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GOVERNANCE, STRATEGIC RISK, INTERNAL AUDIT: WHAT AUDITORS NEED TO KNOW

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Abstract. According to Richard Chambers, President and CEO of the Institute of Internal auditors (IIA), ideally internal audit should follow the risks. Yet as strategic business risks rank near the top of executive and audit committee concerns, Chief Audit Executives (CAEs) reported that such risks account for only 4 percent of audit plan coverage overall.

It is not surprising that strategic risk is top of mind for boards and senior management. As regulators around the world increase expectations, many suggest objective, independent evaluation is a critical component that boards should take advantage of in fulfilling their oversight role. These developments present tremendous opportunity for internal auditors to provide much needed assurance on strategic risk. Taking advantage of this opportunity requires that internal auditors not only apply their expertise in effective risk governance, but also demonstrate their knowledge of strategy, and perhaps more importantly, their understanding of the relationship between risk and strategy.

Given the changing landscape of the field of strategy and risk management, some internal auditors may feel that contributing to strengthening this area is beyond their capacity. However many tools are available to support auditors. Developing competency requires not only knowledge of the organization's strategy and associated risks, but also staying current on emerging thinking and best practices in the field of strategy and risk management as well as emerging expectations of regulators and standard setters. Providing assurance on strategic risk is a challenge, however one that is within our grasp through thoughtful, deliberate planning and action.

According to Richard Chambers, president and CEO of the Institute of Internal Auditors (IIA), ideally internal audit should follow the risks.[i] Yet recent reports suggest that this is not the case. The October 2013 Pulse of the Profession[ii] reports that while strategic business risks rank near the top of executive and audit committee concerns, Chief Audit Executives (CAEs) reported that such risks account for only 4 percent of audit plan coverage overall. This limited coverage suggests a misalignment between assurances required by the board and senior executives and what is being provided by internal audit departments.

EMERGING EXPECTATIONS

It is not surprising that strategic risk is top of mind for boards and senior management. Since the financial crisis of 2008, regulators and standard setters have been increasing expectations for risk management and specifically the necessity of ensuring risk governance and strategy is aligned. Not only are expectations increasing for companies, but the supervisory practices of the regulators themselves are becoming more rigorous.

For example, the Financial Stability Board (FSB) in its release of "Principles for An Effective Risk Appetite Framework" in July 2013 highlights the importance of the risk appetite framework in setting the risk profile in implementing the firm's strategy. Specifically it defines risk appetite as "the aggregate levels and types of risk a firm is willing to accept to achieve its business objectives"[iii] and expects that firms will directly link the risk appetite statement to the strategy; both short and long term. In assessing compliance, regulators are encouraged to review strategy, planning documents, and board reports, in the context of how the board determines, implements, and monitors its risk appetite so as to ensure that risk-taking is aligned with the board-approved risk appetite statement. The influence of the FSB recommendations are felt here in Canada, as the Office of the Superintendent of Financial Institutions updated its Supervisory Framework to reflect the FSB recommendations for enhancing the supervision of financial institutions.

Influencing the role of Canadian boards in risk governance is "A Framework for Board Oversight of Enterprise Risk" released in 2012 by the Canadian Institute of Chartered Accountants. Across Canada, boards of directors are attending workshops on this document that provides a practical approach to risk oversight, including a framework, methodology and toolsets. It is designed specifically for boards of directors and is rooted in the belief that boards must take a more active and direct role in risk assessment, in particular, risks associated with leadership and strategy. The framework defines the role of the board in its oversight of strategic risk and suggests tools required to fulfill this role; including a strategy process audit.

The shifting role of boards in managing risk and the increased emphasis on strategic risk is reflected in the findings of the Deloitte study "Exploring Strategic Risk" released October 2013. The survey confirmed that strategic risk has become a major focus for organizations around the world. In addition, the majority of respondents reported that they have changed their approach to strategic risk management over the past three years. Despite efforts to improve strategic risk management capabilities, room for improvement remains. In fact, the study found that organizations are open to any ideas for increasing capacity in this area.

All of these developments provide an exciting opportunity for internal auditors. Regulators around the world are increasing expectations of boards and senior executives in managing strategic risk. In response, frameworks and tools are being developed and many suggest objective, independent evaluation is a critical component that boards should take advantage of in fulfilling their oversight role.

EMBRACING OPPORTUNITY

For many internal auditors, evaluating governance, and specifically strategic risk management, is an area not often embraced. Taking advantage of the current opportunity requires that auditors first develop an understanding of strategic risk and strategy.

