



# **White Paper – Integrated Risk-Based Internal Auditing**

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Australia

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# 1. Background

## 1.1 Purpose

Integrated risk-based internal auditing aims to deliver increased value through effective and relevant internal auditing. It does this through a combination of aspects, approaches, and techniques into a single audit while focussing on areas of highest risk to customers, stakeholders, organisation, community and the environment. It is focused on achieving business objectives and an overall sustainable outcome by taking into account the interrelated nature of business areas and the wider environment in which it functions.

It is a powerful approach for ensuring the internal audit activity stays effective and relevant. It is a mindset change, to focus internal audit attention on things that will make the area of focus successful, or that could cause it to fail. It is flexible for each organisation to consider what extent it will identify and minimise coverage of the less important components of the organisation.

## 1.2 Background

The public, investors and other stakeholders through their respective groups demand value for money and an optimal return on investment. Therefore any cost incurred should provide some benefit to justify the effort.

### Conventional way of Auditing

- Financial
- Compliance
- Operational
- Performance
- Security
- Review
- Probity
- Ethical
- Fraud
- Risk
- Environmental
- Information Systems
- Health & Safety
- Management
- Procurement
- Assessment
- Investigation

**Approach mainly focuses on a narrow scope, part or aspect of the organisation,**

Conventional audits still have a place to provide assurance of outcomes, or that areas have been covered and comply with legislation. But this conventional way of auditing cannot cost-effectively cover all aspects of the organisation and the environment in which it functions. The conventional auditing approach allows, for example, auditors to assess the organisation's financial position after a financial and controls audit.

As internal audit mostly works for the audit committee and management, their focus is not just about assurance, but identifying weaknesses, improving value-for-money, enhancing processes, and discovering errors or fraud. Therefore internal audit helps the organisation to identify risk and deal with it in a cost-effective way; it is not about checking every aspect, but to hone in on key matters.

A financial and control audit covers just a small part of the organisation, the objectives it needs to achieve, the risks it faces, and the transactions, discussions and decisions it makes every day.

Therefore, to conduct specialist individual audits purely on the types of elements in the adjoining box, may not be the most effective and efficient way to uncover problems and

control weaknesses, and maximise business opportunities.

Providing coverage across the organisation in width, length, height and depth is expensive, whereas integrated risk-based auditing can cover a lot of ground quickly.

### Drivers for Change

- Escalating Costs
- Customer Demands
- Corporate Governance
- Increasing Complexity
- Legislative Requirements
- Growth in People & Services
- Technological Improvements
- One Stop Shop Demands

Audit clients often prefer one audit covering their whole business, rather than various audits covering small parts continuously over a period of time. They also have more interest in key aspects of their business in order to help them to be successful, or to prevent them from failing. Comprehensive audits have a greater possibility of delivering significant benefits across the business and its bottom line.

The conventional way of auditing might be the *safest* way clear and ring-fenced audit scope.

to audit with a narrow,

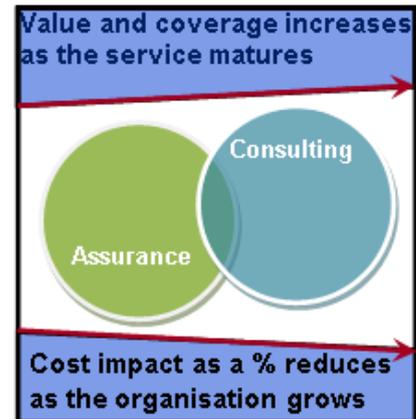
This is actually a contradiction, as the safer approach might provide fewer challenges but result in less impact, less value, and less relevance.

As an alternative, integrated risk-based internal auditing might be too complex for persons new to internal auditing, as it requires a broad understanding and experience. This can be overcome by using newer auditors as part of a team to work with more experienced auditors.

Another way to get a transfer of knowledge is to use the tried and tested method of letting the business tell you what is wrong. Even junior auditors using integrated risk-based auditing have surprised others and themselves on what they are able to achieve using this approach.

