



THRIVING IN DIGITAL WORLD – EMBRACE OR DISAPPEAR, INTERNAL AUDIT AT CROSSROADS

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Volatility, Uncertainty, Complexity and Ambiguity are four realities that any business would have to deal with in the changing environment which is commonly termed as VUCA world. Businesses either evolve to meet the demands of its new world or it becomes extinct. Method of doing business, various risk landscapes and the business leapfrogs are common business phenomena that need to be inbuilt into business strategies stemming from the technological advancements. Those businesses that evolve to meet the changing needs of the stakeholders thrive and remain.

Business success is stakeholder centric and technology is transforming the way the stakeholders think at an alarming speed. Be it a shareholder, supplier, vendor, customer or an employee, the way they think and their expectations have changed remarkably. Businesses that fail to assess customer behavior, no doubt will struggle to continue in business. Digitalization is redefining the rules of engagement for how businesses compete. The digital transformation is empowering a new breed of consumer who is in a constantly connected state. Only businesses who lead with a winning digital strategy that drives a multi-channel engagement can survive. In this equation, businesses for their very existence need to adopt and embrace technology.

In the late 1980s for the first time, the banking sector in Sri Lanka experienced unibank and anywhere banking with the introduction of online real time update of computerized databases. In the same year, recognizing the needs of the customer, first ATM machine and the debit cards were introduced. Two and a half decades in, entire industry has embraced technology, some of them for their own survival. Since then the industry has moved into online clearing, RTGS, SLIPS, common ATMs to name a few. Those banks that adapt to change have survived and those that embraced it made a triumphant existence.

There is a widely held belief that technology only refers to digital technology. Technology as per Webster dictionary is “application of scientific knowledge in practical purposes especially in industry to solve problems”. Technological advancement does not necessarily mean digital advancement but the way the business is conducted.



Businesses that embraced technology

Businesses that have embraced technology and let their strategists to think “outside the box” have changed the entire landscape of business and the way the business is conducted. Across the world, there are highly successful businesses that adopted different business models simply understanding the need of the stakeholders. These were the game changing business models. Similarly there are successful local businesses that adopted similar business models and made a household name in Sri Lanka.

This article touches on few examples of global companies that used digital transformation to their advantage and few local companies that have been successful in following a similar business model.

Airbnb is a global giant that moved into travel and accommodation industry without owning a single room. Two roommates in October 2007 understanding the need of the time, siezing the opportunity, made their living room into air mattress beds and provided homemade breakfast to few guests. They launched their website “Airbedandbreakfast.com” officially in 2008 and the name of the company became Airbnb. Today, **Airbnb** is a USD 30 Billion company having over 1,500,000 listings in 34,000 cities and 191 countries. **ikman.lk** is a local company that followed a similar business model in trading used items without owning a single asset to sell.

Uber Technologies is a global transport service provider without owning a single car. It develops markets and operates the **Uber** mobile “app”, which allows consumers with smartphones to submit a trip request (taxi), which the software program then automatically sends to the **Uber** driver nearest to the consumer, alerting the driver to the location of the customer. **Uber** drivers use their own personal cars. As of August 2016, the service was available in over 66 countries including Sri Lanka and 507 cities worldwide. The **Uber app** automatically calculates the fare and transfers the payment to the driver. Since its launch, several other companies have replicated its business model. **Pickme.lk** is a local business that adopted a similar model.

Alibaba group is a Chinese e-commerce company that trade successfully without having any goods. **Wow.lk** is a local company following a similar business model successfully.

Businesses that ignored technology and disappeared

There were multiple business giants that did not want to accept the ground reality. Those were the strategists that had no difference to a crab in the heating pot, they did not feel the heat, and they were so engrossed with their tried and tested business models that worked for them for the past centuries. When they realized, the water was already boiling.



