

Core and Legitimate Roles of Internal Audit Function and Enterprise Risk Management: Propositions for Future Research

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Abstract: In the aftermath of global corporate scandals at the start of the new millennium government policy makers and international regulatory organizations launched several initiatives to anticipate and mitigate the impact of enterprise risk that can seriously damage economies of nations and bankrupt globally recognized companies. The typical roles of internal auditors have failed to prevent frauds and financial crimes from taking root in organizations. As a result, paradigms such as Enterprise Risk Management took centre-stage and became vital considerations and organizations such as the Institute of Internal Auditors along with other global platforms such as the Committee of Sponsoring Organizations of the Treadway Commission to address the issue of enterprise risk. However, despite all these measures new corporate scandals have emerged, inviting scope for further investigation on matters such as how defined internal audit functions relate to Enterprise Risk Management.

This paper proposes a conceptual link between the core and legitimate roles of internal auditor function and enterprise risk management. The roles of internal auditor function are based on the Institute of Internal Auditors Position Paper (2009) and the core components of Enterprise Risk Management are identified based on the Committee of Sponsoring Organizations (2017) Enterprise Risk Management Integrated Framework. This study further proposes a set of propositions suggesting the possible association of the core and legitimate roles of internal auditors on the five core components of Enterprise Risk Management. The output of this study is expected to lay the foundation for further empirical studies to develop a finer-grained understanding of how internal auditor function roles relate to Enterprise Risk Management implementation.

Key words: enterprise risk management; internal auditor function; chief risk officer; CRO

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1. Background

The Malaysia-based 1Malaysia Development Berhad scandal (1MDB), which is branded as the biggest corporate heist in history, has now engulfed many governments (e.g., UAE, Malaysia, Singapore, USA) and global companies (e.g., Goldman Sachs, Deutsche Bank), and has brought back memories of the aftermath of corporate financial reporting scandals at the turn of the new millennium, names such as Enron and Tyco are again resonating in peoples' minds (Wright & Hoffman, 2019). Stakeholders are demanding greater oversight of key risks facing their enterprise to ensure that stakeholder value is preserved (Baranek, 2018; Groysberg et al., 2018;

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Tysiac, 2017). In the aftermath of the corporate fraud cases in the late 1990s, numerous regulatory reforms were initiated, particularly the Sarbanes-Oxley Act of 2002 (SOX 2002) signed during the Bush administration and the Dodd-Frank Act of 2010 (Dodd-Frank) signed by the Obama administration in the United States, both significantly expanded public policy debates around the world related to effective oversight over corporate governance and risk management (Ge & McVay, 2005; Gunz & Thorne, 2018).

However, even after the implementation of stringent guidelines of SOX which were mirrored by other developed and developing countries, several new corporate scandals have emerged such as Toshiba's over-statement of profits by USD\$ 2 billion (Addady, 2017; Pfanner & Fujikawa, 2015), the database breaches by Facebook and Cambridge Analytica (Leetaru, 2018), and the Volkswagen emissions scandal (Bachman et al., 2107) bringing realization to stakeholders that, enterprise risk management (ERM) needs to be reassessed to see whether the issue lies with how guidelines are being implemented (Trautman & Kimbell, 2018). In the above scenario, ERM practices are being reassessed and policy makers continue to focus on mechanisms to improve corporate governance and risk management (Perez-Cornejo et al., 2019; Pierce & Goldstein, 2018).

Despite increasing efforts by policy makers and regulators to gain further oversight into ERM practices, there has been insufficient research on factors associated with the implementation of ERM and the possible role of internal auditors in the ERM implementation process. The traditional role of implementing and monitoring ERM typically starts with active involvement of internal auditors, yet the relationship between the roles of internal auditors and ERM is not clearly understood (Trautman & Kimbell, 2018, p. 34). Therefore, further research is needed determine whether the core and legitimate roles of internal audit functions have significant and positive influences on ERM systems in organizations. Therefore, this study proposes to look into how the roles of the internal auditors as defined by the Institute of Internal Auditors (IIA) Position Paper (2009), impact the five components of ERM outlined by the updated COSO Framework (2017) of the Treadway Commission.

