



Management and Audit Committee Considerations

57. How can management utilize internal audit most effectively?

Internal audit represents a valuable resource to management as it seeks to meet business objectives, especially as it relates to the objectives of internal control: efficiency and effectiveness of operations, reliability of financial reporting, compliance with applicable laws and regulations, and the safeguarding of assets.

Each company's internal audit function possesses unique individuals, skills and competencies, which management needs to understand and use effectively in helping meet its objectives. Internal audit should not be a function for the exclusive use of the audit committee. As the SEC and related literature suggest, an internal audit function, by its very nature, is a part of management's systems of internal control and thus should be an asset and tool for management.

While the charter of, need for and capability of each company's internal audit function vary, management may find the following suggestions helpful in determining how to best leverage internal audit resources to achieve strong, well-designed and effective risk management, internal control and corporate governance processes:

- Utilize internal audit resources as part of the company's enterprisewide risk assessment/management process to identify, source, measure, prioritize and develop a plan to address and manage the most significant business risks it faces in achieving its business objectives.
- Provide key input to the internal audit function in the development of the annual internal audit plan and changes to the plan during the year to focus limited resources on risks and areas of the greatest importance.
- Discuss and develop plans for internal audit to assist in efforts related to compliance with Sarbanes-Oxley, specifically Sections 301, 302 and 404.
- Consider how the internal audit function might be used as a rotational management-training program for company employees. Also, consider how guest auditor and short-term temporary assignments of employees can provide needed specialized skills to the function. Evaluate and discuss with internal audit the need to supplement its resource base and skill sets with outside resources.
- Support the function in connection with its key findings and its plan for process owners to make changes and improvements to internal controls and process issues and deficiencies.
- Visibly support and encourage the mission and efforts of the internal audit function with an appropriate "tone at the top."
- Work closely with the audit committee to help ensure the internal audit function remains objective and adds value to the organization.

58. What should the audit committee's relationship be with an organization's board of directors, compensation committee, disclosure committee, and nominating and governance committee?

The audit committee is a separately chartered committee of the board of directors. The audit committee has a direct relationship with the board of directors as it reports to the board on a quarterly or more frequent basis on such things as audit plans, audit findings and other items deemed to be significant. Generally, the audit committee's purpose is to assist the board in overseeing the:

- Reliability of the entity's financial statements and disclosures
- Effectiveness of the entity's internal control and risk management systems
- Compliance with the entity's code of business conduct and legal and regulatory requirements
- Independence, qualifications and performance of the external auditors
- Performance of the internal audit activity

The role of the audit committee has significantly expanded in recent years. Realizing this, the board of directors has begun to shift some of the audit committee's responsibilities to separately chartered committees to create a balance of duties and ensure they are effectively executed. These additional committees have often included a compensation committee, disclosure committee, and nominating and governance committee.

The audit committee, compensation committee, disclosure committee, and nominating and governance committees have interlocking goals. These goals, along with defined roles and responsibilities, should be documented within individual committee charters. Strong working relationships with these committees enable the audit committee to help each one fulfill its responsibilities to senior management, the greater board of directors, shareholders and other stakeholders. A direct channel of communication between committees is essential to this process.

59. What is the audit committee's role with respect to establishing and monitoring corporate governance practices?

The audit committee plays a critical role in establishing and monitoring corporate governance practices. The board of directors has overall responsibility and accountability for risk management, internal control and corporate governance within the organization. The audit committee's role, as a separately chartered committee of the board of directors, includes focusing on the qualitative aspects of financial reporting to shareholders, on the company's processes to manage business and financial risk, and on compliance with significant applicable legal, ethical and regulatory requirements.

As part of the audit committee's oversight of the internal audit process, the internal audit function is responsible for auditing the organization's corporate governance process and communicating these results to the audit committee. In turn, the audit committee is responsible for monitoring the process put in place to implement needed improvements in corporate governance processes and controls. The execution of this system is carried out by management and the internal audit activity.

