

An aerial, black and white photograph of a desert landscape. The ground is sandy and marked with several deep, winding tire tracks that curve across the terrain. A bright yellow triangle is positioned on the right side of the image, pointing towards the center. In the lower-left quadrant, there is a series of vertical white bars of varying heights, resembling a barcode or a data visualization.

The internal audit paradox - marrying flexibility with strength

Strength through diversity: how a new audit model can deliver assurance.

No one can predict the future with complete accuracy. But if there is one thing most observers can agree on, it is that the next 10 years will see a significant rebalancing in the relationship between the established economies of the West and those economies we currently class as emerging markets.

And the economic environment in which this will play out is also uncertain. Clearly, while the global economic recovery has taken hold in some regions, serious dangers remain. Fiscal tightening and de-leveraging by Western households may stall the incipient growth. Meanwhile, the threat of bank failures and sovereign default may have temporarily slipped down the news agenda, but they remain real.

The Eurozone will remain, at least for the short term, to be the focus of attention. Politics aside, instability and uncertainty within the zone will bring with it a significant financial risk, principally focused on currency movements. For corporates, the fluctuations in currency prices will present the most immediate threat in the coming years.

Naturally currency movements will pitch the world's economies further into a competition, and clearly corporates in all regions will need to be aware of the dangers of trade disputes and the rise of protectionism. In that context, sectors outside banking and finance - automotive and pharmaceutical, for example - will be vulnerable to shocks. In short, while many of the risks are clear, many are less so.

Emerging markets present a particular challenge to corporates: they offer opportunities for growth unparalleled in more established markets, but the risks are various and dynamic. Clear risk management policies will allow a company to safeguard its business assets, identify and manage the known and unknown risks, reassure customers and suppliers and satisfy shareholders and investors.

But failing to address the myriad challenges can expose companies to serious risks: brand damage, financial losses and suboptimal operational efficiency are just the tip of the iceberg.

Therefore, corporates taking up the opportunities offered by emerging markets are presented with a range of options for their internal audit function: flying in a team from headquarters, building a team locally, sourcing risk management expertise from the local business or working with an external provider well versed in risk management techniques and strategies.

For one large multinational concern, that has meant ordering its audit function in such a way as to maximize the talent available to tackle the myriad risks facing the business.

Operating in over one hundred countries, the business carries out enormous projects around the world. It employs people in every continent and many countries globally. Its operations take place in deserts, swamps and the poles. The risks it faces defy any regulation-size audit function, so it has had to adapt its approach to identifying and assessing risk on an ongoing basis.

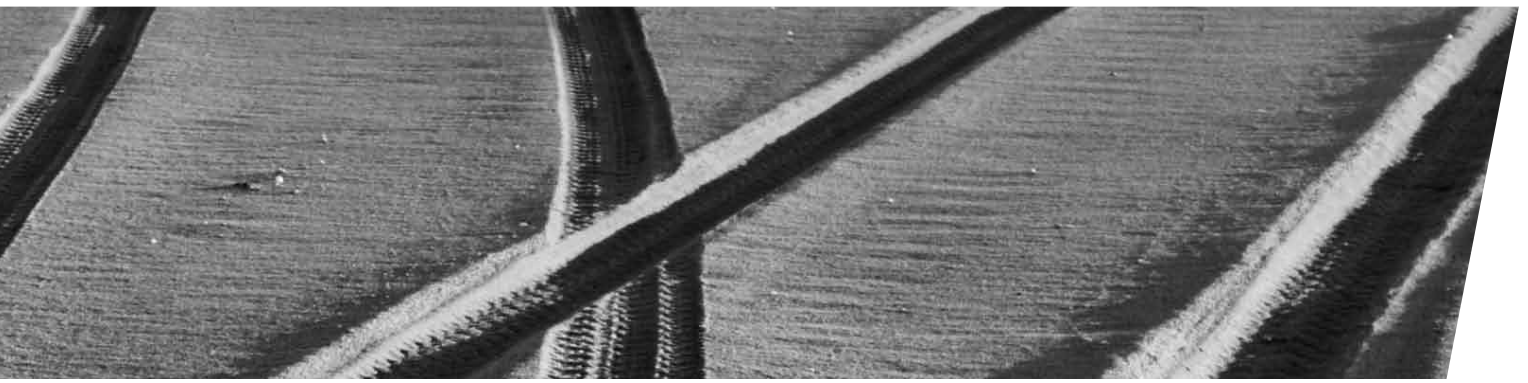
Firstly, to do that, it runs a global audit function. There are over 200 internal audit staff spread all over the world working in a rotational model. More than half of the rotation's intake from the business has no audit experience. However, they do know what operations are, what contracting and procurement is, what health and safety is, and what IT means. Once they are on board, seconded from their original function, new arrivals undergo a full and thorough training program.

For the organization's risk leaders, the benefits of this approach are clear: the business at any one time has a well-trained, nimble audit resource available across the organization. But with a turnover rate of "one in, one out" every week, the onus is on the audit managers to deliver straight away on the training program in order to maintain the function's battle readiness. The model also presents a challenge to persuade a talented business professional of the benefits of three or four years in an audit rotation. To address this, incentives are offered to the talented people to ensure internal audit gets the talent it needs.

For this organization, the audit function has a life well beyond simple finance. Indeed, the head of audit estimates that 80% of audits are non-financial. In practice, that non-financial segment is made up of capital projects, technology and logistics, as well as encompassing the legal function; strategy, joint venture management and governance; and so on across the spectrum of assets.

