INNOVATE TO WIN - INTERNAL AUDITOR'S PERSPECTIVE

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Traditionally Internal Audit has been the independent function advising the board and the management both in terms of risk oversight and compliance. The risk complexities that have evolved from the volatility of the market, change of business strategies, pressure for turnaround, technological advancements and the demanding regulatory requirements; have pushed the Internal Auditors to focus more on risk and compliance.

Internal Auditors have been the "watch dogs" that guarded the organizations relying heavily on the internal control systems that prevailed. Historically the internal controls have been safeguarding the business from frauds and scams through prevention and detection. In the present complex markets, with the eternal pressure on the business leaders and business representatives for compounded growth on profits, gone are the days that the internal auditors could simply rely on the internal controls in discharging their responsibilities. As such, it is inevitable that internal auditors revisit their approach and bring about innovation.

It has been observed in the recent past that the incumbent business leaders were under considerable pressure for profits and growth. Nine months into 2015, we have seen heads rolling in many corporates in the West and East alike. The undebated challenge for the incoming business leaders would be to make a quick turnaround. In this aspect, the most common hunting grounds have been to squeeze the expenditure budget, cut spending and sell company assets. That said, in the past, this strategy had been working for many business leaders for 2-3 years but unfortunately had not been sustainable as the expenditure accounts got dried up and assets exhausted after a few years. That was when the smart leaders said good bye to their leadership roles sighting "personal commitments" or "health reasons". The ones who were not so smart to take that call and continued in the job, and the incoming business leaders alike would eventually undergo immense pressure from stakeholders for delivery.

These conditions have eventually forced certain business leaders and the management to resort to various unethical practices and in time the end result has been a financial fraud. Business leaders are the superpowers in businesses that possibly could bend rules and bypass controls, if they so wish to. That said, only linking pin that keeps the balance to prevent unethical practices or financial fraud is the individual's integrity or the corporate ethics.

Organizational Ethics – the fundamental pillars

Any framework be it legal, human rights or accounting, would work on certain fundamental principles. Legal framework is built on the principle of natural justice, everyone is equal, and has the right to fair treatment. Human rights framework is based on the fundamental principles of universality, indivisibility, non-discrimination and transparency. Accounting framework is built on fundamental accounting principles and concepts such as accruals, prudence and materiality.

Similarly, the organization's internal policies and procedures are built on the fundamental pillars of organizational ethics.

The internal controls and professional ethics are intertwined.
Organizational ethics uphold:-

- Integrity
- Objectivity
- Competency
- Confidentiality, and
- Professional due care.

Ethical behavior of all staff irrespective of the job and the position provides the essential basis for a sound internal control framework that would lead to a sustainable control culture. Any organization that has strong ethical values will undoubtedly have a strong control culture.

Ethics and internal controls

Internal controls could broadly be recognized in terms of -

- Segregation of duties,
- Physical protection,
- Accountability for action,
- Monitoring and management,
- Supervision,
- Organizational structure (span of command),
- Authorization/approval, and
- Personnel

(Mnemonic **SPAMSOAP**).

The effectiveness of the internal control is dependent on the strength of the ethical culture of the organization. No matter how well internal controls are designed, they can only provide reasonable assurance to the extent that ethical values are upheld in an organization. There are few limitations that are inherent in all internal control systems.

Limitation of internal controls:-

- Judgment: The effectiveness of controls will be limited by decisions made with human judgment.
- Management Override: High level personnel may be able to override prescribed policies and procedures for personal gain or advantage.
- Collusion: Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

No control will work if there is collusion, overrides and wrong judgment involved. Wrong judgment could be eliminated through competency aspect of ethics and the override and the collusion could be eliminated through the integrity aspect of the ethics.

Just for discussion purposes, I have elaborated on the more commonly used control in the banking context, the "segregation of duties".

The objective of segregation of duties (Maker–Checker) is to ensure that no one individual or group of individuals have unrestricted control over an activity or transaction from end to end. However, this fundamental control could be made ineffective by merely appointing an ethically unsound "Checker". In day to day banking, Input/Authorization is an example of commonly applied "segregation of duties" control. It is a strong preventive control validated through system driven user access controls.

That said, what would prevent the "Authorizer" from sharing his/her password with his/her "Input" colleague?, What would prevent him from divulging business/customer sensitive confidential information that he/she may possess?, What would prevent him/her from authorizing the transaction without exercising due care?

It is the underlying moral values and business ethics such as integrity, objectivity, confidentiality, and competency that would make the control effective.

Essentials:

For Input/Authorization control to be more effective, each and every standard operating procedure (SOP) should expressly state that this rule should be applied without any bias (objectively). Officer authorizing the transactions should be (competent) to review the transaction prior to approval and (due care) should be exercised prior to authorizing the transaction without placing much reliance on trust. The authorizer should not authorize his/her own transaction nor should the transactions of connected parties be reviewed by him/her, as this may make room for someone to question his/her independence (integrity). The information that the officer may be privy to shall not be divulged or disclosed to 3rd parties without authority (confidentiality).

