

RISK IN FOCUS 2020

Board briefing



BOARD BRIEFING

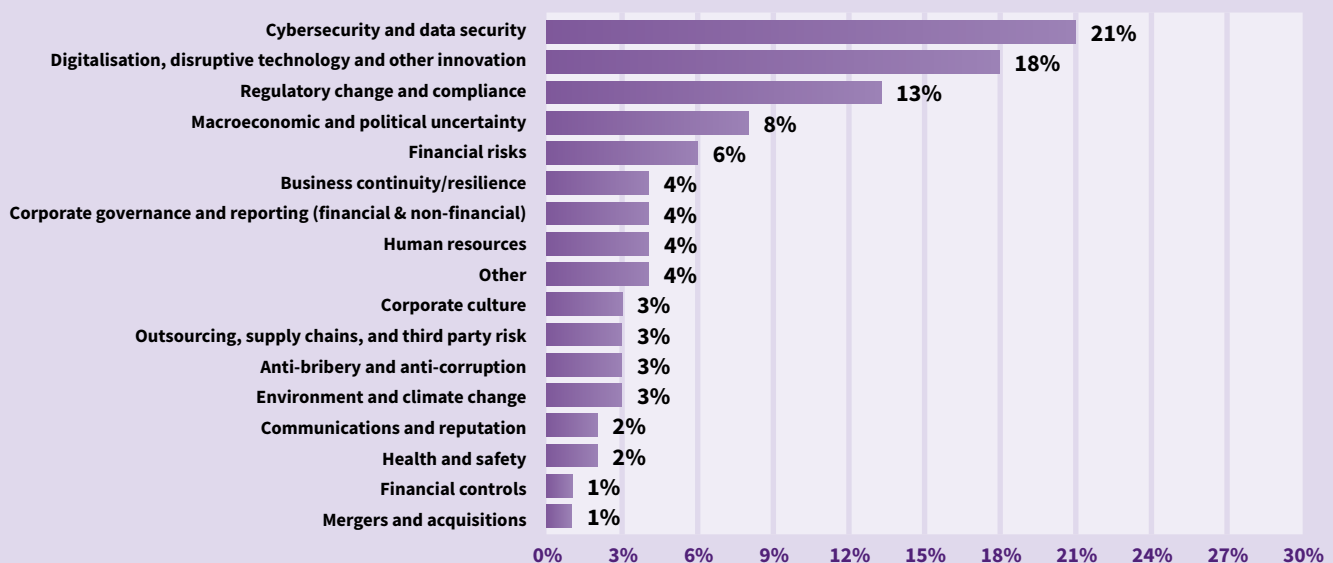
Why Risk in Focus 2020 matters for you

As a board member, it is imperative that you understand the key risks (and opportunities) your organisation faces and assure yourself that internal audit is addressing them. Some of these risks will no doubt be specific to your company, its unique operations and senior management's growth strategy; others, however, are pervasive issues that are relevant for all businesses, big or small.

