



# An Evolving Internal Audit Landscape

***Beyond  
conventional  
compliance***

**Internal**

**AUDIT**

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# Joint Foreword

2017 offers a moment of reflection – with a full year having passed since Hong Kong’s Corporate Governance Code was updated to incorporate a new Code Provision C.2.5 requiring issuers to maintain an internal audit function, within the Code’s comply or explain framework, and a revision to Code Provision C.2.2 requiring the board to ensure the adequacy of resources, staff qualifications and experience, training programs and budget of the issuer’s internal audit function. In addition, in a rapidly changing world, it is opportune to assess emerging risks and challenges facing internal auditors in Hong Kong and their experiences and insights in making improvements to address the threats they currently face and the challenges that still need more work.

IIA Hong Kong are grateful to be able to collaborate with KPMG in preparing this survey report which provides directors, executives, and industry practitioners with a comprehensive analysis on how companies have responded to recent changes, the key challenges they face and the positioning of their internal audit functions. Our survey explores the experiences of senior audit executives based in Hong Kong and how they are responding to today’s risks and challenges in an environment where risks are numerous, rapidly evolving and increasingly complex. It also contains insights from a number of senior board/audit committee members on their experiences in building an effective internal audit function. In addition, KPMG risk advisory professionals also conducted additional research to provide depth and context to our survey findings, and to point to the solutions organisations need to develop to address risks and challenges that are just around the corner or may be soon appearing on the horizon.

I would like to extend a personal note of thanks to all of our survey participants. We appreciate the time they took to share their insights and experiences with us. We welcome the opportunity to discuss in greater detail the implications of these findings and look forward to hearing from you.



**Mr Stephen Lee**  
President,  
IIA Hong Kong



# Joint Foreword

The future of internal audit in Hong Kong looks both promising and challenging as companies come to grips with the age of digitalisation. The purpose of this survey is to provide market participants with the latest internal audit trends in Hong Kong and provide insights on how they could improve their internal audit functions.

Our joint internal audit survey with IIA Hong Kong is based on the responses of almost 100 senior audit executives and other internal audit stakeholders from Hong Kong across multiple sectors.

Our survey findings revealed that there is a need for internal audit functions to innovate, change and mirror the fast changing business environment that organisations operate in today. We identified five key attributes that a top internal audit function should possess.

We would like to thank everyone who contributed to this survey for their time and insights. We hope you find our analysis thought-provoking and useful. We welcome your feedback and are open to further discussions.



**Paul McSheaffrey**  
Partner,  
KPMG China



**Alva Lee**  
Partner,  
KPMG China

# Executive Summary

In a complex and fast evolving business environment, internal audit can play a key role in helping organisations achieve their strategic objectives. Internal audit can enhance shareholder value by challenging the way a business operates and providing assurance on risk and internal control systems. In addition, there are growing expectations among market practitioners that an internal audit function can grow beyond conventional compliance-type roles and evolve into a trusted business advisor.

Based on our analysis, we have identified five key attributes that a leading internal audit function should possess in today's business environment in order to continue to provide value to stakeholders.



## ***Key Attribute 1: Becoming a trusted business advisor***

The complex, fast changing world of corporate governance means an internal audit function needs to be more than a compliance checker or a watchdog over an organisation's operations. Our survey findings show that internal audit functions are increasingly looking to evolve into trusted business advisors to support senior management in achieving their strategic objectives. However, more work is to be done before this trend can fully take shape in Hong Kong.



## ***Key Attribute 2: Embracing big data analytics in audits***

The importance of data is growing faster than ever before as we enter a new age of digitalisation. However, the insufficient use of data analytics in internal audit is listed by our survey respondents as one of the key challenges they face.



## ***Key Attribute 3: Staying ahead of digital threats – focus of internal audit plans***

IT systems are now the lifeblood of every organisation. A top internal audit function needs to play an integral role in assessing and identifying the risks and opportunities brought about by digitalisation in order to strengthen enterprise security.



## ***Key Attribute 4: Auditing culture and behavioural controls beyond traditional process-level audits***

The role of an internal audit function is to focus on reviewing high risk areas, which could hamper a company's ability to meet its business objectives. In recent years, the culture, behaviour and conduct of an organisation has been acknowledged as having a significant impact on an organisation's success. Undertaking cultural and behavioural audits will help to align a company's culture with its strategic business direction such as its digital strategy.



## ***Key Attribute 5: Assessing the effectiveness of an internal audit function***

A key attribute for an internal audit unit to perform its duties and achieve its objectives effectively is to have the ability to track and assess its own performance.

Many companies are attempting to stay ahead of the curve by focusing and exploring new technologies such as data analytics.





**“ Do not mend the gate after the sheep have bolted. Developing risk management tools and skills will help**

**us to test how well the Board really understand the dynamics and challenges of the Company's operating plan and performance goals. The internal audit function can do much more than just applying these skills to build frameworks of warning parameters. We should embrace a new frame of mind when approaching internal audit coupled with foresight and perceptive advance planning. ”**

*Dr Eric Ka-Cheung LI, GBS OBE JP*

Internal audit should not lag behind either and need to adapt to new ways of thinking and new technologies to enhance their effectiveness. They also need to start becoming more proactive and effective in responding to the risks and opportunities brought about by digitalisation.

The Hong Kong Exchanges and Clearing Limited (HKEx) has increased the emphasis on improving corporate governance standards. This has prompted companies to either visit or revisit the role, structure and tools of their internal audit functions.



# About the Survey

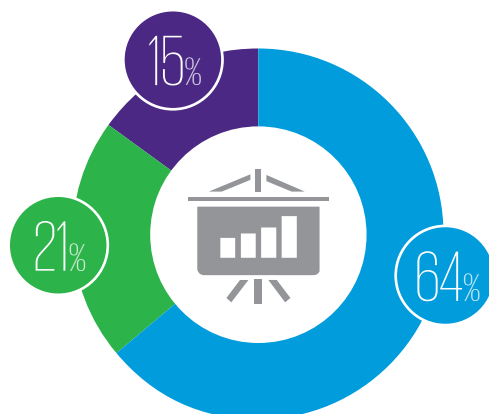
Hong Kong's internal audit landscape has undergone a significant transformation over the last year and a half when a new set of corporate governance rules from the HKEx came into effect at the start of 2016.

