

20 Questions

Directors Should Ask about
Internal Audit

Second Edition

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How to use this publication

Each “20 Questions” briefing is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management — and themselves — tough questions.

In some cases, boards and audit committees may not want to ask the questions directly and prefer to ask the Chief Audit Executive or management to include the topics or answers to the questions in the annual audit plan or other presentations to the Committee. The questions are not intended to be a precise checklist, but rather a way to provide insight and stimulate discussion on important topics.

The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper as necessary. The comments summarize current thinking on the issues and the practices of leading organizations. The “Recommended Practices” may not be the best answer for every organization. Thus, although the questions apply to most medium to large organizations, the answers will vary according to the size, complexity and sophistication of each individual organization.

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Preface

The Risk Management and Governance Board has distributed more than 5000 copies of the first edition of this book, both in Canada and internationally in collaboration with the Institute of Internal Auditors. Board members have used the questions as a process to better understand and assess the internal audit function at the organizations they oversee.

Directors of organizations that have internal audit functions are expected to satisfy themselves that the internal audit function is effective. This briefing provides suggested questions for boards to ask the chief audit executive or others in an internal audit function. For each question there is a brief explanatory background and some recommended practices. We hope that directors and CEOs will find it useful in assessing their approach to the management of risk and internal control.

Since publication of this book there has been an increasing interest in the topic of internal audit and an evolving regulatory environment causing enhanced focus on internal audit in the boardroom. It is under these circumstances that the Risk Management and Governance Board decided to review the material of the first edition of this book to ensure it is relevant and up to date. We are pleased to find the concepts and processes continue to be applicable. We believe the questions asked and fundamental principles in this book align with recent regulatory initiatives and will continue to be helpful to readers.

The Board acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, the authors Hugh Lindsay and John Fraser, and the CICA staff who provided support to the project.

We are grateful as well to individuals who contributed to the first edition, including Frank Barr, Michel Doyon, Dr. Parveen Gupta, Michael Harris, Fred Jaakson, Colin Lipson, Mary Jane Loustel, and Josee Santoni, former members of the Risk Management and Governance Board. Also, Robin Korthals, former member of the Directors Advisory Group.

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Chair, Risk Management and Governance Board

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Dan Swanson, former Assistant Vice President, Professional Practice of the Institute of Internal Auditors, who coordinated the review process.

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Why directors should ask questions about internal audit

National Policy 58-201, “Corporate Governance Guidelines” states that, as part of their stewardship role, boards of directors are responsible for:

- The identification of the principal risks of the corporation’s business and ensuring the implementation of appropriate systems to manage these risks, and
- The integrity of the corporation’s internal control and management information systems.

The internal audit function plays a key role in assessing and reporting on an organization’s risk management, internal controls and management information systems. Directors of companies that have an internal audit function should have a general understanding of its role and contribution. In addition, the audit committee should confirm that the internal audit function is properly constituted, has the necessary resources, and operates professionally. Boards of medium to large organizations that do not have an internal audit function should assess the need at least annually.

The questions in this briefing are designed to help directors understand the contribution of internal audit and to provide guidance to audit committee members on what to ask their chief audit executives. With each question there is a brief discussion that provides background on the reasons for asking the question and, where appropriate, some recommended practices.

The questions are organized into six groups:

- Internal Audit Role and Mandate
- Internal Audit Relationships
- Internal Audit Resources
- Internal Audit Process
- Closing Questions
- Audit Committee Assessment

Asking questions is only the first step. Directors must satisfy themselves that the answers are appropriate and that the internal audit function is effective. The comments and recommended practices in this document provide a basis for assessing the answers. Experienced directors test the answers against their own personal observations, experience, general knowledge and good business sense. They also respect their “gut feelings”—their experienced-based intuition that warns them that something is wrong or requires further explanation. Intuition alone isn’t enough to challenge answers, but it’s valuable if it gets people’s attention and prompts them to ask more probing questions or to seek independent advice.

Terminology

In this document the term “**internal audit function**” includes the internal audit department and/or any other departments, activities or outsourced services that fulfill an internal audit role. In some cases “internal audit function” is abbreviated as “internal audit”.

The **chief audit executive** is the individual responsible for leading or coordinating all or most of the internal audit function, usually on a full-time basis. Alternative titles generally include the words “audit”, “internal audit”, “inspection” or “risk”; e.g., Vice President Audit and Risk; Vice President, Inspection; Director of Internal Audit; Manager Internal Audit Services, etc.

Internal Audit Role and Mandate

The audit committee is responsible for ensuring that management has implemented an effective system of internal control to manage the risks facing the organization. In larger and more complex organizations an internal audit function can provide cost-effective and independent assurance that internal control is effective, provided that it has an appropriate role and mandate.

These questions, together with related discussions with the CEO and professional advisors, will put the audit committee in a position to understand what internal audit functions they need and what they have in place.

