



INTERNAL AUDIT CODE OF PRACTICE

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ICAEW welcomes the opportunity to comment on the draft Internal Audit Code of Practice published by the Chartered Institute of Internal Auditors on 15 July 2019, a copy of which is available from this [link](#)

This response of 11 October 2019 has been prepared by the ICAEW Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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KEY POINTS

1. We believe an Internal Audit Code of Practice is desirable to help organisations determine the internal audit function they ought to have. We want to see the new voluntary Code promoted as part of best practice corporate governance practice for any organisation with an internal audit function. It should be implemented in a proportionate and cost-effective way.
2. The objectivity of internal audit may be compromised if reporting lines or blurring of responsibilities occur between lines of defence. These compromises need to be clearly identified and the related risks effectively managed by the board through the audit committee.
3. Boards, audit committees and internal audit functions struggle with the potential conflict between providing assurance and consulting services. The critical element is that internal audit should never be assuming executive responsibility for the control functions and activities that it is providing assurance on.
4. There should be a commitment to monitoring how the new Code works as it will represent a big change for many organisations.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: Which companies, organisations and sectors should the new Internal Audit Code of Practice cover and what should its scope be?

Internal Audit has the potential to contribute to effective risk management and governance in both private and premium listed companies, as well as of course third sector organisations including major charities. We will therefore need to consider carefully which types of organisations the new Internal Audit Code of Practice should apply to.

We will need to consider whether the new Code should be primarily focused on publicly listed companies, or should private companies with an internal audit function also be in scope – particularly large private companies? Going even further than that, should the new Code be extended to third sector organisations? In due course, a Code could also be developed for the public sector.

5. We agree that the Financial Services Code has been a success because it is principles-based rather than establishing detailed rules, while at the same time setting clear standards for internal audit. We would like to see this continue as the scope of the Code is extended to all other sectors. This should include adoption by publicly-listed companies, private companies, and third sector organisations. We see no reason why the Code should also not be extended to the public sector at the same time.
6. As the Code will be voluntary, it should be implemented in a proportionate and cost-effective way. Companies should be offered the flexibility to comply with its principles or explain why they do not, and how any non-compliance will not impact the value of internal audit's role and scope. The comply or explain decision should be explained publicly in the interests of transparency, for example on the company's website. This flexibility will benefit organisations with small internal audit functions who will be able to adapt the principles proportionately to their requirements, and avoid the Code becoming a box-ticking exercise.
7. As part of adopting the new Code proportionately, there should be a commitment to monitoring how it is being implemented, to share experiences and lessons that are being learnt, and to make changes where they are required to enhance best practice internal audit.

Question 2: How far should there be independence between the second and third lines of defence?

Does the draft Code adequately reflect the range of practices that organisations have adopted with regard to the existence or not of separate risk and compliance functions? And what does the Code need to say specifically about circumstances where risk and internal audit are combined?

8. We believe that internal audit is strongest if it is neither responsible for, nor part of, the control functions, and such clear segregation is best practice. Some organisations may choose to adopt a less rigorous separation between the 2nd and 3rd lines of defence. This represents a compromise over the lines of defence and will need to be managed well.
9. Where overlap does take place, it is important that safeguards are put in place to ensure the activity does not threaten the objectivity of internal audit. In this regard, the Institute of Internal Auditors (IIA) [position paper](#) on the role of internal audit in enterprise risk management sets out safeguards needed to achieve this.
10. The Code would benefit by highlighting the need for boards to set out clearly the scope and purpose of their internal audit function. This should be documented to avoid the erosion of internal audit's objectivity or the scope of their activities without board and relevant committee approval.
11. Where separate internal audit and risk management teams are managed by a joint head of audit and risk, there should be a mechanism in place to ensure that the audit committee and senior management receive separate, clear and objective communication from each function.

Question 3: Should internal audit have the right to attend and observe Executive Committee meetings?

Do you agree that we should now raise the bar for the profession and insist that internal audit have a seat at the table at the Executive Committee?

12. ICAEW believes in the principle that the head of internal audit should have the right to attend, observe and where appropriate contribute at Executive Committee meetings. There should be no aspect of the organisation which internal audit should be restricted from looking at as it delivers its mandate.
13. The Code should be expanded to set an expectation about internal audit's role at the Executive Committee. Internal audit should be an active participant, sharing their views on the risks, controls and governance they have assessed. But it should be made clear to all members of the Executive Committee that internal audit will not be involved in executive decision-making since that compromises its independence and objectivity.
14. Internal audit's attendance will enable it to assess whether the decision-making, 'tone at the top' and observed behaviours are in line with the organisation's espoused values, ethics, risk appetite and governance.
15. The Code would benefit by setting out the principles governing internal audit's attendance, and its role as a participant. It should also explain how the audit committee chair will be expected to ensure that internal audit maintains its objectivity.

Question 4: Should the new Code include guidance and best practice on the outsourcing of internal audit provision?

Is it desirable to develop further guidelines around outsourcing best practice? If so, what should these be?