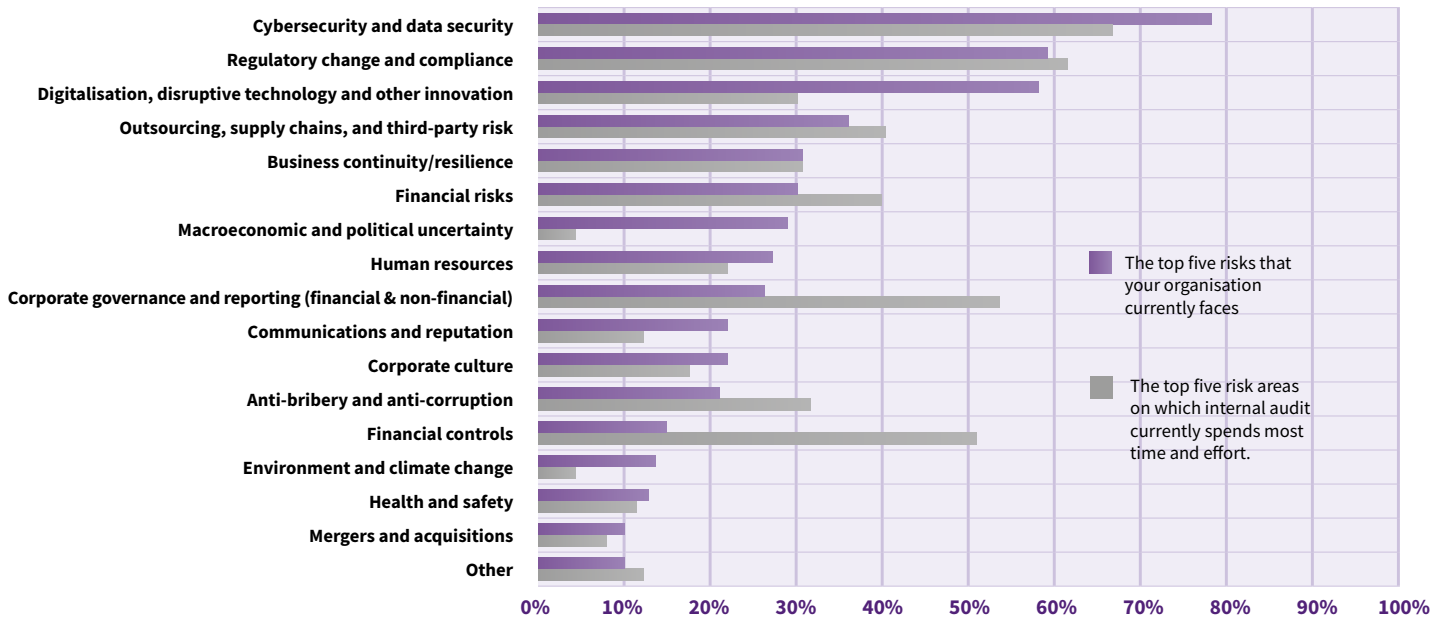
With this in mind, we are briefing you on a newly published report, Risk in Focus 2020 (RiF20), a collaboration between eight institutes of internal auditors and available at iaa.org.uk/riskinfocus. RiF20, the fourth instalment of this annual report, highlights salient risks that have been identified by Chief Audit Executives (CAEs) and which you should be aware of in your discussions with senior management, audit committees and CAEs.

RiF20 is the product of 46 qualitative interviews in Belgium, France, Germany, Italy, the Netherlands, Spain, Sweden and the UK & Ireland, and a quantitative survey that this year received 528 responses, a 70% annual increase in engagement.

We asked CAEs what the single biggest risk to their organisation is:



The top five risks that your organisation currently faces vs the top five risk areas on which internal audit currently spends most time and effort:



The survey results also showed key areas where there is a notable mismatch between the priority level of certain risks and the time spent auditing those risks. As the graph above shows, the biggest discrepancies apply to ‘Macroeconomic and political uncertainty’, ‘Digitalisation, disruptive technology and other innovation’, ‘Financial controls’ and ‘Corporate governance and reporting (financial & non-financial)’ risks.

We therefore recommend open dialogue between CAEs and their boards around whether internal audit’s time and resources are being allocated to best effect, i.e. is internal audit providing assurance around risks which are of greatest priority to the business?

These are themes that, to a greater or lesser extent, are applicable across sectors and countries. The research may have been conducted in Europe, but in many cases the audit executives who participated manage the internal audit functions of multinational businesses. Therefore, RiF20 and this briefing are relevant for all boards, audit committees and senior management, not to mention the internal audit profession.

Download the full Risk in Focus 2020 report at:
iaa.org.uk/riskinfocus

Risk in Focus report topics

The following topics are the result of quantitative and qualitative data gathered through a survey and interviews with CAEs. These provide comparative data and a more in-depth analysis of the risk priorities for their organisations.

1. **Cybersecurity & data privacy: rising expectations of internal audit**
2. **The increasing regulatory burden**
3. **Digitalisation & business model disruption**
4. **Looking beyond third parties**
5. **Business resilience, brand value & reputation**
6. **Financial risks: from low returns to rising debt**
7. **Geopolitical instability & the macroeconomy**
8. **Human capital: the organisation of the future**
9. **Governance, ethics & culture: the exemplary organisation**
10. **Climate change: risk vs opportunity**

1. Cybersecurity & data privacy: rising expectations of internal audit



Cybersecurity is undoubtedly the perennial risk of the modern era and it should come as little surprise that it has come to feature prominently in the minds of CAEs and in their audit plans every year. This is likely to remain the case for years to come and 2019 was no exception, 'Cybersecurity and data security' was more widely cited as a top five risk (78%) than any other.

