

Making Internal Audit More Consistent While The Review Of Effectiveness Can Be Risk-Based, The Review Of Adequacy Should Not Be

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GUIDELINE 13.3 of the Code of Corporate Governance states: ‘The (audit committee) should ensure that the internal audit function is adequately resourced and has appropriate standing within the company.’

For the avoidance of doubt, the internal audit function can either be in-house, outsourced to a reputable accounting/auditing firm, or performed by a major shareholder, holding company, parent company or controlling enterprise with an internal audit staff.’

Guideline 13.4 states: ‘The (audit committee) should, at least annually, ensure the adequacy of the internal audit function.’

And Guideline 11.4(c) includes as one of the duties of the audit committee (AC) the review of the effectiveness of the company’s internal audit function.

Actual Performance

How actually do our listed companies satisfy these guidelines?

Most listed companies disclose in their annual report that:

- AC reviews and approves the internal audit plan.
- AC meets with the internal auditor to discuss the results of its examinations.
- AC discusses with the management the significant internal audit observations, together with the management’s responses and actions to correct any deficiencies.

- AC meets annually with the internal auditor without the presence of management.

Larger listed companies with an in-house internal audit department would usually include the following additional disclosures:

- The company has an internal audit charter.
- The AC reviews and approves the annual internal audit plans and manpower to ensure that the internal auditor has the necessary resources to adequately perform its functions.
- Some state that their internal auditor has a rolling three-year plan to comprehensively cover the company’s policies and procedures.
- Internal audit department recruits and employs suitably qualified staff with the requisite skills and experience.

Internal audit department adopts the standard of professional practice of internal audit set by the IIA.

Some even disclose the qualification of their head of internal audit.

- Internal audit staff is given relevant training and development opportunities to update their technical knowledge and auditing skills.
- Some companies disclose that they have both in-house and outsourced internal audit functions.
- Internal audit personnel adhere to a set of code of ethics adopted by the Institute of Internal Auditors (IIA).
- Internal audit department adopts the standard of professional practice of internal audit set by the IIA.

All companies conclude that they have adequate and effective internal audit functions. But is this really the case or have they merely ticked the right boxes? In this regard, it is interesting to note that the IIA's Standards Exposure Draft issued on Feb 15, 2010 has a new Standard 2070 that states: 'When an external service provider serves as the internal audit activity, the provider must make the organisation aware that it has the responsibility for maintaining an effective internal audit activity.'

This new standard is probably meant to address the inadequacies resulting from the current pervasive practice of piecemeal internal audit engagements. The buck is passed back to the company's directors.

Resources Factor

One often-drawn conclusion is that the adequacy and effectiveness of the internal audit function depends on the financial resources of the company and the size and quality of their in-house or outsourced internal auditors. Some recent cases, however, would suggest that even some of our biggest companies or

organisations have not been spared the embarrassment of fraud cases although they may have better internal audit resources than most.

Effective internal controls require the conscientious collective effort of all key players; the right tone from the top; competent finance professionals to design, implement, enforce and monitor the operations of an appropriate system of internal controls; an integrated strategic financial management framework encompassing business planning, budgeting, forecast, analysis, reporting and a deviation approval mechanism; the integrity and honesty of everyone in the organisation; and effective policing by the internal and external auditors. But specifically, how can the internal audit function adequately and effectively contribute to the process?

Guideline 13.2 states: 'The internal auditor should meet or exceed the standards set by nationally or internationally recognised professional bodies including the Standards for the Professional Practice of Internal

Auditing set by The Institute of Internal Auditors.'

But that is a long 19-page technical document. How does the AC verify that the internal auditors have met or exceeded the standards? From reviewing annual reports of listed companies, some of the key standards that have not been consistently applied are:

- Standard 1000: 'The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.'
- Standard 2010: 'The chief audit executive must establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organisation's goals.' And Standard 2010.A1: 'The internal audit activity's plan of engagement must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.'
- Standard 2060: 'The chief audit

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Therefore, in order to ensure consistency in the quality of the internal audit function, whether it is in-house or outsourced, we should consider stating more explicitly in the Code of Corporate Governance some of the specific duties of the internal audit function.

executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board.'

Therefore, in order to ensure consistency in the quality of the internal audit function, whether it is in-house or outsourced, we should consider stating more explicitly in the Code of Corporate Governance some of the specific duties of the internal audit function. Here are some examples.

- The chief internal auditor (either in-house or outsourced) shall prepare an appropriate Internal Audit Charter which shall be approved and periodically reviewed by the board.
- The chief internal auditor should conduct an annual risk assessment of the company's processes and internal controls in the preparation of the annual internal audit plan.
- The chief internal auditor should report annually to the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks and governance issues and other matters requested by the board.

Other Reviews

There are other areas of the Code which should also be reviewed to ensure consistency. For example, Guideline 12.1 says that the AC should ensure that a review of the effectiveness of the company's internal financial controls, operational and compliance controls, and risk management policies and systems established by the management (collectively, 'internal controls') is conducted at least annually. This is a broad statement which may be difficult to comply with in practice as the review of internal controls is usually done on a rotational basis over different business units or sectors within the group, and over, say, a period of three years pursuant to the internal audit plan. This means that, subject to risk assessment, only a specific part of the group's internal controls is reviewed and focused on each year, such that the review is only

complete when the three-year cycle concludes.

In summary, irrespective of the size of the listed company and whether the internal audit function is in-house or outsourced, the required standards of the internal audit function should be the same and consistently applied. While the review of the effectiveness of internal controls is an important function of the internal audit, it is more critical for internal audit to conduct a comprehensive (as opposed to the so-called 'risk-based') review, and monitor the changes of the company's business and financial processes and control environments to ensure that management has installed appropriate and adequate systems of internal controls.

And while the review of effectiveness can be risk-based, the review of adequacy should not be. This is because the review by the external auditors is already risk-based, and if the review of adequacy by the internal auditors is also risk-based, many of the company's systems and processes may fall under the radar by being 'risk-screened' out and thus not be documented or reviewed at all. The danger is that these may later become the source of problems as we have seen in many cases.