16. Outsourcing internal audit is common across all industries, particularly where the cost of establishing an in-house capability clearly outweighs the benefits. As with any outsourcing decision, stakeholders should have approved a clear business case that includes an assessment of the risks and how these will be mitigated over the course of the outsourcing relationship. In this regard, the Code should provide guidance on the principal risks of outsourcing to help an organisation make informed decisions.
17. The Code could also include guidance on the principal risks of co-sourcing, which again is common practice where an in-house function needs periodic cost effective access to subject matter expertise and additional capacity.
18. It should be emphasised that the oversight and responsibility for the internal audit function cannot be outsourced. The board, through the audit committee, will continue to be ultimately responsible for the oversight of internal audit.

Question 5: Should the secondary executive reporting line be to the CEO, or should we adopt a more flexible approach in the new Code?

In the majority of organisations spanning all sectors there is a formal reporting line to the Audit Committee via the Audit Committee Chair. However, whilst a secondary reporting line to the CEO is now common practice in the financial services sector, for other organisations it is often the case that they will have a secondary reporting line to another member of the executive management team such as the CFO.

In promoting internal audit best practice and in raising the bar across the profession, should we provide clear guidance that the secondary reporting line should be to the CEO? Or should we adopt a more flexible approach? If we adopt a more flexible approach, how do we mitigate the risk of potential conflicts of interest that could arise from a secondary reporting line (eg, to the CFO)? As an alternative to a secondary reporting line to the CEO, would it be acceptable to have a secondary reporting line to another member of the executive management team?

19. Internal audit reporting lines do not always promote sufficient independence and objectivity, particularly where audit committee oversight is weak and/or senior management has too much say in the scope and approach of the internal audit work and plans, and the budget allocated to it.
20. The objectivity of internal audit would be enhanced by having a primary reporting line to the audit committee and board via the audit committee chair. This removes the opportunity for undue influence from executive management in the scope and delivery of internal audit work. This will not detract from the internal audit function being efficient and effective, and will ensure that the CEO is also subject to objective oversight.
21. If a second line of reporting is considered necessary, this should only be to the CEO. This will ensure that heads of internal audit are not competing for budgets, bonus or incentive payments and investments in the function with those they are auditing.
22. We agree with the proposed Code that the chair of the audit committee should be accountable for setting the objectives of the head of internal audit, and appraising their performance at least annually. We would expect their objectives and appraisal would take

into account the view of the CEO. We believe that the chair of the audit committee should have a central role in determining the remuneration of the head of internal audit.

Question 6: Should the new Code include guidance on how an internal audit function may provide assurance services where it had previously performed consulting services?

The issue of safeguarding against compromise of objectivity where internal audit are asked to perform consultancy services is an important one to consider in the development of the new Internal Audit Code of Practice.

The current IIA Standards offer clear guidance in this respect. They state that the internal audit function may provide assurance services where it had previously performed consulting services, provided the nature of the consulting does not impair objectivity and provided objectivity is managed when assigning resources to the engagement, and that internal auditors may provide consulting services relating to operations for which they had previous responsibilities. If internal auditors have potential impairments to independence or objectivity relating to the proposed consulting services, the IIA Standards state that disclosure must be made to the engagement client prior to accepting the engagement.

In promoting best practice should the new Code also offer clear guidance on this issue?

23. A clear definition is required of what is meant by consulting services as compared to assurance work.
24. Whatever consultancy work is undertaken it is critical for effective governance that the objectivity of internal audit is not impaired. As a consultant the internal auditor should not undertake any managerial or decision-making responsibility, or act as a substitute for management's own efforts to address the issue, but give advice and make recommendations.
25. ICAEW believes the new Code would benefit from including guidance on how an internal function may provide assurance services where it had previously performed consulting services. However, it should be clear from the outset that the objectivity and independence of the internal audit function is a fundamental requirement – internal audit can make recommendations but it should not be accountable for the design or operation of any part of the control environment because it cannot then audit this area subsequently.
26. The audit committee chair needs to be satisfied that the internal audit function has adequate safeguards in place to ensure its objectivity in providing assurance over areas where it has previously provided consultancy or advice.

Question 7: Are there any other matters which should be addressed in the Internal Audit Code of Practice?

The questions we have asked cover some of the key issues and areas of importance we will need to consider carefully in the development of the Internal Audit Code of Practice.

Inevitably there may be other areas of importance that we have not covered or thought about that we may need to address in order to make the Code a success. So, are there any other practical issues or ideas that you would like the Steering Committee to consider as part of this consultation?

27. We believe the new Code has an important role to play in helping organisations to determine the internal audit function they ought to have. This is a key component of good governance, and should be emphasised strongly as part of the promotion of the Code.

28. We have suggested further guidance be provided around outsourcing and co-sourcing as this is a potentially complex issue which will vary from organisation to organisation. As such, the area may benefit from further consultation with key stakeholders.
29. The new Code recommends that internal audit should provide assurance on information being submitted to the board and its committees. This is very broad and would benefit from greater specificity in the new Code. For example, the focus could be on providing assurance on significant information to the board. This would allow an organisation to adopt a proportionate response to its assurance needs.
30. The new Code requires internal audit to assess the risk appetite of an organisation and to report to the board on whether it is complied with. It is worth noting that different organisations will be at different stages with regards to the establishment of a risk appetite framework, and this might be an area for further guidance.