Reporting lines are clear: the audit function reports straight into the Audit and Executive Committees, demonstrating the importance it has. New board members are expected to meet with internal audit as part of their induction program, in order to gain insight into business risk and the dynamic nature of audit's work.

Clearly, with a business of this size, compiling, assessing and reporting risk is an enormous task. As a truly global business, it adopts a global risk and audit model. But while writing that in standardized form is reasonably simple, enforcing compliance across such a wide range of territories presents a major challenge.



Further complicating matters is the business's unavoidable reliance on contractors. To reduce this, a broad system of inspection, incentives and tightly written worded contracts has been developed, with audit serving as the bulwark against complacency in the face of risk.

And those risks change; they mutate and evolve. They range from significant operational challenges to regulatory risk both financial and sector-specific. They encompass corruption, technology, trading and exchange risk. This breadth of risk demands that internal audit be both strong and flexible: strength being derived from proper resources and guidelines, and flexibility and fleet of foot to react to any given circumstance. Audits can be added or canceled in response to a change in circumstances.

Successful preventative work can only be carried out by an audit function that understands the business's operations in the field while maintaining clear reporting links to head office. The head of audit believes strongly in auditors getting out in the field, not just for deterrence but to develop understanding of risk.

So, for example, as the regulations surrounding corruption continue to be strengthened, internal audit must react: it must get on the front foot to ensure employees and contractors are in compliance with the latest rules. That means identifying hotspots of corrupt practices, sending teams to audit the practices and if necessary carry out investigations.

Only by producing a robust plan can the audit function expect to retain the confidence of the organization's leadership. A prime example of this is IT risk. Never core to the business operations, audit now estimates a third of its time on this emerging aspect of risk. Data protection, access, industrial espionage, hacking: they all represent an emerging risk the business must focus on. Heightening the risk is the significant amount of offshoring and outsourcing done in IT, so internal audit works closely with third-party IT providers to write watertight SLAs with audit plans and access rights built in.

Of course, the organization is run by people and takes its direction from the culture within. One of the more innovative aspects of the internal audit function has been its attempt to audit "culture." It did so in conjunction with HR on the back of a major transformation program which involved headcount reduction.

Over one hundred staff interviews were conducted and from that came the realization that there was dissatisfaction around certain management practices and processes. Audit reported back to the board and a set of key actions was agreed to address the issues. The initiative proved internal audit was flexible enough to bring significant value to all parts of the organization.

Ultimately, in order to be fit for purpose, this organization's audit function has needed to become embedded in the business and not seen as a separate function housed in an office somewhere. In doing so, it has to make sure its audit model is clearly aligned with the business's key risks in order to maintain assurance capacity and avoid duplication and inefficiency.

Part of that comes from demonstrating to the business that audit is everywhere: reports are not just produced and left with the business as auditors move on. Quality follow up and assessment form a central plank of the audit function's work.

There are many signs this is working, but perhaps the most telling is the reduction of financial audits by around 20% in the last year.

Self-assurance has grown with the improvements in financial governance following a strong internal audit influence within the department.

The overarching tone of its approach, however, is an acceptance that a business of this type, to flourish and grow and create real value, has to accept risk. Indeed, looked at in one way, aside from developing new operational methods, the organization's primary function is the management of big risks.

So far it has worked well, and has even led to business units increasing the amount of self-assurance they do as internal audit backs off to maintain vigilance over their risks. That, more than anything, shows that risk management and quality control has embedded itself into the business on a sustainable basis.

Ernst & Young recognizes that there are enormous opportunities in doing business in emerging parts of the world and in entering growing markets - but hand in hand with those opportunities come new risks. Understanding and managing those risks is a huge challenge. Companies are not just concerned about safeguarding their own business; but must reassure customers, investors and shareholders that risk management is a top strategic priority. Ernst & Young suggests these practical steps for addressing emerging market risks:

1. Understand your risks - a selection of overarching emerging market risks, for internal audit consideration:

Strategic risks

Political situation
Business partner relationships
Management issues

Operational risks

Investments and acquisitions
Operating results

Financial risks

Financial reporting rules and regulations
Internal control regulations
Tax laws

Compliance risks

Fraud, theft and corruption
Compliance with local rules and regulations

2. Determine appropriate coverage plan
3. Allocate appropriate resources from available options:
 - In-house - local
 - In-house - regional or corporate
 - Third party
 - Political situation

Ernst & Young firmly believes that you can't deal with what you can't see, and knows that a fragmented approach to risk management at a local level produces inconsistent results at a multinational level. Ernst & Young has unrivaled experience in working with multinational companies in these emerging markets to help make rapid business decisions in a highly cost-effective way.

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EMEIA MAS 50.0311.

Contacts

Area	Leader	Telephone
EMEIA	Martin Studer	+41 58 286 3015
Africa	Celestine Munda	+27 11 772 3315
BeNe	Tonny Dekker	+31 88 407 1004
CIS	Galina Maloshenko	+7 495 755 9879
CSE	Linas Dicipetris	+370 5 274 2344
FraLux	Dominique Pageaud	+33 1 4693 7563
FSO	Stephen Gregory	+44 20 7951 2324
GSA	Kai Baetge	+49 211 9352 29475
India	Ram Sarvepalli	+91 11 4363 3000
Mediterranean	Alberto Girardi	+39 0272212959
MENA	Cyril Salibi	+971 4 3324000
Nordics	Terje Klepp	+47 24 00 28 21
UK&I	Paul Kennard	+44 20 7951 5774