization.

XI. Conclusion

The roadmap of any business strategy is then meeting the transformational influencers, improvers and advisors of the organizational ultimate business partners. Engaging stakeholders to enable the internal audit leadership and pull the trigger to sourcing talent in order to generate deep business insights and an understanding of the ultimate root causes inclusively. Effective communication and risk-based adoption improve the organization cognition and understanding of the current and emerging risks and nonetheless to proactively addressing the thematic issues. “96% of very effective leaders inspire stakeholders trust and confidence that risks are covered, which is risk management functions’ ultimate responsibility.” (PWC, 2016)

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