Effectiveness of an internal audit function

**MCCG Intended Outcome 10.0**
Companies have an effective governance, risk management and internal control framework and stakeholders are able to assess the effectiveness of such a framework.

**MCCG Practice 10.1**
The Audit Committee should ensure that the internal audit function is effective and able to function independently.

**MCCG Practice 10.2**
The board should disclose:

- whether internal audit personnel are free from any relationships or conflicts of interest, which could impair their objectivity and independence;
- the number of resources in the internal audit department;
- name and qualification of the person responsible for internal audit; and
- whether the internal audit function is carried out in accordance with a recognised framework.

(The application of Practice 10.2 of MCCG in its entirety entails the disclosure of the following four elements by the board:

- **whether internal audit personnel are free from any relationships or conflicts of interest, which could impair their objectivity and independence;**
- **the number of resources** in the internal audit department;
- **name and qualification of the person responsible for internal audit;** and
- **whether the internal audit function is carried out in accordance with a recognised framework.**)

⚠️ The internalisation and application of the content “Why” and “How” should be read in tandem with the line of sight outlined by the Intended Outcome.

**The case for change**

An internal audit function helps a company to accomplish its goals by bringing an objective and disciplined approach to evaluate and improve the effectiveness of **risk management**, **internal control** and **governance** processes. The internal audit function is essentially the “eyes and ears” of the audit committee, serving as a sounding board on deficiencies in the aforementioned areas and providing advice on the remedial measures to be meted out by the company.
Point for reflection

The internal audit function has changed considerably over time to meet the challenges of modern economy and the complexities of business. Stakeholders are increasingly looking to the internal audit function for insights regarding the future and to provide advisory services early in the life cycle of business initiatives.

A global survey titled “Evolution or irrelevance – internal audit at a crossroads” which was conducted by Deloitte in 2016 revealed that 55% of Chief Internal Auditors expect the proportion of advisory services rendered by internal auditors to expand over the next three to five years.

Internal auditors are now deploying enhanced methodologies such as predictive risk analysis and advice on risk mitigation in the planning stages of a business initiative. This is expected to deliver more value rather than noting what management could have done differently after the initiative has been launched or completed.

Given the significance of this function in safeguarding a company against weaknesses in risk management, internal control and governance, a facilitative environment should be created to enable the internal audit function to carry out its responsibilities in an effective manner.

To this end, the need for listed issuers to establish an internal audit function and the responsibilities of the audit committee in overseeing the effectiveness of this function are well-codified in Bursa Securities Listing Requirements.

Paragraph 15.27 of Bursa Securities Listing Requirements

Internal audit

(1) A listed issuer must establish an internal audit function which is independent of the activities it audits.

(2) A listed issuer must ensure its internal audit function reports directly to the audit committee.

Paragraph 15.12(1)(e) and (f) of Bursa Securities Listing Requirements

Without limiting the generality of paragraph 15.11 above, a listed issuer must ensure an audit committee, amongst others, discharges the following functions:

(1) review the following and report the same to the board of directors of the listed issuer:

   e) the adequacy of the scope, competency and resources of the internal audit function and that it has the necessary authority to carry out its work; and

   f) the internal audit plan, processes, the results of the internal audit assessments, investigation undertaken and whether or not appropriate action is taken on the recommendations.

Note: Only requirements pertaining to internal audit function are extracted from the said Paragraph.

1 Requirement for audit committee to have written terms of reference
Similar provisions are also encapsulated for financial institutions in Bank Negara Malaysia’s Policy Document on Corporate Governance. For example, Appendix 1 of the said document requires audit committees of financial institutions to oversee the effectiveness of the internal audit function in relation to its scope, procedures and frequency, key audit reports, disagreements between the chief internal auditor and the senior management team as well as the performance evaluation of the function. Note: Detailed supervisory expectations on an effective internal audit function are outlined in the Guidelines on Internal Audit Function for Licensed Institutions 2010 issued by Bank Negara Malaysia.

Recognising that the value of internal audit lies in the objectivity of its process and the trust that has been placed on this function by stakeholders, regulators have also enumerated prescriptions to enhance transparency in this regard. It is therefore important for companies to appreciate that the disclosed information serves as the basis for constructive dialogue with stakeholders.