1. Should we have an internal audit function?

Many medium and large organizations have an internal audit function. This is a requirement for companies listed on some stock exchanges and for banks and other financial institutions with major fiduciary responsibilities. Other companies have an internal audit function because it is considered to be a valuable element of management control which provides assurance to the audit committee and management and adds to the organization's credibility with investors and creditors.

Management is responsible for establishing and maintaining a system of internal financial controls and in some cases, may be required by regulators to provide written certification of the adequacy of the controls. Legal and regulatory requirements are changing fast and companies must make sure they are aware of the latest rules.

In smaller organizations, managers are usually close enough to daily operations that they can effectively supervise and monitor the activities of their staff. When the volume and/or complexity of transactions become too great, management may need to add people whose primary role is to check the work of others and thereby strengthen internal control. Financial institutions and other organizations that deal in cash and other liquid assets usually need some form of inspection or audit function.

Organizations that do not have an internal audit function should give strong consideration to establishing one if their size and type of business, source of capital and risk factors warrant it. The potential benefits of the internal audit function should be assessed and compared against the estimated costs.

The decision to establish an internal audit function should involve the CEO, CFO and audit committee. The following is a list of criteria they may consider:

- The audit committee wants to get independent and objective assurance on the adequacy of internal controls from someone other than the CEO or CFO.
- The CEO wants to get independent and objective assurance on the adequacy of internal controls from someone other than the CFO or line managers.
- The CFO wants to get independent and objective assurance on the adequacy of internal controls from someone other than the line managers.
- The organization gets too large or geographically dispersed for frequent and economical first-hand monitoring of controls by the audit committee, CEO or CFO.

The roles of internal audit and the external auditors differ substantially and provide very different assurance to the audit committee and management, namely:

- Internal auditors review and test controls at a significantly lower level of materiality than do external auditors and often review a much broader range of risks than those for external financial reporting.
- External audits are designed to report on historical data, whereas internal audits are generally focused on the efficiency and effectiveness of current and future operations.

Recommended practices:

In organizations that have no internal audit function the audit committee periodically requests from management a review of the need for an internal audit function and, on the basis of this review, determines whether such a function should be instituted.

The audit committee may consider contracting outside assistance to review the need for an internal audit function if the committee is concerned that management may not have the objectivity or qualifications to conduct the review.

2. What should our internal audit function do?

This is a more difficult question than it seems. Unlike external auditors, internal auditors do not always have a clearly defined role that is established by law or regulation. Each organization must identify its own audit needs and use them to define the role of its internal audit function. The Institute of Internal Auditors (IIA) has developed

a definition of internal auditing (see page 7) that organizations may find useful in establishing the role of their internal audit function. In addition, there are numerous books on internal auditing.

Internal auditing is a valuable resource for management and the audit committee because of its objectivity, auditing skills and in-depth knowledge of the organization.

Internal audit functions, in many cases, are set up by corporate management to assess the internal control system that management is responsible for establishing. Internal audit does not perform the controls since this is a line management responsibility, but their role does provide another level of assurance to management and the audit committee that controls are effective. Historically, the emphasis was on compliance with company policy and the deterrence, prevention and detection of fraud and errors. These are still important roles for internal audit functions.

Over time, many internal audit functions have addressed broader aspects of control and provide services in areas other than the assessment of internal financial controls. These may include:

- Reviewing controls over major projects and new computer systems to help anticipate problems. This can allow corrective action to be timely and controls to be “built in” rather than retro-fitted after being detected by a subsequent audit or system failure.
- Conducting audits of the efficiency and effectiveness of operations.
- Assessing the risks related to reputation, customer service, the environment, privacy, etc.
- Providing consulting and advisory services on enterprise risk management, control and related matters.
- Participating in the investigation of fraud.

Occasionally, management may ask internal audit to assist with special projects. These may be appropriate and acceptable if done for staff development or some critical reason, but should be discouraged if the auditors are merely used as a “free” resource or if such projects distract from the internal audit function.

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

The internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organization’s governance, operations, and information systems. This should include:

- Reliability and integrity of financial and operational information
- Effectiveness and efficiency of operations
- Safeguarding of assets
- Compliance with laws, regulations, and contracts.

Institute of Internal Auditors—International Standards for the Professional Practice of Internal Auditing

Recommended practices:

The chief audit executive, in consultation with senior management and the audit committee, establishes the scope of activities of the internal audit function. The process takes into account the cost justification of each element of audit activity.

The role of internal audit is formally defined in a written internal audit charter (See Question 3) and the audit activities are set out in the annual audit plan (Question 9).

The audit committee approves the internal audit charter periodically and the audit plan annually.

3. What should be the mandate of the internal audit function?

Internal auditors need a mandate that provides the authority they need within a structure that supports their independence and objectivity. This can best be achieved through a written charter for the internal audit function that is aligned with the mandate and needs of the audit committee. The mandate should be compatible with the best current practices and approved by the board or audit committee. Any restrictions by management should be disclosed to, and approved by, the audit committee.

Internal audit should not have any operational accountability or perform functions that would be subject to subsequent internal audit review.