1.1 Problem Statement

It seems that traditional governance models are not adequate for the more complex risk environment, which is needed in order to prevent fraudulent corporate acts. For this reason, stakeholders are demanding that internal auditors play a more proactive role by including internal control and risk management functions (Coetzee, 2016). The ERM concept was introduced to give enhanced transparency and a consolidated view of risk management capabilities as the primary objective of the ERM is to create, protect, and enhance shareholders' value by managing the uncertainties surrounding the achievement of the organisation's objectives (Braumann, 2018; Walker et al., 2002).

The IIA , which is the largest professional organization for internal auditors with a global presence in 190 countries, claimed that internal auditors can make a significant contribution to risk management within their respective organizations. The IIA defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations" (Kerazan, 2016, p. 184), and emphasizes its' function in improving the effectiveness of risk management, control, and the governance processes of an organization. It is important to note that the cotemporary role of internal auditors has shifted to responding to the changes in stakeholder expectations and new perspectives on risk management. New demands from the board of directors, senior organizational leaders, and regulators, etc. requires internal audit units to refocus their efforts beyond regulatory compliance issues (Delloite Risk Advisory, 2015).

In context of Asia, for instance in Malaysia which is an Upper-Middle Income nation (World Bank Growth Report, 2018), the degree of ERM adoption varies between organizations. It was reported that many Malaysian

companies have adopted ERM systems because it is the current trend (i.e., “keeping up with the Joneses”) but many organizations are yet to fully appreciate and embrace the spirit of the ERM and are still in the early stages of the ERM strategies suggested by the COSO Framework 2017 (Annamalah et al., 2018). Traditionally, enterprise risk detection and reporting has been under the preview of the internal auditor’s function (Norlida et al., 2007). Therefore, one of the primary drivers of ERM implementation in organizations is the critical role of internal auditors and hence it is deemed important to explore the current scenario in terms of examining how the internal audit functions are impacting ERM implementation. Therefore, the current study presents a set of propositions that suggest relationships between core and legitimate roles of internal auditors on the components of ERM as proposed by the IIA Position Paper (2009).

2. Significance of the Research

This research study proposes to examine the latest evidence on the impact of the various roles of the internal audit function (IAF) on success of ERM implementation. Most government regulatory authorities and stock exchanges around the world have mandatory guidelines for ERM policies. For example, Bursa Malaysia (Malaysian National Stock Exchange) has mandated ERM implementation in publicly listed companies (PLC) through the 2013 Bursa Malaysia Guidelines, however many Malaysian PLCs are yet to fully realize the importance of having a proactive risk management platform such as ERM in their organizations (Togok et al., 2016).

The current study proposes a research framework leading to a set of propositions to examine the relationships between the core and legitimate roles of IAF on the five (5) components of ERM. This conceptual paper hopes to encourage future research to consider these propositions and develop relevant hypotheses to test the relationships with suitable data. There appears to be a dearth of studies that have considered the new COSO ERM Framework (2017) to examine whether roles of IAF have any significant impact on the ERM components (Trautman and Kimbell, 2018). Therefore, this conceptual work is expected to contribute to both the relevant literature as well as bring the practical role of the internal audit profession as a value-added function in the area of ERM implementation to the surface. Further empirical investigations based on this study could be valuable to policy makers, industry practitioners and academic researchers.

The remaining sections of this article are as follows: literature review with discussions on empirical evidences with regards to the development of ERM and internal auditor’s roles in ERM implementation. Subsequent sections cover the research framework, development of propositions, and conclusions with directions for future research.

