



Guidance for audit committees

The internal audit function



March 2004



The Combined Code on Corporate Governance – July 2003

C.3 Audit Committee and Auditors

Main Principle: The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm;

and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded.

Introduction

This publication is part of a series which has been prepared by the Institute of Chartered Accountants in England & Wales to assist non-executive directors on audit committees to gain an understanding of the provisions of the Combined Code on Corporate Governance – July 2003 (The Combined Code) relating to Audit Committees and Auditors and the guidance set out in Guidance on Audit Committees (The Smith Guidance). The Guidance is based on the proposals set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

The internal audit function

One of the Combined Code provisions (C.3.2) is a requirement that the audit committee:

‘monitor and review the effectiveness of the company’s internal audit function.’

It further requires that (C.3.5):

‘The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.’

This publication provides a brief background to internal audit and explains how an internal audit function might operate in an organisation, what standards internal auditors may follow and how the function might interact with the audit committee.

The Audit and Assurance Faculty of the ICAEW published *The Power of Three: understanding the roles and relationships of internal and external auditors and audit committees* in May 2003 and *Evaluating the Effectiveness of Internal Audit* in November 2003. Both publications provide further practical guidance on the internal audit function.

Each company is unique and audit committees will need to apply the Smith Guidance in a manner that is appropriate to them. This publication does not provide guidance on how to deal with individual situations and reference may need to be made to the various pronouncements mentioned in the text for further information and guidance.

Background

Risk is inherent in the decisions that an organisation takes to manage and run its business and in the business processes established to assist in the achievement of its business objectives. Changes in the way organisations carry out their normal activities resulting from, for example, expansion of the business or changes in the regulatory framework, can place enormous strain on an organisation's control mechanisms and become major sources of risk. That is why establishing, implementing and embedding effective risk and control elements of the overall corporate governance framework are of fundamental importance to all organisations.

Internal audit can play an important assurance role in an organisation's governance processes, particularly in the area of risk management and control. In many organisations, the expectations placed upon internal audit have increased and the function is being relied on to make a significant contribution.

With the introduction of the revised Combined Code and the Smith Guidance, audit committees are expected to take a more focused oversight role in respect of risk management and internal control. They need assurance from management and independently that good internal controls are in place and operating effectively. Internal audit can contribute to independent assurance on the overall risk management, control and corporate governance processes. It can also be a useful catalyst for change and improvement within the organisation.

It is important therefore for the audit committee to distinguish between the role of management and that of internal audit. Management has primary day-to-day responsibility for managing risk and for the operation of internal controls within an organisation. Internal audit's role is separate and independent from management.

'Independence' has a different meaning for internal audit than it does for external audit.⁽¹⁾ The internal audit function is generally considered independent when it can carry out its work freely and objectively.

What is internal audit?

A commonly used definition for internal audit is:

'An independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an

⁽¹⁾ Independence in the context of external audit is explained in *Reviewing auditor independence* in this series.

organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes’.⁽²⁾

This definition recognises two roles for internal audit:

- to provide an independent assurance service to the board, audit committee and management, focusing on reviewing the effectiveness of the governance, risk management and control processes that management has put into place.
- to provide advice to management on governance risks and controls, for example, the controls that will be needed when undertaking new business ventures.

Professional guidance is available from a number of sources. Building on the definition above, the Institute of Internal Auditors (IIA) has issued professional standards for both assurance and consulting work. Public sector organisations are likely to follow internal auditing standards and guidance set by HM Treasury and other public sector-related bodies such as the Chartered Institute of Public Finance and Accountancy (CIPFA).

The audit committee might wish to consider:

- *How does the head of internal audit view the role of internal audit?*
- *What standards and guidance does the internal audit function follow?*

Whether to have an internal audit function

Having an internal audit function is not mandatory for listed companies, although it is for certain public sector organisations. Therefore the board of a smaller listed company may decide that it already gains sufficient assurance on risk, control and governance from other assurance activities within the organisation, for example, directly from regular management information and self-monitoring, from other assurance functions such as security or health and safety or from its external auditors. In short, a company may conduct internal audit activities even though there is no internal audit function.