Recommended practices:

The mandate of the internal audit function is set out in a written charter that is compatible with the charter of the audit committee and consistent with the Standards of the Institute of Internal Auditors.

The internal audit charter is reviewed and updated regularly and includes:

- Role and responsibilities of the internal audit function;
- Functional reporting relationship to the audit committee;
- Administrative reporting relationship;
- Access to corporate employees, facilities and records (including those of contractors);
- Any restrictions of the scope or authority of internal audit;
- Requirement that managers cooperate with internal audit and respond to reports;
- Code of ethics;
- Internal audit standards;
- Relationship with external auditors;
- Distribution of audit reports and summaries;
- Follow up of recommendations;
- Specific mention of areas such as fraud, technology, safety, environment, etc. as may be required for clarification;
- The right of the chief audit executive to attend audit committee meetings.

Internal Audit Relationships

The chief audit executive's relationships with the audit committee and senior management are critical to the success of the internal audit function. The audit committee can use the following questions to confirm that the relationships give internal audit the support and access it needs and that the committee receives the range of services and support it needs to meet its own mandate.

4. What is the relationship between internal audit and the audit committee?

The internal audit function is a major source of information and assurance to the audit committee on internal financial controls and other risk management activities. For this reason, most internal audit functions have a functional reporting relationship to the audit committee which is defined in the charters of internal audit (Question 3) and the audit committee. A key element of this relationship is a direct channel of communication between the chief audit executive and the audit committee. This typically includes provisions for the chief audit executive to have access to the chair of the audit committee and attend audit committee meetings to present the audit plan for approval and to report audit findings.

The CFO and chief audit executive are usually present at all audit committee meetings. Much of the work performed by the audit committee relates to the roles of these individuals and one or the other may take a role in supporting the committee's planning activities. There is generally no requirement for the CEO to be present at audit committee meetings but in many cases he or she may attend for information purposes.

Chief audit executives do not generally attend board meetings. At least annually the chair of the audit committee should include a reference to internal audit's effectiveness, capabilities, the results of its work and any concerns when reporting to the board.

Relationship with and expectation of the internal audit function

There are many operational aspects of the audit committee's relationship with the internal audit function that are important for the effective oversight of the internal control framework and culture. Where a corporation has an internal audit function, the audit committee should approve its mandate, be satisfied that it has adequate resources to perform its responsibilities, and ensure that the director of internal audit has direct and open communication with the committee. Where internal audit does not exist, the audit committee has an important oversight role that goes beyond the normal operational issues.

Beyond Compliance: Building a Governance Culture,
Final Report, Joint Committee on Corporate Governance,
November 2001

Recommended practices:

The audit committee charter includes provisions for:

- The audit committee to review and endorse the appointment or replacement of the chief audit executive;
- The internal audit charter to be compatible with that of the audit committee;
- The internal audit charter to be approved by the audit committee periodically (e.g., at least every three years);

- Internal audit to provide the audit committee members and senior management with independent, objective views on risk and internal controls within the organization;
- The chief audit executive to attend audit committee meetings.
- The audit committee to approve the internal audit plan annually;
- The chair of the audit committee to meet privately with the chief audit executive prior to audit committee meetings to:
 - build the necessary trust between the two individuals,
 - allow the chief audit executive to provide context informally about the function and its relationships with management that may not be possible in a formal report, and
 - allow the audit committee chair to gain insights into issues that merit discussion at audit committee meetings but which may not otherwise get a high priority;
- The chief audit executive to report the results of major activities and key findings and issues to the audit committee;
- The chief audit executive to be expected to raise matters that have a material effect on controls, integrity of management and quality of financial reporting;
- The chief audit executive to meet with the audit committee periodically without management present;
- The chief audit executive to have unrestricted access to the chair of the audit committee at any time.

The external auditors are present when internal audit reports formally to the audit committee — except for in-camera sessions.

5. To whom does internal audit report administratively?

The chief audit executive reports functionally to the audit committee on the planning, execution and results of audit activities. However, like any other corporate employee, the chief audit executive must report to someone administratively for purposes of pay, performance, space, equipment and related matters. This person should be sufficiently highly placed to reinforce the organizational status of internal audit and to support its unrestricted access to corporate resources, but must not impair the independence of the internal audit function. In practice, the individual to whom the chief audit executive reports administratively should be selected on the basis of his or her ability to respect and give effective support to the independence of internal audit, rather than for the position he or she holds.

The role of internal audit is both internal and independent. Constructively evaluating the work of fellow members of the management team and providing advice to them can create tension — although this can be healthy when handled professionally by all parties. Relationships with management should be balanced — not too friendly but not hostile. Helping achieve this balance is part of the role of the audit committee and the CEO.

A major issue for the audit committee is the career risk to the chief audit executive of challenging or fully reporting serious and embarrassing deficiencies in the areas of accountability of the person who sets his or her salary, bonus and other benefits.

