



AUDIT COMMITTEE BRIEFING...

INTERNAL AUDIT STANDARDS: WHY THEY MATTER

Why Do Internal Audit Standards Matter?

Internal auditing is one of the cornerstones of corporate governance, along with the board of directors, senior management, and external auditing. Because of internal auditors' unique position within the organization, they provide audit committee members with valuable assistance by giving objective assurance on governance, risk management, and control processes.

To do this effectively, an internal audit activity must be adequately resourced, professionally staffed, and follow the internationally recognized framework for internal auditing. Provided by The Institute of Internal Auditors (IIA), the *Professional Practices Framework* (PPF) comprises the *International Standards for the Professional Practice of Internal Auditing (Standards)*, Code of Ethics, and Practice Advisories.

For their part, audit committee members must play an active role in supporting the independence of internal auditing and ensuring it has enough resources to provide the appropriate level and quality of information. Commonly, and in best-practice organizations, internal auditing has a direct reporting line to the audit committee, which is frequently the most important of internal audit reporting lines.

The following overview explains how internal audit activities that adhere to the *Standards* and Code of Ethics can help audit committees comply with their own charters and regulatory responsibilities. Moreover, audit committees will find it much easier to execute their oversight responsibilities effectively in organizations where the internal audit activity complies with the *Standards*.

Because the *Standards* apply globally, including in countries that do not have audit committees, the *Standards* use the term "board" for the governing body typically serving the audit committee role. For purposes of this publication, the term "board" has been replaced with "audit committee."

In addition, this briefing provides guidelines for the relationship between audit committees and internal auditors and is a useful tool for anyone who wants to better understand the responsibilities, benefits, and qualities of an effective internal audit activity.

An effective internal audit activity acts as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

"Today more than ever, audit committees need to work closely with internal auditors to ensure strong internal controls, accurate financial reporting, and adequate risk management in every company they serve. To work effectively with internal auditors, audit committee members need to know best practices for this vital function. By understanding internal audit standards, audit committees can strengthen their own work of oversight."

Roger Raber, CEO
National Association of
Corporate Directors (NACD)

How Do Internal Auditors and the Audit Committee Work Together?

To forge closer working relationships, as outlined in the *Standards* and various regulatory requirements for audit committees, the internal auditors and audit committee should examine their working relationship.

Audit committee members should ask themselves how much input they have to the leadership and work of their internal audit team:

- How well do I know the head of internal auditing? How often do I talk to him or her?
- Do I appoint the head of internal auditing? Does he or she report directly to the audit committee?
- When was the last time I reviewed the internal audit charter? Do I know what it says?
- Do I know how the internal audit activity sets its plan? Do I review and approve the annual plan?
- How well is the management team implementing actions agreed upon during internal audit work?
- If the chief audit executive (CAE) came to me and expressed concerns based on his or her business judgment, would I listen? How would I act?

Audit committee members should also examine the internal audit activity performance:

- Does the internal audit activity comply with The IIA's *Standards*?
- Is internal auditing's position in the organization at a sufficiently high level and sufficiently detached from functional areas to guarantee its independence?
- Do the internal auditors avoid activities that could undermine their objectivity?
- Is the internal audit plan based on the organization's risk profile?
- How well is the internal audit activity completing its plan this year?
- Does internal auditing have a quality assurance program? Does it have a plan to undergo an external quality assessment every five years as required by the *Standards*? What are the results of the most recent quality assessment?
- Is internal auditing sufficiently resourced to provide objective assurance on risk and control?
- How does the CAE respond to probing by the audit committee?

If You Do Not Know the Answers to These Questions, Now Is the Time to Ask.

Meeting Internal Audit Oversight Responsibilities

In recent years, the responsibilities of the audit committee have come under scrutiny or have been enhanced by regulators around the globe. In addition, audit committees frequently have stated roles related to internal auditing in their charters. The roles typically include monitoring the effectiveness of internal auditing. The Institute of Internal Auditors' *Standards* and Code of Ethics clearly outline what internal auditors need to do to be effective. An ever increasing number of regulatory bodies are recognizing the importance of this guidance in ensuring that internal auditing is effective.

The table below shows common charter or regulatory requirements regarding audit committee oversight of internal auditing, and the associated IIA Standard. This clearly illustrates that in organizations in which the internal audit activity complies with the *Standards*, the audit committee will find it much easier to comply with its own charter and regulatory requirements.