One of the key aspects of the change is the requirement for listed companies to establish an internal audit function. Establishing an internal audit function was previously only a recommended best practice, but has since been changed to a code provision. Many companies were impacted by this as HKEx estimates showed that only 51 percent of Hong Kong listed firms had internal audit functions in 2012.

KPMG and IIA Hong Kong conducted a survey in March 2017 to analyse and understand the extent to which companies have approached and adopted the new Corporate Governance Code. The intention of the survey was to understand the role internal audit plays in their business operations and capture the key challenges companies faced when adapting to the new rules.

The survey will provide a reference for organisations looking to adopt best practices by providing a comprehensive analysis on the state of the internal audit landscape in Hong Kong. In addition, it provides the outlook of an industry that is coming to terms with the challenges and opportunities brought about by digitalisation. In this regard, our survey results show that over 85 percent of respondents had conformed or partially conformed to the standards laid out by the IIA's International Professional Practices Framework.

## An organisation's level of conformity with the IIA Standards

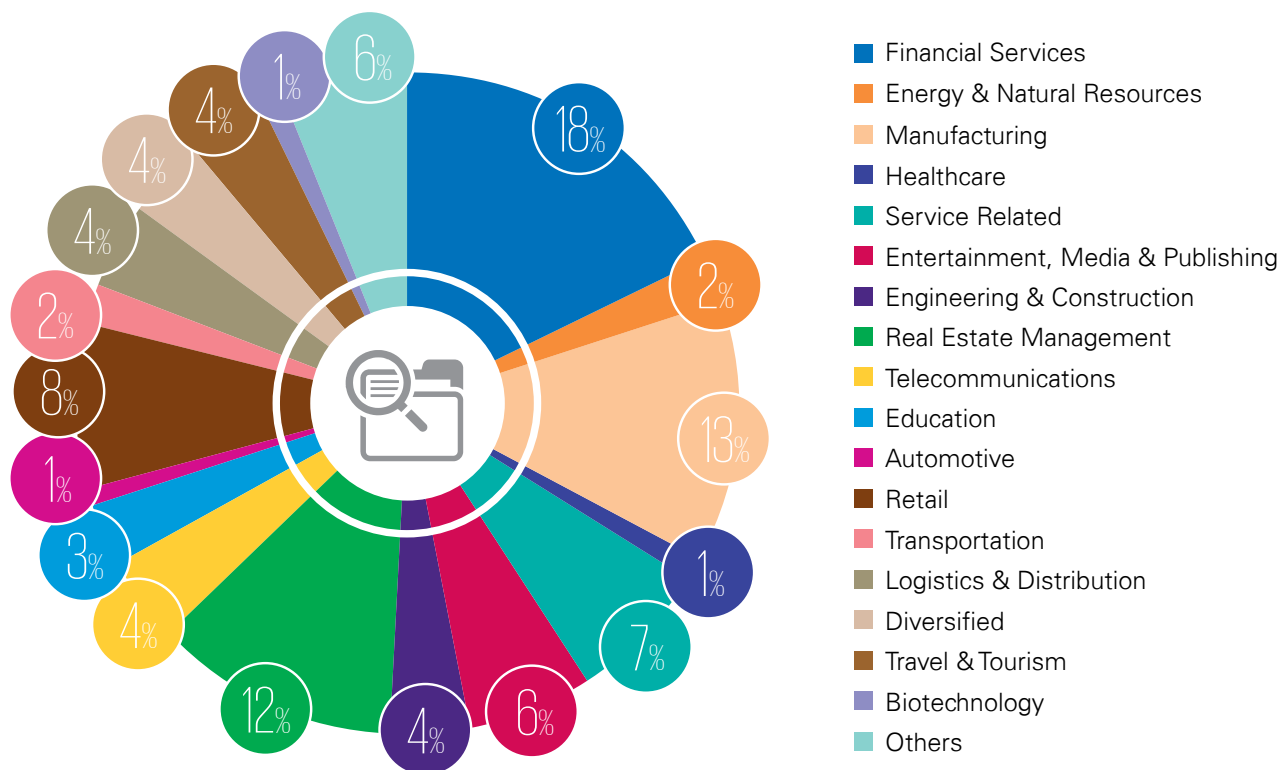


- Generally conformed - Internal audit policies and processes are mostly in-line with the IIA Standards with room for some improvement
- Partially conformed - Several internal audit processes deviate from IIA Standards, but do not obstruct the function's ability to perform its responsibilities in an acceptable manner
- Did not adopt the IIA Standards

Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

We gathered responses from around 100 senior audit executives and stakeholders including Heads of Internal Audit, Chief Audit Executives, Chairman and members of Audit Committees and other senior management across a range of industries.

### Industry breakdown of survey respondents



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey





# Hong Kong's Internal Audit Landscape



In order to understand the role internal audit functions are playing, we need to first understand the internal audit landscape in Hong Kong.

