FROM COMPLIANCE TO RISK MANAGEMENT: THE CHANGING ROLE OF INTERNAL AUDIT
Rapid regulatory change and technology-fuelled trends have shifted internal auditors’ focus towards risks. Jemelyn Yadao finds out how the specialty is changing

Illustrations by Jason Kofke

Raymond Yim’s professional image is having a makeover, and that’s not just because he works at fashion icon Chanel. “The business professionals [within the company] see me now as their partner,” says Yim, Head of Internal Audit at Chanel Greater China and Asia Pacific, and a member of the Hong Kong Institute of CPAs. “Because of this image and because they know what we are capable of, more people [in the company] are picking up the phone to seek my advice.”

Like many internal auditors in recent years, Yim’s work responsibilities have expanded from focusing purely on compliance and reporting issues to helping people within the organization deepen their understanding of emerging risks. He expects this role he increasingly plays today – a supportive yet independent “business partner” – to be echoed by most internal auditors in the near future.

In Hong Kong, internal auditors have been put in the spotlight by the Consultation Conclusions on Risk Management and Internal Control: Review of the Corporate Governance Code and Corporate Governance Report, published by the stock exchange. The new code provision, which will be implemented in January 2016, calls for a more integrated approach to risk management and internal control and is expected to drive an increase in demand for more effective internal audit functions in Hong Kong.

As the requirements for internal audit becomes tougher, so too will the scope of the internal auditor’s work. One driver is the increased expectations of stakeholders worldwide, who are demanding guidance from internal auditors to address strategic and emerging risks, notes Stephen Lee, President of the Institute of Internal Auditors Hong Kong.

“Internal auditors today are faced with an unprecedented array of changes,” he says. “Businesses are continually restructuring, merging and acquiring. Supply and distribution chains are expanding quickly across multiple geographies... Regulations are increasingly more complex and involve multiple jurisdictions around the world, and are sometimes contradictory in application.”

Despite this shift towards focusing on holistic strategic business risks being generally less prominent in Asia, many internal auditors today, like Yim, are already spending more time on activities beyond traditional financial audits.

According to the Institute of Internal Auditors’ 2014 Pulse of the Profession Global Report, which surveyed nearly 2,000 auditors around the world, the financial audits portion of an internal audit plan is decreasing with the percentage dropping to 8 percent last year from 14 percent in 2013. Also according to the survey, increased areas of internal audit focus include risk management effectiveness (10 percent, up from 7 percent in 2013), business strategy (8 percent, up from 5 percent) and corporate governance (5 percent, up from 4 percent). The largest increase was reflected in “other” areas, not defined in the survey, which rose to 11 percent of 2014 internal audit coverage, from 6 percent in 2013.

New challenges

James Ye, Practising Director of Business Risk Services at Mazars and an Institute member, agrees that internal auditors are increasingly developing into “big picture-thinkers.” “These days, risked-based internal auditing has broadened the internal auditor’s horizons,” he says. “No longer are they only monitoring accounting controls or numbers. Now they look at sustainable growth and enhance companies’ operational efficiency.”

In addition, internal auditors worldwide are taking on new risk areas amid a number of notable trends shaping the internal audit landscape. “The proliferation of social media, e-commerce, mobile computing and apps have brought much convenience, along with increased threats and vulnerabilities. Just look at the recent cyber attacks on Sony Pictures,” says Patrick Rozario, Director and Head of Risk Advisory at BDO.

Companies in Hong Kong and elsewhere are taking advantage of social media platforms, such as Twitter and Facebook, to strengthen their brand and grow market share. But with these opportunities come risks including employees inadvertently disclosing confidential company information.

Mobile computing and increasingly common policies within companies, such as “bring your own device,” also bring new risks. “It’s a
continuing trend that employees are using their mobiles [and other personal devices] to access the company’s database, email, calendars and applications. You can easily access company information anytime, anywhere,” says Avon Yue, Partner, Advisory Services at EY and an Institute member. “Internal auditors today have a big role to play here in terms of advising on how to put in effective controls and how to educate people.”

