The Ingredients of a Successful IA Department

Reflections of a Chief Audit Executive and Businessman
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“Two of the biggest lies in business: Internal Audit is there to help and Management is glad to see them…”

~Management Proverb

There is a huge disconnect between Internal Audit’s perception of adding value and Management’s perception of receiving value!
From PwC...

A call to action

Stakeholders reporting Internal Audit contributes significant value

54%
44%

2016 stakeholders
2017 stakeholders
From KPMG...
Why is this GAP widening?

A host of reasons...
Contributing Factors for the Disconnect

- “Where there is no vision, the people perish” –Proverbs 29:18 KJV
- “My people are destroyed for a lack of knowledge” –Hosea 4:6 KJV
- Key attributes missing to be a trusted advisor –Richard Chambers
- IA doesn’t understand the Company’s business operations
- IA doesn’t understand the Company’s **RISKS**!
- IA isn’t listening to Management
- SOX is mistakenly confused as the sole function of Internal Audit
- IA has great *managers* but not great *leaders*!
Contributing Factors for the Disconnect

- The culture of the Company and/or Internal Audit are incompatible
- Lack of strategic thinking between Internal Audit and Management
- Stale annual audit plans
- Lack of training
- External auditor interference
- Inflexible and myopic views of the business
- Passive Board of Directors
How do you transform Internal Audit from good to great?

Closing the GAP...
Where to start...

- Search for opportunities to get involved in the business
  - Facilitate Enterprise Risk management (attend the meetings!)
  - Get yourself (and your teams) into operational and business meeting
  - Volunteer for projects (Management needs the help!)
  - Meet with Executive Management on a regular basis (standing meetings)
  - Sit on advisory boards
  - Never miss an opportunity to present to the Board of Directors
    - Actually, find ways to be in front of the Board as much as possible!

- Align your audit plan to the Company’s strategic priorities, strategic objectives, and its top risks
Where to start...

- What is keeping the C-suite up at night? Make that a component of your audit plan

- Be as knowledgeable OR MORE knowledgeable than your key stakeholders (this is going to take work!)
  - Don’t just read the 10-Q of 10-K, see the business behind the filings!
  - Review analyst reports, SEC special filings, everything publicly available about your Company (If it is out there, it is your job to know it!)
  - Got competitors? Read their stuff, too! Know their strategies, plans, objectives, and priorities!
    - Competitive pressures are on the mind of your executives and it should be on your mind, too!
An Illustration...

...using the Cost of Capital
A firm is currently faced with two investment opportunities. They hire two independent analysts.

We are given the following:

- **Investment A**
  - Cost = $500,000,000
  - Life = 20 years
  - Expected Return = 7%

- Least costly financing source available
  - Debt (bonds) = 6%

**Because the firm can earn 7% on the investment of funds costing only 6%, the first analyst recommends that the firm undertake this investment.**
An Illustration (Investment B)

- Investment B
  - Cost = $500,000,000
  - Life = 20 years
  - Expected Return = 12%

- Least costly financing source available
  - Equity = 14%

- In this instance, the second analyst recommends that the firm reject the opportunity, because the 14% financing cost is greater than the 12% expected return.
The True Cost of Capital

What if instead the firm used the combined cost of financing?

- The firm has a 50–50 mix of debt and equity and that mix is targeted LT, therefore, the weighted average cost here would be:

\[(0.50 \times 6\% \text{ debt}) + (0.50 \times 14\% \text{ equity}) = 10\%\]

- With this average cost of financing:
  
  - The first opportunity would have been **REJECTED** (7% expected return < 10% weighted average cost), and the second would have been **ACCEPTED** (12% expected return > 10% weighted average cost).
An Illustration using the Cost of Capital...

...is your IA Department involved in assisting Management with these kinds of decisions?
How could IA help Management here?

- Start with the current set of facts in the illustration – Knowledge!
- Anticipate Management’s needs and get there before they do!
  - When asked what made him successful, the GREAT ONE, Wayne Gretzky, said:
    "I skate to where the puck is going to be, not where is has been."
- Send your IA team to training!
  - Business is moving at the speed of a bullet, is your team getting ahead of it or are you behind it?
  - Training is an investment in your people that will pay off!
Where should you go to training?