Strategic risk is commonly defined as the risks arising from the execution of the strategic plan. The CICA Risk Oversight Framework[iv] aptly sums up the concept "Since strategy ultimately involves choices, risks are inherent in virtually every strategic plan."

The relationship between risk and strategy is further explained in COSO's Thought Leadership document on Risk Assessment.[v] "Value is a function of risk and return. Every decision either increases, preserves, or erodes value. Given that risk is integral to the pursuit of value, strategic-minded enterprises do not strive to eliminate risk or even to minimize it. . . . Rather, these enterprises seek to manage risk exposures across all part of their organizations so that, at any given time, they incur just enough of the risk kinds of risk—no more, no less—to effectively pursue strategic goals." It is important to note that by virtue of pursuing strategy that risk will incur. However, it is the key activity of managing risk at the right level that will pave the way for strategy to succeed.

Although on the surface the definition of strategic risk is fairly straight forward, delving deeper to begin to understand strategy, how it is formulated and executed, adds an element of complexity. For example, in trying to define strategy, it quickly becomes apparent that there is little consensus.

In 1987 Henry Mintzberg in his article "Crafting Strategy"[vi] offered that strategy can be defined in one way and used in another. For example, many will define strategy ". . . as a plan of some sort, an explicit guide to future behavior." However Mintzberg also goes on to note that "pattern in action, or what we call realized strategy" can be identified in an organization without the organization knowing it or making it explicit. In other words, strategy can either be deliberate and planned or an unintended consequence of organizational action.

Confusion over the definition of strategy was further explored by Michael E. Porter in his article "What Is Strategy?" Porter noted that companies failed to distinguish between operational effectiveness and strategy. He goes on to define strategy as ". . . about being different. It means deliberately choosing a different set of activities to deliver a unique mix of value."[vii] Providing a more practical perspective, Todd Zenger[viii] defines strategy as ". . . discovering and targeting attractive markets and then crafting positions that deliver sustained competitive advantage. . ."

Although confusion may exist when trying to define "strategy," most organizations would agree on the traditional process for establishing and executing strategy. Typically the board and senior management would gather together every three to five years to establish a strategic plan. Common elements in this process included establishing a common direction through a vision and/or mission statement, collecting and assessing external and internal data, and developing a plan of action. The plan would then be rolled out to senior management and ideally, progress against the plan would be assessed on a regular basis.

THE CURRENT ENVIRONMENT

Today's environment is calling into question the effectiveness of the traditional strategic planning approach. This approach is rooted in Michael Porter's[ix] five forces model. The model, developed in 1979, was instrumental in changing the thinking and practice of strategy at the time by identifying five forces that provided insight into ". . . current profitability while providing a framework for anticipating and influencing competition (and profitability) over time." The five forces are:

1. Threat of New Entrants
2. Bargaining Power of Buyers
3. Threat of Substitute Products of Services
4. Bargaining Power of Supplies
5. Rivalry among Existing Competitors

According to Porter ". . . defending against competitive forces and shaping them in a company's favor are crucial to strategy."[x]

Embracing Porter's five forces is reflected in the traditional approach in developing a strategic plan; a plan that spends considerable effort in assessing the external environment and developing a direction that will leverage internal strengths to fill a void in the marketplace and ultimately gain a competitive advantage. However, given the velocity of change in our current environment, this concept is being challenged.

According to Rita Gunther McGrath,[xi] "The dominant idea in the field of strategy—that success consists of establishing a unique competitive position, sustained for long periods of time—is no longer relevant." McGrath notes that the environment is changing dramatically. Factors include the digital revolution, a "flat" world, fewer barriers to entry, and globalization. As a result, competitors and customers are becoming increasingly unpredictable. Her conclusion is that "Sustainable competitive advantage is now the exception, not the rule. Transient advantage (as defined as a series of strategic initiatives that create a portfolio of advantages that can be built quickly and abandoned just as rapidly) is the new normal."

The above discussion highlights the complexity that is embedded in undertaking an evaluation of the effectiveness of strategic risk. The volatility and uncertainty in the environment means that organizational response needs to change. Yet, despite the turbulent times, according to Rita Gunther McGrath,[xii] strategy is more important than ever. "It still requires making tough choices about what to do and, even more important, what not to do." More than ever, boards and senior executives need to effectively manage the strategic risks inherent in any strategic response. The internal auditor can play a key role in improving governance and specifically the management of strategic risk.