That said, are all those spelt out clearly in the internal procedures and standard operating procedures or left to be implied conditions?

In most organizations the standard operating procedures are not so granular and some components of the ethics are addressed in the Code of Ethics under HR policy. The un- written fundamental is that ethical behavior is assumed across the organization which is not adequately stressed upon or reinforced frequently enough to keep afresh in the minds of the employees.

For internal controls to be effective, most importantly to be sustainable, it is inevitable that the board and the senior management should refocus their attention to ethical values of staff and business ethics of the organization.

Uplifting the ethical values

Integrity/Objectivity – Individual's honesty is a function of many factors. Anyone would be honest as far as it is smooth and does not threaten the status quo. Mostly when individuals are challenged and under pressure, there is a tendency to compromise integrity. Especially in the banking context, the human resource management function needs to play a bigger role to assess the staff members on an ongoing basis in order to ascertain whether they are faced with financial or situational pressures.

Maintaining a close relationship by HR team with the staff is essential, and many organizations have appointed HR relationship managers who would be keeping a close tab on the staff members. Monitoring staff accounts, borrowings from other financial institutions, lifestyle changes and spending habits would be a very useful tool that helps to identify early warning signals that someone is under financial pressure.

Competency/Professional Care – Job competency could be improved through regular training and encouraging the staff to acquire professional qualifications. It was observed that the new generation bankers are aspiring to other qualifications over banking qualifications. Bank management should encourage staff to get qualified in banking and should recognize their effort. Furthermore job related quizzes could be added to online learning assessments.

Confidentiality – With the complex information management era, maintaining confidentiality of information has undoubtedly become a real challenge. All bankers are under oath of secrecy. Some of them have signed those at the time of joining without understanding the value of the document and some of us signed the secrecy and the code of ethics more than 20 years ago. Therefore, bankers need to be reminded of this commitment on an ongoing basis, may be through respective intranet communications and online assessments. Implementing a clear desk policy where workstations and work desks should be cleared of all customer information if the staff member is leaving the desk would be another option that would help reduce breaches of confidentiality.

Internal audit -beyond the comfort zone

In this context, it is very important that internal auditors shift their focus to organizational ethics and professional conduct from their traditional internal control focus.

Are internal auditors ready to take on this challenge. ?

Unfortunately the ground reality is that many internal audit officers are not ready to live up to this expectation.

Auditors undoubtedly are trained control evaluators. Although auditors may find it easier to evaluate the strength of internal controls, they should challenge the tendency to spend time where they may be most comfortable. The ethical climate and other "soft" controls are so important to the control environment that they deserve a considerable share of auditor's attention.

Internal auditors now need to move beyond their comfort zone of standard compliance focus to continue to support business by proactively involving in business deliberations whilst keeping a tab on ethical conduct. As the internal auditor's mandate expands and its scope widens, the function needs to build in different skill-sets within, to face this new challenge. Given its cross functional acumen, if rightly resourced, the internal audit is the right unit to do just that. But internal audit is faced with multiple challenges in living up to this expectation.

* Expectation dilemma

More often than not, board audit committees have not aligned their perception of internal audit to focus on business ethics and risks that may arise from complex business strategies, market volatility, technological advancements, loss of opportunity due to unethical conduct by staff, confidentiality breaches, or loss of business as a consequence of rash decisions. They continue to expect the internal audit to be control, compliance and regulatory focused.

Similarly the management wants internal audit to focus on identifying process inefficiencies and help with internal investigations rather than reviewing associated risks from ethical considerations, new ventures and technological advancements. Regulators expect the internal audit to be the "whistleblower" for regulatory non compliances.

Quite contrarily, some of the Chief Audit Executives (CAE) assess that for higher value delivery, the internal audit should be proactively involved in strategic business decision making process in a consultative capacity, highlighting the associated risks and ethical concerns within the pre-implementation phase rather than commenting on same once implemented. Chief Audit Executives (CAE) are faced with a situation in which a difficult choice has to be made whether the unit should live up to the expectations of the management, regulator and the board audit committee or gear up to address the need of the hour.

As companies raise the threshold on their own performance to contend with the ever-changing market dynamics, stakeholder expectations and risk landscape, they should also raise the expectation threshold of the internal audit at the same pace. That said, surely, the internal audit would not be able to evolve into a higher value delivery and without the support of the audit committees and if they want internal audit to focus only on financial controls and compliance.

It is time the board, audit committee members and the management thought about what they require from internal audit, while chief audit executives must determine the appropriate internal audit strategy to deliver against those requirements. Consequently, it is of the utmost importance that the CAE upon deliberations and continuous dialogue, explain to the audit committee and the management the importance of the proactive value delivery and the change of focus from controls to ethics. This would help internal audit to know how much of its time should be spent on control activities and how much on consultative proactive activities and ethics.