It is important to note that corporate governance and the role of the audit committee, like any other organizational structure, are significantly affected by the legal, institutional, financial, cultural and political circumstances in each country.

60. What is an audit committee's role with respect to an internal audit function?

Although the exact nature, charter, scope and reporting lines of internal audit may vary between companies, the audit committee plays a key role in supporting and overseeing aspects of an internal audit function's activities. While needing to ensure it does not assume day-to-day oversight activities on behalf of management or the internal audit function, the audit committee generally should be involved in the following matters:

- Provide input and approve the written charter for the internal audit function, including periodic review and updating.
- Understand, discuss and approve the company's risk assessment and resulting internal audit plan. As appropriate, review, discuss and approve changes to the audit plan during the year.
- At least annually, evaluate the internal audit function in relation to meeting the needs of the company and the audit committee, including compliance with its written charter.
- Hold executive sessions with the company's CAE.
- Provide input and direction as to the appropriate escalation protocols for significant findings and issues.
- Review, discuss and approve the compensation of the CAE, any changes therein and the hiring or termination of the CAE.
- Understand, discuss and approve the funding level for the internal audit function, and discuss its appropriateness and adequacy with management and the CAE.
- Review ongoing activities of the internal audit function, including its reports, and inquire as to any other matters that should be brought to the committee's attention.
- Direct the internal audit function, as necessary, to perform special reviews on behalf of management or the audit committee, including investigations of fraud or suspected fraud.
- Participate with internal audit to design and provide control, governance and ethics training to employees.

While the above listing is not intended to be all-inclusive, it provides reasonable overall guidance. Each audit committee should discuss, along with input from management, the role it should play in connection with the company's internal audit function. Of course, the requirements of all related regulations and stock exchange listing standards related to audit committees should be followed.

61. Should executive sessions (without management present) be held with the internal auditors as part of an audit committee meeting?

Yes. Executive sessions are beneficial to the audit committee and the company as a whole in furthering effective corporate governance. Our experience is that most high-performing audit committees already allow for such executive sessions (one each for the external and internal auditors) and that it is a best practice.

Further, we believe that executive sessions should be a standing part of the audit committee's regular agenda, whether or not there are specific matters or concerns that the internal audit function would like to communicate. This approach eliminates the discomfort that can occur when, during an audit committee meeting, the CAE calls for an executive session with the committee.

62. What should internal audit report to the audit committee?

Appropriate reporting by internal audit varies considerably from company to company based on a number of factors, including the charter and scope of the function, frequency and length of audit committee meetings, amount of material provided, and communications between meetings, as well as issues arising at the company.

However, as a guide, it might be reasonable to expect the following information to be reported to the audit committee by internal audit (assuming that meetings are conducted quarterly):

- Activities and audits completed during the last quarter
- Presentation and discussion of key findings from audits recently completed

- Status of past audit recommendations requiring resolution
- Planned activities for next quarter
- Any reported instances of fraud and internal audit's role in investigating such fraud
- In highly regulated environments, the results of recently completed audits by outside regulatory agencies
- Depending on the role and scope of internal audit, a status report on calls received from the company's hotline developed in connection with Section 301 of Sarbanes-Oxley
- As appropriate, reports related to assistance provided by internal audit in connection with other areas of Sarbanes-Oxley, such as Section 302 and 404 compliance efforts
- An update on any new risks or other issues facing the company that internal audit thinks should be addressed, and a determination whether the current internal audit plan should be modified to take these matters into consideration
- Other matters specifically requested of management or the audit committee

Every audit committee meeting presents an opportunity for internal audit to assist in educating the committee on timely issues and current matters. As an example, it might be appropriate for internal audit's presentation to include educational materials, articles and white papers for later reading by both management and the audit committee.