Audit Committee Internal Audit Oversight Responsibilities	IIA Standards
Reviewing and approving the internal audit activity's charter	"The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the <i>Standards</i> , and approved by the organization's audit committee."
Ensuring communication and reporting lines between the head of internal auditing and the audit committee	<p>"The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities." The IIA strongly believes that to achieve necessary independence, the chief audit executive should report functionally to the audit committee and administratively to the chief executive officer.</p> <p>"The chief audit executive should report periodically to the audit committee and senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan."</p>
Reviewing internal audit staffing and ensuring that the function has the necessary resources	<p>"The chief audit executive should communicate the internal audit activity's plans and resource requirements ... to senior management and to the audit committee for review and approval. The chief audit executive should also communicate the impact of resource limitations."</p> <p>"The internal audit activity collectively should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities."</p>
Reviewing and assessing the annual internal audit plan	"The chief audit executive should communicate the internal audit activity's plans ... to senior management and to the audit committee for review and approval."
Overseeing the coordination of the internal auditor with the external auditor	"The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts."
Reviewing periodic reports on the results of the internal auditors' work	"The chief audit executive should report periodically to the audit committee and senior management ... Reporting should include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the audit committee and senior management."
Reviewing management's responsiveness to internal auditing's findings and recommendations	"The chief audit executive should establish a follow-up process to monitor and ensure that management actions have been implemented effectively or that senior management has accepted the risk of not taking action."
Monitoring and assessing internal audit effectiveness	<p>"The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness."</p> <p>"External assessments, such as quality assurance reviews, should be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organization."</p> <p>"The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization."</p> <p>"The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach."</p>

Professional Internal Auditing

An effective internal audit activity acts as an independent, objective assurance and consulting service 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.

Since 1978, the *Standards* and the Code of Ethics have set out the expected approach, principles, and behaviors that internal auditors apply to their work. Adopted by worldwide standard-setting bodies in the public and private sectors, as well as by all IIA members, the *Standards* and Code of Ethics are the profession's foundation and quality benchmark. By following the *Standards* and the Code of Ethics, internal auditors can provide an effective, independent assurance and consulting service to their organizations. Audit committees that are well-versed in the *Standards* and Code of Ethics will be in a better position to appoint, appraise, utilize, and support their internal auditors.

INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING – A SUMMARY

The *Standards* describe the nature of internal auditing and the characteristics of parties performing internal audit activities. They also provide quality criteria against which the performance of internal auditing can be evaluated.

The **purpose, authority, and responsibility** of the internal audit activity should be defined formally in a charter, consistent with the *Standards* and approved by the audit committee.

The function should be **independent** and internal auditors should be **objective** in performing their work. In addition, all internal audits should be performed with **proficiency and due professional care**.

The internal audit activity, collectively, should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

The chief audit executive should develop and **maintain a quality assurance and improvement program**, including internal and external quality assessments. He or she also should ensure the internal audit activity **adds value** to the organization and **follows a risk-based audit approach**.

In addition, internal auditing should **evaluate and contribute to the improvement** of risk management, control, and governance processes using a systematic and disciplined approach.

Before each audit, internal auditors should **develop a plan** that includes scope, objectives, timing, and resources.

During the engagement, internal auditors should **identify, analyze, evaluate, and record** sufficient information to achieve the internal audit project's objectives. Once the audit is complete, the results should be communicated in an accurate, objective, clear, concise, constructive, complete, and timely manner.

As a result, management should agree to take actions to improve their controls, and the chief audit executive should establish a **follow-up process** to monitor and ensure that these management actions have been implemented effectively.

INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING – CONTINUED

When the chief audit executive believes that management has accepted a level of residual risk that may be unacceptable to the organization, he or she should discuss this with management. If the issue is not resolved, the chief audit executive and senior management should report the matter to the audit committee for resolution.

Note: Because the *Standards* apply globally, including in countries that do not have audit committees, the *Standards* use the term “board” for the governing body typically serving the audit committee role. For purposes of this publication, the term “board” has been replaced with “audit committee.”

THE CODE OF ETHICS – A SUMMARY

The purpose of the Code of Ethics is to promote an ethical culture in the internal audit profession.