Eastman Kodak, for nearly a century, no company commercialized the camera and Kodachrome color film as successfully as **Kodak**. But their glory began to end with the advent of digital photography and all the printers, software, file sharing, and third-party apps that **Kodak** has mostly missed out on and the magic has never returned. **Motorola's** first big success came with car radios, which led to two-way radios, which eventually led **Motorola** to build and sell the world's first mobile phone. They dominated that business as recently as 2003. But **Motorola** failed to focus on smartphones that can handle E-mail and other data, and rapidly lost share to newcomers. **Blackberry** was another example.

Embrace or Disappear, internal audit at crossroads

Chief Internal Auditors (CIAs) know that entire business landscape is changing and so is their organizations. They know that Internal Audit needs to respond to meet the changing needs of their organizations. Those organizations need Internal Audit to inform them about the future rather than only report on the past. They need insights as well as information, advice as well as assurance. They need reviews on operational controls, but also of strategic planning and risk management processes. They need Internal Auditors to apply their rigor, objectivity, independence, and skills in new ways. CIAs are aware that Internal Audit will have to evolve and embrace technology if not they sure will be outcasted. The needed changes are clearer than ever. CIAs must now lead their functions to take the next critical steps.

From insight, foresight to oversight

Simply put, the Internal Audit function needs to transform from insight to foresight to exercise their oversight role.

The CIA's overall strategy should be to have an **insight** over the business transformation that is taking place. Based on which, should be able to project the future of the business in a VUCA world and the potential risks stemming from the transformation. This **foresight** will help CIAs to exercise their **oversight** responsibilities effectively and stay up to the expectation of their stakeholders, if not beyond.

Insight

Insight is the capacity to gain an accurate and deep understanding of something. Unlike an outside consultant who just walks into the organization, Internal Auditors are homegrown and have been with the organization for an extended period of time.

Fault Finders to In-house Consultants - Simply, the Internal Audit could best perform this task as the most qualified in-house consultant in terms of wealth of experience in dealing with the



issues internally who understand best the internal values and strengths and weaknesses of business resources. They are industry veterans who have probably worked in number of areas within the organization at different capacities prior to moving in to Internal Audit. They are the best consultants that the business can think of to guide them, who understand internal capabilities well.

Looking Beyond Blind Partitions - In traditional vertical structures, compartmentalization is amply evidenced. The business managers who are responsible for a given process, however much conversant with their operations may have a little knowledge on the rest of the processes that linked end to end. For an instance, to get an ATM up and running 24X7, technology alone would not help. Location of the ATM, premises management, machine installation, network communication, cash loading, balancing, technical support, CCTV monitoring and issuance of Debit Cards may all need to work seamlessly. In real vertical structures, these individual business lines may operate in the same location but separated through blind partitions. They may not have the bigger picture in mind. Many examples could be given in the assembly line industry where individual players would not know their final product. Internal Auditors understand the processes end to end looking over the respective departmental boundaries. They are the floor walkers and in times the drifters who could best look through “blind partitions”. They could be the linking pin that could identify process bottlenecks and suggest improvements.

Ticket Checker to Data Analyst – Use of digital technology affords a number of benefits to the auditors, starting with the level of assurance and confidence that an audit leader can provide the organization. Auditors need to exit the traditional vouching mindset and “ticket checker” attitude and embrace digital technology. Through the use of analytical tools, audit achieves a far higher level of assurance than is possible through more traditional audit methods. Efficiencies created by the use of technology and by integrating data analysis and continuous auditing into the audit process also mean that the audit department is better positioned to contribute effectively, which is a significant challenge for many audit departments. When internal auditors use audit-specific data analysis technique, they are often able to gain insights beyond the reach of anyone else in the organization. By providing the results of such analysis to the business managers on a timely basis, management can respond, fix problems, and the entire organization can benefit.

Drifter to Online Monitor - Internal Auditors needs a change in the way they look at things. The areas of continuous auditing and monitoring are effective techniques. On an ongoing basis, exceptions could be monitored by a team of auditors within who will be following up with the respective business lines for quick clarifications. This monitoring team could eternally engage the processing staff to get clarifications so that this procedure would act as a strong deterrent for irregular practices. When audit departments implement automated continuous auditing, the benefits of providing timely notification of control risks and anomalies to management often become apparent. The next logical step can be for management to take on responsibility for similar processes in the form of continuous control monitoring. This can become a key component of



financial and operational risk management strategy, allowing management to continually assess risks and the effectiveness of the controls for which they are responsible.

