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Agility and Innovation

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Agility and Innovation

The modern internal audit function needs to tie traditional audit activities *more closely* to the organization's strategic objectives and risks. Most chief audit executives (CAEs) recognize that reality already — either at some visceral level, through conversations with the board and executives in the first line of defense, or through implementation of *The International Standards for the Professional Practice of Internal Auditing.* In fact, conformance to the *Standards* requires that internal audit evaluate risks from the perspective of achieving the organization's strategic objectives. This is not optional, but rather a necessity to ensure internal audit serves its role to protect and enhance organizational value.

Two realities thwart that need, however. First, organizations simply *have more risks coming at them*, and those risks can harm the organization in swift, painful ways: a social media campaign that emerges overnight; a sexual harassment scandal that ousts a key employee; a food safety incident; a merger of competitors or suppliers; a new trade or regulatory policy that upends years of carefully constructed business models.

Second, the reality is that CAEs also must dedicate resources to additional tasks providing assurance support for other assurance providers within and for the organization, including monitoring how operational risks are managed; compliance testing; the preparation of evidence for external auditors; and the vetting of accounting policies to ensure compliance with anti-bribery statutes.

By continuing to fulfill those more traditional audit tasks, while also becoming agile and innovative, internal audit can transform into something that works more swiftly to help the rest of the organization address an increasingly chaotic, unpredictable environment. That will be a struggle, but one that The IIA feels can be done with awareness of and alignment to the organization's strategic objectives and risks.

We see a frustrating split in The IIA's 2018 North American Pulse of Internal Audit report, which outlined the results of a survey of more than 600 CAEs across North America. Two-thirds of respondents said agility will be vital to future success of the audit function, and that makes sense. Advances in technology, globalized markets, and the heightened importance of reputation to corporate value all add up to a mix of *accelerated, unpredictable risk*. Boards and business unit leaders want assurance that they can confront those risks as effectively as possible.

Yet only 45 percent of those same CAEs said their audit function actually *is* agile. In a certain glum way, that makes sense, too. The most common obstacles to an agile audit function were inadequate resources, organizational complexity, and management clinging to a traditional view of what audit does. CAEs need to help management realize that it must change its *view* of internal audit and provide the function with the support it needs to provide assurance over accelerated, unpredictable risk.

Those obstacles are stubborn and longstanding, but some impediments may come from within internal audit itself. CAEs need to think creatively to overcome them. And while most CAEs grasp that point in the abstract, the harder questions remain.

Namely, how does the modern audit function achieve agility in practice? What can an agile audit function actually do? What is the distinction between innovative risk management, and objective risk assurance?

Begin with capability among chaos

To be an "agile" audit function, the audit team must bring new capabilities to the risk assessment process — ones that allow the audit function to keep pace with the chaotic, demanding business landscape outlined above.

For example, **audit leaders will need much more flexibility in scoping and understanding a risk**. That might mean closer communication with operations executives in the first line of defense to understand what the operational threat is; and closer communication with the second line of defense to understand how the organization has been trying to manage that risk so far.

It might also mean more conversations with other committees of the board, beyond the audit committee. One can't fault audit committees for thinking foremost about financial reporting and regulatory compliance; that is their job. But those risks are *not* the same as larger strategic risks, and they are *not* strategic objectives. (If anything, they are the objectives the company must achieve so it can pursue those larger strategic objectives.)

Audit Focus

IIA Standard 2120: Risk Management

The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

2120.A1: The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:

- Achievement of the organization's strategic objectives.
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations and programs.
- Safeguarding of assets.
- Compliance with laws, regulations, policies, procedures, and contracts.

CEO Assessment of Threats

A survey of nearly 1,300 CEOs in 85 countries shows that the CEO's perspective impacts both the organization's strategic risks and the board's view.

According to PwC's 21st CEO Survey report, "CEOs across the world are increasingly anxious about broader societal threats — such as geopolitical uncertainty, terrorism, and climate change — rather than direct business risks such as changing consumer behavior or new market entrants."

Further, PwC reports that CEOs have anxiety about the promise and perils of artificial intelligence.

The top five threats assessed by CEOs are:

1. Over-regulation.
2. Terrorism.
3. Geopolitical uncertainty.
4. Cyber threats.
5. Availability of key skills and the speed of technological change (tie).

Interestingly, over-regulation has been the top concern since the question was first asked in 2008 but has remained flat. Others are rising, such as terrorism, which jumped from No. 12 to No. 2.

What are those risks on board directors' minds? Consider the top five risks identified in a survey of more than 700 board directors and senior directors worldwide, done by Protiviti and North Carolina State University.

1. An inability to understand or keep pace with rapid pace of disruptive technologies.
2. Resistance within the organization to change, which might thwart efforts to improve operations.
3. Cybersecurity.
4. Regulatory change.
5. An aversion within the organization to identifying, reporting, or escalating key risks.

Likewise, the top five issues from a recent survey of public company board directors by the National Association of Corporate Directors are:

1. Significant industry change.
2. Business model disruption.
3. Changing global economic conditions.
4. Cybersecurity.
5. Competition for talent.

Notice that regulatory compliance is not among the top five. It placed ninth.

To assess issues like those identified in both surveys, **audit leaders will need to tap the correct human input to identify risks clearly**. That is, the CAE will need to collaborate with operations executives in the first line of defense and managers in the second line of defense, perhaps after new conversations with board committees seldom dealt with before. The CAE may need to tap outside expertise for specific engagements, such as those addressing cybersecurity risk or data governance procedures.

The good news is that those conversations seem to be happening already. In the Pulse survey, 58 percent of respondents cited new collaborations with other lines of defense as something they do to increase the audit function's agility.