Encouragingly, we see that 68% of CAEs report that 'Cybersecurity and data security' is one of the top five risks on which internal audit currently spends most of its time and effort, indicating that it is taking an appropriately risk-based approach on this matter.

There is a need for internal audit to step up to meet the assurance demands of organisations. Given the financial

and reputational costs of cyber breaches and data leaks, CAEs have a strong case to make with their boards and audit committees for increased budget allocations to address this interminable risk. As a board/audit committee member, you should be prepared to have this conversation with your CAE and recognise the value in appropriately resourcing your company's internal audit function with cyber and data security capabilities.

2. The increasing regulatory burden



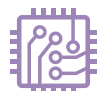
More than half (59%) of our survey participants said that 'Regulatory change and compliance' is a top five risk to their organisation. In keeping with these quantitative findings, half of the CAEs interviewed for RiF20 cited regulatory compliance as being one of their organisation's primary risks.

This comes against a backdrop of active enforcement. Anti-money-laundering (AML) fines in Europe reached a new record in 2018, after €775m was levied against ING for failing to spot money laundering. EU competition authorities have been similarly punitive. Google was hit with a record €4.3bn fine in 2018 for preventing smartphone manufacturers from installing competing search engines on Android phones, and has been subjected to a further landmark antitrust fine in 2019. This coincides with nearly one-third (30%) of interviewees in RiF20 referencing AML, anti-bribery and

corruption (ABC) and antitrust related compliance as areas of particular concern.

Beyond Europe's borders, global business legislation and regulation as a whole is growing more complex, especially in sectors such as financial services that face the greatest oversight. The extra territoriality of laws and rules is increasing the burden upon compliance functions, and in some cases makes it impossible for companies to fully comply with local/national interpretations of regulations.

3. Digitalisation & business model disruption



Digitalisation risk (and opportunity) is at the forefront of internal audit's thinking. Not only did 58% of CAEs in this year's Risk in Focus survey say that 'Digitalisation, disruptive technology and other innovation' is a top five risk to their organisation, 18% singled it out as their number one risk, putting it in second place behind cybersecurity.

Digitalisation represents a threat to established business models and an opportunity to develop new, high-growth ones. Technology is a primary component of disruption and businesses must understand how they can defend against this external threat and how they become disruptors themselves. The challenge for already well-established

companies is in balancing growth in their core businesses while funding innovation. Abandoning a still profitable business will not be rewarded by shareholders and in many instances will not be desirable; however, digitalisation is accelerating disruption and businesses must be prepared to defend against this — and harness it for their own gain.

4. Looking beyond third parties



More than one-third (36%) of audit executives in this year's survey cited 'Outsourcing, supply chains, and third-party risk' as one of the top five risks to their organisation. The outsourcing trend has been in train for a number of years already, with virtually each and every business operation, process or function having the potential to be handled outside of the organisation. Despite evidence of activities being re-shored in recent years, there has been a rapid uptake of cloud services and data security risk, including how it pertains to third parties, has risen up the corporate agenda with the introduction of GDPR.

It is not enough to stop at auditing third-party risk. For core services and processes, boards should be considering whether the business understands third party risk deeper

into supply chains. Financial services regulators are paying increased attention to third parties; companies in all sectors should view high standards of third party risk as best practice.

5. Business resilience, brand value & reputation



The first few months of 2019 provided plenty of cause for some businesses to reflect on and review their ability to respond to crisis.

In one of the worst corporate health and safety failings of recent times, Boeing's new 737 Max aeroplane was involved in two fatal crashes just five months apart.

Examples such as this are rightly gaining the attention of boards and internal audit. In the RiF20 survey, nearly one-third (31%) of respondents cited 'Business continuity/resilience' as a top five risk. Strong public relations are a key component of business resilience and we found that 22% of our CAE survey respondents said 'Communications and reputation' is one of their organisation's top five risks.

Reputation may appear to be less tangible than traditional risk areas, but negative sentiment among stakeholders and the general public clearly has a harmful impact upon a company's share price and revenues. As businesses increasingly acknowledge the significance of brand value, and as the number of examples of brand damage increase, reputational risk is now recognised as calculable and manageable.

6. Financial risks: from low returns to rising debt



'Financial risks' scored highly in this year's survey, 30% of CAEs reporting it as a top five risk to their organisations. Notably for boards and audit committees, 40% of CAEs say this is one of the top five risk areas on which internal audit focuses most of its time and effort.