Box Tickers to Outside the Box Thinker-To achieve corporate objectives, companies have to carry out both conformance and performance related work. The secret is to understand that the two are not mutually exclusive. As oppose to strictly comment on non-conformances, Internal Audit can review the process efficiencies, performance evaluations, economies of scale, business process re-engineering etc focusing outside the box. The value additions that the Internal Auditors could give in this area are invaluable. Simply because the respective processes owners are so accustomed to the process that they struggle to think afresh. Internal Auditors using their wide experience could look at the process end to end with unaccustomed mind.

Foresight

Foresight is the ability to project what will happen or be needed in the future. Internal Auditors with their multitude of knowledge and expertise should be able to project and predict possible risks stemming from the change in business models and markets.

Conformance to Performance- Internal Auditors could be of more use to business if they changed the focus from conformance to performance especially in a complex market conditions. It would, no doubt, would turn a typical assignment into something more meaningful to executives. Internal Auditors used to focus internally on the processes, procedures, practices within an organization mostly without much reference to external developments. Now, the Internal Auditor needs to be both focusing on inside and outside of the company. Internal Auditors need to know their own company very well, and they also need to know what other firms in their industries and in other industries are doing. Their inside knowledge tells them where to focus attention, and their outside knowledge helps them make constructive and authoritative suggestions and comparisons. A key role of the internal auditor is to employ benchmarking not for comfort and complacency, but to highlight opportunity and challenge.

Reactive to Proactive - Conventionally Internal audit assignments are post event reviews, often, internal auditors spend their time “patching up processes that worked yesterday but are broken today”. Examining the root cause would probably help internal audit to add value to business process with greater acceptance. Similarly, reviewing processes proactively in terms of “what could go wrong” approach would be more meaningful as opposed to reactive approach in complex market conditions. For Instance, Internal auditors could be part of the core team that implement a strategic IT application who provide assistance with regard to control aspects of the system as opposed to writing lengthy reports, post implementation, highlighting weaknesses.



Oversight

Oversight is overseeing something. Traditional Internal audit approach has been to carry out a strict compliance review which highlight the deviations. Most auditors never bothered to inquire why the rules were bent. The rigidity in processes in a dynamic market was often overlooked by auditors. Internal auditors could be of more use to business if they changed the focus from conformance to performance especially in a turbulent market scenario. It would, no doubt, would turn a typical assignment into something more meaningful to executives.

Process Focus to Human Focus-The real risk of irregular practices and frauds lies not in a company's processes or the controls around them, but in the people behind the processes and controls that make the organization's control environment such a dynamic, challenging piece of the corporate consciousness.

Reports and papers that analyze misstatement risk use words like "mistakes" and "irregularities" Automated controls don't do anything "irregular", if it is not designed to do so. Similarly record keeping systems and data management processes don't make "mistakes". Computers and systems don't carry-out frauds but people make mistakes, and people commit frauds.

You can have a well-designed control, but if the person in charge doesn't know or care what to do, that control won't operate. A negative behavior of an employee in terms of control doesn't mean that employee is a bad worker. It may simply mean he or she is new to the job, or it may reveal training problems in that employee's department. Internal auditors need to keep in mind that, in some instances, competence may be so low that it results in greater risk. Human error has always been part of the internal auditor's universe, risk based assessment of a company's control environment with a view to target controlled processes need to focus on the ability and integrity of the people who handle the function.

Focusing on the human element of fraud risk is one important way companies can make a significant difference in finding their true problems. It also represents an opportunity for management to identify the weak links that could ultimately result in a drastic damage, as well as for Internal Audit departments to make management's evaluation a much simpler task. Dramatic corporate meltdowns like Enron and WorldCom could happen under today's regulatory structures because the controls weren't the problem, the people were. That hasn't changed. Hence, smart Internal Auditors are integrating the performance evaluation information, soft skill assessments etc which are extremely important for such an approach.

