



A GUIDE TO MEETING YOUR OBLIGATIONS UNDER ASX CGC RECOMMENDATION 7.3 - A GUIDE FOR FIRST TIME ADOPTERS

KEY POINTS

The ASX Corporate Governance Principles and Recommendations were updated in March 2014 and include specific recommendations on internal audit (recommendation 7.3).

This paper answers frequently asked questions for first-time adopters on how to respond and make best benefit from the changes in relation to internal audit.



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1. WHAT IS REQUIRED?

On 27 March 2014, The Australian Securities Exchange Corporate Governance Council (ASX CGC) released the 3rd edition of its Principles and Recommendations.

Under the ASX listing rules, listed entities are required to actively consider each of the Principles and Recommendations, and disclose how they comply with each recommendation, or if another practice is taken, what that practice is, and why that alternative practice is considered to be appropriate (known as the “if not, why not” approach).

The 3rd edition contains a new recommendation (7.3, which is part of the overall Principle 7 “Recognise and Manage Risk”) that requires each listed entity to disclose:

- a. if it has an internal audit function, how the function is structured and what role it performs; or
- b. if it does not have an internal audit function, that fact and the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes.

All listed entities are required to report against the revised recommendations for full financial years from 1 July 2014 onwards.

2. WHAT DO WE NEED TO DO?

If an entity does not already have an internal audit function, the Board should review this carefully, respond appropriately and be prepared to disclose that response. Entities can choose to:

- a. put an internal audit function in place, and describe its structure and role;
- b. put alternative arrangements in place that aims to deliver an equivalent outcome;
or
- c. choose not to adopt the recommendation, and explain their rationale to the market under the “if not, why not” approach.

Option A (internal audit) will be the preferred option for most entities and is the focus of this fact sheet.

Option B may be appropriate in some circumstances.

Option C is likely to only be appropriate for the smallest entities.

Boards of entities that are considering options B or C will need to satisfy themselves that:

- The costs of other options outweigh the likely benefits;

- The board is comfortable with the risks arising from not implementing other options; and
- The board is comfortable disclosing and explaining this decision to the market.

Entities that have an established Internal Audit function are advised to refer to the separate IIA–Australia publication *A Guide to Reporting under ASX CGC Recommendation 7.3*. This is available free of charge from www.iaa.org.au.

3. WHAT DO WE NEED TO DISCLOSE?

All listed entities are required to report against the revised recommendations for full financial years commencing on or after 1 July 2014.

Recommendation 7.3 requires organisations to disclose whether they have an internal audit function or explain why not and what they have as an alternative.

The recommendation also requires disclosure of key attributes where an internal audit function is in place. These disclosures will deal with key matters of scope (role) and independence (structure).

Model disclosures are available Australia in the separate IIA–Australia publication *A Guide to Reporting under ASX CGC Recommendation 7.3*.

4. WHAT IS INTERNAL AUDIT?

Internal auditing is an independent, objective assurance and consulting activity. It brings a systematic, objective and disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes.

A well-structured and appropriately resourced internal audit function can be a catalyst for improving an organisation's governance, risk management and internal controls by providing insights and recommendations based on analyses and assessments of controls, data and business processes.

Internal audit gives the Board and management comfort that:

- the entity's key risks are being managed;
- controls are appropriate and operating effectively; and
- known deficiencies are known and being acted on.

5. WHY WOULD WE WANT AN INTERNAL AUDIT FUNCTION?

Boards and management can derive significant value from internal audit. An internal audit function can provide the Board and management with:

- Independent and objective opinions, findings and recommendations;

- A systematic and disciplined approach to focus on what matters most, timely escalation of issues found and follow through to issue resolution;
- Comfort on the adequacy and effectiveness of the entity’s governance, risk management and internal controls;
- Confidence that the entity complies with all relevant laws and regulations; and
- Recommendations on the effectiveness and efficiency of operations.

The need for internal audit is typically triggered when the Board or management does not have a full and direct line of sight into the key areas of the organisation, or the expertise to assess them fully. This is typically triggered by factors such as:

- Senior management being unable to be fully familiar with the detail due to the entity’s size, complexity or locations;
- Non-executive directors requiring additional comfort over the key areas of the business that is independent from management; or
- Technical areas such as compliance, fraud prevention, cyber-security that would benefit from independent expert review.

6. WHAT WOULD INTERNAL AUDIT DO?

Internal auditors provide the Board and management with a mechanism to systematically review and assess of the adequacy and effectiveness of the entity’s processes, systems and operations.

Typically an internal audit function’s activities are performed in four steps – plan, execute, report and follow up.

PLAN

Internal audit works with the Board and management to identify areas of greatest exposure, and those where greatest assurance is sought. Using a structured process, Internal Audit would present recommendations on areas for review during a given period in the form of an “audit plan”. The audit plan is typically set with a 12 month horizon, although it should be periodically reviewed and refreshed as circumstances change.