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<tr>
<th>What could go wrong:</th>
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<td>• Key control failures and potential fraud issues are unsurfaced.</td>
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<td>• Internal audit personnel succumb to pressure from management to reconsider audit issues and to make them more “user friendly”, thus, diminishing the actual level of risk that the company is exposed to.</td>
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<td>• Limitation on the scope of internal audit (e.g. excluding the coverage of managing director or chief executive officer’s office from the scope of the audit).</td>
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<td>• Lack of co-ordination between the internal auditors and external auditors which leads to gaps in the audit coverage.</td>
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<td>• The internal audit work performed is not sufficiently responsive to changes in business strategies and risk profile of the company.</td>
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<td>• Corrective actions recommended by the internal audit function are not acted upon and addressed in a timely manner by management.</td>
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**Paragraph 15.15(3)(e) of Bursa Securities Listing Requirements**

The audit committee report must include a summary of the work of the internal audit function.

**Paragraph 30, Part A, Appendix 9C of Bursa Securities Listing Requirements**

The contents of an annual report must include a statement relating to the internal audit function of the listed issuer, i.e. whether the internal audit function is performed in-house or is outsourced and the costs incurred for the internal audit function in respect of the financial year.
The practice in substance

In order for the internal audit function to provide objective assurance on the quality of a company's risk management, internal control and governance processes, it is imperative to ensure that this function is well-equipped to deliver the depth and quality of the work that is expected of it.

Key considerations relating to the application of these Practices (Practices 10.1 and 10.2 of MCCG) are discussed below:

What are the key activities undertaken by an internal audit function?

It is the responsibility of the audit committee to decide on the remit of the internal audit function including its objectives and activities. The internal audit function is normally involved in carrying out the following:

- a review and objective evaluation of the governance, risk and control environment of the company and entities across the group;
- a systematic analysis of business processes to identify the associated controls in place;
- an assessment of how information on fraud and irregularities is reported including providing feedback on adherence to the company's code of conduct and/or code of ethics;
- ad-hoc reviews of other areas where there is a concern that affects financial reporting or a threat on the safeguarding of the company’s assets;
- reviews of the compliance framework and specific compliance issues;
- follow-up visits to determine the status of management implementation of plans to address observations reported in preceding internal audit visits; and
- value-added recommendations for more effective and efficient use of resources within the company.

Dos

✓ Establishing an internal audit charter to set forth the purpose of the internal audit function, its responsibilities and the necessary authority that it has been conferred with to carry out its work.
✓ Formalising the qualifications and competencies that are expected of those carrying out the internal audit work.
✓ Establishing platforms for external auditors and internal auditors to communicate and co-ordinate.
✓ Keeping close tabs on the resignation of internal auditors so as to ascertain if it is indicative of broader issues.

Don’ts

× Disclosing adherence to a professionally recognised internal audit framework when the company only adopted a minimal number of standards or practices encapsulated in the said framework.
× Maintaining that an outsourced internal audit provider’s confirmation on independence and other regulatory requirements is the be-all and end-all.
What are the key attributes of an effective internal audit function?

The salient characteristics which are commonly exhibited by an effective internal audit function are outlined below:

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<th>Attribute</th>
<th>Description</th>
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<td><strong>Objective and free from undue influence</strong></td>
<td>Internal audit personnel should be able to exercise objectivity by being free from conflicts of interest or the undue influence of others that will override professional and business judgment. In order to preserve the independence of this function, the head of internal audit should report directly to the audit committee. The audit committee should also be responsible for deciding on the appointment and removal as well as the performance evaluation and remuneration of those in the internal audit function.</td>
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<td><strong>Adequately resourced</strong></td>
<td>The internal audit function should be resourced with adequate manpower and supporting infrastructure, such as auditing tools and knowledge repositories. The resources and budget allocated should be proportionate with the envisaged extent and complexity of the audit work, in line with the company’s size and circumstances. The audit committee should ensure that internal audit personnel, particularly the head of internal audit, is competent to carry out the work.</td>
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<td>** Appropriately positioned**</td>
<td>The internal audit function should be appropriately positioned within the company to be recognised as an authoritative voice. In this regard, as highlighted in Guidance to Practice 10.1 of MCCG, the audit committee should ensure that the head of internal audit has sufficient standing and authority to discharge his or her functions effectively. The function should be accorded with unrestricted access to the necessary information, records, physical properties and personnel to perform its agreed-upon objectives and responsibilities.</td>
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<td><strong>Aligned with the strategies and risks of the company</strong></td>
<td>The internal audit coverage should be tailored in response to changes in the company’s business, risks and operations. The evaluation performed by the internal auditor should be contextualised to the business and industry, identify root-causes of issues and offer new insights with a consideration of the future impact.</td>
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What are the key factors that should be taken into account in evaluating the capability and adequacy of resources of the internal audit function?