THE ROLE OF INTERNAL AUDITORS IN PROVIDING ASSURANCE ON STRATEGIC RISK

For some auditors, venturing into the area of evaluating governance, and more specifically strategic risk management and strategy, may be a reach. In fact, given the changing landscape of the field of strategy and risk management, some may feel that contributing to strengthening this area is beyond their capacity. Despite these changes, the value that internal auditors can bring as independent, objective partners in effective structure, processes, and practices is more important now than ever.

In promoting frameworks and tools for linking strategy and risk, both the FSB and the CICA Risk Oversight Framework suggest that boards benefit from independent, objective insight and feedback. The CICA Risk Framework suggests the objective view is of utmost importance when it comes to risks associated with strategy. The FSB expands on this concept and found in its review that many jurisdictions expect internal audit to fulfill this independent assessment role.

To support auditors, the IIA offers guidance on the role of internal audit in the area of strategic risk. For example, recent changes to the International Standards for the Professional Practice of Internal Auditing, effective in 2013, strengthened the relationship between risk and strategy by requiring internal audit to evaluate risk exposures regarding the "achievement of the organization's strategic objectives" (2120.A1). Supporting this change is a new Practice Advisory 2120-3: Internal Audit Coverage of Risks to Achieving Strategic Objectives (June 2013) advising that "Internal audit should have an understanding of the organization's strategy, how it is executed, the associated risks, and how these risks are being managed."

The shifting role of internal audit into governance and risk management, of which strategic risk is a key element, is further supported by the IPPF–Practice Guide "Assessing the Adequacy of Risk Management Using ISO 31000" (December 2010) that requires risk management to be rooted in the strategy of the organization and requires internal audit to opine on the following points:

- Organizational objectives support and align with the organization's mission;
- Significant risks are identified and assessed;
- Appropriate risk responses are selected that align risks with the organization's risk appetite; and
- Relevant risk information is captured and communicated in a timely manner across the organization, enabling staff, management, and the board to carry out their responsibilities.

Finally, the role of internal audit in assessing strategy is further defined in IPPF—Practice Guide "Assessing Organizational Governance in the Private Sector" (July 2012). The Practice Guide describes the role of internal audit in strategy as one that is not intended to question strategy, but rather the strategic planning process and its execution.

AUDITING STRATEGIC RISK

Even with an understanding of the role, it is sometimes difficult to know where to begin as auditing strategy and strategic risks can include many facets and complexities. One source of insight is the causes of strategic failure. Much has been written in this area as it is well known that effective strategy formulation and execution is critical to success, and yet, many strategies fail. Understanding the causes for strategy failure can provide us with valuable insight into the direction and focus of audits.

Throughout the literature, there are three themes that appear common to many failed strategies. A discussion of each follows.

- **Ineffective management of strategic risks.** Misunderstanding the associated risks of the enterprise strategy appears to be a leading cause of business failures. In its review of financial institutions, the FSB[xiii] found that a number of governance weaknesses contributed to the 2008 financial crisis. Of relevance to strategy, were findings related to managing strategic risks. Specifically the FSB found weaknesses in risk appetite frameworks and their alignment with the strategy of the organizations. Going forward, FSB supervisors are raising the bar and expect institutions to have risk appetite statements that allow all stakeholders to see "the level and types of risk the firm is willing to accept to achieve its business objectives" as well as "key background information and assumptions that informed the risk appetite statement and the firm's strategic and business plans at the time they were approved."
- **Flawed strategy formulation.** Success is elusive if the process for strategy formulation is flawed. Critical errors that can occur during the formulation process include insufficient or inaccurate data and assumptions, both externally and internally. For example, insufficient data may lead to erroneous assumptions of competitors and the market place or to underestimating internal capacity. Therefore, as noted in "A Framework For Board Oversight of Risk"[xiv] having relevant facts to formulate strategy is critically important. In addition, given the pace of change in the environment, many believe that strategy development as a "one-time" annual event is no longer effective. If appropriate and regular reporting of performance is in place, then evidence will be in place to validate assumptions and update the strategy if appropriate.
- **Disconnect between strategy formulation and execution.** According to Robert Kaplan and David Norton,[xv] strategy at many companies is almost completely disconnected from execution. In fact, research found that 95 percent of the typical company's workers are unaware of, or do not understand, its strategy. Several factors can contribute to this disconnect. First, strategy that is developed in isolation by different groups with different reporting lines threatens the entire implementation process. Not involving those responsible for execution can lead to situations such as corporate and unit budgets that do not link to strategic priorities. Second, failure to communicate strategy results in a lack of understanding and employees cannot effectively contribute. According to Lawrence Hrebiniak,[xvi] strategy implementation requires ownership at all levels. Communication at all levels is needed to foster commitment and allow people to own the processes and actions. Responsibility and accountability must be clear. Finally, Kaplan and Norton's research[xvii] found that 85 percent of executive leadership teams spend less than one hour per month discussing strategy. Execution can take time and relevant metrics along with timely and valid feedback of performance and changes in the environment are needed to ensure strategy remains current.