* Competency gap

Internal Audit has traditionally been hiring and training auditors in financial acumen, regulatory expectations, IT general controls, process and control reviews, operational audits, investigative and interrogative techniques, which would be of little use in the elevated expectations of the internal audit function. With the expansion of the internal audit mandate and change in focus, the internal audit function needs to be rightly equipped to ride beyond its comfort zone. In this context, it is obligatory that the internal audit would also need to add a number of other competencies to its arsenal to keep pace with the expectations. The problem is that many internal audit functions may be struggling to assess the right mix of resources.

An in-depth knowledge of business, customer service orientation, data analytics, interpersonal skills, industry specialization and Information Technology savviness have now topped the essential skill requirements of a modern auditor. There is no doubt that the CAEs would find it extremely difficult to hire such resources given the cost constraints, scarcity of such resources in the job market and more than anything, the major challenge would be to convince the business and the human resource units to think beyond their comfort zones.

Innovate to win

As an alternative to hiring, CAE could consider following other options to supplement staffing shortages or resource gaps,

- Guest auditor
- Thematic reviews
- Auditor rotation
- Technology savvy interns
- Industry veterans

* Guest auditor program

This program generally allows high performing specialist staff from the business an opportunity to work with internal audit on specific assignments on a temporary basis as part of their personal development. There are multiple benefits in such an arrangement where the business unit will receive a well-rounded individual who has a better understanding of how the internal audit operates, how ethical values are being upheld and he/she could also be a catalyst for change within the business. The business unit can leverage the new internal audit relationship to consult with audit on business deliberations and gain a better appreciation of how to engage with audit prior to making decisions. Internal audit will benefit through tapping into a pool of business and industry specialists with minimal cost. The guest auditor would be the change agent in internal audit who would bring in the business perspective to other auditors.

Simply put a golden opportunity for the auditors to "get in to their shoes before getting into their minds". The new resource could be the linking-pin between the business and the internal audit.

* Thematic reviews

It is customary for internal audit to conduct process audits such as procurement process, customer billing process, setting up standing orders and accounts opening procedures, or functional reviews such as full branch, stores, finance and treasury function. The main disadvantage of this approach is the tendency to miss the big picture when focusing on individual pockets of operation in functions or processes. Considering the traditional organisational structure, a functional/process audit could be recognised in "vertical dimension" that more often considers a single function of a process that would cut across multiple functions.

Quite in contrast to which, a thematic review would consider an activity "end to end" that cut across multiple functions. In the traditional organisational structure a thematic review could be recognized in "horizontal dimension". The main advantage in this approach is that it would give a wider picture from end to end of the process cutting across multiple functions and business owners. This methodology can help identify systemic problems or process "bottlenecks", correction of which would enhance sustainable process efficiency, efficacy and economy as opposed to quick fixes in functional reviews. For instance, in a chain of process, a delay could be stemming from an activity performed by another department which would most likely be missed in a functional review, but be recognized in a thematic review. Thematic reviews have a wider coverage within a review, with limited resources and have more visibility.

* Auditor rotation

Similar to that of "Guest Auditor" program, reciprocal benefits would be gained if auditors were periodically exchanged with business. The returning auditor would better understand how the businesses operate and more than any, would understand how business would look at them.

Auditor rotation is a good tool for CAEs to replace the "old hats" and business to reinforce the control perspective within the business. Trained auditors are well disciplined individuals who have proven to be sustainable performers mostly capitalising on their wide experience within the organisation.

* Technology savvy interns

Fresh from graduation, interns challenge "that is the way we have been doing it" mentality and bring fresh, new ideas to the company. Interns are not reluctant to ask questions as they are in a learning phase and often see a better way of doing things. They are technology savvy, connected and smart in usage of computers and search engines for research. It is a cost effective way of hiring that helps the CAEs to decide whether they would absorb the intern or not at the end of the trial period as opposed to hiring someone in the permanent cadre.

* Industry veterans

They are the retired professionals with a wealth of industry experience. Especially in the banking industry, it is next to impossible to find professionals in the areas of credit, trade finance, treasury, business strategy reviews etc. The hands on experience of long years and what they probably learnt from their mistakes in their time, would be extremely helpful to groom young auditors. They could be hired cost effectively on contractual basis. As seasoned professionals, they generally command good respect among their audit clients.

Conclusion

Ethics is defined as moral conduct and is the spirit of any rule. Professional ethics upholds integrity, objectivity, competency, confidentiality and due care in individuals that could be recognized as the fundamental basis for corporate policies and procedures. An employee's compliance with the policies and procedures would depend upon the individual's personal morality or values. The tone at the top should strive for moral values in their employees as much as they insist on strict compliance with the rules and procedures. In this perspective, internal auditors have to look beyond their comfort zones to focus on reviewing the ethical conduct and behavior of the individuals rather than mere compliance. It is time for the audit committee members and management to think about what they require from internal audit. Organisations that expect internal audit to play a more expansive role must ensure that the function has the right capabilities and approach to succeed.

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