EXECUTE

The audit plan would contain a number of areas, which would typically be addressed as individual audit projects. In the execution of an audit project, the internal audit team would form a view of the adequacy and effectiveness of processes and internal controls. It would perform detailed work to give comfort that key areas are working as intended and identify any deficiencies.

REPORT

Internal audit would report and escalate any findings and conclusions as appropriate. Findings and management response plans would be agreed with management and reported through to the Board or relevant Board committee. As well as reporting the



results of individual audits, Internal Audit will normally provide summary reporting to allow a “bigger picture” of the entity’s controls and risk exposures to be developed.

FOLLOW UP

Internal audit would work with management to track progress to address any deficiencies identified in previous audits and ensure that these are resolved on a timely basis and in full.

7. KEY ATTRIBUTES OF AN INTERNAL AUDIT FUNCTION

Internal Audit has a number of attributes that are set out in the *International Standards for the Professional Practice of Internal Auditing*.

An effective internal audit function should:

- Evaluate and improve the governance, risk management and internal control processes using a systematic and discipline approach as set out above in section 6 – “What would Internal Audit do?”
- Be objective and independent of management as set out in section 14 below – “How can I be assured that internal audit is independent of management?”
- Have direct access to the Board or Board Audit Committee to discuss the plan and any findings or concerns the internal auditor may have.
- Have access to all entity’s activities, records, premises and personnel as necessary to discharge its responsibilities.
- Be compliant with the *International Standards for the Professional Practice of Internal Auditing*.

If the function does not meet these key attributes, then it does not meet the generally accepted definition of internal audit. In this case, entities should carefully consider the basis on which they state they are compliant with Recommendation 7.3, as such statements could be misleading.

8. WHAT CAN WE EXPECT FROM INTERNAL AUDIT?

A board audit committee and management should have high expectations of internal audit. If internal audit is appropriately resourced and supported by the Board, it should:

- Provide independent and objective assessments and opinions on the most important areas of the business;
- Follow a systematic and disciplined approach to focus on what matters most;
- Provide independent assurance on the adequacy and effectiveness of the entity’s governance, risk management and internal controls and deliver confidence that the entity complies with relevant laws and regulations;
- Provide commercially focused recommendations that improve the organisation’s internal control and performance; and

- Operate professionally, with high competence and integrity.

WHAT INTERNAL AUDIT CANNOT DO

There are some limitations on what internal audit can do.

- Business decisions – Internal audit cannot make business operating decisions (except for those necessary for the operation of the internal audit function itself).
- Risk management – Internal audit does not manage the risks of the organisation as this is a role for management.¹
- Fraud – While internal audit will be alert to the risk of fraud, it cannot prevent or detect all fraud in the organisation.
- Coverage – Internal audit focuses on areas of greatest need, and typically would aim to cover all key areas over a 3-5 year cycle. It cannot cover all areas every year as the cost of doing so would likely to be prohibitive.
- Reasonable but not absolute assurance – All audit procedures aim to provide the best level of comfort in a cost-effective manner. As such any assurance given will be conclusive, but not absolute.

9. HOW DOES INTERNAL AUDIT DIFFER FROM EXTERNAL AUDIT?

External audit is a statutory function that provides assurance over the entity's annual report and financial statements. Its primary responsibility is to ensure that the financial statements are materially correct and present a "true and fair" view of the entity's financial position. While external audit will review internal control over financial reporting, external audit's scope is limited to work that supports their opinion on the financial statements.

The work to give the Board and management comfort over the entity's governance, risk management, internal controls and compliance with laws and regulations more broadly normally is outside the scope for external audit.

10. HOW DO I RESOURCE INTERNAL AUDIT?

- Entities have three options for resourcing the internal audit function:
- In-house – the internal audit team is employed by the entity;
- Outsourced – a specialist third party delivers the internal audit activity on behalf of the entity; or

¹ For more information see: *The Role of Internal Auditing in Enterprise-Wide Risk Management*, Institute of Internal Auditors, Jan 2009

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- A blend (co-sourced) – in-house internal auditors are supplemented by specialist third parties.

All three models are acceptable for the purposes of recommendation 7.3 provided that the arrangements meet the key attributes listed in section 7 above. In the case of a fully outsourced internal audit activity, it is generally accepted that having an in-house internal audit professional on a full-time or part-time basis to lead the function helps to get the most of that investment.

11. WHAT WILL THIS COST?

The level of investment should be proportional to the level of comfort and assurance required, and need not be prohibitive. Many small organisations experience the positive contribution of internal audit from a relatively small investment.

Conversely, organisations tend to increase their level of investment when additional comfort is required, and see this as a good investment.

The IIA runs a low cost benchmarking service and can also provide some “rules of thumb” for a new function. For more information, call the IIA-Australia and ask for information on the “GAIN” benchmarking service.

