

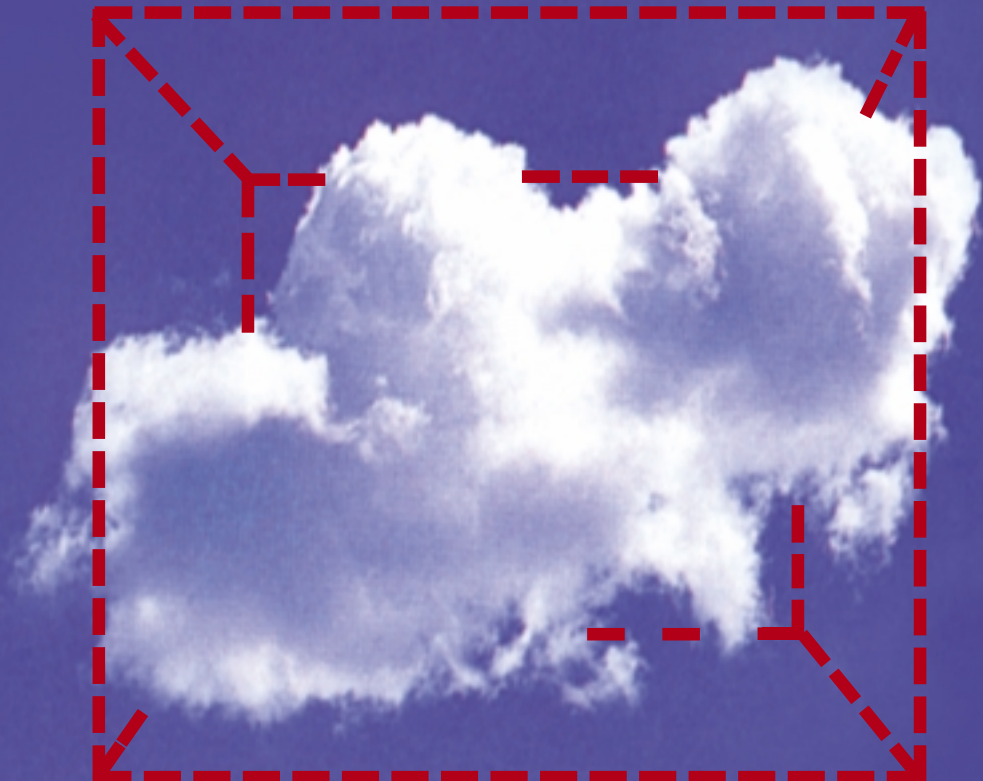


The Institute of
Chartered Accountants
in England & Wales

Audit Faculty

Risk Management

and the value added by Internal Audit



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Foreword



The risk of failure by a company to achieve its full potential is of concern to every board of directors. Risk is inherent in business processes, it arises from actions taken in pursuit of objectives and from changes in the external environment. Change in the ways companies do business, in technological developments, in the regulatory framework and in the size of a business in terms of the strain such change places on its control mechanisms are all major sources of risk.

Establishing and embedding effective risk management processes is of fundamental importance to all enterprises. Internal audit has a major role to play in an organisation's risk management, control and governance processes. To back this up, the two most recent pronouncements on corporate governance in the UK, the Combined Code and the Turnbull report, both highlight the role of internal audit.

The value of internal audit comes in the objective assurance and advice that it provides to boards, especially the non-executive directors, on the effectiveness of both the risk management processes and the ways in which risks are managed and controlled. It is this style of internal audit function that is increasingly becoming an 'essential' for organisations.

I commend this booklet to you. It places internal audit and its value in the context of risk management, and is written for a high level audience by a group of experienced and knowledgeable professionals.

We are now in an era when more focus is being placed on gaining business advantage from good governance practices and sound risk management. It is also clear that internal audit has an important role to play now and in the future.

Sir Roger Hurn

June 2000

Sir Roger Hurn is Chairman of Marconi plc,
Deputy Chairman of GlaxoWellcome plc, and a
Non-executive director of Imperial Chemical Industries Plc.