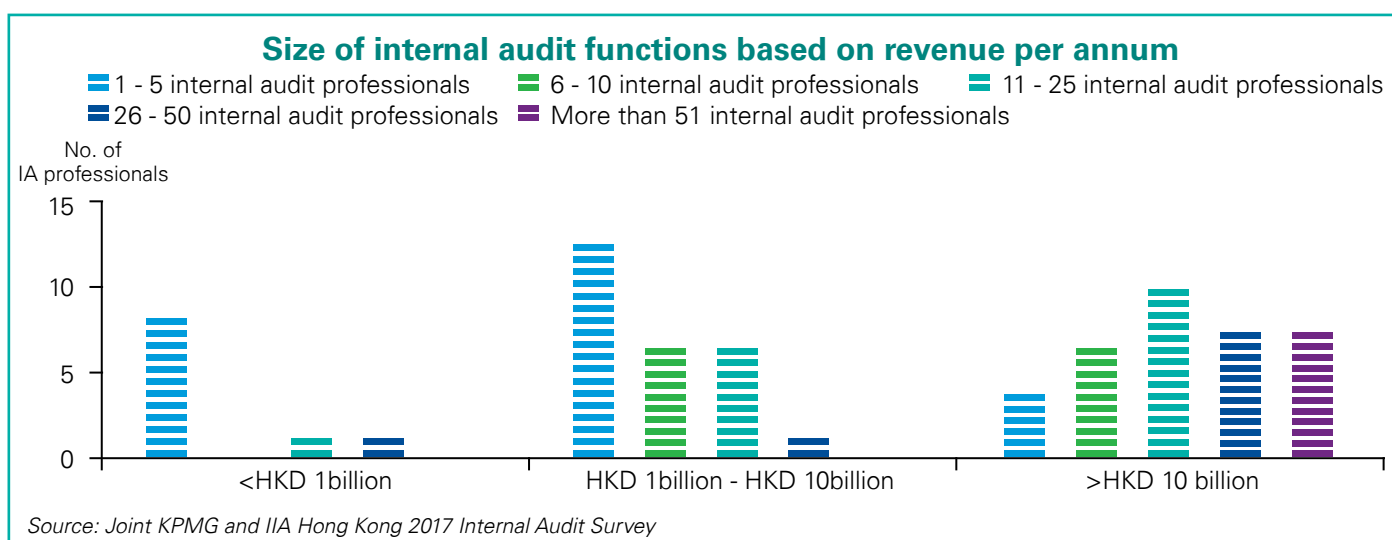
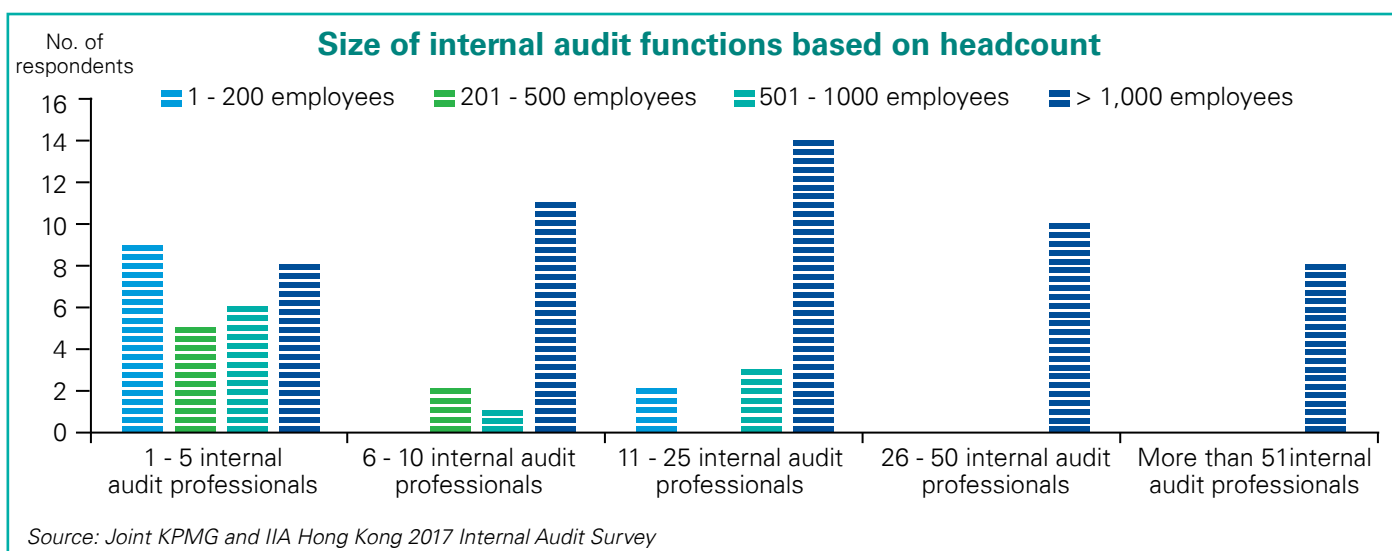
### The size and composition of internal audit functions

Even though the revised Corporate Governance Code requires all listed companies to have an internal audit function, there is no guidance on what the appropriate size of an internal audit function should be.

There is no one size fits all approach to determine the appropriate size of an internal audit function. However, the size of an internal audit function should more or less correspond to an organisation's business structure, diversity and geographical reach. To ensure a company possesses an internal audit function of the right size, a company's board and, in particular, the audit committee should conduct a review annually to ensure their internal audit teams have sufficient resources, training, and the required qualifications and experience.

The size of an internal audit function was found to be generally proportional to the size of an organisation. We noted that in most cases, the total number of internal audit professionals is approximately 2 to 3 percent of an organisation's total headcount.

The size of an internal audit team appears to be less related to a company's revenue. Firms with annual revenue between HKD 1 billion to HKD 10 billion tend to possess an internal audit function of 6 to 25 professionals. Yet for organisations with annual revenue of more than HKD 10 billion, the size of their internal audit teams can vary. In today's complex environment, large companies with smaller internal audit functions should critically assess whether the function has the right level of resources.



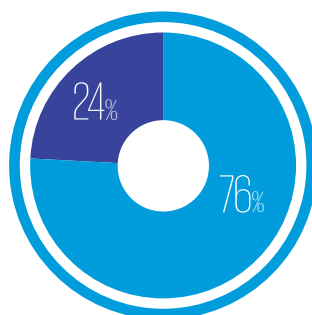
### Composition of internal audit functions



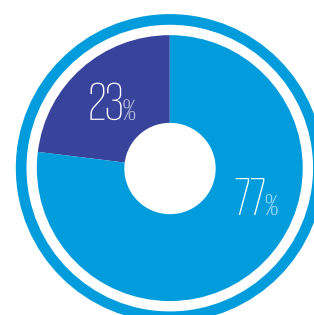
Size aside, another important aspect of an internal audit unit is the composition of the team. More than 77 percent of survey respondents indicated that their internal audit teams are comprised predominately of audit professionals. Some 22 percent indicated they have a mix of audit professionals and business executives, while only 1 percent indicated their internal audit functions consist mainly of business executives. The composition of an internal audit function is related to whether a unit has the required skill set and experience to perform their duties.

### Level of resources, skill set and experience of internal audit functions

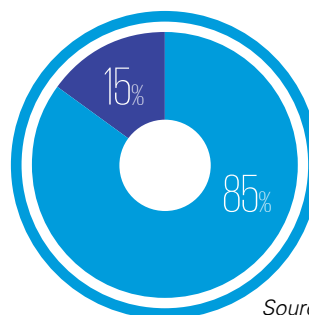
Does your internal audit function have sufficient resources to perform its duties?



Does your internal audit function possess the required skill set to perform its duties?



Does your internal audit function have enough experience to perform its duties?