At a more practical level, however, CAEs **also will need to assemble the correct blend of human talent and technology to analyze risks quickly**. For example, an operations executive might welcome the idea of an analytics project to improve logistics and supply chain management to better manage volatility and cost fluctuations. (Note how this example reframes a traditional audit activity as helping a strategic objective.) Still, the audit team will need to know how to work with operations personnel to understand the process; where to find IT analytics expertise to study the process; and which parts of the exercise are sheer testing challenges that could be cosourced or handed off to robotic process automation.

Agility and innovation in practice

In the real world of constrained budgets, overworked fellow executives, and exacting regulatory requirements, audit functions will need to follow a certain evolution to achieve that agile, innovative ideal.

First, **strong internal controls will remain the foundation of agility and innovation**. Internal controls generate the data that drives everything else; if those controls falter, the organization risks bad data, which leads to bad outcomes. How internal controls are designed and tested may change dramatically in years to come, but audit leaders never forget that *in a data-driven world, strong data management is crucial* — and strong internal controls are *how* the company manages enterprise data.

Second, **from strong data management, strong data analytics can arise**. Audit leaders will need to recruit or develop the right talent to analyze data usefully, and that is no easy task. Without the necessary collective skills, internal audit may need to integrate with an IT audit function, the general IT department, or even a business analytics team (if the organization has one).

In a 2018 discussion paper based on hundreds of use cases of artificial intelligence (AI) worldwide, McKinsey Global Institute (MGI) focuses on AI "deep learning" techniques, including reinforcement learning, feed forward neural networks, recurrent neural networks, convolutional neural networks, and generative adversarial networks. The use of traditional analytics techniques is important. According to MGI, AI can provide incremental value to existing, traditional analytics used in an organization. MGI estimates that on average across industries, AI has the potential to boost the value derived from traditional analytics techniques by 62 percent.

Third, **strong analytics provide audit the means to help achieve strategic objectives**. Traditional testing only determines whether a business process is working within prescribed controls; analytics allow the audit team to improve business processes. To take full advantage of that ability, however, the audit function will need to work with teams that *know* the business processes — which, again, underlines the importance of working with new parts of the organization.

In many ways, innovation and agility will go hand in hand. To pivot and address emerging risks quickly (that is, to be agile), audit leaders will need to wean their departments off the labor-intensive tasks of testing and documentation; that implies an embrace of new innovative technologies such as robotic process automation to automate routine internal audit tasks or AI to automate the analysis of audit evidence.

To improve business processes and help the enterprise achieve strategic objectives (that is, to innovate), audit leaders will need to cultivate new ties with board directors and operations executives (that is, to be agile).

One byproduct of the focus on innovation and agility also is worth noting: the more cutting-edge an audit project is, the easier it should be to attract or engage talent *outside* the audit function to help. That will be true at the department head level, as managers and senior executives see how audit might help them solve their problems; and at the staff level. Operations needs to see that internal audit is tackling problems relevant to *them,* and tackling those problems in new ways.

Take action now

The good news is that forward-thinking internal audit leaders have set the groundwork. The attention to data governance is there. The early experiments with analytics and collaboration with the first and second lines of defense are there. Most important, the appetite *from the board* is there. (One final statistic: Only 21 percent of Pulse survey respondents said their board has an overly traditional expectation of internal audit.)

The path toward agility and innovation may be challenging, with pitfalls, dead-ends, and false starts blocking the road ahead. Regardless, the alternative to an agile, innovative audit function is one that remains slow and traditional — and that function just won't last in the world that's coming. To move forward:

- Start with a change in mindset. To prepare for and utilize the opportunities that come with agility and innovation, internal audit needs to refocus processes, rethink resources, and reposition.
- Gauge the board's appetite for internal audit's participation in strategic risks and objectives. Ask potentially tough questions about what role the audit committee plays in strategic risks and what other committees might lead the charge.
- Consider the technology roadmap that will allow internal audit to pursue more agility and innovation. Has the team embraced electronic audit workpapers? Is process automation feasible? Does the team use a collaborative online platform that lets everyone work where they are?
- Consider the resources roadmap that will allow the audit function to pursue more agility and innovation. How can the audit team cultivate a strong analytics function? What traditional audit activities could be cosourced to outsiders or automated entirely?
- Work with the first line of defense to identify the business risks to achieving their objectives. Plan ways to bring analytics power to those objectives. Develop audit projects that can entice talent in IT or operations functions to work with internal audit.

Insights from Uganda

At IIA–Uganda's 13th Annual National Internal Audit Conference in April 2018, IIA–Tanzania Vice President Juma Kimori stressed that agile auditing is in line with The IIA's Core Principles for the Professional Practice of Internal Auditing, which state that *internal auditing is insightful, proactive, and future-focused*.

Kimori is chief audit executive at NMB Bank Plc, where he leads an internal audit staff of 34. "Effective leadership is critical for the future and survival of the internal audit profession and of the organization" says Kimori, "and that means that in addition to day-to-day responsibilities, CAEs have to be keenly aware of what is happening in the organization's internal and external environments."

But awareness alone is not enough. Kimori emphasizes that agility means being nimble enough to quickly act on awareness. It means that internal audit must be prepared with a quick response to changes in organizational strategy or priorities, the competitive landscape, and the regulatory environment.

While internal audit functions in large, global organizations might have more resources to support agile auditing, their size and complexity also mean that the CAE has to keep up with many more moving parts related to both the internal and external business environments.

Kimori says that as result, CAEs need to build flexibility into the audit plan, ensure that audit processes are lean, and accelerate the audit cycle and delivery of results.

About The IIA

The Institute of Internal Auditors (IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 190,000 members from more than 170 countries and territories. The association's global headquarters are in Lake Mary, Fla., USA. For more information, visit www.globaliia.org.

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