The more complex a control, the more likely it is to require complicated input data and to involve highly technical calculations that make it difficult to determine from system output whether something is wrong with the process itself. Having more human judgment involved gives rise to greater apparent risk.



A computer will do exactly what we tell it to over and over. A human may not, but that's what makes people special and risky. In the case of controls, our human uniqueness can manifest as simple afternoon sleepiness or family troubles that prove too distracting to put aside during the workday. So many things can result in a mistaken judgment and simple mistakes in judgment can be extremely material to the financial statement.

Information focus to Information Security Focus- With the complexities stemming from the digital advancement in the way the business is conducted; there are loads of operational risks and threats that come into the business that have never been thought in the past. Threat to information is the possibility of a malicious attempt to damage or disrupt a computer network or system through unauthorized access to a control system device and/or network using a data communications pathway. This access can be directed from within an organization by trusted users or from remote locations by unknown persons. Threats to control systems can come from numerous sources. Technologies, processes and practices designed to protect networks, computers, programs and data from attack, damage or unauthorized access are commonly referred to as Information Security. Unlike in the past, Internal Auditors are required to be the "guard dog" against the ever increasing information security threats. In the present context, Internal Auditors have no option but to embrace the digital transformation and sharpen their skills to stand up to the ever enhancing expectations.

Around the Computer to Through the Computer- In the present context, it is very rare if one come across an organization that does not use computers for their day to day operations. The minimum internal and process controls that an organization expects that used to be all manual and visible are now seems to be built into the computer system. Auditors who did not have required IT skills, used to adopt around the computer techniques in conducting audits. This approach is also referred to as "black box" approach which in essence presumes that the controls are inbuilt inside and perform audits based on the output it generates. In the complexities that the businesses face today, assumptions and presumptions would not hold value. Internal Auditors now have to embrace technology that essentially use computer assisted auditing techniques; commonly referred to as CAATs which technique is broadly termed as auditing through the computer. Auditors no matter what level of experience they may have, need to sharpen their IT skills if they would want to retire as auditors.

Up Down to Left Right - It is customary for the Internal Audit to pick areas by function to review. Traditional organization structures are vertical, where auditors conveniently chose such vertical functions to include in their annual audit plans. For an instance, Internal Auditors would review a branch as a vertical, mostly ignoring the other linking processes. Unlike in the past, most of the banks have adopted centralized processing, centralized credit approval and in times relying on outsource partners to provide certain critical functions for up and running of their branch network. If it is so, performing a branch audit at the branch may not necessarily help the auditor in effective discharge of his responsibilities. 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.

Quite contrast to which, a thematic review would consider an activity “end to end” that cut across multiple functions. In the traditional organizational 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 is capable of identifying systemic problems or process “bottlenecks”, correction of which would enhance sustainable process efficiency, efficacy and economy as opposed to mono focus in functional reviews. For an 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 horizontal review. Thematic reviews have a wider coverage within a review, with limited resources and have more visibility.

Hard Skilling to Soft Skilling - Hard skills are specific, teachable abilities that can be defined and measured. Conventionally Internal auditors are well read and well taught in their respective domains. They know well the auditing techniques, vouching and evidencing. Well trained on report writing and presenting facts. They are battle hardened on their own areas. By contrast, soft skills are less tangible and harder to quantify, such as getting along with others, listening and engaging.

Institute of Internal Auditors, at a recent research found that 7 winning attributes of a future Internal Auditor are;

- Natural inquisitiveness;
- Persuasiveness;
- Change management proficiency;
- A service orientation;
- An ability to recognize and respond to diverse thinking styles, learning styles and cultural qualities; and
- A global mindset.