Executive summary

This booklet has been written primarily for directors and senior executives of listed companies who are implementing the Turnbull report. The principles are, however, also relevant to unlisted companies, and to the public and not-for-profit sectors.

The booklet places the role and value of internal audit in the context of risk management and corporate governance, including the Turnbull report. It therefore briefly leads readers through each of these topics, outlines the role and value of internal audit, and provides some ideas for assessing the need for an internal audit function where there is none, and for reviewing an existing function. The booklet is not intended to be a visionary document on internal audit; that topic will be part of a future publication.

The achievement of business objectives is of fundamental importance to the success and survival of an organisation, especially in a changing and increasingly competitive world. To achieve their objectives, boards and line management have specific roles to play in the identification and management of the risks facing their organisation. Line management has an operational responsibility, whereas the board has an oversight role. Internal auditors assist the board and management by examining the effectiveness of the processes by which the risks are:

- identified and prioritised;
- managed, controlled and mitigated; and
- reported.

Internal auditors are not there to judge the appropriateness of an organisation's objectives or the board's strategies to achieve them.

Risks exist in most business processes, financial or non-financial. They also arise from changes within the organisation and in the external environment, as well as from the decisions and actions of the board and management. Business risk is not solely about the adverse characteristics of risk, but also about the risk of not identifying or adequately exploiting sound business opportunities.

Risk management is about identifying and assessing key risks, and then designing and implementing processes by which those risks can be managed to, and be maintained at, a level acceptable to the board. To ensure the effective direction and use of the organisation's resources to manage these risks, the board should:

- have a clear understanding and assessment of the risks;
- ensure that the organisation has effective risk management and control processes; and
- be provided with assurance that the processes and the key business risks are being effectively managed.

The most recent development in corporate governance in the UK has been the Turnbull report. It takes a risk-based approach to internal control in providing guidance on the implementation of the following Principle and related Provisions of the Combined Code on Corporate Governance:

Principle D.2: 'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'.

Provision D.2.1: 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management'.

Provision D.2.2: 'Companies that do not have an internal audit function should from time to time review the need for one'. (The phrase 'from time to time' has been clarified by Turnbull to mean an annual requirement).

The Turnbull report emphasises that in order for a board to be able to make the statement in their company's annual report that is required by the Combined Code, it will need to obtain assurances from management, internal audit and others that its risk and control processes are effective. Objective assurance and advice is provided by an internal audit function, thereby assisting the board and senior management with their continuing responsibilities for compliance with the Turnbull report. Additionally, during the implementation phase of Turnbull, the internal audit function in those companies that have such a resource is likely to have acted as a valuable catalyst in the development of practical implementation proposals.

Boards, audit committees and senior management should recognise that what is of relevant value to their business is the internal auditors' knowledge of the organisation, its systems and its processes, as well as and their skills and experience in:

- systematically analysing business processes;
- objectively assessing the effectiveness of processes;
- independently reporting on their findings and making recommendations to improve the effectiveness of the processes; and
- using their knowledge to help spread good practices throughout the organisation.

In today's business environment, where change is constant and can be unpredictable, sound processes of risk management and control are critical pre-requisites. If risks and opportunities are managed more effectively, then the ability to achieve the organisation's objectives will be enhanced, and shareholder value is likely to improve.

An effective and properly resourced internal audit function should have a key role in helping organisations respond to the challenges of the Turnbull report. It plays a significant part in the processes for the identification and mitigation of risk and thereby can contribute to the achievement of business objectives, and to the success and resilience of the organisation.

Risk and risk management: an overview

Risk

Risk is present in all companies. It occurs in most business processes, financial or non-financial, and also arises from the decisions and actions of the board and management in pursuit of the company's objectives. Changes in the external environment also create risks that companies need to address.

In order to meet the ever-increasing demands from investors, customers and other stakeholders, and to achieve their business objectives, companies have to change and innovate. They look for new opportunities, expand into new business areas, change their operating processes, and embrace new technologies. New initiatives and changing circumstances inevitably create new or changed risks. It should be emphasised that business risk is not solely about the adverse characteristics of risk, but also about the risk of not identifying or adequately exploiting sound business opportunities.

