



**Internal  
audit:**

# Reinforcing checks and balances

**The checks and balances needed in a company are many and varied. Risk management is strongest when there are separate and clearly identified lines of defence. Internal audit plays a pivotal role in ensuring that the assurance framework is effective.**

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**C**orporate governance has to do with the way in which companies are managed and controlled. Good corporate governance requires a range of checks and balances, especially on those with the power and influence to make decisions and act in ways that can be either beneficial or detrimental to the company.

From the viewpoint of investors and regulators, their first line of protection is the board of directors. Thus, the law imposes various duties on directors. These include fiduciary duties such as the duty to act fairly and honestly, and to exercise due care.

For the board to fulfil its stewardship responsibilities, it has to, in turn, ensure an effective system of checks and balances within the corporation.



A common means to achieving this is to ensure that the company has established and implemented an effective risk management (ERM) framework with sound internal control systems.

Indeed, the regulators insist that boards “should ensure that management maintains a sound system of risk management and internal controls to safeguard shareholders’ interests and the company’s assets” (Principle 11 of the Singapore Code of Corporate Governance 2012).

### Enterprise Risk Management

ERM is a process to manage risks and seize opportunities related to the achievement of business objectives. ERM frameworks help to codify and integrate a holistic, structured and disciplined approach to managing risks, with the company’s core business processes and decision-making.

There are various ERM standards, methodologies, and frameworks to identify, analyse, manage and monitor risks and opportunities. Two principal international frameworks are the International Standards Organisation (ISO) 31000 International Risk Management Standard, and the Committee of Sponsoring Organisations of the Treadway Commission (COSO) ERM Framework (see diagram, “COSO ERM Integrated Framework”).

### Lines of Defence

The purpose of ERM is to govern, manage and control risks in a holistic manner. This requires a systematic approach for delegating and coordinating essential risk management duties.

This can be achieved through a Lines of Defence model which provides for a balance of mechanisms across the different layers of management assurance, assurance process and independent assurance.

There are several Lines of Defence models. A good example is the Institute of Internal Auditors' "Three Lines of Defence" model (see diagram with same name).

The first line of defence is the operational managers who own and manage the operational risks. They are responsible for maintaining effective internal controls and executing risk and control procedures on an on-going basis. They are also responsible for implementing corrective actions to address process and control deficiencies.

The second line is the various risk and control oversight functions established by the company to facilitate active compliance with the implementation of effective risk management by the first line. Typical functions in the second line include a risk management function or committee to facilitate and monitor risk management practices by the line managers, a compliance function to monitor specific risks, and a controllership function that monitors financial risks and reporting issues.

The third line of defence is internal audit, which provides an independent check on the first two lines of defence and management.

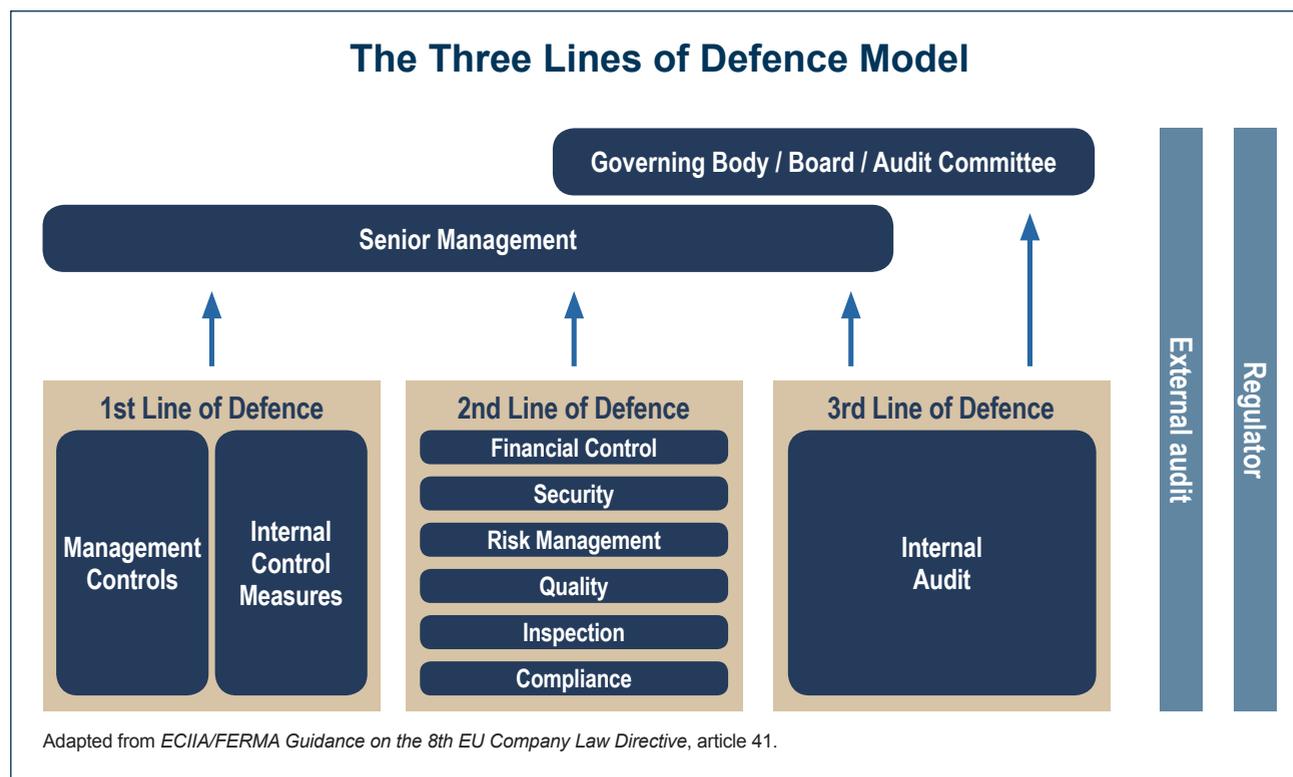
Some Line of Defence models include the external auditors in the third line of defence. Other models consider the external auditor and regulator to be a fourth line of defence. Yet, other models include the board of directors as the last line of defence in the company.