As this type of internal audit service develops and matures, it has the ability to provide audits at a lower cost while delivering more value.

### Value versus Cost



## 2. Discussion

### 2.1 Issue

The key consideration is whether internal audit can and should conduct audits in a conventional way or in an integrated risk-based manner ... or perhaps have a blended internal audit plan that includes both of these options depending on the nature and objectives of each specific engagement in the plan.

The key difference integrated risk-based auditing brings is that it allows auditors to immediately hone in on the key risks and controls over wider areas.

### 2.2 History

*"Integrated Auditing currently is considered a major element of the internal auditing function. However, portions of the integration philosophy have a history of being employed in internal audits of the 1940s."*<sup>1</sup>

Gregg R. Maynard sums up the positive approach to risk by saying:

*"Holistic risk management strategies have pushed aside internal auditors' traditional myopic focus on controlling the downside of risk. A fully integrated audit operation now understands and embraces risk as a source of profit."*<sup>2</sup>

<sup>1</sup> Sawyer's Internal Auditing earlier and 5<sup>th</sup> Edition – The Practice of Modern Internal Auditing page 162

<sup>2</sup> Maynard, Gregg R., "Embracing Risk," Internal Auditor, February 1999, page 24-28.

The Institute of Internal Auditors (IIA) Standards & Guidance — 'International Professional Practices Framework' (IPPF)<sup>®</sup> has clear indications in this regard, notably:

*IIA Practice Advisory 2010-1:*

Linking the Audit Plan to Risk and Exposures infers that the internal audit plan should consider risks and exposures. It further indicates that the audit universe will normally be influenced by the results of the risk management process and it is advisable to assess the audit universe at least annually.

*IIA Practice Advisory 2010-2:*

Using the Risk Management Process in Internal Audit Planning indicates that risk management is a critical part of providing sound governance that touches all the organization's activities. It further indicates that many organizations are moving to adopt consistent and holistic risk management approaches that should, ideally, be fully integrated into the management of the organization. Another key statement is that the internal audit charter normally requires the internal audit activity to focus on areas of high risk, including both inherent and residual risk. This clearly sets the path that internal audit should focus on the key risks and not attempt to audit all risk or controls.

An important consideration is that risk is not static and cannot therefore be pinned down. It is also a perception at a point-in-time and each organisation will have a different view on how serious a risk is. It is normally easier to agree on whether a risk is real to the organisation, but the actual rating of likelihood or impact is often a subjective judgement.

Therefore integrated risk-based internal auditing is more about agreeing what risks across a whole organisation or business unit are significant enough for attention, without having to agree on an exact rating. This requires internal audit to effectively communicate over a broad number of subjects.

## **2.3 Audit Universe**

The concept of the audit universe is to summarise potential internal audit topics in an easily understandable list. This is relatively straight-forward if only dealing with financial and conventional audits conducted in a standard way. In the twenty-first century the environment, risks and interrelationships are more complex.

Risk constantly changes, and this requires the auditor to include and exclude audit topics and approaches as the environment and requirements change. A standardised approach will, in many cases no longer suffice. Parts of organisations are interdependent and the strengths and weaknesses of various organisation areas impact on other areas. Very few, if any, areas work in isolation, and therefore auditors cannot readily ring-fence aspects or review them effectively on their own. For instance, finance may have a significant impact on engineering and, in return, engineering may have a significant impact on the financial position of the organisation.

Audit planning increasingly requires use of documents such as the strategic plan, service catalogue, business plan, budget, annual report and organisation structure as key planning inputs.

Gregg R. Maynard advocates "*Combining objective and subjective analysis of the audit universe to reveal audit priorities.*"<sup>3</sup>

## **2.4 Three Lines of Defence**

The development of '*The Three Lines of Defense*'<sup>4</sup> model demonstrates that internal audit is one assurance mechanism in a suite of assurance mechanisms. This clearly suggests the chances of something slipping through is lessened due to the many assurance mechanisms

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<sup>3</sup> Maynard, Gregg R., "Embracing Risk," Internal Auditor, February 1999, page 24-28.