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

On the back of growing expectations and demands from the Board, Audit Committee and all relevant stakeholders, we are not surprised to see that nearly a quarter of respondents consider their internal audit functions to have insufficient resources, skill set or experience to perform their day-to-day duties. Around 24 percent indicated that their internal audit functions do not have sufficient resources to perform their duties. Some 23 percent believed that their internal audit functions do not have the required skill set, while around 15 percent noted that their internal audit teams do not have enough experience to perform their duties.

The skill set and experience of an internal audit function is related to the composition of the team. Among the 23 percent who indicated that their internal audit function do not have the required skill set, nearly 70 percent had internal audit teams that mainly comprise of audit professionals. On the other hand, for the 15 percent who claimed that their internal audit teams do not have sufficient experience, their teams are evenly split between consisting mostly of audit professionals and having a mix of audit professionals and business executives. This suggests that a more balanced mix of audit professionals and business executives provides a more complete skill set to operate in an increasingly complex business environment.

The diverse competencies required to be a successful internal auditor is reflected in the IIA's Global Internal Audit Competency Framework, which defines the competencies needed to meet the requirements of the IIA's International Professional Practices Framework. Attributes such as "business acumen", "communication" and "critical thinking" suggest a diverse mix of competencies is needed for internal auditors.

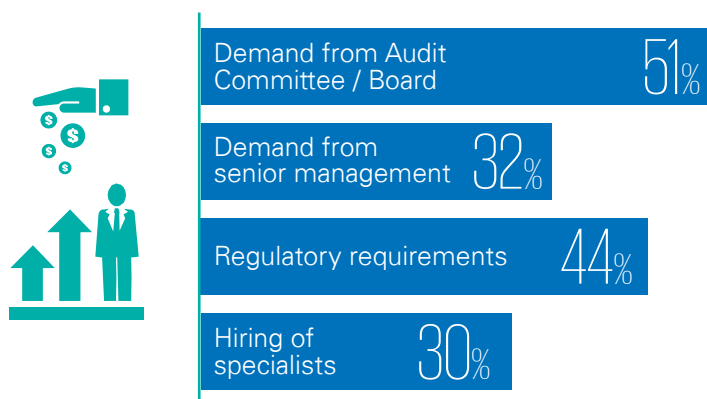




## The level of investment in internal audit is anticipated to increase

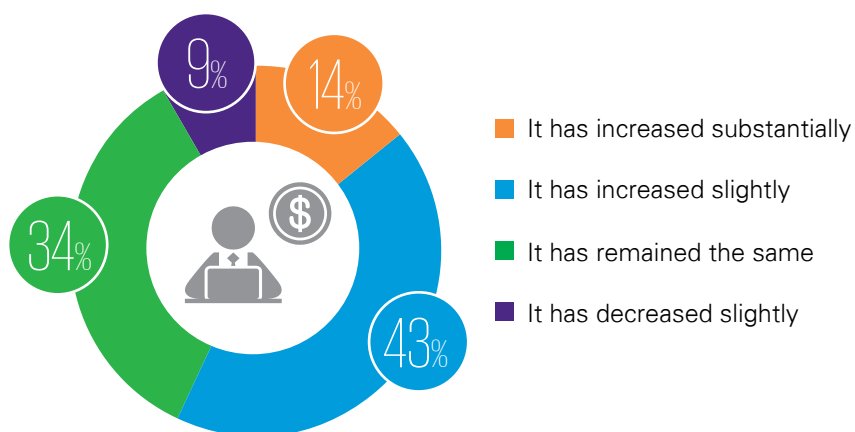
Around 57 percent of respondents recorded an increase in their investment in internal audit over the past three years and approximately 53 percent expect their internal audit investment to increase over the next three years. The expected increase is driven by demand from Audit Committee / Board (51 percent), senior management (32 percent), stricter levels of compliance and regulatory requirements (44 percent), and increasing need to hire more specialists (30 percent). Many respondents believed that an increase in investment would help them meet the increasing demand for internal audit services.

### Drivers for increasing internal audit investment



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

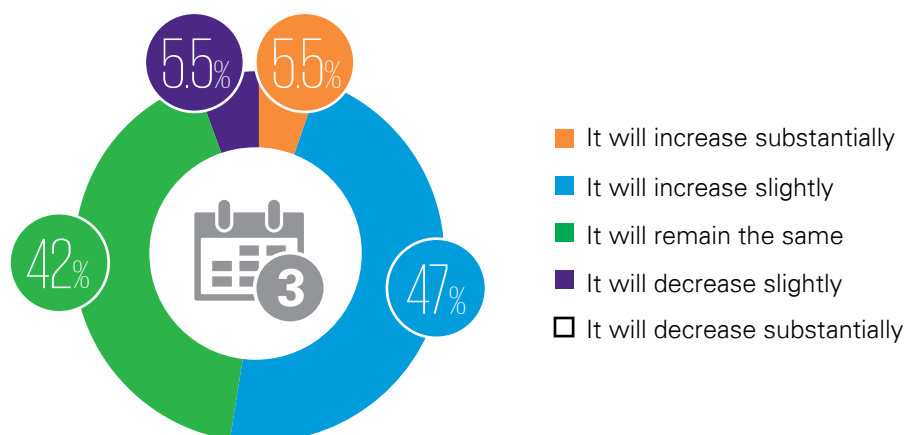
### An organisation's change in internal audit investment (as a percentage of total operating expenses) over the past three years



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey



### An organisation's anticipated level of internal audit investment (as a percentage of total operating expenses) over the next three years

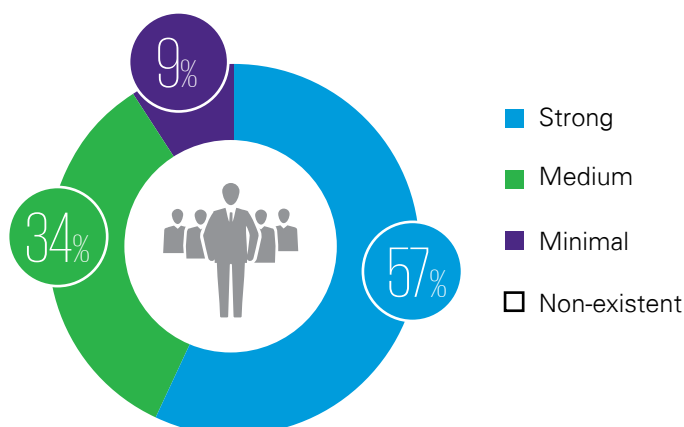


Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

### Internal audit functions receiving strong support from senior management

Apart from monetary investment, support from senior management is also crucial to the success of an internal audit function. Having strong management backing and leadership support can help improve an internal audit function's performance and their ability to add value to a firm's business. Some 57 percent of respondents felt the level of support they had was strong, while 34 percent felt management support was moderate. The key is for an internal audit team to demonstrate their value to senior management in order to generate greater support.