### Internal Audit

A critical aspect of the assurance framework is the role performed by internal auditor.

The internal audit function can provide assurance on risk management and internal control based on the highest level of independence and objectivity within the organisation, which is not available in the first and second line of defence.

The independence of the internal audit function is achieved by an organisation construct where it reports to and is accountable to the audit committee,



even though it may administratively report to the CEO or other senior management person.

Yet, the role of the internal auditor is evolving with the increasing complexities and needs of modern business. Increasingly, internal auditors are finding ways to value-add beyond the traditional role of just conducting internal control reviews.

From its humble beginnings of just providing independent and objective assurance in the organisation, many internal auditors are being asked to be a “partner” and “change agent” to provide insights, advice and recommendations.

In many respects, the internal audit function is in a unique position to do so. With its unfettered access to the business and process owners, internal auditors are able to develop broad and deep business knowledge and are able to assess risks and the supporting internal control system.

For this reason, the internal audit function is well positioned to facilitate coordination of assurance activities across all the lines of defence. It can ensure and educate the company on a common risk-language. Only when the different stakeholders (including the regulators) agree on this common risk-language will internal control design and implementation be more effective.

In fact, internal audit can value-add by bringing corporate governance to the forefront. It should create the necessary control and fraud awareness in the organisation using different media platforms to outreach to all staff, informing them of their individual responsibilities in corporate governance, risk management and internal controls. In addition, internal auditors should consider establishing an overall fraud risk management framework in companies by incorporating the five key elements of fraud governance, fraud risk assessment, fraud prevention, fraud detection and fraud investigation

and response protocol as it will help foster the right risk culture in the company against fraud.

Technology has also provided a significant opportunity for the internal auditor to value-add through data analytics and continuous auditing. With the ability to scan the plethora of data in a company, technology can automate the identification of exceptions or anomalies, and analyse trends and patterns, thereby providing a real-time or near real-time check on transactions and operations.

In all these value-adding activities and “good” working relationships with management, the internal auditors need to be conscious of the need for them to remain objective and independent. The Institute of Internal Auditors Code of Ethics are based on the principles of Integrity, Objectivity and Confidentiality. Where there is a potential conflict of interest, the auditor should declare this internally and be excluded from involvement in the work.

The support and oversight of the audit committee, to which internal auditors report to, is also critical in this respect.

### **Forward with Defence**

For many enterprises, the setting up of a risk governance structure and ERM framework can seem relatively simple.

However, the challenge is ensuring an effective ERM system, and the alignment of all stakeholders to their respective roles and working together on them. Often, the value of the second and third lines of defence are not incorporated effectively in the overall governance approach.

A sound ERM and risk assurance framework requires that there are separate and clearly identified lines of defence, each of its clear set of responsibilities, but working together in a synergistic and coordinated fashion. To help achieve this, the internal auditor can play an important role. ■