MINORITY SHAREHOLDERS WATCH GROUP
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FOURTH PILLAR OF CORPORATE GOVERNANCE

ROLE OF INTERNAL AUDIT

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THE internal audit function (IAF) can be viewed as the fourth pillar of corporate governance (CG).

It is considered the fourth pillar because the other three pillars, namely board of directors, executive management and external audit, were already there before the IAF rose in relevance and importance in Malaysia.

It was obviously felt by regulators that the existing three pillars did not quite support adequately the quest for good CG. Thus, Bursa Malaysia has made it mandatory for public-listed companies (PLCs) to have an IAF.

The financial sector was an even earlier mover in mandating the IAF.

The IAF provides independent assurance on governance, control and risk to none other than the audit committee of the board. For the benefit of the uninitiated, internal auditing is defined as an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations.

It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

The IAF does not report to management. This enhances its ability to provide independence assurance to the board through the audit committee, and puts it in a powerful, persuasive and influential position. Independence of management is a key attribute for the IAF to play its role without fear or favour.

Hence, it is said that the IAF is independent of management, though not independent of the company. At the most, there is only a dotted line to the chief executive officer mainly in relation to administrative functions with a bold reporting line to the audit committee for functional matters, key among which is the audit findings and recommendations.

Supplementing the power and independence of the IAF is the mandate for the audit committee to hire, fire and remunerate the head of the IAF, and approve the IAF's budget.

In fact, the typical IAF terms of reference gives the IAF access to all information, documents, assets, locations and people within their organisation. Given the important role, responsibilities and positioning of the IAF, it is disheartening to note how unimportantly and irreverently the IAF is treated by some PLCs.

Having a listing requirement that an IAF is mandatory is well and good, but it should not just end there. We must see how seriously it is being taken by those tasked with having such a function.

Form is good, but substance is better. It is not all right to pretend that all is well when all is not well. And it is not well when there is compliance in form but blatant disregard in substance.

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CG FINDINGS

The Malaysia-Asean CG Report 2021 discloses some startling findings when it comes to the IAF. In form, all PLCs had an IAF. But the substance seems to tell another story altogether for some PLCs.

Of the 864 PLCs assessed, 63 PLCs (seven per cent) had housed the IAF at the group level. A total of 231 PLCs (27 per cent) had an in-house IAF while 21 PLCs (two per cent) had co-sourced IAFs — a combination of an in-house function with an outsourced element. A majority of 549 PLCs (64 per cent) outsourced the IAF to third parties.

It is among the outsourced IAFs that the disappointment begins.

The listing requirements require the disclosure of the cost of the IAF. The average annual cost of the in-house IAF was a respectable RM1,361,000 per annum while that for the outsourced IAF was a low RM50,000 per annum.

The disparity in the cost seems telling. As we dive down, on an overall basis, 327 PLCs (38 per cent) had an internal audit cost of below RM50,000 per year or a monthly cost of RM4,166. Even recruiting one internal audit staff member of reasonable experience at the executive level will cost more than that.

And among these 327 PLCs, 23 companies (two per cent) disclosed an internal audit cost of below RM10,000 per annum. It does not take a genius to figure out the importance that these PLCs place on the IAF — a cost of a mere RM833 (and below) per month.

And the ultimate prize for disregard should go to the PLC which disclosed an annual internal audit cost of RM2,500 or only RM208 a month.

Quality comes at a price. Good service comes at a reasonable price. You pay for what you get. Crudely put, if you pay peanuts, you get monkeys.

And yet we pretend all is well. Regulators, relevant professional bodies and shareholders should question such PLCs on their disregard of the IAF. If something is important enough to be mandated, it should be important enough to be regulated. Just like what the Malaysian Institute of Accountants and the Audit Oversight Board do with the external auditors.

Given that the IAF provides assurance on the three key touchpoints which must be foremost in the minds and close to the hearts of any board and management, i.e. governance, risk and controls, surely more efforts should be made to ensure that there is adherence in substance.

Boards should be foremost in instilling in themselves the self-discipline to ensure that the IAF is adequately resourced to play its important role.

Shareholders should hold PLCs, which have unreasonable IAF costs, accountable as part of market discipline. Regulatory discipline should also play its part. The three disciplines do not have to be brought about in any particular order — they can happen simultaneously. And they should so happen.

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