“The internal auditor occupies a unique position — he or she is “employed” by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor’s “independence” from management is necessary for the auditor to objectively assess management’s actions, but the auditor’s “dependence” on management for employment is clear. Recognizing this tension, the committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit committee and the internal auditor should lose its “taboo” nature and no longer imply treason against management.

The audit committee must establish and support a culture that promotes open disclosure on the part of the internal auditor and a recognition that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee. Management should more than acquiesce in this duty to disclose; management should encourage and support such disclosure by word and deed.”

New York Stock Exchange—Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees—Guiding Principles for Audit Committee Best Practices, 1999

Reporting options, each of which has advantages and disadvantages, include:

Reporting to	Advantages	Disadvantages
CEO	Establishes audit status.	CEO may have too many direct reports.
CFO	Reinforces financial control. CFO often understands the role of internal audit and can provide advice.	Potential conflict of interest: • if audit findings reflect badly on CFO • if resources are diverted to lower priorities.
Other senior executive	Good for audit independence if the executive has no or few direct operational responsibilities subject to significant internal audit scrutiny.	Executive may lack knowledge of operations and internal controls, may not have a motivation for internal audit to be effective, or may lack the ability to influence.
Chair of audit committee	Good for audit independence.	Internal audit is no longer seen as supporting and partnering with management. Chief audit executive may lose status and acceptance as a member of the management team.

Recommended practices:

The internal audit function reports administratively to the CEO or other senior executive and has a functional reporting relationship to the audit committee to ensure objectivity in the planning and execution of internal audit work.

The CEO and senior management team includes the chief audit executive in senior meetings such as strategic planning sessions and operational committees where appropriate. This shows support by helping the chief audit executive understand what is going on at a senior level and exposes him or her to other executives in a more collegial environment.

The audit committee reviews this administrative relationship annually or whenever there is a significant reorganization within the senior management team. In some parts of the discussion, the views of the chief audit executive should be invited.

The individual to whom the chief audit executive reports, the chair of the audit committee and the CEO jointly approve the performance review, salary, bonus and other benefits of the chief audit executive.

Internal Audit Resources

Internal audit functions need an adequate complement of staff with the appropriate experience and qualifications for the risks and businesses they audit. Staff require continued training in their disciplines and must stay abreast of technological advances and changes in the organization's business. The internal audit function should also make full advantage of the work and resources of the external auditors by coordinating activities.

These questions are designed to be directed at the chief audit executive at an audit committee meeting as part of the process of understanding and assessing the quality of the internal audit function.

6. How is the internal audit function staffed?

Internal auditing activities can be conducted by:

- In-house resources —The organization may assign responsibility for audit activities to a corporate internal audit department or include some audit activities in the responsibilities of line functions (for risks such as safety, environment, etc.). The internal audit department may include staff from other departments as part of audit teams.
- A fully outsourced internal audit function reporting to a designated executive —The organization engages an external firm to perform the entire internal audit function. Some companies may be prohibited by statute or regulation from outsourcing internal audit work to their external auditors. Professional accounting standards may also restrict this activity.

- A combination of the above —The organization may outsource specific activities or projects to specialist firms or include one or more outside experts with internal audit staff on a project team.

To meet the needs of boards, management and regulatory requirements, a designated executive (who may be the chief audit executive) should be responsible for ensuring that all important internal audit activities are coordinated.

Recommended practices:

The staffing of the internal audit function is based on the number of skilled individuals required to cover the activities identified in the approved audit plan.

The chief audit executive, in consultation with senior management and the audit committee determines the most cost-effective mix of in-house and outsourced internal audit staffing.

The size of the internal audit function is benchmarked against similar organizations.

The audit committee reviews and assesses the appropriateness and expertise of the resources as part of the annual audit plan.

Where material, the audit committee reviews and approves the appointment of outsourced audit firms and subsequently monitors the effectiveness of this arrangement.

7. How does internal audit get and maintain the expertise it needs to conduct its assignments?

Internal auditing calls for a diverse set of knowledge, skills and experience. It is critical that the internal audit staff have the skills, industry knowledge and experience (supplemented where necessary by external resources) to provide the control assurance and related advice that the audit committee requires.

Chief audit executives should not plan or accept assignments unless they are able to staff them competently, as this can provide false assurance or weaken the function's reputation. Consideration should be given to using the expertise of other corporate staff, engaging outside experts or outsourcing where the necessary skills do not reside within internal audit.

Qualifications for internal auditors include:

- Professional accounting designations (CA, CGA, CMA, and CPA).
- Internal audit qualifications (Certified Internal Auditor (CIA) and Certified Information Systems Auditor (CISA)).
- Specialist qualifications, e.g., CA•CIA.
- Qualifications in specialized areas of audit such as Certified Environmental Auditors (CEA).
- Other disciplines: engineers, economists, environmentalists, etc.

Recommended practices:

The qualifications of internal auditors are established and included in job descriptions and postings.

Internal audit recruits only people with appropriate qualifications and/or experience in auditing, accounting, information technology, organizational analysis, industry knowledge, etc.