- Take advantage of your local IIA Chapter (one of the best available outlets to expand your IA toolkit!)
Grow your IA Brand Internally

- Market yourself and your team to Management and the Board of Directors
  - The easiest way to do this to get involved!
  - Volunteer, volunteer, volunteer! (Advisory Boards, Risk Committee, IT Committees, Project Management, etc.)
  - Sponsor events and/or training for Management
  - Find “hot topics” and disseminate them, hold forums and Town Halls to discuss them!
  - Put on an event for the Audit Committee
  - Constantly market the skills of your department to Management!
Turn Managers into Leaders

**Managers**
- Worry about today
- Prefers stability
- Focuses on procedure
- Asks “what” and “how”
- Prefers controls
- Is happy in complexity
- Uses the rational mind
- Does what is required
- **Is efficient!**

**Leaders**
- Focuses on the future
- Appreciates change
- Engages in a vision
- Asks “why” and “what”
- Knows how to delegate
- Likes simplicity
- Trusts intuition
- Goes beyond requirement
- **Is effective!**
When I talk to managers, I get the feeling they are important... When I talk to leaders, I get the feeling that I am important.

Managers do things right, Leaders do things that are right...
Managing or Leading...

...How could IA have helped Whirlpool make working capital decisions?
Once upon a time...

- Whirlpool Corporation reported that it had revenues of $18.1B, COGS of $15.2B, A/R of $2B, and inventory of 2.4B.
Once upon a time...

The resources Whirlpool had invested in this cash conversion cycle (assuming a 365-day year) were:

- Inventory = $15.2 billion x (58/365) = $2.4, plus
- Accounts receivable = 18.1 billion x (40/365) = 2.0, minus
- Accounts payable = 15.2 billion x (89/365) = 3.7, equals
- Resources invested = $0.7 Billion or $700 million

Would your Internal Audit department be involved in advising on how Whirlpool would manage its working capital?

Would you manage or lead?
Your CFO thinks about working capital a lot!

- A survey of CFOs from firms around the world suggests that working capital management is a top the list of most valued finance functions!

- Among 19 difference finance functions, CFOs surveyed viewed **working capital management** as equally important as capital structure and tax management.

- Is working capital management important to IA? Your CFO’s worries are IA’s worries!
Enterprise Risk Management

Where Internal Audit Adds Real Value
NEXT ITEM ON THE AUDIT COMMITTEE AGENDA ...
RESULTS OF INTERNAL AUDIT'S DEEP DIVE
Evolving Perspective of ERM

- IIA Standard 2120:
  - The Internal Audit activity...
  - Must evaluate the effectiveness...
  - Contribute to the improvement of risk management processes

- IIA Practice Advisory 2010-1 and 2010-2
  - Linking the audit plan to risks and exposures
  - Must establish risk-based plans
  - Must consider organizations risk management framework

- “Internal audit is most effective when it is focused on the critical risks to the business” - KPMG
Enterprise Risk Management

Lessons from the Alere Perspective
Enterprise Risk Management – 2017 Plan

Step 1: Identify Risk
Step 2: Assess Risk
Step 3: Plan Response Strategy
Step 4: Implement Mitigation Strategy
Step 5: Monitor Performance

Risk Mgmt. Oversight Committee

Work completed to Date (2015/2016)
- Launch Global ERM initiative announcement
- Develop ERM Plan
- Create Risk Management Oversight Committee
- Approve ERM Charter
- Identify Risks
- Assess Risk through Survey/Interviews

2017 – Reevaluate Risk in Post Merger Environment
2017 IT Risk Management

- Q1-2017
  - Create IT Risk Oversight Team
  - Perform IT Risk Survey and Analysis
  - Communicate IT Risk Governance
- Q2-2017
  - Evaluate and Present Top IT Risks
  - Develop Risk Response Plans for Top Risks
- Q3/Q4-2017
  - Monitor Risk Response Plans
  - Assess Emerging IT Risks
Audit and Tools...

