

Implementing best practices and high standards



# THE AUDIT COMMITTEE: INTERNAL AUDIT OVERSIGHT



The Institute of  
Internal Auditors

# ROLES AND RESPONSIBILITIES

## AUDIT COMMITTEE RESOURCES

- The Institute of Internal Auditors (IIA)  
[www.theiia.org](http://www.theiia.org)
- *Tone at the Top* newsletter from The IIA  
[www.theiia.org/periodicals/newsletters/ton-at-the-top](http://www.theiia.org/periodicals/newsletters/ton-at-the-top)
- American Institute of Certified Public Accountants (AICPA) Audit Committee Effectiveness Center  
[www.aicpa.org/audcommctr](http://www.aicpa.org/audcommctr)
- Committee of Sponsoring Organizations of the Treadway Commission (COSO)  
[www.coso.org](http://www.coso.org)
- KPMG's Audit Committee Institute  
[www.kpmg.com/aci](http://www.kpmg.com/aci)
- Moody's Corporation  
[www.moody.com](http://www.moody.com)
- National Association of Corporate Directors (NACD)  
[www.nacdonline.org](http://www.nacdonline.org)
- The Conference Board  
[www.conference-board.org](http://www.conference-board.org)

Over the years, the roles and responsibilities of boards of directors — specifically, of the board's audit committee, if in existence — have become increasingly demanding and scrutinized. While today's audit committee must encompass a level of financial literacy, independence, and knowledge about risk management and internal control; individual audit committee members must be deeply committed, highly experienced, and fully qualified in order to effectively carry out their varied responsibilities.

Among the many important roles the audit committee plays within an organization, is to provide internal audit oversight. This document focuses on a single aspect of audit committee performance: its oversight of quality-oriented internal audit activities. While — at first glance — this role might not appear to be terribly complex or time-consuming, further consideration reveals that the

reality is the antithesis of simplicity. And as internal auditing's contribution to effective organizational governance has evolved and become increasingly acknowledged and revered, the audit committee's understanding of internal audit value, processes and procedures, strengths and weaknesses, and potential has escalated exponentially. As such, best practice indicates that the audit committee should define in its charter the scope of its relationship with the internal auditors, and should work to enhance its oversight ability — subsequently strengthening the internal audit activity.

Quality-oriented audit committees beget quality-oriented internal audit activities. But the return on investment goes both ways. The internal auditors also can be an important resource for audit committee enhancement. They do this by reviewing the audit committee charter, providing timely information on new legislation and regulations, and fulfilling the role of educator to audit committee members.



## EMPOWERMENT AND EXPECTATIONS

In some organizations, internal auditing is not widely recognized for its invaluable role. It is critical that audit customers throughout the organization understand the value that internal auditors can bring to their operations by identifying opportunities for enhancing efficiencies and effectiveness. The audit committee, in concert with executive management, can play a critical role in empowering and elevating the image of the internal audit activity, ensuring that it is not misunderstood.

By routinely communicating its value throughout the organization, those at the top can and should promote the importance of the internal audit activity. They can position the function as fully empowered to provide a critical check for management, to be a knowledgeable provider of assurance and a revered consultant, and to add value to the organization's governance, risk management, and internal control processes.

### 10-POINT OVERSIGHT CHECKLIST

TO PROVIDE ADEQUATE OVERSIGHT OF INTERNAL AUDITING,  
AN AUDIT COMMITTEE SHOULD ENSURE THE FOLLOWING:

- 1 The audit committee engages in an open, transparent relationship with the chief audit executive (CAE).
- 2 The audit committee reviews and approves the internal audit charter annually.
- 3 As a result of discussions with the CAE, the audit committee has a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems.
- 4 The internal audit activity is sufficiently resourced with competent, objective internal audit professionals to carry out the internal audit plan, which has been reviewed and approved by the audit committee.
- 5 The internal audit activity is empowered to be independent by its appropriate reporting relationships to executive management and the audit committee.
- 6 The audit committee addresses with the CAE all issues related to internal audit independence and objectivity.
- 7 The internal audit activity is quality-oriented, and has in place a Quality Assurance and Improvement Program.
- 8 The audit committee regularly communicates with the chief audit executive about the performance and improvement of the CAE and the internal audit activity.
- 9 Internal audit reports are actionable, and audit recommendations and/or other improvements are satisfactorily implemented by management.
- 10 The audit committee meets periodically with the CAE without the presence of management.



## INTERNAL AUDIT CHARTER

The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* recommend defining the internal audit activity's purpose, authority, and responsibility in a charter that is approved by the board. The internal audit charter is a useful tool for the board and management when evaluating the internal audit activity's performance.