### The level of senior management support for internal audit functions to perform their duties effectively



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

## Firms adapting well to new corporate governance requirements

The HKEx published its new corporate governance requirements - the Consultation Conclusions on Risk Management and Internal Control: Review of the Corporate Governance Code and Corporate Governance Report ('the Consultation Conclusions') – in December 2014. These requirements affect all Hong Kong listed companies and came into effect for accounting periods beginning on or after 1 January 2016. Listed companies are required to establish an internal audit function under the revised code provisions. Companies without an internal audit function should review the need for one on an annual basis and are required to disclose the reasons for not having one in their Corporate Governance Report.

Most listed companies in Hong Kong have adapted well to the corporate governance requirements, according to the findings of our survey. Some 81 percent of respondents have an internal audit function in place and recognise its importance in ensuring the effectiveness of its risk management and internal controls. About 77 percent of respondents already had an internal audit function prior to the new requirements coming into effect last year and only 3 percent said they do not have an internal audit function. Approximately 16 percent have either co-sourced or out-sourced their internal audit processes to independent third parties.



It is encouraging to see listed companies adapting well to the new corporate governance requirements with many now possessing their own internal audit functions. Even more important, however, was the respondents' rationale for doing so – many companies appreciate the value an internal audit function can bring to an organisation rather than view them as a mere box ticking exercise. The role of an internal audit function cannot be underestimated. A high performing internal audit unit can play a key role in helping organisations achieve their strategic objectives, enhance shareholder value by challenging the way a business operates and provide assurance on their internal control systems. This versatility is a function of growing expectations among market practitioners that internal audit can grow beyond traditional compliance type roles and evolve into a trusted business advisor. Many Chief Audit Executives, for example, are responsible to provide insights, deliver efficiencies and identify inherent issues.

Based on our analysis, we identified five key attributes that a premium internal audit function should possess in today's business environment.

# Key attribute 1: Becoming a trusted business advisor



**“Strong and supportive internal audit is key to a strong and successful business.”**

*Mr Alan Howard Smith*

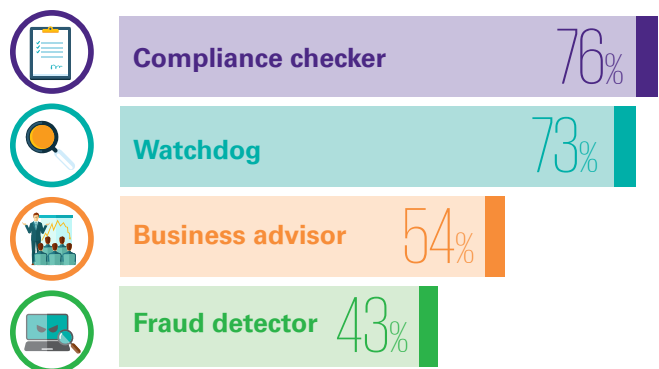
What is noteworthy is that over 50 percent of respondents said a driver for an internal audit function is to improve business performance and efficiency, beyond its traditional role of assurance against internal policies, Listing Rules, Companies Ordinance and other industry regulations.

In addition, more than 80 percent of the Head of Internal Audit/ Chief Audit Executive/ Deputy Head of Internal Audit rated the role of their internal audit function as a business advisor. This clearly demonstrates that internal audit practitioners in the territory see their function as a value provider. In contrast, only 4 percent of surveyed Audit Committee Chairman and committee members, and 16 percent of senior management viewed an internal audit function as a business advisor. This huge discrepancy suggests that there is plenty of room for improvement before internal audit can be fully considered as a business advisor by some key stakeholders.

Higher corporate governance standards mean an internal audit function needs to be more than a mere compliance checker or a watchdog over an organisation's operations. Our survey findings show that internal audit functions are trying to evolve into trusted business advisors to support senior management in achieving their strategic objectives. However, more work is to be done before this trend can fully take shape in Hong Kong.

An internal audit function is generally regarded as the third line of defence in an organisation, providing independent assurance over internal controls. Over 75 percent of respondents indicated that compliance checking is the primary role of internal audit and over 73 percent considered internal audit as a watchdog.

## How would you describe the role of your internal audit function?



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

There are a number of ways to close this gap. The talent composition of internal audit functions can be altered from predominantly audit professionals (78 percent), to a combination of audit professionals and business executives. This can help to expand the skill set of an internal audit function, which would then reinforce their importance to key stakeholders. Expanding the function's capabilities in data analytics and risk identification is another way to promote the internal audit function's role as a business advisor to an organisation. Enlisting the help of data analytic tools can help flag issues to senior management at an earlier stage, while outsourcing or co-sourcing selected projects to external subject experts is another option to provide more valuable insights.

The IIA's official definition of internal auditing also implies leveraging 'objective assurance' and its deep knowledge of the firm to offer 'consulting activities designed to add value and improve an organisation's operations.'

As internal audit continues to transition to a higher value-added model and a more forward looking approach, it should become an increasingly valuable resource for companies, their audit committees and various business units. This, however, will require more investments in new tools and technologies such as data analytics.



## IIA Global Internal Audit Competency Framework

### Core competencies IX Internal Audit Delivery:

Provides assurance and advisory services to senior management and the board

#### Benefits for becoming a trusted business advisor

- Provide the organisation an independent view of underlying risks to make better strategic decisions
- Internal audit function is more involved with business operations and enhances trust levels with senior executives and leaders from other business units
- Greater emphasis on managing risks rather than assuring compliance with company policies

# Key attribute 2: Embracing big data analytics in audits



**“ Internal  
audit plays  
a crucial  
role for the  
organisation**

**in the form of its third line of  
defence. As business risks  
evolve, internal audit also need  
to re-invent itself to address  
the ever changing key risks to  
an organisation. An effective  
independent internal audit  
function should be agile and  
innovative in adapting to the  
volatile risk environment. ”**

*Mr Eddy Fong*

The importance of data is increasing as we enter this new age of digitalisation. However, the insufficient use of data analytics in internal audit is listed by our survey respondents as one of the key challenges they face.