3. Literature Review

This section provides an overview of the existing literature on enterprise risk, followed by a more detailed discussions on ERM implementation, and the value-added roles of the internal auditor through the skills and expertise required for ERM assurance and consulting engagements. The professional standard requirements and results of the professional body’s research pertaining to internal audit function are also discussed.

3.1 Enterprise Risk Management (ERM)

Although the concept of managing risks is not a new idea, scientific inquiry into enterprise risk started about 30-40 years ago (Aven, 2016). The International Standards for the Professional Practice of Internal Auditing (ISPPIA) was issued by IIA and it defines risk management as “a process to identify, assess, manage, and control

potential events or situations to provide reasonable assurance regarding the achievement of the organization's objectives" (Pett & Poritz, 2018). It is consistent with the definition of risk management given by International Standards Organization (ISO), which defines it as "to coordinate activities to direct and control an organization regarding risk" (McShane, 2018). While the term ERM can be viewed as a natural evolution of the process of risk management (Fraser & Simkins, 2009; Bromiley et al., 2016), the COSO defines it as "a process, effected by an entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives" (COSO, 2004, p. 16).

COSO was originally formed in 1985 with the objective of providing thought-leadership through the development of frameworks and guidelines on matters such as ERM and internal control and fraud deterrence to improve organizational performance and governance. In 2014, the commission announced that they would initiate changes in their integrated frameworks (i.e., ERM Integrated Framework-1 and the Internal Control-Integrated Framework-2) that were collectively referred to as "the COSO 2004 frameworks" (Pierce and Goldstein, 2018). Both the frameworks were intended to provide guidance for management on how to implement and evaluate effective ERM and internal control processes, leading to the improvement of management and governance processes (DeLoach & Thompson, 2014). In 2017, COSO finally released the much awaited ERM Integrating Strategy and Performance, which was necessary because the previous integrated framework did not address strategic planning.

ERM is different from traditional risk management approaches where the risks are normally managed in isolation at the business unit level. Under past practices, the detected risk in one unit was not communicated through the organization as a whole, resulting in the underutilization of resources (Aven, 2016). However, under ERM, the presence of a comprehensive risk management system means that all risk areas are managed in an integrated, organization-wide system and dealt with at strategic levels, which means ERM is not only coordinated with senior-level oversight, but also encourages employees at all levels to view risk management as an integral and on-going part of their jobs (Beasley & Frigo, 2009; Trautman & Kimbell, 2018). The ultimate objective of ERM is to increase the likelihood of reaching strategic objectives and adding value to the organization (Fraser & Simkins, 2009; Pierce & Goldstein, 2018). COSO's ERM Framework (2017) includes five components that integrates all previous eight components of the COSO (2004) framework along with strategic planning dimension (Trautman & Kimball, 2018) (shown in Table 1 and Table 2).

Table 1 Previous Components of the Enterprise Risk Management (ERM) (COSO Framework, 2004)

No.	Components	Description
1	Internal environment	The internal environment establishes the tone of the organization, influencing the risk appetite, attitudes towards risk management, and ethical values.
2	Objective setting	The board should set objectives that support the organization's mission and which are consistent with its risk appetite.
3	Event identification	The organization must identify internal and external events that affect the achievement of its objectives.
4	Risk assessment	The likelihood and impact of risks are assessed, as a basis for determining how to manage them.
5	Risk response	Management selects appropriate actions to align risks with risk tolerance and risk appetite.
6	Control activities	Policies and procedures should operate to ensure that risk responses are effective.
7	Information and communication	Information systems should ensure that data are identified, captured, and communicated in a format and within a time-frame that enables managers and staff to carry out their responsibilities.
8	Monitoring	The management system should be monitored and modified if necessary.

Source: COSO (2004).