## DEFINITION OF INTERNAL AUDITING

*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.*

Reporting to executive management and having direct access to the audit committee well positions the internal audit activity within an organization. Internal audit independence is furthered by periodic private meetings between the audit committee and the CAE, during which time sensitive issues are discussed, without management's presence.

## SHARING THE VISION

The audit committee and the CAE should agree on the internal audit charter. This requires them to share the same vision in regard to the internal auditors' scope of work, including how their attention and focus will be divided among assurance and consulting; operational, financial, and compliance auditing; and issues related to risk management, internal control, and ethics. This also requires agreement as to the internal auditors' role, as described in The IIA's official definition of internal auditing; as well

## PLANNING AHEAD

Although insight provided by the audit committee during the development of the internal audit plan can be invaluable to the internal auditors, a well-developed and implemented plan also can bring great value to the committee in its oversight role. Audit committee members can review the scope, determine whether the internal audit plan addresses previously identified areas of risk, recommend changes to internal audit activities, and determine whether the plan supports the objectives of

# BEST PRACTICES < BEST PRACTICES

as ensuring the internal auditors have the authority to access all company employees and to examine all company records and physical assets.

To provide effective internal audit oversight requires the audit committee to have an in-depth understanding of the business, the associated risks, and the internal control environment. The audit committee also must be diligent in reinforcing the importance of internal audit independence, as well as the CAE's accountability to senior management and the audit committee. Once the vision is aligned and the internal audit charter is in place, the audit committee periodically should assess the organizational structure to ensure the internal audit activity has the resources and skill sets necessary to effectively and efficiently accomplish its goals.

management and the board. Once this is determined, a budget must be developed to accommodate the audit plan. The IIA recommends that the budget be reviewed and approved by the audit committee.

## COMMUNICATING CRITICAL INFORMATION

Few components of oversight are as critical to effective and successful audit committee oversight of internal auditing as is two-way communication with the internal audit activity. Because of their position and role within an organization, internal auditors possess a good and objective understanding of the culture, system of internal control, operations, and industry. Hence, the audit committee should rely upon them for important information about the organization's control environment and processes, including significant control process issues, potential improvements, and resolution; as well as the overall adequacy of internal controls.

# THE AUDIT COMMITTEE: INTERNAL AUDIT OVERSIGHT

Specifically, the audit committee should ensure the lines of communication are open with the internal auditors to discuss significant issues that have been brought to the attention of management and the resulting responses. Should management place limitations on the scope of internal audit processes that have been authorized by the charter, the audit committee should be informed by the CAE. Such discussions will provide valuable information that will help the audit committee in its role of management oversight.

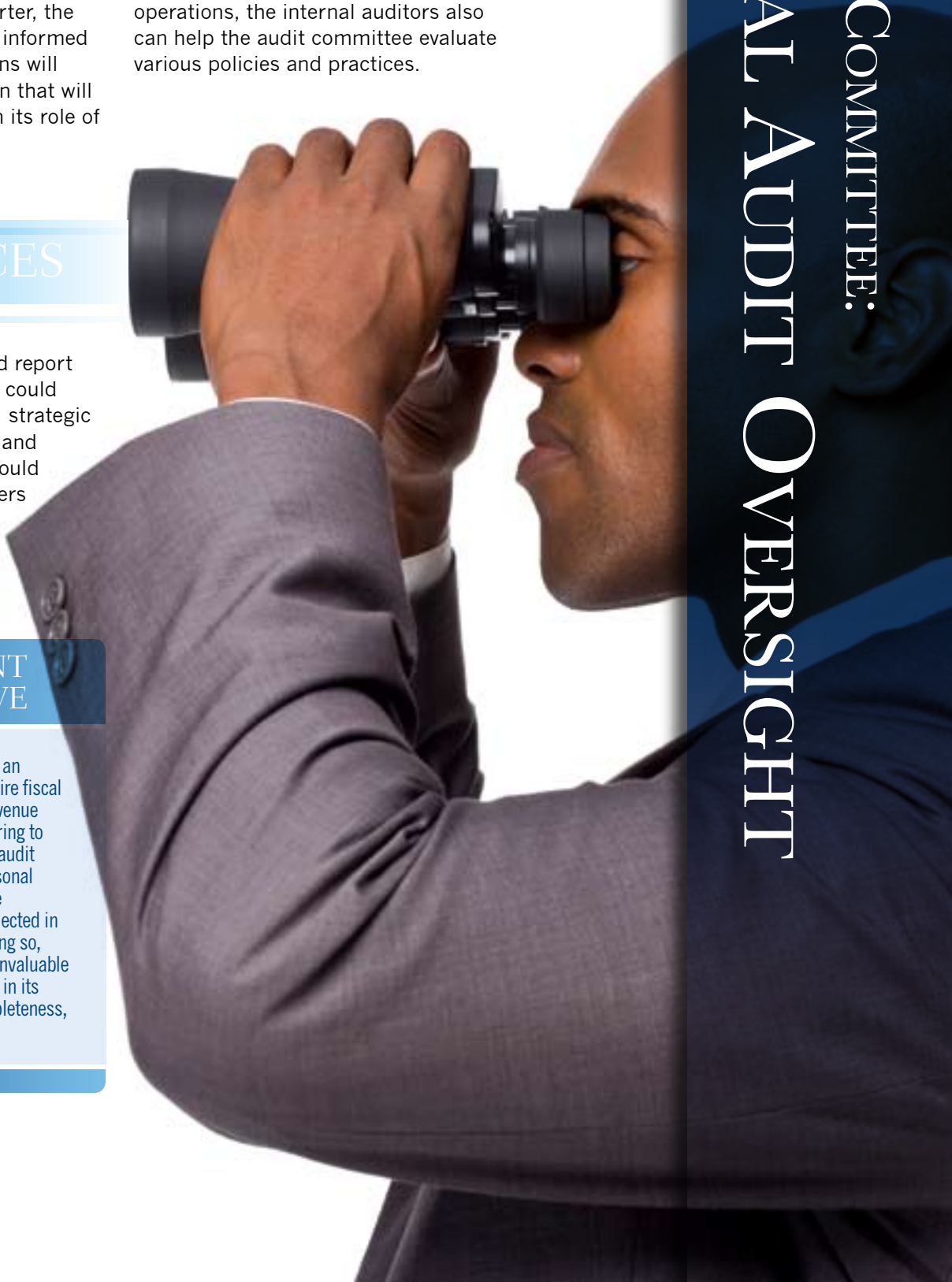
discussion include the reliability of operational information, safeguarding of assets, appropriate disclosures, and compliance with contracts, regulations, and laws. And because of their extensive knowledge and based on their observations of accounting decisions, policies, and any complex or unusual events, transactions, and operations, the internal auditors also can help the audit committee evaluate various policies and practices.

