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Leading practices in Internal Audit

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Internal Audit (IA) is once again in the spotlight. Beginning this year, the new Hong Kong Corporate Governance code requires, on a comply or explain basis, that listed companies set up their own IA functions. This takes place at the same time as senior management is starting to expect their Heads of IA to move beyond a simple 'box-ticking' approach and to provide meaningful insights into their organisation's corporate governance and management.

During an era of uncertainty in the global economy, many organisations are taking an approach to internal audit that goes beyond simply reviewing past activities. Increasingly, IA functions are expected to provide more forward looking insights in order to help management in the day-to-day running of the business. This paper discusses three of the most common challenges facing IA functions in Hong Kong and China and how a number of companies are seeking to address these issues.

The challenges

China is rapidly evolving as a global centre of business. Today, senior management is mostly concerned about volatility in the global economy, the impact of new regulatory developments and remaining competitive in an environment of rapid technological change. These developments bring with them three major challenges for heads of IA functions:

- The **position** of IA in the organisation and existing perceptions that it does not focus on the real business issues that are at the top of management's agenda,

- IA **people** not having the requisite skills and experiences to adapt to emerging risks affecting the organisation,

- Manual **processes** creating inefficiencies that prevent IA identifying the underlying causes of issues and introducing new perspectives.

Given these new challenges, the traditional approach of internal audit to monitor for compliance with established policies and procedures is no longer sufficient to meet the expectations of stakeholders. IA functions need to adapt quickly in order to thrive in this new environment.

Hong Kong and China Snapshot: in a 2015 KPMG survey of Greater China audit committee members, only 19 percent (compared with a global average of 40 percent) said they were fully satisfied with the value that their IA function delivered to their company. As many as 38 percent (compared with a global average of 25 percent) said they thought that the quality of communication and interaction with their IA executives needed to improve.

(source: Global Audit Committee Survey, KPMG International, 2015)

What makes a leading IA function a worthwhile investment?

A successful IA function does not just highlight the challenges that the company is already aware of but presents new findings, offers fresh perspectives and provides new ways of gathering such insights.

Creating a leading IA practice requires an optimum balance between the function's positioning, people and processes. Some of the key questions that organisations should be asking of themselves include:

- **Positioning:** what is the primary purpose of IA? Does it have a voice at the top table? Are existing reporting lines appropriate for making sure IA is sufficiently heard? Does IA activity have a real effect on the actions of people across the organisation? Where does it fit into the wider risk and governance framework? Does it cooperate with other assurance providers to help mitigate risks?

- **People:** is there an appropriate strategy in place for recruiting and training personnel? Are IA's requirements adequately reflected in the number of staff and their relevant skillsets? Should IA be an area for audit specialists or for high performing staff from other divisions to obtain broader business exposure? Do IA staff fully grasp the organisation's wider business strategy?

- **Processes:** is there a standard methodology in place to foster an efficient audit process? Is there an appropriate balance between controls compliance and value adding audit activity? Are management concerns and emerging risks given sufficient attention? Are audit recommendations being properly monitored for implementation? Is technology being adequately leveraged in the audit process?

Positioning: focusing on the right issues

Many IA functions suffer from a negative perception due to their tendency to focus on compliance as opposed to business issues. Leading IA functions are addressing this by:

- Articulating a clear vision for IA's role and position within the organisation as an independent third line function,

- Developing contingencies in annual audit plans to respond to emerging issues and management requests,

- Making sure they are present in governance and internal control forums (executive meetings, audit committees, change initiatives, etc.),

- Collaborating with second line functions such as risk and compliance in order to form an integrated view of assurance across the organisation and place greater reliance on their work.

Spotlight: focusing on the right audit areas

- **Lay of the land:** the focus of many IA functions continues to be skewed towards assessing procedural compliance.

- **Learnings:** a 2016 KPMG survey* found that 61 percent of senior stakeholders would like IA to become more diversified in their skills and activities. Leading functions are auditing areas such as governance processes, business strategy, risk/control procedures and one-off events that result in business changes (e.g. mergers, system implementation, etc.).

People: accessing the right skills

The increasing complexity of the global economy presents challenges for IA functions in recruiting staff with technical expertise in all areas of risk facing the business. To address this, leading IA functions are:

- Developing medium-term strategy for both their operating model and staff skillset in order to help deliver IA's objectives,

- Establishing a competency framework that defines the level of skills and training required at each staff grade with greater focus on data analytics and soft skills such as communication and report writing,

- Rolling out a guest auditor programme to attract subject matter expertise from across the business,

- Taking a strategic approach to hiring external consultants (e.g. to reduce gaps in particular areas, to complete routine tasks to free up in-house auditors for other tasks, etc.).

Spotlight: developing the right skillset

- **Lay of the land:** local IA functions mostly comprise generalist financial auditors with limited experience in emerging risks facing their businesses.

- **Learnings.** In a 2016 KPMG survey*, the top 3 IA skills identified by senior stakeholders were: good communication (68 percent), regulatory expertise (68 percent) and industry expertise (55%). Many leading functions are creating divisions that are responsible for technical training, professional development and quality assurance as well as centres of excellence in areas such as IT and data analytics.

Source: Seeking value through Internal Audit, KPMG International, 2016

Processes: making audits efficient and effective

Stakeholders often complain that IA does not focus on the right risks, often does not identify the causes of any shortcomings and takes long to deliver audits. To combat this, leading IA functions are taking a number of steps including:

- Developing an internal audit methodology that also embraces technology and analytics in order to improve the depth and breadth of coverage, streamline audits, drive consistency, improve quality and increase data sharing,

- Taking a more holistic approach to risk through continuous risk assessments, anticipatory auditing and considering the external environment and emerging risks,

- Defining the auditable universe and making sure planning processes link back to the top enterprise risks,

- Increasing the use of management self-identified issues and management awareness grading on audits,

- Setting up 'toll-gate reviews' at key stages of the audit cycle (planning, fieldwork, review, etc.) to ensure quality is embedded throughout the process,

- Establishing a quality assurance function (or a process of peer reviews for smaller IA functions) to assess the quality of IA's work both during and after the audit.

Spotlight: maximising value through data analytics

- **Lay of the land:** the use of analytics is still at a nascent stage. In a 2016 KPMG survey*, only 35 percent said they had robust enterprise wide data analytic capabilities. This was mostly due at least in part to lack of resources, in terms of both finances and personnel.

- **Learnings:** while mature IA functions are now leveraging data analytics in audit execution, leading functions are increasingly utilising it throughout the audit lifecycle. This includes, for example, continuous auditing (CA), which helps to enhance audit planning and improve audit efficiency. Effective planning is key to success. Leading functions set out their objectives clearly and consider how analytics can help contribute. They then design governance and reporting methodologies for their CA activities and seek to integrate analytics into the methodology before considering which particular tools to use.

Call for action:

In order to bridge the gap between current practices and best practice as outlined above, we recommend the following three step plan:

- **Understand expectations:** actively engage with the audit committee to understand how IA is meeting expectations in areas such as mandate, coverage and quality of findings.

- **Benchmark:** benchmark IA against leading practices or standards such as those issued by the Institute for Internal Auditors (for all organisations) or the Chartered Institute for Internal Auditors (for financial services).

- **Develop a roadmap.** develop a roadmap of actions that need to be taken to improve the function so that it can better meet stakeholder expectations.

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