Table 2 New Components of ERM (COSO Framework, 2017)

No.	Components	Description
1	Governance and Culture	<ul style="list-style-type: none"> • Exercises board risk oversight • Establishes operating structures • Defines the desired culture • Demonstrates commitment to core values • Attracts, develops, and retains capable individuals
2	Strategy and Objective-Setting	<ul style="list-style-type: none"> • Analyses the business context • Defines the risk appetite • Evaluates alternative strategies • Formulates business objectives
3	Performance	<ul style="list-style-type: none"> • Identifies risks • Assesses the severity of risks • Prioritizes risks • Implements risk responses • Develops the portfolio view
4	Review and Revision	<ul style="list-style-type: none"> • Assesses substantial change • Reviews risk and performance • Pursues improvements in ERM
5	Information Communication and Reporting	<ul style="list-style-type: none"> • Leverages information and technology • Communicates risk information • Reports on risk culture and performance

Source: Trautman and Kimbell (2018).

ERM is considered to be effective when all five of the above core components are present and functioning well (Walker, 2018; Trautman & Kimbell, 2018). However, globalization and economic inter-connectedness has changed the risk landscape across the globe and at a faster pace. Therefore, organizations are increasingly investing in improving their risk management as they are aware of the need to be dynamic so that the system may be regularly reviewed and improved to face ever growing uncertainties and challenges (Ravindran et al., 2015). Establishment of an effective enterprise-wide risk management system at both the strategic and operational levels is the primary responsibility of the board and management : they are expected to identify various organizational risks, create controls to mitigate those risks, and then monitor and review the identified risks and controls regularly (Bromiley et al., 2015; MacLeod et al., 2012). The board should actively exercise its oversight role and emphasize the importance of ERM to the senior management and its' employees (Branson, 2009). Thus, there is a shared responsibility between the members of the board and the senior management team to promote a risk-awareness culture and align the risk management system with the organization's strategic plan.

3.2 Internal Auditor's Involvement in Risk Management

Historically, internal audit has been considered a monitoring function, the "organizational policeman and watchdog" (Morgan, 1979). More recently, internal auditing was defined by IIA as "...to evaluate and improve the effectiveness of risk management, control and governance processes". As such, internal auditors are expected to play a key role in consulting and providing assurance on risk management processes in order to practice internal auditing in accordance with the standards (Abdullatif & Kawuq, 2015; Pett & Poritz, 2018). A study by Ali et al., (2018) reported that internal auditors in South east Asian countries such as Malaysia perceived themselves more to be consultants rather than "policemen" although in fact most of their jobs are related to the assurance service. This was substantiated by an earlier survey in 2008, which revealed that 53% of the internal auditors in Malaysia focus their work in assurance activities while only 10% of them perform consulting activates (KPMG, 2009).

Regarding the relationship between internal auditing and risk management, Stewart and Kent (2006) conducted research on the voluntary use of internal auditors in 450 Australian companies. The result showed that companies with strong commitment towards risk management are more willing to establish an internal audit function (IAF), while audit committees face more difficulties in exercising their monitoring function among companies that do not use internal auditors. Branson (2009) stated that the internal auditor has a role in supporting the risk management process and in many cases audit executives who lead the internal audit function have often initiated the ERM launch within the organization. According to Allegrini and D'Onza (2003), from the research conducted among internal auditors in top 100 Italian listed companies, 67% of them have confirmed their contribution to risk management. Similarly, based on a survey conducted in 15 European countries on whether risk assessment and risk management are part of the duties of the IAF, Paape et al. (2003) concluded that two-thirds of the respondents said that they advise and/or support in this area.

The coming of new risk areas, change of systems, and processes in organizations make traditional compliance-based internal auditing dysfunctional, which has led to a dramatic rise in the demand for risk professionals in the IAF (Mahzan et al., 2012). For example, Bursa Malaysia (Malaysian National Stock Exchange) mandates the implementation of ERM and establishment of IAF for all publicly listed companies in Malaysia, which is consistent with the new expanded roles of internal auditors as well as the significance of internal auditors in risk management (Norziaton et al., 2017).