...That Will Make a Difference!
Tools and Audits to Create Value

- Wireless and Telephony
- Freight Forwarders / Transportation
- Inventory Management systems
- Category Spend / SC – HR/Temp, etc. (see Example)
- Healthcare Benefits Payouts
- Duplicate Payments Audits
- Data analytics / tracking via - SQL / ACL / QliK / Tableau / Onsprings
- Continuous Controls Monitoring – with tools such as PIVOT from Rausch Advisory Services
Tools and Audits to Create Value

- Metrics Reviews (compare plant yields, utilization rates, IT, etc.)
- Software License Audits (two edged sword...)
- Cyber Security, A&P, Phishing Audits and Reviews
- Category Spend Audit – HR/Temp/Consulting, etc. (Example)
- Cash Conversion Cycle (“OTC” Review with a BIG twist)
- Royalties / Contracts
- Pricing Review
- Compensation and other benefits audits (Particularly OVERSEAS)
Adding Value

Lessons from an Alere Sourcing Review
Alere engaged Firm X to perform a spend assessment with the following objectives:

- Collect and analyze spend data to create a comprehensive, procurement-focused spend database.
- Identify categories that can be addressed via sourcing.
- Prioritize categories with maximum savings potential.
- Provide a recommended roadmap to capture savings.

Firm X collected $2B in AP spend data across six Alere business units. The data was then cleansed and categorized into a procurement-focused spend.
Value Added from an Alere Sourcing Review

- Interviews were conducted with stakeholders from each business unit to review the spend profile and understand current purchasing habits.
- Of the $2B in total spend, $404MM was identified as potentially addressable and then segmented and prioritized based on savings potential.
- Based on the assessment, Firm X recommends launching a comprehensive sourcing campaign to address over $262MM in spend through multiple sourcing waves and consortia offerings with an aggregate savings target of over $20MM.
Spend Overview ($M)

Spend Analysis Statistics
- **Consolidation**: 9 files were consolidated to create a cross-entity spend database.
- **Normalization**: Cleansed 19k unique vendor names resulting in 11k normalized vendor names.
- **Categorization**: Categorized over 99% of $2,010MM using a two-tiered, procurement-focused taxonomy.

Alere Inc $1,258
- Alere Inc $1,123
- Alere North America $299
  - Alere North America $225
  - Alere North America $74
- Alere San Diego $165
  - Alere San Diego $161
  - Alere San Diego $4
- Alere Health $150
  - Alere Health $144
  - Alere Health $6
- eScreen $123
  - eScreen $99
  - eScreen $24
- Alere Home Monitoring $15
Value Added from an Alere Sourcing Review

- $312M in potential sourcing categories were prioritized based on savings potential and ease of implementation.
Value Added from an Alere Sourcing Review

Kits / Reagents, $28.7
Temp Labor, $30.2
Outsourced Labs, $22.6
Employee Ins., $28.1
3PL, $13.3
IT SW, $16.8
IT Contractors, $12.0
Medical Sundries, $8.0
Print, $11.8
IT HW, $8.2
Small Parcel, $8.3
Shipping Supplies, $3.7
Lab Supplies, $7.1
Packaging, $4.4
Consulting, $9.8
Incentive Programs, $3.0
Utilities, $3.3
Compliance Services, $4.0
Meters, $5.1
Postage, $5.8
Investor Relations, $12.9
Corp. Insurance, $6.7
Accounting, $7.5
Consulting, $9.8

