



Audit Committee Forum

Position Paper 7

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The internal audit function and the evaluation of its effectiveness



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What is internal audit

Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an entity's operations. It helps an entity accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Internal auditor oversight

Companies often need to weigh the benefits and the costs of internal control considerations. One such decision relates to the need for, or the desirability of, having an internal audit function. An internal audit function, designed and deployed effectively, can have a positive impact on the control environment of an entity and on the effective design and operation of internal controls. As an important aspect of its mandate, internal audit can provide the audit committee with a means of monitoring if the controls management has put in place are reliable, functioning properly and sufficient to address the risks in the financial reporting process.

Accordingly, audit committees should regularly review the need for, and scope of, the internal audit function. A significant challenge for internal auditors is the fact that while they report to the audit committee, they interact on a daily basis with management, are employed by management and yet are expected to review management's conduct.

Internal audit should acknowledge the audit committee and not management as their primary client. It is important that the internal audit function retains a degree of independence from management so that it may carry out its function impartially. The head of internal audit has a clear responsibility to report to, and has independent access to the chairperson of the audit committee. The head of internal audit also has access to the chairperson of the board.

Unless specifically prohibited by legislation, internal audit can be resourced either through an in-house function or an external service provider. The decision as to the appropriate sourcing for the entity will usually be driven by the availability of appropriate skills (such as Information Technology skills) and the breadth and depth of ability to cover the entity's business operations adequately. The internal audit team should be capable of providing services across the spectrum from compliance audit work to ad-hoc work.

It should be noted that in certain industries in South Africa, for example banking, legislation prohibits the internal audit function from being outsourced without special dispensation.

In deciding on the most appropriate resource to outsource the internal audit function to, the audit committee should note the current legislation and principles in this regard. In the first draft of the Sarbanes-Oxley Act an



extensive list of non-audit services was deemed “unlawful”, including internal outsourcing services.

On deliberating more fully, this initial legislation has been significantly modified in that the prohibition on internal outsourcing services and certain other non-audit services to audit clients is only applicable if it is concluded that the service will be subject to audit procedures during the audit of the annual financial statements. This principle is in line with the regulations contained in the International Federation of Accountants’ Code of Ethics.

If an entity has an internal audit function, the scope of their work and that of external audit comprise audit coverage. While each has its own unique responsibilities, the audit committee should ensure that they complement each other, that their audit efforts are co-ordinated and that there is effective communication between them. The external auditor is responsible for auditing and attesting to the financial statements; the internal auditor for monitoring performance of the internal controls and monitoring the efficacy of the controls in new information technology systems. The external auditor should identify the internal audit activities that are relevant to planning the external audit.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion or dismissal of the head of internal audit and help determine his or her

qualifications, reporting hierarchy – to ensure access to all necessary contacts both at board level and within the entity – and compensation. The audit committee should also be involved in developing and approving the internal audit department’s mandate, goals and mission to be certain of its proper role in the oversight function. These responsibilities of the audit committee relate equally to an outsourced or co-sourced internal audit function.

A collaborative effort between management and internal audit in the development of the internal audit mandate often helps to ensure a proper balance between the assessment of internal controls related to financial reporting and other special projects, operational efficiency and risk management responsibilities. The committee should stay up to date on the scope and results of the department’s operations and management’s responses to the department’s recommendations on internal controls and compliance. The department’s objectivity and independence of judgement should be periodically evaluated. The audit committee should ensure that the internal audit department’s involvement in the financial reporting process is appropriate.

Recognising the important role of internal audit and its changing activities in today’s business environment, the audit committee should also consider the following in respect of the internal audit function:

- How does the internal audit department best add value to the business model?
- How effectively is the internal audit department used to evaluate management’s response to its strategic, financial, technology, security and operational risks?
- How effectively does internal audit encourage process improvement and best practice?
- Is internal audit a training ground for future managers and leaders?
- Does the internal audit department have the resources and appropriate expertise to satisfy its responsibilities?
- Would the entity’s objectives for the internal audit function be better served or supplemented through the use of a third-party service provider or a combination of the two?

Role and scope of internal audit

Internal audit’s role is to assist the audit committee in discharging its governance responsibilities by providing:

- a review of the ‘tone at the top’ of the entity;
- an objective evaluation of the risk and internal control framework;
- systematic analysis of business processes and associated controls;
- reviews of the existence and value of assets and liabilities;



- a source of information on frauds and irregularities;
- ad hoc reviews of other areas where there is a concern or an unacceptable level of risk;
- reviews of the compliance framework and specific compliance issues;
- reviews of operational and financial performance;
- performance of efficiency and effectiveness reviews as is required for example by the Public Finance and Management Act (PFMA);
- recommendations for more efficient and effective use of resources;
- assessments of the accomplishment of corporate goals and objectives; and
- feedback on adherence to the entity's values and code of conduct and/or code of ethics.

Although most publicly listed companies in South Africa have an internal audit function, the audit committee or board should regularly assess the need for one in companies that do not have an internal audit function. As internal audit's role includes the evaluation, monitoring and reporting on the adequacy and effectiveness of control, the absence of such a function means that the audit committee must use other means to ensure that alternative monitoring systems are in place and are operating effectively and consistently.

The complexity of the current business environment is leading to greater expectations of internal audit. Internal audit is increasingly expected to be proactive in identifying opportunities for operational improvement and to act as a facilitator for sharing best practices throughout the whole entity.

In meeting these heightened expectations, it is important for the primary function of internal audit not to be compromised. That is, to evaluate, monitor and report to management and the audit committee on the key exposure to risks and the adequacy of the controls put in place to mitigate them.