Internal audit promotes professional development and formal certification of audit staff.

Internal audit uses internal and outside experts when its staff lacks specialized expertise.

The internal audit budget includes adequate funds for professional development and the planned use of external experts.

Internal audit periodically reports to the audit committee on its staff capabilities, including academic and professional qualifications and years of audit, industry and organizational experience.

8. Are the activities of internal audit appropriately coordinated with those of the external auditors?

External auditors rely on the work of internal auditors to the extent that it confirms the quality of an organization's system of internal control. Before accepting the work of internal audit the external auditors review

the scope, audit approach, standards and results of the internal audit function in accordance with their own professional standards.

The internal and external auditors should work cooperatively to achieve the best possible value in audit coverage. Any such cooperation must respect the legal obligations of the external auditors. These obligations are evolving rapidly and require close monitoring.

The committee should ask both internal and external auditors if they are satisfied with the extent of coordination and compare the answers.

Recommended practices:

As far as possible, the presentations of audit plans are developed and coordinated to help the audit committee members understand their combined scope.

The audit committee reviews the plans of the external and internal auditors and questions any situations where areas are apparently not covered or duplicated.

Internal audit staff are used on the external audit assignment only where it is beneficial to the organization and does not take them away from more valuable work. It should not merely be a way to reduce the external audit fees.

The committee determines whether the relationship of internal auditors and external auditors exhibits a mutual professional respect and appreciation for the other's role and contribution, and also recognizes that the audit committee's needs are paramount to each group.

Internal Audit Process

An effective internal audit function is run in a professional manner. Chief audit executives should demonstrate to their audit committees how they set priorities, plan, supervise and review the various internal audit projects and activities.

These questions are designed to be directed at the chief audit executive at an audit committee meeting. They deal with matters of organization and process and may be discussed in the presence of senior management.

9. How is the internal audit plan developed?

An annual internal audit plan is the key to matching the work of internal audit to the needs of and expectations of the audit committee, external auditors and senior management. It allows the audit committee to confirm that board priorities are addressed and provides a basis for evaluating internal audit performance.

Recommended practices:

The chief audit executive prepares an annual audit plan based on a comprehensive review and analysis of the organization's business activities and associated risks. Where an enterprise risk management process is already in place, this will provide a critical basis for developing an audit plan aligned with corporate priorities.

The chief audit executive seeks management input and agreement on the scope and priority of the proposed audit projects.

The audit plan includes all projected internal audits and other activities, including reviews of the development of major new computer systems and critical business projects, and the provision of consulting and advisory services, where appropriate.

The audit plan includes the budget and staff resources required to accomplish the plan.

The audit plan allows flexibility to respond to unforeseen issues and events during the year.

The external auditors are consulted and their input and audit scope considered in developing the plan. They also receive a copy of the final audit plan.

The audit committee reviews the audit plan and assesses its adequacy based on their knowledge of the industry and the organization. Before they approve the final audit plan they satisfy themselves that it covers the areas of risks for which they require independent assurance from internal audit.

The chief audit executive informs the audit committee of any significant changes to the audit plan during the year.

10. What does the internal audit plan not cover?

Omissions from the audit plan may expose the organization's CEO and board to unnecessary risk. Ideally, the committee, senior management and the chief audit executive should agree on those areas of risk that will not be audited and the reasons. Audit committee members should be alert to the possibility of under-funding of the internal audit function.

Recommended practices:

The internal audit plan includes a list of those areas of risk that ranked just below those selected for inclusion in the audit plan. This enables the audit committee to assess what risks management and the committee will accept by excluding them from the plan.

11. How are internal audit findings reported?

Boards, audit committees and senior management rely on internal audit reports to confirm the quality of the system of control. Where the volume of audit reporting is high, the chief audit executive may prepare summaries at an appropriate level of detail.

Recommended practices:

Audit reports, as historical records of audit work and findings, are in writing and include the scope and objectives of the audit, the findings and recommendations for improving control.

Reports are action-oriented and include comments and proposals for corrective action from the management of the audited business unit.

Reports are balanced — reporting the good risk and control practices as well as the weaknesses observed.

Reports identify the best practices observed throughout the organization.

Reports rate recommendations as high, medium and low in order to assist management in assigning priorities for action to the issues raised.

The chief audit executive provides summaries of audit reports to senior management and the audit committee. The level of detail depends on the size of the organization but is sufficient to allow the audit committee to understand the types and frequency of control issues that internal audit raises and how management is responding to them.

Periodically, the audit committee asks to see a detailed internal audit report to understand the methodology and quality of reporting.

12. How are corporate managers required to respond to internal audit findings and recommendations?

Internal audit reports are only of value when managers address the problems and deficiencies identified by the audits or make informed decisions to accept the risks. Audit committees and senior management play an important role by monitoring and enforcing commitments to take corrective action.