According to an EY thought-leadership report on governance, risk and compliance released last year, third-party risk management is an important area for both stakeholders and internal auditors. For companies that outsource certain functions, such as payroll, to third parties or suppliers, it is critical to have a third-party risk management programme in place to avoid financial, reputational and compliance risk. “Are [the external supplier’s] standards aligned with the company’s own policies?” asks Yue. “How do you ensure that third parties do not leak confidential company information—their key questions to consider during an audit.”

High-profile events caused by natural disasters and technology infrastructure failures and even smaller, less impactful disruptions have prompted business continuity management to be another focus area. Yue says that internal auditors are increasingly helping to ensure companies can recover and that business can continue as usual after a big disaster.

The mix of traditional and non-traditional roles has made it harder for companies to find internal audit employees with the right knowledge and experience in doing audits around cybersecurity or social media, because it’s all very new,” says Yue. “Whether the internal auditor is competent enough to review information security settings, or review whether they have a proper social media usage policy is a big challenge.”

### Auditing culture

With the negative impact poor culture has on an organization’s reputation and finances, some companies in a range of sectors are auditing culture. According to a recent outlook by global business consulting firm Protiviti, the British-based Barclays is one of them. The bank’s head of internal audit reportedly guided his group through a period of cultural change, which was needed following the LIBOR scandal that hit the bank in July 2012, and the resignation of its chairman and chief executive soon after. As a result, most of the audits the team conducted in 2013 included separate reviews of risk, fraud and culture.

Anthony Crampton, Director, Risk Consulting at KPMG China, says the internal auditor will be a key player in monitoring organizational culture in the future. They often sit on risk committees and report audit findings on culture-related activities.

However, with the profession used to reporting on hard facts, auditing a qualitative concept such as culture will perhaps take internal auditors out of their comfort zone. For the future auditor to work effectively in the area of culture, and to ensure such an audit is credible, it’s critical for organizational culture to be properly defined, says Crampton.

“When auditing culture, it is important to clearly define the elements you will assess – e.g. ‘tone from the top,’” Crampton adds, “and it is important for a top-down approach from the board and executives to define what corporate culture, particularly concerning risk, should look like.”

As well as supporting boards in relation to culture, it is believed that the future internal auditor in Hong Kong will place deeper emphasis on addressing fraud and corruption. Internal auditor directors from various listed Hong Kong companies are looking ahead on how they can play a more significant role in anti-fraud activities from an advisory perspective, says Yue at EY.

“For some of the more mature internal audit functions, I see the role [of an internal auditor] shifting more towards focusing on this area, but of course, it depends on what risks they are facing. Every organization is different,” says Yue, citing the updated internal control framework of the Committee of Sponsoring Organizations of the Treadway Commission as a key driver.

“One of the key principles of the 2013 COSO framework is around fraud risk assessment and monitoring, so if the organization is adopting COSO, it would need to revisit whether controls are sufficient enough to address that.”

### Modern Mainland

In order for the future internal auditor to make significant long-term contributions to an organization’s success, they would have to assume a number of impactful responsibilities, according to Protiviti. These include thinking more strategically when analyzing risk and framing audit plans, providing early warning on emerging risks and broadening their focus on operations, compliance and non-financial reporting issues.
The transformation of the traditional auditor into a “modern auditor” reflects how they think more strategically and understand the business.
“An internal auditor should achieve a balance as an inspector and a trusted advisor to provide value-added services.”
Striking the right balance

Internal audit chiefs around the world appear to be moving to master the diverse tasks of their ever-expanding function – from addressing operational risk and compliance to dealing with technology vulnerabilities and even corporate culture.