Risks, and related matters, can be grouped in a number of ways. Groupings can include:

- risks that are applicable to all companies;
- risks that arise from the strategies adopted by the board and management of a company; and
- risk areas that are industry specific.

Some examples of each grouping are:

Applicable to all companies

Risks associated with:

- changing political and competitive environments;
- compliance with laws and regulations;
- reliability and/or timeliness of financial and other management information;
- safeguarding assets and information systems;
- an appropriate corporate culture and the integrity of people;
- effective investment in technology;
- fraud.

Company strategy

Risks that arise from the strategies adopted by the board and management of a company, and the means by which they implement the strategies to achieve the company's objectives. Examples include:

- expansion by acquisition;
- investment in emerging markets;
- outsourcing key processes;
- embracing new technologies e.g. e-commerce;
- developing and marketing major new products or services;
- raising capital;
- major organisational restructuring/downsizing;
- major changes in the supply chain whether inward, internal, or outward;
- joint-ventures in production/marketing;
- major capital investment projects.

- Risk is present in all companies

- Ever-increasing demands from stakeholders

- New initiatives and changing circumstances inevitably create new or changed risks

- Applicable to the corporate, public and not-for-profit sectors

- A clear understanding of risk can enhance informed decision making

- Directors need assurance that processes are adequate and effective

- Objective assurance and advice can be provided by an internal audit function that is independent of management

Industry specific risk areas

Examples include:

- airlines: passenger safety;
- automobiles: product reliability and safety;
- banking: credit;
- extractive industries: environmental issues;
- gaming: compliance with licence conditions;
- pharmaceuticals: product safety;
- retailing: customer satisfaction.

Risks and their related groupings can also be identified in the public and not-for-profit sectors. The objectives and strategies in these sectors also include an increased emphasis on value for money and greater efficiency in the use of resources funded by taxpayers or donors.

A clear understanding of the risks faced by a company can enhance:

- the board's risk management policies and, in particular, the nature and degree of risk that it is prepared to tolerate and the opportunities it is willing to accept;
- informed decision-making; and
- the effective direction and use of management time and the company's resources to manage risk.

Risk Management

The management of a company has operational responsibility for the management of risk, whilst the role of the Board is to ensure that risk management processes are in place, as well as obtaining assurances from management, internal audit and others that the processes are adequate and effective.

Risk management is about (a) identifying and assessing key risks, and (b) designing and implementing processes by which those risks can be managed to, and maintained at, a level acceptable to the board.

Risks can be managed to acceptable levels by:

- transferring them to other parties (such as suppliers, insurers, dealers in futures);
- applying appropriate internal control policies and procedures;
- outright avoidance through non-engagement in the related activity; and
- risks can be knowingly and objectively accepted, providing they clearly satisfy the company's policy and criteria on risk tolerance.

To be effective, the management of risk requires information which is relevant, meaningful and timely. Such information is required to facilitate decision-making and the monitoring of the business activities and supporting processes as well as the operational health of the company. The information needs to alert the board and senior management to 'exceptions' or other warning signals. Internal audit has a role to play in the provision of relevant information to the board and senior management.

The board takes ultimate responsibility for risk and control issues, and in the case of a listed company it has to make a public statement in the annual report. The board will therefore need to obtain assurances that the processes are adequate and effective. Objective assurance and advice can be provided by an internal audit function that is independent of management.

- A company's internal audit function can add value and play a key part in the control environment

As previously stated, the management of a company has operational responsibility for the management of risk. It is their role to implement board policies on risk and control, to embed those policies and related processes throughout the company, and report back to the board.

Companies need an organisational and management structure that helps to ensure that:

- the business operates as intended;
- the assets (tangible and intangible) are protected; and
- the company observes legal and regulatory obligations and meets relevant accounting and financial reporting needs.

Such a structure will necessarily include the establishment of an appropriate control environment in which an internal audit function can add value and play a key part.

Provided proactive risk management and control processes are embedded within the company and are working effectively, then the stakeholders in that company should gain value through reduction in the volatility of the performance of the business.