<sup>4</sup> The IIA's Position Paper, The Three Lines of Defense in Effective Risk Management & Control, 2013.

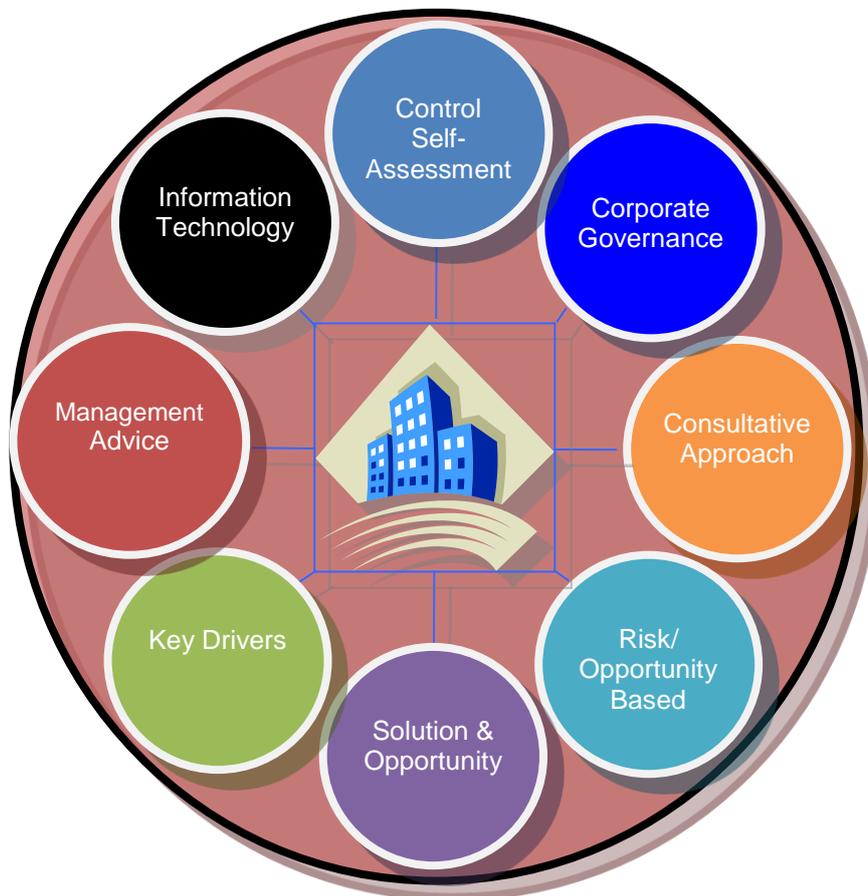
in place to review organisation activities. This model provides a good way to identify gaps in assurance and areas requiring audit attention, and further supports the shift for internal audit to focus on the most important components.

## 2.5 Integrated Risk-Based Internal Auditing

This means an audit could include areas that management have identified should be considered based on their perception of high risk or purely for further assurance. Internal audit may include areas they know other stakeholders may be concerned about. An industry scan or colleagues in similar organisations are avenues to provide further aspects that could potentially be considered.

Any new ideas or methodologies could then provide new or different results. For instance, fraud risks could be considered systematically as part of the audit, and this approach could pinpoint contemporary fraud factors that are potentially overlooked with a conventional audit approach. Auditors have to adapt and modify their methods as the organisation environment changes.