As Raytheon’s Chief Audit Executive Larry Harrington so passionately puts it, “Soft skills are the new hard skills, believe me.” Internal Audit professionals are expected to operate with the same agility that their companies need to exhibit amid ongoing external volatility. On a professional level, this agility could be the intellectual ability required to constantly absorb new information; and the flexibility that enables them to switch priorities and projects quickly and comfortably in response to rapidly changing business conditions. Part of the balancing act includes managing both assurance and consultative work. In short, Internal Auditors should apply as much effort and precision to the acquisition and development of non-technical attributes.



In essence, CIAs should look for people who have a passion for truly understanding the business and a knack for remaining inquisitive within environments that can change on a weekly or even daily basis. In general, very few people in the company look at anything Internal Audit writes other than the audit report. The audit report is the only document depicting a 1,000 hour audit, so we need this document to tell a story that is untold before. Internal Audit reports also represent an extension of its brand. Besides conveying factual information, the tone should inspire trust and credibility, as well as demonstrate a service orientation.

Shallow Swimmers to Deep Divers -Conventionally Internal auditors have been strong compliance reviewers. Their strengths have been the thorough understanding of the internal procedures and reviewing whether those guidelines have been adhered to or not. The standard audit recommendations have been “strict compliance” with the requirements. In a rapidly changing business environment, with more dynamic and complex business models, there is a tendency for businesses to move into areas that have not been supported by laid down procedures. Internal auditors will increasingly come across areas that are not guided by procedures. In such an environment “shallow swimming” may not necessarily help the auditor in effective discharge of his responsibilities effectively.

Internal auditors need to stimulate their enquiring mind and be ready to “deep dive”. Proper understanding of the business area that is conducted without the guidelines is a must. Tuning the probing mind to gather answers to “what could go wrong” and “what would prevent/ detect” the wrong, would be the next. Process flowcharting, performing walk through tests and assessing the controls and expected controls, prior to performing any test, is key.

Auditors to Guest Auditors - This program generally allows high performing specialist staff from the business, an opportunity to work with IA 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 IA operates, how ethical values are being upheld and he/she could also be a catalyst for change within business. The business unit can leverage the new IA relationship to consult with Audit on business deliberations and gain a better appreciation of how to engage with Audit prior to making decisions. IA will immensely benefit through tapping into a pool of business and industry specialists with minimal cost. The guest auditor would be the change agent in IA 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 IA

Playing the Old record to Saying an Untold Story – If you may ask the management of their Internal Auditors, often than not we get to hear that the auditors always tell me what I already know, not what I don’t know. Auditors get us to talk, learn from us and write. That said, conventionally, Internal Auditors are famous for looking at things as they are. This is because they do not adequately plan and failing to get the bigger picture into consideration. What eventually



happens is they often get sucked into the system. So they end-up playing the old record over and over.

Conclusion

It is quite evident that the Board members and the top management are now seriously faced with the challenge of steering their businesses through the VUCA world. Business success is customer centric and technology is transforming the way the customers think at an alarming speed. Customers who are constantly living in a connected state expect quick fixes with thin margin for error and no waiting time. Active social media can destroy trust, credibility and an image a bank has built for many years, just overnight.

In this context, it is inevitable that the CIAs rise to the challenge and be of great help to the Board Audit Committees and management. They are expected to be deep divers who should tell an untold story. Board room doors are now increasingly being opened for the Internal Auditors and they are frequently being consulted. Internal Auditors are the newly found inhouse consultants who need to think outside the box. Their presence is felt valuable at sensitive committees which they were not privy to before. Auditors need to divert from the conformance mindset and to be proactive and performance oriented. Their focus should be people as oppose to processes. Everything now seems to be people centric. Weakest link in the process that gives way is the employees. Data analytics and online monitoring should be essentials in Auditor's armory. Auditors not for comfort or complacency but for their own survival need to be IT savy.

As oppose to hard skills, it is time for the Internal Auditors to brush-up their soft skills such as natural inquisitiveness; persuasiveness; change management proficiency; service orientation; ability to recognize and respond to diverse thinking styles, learning styles and cultural qualities; and global mindset.

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