## BEST PRACTICES

The internal auditors should report to the committee risks that could hamper the achievement of strategic and operational objectives, and fraud risks that involve or could involve management or others who play a significant role in the internal controls. Other important areas for

### A DIFFERENT PERSPECTIVE

Full-time internal auditors have an advantage of witnessing the entire fiscal year with an ongoing view of revenue and expense cycles. They can bring to executive management and the audit committee an up-close and personal perspective on the results of the organization's operations as reflected in the financial statements. By doing so, the internal auditors can be an invaluable resource to the audit committee in its oversight role for financial completeness, accuracy, and disclosure.



# QUALITY OF INTERNAL AUDIT PERFORMANCE

## OVERSEEING QUALITY

Inherent in the audit committee charter is its responsibility for monitoring and reviewing the performance of the internal audit activity. Because the input of the internal auditors is so critical to the success — and potentially, the very survival — of an organization, it is important for the audit committee to have a clear picture of the internal audit activity's performance, and ensure that it is functioning well.

Clearly, the CAE should report to the audit committee on the performance of the audit plan. But this is not sufficient to ensure quality of the entire internal audit activity. Every internal audit activity, regardless of size, should have in place a Quality Assurance

## IMPORTANT QUESTIONS TO ASK

### QUESTIONS THAT SHOULD BE ANSWERED IN ORDER TO ADEQUATELY GAUGE AND PROVIDE TO VARIED STAKEHOLDERS REASONABLE ASSURANCE OF INTERNAL AUDIT QUALITY:

- Does the internal audit activity have in place a Quality Assurance and Improvement Program?
- Does the activity have the tools and other resources it needs?
- Has the activity performed its work in accordance with its charter?
- Does the activity engage in ongoing internal reviews and analysis of supervision, documentation, policies, and procedures?
- Do the internal auditors adhere to The IIA's Code of Ethics?
- Does the activity engage in periodic reviews that include customer surveys, risk assessments, work paper reviews, review and analysis of performance metrics, and best-practice benchmarking?
- Are the internal audits conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*?
- Do members of the team participate in professional development training?
- Does the activity operate effectively and efficiently?
- Have team members acquired professional designations that demonstrate their competency?
- Is the staff size adequate?
- Are the existing skill sets appropriate?
- Does the activity contribute to the improvement of organizational operations, and is it perceived by stakeholders to add value?
- Has the internal audit activity obtained an independent external quality assessment within the past five years?

