Corporate Trends

Turning Knowledge Into Value | Issue 02 / July 2004

INTERNAL AUDIT'S ROLE IN CURRENT CORPORATE GOVERNANCE

Recent events have highlighted the critical role of boards of directors in promoting good corporate governance. In particular, boards are being charged with ultimate responsibility for the adequacy and integrity of their organizations' internal control system.

An "if not, why not" disclosure is required if a public listed company does not have an internal audit function.

An effective internal audit function plays a key role in assisting the board to discharge its governance responsibilities. In Malaysia, the *Statement on Internal Control Statement: Guidance for Directors of Public Listed Companies* ('ICG") issued in February 2001 echoes the Bursa Malaysia's Listing Requirements in requiring an "if not, why not" explanation on the existence of an internal audit function in the public listed company. Essentially, disclosure is required in the audit committee report to be furnished in the annual report where an internal audit function does not exist in the company, with reasons why this function has not been put into place. [1]

The internal audit function supports the audit committee, which is a committee of the board of directors, to evaluate and improve the effectiveness of risk management, control and governance processes. Yet how does the board – and its audit committee – satisfy itself that internal audit is functioning effectively and efficiently?

The board's responsibility for internal controls

Through working with a broad range of organizations in Malaysia and internationally, KPMG has identified a number of best practices in relation to the role played by the board audit and/or risk management committees.

- Assessing the scope and effectiveness of the systems established by management to identify, assess, manage and monitor the various risks arising from the organization's activities.
- Ensuring senior management establishes and maintains adequate and effective internal controls.
- Satisfying itself that appropriate controls are in place for monitoring compliance with laws, regulations, supervisory requirements and relevant internal policies.
- Monitoring and reviewing the effectiveness of the internal audit function.
- Reviewing and assessing the internal audit plan and its progress.
- Ensuring that the internal audit function is adequately resourced and enjoys appropriate standing within the organization.
- Considering management's response to major internal audit recommendations and progress in their implementation.
- Approving the appointment of dismissal of the head of internal audit.

[1] Refer to paragraph 54 of the ICG and paragraph 15.16(3)(e) of the Bursa Malaysia Listing Requirements.

IN THIS ISSUE

Internal audit assists the board discharge its corporate governance responsibilities

Corporate governance developments both in Malaysia and internationally have reaffirmed the board's responsibility for ensuring the adequacy and integrity of their organization's internal control framework.

These developments have highlighted the key role that internal audit can play in supporting the board in ensuring adequate oversight of internal controls and in doing so form an integral part of an organization's corporate governance framework.

The key role of internal audit is to assist the board and/or its audit committee in discharging its governance responsibility by delivering:

The structure and reporting lines adopted for the internal audit function should promote independence, objectivity, consistency and business understanding.

- A review of the organization's control culture, especially the "tone at the top".
- An objective evaluation of the existing risk and internal control framework.
- Systematic analysis of business processes and associated controls.
- Reviews of the existence and value of assets.
- A source of information on major frauds and irregularities.
- Ad hoc reviews of other areas of concern, including unacceptable levels of risk.
- Reviews of the compliance framework and specific compliance issues.
- Reviews of operational and financial performance.
- Recommendations for more effective and efficient use of resources.
- Assessments of the accomplishment of corporate goals and objectives.
- Feedback on adherence to the organization's values and code of conduct/ code of ethics.

However in attempting to adequately discharge their responsibilities, internal auditors often find themselves in an anomalous position. They report to senior management within the organization, yet are expected to objectively review management's conduct and effectiveness. The only satisfactory solution to this problem is for internal audit to report primarily and directly to the board and its audit committee rather than to senior management.

The remainder of this discussion paper considers why this is a desirable step if the board is to strengthen its supervision of internal control systems, and suggests how it might be achieved.

Governing internal audit

Amidst all the debate over corporate governance and the board's supervision of internal control mechanisms, surprisingly little attention has been given to the role of internal audit, and particularly to whom it is ultimately responsible.

While several high level reviews by regulators and others have acknowledged that the internal audit function and the oversight of internal controls has become an important responsibility of boards, the implications of this for internal audit have not always been followed through. Thus in the US, the Sarbanes-Oxley Act of 2002 makes no mention of internal audit, or of any equivalent role other than the board's role generally in the preparation of the accounts and the setting of accounting standards.

Critical success factors for an internal audit function

Is internal audit strategically positioned to contribute to business performance?

- The mission and role of internal audit are defined within a wider governance framework and are effectively communicated.
- The structure of internal audit promotes objectivity, consistency and business understanding.
- Internal audit is funded in a way that promotes objectivity and consistency in the quality of services it provides across the organization.
- Internal audit contributes value to the business as defined by appropriate success criteria.

Are internal audit's processes enabling and dynamic in meeting business needs?

- Internal audit has a strong risk identification and planning methodology and delivers a high quality service.
- Technology is used appropriately to enhance the provision of internal audit services.
- An appropriate framework is in place to measure internal audit's performance.
- Internal audit develops and manages appropriate relationships with its key stakeholders.

Does internal audit have the right people strategy to deliver its mission/objectives?

- Internal audit's core competencies are directly related to its mission, role and required competencies
- The strategy is sufficiently flexible to respond to changes in mind.