The Smith Guidance calls upon the audit committee to recommend to the board whether there should be an internal audit function. In such a situation, the audit committee needs to be satisfied that all arrangements that the board has put into place are sufficient and appropriate for the organisation.

⁽²⁾ This definition of internal audit is taken from the International Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors.

Internal audit is a source of independent and objective assurance. Therefore when making the decision not to have an internal audit function, the board and the audit committee must be in a position to demonstrate that the assurance it is already receiving is sufficient. Paragraph 4.9 of the Smith Guidance requires the audit committee to explain this in its report to shareholders so it must also be in a position to demonstrate to external parties that an internal audit function is not necessary.

The audit committee might wish to consider:

- *Where there is no internal audit function, what are the sources of assurance within the business?*

Status of internal audit

Where there is an internal audit function, its status and remit derives from the needs of the organisation and should be set at the top of the organisation, i.e. by the board and the audit committee. There is no single model for internal audit and each organisation will determine what is appropriate to suit its requirements. In general, internal audit could, if agreed by the audit committee, seek assurance that:

- The organisation has a formal governance process which is operating as intended: values and goals are established and communicated, the accomplishment of goals is monitored, accountability is ensured and values are preserved.
- Significant risks within the organisation are being managed and controlled to an acceptable level as determined by the board.

In addition, internal audit can be used to facilitate the strengthening of the governance and risk framework within the organisation.

The audit committee will need to consider the role that has been set for internal audit within the organisation's overall assurance framework.⁽³⁾ It will, on an ongoing basis (at least annually), wish to challenge the organisation's decisions in relation to the role that has been set for internal audit and question whether its scope, authority and resources are adequate and consistent with the risks that the organisation faces and the effectiveness of the internal controls that are in place to address those risks.

⁽³⁾ The overall assurance framework is defined in the ICAEW's publication *The Power of Three: understanding the roles and relationships of internal and external auditors and audit committees*. It is the process through which senior management and those charged with governance assess the organisation's various assurance needs and identify at a strategic level, how it will meet those needs.

The audit committee might wish to consider:

- *Does the status and remit of internal audit that has been set by the board reflect the requirements of the organisation?*
- *Does the remit fit clearly within the overall assurance framework?*

Terms of reference

The overall status and remit of internal audit should be formalised in terms of reference, often referred to as an audit charter, and approved by the board, normally through the audit committee. These should then be communicated to relevant people within the organisation.

Internal audit's terms of reference or charter should provide clarity about its:

- strategy and objectives;
- role and responsibilities within the organisation;
- scope of work;
- accountability to the audit committee;
- reporting lines for line management purposes;
- accessibility to the board and the audit committee; and
- unfettered access to all information, people and records across the organisation.

The terms of reference should make it clear that internal audit should not be put in a position where it has to review its own work.

The audit committee might wish to consider:

- *Are there formal terms of reference/an audit charter that are approved by the board?*
- *Have they been communicated to relevant people within the organisation?*
- *How frequently are the terms of reference refreshed?*
- *What safeguards protect the independence of internal audit and the position of the head of internal audit?*

Audit approach

The audit approach taken by internal audit will largely depend on its remit and the objective assurance that the board requires.

Audit plans

Internal audit should, on at least an annual basis, develop a plan of work that it will cover to provide the required assurance to the audit committee and the board. This plan should retain some flexibility to enable internal audit to respond to new issues as they arise.

The audit plan should identify how internal audit will:

- obtain assurance on the effectiveness of the governance and risk management processes;
- support the development and maintenance of governance and risk management processes;
- challenge the board's assessment of risk and the controls in place to manage the identified risks;
- evaluate and test the effectiveness of controls in place to manage the identified risks; and
- co-ordinate with other sources of assurance, e.g. health and safety, external auditors, etc.

In setting the audit plan, there should be effective dialogue between the audit committee, management, internal audit and external auditors to ensure that there is adequate assurance from all sources to cover all key business risks. Audit committees need to make clear their expectations that both internal and external auditors will communicate effectively with each other about how their respective audit plans and objectives will cover these key business risks.