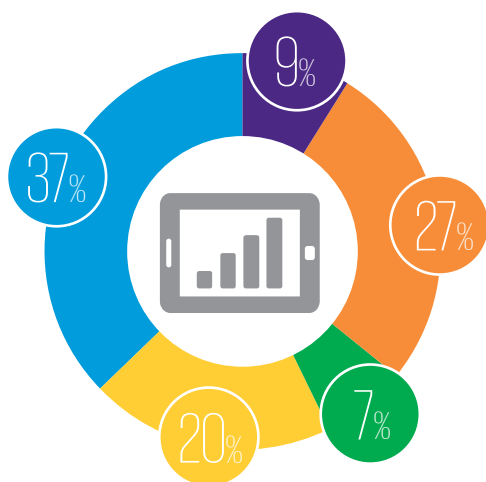
In our survey, over 40 percent of respondents noted the insufficient use of data analytics as a key challenge within their internal audit function. This lack of usage was highlighted by the fact that only 9 percent of the respondents had fully used data analysis tools for all internal audit projects - an area with significant room for improvement for internal audit.

Using data analytics, internal auditors may uncover insights about an organisation's business processes that would allow management to better identify opportunities to improve efficiency or better leverage their enterprise resource planning (ERP) investments through more automated controls. In doing so, organisations can improve their ability to tackle specific challenges and achieve more streamlined production. Data analytics also allow basic control testing to be performed more effectively and efficiently, freeing up time for the internal audit team to focus more on risk identification.

Technology tools are becoming more cost effective and mature. The opportunity is there for internal audit functions to start utilising it throughout the audit lifecycle and apply them to all internal audit projects. This includes the utilisation of continuous auditing techniques through the use of embedded analytics to assess emerging risks, identify red flags, and respond to changing risks on a real-time basis.



## An organisation's use of data analysis tools and CA/CM solutions in internal audit processes



- We are required to use data analysis tools and CA/CM solutions for all internal audit projects.
- We occasionally adopt data analysis tools and CA/CM solutions for our internal audit projects.
- We adopt CA/CM solutions but not data analysis tools for our internal audit projects.
- We adopt data analysis tools but not CA/CM solutions for our internal audit projects.
- We do not adopt data analysis tools or CA/CM solutions for all internal audit projects.

Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey



## IIA Global Internal Audit Competency Framework

### Core competencies V Business Acumen:

Assesses and takes account of how IT contributes to organisational objectives, risks associated with IT, and relevance to the audit engagements

### Core competencies VIII Critical Thinking:

Applies process analysis, business intelligence, and problem solving techniques

### Core competencies IX Internal Audit Delivery:

Selects and applies the appropriate tools and techniques to data gathering, analysis and interpretation, and reporting

### Benefits for embracing big data analytics in audits

- Provide more in-depth opinions and insights
- Aid risk assessment through identification of instant anomalies, red flags and trends
- Improve ability to test complete data sets rather than sample selections, which leads to better assurance quality

# Key attribute 3: Staying ahead of digital threats - focus of internal audit plans

**“With the ongoing battle of cyber threat and other emerging risks from the digital world, an Audit Committee would expect the internal audit function to cover these risks in their audit plan and suggest ways of managing as well as mitigating these risks.”**

*Mr David Hon To Yu*



**IIA Global Internal  
Audit Competency  
Framework**

## **Core competencies X Improvement and Innovation:**

Adjusts team priorities to new and changing priorities of the organisation

IT systems are now the lifeblood of every organisation. Leading internal audit functions need to play an integral role in assessing and identifying the risks and opportunities brought about by digitalisation to strengthen enterprise security.

The number of cybersecurity incidents has increased dramatically across all sectors in recent years. In mid-May 2017, a global “ransomware” attack began spreading across the globe, infecting more than 300,000 computers in more than 150 countries, including Hong Kong. According to MalwareTech – a UK cybersecurity research site – around 40 to 50 computers are being infected every minute.

Even though companies are starting to grasp the threat cyber risks pose and are putting more emphasis on security oversight, there are others, which have yet to have a clear cybersecurity strategy. Companies should consider putting cybersecurity as a focal point when formulating their internal audit plans, and conduct reviews at regular intervals. Many senior audit executives do consider the management of cyber risks to be important with 73 percent of respondents possessing a clear plan to review their information governance and data privacy. This high percentage suggests that companies are keen to strengthen their ability to identify, assess and mitigate cybersecurity risks and avoid unusual risk-taking.

However, the impact of digitalisation goes far beyond that and digital transformation has the potential to be embedded and drive changes across all aspects of a firm’s business operations.

### Benefit for staying ahead of digital threats

- Strike a balance between risk and control in the use of digital technology
- Identify internal vulnerabilities and adopt proactive measures against attacks
- Minimise potential impact and reduce response time to digital threats

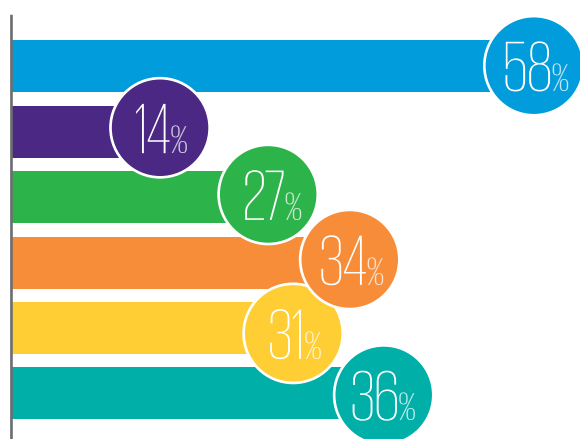
Technology is emerging as a most important opportunity, as well as an overarching risk, for businesses across all sectors as it increases an organisation's vulnerability to attacks through increased online presence, broader use of social media, mass adoption of mobile devices, increased usage of cloud services and the collection/analysis of big data. Regulators are seeing this threat and are putting pressure on businesses to comply with tighter rules and regulations, to admit to cyber breaches publicly, and to submit to detailed examinations.