## SETTING THE STANDARD

As the internal audit profession's trustworthy global guidance-setting body, The Institute of Internal Auditors (IIA) promulgates the *International Standards for the Professional Practice of Internal Auditing (Standards)*. Professional internal audit activities work in conformance with the *Standards*, which — along with the Definition of Internal Auditing and the Code of Ethics — are a mandatory component of the International Professional Practice Framework (IPPF). Included in the *Standards* is a mandate for internal audit activities to obtain an external quality assessment every five years.

and Improvement Program. Not only does such a program help ensure the activity is on the path to optimal quality, but it also sets an example of excellence for all audit customers and stakeholders, by demonstrating the activity's commitment to confronting areas in need of improvement, and taking steps to make the requisite changes.

## AUDITING THE INTERNAL AUDITORS

The internal audit activity is a part of an organization's risk universe,

and should be assessed. Although the audit committee clearly is responsible for internal audit oversight, it is not the committee's role to "audit" the activity. The audit committee's oversight is at a much higher level. So who audits the internal auditors? That is the role of the external quality assessment (QA) team — an independent group of professionals who are well-versed in best internal audit practices, under the leadership of an experienced and professional project manager.

The objectives of an external QA team are to evaluate the efficiency and effectiveness of the internal audit activity within the organization, to make best-practice recommendations for improvement, and to determine whether the activity is in conformance with the *Standards*. This is especially important, as it sends the message to everyone that the internal audit activity systematically submits itself to the same level of scrutiny that the rest of the organization undergoes through internal audits. This represents the internal audit activity's commitment to excellence and dedication to quality.

In addition, the external QA validates — for the CAE, executive management, and the audit committee — the level of the internal audit activity's performance. It also provides assurance that enables the audit committee to report to the board with the highest level of confidence that internal auditing is functioning as it should.

#### REST ASSURED

The CAE's reports on the status of the activity's Quality Assurance and Improvement Program should provide to the audit committee assurance of the internal audit activity's quality. This assurance is derived from a variety of sources:

- Internal assessments — periodic and ongoing feedback on what's working and what gaps need to be filled to ensure effectiveness, efficiency, economy, and conformance with the *Standards*.

#### QUALITY RESOURCES

On The IIA's Web site at [www.theiia.org/quality](http://www.theiia.org/quality) are a variety of resources for improving quality internal auditing, including a Quality Maturity Model and overview of what is entailed in a Quality Assurance and Improvement Program. "The Path to Quality" provides a step-by-step guide for getting to the next level.

- Action plans — documenting action needed and steps taken to fix issues and align goals and objectives in a changing environment with competing priorities.
- External QAs — independent validation that what you are hearing from the CAE about the activity is accurate.
- External auditors — the level to which they are comfortable relying on the work of the internal audit activity.

By establishing an open and trusting relationship with the CAE, clearly delineating your expectations of the internal auditors, being attentive to all reports provided, and asking the right questions, you and the entire audit committee can stay up to date on the internal audit activity. Following these practices will help ensure that the CAE has the tools, resources, and support necessary for optimal performance. It also will help keep you informed about the quality of your internal audit activity. And when it comes to effective organizational governance and oversight, this level of knowledge will go a long way toward ensuring you don't lie awake worrying at night!



## BENEFITS OF EXTERNAL QUALITY ASSESSMENTS

**A**s the internal audit profession's recognized authority, The IIA promulgates the accepted global methodology for assessing internal audit quality. The IIA also provides cost-effective external QA services to help organizations validate and strengthen their internal audit activities, and enhance their effectiveness, efficiency, and best-practice implementation.

In addition to ensuring the internal audit activity's conformance with the *International Standards for the Professional Practice of Internal Auditing*, the benefits of external quality assessments are well documented.

**JCPENNEY**

"Additional benefits qualified external parties can bring to your audit function include experiences, leading practices, and value-added processes they have been exposed to as a result of conducting QAs for other internal audit shops."

**MERCK & CO.**

"External quality assessments provide ... a critical opportunity to benchmark Merck against other companies following the same standards and guidelines."

**CHINA NATIONAL OFFSHORE OIL COMPANY AND SHELL PETROCHEMICALS CO. LTD. (CSPC)**

"Through the QA process ... we have embedded quality into the mindset and daily operations of our internal audit activity, and the company as a whole."

**POST DENMARK**

"We received great benefit from having an independent validator from The IIA challenging us on our processes. Moreover, the validator facilitated fruitful discussions with executive management and the chairman of the board on the role of our function."

**GRUPO BANCOLOMBIA**

"External quality assessments have been crucial in our continuous improvement process."

**DELL INC.**

"Quality assessment programs are foundational to performing and sustaining high-quality production."

**DYNEGY, INC.**

"To really benefit from a QA ... it is important to acknowledge your identified shortcomings and develop and implement plans to rectify them."

FULL CONTEXT OF TESTIMONIALS IS AVAILABLE AT [WWW.THEIIA.ORG/QUALITY](http://WWW.THEIIA.ORG/QUALITY).



**The Institute of  
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