Corporate governance and the Turnbull report

The most recent development in corporate governance in the UK has been the Turnbull report published in September 1999 by the ICAEW working party, chaired by Nigel Turnbull, that was established at the request of the London Stock Exchange. This followed the appending of the Combined Code on Corporate Governance to the London Stock Exchange Listing Rules.

The Turnbull report, which takes a risk-based approach to internal control, provides guidance on the implementation of the following Principle and two related Provisions of the Combined Code:

Principle D.2: 'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'.

Provision D.2.1: 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management'.

Provision D.2.2: 'Companies which do not have an internal audit function should from time to time review the need for one'. (The phrase 'from time to time' has been clarified by Turnbull to mean an annual requirement).

Listed companies are required to state in their annual report (a) how they have applied this Principle and (b) how they have complied with these Provisions.

The Stock Exchange requires compliance with these reporting requirements for accounting periods ending on or after 23rd December 2000. Therefore companies with end December 2000 year-ends cannot delay implementation of these Listing Rule requirements and the related Turnbull guidance. Action needs to be taken now and on a continuous basis.

- Annual requirement to review internal audit

- Directors need to take action now and on a continuous basis

- Internal audit can act as a catalyst in the development of proposals for the practical implementation of the Turnbull report

- The board is responsible for assessing what constitutes a sound system of internal control in its company

- The board needs to obtain assurance that the risk management policies that it has established are adequate and are operating effectively.

- Internal audit is an objective support service to the board and senior management

Where a company has an internal audit function, that function is likely to have acted as a catalyst in the development of proposals for the practical implementation of the Turnbull report. Its work is likely to have included advice and assistance to directors and senior management on:

- risk identification and assessment;
- the development of policies and procedures on risk and control; and
- methods used to review the effectiveness of risk management and internal control.

Having advised and probably assisted boards and management on the establishment of the company's procedures to implement the Turnbull report, internal audit will continue with its on-going assurance and advice role. It is this 'objective support service' role that will assist the board and senior management with their continuing responsibilities for compliance with Turnbull.

The board and its committees

Risks, once identified and quantified, need to be addressed decisively by the board and management.

The board is responsible, after due and careful enquiry (assisted by the information and assurances provided to it), for assessing what constitutes a sound system of internal control in its company. To do this the board needs to consider:

- the nature and extent of the risks facing the company;
- the likelihood of the risks concerned materialising and their impact;
- the extent and categories of risk which it regards as acceptable for the company to bear;
- the company's ability to reduce the incidence of the risks concerned materialising;
- the company's ability to reduce the incidence and impact on the business of those risks that do materialise; and
- the costs of operating particular controls relative to the benefits obtained in managing the related risks.

It is, as previously mentioned, the role of management to implement board policies on risk and control and to embed those policies and related processes throughout the company. The role of board committees in that process, including that of the audit committee, is for the board to decide. The board/board committee should also consider the scope and quality of management's ongoing monitoring of risks and of the system of internal control and, where applicable, the work of the internal audit department and other providers of assurance.

The board needs to obtain assurance that the risk management policies that it has established are adequate and are operating effectively. When reviewing information and assurances provided to it, the board/board committee should:

- consider and assess how the significant risks have been identified, evaluated and managed;
- assess the effectiveness of the related system of control in managing the significant risks, having regard in particular to any significant failings or weaknesses in control that have been reported;
- consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
- consider whether the findings indicate a need for more extensive monitoring of the system of risk management and control.

Internal auditors can provide considerable assistance to the board and management on the above bullet points. They reflect the core skills that should be present in most internal audit functions today.

The role and value of internal audit

Internal audit provides an independent and objective assurance and advice service to the board and senior management to assist them in their responsibilities to comply with the Turnbull guidance. The assurance role of internal audit is to deliver assessments of the adequacy and effectiveness of the processes by which risks are:

- identified and prioritised;
- managed, controlled and mitigated; and
- reported

such that the residual risks are recognised by, and are clearly acceptable to, the board.

The Institute of Internal Auditors has recently updated its definition of the role of internal audit as follows: 'Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and corporate governance processes.'

