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How Internal Auditors Can Be More Effective

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Increasingly, audit committees (ACs) are facing heavier responsibilities as they manage conflicting expectations from shareholders, regulators, and a myriad of stakeholders.

In this demanding context, the AC cannot perform optimally without the support of an effective internal audit function. This was the clear feedback from a majority of the AC chairmen interviewed in *A Study on the Profile of ACs of Listed Companies in Singapore 2015* by the National University of Singapore (NUS) and the Institute of Singapore Chartered Accountants (ISCA).

The same respondents also felt that the effectiveness of their companies' internal auditors (IAs) could be improved. Three areas stand out in their views of how this can be achieved: the use of risk-based audits; the judicious use of outsourcing; and ensuring IA independence.

Risk-based auditing is a style of auditing which focuses on the analysis and management of risks. While the traditional internal audit focuses on documenting the presence and compliance of the relevant internal controls, the risk-based internal audit seeks to identify critical issues with the greatest potential impact on a company. For example, strategic risk analysis may include political, business and social risks such as the potential effect of legislation, and technological and demographic change.

By adding risk considerations to the more traditional compliance audit, ACs are provided with another layer of critical information which may enable them to gain deeper insights that result in more effective decision making. This allows for decisions to be made in recognised high-risk areas and even in complex factual scenarios, and better utilisation of the limited resources available.

DIFFERENT VIEWS

The traditional compliance-based or "box-ticking" internal audit is just not good enough today. Risk-based audits change the way internal auditors think and talk about risk and its impact on the company. It ensures the proper allocation of resources to areas of greater risk. It closes the loop between providing control assurances in business operations to risk assessment in planning for business strategy.

The AC chairmen of small listed companies (market capitalisation of up to S$500 million) and large ones differ in their views of the ideal outsourcing arrangement.

For small listed companies, the AC chairmen preferred the IA to be outsourced. The concerns that they cited include inadequate manpower for the IA unit, the lack of career progression and succession planning, the reporting line and, in some cases, the independence of the IA.

However, in-house IAs possess more firm-specific knowledge, and their longer tenure can ensure institutional weaknesses are duly fixed. Notably, research documents show in-house IAs are more effective in preventing and discovering fraudulent practices.

While AC chairmen of the large listed companies tend to rely on in-house IAs due to greater control and perceived greater cost-effectiveness, many support some level of outsourcing to obtain specialty skills, fill up peak period requirements, and deal with tasks which require absolute independence.

Outsourced IAs are also perceived as more competent by finance directors. This leads to greater reliance by the AC on the work done by outsourced expertise.

Perhaps the single most important and challenging view AC chairmen shared and documented in empirical studies is the independence of the IA.

The Singapore Code of Corporate Governance specifies that the IA's "primary line of reporting should be to the AC chairman although the IA would also report administratively to the CEO". The SID-SGX *Singapore Board of Directors Survey 2015* found that this happened only for 81 per cent of the respondent companies, and in some cases, the IA even reported to the CFO. Further, only 54 per cent of the respondents indicated that the AC or AC chairman decides on the IA's compensation.

For larger listed companies with an in-house IA, the AC chairmen were concerned about the IA's reporting line as its independence may be significantly influenced by management. Some AC chairmen argued for the IA to be protected so the he can properly discharge his varied roles and responsibilities.

INDEPENDENCE

Significantly, both large and small listed company AC chairmen believe that a major argument for outsourcing IA is to ensure IA independence. Research findings point to how outsourced IAs have fewer economic ties with the company, and are often perceived as more objective than an in-house IA.

In its best form, the AC can count on the IA as its most reliable and powerful ally. Strategically, it functions as the key "third line of defence", since its functional reporting is at the AC's full disposal.

Achieving a happy and effective unity of purpose with the IA is a working challenge, but both the AC and management cannot deny that a good internal audit foundation will only advance the shared interests of all parties in problem solving and astute counsel. In this particular role, the internal audit function generates its highest value for the company, the board and management. ■