The CEO and senior management team establish the “Tone at the Top” that is critical to the success, value and credibility of the internal audit

function. This means providing support in accordance with the internal audit charter, by:

- maintaining the independence of internal audit;
- ensuring line management’s cooperation in the performance of audits;
- requiring prompt responses and action from management on audit reports;
- recognizing and promoting internal audit as a value added activity;
- refraining from using internal audit resources for non-audit purposes that cut into audit time or create a conflict of interest; and
- keeping internal audit informed of key plans and changes to the risk and control profile of the organization’s policies and procedures.

Line managers do not always view the role of internal audit positively and it can require great skill and diplomacy to obtain their cooperation on audits. Open support and monitoring of internal audit activities by the CEO and the audit committee can help ensure that all managers cooperate with the internal auditors.

Recommended practices:

Line management is required to review all audit findings and provide action plans and dates for implementation before or soon after the audit report is issued. Where management recommends that no action be taken, the decision to accept the related risk is approved at the appropriate level.

Management accepts responsibility for monitoring corrective action on weaknesses reported by internal audit.

The chief audit executive establishes and maintains a formal follow-up process for monitoring and ensuring that management actions have been effectively implemented.

Senior management, the CFO and the CEO periodically review high-risk outstanding audit recommendations as part of a management process.

The CEO (or whoever performs this role with the chief audit executive) meets periodically with the chief audit executive to review audit reports and outstanding recommendations, and to obtain input on risk and controls.

The audit committee receives periodic reports on high-risk audit recommendations that have not been resolved.

13. What services does internal audit provide in connection with fraud?

The prevention, deterrence and detection of fraud are the responsibility of management. The usual role of internal auditors is to develop audit programs and procedures to evaluate the internal controls that management has established to manage the risk of fraud. In practice, auditing sometimes deters employees from committing fraud and occasionally detects a fraud, but these are not usually the major objectives of auditors.

The term “fraud” covers a number of activities; principally:

- Property fraud — the theft or misuse of assets and, sometimes, the related information;
- Financial reporting fraud — the manipulation of information to mislead or deceive stakeholders.

Internal audit may participate in the investigation of fraud and provide forensic accounting services — provided that it is cost-effective to do so. The skills to investigate frauds may be within the internal audit function, or in a separate security department.

Recommended practices:

Internal audit includes fraud as a risk to be evaluated and included in the audit plan.

The organization has a system for investigating activities that appear to be fraudulent. The process involves individuals with legal and human resources expertise to ensure that individual rights to privacy are respected and that the investigation will support prosecution by the police and law courts.

14. How do you assess the effectiveness of your internal audit function?

Good internal audit functions have processes for assessing their own effectiveness. They use the results, together with feedback from the external auditors and other stakeholders, to monitor trends over time and achieve continuous improvement in their practices and performance.

Recommended practices:

The chief audit executive develops performance measures for the internal audit function and agrees them with the audit committee. Examples of measurement techniques include: customer satisfaction surveys, post audit debriefing and internal quality assurance reviews.

Internal audit evaluates its own performance against the agreed measures.

There is an external quality assurance review of internal audit at least once every five years. The quality assurance review is performed by qualified individuals in accordance with Institute of Internal Auditors standards.

Internal audit uses benchmarking to compare its operations and effectiveness with those of other organizations.

Evaluation results are reported to the audit committee.

Closing Questions

The questions in this section are designed to help the audit committee reach a conclusion on the effectiveness of internal audit. In most cases the audit committee may use them to sum up discussions of audit relationships, resources and process with the chief audit executive in the presence of the CEO and external auditors. The timing and venue for asking the questions are appropriate topics for the chair of the audit committee to discuss with the chief audit executive. Where there may be problems the audit committee may consider asking them in an in-camera meeting with the chief audit executive.

15. Does internal audit have sufficient resources?

This is a sensitive but important question. The answer from the chief audit executive and resulting discussion can provide the audit committee with valuable insight not only into the reliability of the audit work but also into potential problems with management. Chief audit executives who answer “no” must be prepared to provide the audit committee with a comprehensive analysis of the situation including the steps they have taken to resolve the problems with management.

Assessing the sufficiency of resources should generally include comparisons with similar organizations and the business risks and the degree of change within the organization. Internal audit resources may be insufficient because:

- Management does not respect the role and contribution of internal audit;
- Management includes internal audit in a general under-funding to meet short-term forecasts;
- Management diverts internal audit resources to manage short-term goals, operational crises and special projects.

Internal audit functions not only need an adequate budget, they must be able to attract and retain skilled people. The issue of attracting qualified staff can sometimes be a more challenging problem than budgetary constraints. The audit committee should be aware of reasons for excessive turnover that could indicate poor management or a lack of respect for the function in the organization. Depending on the function’s staffing strategy, there may also be insufficient turnover when internal audit staff are not progressing in their careers and become stale or too close to management.

The audit committee should also ask the CEO about audit resources to get his or her perspective and recommendations. The committee should seek to understand management's explanations for any resource shortage and the risks the organization and committee accept as a result.