The IIA's Performance Standard 2201, *Planning Considerations*, states that internal auditors, in planning their work, should consider the objectives of the activity being reviewed, the risks related to that activity, the adequacy and effectiveness of the activity's risk management and control systems and the opportunities for making significant improvements to those systems.

Skills and resources

Internal audit needs to have adequate budget and resources to complete its work plan and fulfil its remit. In achieving appropriate

coverage of the agreed risk areas, it will need to have staff with the right skills and expertise. It may also require access to specialist resources which might include using staff from elsewhere in the organisation or external resources. Paragraph 4.10 of the Smith Guidance requires the audit committee together with the head of internal audit to ensure that the current complement of staff is sufficient and appropriate to achieve the audit plan.

The audit committee might wish to consider:

- *Is the resourcing of internal audit sufficient to meet current needs; or is the scope of its work being reduced to fit the available budget?*

Sourcing of internal audit

There is no requirement for internal audit to be provided by an organisation's own employees. The organisation may choose to have the service provided fully from within, may outsource it entirely to an external provider or may consider a mixture of internal and external sourcing. However the service is provided, it needs to fit into the overall remit and scope that has been set and its effectiveness needs to be monitored and reviewed on a regular basis by the audit committee.

Performing the audit work

In order to perform its work efficiently and effectively, internal audit will need to have unfettered access to necessary information, people, records and outsourced operations across the organisation. IIA Performance Standard 2300, *Performing the Engagement*, states that internal auditors should identify, analyse, evaluate and record sufficient information to achieve the engagement's objectives. The head of internal audit will need to determine how internal auditors carry out their work and the level of evidence required to support their conclusions.

Evaluation of findings

Internal auditors will normally evaluate the findings of each engagement. They should assess whether the actions adopted by management address risks in the manner and to the extent intended and identify and report any weaknesses.

Communication of results

Under the IIA's Performance Standard 2400, *Communicating Results*, it is recommended that internal auditors report internally to the board, the audit committee and management on a regular basis.

Internal audit's reports, opinions and any recommended management actions need to be communicated in a clear, concise, reliable and constructive way. They should demonstrate a clear understanding of the organisation and its objectives. All significant actions need to be communicated to the audit committee regularly, together with dates of implementation. Where key agreed actions are not appropriately implemented by management, there needs to be a mechanism for internal audit to investigate the reasons why and, if necessary, escalate matters to the audit committee.

It is important for both internal and external auditors to co-operate, communicate and share their evaluations and the results of their audit work when relevant and subject to any confidentiality requirements. This dialogue should take place regularly throughout the year.

The audit committee might wish to consider:

- *Is there a schedule of actions together with agreed implementation dates?*
- *Can management provide adequate explanations for situations where actions have not been implemented?*
- *Does internal audit have confidential access to the audit committee?*

Effectiveness of internal audit

Internal audit activities play an important part in the effective governance and risk and control framework of any organisation. As required by code provision C.3.2, the audit committee should monitor and review the effectiveness of the internal audit function. It should provide feedback and guidance to internal audit to help it provide the assurance service the audit committee needs.

Reviewing internal audit reports will help the audit committee assess the quality of internal audit's work during the course of the year. Building on this ongoing review, an annual review may involve obtaining feedback from management, external auditors and other stakeholders.

In addition to these ongoing and annual reviews, IIA Performance Standards recommend that a quality review of the internal audit function should be carried out by an independent qualified reviewer at least every five years.

The audit committee might wish to consider:

- *Are there adequate procedures in place to evaluate the effectiveness of internal audit within the organisation?*

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The Institute of Chartered Accountants in England & Wales has issued a series of publications to assist non-executive directors on audit committees to gain an understanding of the guidance included in the revised Combined Code on Corporate Governance as 'Audit Committees: Combined Code Guidance'. This is closely based on the proposals originally set out in the report of the FRC-appointed group chaired by Sir Robert Smith.

The following titles are available:

- Company reporting and audit requirements
- Monitoring the integrity of financial statements
- The internal audit function
- Evaluating your auditors
- Reviewing auditor independence
- Working with your auditors
- Whistleblowing arrangements