- By acting with **integrity**, internal auditors establish trust and provide the basis for reliance on their judgment. Internal auditors perform their work honestly, observing the law, while contributing to the legitimate and ethical objectives of the organization.
- Internal auditors exhibit the highest level of professional **objectivity** in gathering, evaluating, and communicating information. Internal auditors make a balanced assessment of all relevant circumstances and are not unduly influenced by their own interests or by others. Internal auditors avoid activities and relationships that might be seen to undermine their objectivity.
- Internal auditors **respect the value and ownership of information** they receive and do not disclose information without appropriate authority, unless there is a legal or professional obligation to do so. Internal auditors should use information prudently and not for their personal benefit.
- Internal auditors **apply the knowledge, skills, and experience** needed for their role. They perform their work in accordance with the *Standards* and engage in continuing professional development.

A full copy of the *Standards* and Code of Ethics can be found at www.theiia.org/Guidance.

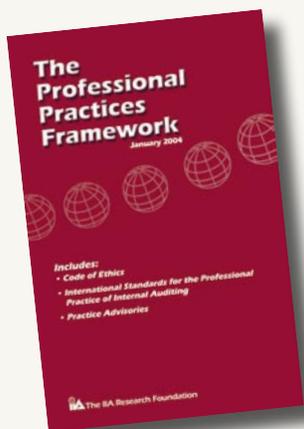
PROFESSIONAL PRACTICES FRAMEWORK

- *The Professional Practices Framework* – The IIA’s blueprint for the profession that offers practitioners a full range of internal audit guidance, including the *Standards*, Code of Ethics, Practice Advisories, and development and practice aids.

To access *the Professional Practices Framework* visit www.theiia.org/Publications click on “**IIA Bookstore.**”

- **Additional Resources** – Find the guidance resources you need in such areas as corporate governance, risk management, and establishing an audit shop.

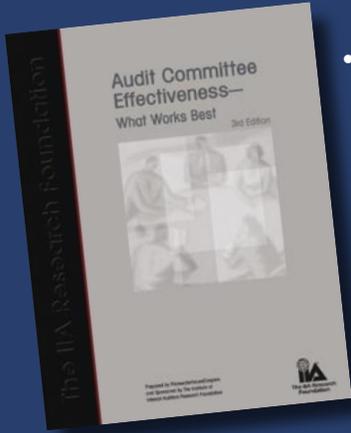
Guidance and resource information is accessible from The IIA’s Web site, www.theiia.org/guidance and www.theiia.org/technology.



Additional Resources

Audit Committees/Governance

PRODUCTS & RESEARCH FOUNDATION REPORTS



- *Audit Committee Effectiveness – What Works Best, Third Edition*
- *20 Questions Directors Should Ask About Internal Auditing?*
- *Audit Committees and Internal Auditing: An Essential Alliance for Effective Governance*
- *Corporate Governance and the Board – What Works Best*
- *Factors Affecting Corporate Governance and Audit Committees in Selected Countries (France, Germany, the Netherlands, the United Kingdom, and the United States)*
- *Governance Update 2003: Impact of New Initiatives on Audit Committees and Internal Auditors*
- *The Audit Committee Handbook, Fourth Edition*

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The Institute of Internal Auditors
Communications & PR
247 Maitland Avenue
Altamonte Springs, Florida 32701-4201 USA
Fax: +1-407-937-1101
www.theiia.org/Publications click on “Newsletters”



THE INSTITUTE OF INTERNAL AUDITORS

Established in 1941, The Institute of Internal Auditors (IIA) is an international professional association with world headquarters in Altamonte Springs, FL, USA. The IIA has more than 108,000 members and affiliates in 90 countries throughout the world. The IIA is the internal audit profession's global voice, recognized authority, acknowledged leader, chief advocate, and principal educator.

The International Internal Auditing Standards Board of The Institute of Internal Auditors sets the *International Standards for the Professional Practice of Internal Auditing* and the Code of Ethics.

For more information on The IIA's guidance,
visit **www.theiia.org/guidance**

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GLOBAL HEADQUARTERS
247 Maitland Avenue
Altamonte Springs, Florida 32701 USA

T +1-407-937-1100
F +1-407-937-1101
W www.theiia.org