Provided this primary function is being adequately fulfilled, internal audit can then consider how it can leverage its unique position to enhance shareholder value through:

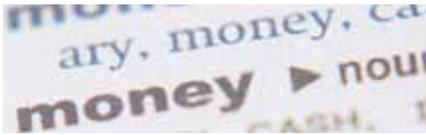
- making recommendations that indicate whether, and in what way, key business risks and exposures, both financial and non-financial, are contributing to or impeding the entity's performance;
- focusing on future key strategic issues facing the entity;
- identifying opportunities for operational improvement; and
- promoting an entity culture that is risk focused and future oriented.

The internal audit plan

The proposed depth and breadth of the internal audit plan, and particularly any restrictions placed on the scope of the plan, needs to be fully discussed and debated by the audit committee before it is approved. This plan should be the guide by which internal audit assists the audit committee, and ultimately the board, in assessing the adequacy of the risk and control framework.

Once the internal audit plan has been implemented, the audit committee should review the internal audit reports and assess the response of management to any weakness in the risk and control environment or any other irregularities. Internal audit should follow up on these issues and report back to the audit committee on its findings. Internal audit should consider utilising an internal control issues register to facilitate this process.

Since part of internal audit's role is the responsibility for monitoring the effectiveness of the entity's risk and control framework, there is alignment to the role of external audit. The audit committee therefore needs to be aware of the interrelationship between the two audit functions. Audit committee members need to fully understand the implications of the internal audit plan to ensure that, when read in conjunction with the external audit plan, there are no significant exposures with respect to financial reporting risk. The scope of the internal audit plan usually covers a three-year



period. While the timing of the individual projects in the plan may be flexible, all amendments and deferrals need to be authorised by the audit committee.

The audit committee needs also to ascertain whether the internal audit plan covers emerging areas of concern such as adherence to organisational values and code of conduct. Management needs to be forthcoming in identifying any areas of potential weakness, which should be included in the internal audit plan to assist in developing a culture of openness.

Audit committee members need to be aware of the need to undertake special investigative reviews from time to time, in addition to the agreed internal audit plan, such as in the area of fraud or conflicts of interest. However, it is essential that the internal audit plan be completed over its plan period and not be side-tracked by ad-hoc tasks requested by management. The audit committee needs to be satisfied that all identified risks are being covered.

Appropriate resourcing

Determining that there are sufficient resources and skills to undertake an internal audit adequately is a critical responsibility of the audit committee. The audit committee needs to be satisfied that its internal audit team consists of people not only with traditional accounting skills but also people with business skills and industry and technology based expertise. If these skills are not available within the internal audit function, the audit

committee may consider contracting specialists to perform these functions on an ad-hoc basis.

While internal audit is employed by management, given the importance of internal audit to successful audit committee outcomes, this committee should be involved in reviewing and confirming the appointment, replacement, re-assignment or dismissal of the head of internal audit.

The audit committee should also be involved in any matters associated with the remuneration of the head of internal audit, if the function is undertaken in-house, or the terms of engagement including the scope of internal audit where the function is either outsourced or co-sourced.

Members of the internal audit function must remain up to date with changes in the accounting and internal audit profession. This should be achieved through in-house update sessions or training workshops presented by the various professional bodies on a regular basis.

The audit committee's expectations of internal audit, including its performance criteria, should be clearly communicated in writing. In addition, all members of the internal audit team should be suitably qualified or studying towards recognised qualifications (CIA) and members of the Institute of Internal Auditors subscribing to the Institute's professional standards.

Communication

The administrative reporting lines of internal audit, although important, are not nearly as critical as a direct reporting line between internal audit and the audit committee. Audit committees that have established clear reporting lines for internal audit are in the best position to use them appropriately as a strong component of the financial reporting process.

It should be clear that the internal auditor must have direct access to the chairperson of the audit committee and vice versa as required. In this way, it is possible for internal audit to retain a degree of independence from management. In addition, the audit committee as a whole should have proper mechanisms in place to ensure that there is a frank and confidential exchange of information with internal audit. One such process may be that it is a standard practice for the audit committee to meet alone with internal audit, without management or external audit, for part of each audit committee meeting.

The committee should receive regular written reports from internal audit on the results of its work, including management's response to internal audit recommendations.



Internal audit's focus is clearly wider than financial risks and controls and therefore it should be questioned on a range of issues and matters. However, in making enquiries of internal audit in relation to financial reporting, the questions the audit committee needs to ask include:

- What is your assessment of the overall control environment?
- What is your assessment of the entity's financial reporting processes, both internal and external?
- What processes are in place to assure that material errors in the financial statements etc. will not occur? Do you consider these to be robust and effective?
- What is your assessment of the entity's compliance with laws and regulations?
- Have you had sufficient access to all areas of the entity and appropriate resources to ensure that your assessments are comprehensive and robust?
- Have there been any disagreements between you and management and/or external audit? If so, what were they and how were they resolved?

Evaluating internal audit effectiveness

In evaluating the effectiveness of internal audit, the audit committee needs to assess the effectiveness of internal audit against agreed performance criteria, including:

- compliance by internal audit – be it in-house, outsourced or co-sourced – with its agreed charter or plan/scope and level of performance;
- the overall comprehensiveness of the internal audit plan and its relationship with the strategic objectives of the business;

- delivery of timely internal audit services in accordance with the plan; and
- the competency of internal audit staff and adequacy of resources to achieve the scope as outlined in the plan. This may require outsourcing certain specialist skills not available in the internal audit function.

The audit committee, should, on an annual basis, request a review of internal audit performance from various sources including management and the external auditor.

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