Possessing an internal audit function with a clear cyber strategy can help better determine the extent to which internal controls can be adapted to these changes.

It is important to point out that the level of incorporation of cybersecurity in internal audit functions can vary drastically across different industries. The financial services sector is well ahead of its peers, according to our survey findings, as all financial services respondents claimed to have incorporated and embedded cyber risks in the planning of their internal audit activities. The emphasis financial services firms place on cybersecurity is unsurprising given the potential risk of significant financial loss. The importance of incorporating cybersecurity in internal auditing in other industries, unsurprisingly, is much less apparent. On average, only 50 percent of non-financial services respondents have incorporated cyber risks in their internal audit plans. This is a potential weakness as cyber risks concern every organisation and those that are not prepared for it in their internal audit plan will be at risk.

Our survey found that 33 percent of respondents' internal audit teams do not provide IT auditing services. It is important for companies to start doing so to improve their ability to assess and monitor cyber or other IT risks. Take the example of a company, which has just entered into cloud computing or other similar technological arrangements directly with service providers. When this occurs, the tools, data and controls tends to reside with the vendors and not the firm itself. Without mastering the new technologies and applications, the internal audit unit will not be able to provide their insights or assurance services from neither a security nor privacy perspective.

### What kind of review (s) has/have been added to your internal audit plans in response to digitalisation and the rise of digital threats?



Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

- Information Governance and Data Privacy – Information accountability review
- Information Governance and Data Privacy – Employee behaviours test
- Information Governance and Data Privacy – Data destruction audit
- Mobile Technologies and Applications – Data encryption assessment
- Mobile Technologies and Applications – Mobile device management audit
- Mobile Technologies and Applications – Application development security risk assessment

# Key attribute 4: Auditing culture and behavioural controls beyond traditional process-level audits

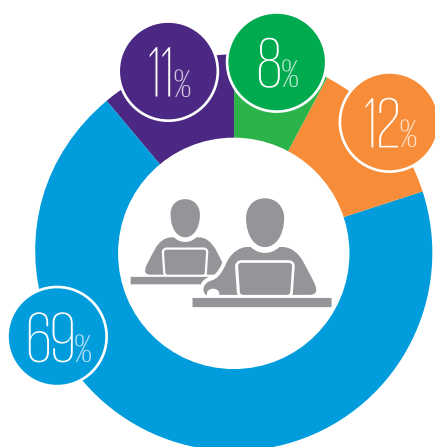
Ever since the 2007-08 financial crisis, regulatory interest in the culture and behaviour of companies has increased. As a result, having independent assurance on culture, conduct and behaviour is becoming increasingly important and is a key challenge for internal audit functions.

Culture can be a rather abstract and complex concept that many companies are unaccustomed to quantifying and measuring. However, a company's consistent inability to audit and monitor culture, conduct and behaviour can have grave consequences.

The ability to audit culture can help support the delivery of stakeholder value by enabling organisations to proactively manage risk and correct internal control failings before things go wrong. Our findings showed that 69 percent of respondents have never performed culture and behavioural control auditing before, and only 11 percent plan to do so in the future.

This suggests that listed companies in Hong Kong are not yet attuned to the concept of cultural and behavioural auditing. However, as we have previously mentioned, this is a key aspect companies should start considering when it comes to internal auditing. The scope of internal auditing should go beyond conventional process-level audits and include areas such as culture and ethics.

## Has your organisation ever performed culture, ethics and behavioural control auditing?



- Yes, we have performed a separate culture and behavioural control audit over the past five years.
- Yes, we have performed a culture and behavioural control audit as part of an internal audit review over the past five years.
- No, we have not performed a culture and behavioural control audit.
- No, we have not performed a culture and behavioural control audit, but are planning to conduct one.

Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey



### IIA Global Internal Audit Competency Framework

#### Core competencies V Business Acumen:

Takes account of cultural aspects of the organisation

#### Benefits for cultural and behavioural audit

- Build a strong culture enabling organisations to be agile
- Strike the right balance between management being in control, and allowing employees the freedom to make decisions
- Spot conduct and behaviour failures, which could lead to reputational damage



# Key attribute 5: Assessing the effectiveness of an internal audit function



**“ In today’s fast changing business environment,**

**internal audit function is expected to provide value added assurance services, embracing technology into their audit process and taking a proactive approach in identifying emerging business risks and embedding such in their auditing road map. To meet this challenge, internal auditors are expected to continuously upgrade their strengths to meet the demands of the digital world and at the same time, enhancing transparency and collaborating with auditees on priority focus areas while maintaining independence. ”**

*Ms Nancy Tse, JP*

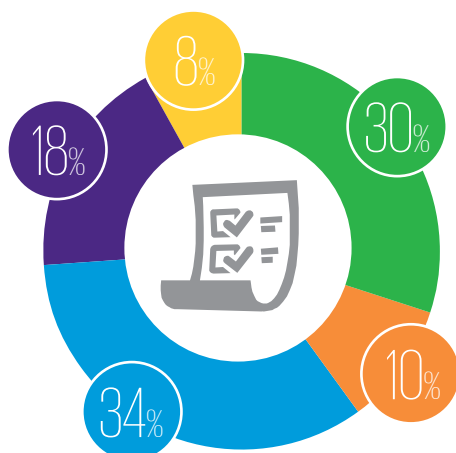
Internal auditing plays a critical role in the governance and operations of an organisation. Organisations that effectively use internal audit are better able to identify business risks, system inefficiencies, take appropriate corrective actions, and undergo continuous improvements. To maintain and enhance the credibility of internal auditing, however, relies on having a well-developed monitoring system to track the function’s effectiveness.

The IIA’s International Standards for the Professional Practice of Internal Auditing, which came into effect on 1 January 2017, has provided the market with guidelines on how to develop a monitoring system. The guidelines include the scope and frequency of internal and external assessments, conclusions of the assessors, corrective action plans relating to the effectiveness of internal audit functions, and the qualifications and independence of the assessors or assessment team, and if there are any potential conflicts of interest.

Even though conducting external assessments of a firm’s internal audit function is encouraged by regulators and other professional bodies<sup>1</sup>, as many as 70 percent of respondents did not perform one in the past five years. The recommended best market practice is to conduct an external assessment at least once every five years by a qualified and independent consultant. The chief audit executive should then communicate the results of the assessment to senior management and the Board.

