Defining An Effective Internal Audit

Though Not Mandatory, It Is Important To Have A Best Practice Guide

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THE Code of Corporate Governance 2005 Guideline 11.4 (d) requires the Audit Committee ("AC") to review the effectiveness of a company's internal audit function. However, what is an "effective" internal audit for a listed company? Today's regulatory environment places an ever higher duty and responsibility on the boards of listed companies, and particularly on the independent directors. Many of these requirements are beyond the scope of a statutory audit. The board, especially the non-executive directors, must therefore rely on the internal audit function to ensure compliance with these regulatory requirements.

However, since there is currently no mandatory requirement for internal audit, the scope of work, the standard and the responsibilities of the internal audit function (either in-house or outsourced) varies from company to company depending on the available budget, the quality of the internal audit staff or the outsourced provider, and the extent of the AC's supervision. Recent high profile cases of internal control breakdowns and governance lapses clearly demonstrate that even in the case of larger entities with a sizeable in-house internal audit team, control deficiencies in high risk areas can remain undetected, resulting in a significant loss of money or corporate reputation.

Internal audit is traditionally used to review certain high risk or high value transactions to ensure compliance with policies and regulations, to investigate incidences of suspected fraud, or to improve efficacy of operations. The work of the internal audit and its findings can be a matter internal to the entity. However, in the context of a listed company, the internal audit function is indirectly relied upon by and may be material information that is required to be disclosed to the investing public. Therefore, to the extent that it sheds light and has an impact on the adequacy of the company's internal controls, the effectiveness of the internal audit function is no longer merely the company's internal matter but may be a matter of public interest. It is therefore important to have a framework (or best practice guide) in place to ensure the adequacy and accountability of the internal audit function. In particular, this framework should provide guidance for the scope of the internal audit, the quality of the persons in the team and the performance standards to be observed.

Essential elements

An "effective internal audit" for a listed company, whether in-house or outsourced and irrespective of the size of the company, should address internal controls over financial reporting and governance processes. The following is an example of the scope of work that should be performed:

- The first phase is to identify key business processes and cash or cash-like transactions within the listed company. These processes and transactions should be summarised and documented, updating them annually to reflect any changes in the company's business, processes and corporate and organisation structure. Management should provide written representation that it has provided all relevant information to the internal auditors for this purpose.
- The second phase is to ascertain whether management has implemented appropriate and adequate controls over these processes and cash or cash-like transactions.
- With this comprehensive understanding, the internal auditor can then analyse the risks to the organisation and identify key controls for testing. The testing of these key risk areas may be performed annually or by rotation, after consultation with the AC. However, key risk areas should be tested at least once every two to three years.
- The internal auditor should also perform an annual review of the state of the company's compliance with the principles and guidelines of the Code of Corporate Governance. Any deviations should be reported to the AC in its report.
- The board and board committees may also instruct the internal auditor to review other critical items or regulatory compliance issues from time to time.
- Annually, the internal auditor should sign off on this work scope and issue his reports to the AC and the board. No attestation or assurance on the figures is required from the internal auditor as the objective of this prescribed internal audit process is the identification of deficiencies for the AC and the board to act on.

The practice of internal auditing is guided by the International Professional Practices Framework ("IPPF"). The IPPF, which is issued by the Institute of Internal Auditors and adopted via Guideline 13.2 of the Code of Corporate Governance, provides authoritative guidance on internal auditing standards, practices and ethics.

Benefits

This proposed framework for the internal audit process and its elements differs from the requirements under the Sarbanes-Oxley Act ("SOX") in that companies are not required to follow the rigid 'one size fits all' form of the Committee of Sponsoring Organisations of the Treadway Commission ("COSO") framework when designing their internal control systems and are also not required to go through the costly SOX Section 404 reporting. As is so rightly pointed out in the King Code of Governance for South Africa 2009 (King III Report), "SOX - with all its statutory requirements for rigorous internal controls - has not prevented the collapse of many of the leading names in US banking and finance". In fact, unwarranted reliance on a Section 404 report might have distracted boards and regulators from exercising vigilance and scepticism while reviewing the accounts of these institutions.

Instead, the responsibility still rests with the AC and the board to address the issues raised by the internal auditor in his reports. This approach is consistent with the "comply or explain" regime of our Code of Corporate Governance. It also allows the AC the flexibility to direct the work of the internal auditor into specific risk areas from time to time, while maintaining an overall supervision of the company's internal controls over financial reporting and governance process.

It is more prescriptive than the King III Report so as to prevent companies from paying mere lip service to the internal audit requirement. While this framework should apply to all listed companies, smaller companies with less complex operations will find it much easier to comply than larger companies with diverse businesses, so the cost of the internal audit function should be proportionate with the size and complexity of the business.

Implementation

It is timely that CDAS (The Committee to Develop the Accountancy Sector) has recommended the development of a specialisation pathway in internal audit, including the development of professional qualifications, a job-specific competency framework, certification programme and a regional examination centre. This would address the qualifications, attributes and resource and talent elements as highlighted above. The Code of Corporate Governance is being revised and is perhaps timely for the Code to address the scope of internal audit elements as mentioned above.