12. HOW CAN I MAKE THIS A USEFUL INVESTMENT?

Internal audit provides comfort and assurance to the Board and management, allowing for better risk taking, decision making, risk management, regulatory compliance and higher performance.

In order to get make the most out of internal audit, it is important that the entity:

- **Focuses the audit plan on the areas that matter most.** This may include providing assurance on the operation of key processes, execution of initiatives, management of risks, compliance with laws or regulations, or assurance over other areas where certainty is required.
- **Establishes open communication channels and trust** between internal audit and the Board and management, and ensures that internal audit is able to say what needs to be said, when it needs to be said. It can achieve this through the independence mechanisms as set out in section 14 below.
- **Ensures their internal audit function operates at a high standard.** It can do this through having the internal audit function conduct a self-assessment against the *International Standards for the Professional Practice of Internal Auditing*, and having this assessment verified every five years or more often if desired.

13. CAN INTERNAL AUDIT BE DONE BY OUR EXTERNAL AUDITORS?

IIA-Australia believes that the external audit firm should not perform the role of internal audit. This view is shared by leading commentators and regulators.

External audit is a statutory function on behalf of the shareholders and also has duties to regulators. Internal audit is a function on behalf of the board and management. IIA-Australia believes these roles are incompatible, and combining the two could deprive the Board of an important additional source of independent advice.

If an entity's external auditors were to provide the internal audit function, then this should be noted in the disclosures in relation to Recommendation 7.3.

14. HOW CAN I BE ASSURED THAT INTERNAL AUDIT IS INDEPENDENT FROM MANAGEMENT?

The following mechanisms are usually applied to ensure independence of the function:

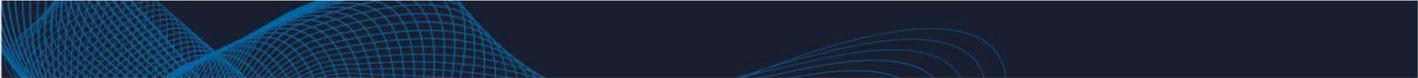
- Prior to, or as part of each meeting, the Board Audit Committee Chairman or the full Board Audit Committee meets with the head of internal audit without management present.
- The head of internal audit and Board Audit Committee have direct access to each other.
- Decisions on the hiring and/or firing of the head of internal audit are reserved for the Board on recommendation from the Board Audit Committee.
- The final decision on the internal audit scope, annual plan and budget is reserved for the Board or Board Audit Committee on recommendation from internal audit and management.
- The Board or relevant Board Committee reviews the reasonableness of the remuneration, and remuneration structure of the head of internal audit.

15. WHAT ARE MY OTHER OPTIONS?

If a listed entity has determined not to put an internal audit function in place, the entity must disclose that fact and the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes.

In doing so, the entity is communicating to the market that the Board is confident that assurances received from management and other sources are sufficient so that internal audit is not necessary.

This option carries some risk for directors if something occurs that may have normally have been found and escalated through the internal audit function.



Nonetheless for some entities, particularly those with low complexity, and a narrow span of control, this approach may be appropriate. Such circumstances may include:

- The Board has direct line of sight into the key areas of the organisation, and the time and expertise to assess those areas fully.
- Strong capability by management and the board in technical areas such as compliance, fraud prevention, cyber-security

16. WHERE CAN I GET ASSISTANCE?

Internal audit is a well-established profession. There are many resources that can help you. The Institute of Internal Auditors is the leading body representing internal auditors across the globe. The IIA-Australia has a connection with nearly 7,000 internal audit professionals inclusive of 3,200 members Australia-wide. Governed by a Board and supported by a national office, the Institute's activities include the following:

- Providing standards, guidance and information on internal auditing best practices
- Providing professional development activities and certification
- Bringing together internal auditors to share information and experiences in internal auditing
- Upholding standards by undertaking quality assurance services
- Advocating, promoting and publicising the profession to industry professionals, universities, government, public and private sectors.
- Contributing to the global profession with representation on international committees and the global board.

There are also many advisors who can assist. These include well established internal audit providers, and specialist advisors and contractors who can help organisations to set up and resource an internal audit function for the first time.

17. FURTHER INFORMATION

This is one of a series of fact sheets designed to assist IIA-Australia members and other stakeholders to interpret and apply the 3rd edition of the ASX CGC Principles and Recommendations. These include:

- *Summary of the 2014 Changes to the ASX Corporate Governance Principles and Recommendations*, IIA-Australia, March 2014
- *Implementing the 2014 Changes to ASX CGC Principle 7*, IIA-Australia, March 2014
- *A Guide to Reporting under ASX CGC Recommendation 7.3*, IIA-Australia, April 2014

For more information on internal audit and related matters, go to www.iaa.org.au