16. Does the internal audit function get appropriate support from the CEO and senior management team?

A critical part of the audit committee's role is to assess the relationship of the chief audit executive and the management team, whose support can greatly influence the effectiveness of the internal audit function and its value to the audit committee. There should be a good working relationship but also a mutual respect for the role of internal audit that includes:

- Support of audit findings — by addressing and requiring timely responses on audit reports including those that are justifiably critical of management controls;
- Inclusion of the chief audit executive, where appropriate, in the communications and forums of the senior management team to keep the chief audit executive informed of strategic and business plans.

This is another very sensitive question because chief audit executives who answer “no” may risk being seen as disloyal to their CEO and colleagues. Under normal circumstances the audit committee would expect to hear that the chief audit executive has no concerns or is in the process of resolving them.

If the audit committee has any concerns about the chief audit executive's response, the committee should respect the sensitivities involved, consider all the evidence and assess whether further action is required.

The audit committee should also ask the CEO about the level of support for internal audit within the organization to get his or her perspective and recommendations.

17. Are you satisfied that this organization has adequate internal controls over its major risks?

The audit committee is responsible for ensuring that management has designed and implemented an effective system of internal control. In preparing to report its conclusions to the board, the committee should seek information and opinions from a range of sources including the CEO, chief risk officer and chief legal officer as well as the external auditors and chief audit executive.

This question requires the chief audit executive to take a broad view of control and audit activities. The chair of the audit committee should discuss the committee's expectations with the chief audit executive in advance. The scope of the chief audit executive's response may involve integrating and summarizing the results of audit work and related activities such as risk and control self-assessments, internal control surveys, consulting projects and involvement in major projects and new systems.

18. Are there any other matters that you wish to bring to the audit committee's attention?

If there are any issues that affect controls, the integrity of management or the quality of financial reporting that are not addressed in the internal audit reports, the audit committee expects the chief audit executive to raise them with its chair or committee in accordance with the internal audit charter. The chief audit executive should be prepared to explain why these matters were not formally addressed in audit reports.

It is critical that the audit committee reach out and build a level of trust with the chief audit executive to permit honest and appropriate communication of sensitive issues and opinions related to risk and control. Generally, the chief audit executive would be wise not to raise issues that have not been already discussed with the CEO unless there are exceptional circumstances. Concerns raised at in-camera sessions should never be disclosed outside the in-camera session by the audit committee unless agreed to by the chief audit executive, or otherwise formally reported in internal audit reports. Chief audit executives must have trust and confidence that disclosures will follow agreed protocols and not damage their relationship with management.

19. Are there other ways in which internal audit and the audit committee could support each other?

This question provides an opportunity for the chief audit executive and audit committee to discuss such matters as improving audit reporting to the committee and using internal audit to provide training on risk and control aspects of the business either for new members to the audit committee or the committee as a whole.

The corporate governance committee may ask the chief audit executive a similar question as part of its periodic evaluation of the audit committee.

Audit committee Assessment

The audit committee is responsible for confirming that internal audit has the competence, independence, resources and corporate support to do its job properly, and is demonstratively effective in getting results. An effective internal audit function will usually have a senior reporting relationship. Its reports and opinions have high credibility and management frequently seeks its advice and consultation on risk and control issues within the organization.

The audit committee should consider asking the external auditors for feedback on the competence and support for the internal audit function within the organization. This may be most appropriate in an in-camera session.

20. Are we (the audit committee) satisfied with our internal audit function?

The following are some additional questions that audit committee members could ask themselves or use in a discussion following their meetings with the CEO, chief audit executive and external auditors:

- How well does the chief audit executive respond to probing by the audit committee?
- How well respected is the chief audit executive by senior management and how healthy is the tension between them?
- How well respected is the chief audit executive by the external auditors and how healthy is the tension between them?
- How often do we get surprises where something that the internal audit has audited subsequently reveals control problems that were not identified by their reports?
- Does the chief audit executive provide adequate assurance in areas requested by the audit committee?
- Does internal audit bring forward significant issues to the audit committee that might not otherwise be disclosed to the committee? Ideally, these should have been raised first by management and their identification attributed to the internal audit function.
- Is the chief audit executive respected within the auditing profession? (Examples would be as a frequent speaker, writing articles, industry organizations, etc.).