Several sources of guidance are available to support internal auditors in evaluating strategic risk and considering the issues noted above.

The IIA has published several practice advisories and guides that provide detailed guidance for auditors in this area. Of most relevance are:

- Practice Advisory 2120–3: Internal Audit Coverage of Risks to Achieving Strategic Objectives (June 2013) provides advice on aligning the internal audit resources to the strategic priorities of the organization and assessing strategic risk management.
- Practice Guide "Assessing the Adequacy of Risk Management Using ISO 31000" (December 2010) provides guidance on assessing the effectiveness of risk management and identifies specific questions that assurance should be designed to answer. It also provides specifics on obtaining audit evidence and assessing the quality of risk management documentation.
- Practice Guide "Assessing Organizational Governance in the Private Sector" (July 2012) provides a number of sources to consider, specific to risk and strategies, as well conditions of satisfaction that can be used in evaluating strategies.

Other sources that internal audit departments would find useful in providing assurance on strategic risk include:

- ISO 31000 Risk Management—Principles and Guidelines[xviii] details principles of risk management along with the components of a framework for managing risks.
- The Financial Stability Board Peer Review[xix] report provides details on expectations regarding key features of a risk appetite framework along with evidence to demonstrate that the strategy and risk limits of each business line and legal entity align with the firm-wide risk appetite statement.
- The CICA's Framework for Board Oversight of Enterprise Risk includes tools that boards can use to oversee strategic risk.

Given the breadth and depth of information available, taking steps to evaluate strategic risk can be daunting. For those internal audit departments just starting out in this area, it is important to keep in mind that the first audits do not need to be a full-blown audit of strategic risk management practices of the enterprise strategy formulation and execution process. The focus and scope of assurance can be tailored to a more manageable and reasonable effort. Consideration may be given to the categorization of strategies; organizational, subsidiary and operational; provided in The Assessing Organizational Governance Practice Guide. This is a useful tool that can be used to implement an approach that incorporates facets of strategy and risk evaluation. Some examples of audits applying this approach include:

- an evaluation of the alignment between business plans and strategic initiatives as part of a broader operational audit
- an evaluation of the alignment between Information Systems (IS) strategic initiatives and the enterprise strategy in an audit of IS portfolio management
- an evaluation of consistency between outsourcing strategies and enterprise strategy in third party outsourcing audits

As knowledge and confidence expands, the audit plan can begin to incorporate more challenging and complex audits.

Regardless of where an internal audit begins, there are some specific steps to be considered in auditing strategic risk:

- Assessing competencies of internal audit staff in strategy and risk management and increasing knowledge where required. Given the developments in both the field of strategy and risk management, it is imperative that internal auditors stay current on emerging thinking and best practices.
- As noted in Practice Advisory 2120-3 internal auditors need to understand the organization's strategy, how it is executed, the associated risks, and how these risks are being managed.
- As the board is the focal point for governance, before executing evaluations in the area of strategy, it is important that the CAE discuss with the board the approach, breadth, and depth of the governance focus.
- CAEs need to stay current on emerging expectations of regulators and ensure required competencies are in place to fulfill future requirements. For example, the FSB is suggesting that responding to the board's need for greater assurance means that internal auditors must be able to evaluate:
    - the link between strategy formulation and risk appetite and that risk limits in the risk appetite statement are reflected appropriately in strategic business plan
    - effective processes are in place to ensure strategy execution is consistently influenced by risk appetite and risk limits
    - mechanisms are in place to alert the board and senior management of breaches in risk limits and of material risk exposures and that action has been taken in a timely manner

CONCLUSION

If we are to agree with Mr. Chambers that "internal audit should follow the risks," then developments in risk management and strategy present tremendous opportunity for internal auditors to provide much needed assurance on strategic risk. Taking advantage of this opportunity requires that internal auditors not only apply their expertise in effective risk governance, but also demonstrate their knowledge of strategy, and perhaps more importantly, their understanding of the relationship between risk and strategy. For many this may be a challenge; however, one that is within our grasp through thoughtful, deliberate planning and action.

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