### INTEGRATED RISK-BASED INTERNAL AUDITING



Could include various aspects based on the highest risks

## 2.6 Practical Elements

Historically, risk has been part of integrated auditing concepts; the key here is to make it one of the main driving factors of what will be included in the audit and to highlight the positive or upside of risk. It subscribes to the philosophy that it is not about how much we do, but more about what difference we make. Practical elements include:

- Allows internal audit to focus on the more important, bigger-dollar and higher risk items, where the greatest impact can be achieved, making the internal audit service more relevant.
- Does not just include financial risks, but includes other aspects of importance such as operational, information systems, performance, environmental, and fraud in a more holistic approach. It also uses different tactics and techniques to ensure different options and possibilities are considered.
- The aim is not to do everything, but to use various kinds of risk indicators to focus internal audit on areas where it can make a significant difference. This is likely to include risk areas the audit client would like covered, without necessarily excluding what they do not want covered. The focus is more on risk management than pure risk identification.
- The aim is not to focus on audit objectives, but more on the strategic overall objectives and outcomes of the business area to ensure the organisation is sustainable in the long-run.
- Areas of the same business do not work in isolation, with many risks interrelated, therefore the aim is to include all risks that have a significant effect on that specific business area or the organisation as a whole.

## 2.7 Pros and Cons

### **Pros**

Integrated risk-based internal auditing has the potential to drive benefits for the business by:

- Increasing the relevance and credibility of internal audit as it focuses its resources where they can have the most impact.
- Making internal audit more cost-effective, so it can cover more ground while focusing on the more important aspects.
- Demonstrating that internal audit can increasingly make a difference to the organisation.
- Integrating knowledge into a single audit producing a more effective outcome through a holistic approach.
- Having fewer audits for managers, with one report honing in on significant aspects of a business area.
- Allowing managers to control, accept, avoid, diversify, share or transfer risk.
- Meeting higher customer demands by providing a one-stop-shop, holistic view or opinion.
- Helping decisions on risk by broadening perspectives and 'thinking outside the box'.
- Using technology so more data to be evaluated and compared at an increased speed.
- Using new ideas and methodologies to achieve different results.
- Allowing for a more consultative approach.
- Using the 'Three Lines of Defence' model to provide a safety net for the risk of something slipping through.
- Spending more time auditing business areas with potential area to make the organisation more successful.
- Putting the 'elephant in the room' in scope.

### **Cons**

Potential downsides of integrated risk-based internal auditing may include:

- May not be able to vouch compliance as the aim is not to audit everything in a business area.

- May be difficult to achieve if auditors are not appropriately qualified, skilled or experienced.
- Requires organisations maturity for things to be open to challenge.
- Possibility of something not being considered important or missed altogether – counter argument to the 'Three Lines of Defence' safety net.

### 3. Conclusion

#### 3.1 Summary

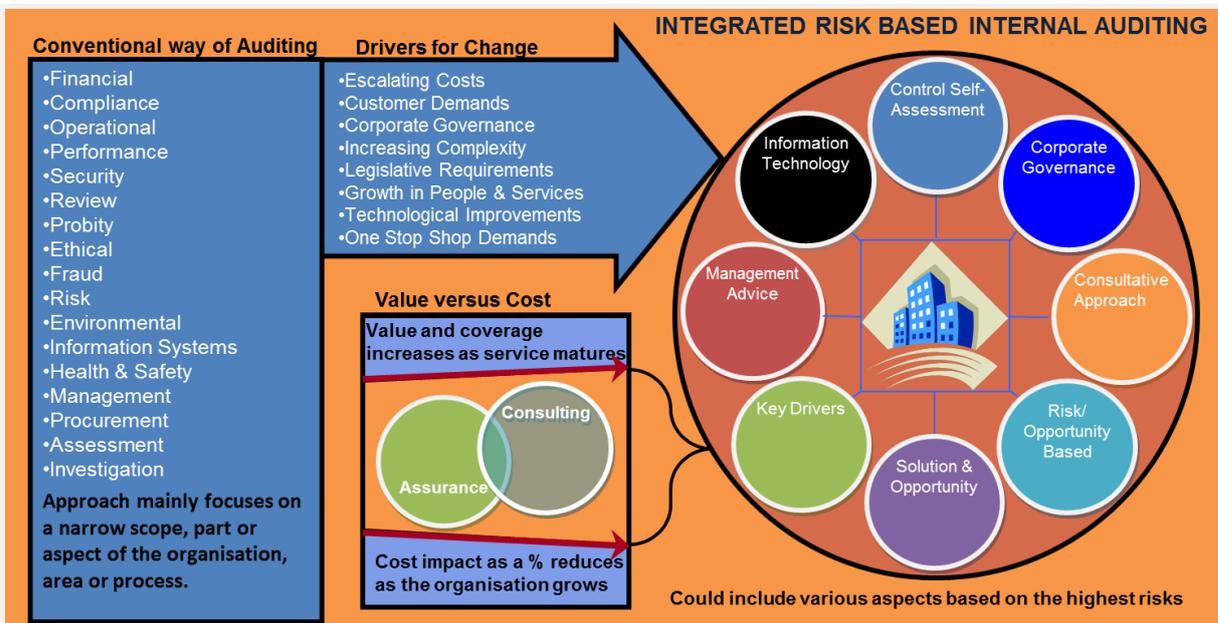
The aim and approach to integrated risk-based auditing is to cover extra ground during auditing and thereby be more effective and efficient. It is not a narrowly focused approach requiring a series of audits to provide coverage, but rather an approach that considers key risks in a business area. For instance, management is likely to gain greater insights from an audit of their whole business area rather than smaller elements periodically.