Financial risks are too numerous to list here; however, many companies are struggling with low capital market returns, which has implications for insurers and businesses responsible for funding significant pension schemes.

Debt is another factor to consider. At the end of 2018 there was \$13trn of corporate debt on balance sheets worldwide, a new record. This means diligence is required in ensuring that companies are able to cope with servicing this debt and are not prone to defaults and costly capital restructurings, again calling for an assessment of the treasury's risk management efforts.

7. Geopolitical instability & the macroeconomy



Trade tensions between the US and China have rumbled on for an extended period. The March 29 2019 Brexit deadline came and went, a new departure date is expected in October.

Politics and the economy are intrinsically linked and this has become especially apparent in recent years. Brexit is expected to cause an economic drag not only in the UK but Europe as a whole, the region already showing close to flat growth. Ongoing tensions between the US and China are being closely watched by investors and are already having a dampening effect on the world's two largest economies.

This is the macro background against which CAEs of Europe-headquartered, and in many cases multinational, organisations participated in RiF20. Nearly one-third (29%) of those surveyed said that 'Macroeconomic and political uncertainty' is a top five risk to their organisation. Boards need to consider to what extent senior management is being mindful of these challenges and what they mean for the business.

8. Human capital: the organisation of the future



Over one-quarter (27%) of CAEs said 'Human resources' is a top five risk to their organisation and one-third (37%) of interviewees referenced HR-related issues as a priority risk or area of concern, including talent management and skill shortages and the development of future organisational models.

This theme represents a confluence of factors. Emerging technologies are already disrupting the nature of work in certain industries by rendering some tasks obsolete while simultaneously creating new ones. Automation capabilities and early applications of artificial intelligence (AI) are transforming jobs, contributing to efficiency, cost reduction and opportunities for scaling. Companies face existential questions such as how humans will work alongside technology and how to train and upskill their workforces.

Organisations are also faced with the challenge of adapting their structures to keep pace with changing societal expectations and to foster innovation. In the face of competitive disruption, businesses are looking to the playbooks of start-ups to see how flatter structures and agile project delivery can improve results. Closing the digital skills gap and enabling the business' strategy with an appropriate, long-term talent management programme and organisational structure/s will be a key business challenge for years to come.

9. Governance, ethics & culture: the exemplary organisation



'Corporate governance and reporting (financial & non-financial)' was cited as a top five risk by 26% of CAEs in this year's survey.

Corporate governance and corporate social responsibility (CSR) are increasingly viewed through the same lens. Rather than simply maximising value for shareholders, companies are expected to maximise value for the wider stakeholder community. Accordingly, the core CSR principle of long-term sustainability is being woven into updated corporate governance codes and legislation. This convergence has paved the way for corporate governance to be driven by high ethical standards and the need for accountability, to investors and the public.

Culture plays a huge role in strong corporate governance and CSR, as it is the living, breathing manifestation of a company's ethics and principles. Encouragingly, 22% of CAEs in the RiF20 survey reported that 'Corporate culture' is a top five risk to their organisation, indicating that this fundamental ingredient in strong governance is firmly on internal audit's radar.

10. Climate change: risk vs opportunity



More than one in ten (14%) CAEs in RiF20 cited 'Environment and climate change' as one of the top five risks to their organisation. While this is relatively low, it represents a 75% year-on-year increase and a full 28% of internal audit chiefs foresee this being a priority risk by 2025.

Real-world impacts of climate change are fast emerging in the business sphere. Extreme weather events such as droughts are disrupting agricultural production and affecting maintenance costs for infrastructure-heavy companies. From a strategic point of view, businesses are increasingly forced to evaluate their futures in a changing physical environment and as governments come under heavy pressure to avert catastrophe.

Businesses that are seen to be taking action on the environment and climate change are turning this risk into a commercial opportunity. Boards therefore would do well to ask senior management how these issues are shaping strategy-making and if more can be done to align the company's aims with those of society and government. Board members should also anticipate an increased focus from internal audit on assignments that relate to environmental and climate change risks.

Download the full Risk in Focus 2020 on our website.



About the French Institute of Internal Auditors and Controllers (IFACI)

The IFACI is a professional association for internal audit and internal control, with more than 5,500 members in all sectors of the economy.

Thanks to its strategic relation with regulators, public authorities, and professional associations, IFACI contributes to the promotion of internal audit and internal control by sharing best practices and ensuring capacity building for all actors from the existing sectors.

IFACI is an affiliate to the IIA network.

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