In evaluating the resources of the internal audit, due cognisance should be given (as a minimum) to the aspects of people and process.

As mentioned above, the quality of the people (i.e. internal audit personnel) should reflect the extent and complexity of internal audit coverage. This would, amongst others, entail:

- the relevant academic and professional accreditation;
- the experience that is crucial to enable them to carry out internal audit work;
- reasonably strong interpersonal skills in discussing with the auditee and writing reports, articulating issues in no uncertain terms;
- maturity of the personnel in engaging with management on contentious issues encountered when carrying out the internal audit projects; and
- the ability to provide recommendations that are not only practical for implementation but also take into consideration the “cost-benefit” aspects of the suggestions.

In terms of process, the evaluation should focus on how structured and robust is the approach deployed by internal audit personnel in achieving the internal audit objective. Internal audit plans should be clear and objective enough to enable the personnel to execute the work procedures and to obtain as well as evaluate the audit evidence for reliability and sufficiency.

Note: A sample exhibit outlining a checklist to evaluate the internal audit function is provided in Appendix VII of this Pull-out.

Should an internal audit function be conducted in-house or outsourced?

Companies may choose to have an in-house internal audit function or outsource it, depending on the circumstances of the company.

It is commonplace for audit committees to consider outsourcing the internal audit work when there is a lack of specialised expertise to carry out the audit. For example, an in-house internal audit function may not have the appropriate information technology skills to conduct an audit of information technology systems, thus necessitating the need to commission specialised information technology auditors to perform the necessary audit work.

In the event the audit committee decides to outsource the internal audit function, it is pertinent that the audit committee assesses the remit of the outsourced internal audit provider to ensure that relevant criteria, such as independence, qualification, skills and experience, adequacy of resources and remuneration have been considered for the work to be carried out effectively.

2 The standards are principle-focused and outline statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of the internal audit function.

3 References to outsource includes outsourcing in full or in part (“co-source”).
Key considerations in outsourcing the internal audit function:

- assessment of outsourcing risks (e.g. contracts and confidentiality agreements including any sub-contracting arrangements);
- scope of internal audit work to be outsourced;
- service provider selection process including the independence, qualification, skills and experience, as well as knowledge;
- adequacy of resources deployed and remuneration of the outsourced service provider;
- internal audit framework adopted by the outsourced service provider;
- roles and responsibilities of the outsourced service provider;
- access to information, records, physical properties, and personnel as well as the reporting workflow; and
- effectiveness of the internal audit service rendered by the outsourced service provider and continuity of such service (for subsequent outsourcing arrangements).

How do the disclosures in relation to “number of resources” and “person responsible for internal audit” (in Practice 10.2 of MCCG) vary for an outsourced function vis-à-vis an in-house function?

Disclosure on “number of resources” and “person responsible for internal audit” should be made in the manner set out below.

If the function is conducted in-house, disclosure shall include:

- name and qualification of the head of internal audit; and
- number of resources (number of personnel in the internal audit department).

or

If the function is outsourced, disclosure shall include:

- name of the outsourced service provider/external firm;
- name and qualification of the lead individual in charge of the engagement (from the outsourced service provider/external firm); and
- number of resources deployed by the outsourced service provider/external firm for the said engagement.

As for partially outsourced (co-sourced) internal audit engagements, a more prudent approach can be adopted by providing disclosure on both the name and qualification of the head of internal audit as well as that of the lead individual in charge of the engagement from the outsourced service provider/external firm. A statement should also be made on the nature of work that is outsourced.