Therefore it neither restricts the scope of an audit, nor overly tries to classify it according to whether it is compliance, operational, performance, financial, or another type of audit. This means audit time can be spent where it makes the most difference, as all key aspects within an area could be within scope.

#### 3.2 Conclusion

This approach can be powerful and help ensure internal audit stays effective and relevant. It requires a mindset change that can be difficult and challenging, but if done well it can be rewarding. It encourages auditors to spend more time on things that can make their organisation more successful.

All the parts together are shown below:



This approach will not work in all situations. But if auditors allow themselves to do one or two of these types of audits in appropriate areas, their audit clients will gain value in having one audit with one report that covers the key aspects of their business area, and typically with a number of significant findings with significant business benefits.

If auditors can focus and deal with the bigger and more important matters, then their impact will be greater.

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- <sup>1</sup> Sawyer's Internal Auditing earlier and 5<sup>th</sup> Edition – The Practice of Modern Internal Auditing page 162
- <sup>2</sup> Maynard, Gregg R., "Embracing Risk," Internal Auditor, February 1999, page 24-28.
- <sup>3</sup> The IIA's Position Paper, The Three Lines of Defense in Effective Risk Management & Control, 2013.

### Purpose of White Papers

A White Paper is an authoritative report or guide that informs readers concisely about a complex issue and presents the issuing body's philosophy on the matter. It is meant to help readers understand an issue, solve a problem, or make a decision.

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## **6. About the Institute of Internal Auditors – Australia**

The Institute of Internal Auditors – Australia (IIA-Australia) ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and abroad. The IIA-Australia became a national institute in 1986 and is affiliated with the Institute of Internal Auditors (IIA). The IIA is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator. The IIA sets the bar for Internal Audit integrity and professionalism around the world with its International Professional Practices Framework (IPPF), a collection of guidance that includes The International Standards for the Professional Practice of Internal Auditing and the Code of Ethics.

The IPPF provides a globally accepted rigorous basis for the operation of an Internal Audit function. Procedures for the mandatory provisions require public exposure and formal consideration of comments received from IIA members and non-members alike. The standards development process is supervised by an independent body the IPPF Oversight Council of the IIA which is appointed by the IIA Board of Directors and comprises persons representing stakeholders such as boards, management, public and private sector auditors, regulators and government authorities, investors, international organisations, and members specifically selected by the IIA Board of Directors.

The IIA was established in 1941 and now has more than 180,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

Historians have traced the roots of internal auditing to centuries BC, as merchants verified receipts for grain brought to market. The real growth of the profession occurred in the 19<sup>th</sup> and 20<sup>th</sup> centuries with the expansion of corporate business. Demand grew for systems of control in companies conducting operations in many locations and employing thousands of people. Many people associate the genesis of modern internal auditing with the establishment of the Institute of Internal Auditors.

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