ASX must call for a mandatory internal audit function

By Christopher McRostie – Chief Executive, Institute of Internal Auditors Australia

The ASX Corporate Governance Council will next week commence a review of the *ASX Corporate Governance Principles and Recommendations* – the definitive 'bible' of corporate governance best practice in Australia's.

With the widespread risk management failures of the financial crisis fresh in the minds of Corporate Australia not to mention the legions of investors who lost their life savings, it is incumbent on the ASX Council to seize this unique opportunity to strengthen the *Principles and Recommendations*.

A major area in need of review is risk management assurance. It is well-documented that boards have become far more focused on risk management following the GFC and are generally more probing of management as they seek to better understand and mitigate their companies' risks.

But directors - particularly non-executive directors who are more removed from the company's operations - cannot carry out their critical oversight role alone. They need a source of information, independent of a potentially conflicted management, to objectively and reliably tell them what's right and wrong in the company. Their natural ally in this regard, is the company's internal auditor. Yet, in the current ASX guidelines, internal audit is framed purely as a discretionary function, with companies urged only to 'consider' having one.

The Institute of Internal Auditors (IIA) believes this must change. As a statement of best practice, *Principle 7* of the *ASX Principles and Recommendations* must unequivocally state that listed companies should have an internal audit function. In the interests of investor protection, companies must accept certain fundamental governance obligations for the privilege of raising capital in Australia. Adoption of an internal audit function is one of these.

The IIA also believes that *Principle 7* should be revised to ensure directors receive internal audit support of a consistently high quality. This can only be achieved by requiring internal audit work to be done in accordance with widely recognised internal audit professional standards, such as the IIA's *International Professional Practices Framework* (IPPF).

The IPPF are used in many of Australia's major corporations. However as no standards are currently prescribed, it is not uncommon for some internal auditors to apply external audit standards which are entirely inappropriate for the job, or to 'cherry-pick' from the IPPF. The ASX Council should strive to stamp out these unacceptable practices and take the opportunity to elevate rigour and consistency in internal audit. Amending Principle 7 to endorse the IPPF is the answer.

Shareholders and investors caught in the eye of the GFC-storm have higher expectations of company directors and management today, when it comes to risk management and assurance. Regulators and governance leaders such as the ASX Council need to be responsive to these demands.

However a glance at our international counterparts suggests that Australia is falling behind in best practice. The New York Stock Exchange (NYSE) mandates that all publicly listed companies maintain an internal audit function, while the UK Corporate Governance Code requires listed entities to annually review whether an internal audit function is required and if not, disclose why in their annual report. Within our own region, the Singapore Stock Exchange, with whom the ASX is contemplating a merger, mandates the establishment of an internal audit function. Singapore's Code of Corporate Governance further requires the function to meet or exceed the requirements of the IPPF.

These leading jurisdictions understand that the existence and health of a company's internal audit function can be an important early warning indicator of the overall health of the company itself. Yet the fact that in Australia, internal audit is neither mandatory nor triggers any disclosure obligations, makes it that much harder for investors to gauge the governance credentials of our companies.

So let's be clear - establishing an explicit expectation that companies adopt internal audit is not about burdening Australian corporates with more compliance-related red tape. Rather, it is a vote for better self-regulation and less 'black letter law'. It encourages companies to monitor and address their own weakspots and ultimately, to better control their own destiny.

At the end of the day, sustainable governance reform should encourage self-led improvements in corporate behavior. These proposals do just that.

The above article was the basis of what appeared in the Australian Financial Review on Friday 11 February 2011.