The Institute of Internal Auditors’ 2014 Pulse of the Profession Global Report, which surveyed global chief audit executives, found that the skills they are recruiting the most are analytical or critical thinking (75 percent) and communications skills (58 percent). As James Ye, Practising Director of Business Risk Services at Mazars and a Hong Kong Institute of CPAs member puts it: “An internal auditor should achieve a balance as an inspector and a trusted advisor to provide value-added services.”

However in Asia, quality internal audit resources are scarce, and a fully staffed function with the appropriate capabilities, industry insight and knowledge, along with regulatory compliance and information technology skills, can be costly points out Stephen Lee, President of the Institute of Internal Auditors Hong Kong. “There is also the issue of strong interpersonal skills required to be effective in the organization,” he says. “The cost of an effective internal audit function can be mitigated by the understanding of the added value that such an internal audit capability can bring to the business and the organization.”

While compliance duties will continue to be part of the internal auditor’s core responsibilities, Avon Yue, Partner, Advisory Services at EY, stresses how important it is for them to sharpen their skills in areas beyond that, especially in the world of big data. “Big-data-related knowledge and data analysis capabilities, so how you leverage data for you to utilize in your internal audit planning or work, is really lacking at the moment,” says Yue, an Institute member.

For Anthony Crampton, Director, Risk Consulting, KPMG China, the most important skill for today’s internal auditors to have is strong risk awareness. “Once that risk awareness is embedded, capabilities can be assessed,” he says. “Future heads of internal audit will need to be more aware of the limitations of their departments’ capabilities and when to communicate to the audit committee where additional support is required to ensure there is sufficient assurance. Otherwise they may be providing the audit committee with a false sense of security.”

Albert Lee, Managing Director at Protiviti and an Institute member, cites Baidu, which operates the most widely used Chinese Internet search engine in China, as a prime example of a company that already has these responsibilities in place through its internal audit function.

“The internal audit team has been expanded and risk management has been strengthened. They cover both financial and non-financial, operational and compliance-related audits,” says Lee. “Nowadays they are using a governance portal to manage and track all the risks, audit activities and update them from time to time.”

Over the years, Kangping Shi, Head of Internal Audit at Baidu, has observed the transformation of the traditional auditor into a “modern auditor,” a term reflecting how his team is now made up of strategic thinkers who understand the business. “A modern auditor is well-rounded and clearly understands all areas, whether it’s merger and acquisitions or tax-related. They also know how to use new advanced tools to assist the audit, such as data analysis.”

Shi and his team currently rely on data analysis results to identify issues related to Baidu’s search app, which is widely pre-installed on new smartphones in China. “Once a new user activates their cellphone, Baidu will pay for the pre-installed app. But in the market, a lot of people are cheating. For example, they would buy a lot of cellphones or sim cards and may manually activate the phone to charge Baidu excess, but actually they are not our end users,” he explains. “So when we pay the mobile carriers, we analyze the activation distribution using data analysis. This gives us a very good hint if fraud has taken place.” Shi adds that he expects to see internal auditors using data analysis more often in the future.

Internal audit in the Mainland, in general, is strengthening, says Lee, with Mainland-listed companies increasing budget to recruit more qualified internal audit specialists. “Recently, the internal audit functions of Mainland-listed companies have expanded their coverage to include more IT-related audits and special audits to identify fraudulent activities or irregularities,” he says. “This is possibly due to the more extensive use of IT and mobile devices in business and the determination of the new Chinese government leadership in eliminating fraud at state-owned enterprises.”

With cybercrime expected to develop even further this year, posing new challenges to detection, it’s important for internal auditors today to leverage technology-enabled auditing to improve process effectiveness and broaden their risk coverage.

Some internal auditors, like Yim at Chanel, are already proving to be ahead of the game. “In the last few years, my knowledge and skills around IT and so-called IT general controls have really picked up,” he says. “I would say we would have to continue developing these skills, and keep our eyes open for regulatory updates to succeed in the future.”

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