Internal audit adds considerable value in reporting its findings, observations and viewpoints to management as well as to the audit committee. Though management is often present at audit committee meetings, there should be more frequent, in-depth and informal communication between internal audit and company management. Internal audit should not be viewed solely as an instrument for the audit committee. In management's ongoing efforts to meet objectives related to risk management, controls and corporate governance, it should be working closely with internal audit.

63. What is the audit committee's role in evaluating the chief audit executive (CAE)?

The audit committee has a responsibility to evaluate the role of the CAE in conjunction with the executive to whom the CAE administratively reports. The IIA recommends that the audit committee endorse decisions regarding the hiring or termination of the CAE. The chairman of the audit committee should also be appropriately involved in performance evaluation and compensation decisions related to the CAE.

An evaluation of the CAE might include items such as:

- Results of a recent external quality assessment review
- Establishment of a process to monitor and follow up on management's actions related to audit findings
- Execution of audit plan (completed vs. planned audits)
- Operating a successful quality assessment and improvement program
- Quantitative and qualitative metrics established to measure internal audit performance
- Contributions to the improvement of risk management, control and governance process
- Stakeholder satisfaction
- Consistent processes for gathering, summarizing and analyzing measurement of data and providing timely feedback
- Training and retention of internal audit staff

In addition, the audit committee's written charter may specifically address the evaluation of the CAE, including the required frequency criteria to be used and reporting requirements.

64. How should the audit committee evaluate the effectiveness of internal audit?

Every audit committee should assess the effectiveness of the organization's internal audit function at least annually, if not throughout the year. The critical role that internal audit plays requires the audit committee to ensure the organization receives substantial benefit from the investment made in the internal audit function. Though the charter, scope, funding and activities of internal audit vary from company to company, audit committees should at least consider the following questions when evaluating their company's internal audit function:

- Has the function met the terms of its written charter?
- Is the function assisting the company in identifying and addressing the most significant risks?
- Is the function sufficiently objective in its mindset and approach? Is the audit committee assisting in creating and maintaining this objective viewpoint?
- Are members of the internal audit function technically competent and proficient? Does the function have the necessary resources to address key risks and issues adequately and appropriately?
- Is the function being led by a competent CAE who has the respect of company management, the audit committee and the internal audit staff?
- Is the function efficient in its efforts, methods and approach?
- Is the function delivering on the definition of internal auditing? That is, is it adding value, helping to improve operations, and bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes?

Evaluations of internal audit functions range from informal processes to formal, documented appraisals, including the use of outside advisors and the completion of a quality assessment review every five years, in accordance with *The IIA Standards*. Audit committees need to determine the appropriate scope and formality of this evaluation.

The audit committee should also receive an annual self-assessment on the internal audit function from the head of internal audit. This could be supplemented by discussions with management, external auditors and other stakeholders as relevant. It is essential that the evaluation process is understood and agreed upon by the board, audit committee and appropriate stakeholders.

65. What is the role of the audit committee in evaluating the role of the external auditor?

The audit committee serves as the liaison among the board of directors, external auditors, internal auditors and financial management. It owns the responsibility for recommending the appointment, reappointment and removal of external auditors. It is best practice to make this assessment an annual practice as this allows sufficient time to identify concerns associated with external auditor activity and correlates to the timing and release of the annual audit of the financial statements produced by the external auditor.

According to the United Kingdom's Financial Reporting Council's *Audit Committees – Combined Code Guidance (The Smith Report)*, criteria for evaluating the role of the external auditor may include:

- The relevance and appropriateness of the auditor's procedures
- The quality of the audit partner and audit staff from a technical accounting and auditing perspective, including their industry knowledge and their specialist technical expertise
- The qualifications of key members of the audit team
- Whether the auditors appeared to be unduly influenced by management during the audit
- Whether the work of internal audit was used appropriately
- Whether formal audit documents such as the audit plan and management letters were of sufficient quality

Other publications on the role of the audit committee, many of them produced by large public accounting firms, address such topics as how the audit committee should evaluate its external auditor.