In the UK, the report by Sir Robert Smith on the Combined Code Guidance for Audit Committees (*the Smith Report*) states that "…management is responsible for the identification, assessment, management and monitoring of risk, for developing, operating and monitoring the system of internal control, and for providing assurance to the board that it has done so – except where the board is expressly responsible for reviewing the effectiveness of the internal control and risk management systems."[2]

In Malaysia, the Malaysian Code on Corporate Governance (the MCCG) recommends that the internal audit function "…should be independent of the activities they audit…" and then goes on to state that the "board of the audit committee should determine the remit of the internal audit function."[3] While the reporting lines for the internal audit is not specifically described in the MCCG, the *Guidelines on Internal Audit Function* applicable to public listed companies in Malaysia recommend that "the internal audit function should report to the audit committee and be appropriately positioned within an organisation for it to operate effectively."[4]

If we look to the financial services industry, we also find that the Basel Committee makes no distinction in its guidelines as to the natural reporting line for the internal audit function except to note that "…the principle of independence entails that the internal audit department operates under the direct control of either the organisation's CEO or the board of directors or its audit committee".[5]

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2 Smith, Sir Robert; "Audit Committees Combined Code Guidance", January 2003.
3 Malaysian Code on Corporate Governance; March 2000.
4 The Institute of Internal Auditors Malaysia; "Guidelines on Internal Audit Function", July 2002.
5 Basel Committee on Banking Supervision; "Internal Audit in Banks and the Supervisor's Relationship with Auditors", August 2001.

Before deciding the reporting lines for internal audit, it is critical to consider the fundamental distinction between the respective roles of the board (oversight) and management (decision making and the execution of those decisions). Key activities which fall within the definition of effective oversight include listening, asking questions, assessing and challenging answers. In many respects this is exactly what an effective internal audit function does.

The structure and reporting lines adopted for the internal audit function should promote independence, objectivity, consistency and business understanding. This can be achieved by combining the concept of a clear reporting line to the board/ audit committee with an organisational structure that allows internal audit to operate independently of other functions within the organisation.

Effective reporting lines for internal audit

KPMG believes that the internal audit function should report functionally to the audit committee, recognising that on a day-to-day basis it should report administratively to the CEO of the organisation.

The Institute of Internal Auditors also suggests that regardless of the reporting relationship the organization chooses, there are key measures that will ensure that the reporting lines support and enable to effectiveness and independence of the internal audit function.[6] These key measures are summarised below:

- The head of internal audit should meet privately with the board/audit committee without the presence of management. This will reinforce the independence and direct nature of the reporting relationship.
- The board/audit committee should have the final authority to review and approve the annual audit plan and all major changes to the plan.
- The board/audit committee should review the performance of the head of internal audit and the overall internal audit function at least once a year, as well as approve the compensation levels for the head of internal audit.
- The charter of the internal audit function should clearly articulate both the functional and administrative reporting lines for the function as well as its principal activities.
- The reporting line should be to someone with sufficient authority to provide internal audit with sufficient support to accomplish its day-to-day activities.
- The reporting line should facilitate open and direct communications with the CEO, the senior executive group and line management.
- The reporting line should enable adequate communications and information flows so that internal audit receives adequate and timely information concerning the activities, plans and business initiatives of the organisation.
- Budgetary controls and considerations imposed by the administrative reporting line should not impede internal audit in accomplishing its brief.

Independence guidelines for internal audit

When considering the reporting lines for internal audit it is prudent to keep the following independence guidelines in mind:

- The internal audit function must be independent of the activities being audited and must also be independent from everyday internal processes.
- The internal audit department must be able to exercise its assignment on its own initiative in all departments, establishments and functions of the organisation.
- Internal audit must be free to report its findings and appraisals and to disclose them internally.
- The head of the internal audit department should have clear authority to communicate directly on his or her own initiative to the board, the chairman of the board, or the chairman and members of the audit committee.

6 The Institute of Internal Auditors, “ Practice Advisory 1110-2: Chief Audit Executive Reporting Lines”, December 2002.

Benefits and challenges of internal audit reporting directly to the board audit committees

Benefits	Challenges
Ability to transcend all departments without fear of limitation of scope by being tied to, for example, the finance department. The board and audit committee know that the information they are receiving on the internal controls and risk management systems reflects a true description and has not been “watered-down” or filtered by management beforehand. The independence of the internal audit function is absolute. The funding of the internal audit function is outside the normal process of budgeting thereby allowing resources to be allocated by the assurance needs of the organisation as assessed by the board/audit committee. Enables the board/audit committee to directly and critcally analyse and evaluate the internal audit function in its contribution to the fulfillment of the board’s responsibility for internal controls. Reinforces the board/audit committee’s knowledge of the business and its risk profile when dealing with management and stakeholders.	Internal audit may not be privy to all sources of information throughout the company if seen as “outside” the management structure. The chairman of audit committee may not have allocated sufficient time, or have adequate resources/ capacity to deal with he oversight of the internal audit function. It would be necessary to set up a specific charter outlining the roles and responsibilities of the board in relation to internal audit, as separate from management. For example, who would look after the HR administration, including personnel evaluations, compensations and career planning for the head of internal audit? The audit committee would be assuming more responsibility and therefore, perhaps, more liability in relation to the adequacy of the internal control and risk systems of the organisation. Potentially restricts the ability of the CEO to use internal audit as a tool to reinforce control principles, or in special projects.

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