1. (i) Main Board Listing Rules: Code Provision C2.1 of CG Code, (ii) International Standards For the Professional Practice of Internal Auditing (Standards): 1300 – Quality Assurance and Improvement Program, (iii) Supervisory Policy Manual of Hong Kong Monetary Authority : 3.1.4 of IC-2 Internal Audit Function

### Does your organisation have a QAIP in accordance with IIA Standards and has an external assessment been conducted at least once every five years?



- Yes, we have a QAIP and an external assessment has been conducted at least once over the past five years.
- We have a QAIP but an external assessment was not conducted over the past five years.
- No, we do not adopt the relevant IIA standards.
- No, but are planning to partially adopt the relevant IIA standards by developing a QAIP.
- No, but are planning to fully adopt the relevant IIA standards by developing a QAIP and conduct an external assessment at least once every five years.

Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey

Once again, there is a big distinction between companies from the financial services sector and non-financial services sector. More than 65 percent of financial services organisations have a Quality Assurance and Improvement Program (QAIP) in place whereas only 30 percent of non-financial services firms do. Non-financial services firms should start implementing their own QAIP as it could provide them the opportunity to improve business performance.

The following are the key attributes to consider when assessing the effectiveness of an internal audit function:



#### Positioning:

The work done by an internal audit function should address the organisation's key risks through practical recommendations.



#### People:

An appropriate people strategy should be in place to ensure the internal audit function has the adequate amount of staff and specialists.



#### Process:

The workflow of an internal audit function should be standardised to ensure effective, efficient and timely audits.

Source: Joint KPMG and IIA Hong Kong 2017 Internal Audit Survey



## International Standards for the Professional Practice of Internal Auditing, January 2017

### 1300 – Quality Assurance and Improvement Program

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

### 1312 – External Assessments

External assessments must be conducted at least once every five years by a qualified, independent assessor or assessment team from outside the organisation. The chief audit executive must discuss with the board:

- The form and frequency of external assessment.
- The qualifications and independence of the external assessor or assessment team, including any potential conflict of interest.

### Benefits for assessing effectiveness of an internal audit function

- Improve performance of internal auditing
- Maximise the value provided by the internal audit function
- Provide degree of comfort to Board and Audit Committee



# Conclusion: The Future of Internal Audit in Hong Kong

The future of internal audit in Hong Kong looks both promising and challenging as companies come to grips with the age of digitalisation. Based on our survey findings, there is a clear need for internal audit functions in Hong Kong to innovate, change and mirror the fast changing business environment that organisations operate in today.

The revised Hong Kong Corporate Governance Code requiring all listed companies to have an internal audit function highlights the growing importance of internal audit in Hong Kong. It has elevated the position of internal audit in Hong Kong from a recommended best practice to a code provision, emphasising internal audit's key role in good corporate governance.

There are multiple ways as to how an organisation should approach internal audit and incorporate it into a vital part of their business operations. There is no one size fits all approach for companies to replicate due to differences in business structures, operations, culture and amount of resources.

However, there are key attributes that a leading, high performing internal audit function should possess in today's business environment in order to continue to provide value to stakeholders.

As the industry continues to develop, an internal audit function should no longer be confined to being a mere compliance checker and is now transitioning into a trusted business advisor that can provide valuable insights to the senior management. It should also expand its scope beyond traditional process-level audits and into areas such as culture and behaviour, which in spite of their abstract nature, are essential cogs of a firm's operations.

And as companies begin to focus more on the opportunities offered by digitalisation, internal audit should also keep up with the times and start embracing big data analytics in their auditing, while making sure they are aware of the threats cyber risks pose.

Lastly, a well-developed monitoring plan needs to be in place to assess the work done by an internal audit function. Only then would companies be able to know and trust the work done by their internal audit units, which would then maximise the value provided by the function.

# About IIA Hong Kong

The Institute of Internal Auditors Hong Kong Limited (IIA Hong Kong) (previously known as The Institute of Internal Auditors Hong Kong Chapter) was formed in 1979 and is affiliated to the global organisation, The Institute of Internal Auditors Inc. (IIA), which is an international professional association headquartered in the US, with more than 180,000 members worldwide. The IIA is the internal audit profession's global voice, recognised authority, acknowledged leader, chief advocate, and principal educator. The IIA has developed a portfolio of globally recognised certifications, the most recognisable of which is the Certified Internal Auditor ("CIA") certification, with over 130,000 CIA certified individuals.

The IIA's definition of internal auditing is as follows: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes".

The IIA provides internal audit professionals worldwide with authoritative guidance organised in the International Professional Practices Framework as mandatory guidance and recommended guidance. IIA Hong Kong supports members in Hong Kong through dynamic leadership in providing comprehensive professional educational and development opportunities, and facilitating The IIA's certification programs in Hong Kong, and bringing together internal auditors from all sectors to network and share information and experiences.

# About KPMG China

KPMG China operates in 16 cities across China, with around 10,000 partners and staff in Beijing, Beijing Zhongguancun, Chengdu, Chongqing, Foshan, Fuzhou, Guangzhou, Hangzhou, Nanjing, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Xiamen, Hong Kong SAR and Macau SAR. With a single management structure across all these offices, KPMG China can deploy experienced professionals efficiently, wherever our client is located.

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and regions, and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China. KPMG China was also the first among the Big Four in mainland China to convert from a joint venture to a special general partnership, as of 1 August 2012. Additionally, the Hong Kong office can trace its origins to 1945. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the Chinese member firm's appointment by some of China's most prestigious companies.



# Acknowledgments

We would like to thank the following individuals for their contribution:

**Mr Eddy Fong**

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Independent Non-Executive Director and Chairman of the Audit Committees of SmarTone Telecommunications Holdings Limited, Transport International Holdings Limited, Wong's International Holdings Limited, Hang Seng Bank Limited, China Resources Beer (Holdings) Company Limited, Roadshow Holdings Limited, Sun Hung Kai Properties Limited, and Steward and Chairman of Audit and Risk Committee of the Hong Kong Jockey Club

**Mr Gianfran Liu**

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Independent Non-Executive Director at Genting Hong Kong Limited, Guangdong Land Holdings Limited, Lei Shing Hong Limited, and Wheelock and Company Limited

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Publication number: HK-RC17-0002

Publication date: June 2017