3.3 Internal Auditor's Roles in ERM

IIA (2009) released a Position Paper, "The Role of Internal Auditing in Enterprise-wide Risk Management", in response to the ERM framework, in which, the active roles for internal auditors, including examining, evaluating, reporting and recommending improvements on the adequacy and effectiveness of management's risk processes are outlined (Lawson et al., 2019). IAA emphasized that when internal auditors provide assurance and consultancy services regarding ERM, it's important that they maintain their objectivity and independence (Grammling & Myers, 2006). The position paper outlined three categories of roles that internal auditors might perform in ERM:

- 1) The recommended or **core roles** of internal audit in ERM.
- 2) The roles that are perceived as **legitimate** provided they are undertaken with safeguards.
- 3) The roles that should **not be undertaken** (prohibited) by internal auditors.

The core role of internal auditors regarding ERM is to provide objective assurance to the board that the key risks are managed appropriately and the internal control system is functioning effectively, while the legitimate role reflects the consulting activities so long as the internal auditor does not actually manage the risk that is the management's responsibility (Lawson et al., 2019). Finally, the prohibitive role in ERM shows several roles that may affect the objectivity and independence of the internal auditors, thus they need to be avoided (IIA, 2009). The specific roles under each category are listed in Table 3.

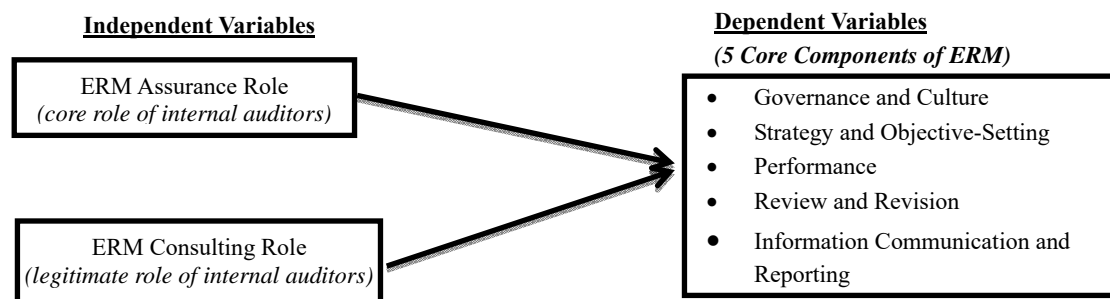
Table 3 Roles of Internal Auditors in ERM

Core internal auditing roles in ERM (Assurance Roles of Internal Auditors in ERM Implementation)	Giving assurance on risk management processes
	Giving assurance that risks are correctly evaluated
	Evaluating risk management processes
	Evaluating the reporting of risks
	Reviewing the management of key risks
Legitimate internal auditing roles with safeguards (Consulting Roles of Internal Auditors in ERM Implementation)	Facilitating the identification and evaluation of risks
	Coaching management in responding to risks
	Coordinating ERM activities
	Consolidating the reporting on risks
	Maintaining and developing the ERM framework
	Championing the establishment of ERM
	Developing the risk management strategy for board approval
Roles internal auditing should not undertake (Roles internal auditors are not permitted to undertake regarding ERM implementation)	Setting the risk appetite
	Imposing risk management processes
	Management assurance on risks
	Making decisions on risk responses
	Implementing risk responses on the management's behalf
	Accountability for risk management

Source: IIA Position Paper, 2009.

4. Research Framework and Propositions

According to the COSO ERM Integrated Framework (2017), internal auditors play significant roles in coordinating processes to assess, measure, respond to, and report the risks involved in the general and early development of ERM during the implementation process (Chambers, 2018; Dumay et al., 2018). The contemporary risk-based audit approach allows internal auditors to perform risk assessment in a more systematic way and link it to the organization's long-term objectives. This may, in turn, be very useful to the IAF in planning their work by improving the accuracy of decision-making information as well as minimizing the duplicated audit work. A conceptual framework (Figure 1) for this study shows the impact of two roles of internal auditors (Table 2): (i) the core functions of the ERM assurance role and (ii) legitimate functions that are permitted if required under the ERM consulting role on the five components of ERM as defined by the COSO 2017 ERM Integrated Framework.