Where to find more information

Canadian Institute of Chartered Accountants publications

The 20 Questions Series¹

20 Questions Directors should ask about Building a Board
20 Questions Directors should ask about Codes of Conduct
20 Questions Directors should ask about Crown Corporation Governance
20 Questions Directors should ask about Director Compensation
20 Questions Directors should ask about Executive Compensation
20 Questions Directors should ask about Governance Assessments
20 Questions Directors should ask about IT
20 Questions Directors should ask about Internal Audit
20 Questions Directors should ask about Management's Discussion and Analysis
20 Questions Directors should ask about Privacy
20 Questions Directors should ask about Risk
20 Questions Directors should ask about Strategy
20 Questions Directors should ask about their Role in Pension Governance
20 Questions Directors should ask about Not for Profit Governance

The CFO Series

Financial Aspects of Governance: What Boards Should Expect from CFOs
How CFOs are Adapting to Today's Realities
Risk: What Boards Should Expect from CFOs
Strategic Planning: What Boards Should Expect from CFOs

The Control Environment Series²

Internal Control: The Next Wave of Certification — Helping Smaller Companies with Certification and Disclosure about Design of Internal Control over Financial Reporting

Internal Control 2006: The Next Wave of Certification — Guidance for Directors

Internal Control 2006: The Next Wave of Certification — Guidance for Managers

Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

Related CICA publications

CICA Handbook — Assurance Recommendations

CICA Handbook — Agreed-upon Procedures Regarding Internal Control over Financial Reporting

CPR Alert, Issue 1, January 2004; Issue 2, January 2006; Issue 3, April, 2006³

Crisis Management for Directors, 2001

Guidance for Directors: Governance Processes for Control, 1995

Guidance for Directors: Dealing with Risk in the Boardroom, 2000

Integrity in the Spotlight: Audit Committees in a High Risk World, 2005

Learning about Risk: Choices, Connections and Competencies, 1998

Management's Discussion and Analysis — Guidance on Preparation and Disclosure, Revised 2004

Managing Risk in the New Economy, 2000

Risk Alert January 2007, Auditor Involvement with Management's Internal Control Certifications (AASB)

www.cica.ca

Securities Laws and Regulations — Canada

www.osc.gov.on.ca/Regulation/Rulemaking/rrn_index.jsp

Securities Laws and Regulations — United States

[http://www.sarbanes-oxley.com/section.](http://www.sarbanes-oxley.com/section.php?level=1&pub_id=Sarbanes-Oxley)

[php?level=1&pub_id=Sarbanes-Oxley](http://www.sarbanes-oxley.com/section.php?level=1&pub_id=Sarbanes-Oxley)

United States Securities and Exchange Commission (SEC) www.sec.gov

¹ To order copies of the 20 Questions series or CFO series contact 416-977-0748 (Toronto) or 1-800-268-3793 (rest of Canada) or visit www.knotia.ca/store

² Available for free download from www.rmgb.ca/index.cfm/ci_id/3083/la_id/1.htm

Other

International Federation of Accountants

Internal Controls—A Review of Current Developments, Information Paper, August 2006
www.ifac.org

Institute of Chartered Accountants in England and Wales

Financial Reporting Council: Internal Control—Revised Guidance For Directors On The Combined Code (The Turnbull Report), October 2005
www.icaew.co.uk

Institute of Internal Auditors

Audit Committee Effectiveness—What Works Best, 3rd Edition -2005 Sarbanes-Oxley and the New Internal Auditing Rules, Robert R. Moeller, 2004
The Audit Committee Handbook, Fourth Edition, Louis Braiotta, Jr., 2004
Essential Project Investment Governance and Reporting: Preventing Project Fraud and Ensuring Sarbanes-Oxley Compliance, Steven C. Rollins, PMP and Richard B. Lanza, CPA, CFE, 2005
The Standards for the Professional Practice of Internal Auditing, 2007
www.theiia.org

Joint Committee on Corporate Governance

Final Report Beyond Compliance: Building a Governance Culture. Toronto, November 2001
www.cica.ca/index.cfm/ci_id/1878/la_id/1

New York Stock Exchange

Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees—Guiding Principles for Audit Committee Best Practices, 1999
www.nyse.com

Public Company Accounting Oversight Board (PCAOB)

Rulemaking Docket #21. Auditing Standard—An Audit of Internal Control Over Financial Reporting that is Integrated With and Audit of Financial Statements
www.pcaobus.org

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)

Internal Control—Integrated Framework, 1992
www.coso.org

³ Available for free download from www.cica.ca/index.cfm/ci_id/247/la_id/1.htm

Notes

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John has served on several non-for-profit boards and is currently a member of Rosseau Lake College's Board of Directors. John is a member of the CICA Risk Management and Governance Board and was an advisor for the recently published *20 Questions Directors Should Ask about Risk*. He co-authored the Investment Dealers Association's book *Internal Controls*, was a project author of the CICA book *Information Technology Control Guidelines — 3rd edition*, and co-author of the Conference Board of Canada's ERM Case Study *Enterprise Risk Management at Hydro One Inc.*

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Hugh has served on the boards of a number of organizations including the Insurance Institute of British Columbia and the Institute of Chartered Accountants of BC, and is currently a commissioner on the board of the Vancouver Museum. He was a member of the Criteria of Control Board of the Canadian Institute of Chartered Accountants and now writes for their Risk Management and Governance Board. His publications for CICA include *Managing Risk in the New Economy*, *Crisis Management for Directors*, *20 Questions Directors Should Ask about Risk*, *Strategic Planning: What Boards Should Expect from CFOs* and *Financial Aspects of Governance: What Boards Should Expect from CFOs*.

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