The illustrative disclosure on the following page outlines an example with regards to the following (in-house internal audit function):

- name and qualification of the head of internal audit (note: experience of the said individual was also provided); and
- number of resources (note: general description of their qualifications was also provided).
Illustrative disclosure (in-house internal audit function)

Disclosure on the name and qualification of the head of internal audit:

**Ms. Say Nee** was appointed as the Acting Head of Internal Audit of Singapore Press Holdings Limited (“SPH”) in October 2014. She subsequently took over as Division Head in April 2015.

Ms. Say Nee has been with the Division for 10 years, having joined in October 2005. Say Nee’s 15 years of experience in the profession spanned across both public and commercial sectors. She began her career in the Auditor-General’s Office in 2000, where she was involved in the financial audit and system controls review at the Ministry of Manpower and Central Provident Fund Board, after graduating from Nanyang Technological University with a Bachelor of Accountancy degree. She was an Internal Auditor with United Engineers Ltd before joining SPH.

Disclosure on the number of resources:

**IAD** is staffed by nine audit executives, including the Head of Internal Audit. Most of the IAD staff have professional qualifications, and are members of the Institute of Internal Auditors, Inc. (“IIA”). Some are qualified IT auditors and/or Certified Fraud Examiners.

Source: Annual Report of Singapore Press Holdings Limited for the financial year end 31 December 2015

In addition to the number of resources in the internal audit department and the name and qualification of person responsible for internal audit, boards should also disclose the following elements as stated in Practice 10.2 of MCCG:

- whether the internal audit personnel are free from any relationships or conflicts of interest, which could impair their objectivity and independence (e.g. annual confirmation by the head of the internal audit to the audit committee on the objectivity and independence of the internal audit function); and
- whether the internal audit function is carried out in accordance with a recognised framework (e.g. IPPF).

Is there a distinction in disclosure requirement for the cost of internal audit [paragraph 30, Part A, Appendix 9C of Bursa Securities Listing Requirements] when the internal audit is outsourced as opposed to being conducted in-house?

The cost is to be disclosed regardless of whether the internal audit function is performed in-house or outsourced. Such cost should include all costs involved in performing the internal audit function, including but not limited to salary of personnel, overhead expenses (e.g. expenses on training and knowledge repositories) and other ancillary expenses incurred.

What should a disclosure on the summary of the work of the internal audit function [paragraph 15.15(3)(e) of Bursa Securities Listing Requirements] include?

In providing disclosures on the summary of activities performed by the internal audit function, companies should provide meaningful insights into the actual areas that were audited during the financial year and how internal audit performed its function. A mere statement that the “internal audit function has reviewed the state of internal control of various operating cycles within the company” would not be particularly useful for stakeholders.
The “Analysis of Corporate Governance Disclosures in Annual Reports” performed by Bursa Malaysia in 2016 across 280 listed issuers has identified the following elements (non-exhaustive) which were encapsulated in the annual reports of listed issuers that exhibited good disclosures in this regard:

- number of internal audit assignments completed during the year and a statement as to whether these were aligned to the audit plan;
- specific areas that were audited such as finance, sales, marketing and procurement, with details of the specific aspects audited;
- a statement or discussion that the scope of internal audit engagements were aligned with the companies’ risk management profile (i.e. the audited areas were identified as key risk areas);
- a statement or discussion that the internal audit’s reports were deliberated at the senior management level and that action plans were put in place to complete the necessary preventive and corrective actions;
- a statement or discussion that the internal audit’s findings and management’s responses were tabled to the audit committee to ensure that management undertakes the agreed remedial actions;
- detailed breakdown of data to show how many internal audit personnel were involved in specific areas audited; and
- analysis of the variations in the internal audit costs or fees with explanations.

Regional/international perspectives

Premised on the importance of a robust internal audit process, many jurisdictions have enumerated provisions for public listed companies to establish an internal audit function with the audit committee being responsible for immediate oversight of this function. As in the case of Malaysia, selected jurisdictions such as Singapore have also provided emphasis on the adoption of professional recognised standards in carrying out this function.

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<tr>
<th>Country</th>
<th>Provision(s)</th>
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<td>Singapore</td>
<td>The Internal Auditor should carry out its function according to 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 (IIA) <em>(Guideline 13.4).</em></td>
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