Potential Sourcing Opportunities

Legend:
-Immediate Sourcing
-Wave 2 Sourcing
-Lower Opportunity

Savings Potential
Ease of Implementation

Marketing Agencies, $2.5

0 5 10
0 5 10
<table>
<thead>
<tr>
<th></th>
<th>A/P Spend ($MM)</th>
<th>Est. Addressable Spend ($MM)</th>
<th>Typical Savings (%)</th>
<th>Projected Savings ($MM)</th>
<th>Projected Hours Range</th>
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<tbody>
<tr>
<td>Temp Labor</td>
<td>$30.2</td>
<td>$22.5</td>
<td>14% - 20%</td>
<td>$3.2 - $4.5</td>
<td>1,380 – 1,840</td>
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<tr>
<td>Kits / Reagents</td>
<td>$28.7</td>
<td>$17.2</td>
<td>5% - 12%</td>
<td>$0.9 - $2.1</td>
<td>1,200 – 1,500</td>
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<tr>
<td>3rd Party Logistics</td>
<td>$13.3</td>
<td>$12.0</td>
<td>12% - 18%</td>
<td>$1.4 - $2.2</td>
<td>500 – 600</td>
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<tr>
<td>IT Contractors</td>
<td>$12.0</td>
<td>$6.0</td>
<td>10% - 21%</td>
<td>$0.6 - $1.3</td>
<td>500 – 600</td>
</tr>
<tr>
<td>Print</td>
<td>$11.8</td>
<td>$9.5</td>
<td>10% - 18%</td>
<td>$0.9 - $1.7</td>
<td>500 – 600</td>
</tr>
<tr>
<td>Small Parcel</td>
<td>$8.3</td>
<td>$7.4</td>
<td>10% - 25%</td>
<td>$0.7 - $1.9</td>
<td>250 – 350</td>
</tr>
<tr>
<td>IT HW</td>
<td>$8.2</td>
<td>$5.7</td>
<td>7% - 15%</td>
<td>$0.4 - $0.9</td>
<td>500 – 600</td>
</tr>
<tr>
<td>Medical Sundries</td>
<td>$8.0</td>
<td>$7.2</td>
<td>8% - 15%</td>
<td>$0.6 - $1.1</td>
<td>500 – 600</td>
</tr>
<tr>
<td>Lab Supplies</td>
<td>$7.1</td>
<td>$4.9</td>
<td>8% - 15%</td>
<td>$0.4 - $0.7</td>
<td>500 – 600</td>
</tr>
<tr>
<td>Meters</td>
<td>$5.1</td>
<td>$4.6</td>
<td>8% - 15%</td>
<td>$0.4 - $0.7</td>
<td>350 – 450</td>
</tr>
<tr>
<td>Packaging</td>
<td>$4.4</td>
<td>$3.9</td>
<td>7% - 14%</td>
<td>$0.3 - $0.6</td>
<td>350 – 450</td>
</tr>
<tr>
<td>Shipping Supplies</td>
<td>$3.9</td>
<td>$3.5</td>
<td>8% - 15%</td>
<td>$0.3 - $0.5</td>
<td>350 – 450</td>
</tr>
<tr>
<td>Sourcing Subtotal</td>
<td>$141.0</td>
<td>$104.5</td>
<td>10% - 17%</td>
<td>$10.0 - $18.0</td>
<td>6,880 – 8,640</td>
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<tr>
<td>Consortia</td>
<td>$2.8</td>
<td>$2.8</td>
<td>10% - 28%</td>
<td>$0.3 - $0.8</td>
<td>0</td>
</tr>
<tr>
<td>Grand Total</td>
<td>$143.8</td>
<td>$107.3</td>
<td>10% - 18%</td>
<td>$10.3 - $18.8</td>
<td>6,880 – 8,640</td>
</tr>
</tbody>
</table>
# 2014 – Enhancing Value in Procurement

## Sourcing Wave 1
- **Categories**: 5-10 immediately addressable categories
- **Spend**: $141.0MM
- **Savings**: $10MM-$18MM (10-17%)

## Sourcing Wave 2
- **Categories**: 5-10 more complex / sensitive categories
- **Spend**: $118.3MM
- **Savings**: $10MM-$20MM (10-20%)

## Sourcing Wave 3
- **Categories**: Alere-led internal projects, with XXX support as needed
- **Spend**: $20MM+
- **Aggregate Savings Target**: $20MM+

## Consortiums
- **Rapid savings, no fees**
- **Spend**: $2.8MM
- **Savings**: $0.3MM-$0.8MM (10-30%)

## Procurement Transformation
- **Capability Blueprint**

## Capability Enhancement
- **E.g., policy redesign, org. structure, training**

## SpendHQ – Spend Visibility and Category Management tools
- **Ongoing savings through compliance, monitoring, and demand management.**
Closing Thoughts
IT'S RISKY.
WE'RE MANAGING IT.

WHILE IT IS CONCISE IT LACKS SOMETHING AS A REPORT.
Human error is still one of our biggest risks!
Closing Thoughts

- Don’t Compromise your Ethics (it’s not worth it)
- Become a Trusted Advisor and a partner to the business
- Nope! The sun does not rise and set on the IA Department
- Recruit the right talent / train & develop
- Be smart and flexible
- Never stop learning and reading

- It’s all about attitude – Make sure you have the right one. 😊😊
Questions and Comments

Ramzi Kanso, CPA, CFF, CIA, CISA, CISM, CISSP
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