**Figure 1** Conceptual Framework

Source: IIA Position Paper (2009); COSO 2017 ERM Integrated Framework

4.1 Propositions

Since the definition of “internal auditing” by IIA emphasizes the close relationship between the internal audit function and risk management, the internal auditor is considered an integral part of ERM implementation (Trautman & Kimbell, 2018). This study posits significant and positive relationships between the two of the roles of the internal auditors (*core role of assurance* and *legitimate role of consulting*) and the five different components of the ERM implementation process. Hence the following two umbrella propositions are stated below:

P1: *The internal auditors’ core role of ERM Assurance will be associated with ERM Implementation.*

P2: *The internal auditors’ legitimate role of ERM Consulting will be associated with ERM Implementation.*

The main propositions are further divided into a set of sub-propositions under each to facilitate a finer-grained analysis between the two internal auditor roles in ERM and the individual components of ERM (Tables 4A and 4B).

Table 4A Sub-Propositions for P-1

P-1: IA’s Assurance Role is related to ERM Implementation	
Code	Sub-Hypotheses
P-1a	The <i>assurance role</i> of internal auditors will have an impact on <i>Governance and Culture</i> .
P-1b	The <i>assurance role</i> of internal auditors will have an impact on <i>Strategy and Objective-Setting</i> .
P-1c	The <i>assurance role</i> of internal auditors will have an impact on <i>Performance</i> .
P-1d	The <i>assurance role</i> of internal auditors will have an impact on <i>Review and Revision</i> .
P-1e	The <i>assurance role</i> of internal auditors will have an impact on <i>Information Communication and Reporting</i> .

Table 4B Sub-Propositions for P-2

P-2: IA’s Consulting Role positively and significantly impacts ERM Implementation	
Code	Sub-Hypotheses
P-2a	The <i>consulting role</i> of internal auditors will have an impact on <i>Governance and Culture</i> .
P-2b	The <i>consulting role</i> of internal auditors will have an impact on <i>Strategy and Objective-Setting</i> .
P-2c	The <i>consulting role</i> of internal auditors will have an impact on <i>Performance</i> .
P-2d	The <i>consulting role</i> of internal auditors will have an impact on <i>Review and Revision</i> .
P-2e	The <i>consulting role</i> of internal auditors will have an impact on <i>Information Communication and Reporting</i> .

5. Conclusions and Future Research Directions

This study presented a more nuanced set of propositions to suggest relationships between the core and legitimate functions of internal auditors and the components of ERM as defined by the COSO ERM Framework 2017. This conceptual paper was deemed necessary in light of the fact that there appears to be a dearth of studies that examine how the IAF core and legitimate functions impact the core components of ERM. Furthermore, Trautman and Kimbell (2018) state that: “The role of internal auditors in ERM are not well understood, and sometimes overlooked entirely” (p. 34), suggesting that such a research endeavour is called for. Therefore, the current study anticipates that this will pave the path for empirical research that could develop hypotheses based on the propositions in this paper and utilize appropriate statistical methods to determine whether the relationships posited are in fact significant and whether the relationships are positive or negative.

Furthermore, it is suggested that future studies can also examine whether having a dedicated chief risk officer

(CRO) at the initial stages of ERM implementation makes any difference to the relationships posited in this study and whether the presence of the CRO impacts the core and legitimate roles of the internal auditors in any way.

The results of this research are expected to make significant contribution to the academic discourse on relationship between IAF and ERM implementation, and also carry important managerial implications for industry practitioners and also for policy makers and regulators.

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