In this context, the key words are independent, objective, systematic, and add value. These attributes of internal audit are well established and proven in the traditional areas of financial risk management and related controls. Despite this, some executives may not realise that these attributes can be applied by internal auditors as effectively in the wider arena of business risk management. Some may perceive internal auditors to have only financial expertise. Boards, audit committees and senior management may therefore be overlooking an opportunity to obtain greater business benefit from this skilled resource.

Boards, audit committees and senior management should recognise that what is of relevant value to their business is the internal auditors' knowledge of the company, its systems and its processes, and their skills in:

- systematically analysing business processes;
- objectively assessing the effectiveness of processes;
- independently reporting on their findings and making recommendations to improve the effectiveness of the processes; and
- using their knowledge to help spread good practices throughout the organisation.

Internal auditors are not there to judge the appropriateness of a company's objectives or the board's strategies to achieve those objectives. They examine the effectiveness of the processes by which the consequent risks are identified and prioritised, managed, controlled and mitigated, and reported.

Internal auditors also add value by the identification of opportunities to improve the cost-effective management of risk, thereby reduce the uncertainty of achieving the company's objectives, and ultimately benefiting shareholder return.

- The attributes of internal audit can be applied effectively in the wider arena of business risk management

- Boards should not overlook an opportunity to obtain greater business benefit from a skilled internal audit resource

- Internal auditors are not there to judge the appropriateness of a company's objectives or the board's strategies to achieve those objectives

- Other assurance functions are not usually positioned in the organisation and reporting structure with the same overview and degree of independence as internal audit

Other review and compliance functions

There may be other functions within the company that also provide assurance and advice covering specialist areas such as health and safety, regulatory and legal compliance and environmental issues. This list could also include product quality and safety, security, insurance and loss prevention, and other risk management or assurance functions.

However, these valuable functions are not usually positioned in the organisation and reporting structure with the same overview and degree of independence as that enjoyed by internal audit, with its direct line into the audit committee.

It should be well within the capabilities of a progressive internal audit function to assess, as part of its remit, the effectiveness these other review and compliance functions by examining matters such as the:

- clarity of responsibilities for the related risks;
- adequacy of their resources to satisfactorily discharge their responsibilities;
- transparency and communication of policy and procedures for the management of these risks;
- effectiveness of the internal reviews of compliance with such policy and procedures;
- reliability of upward reporting of risk management issues; and
- appropriateness of levels and processes of related decision-making.

External audit and internal audit

- Maximisation of the effectiveness of a company's audit services is a priority for the board and the audit committee

Maximisation of the effectiveness of a company's audit services is a priority for the board and the audit committee. This can be helped by:

- a good dialogue and understanding between the two audit functions; and
- a recognition that the two functions have differing responsibilities and scope of work.

It is important for all parties to recognise that the roles, responsibilities and objectives of internal audit and external audit are different. These differences can be summarised as follows:

External Audit

- is appointed by, and has a duty to report to, the shareholders;
- provides an independent opinion on the company's financial statements drawn up to a point in time;
- reports to the board/board committee those material weaknesses in financial and related internal control systems that come to their attention during their work;
- has to consider standards for financial reporting and related requirements; and
- complies with auditing standards issued by the Auditing Practices Board.

Internal Audit

- normally reports to the audit committee and to a senior executive director;
- is a service to the company focusing on the effectiveness of the ongoing risk and control framework and processes;
- can offer added value through recommending improvements to business risk processes and problem solving;
- has its scope of work and responsibilities determined at board/audit committee level within the company and can vary depending upon the size, structure and complexity of the company;
- takes a wider view of risk and control than the external auditors; and
- adheres to professional standards relevant to the conduct of its work.

- Continuous and meaningful dialogue between the external and internal auditors

- It is not the primary role of internal audit to be used by management to reduce external audit fees

- Disclosure implications.

- Turnbull states that “in the absence of an internal audit function, management needs to apply other monitoring processes... the board will need to assess whether such processes provide sufficient and objective assurance.”

The external auditors provide a source of assurance about the financial statements. They also provide information, but not assurance, on controls in the management letters submitted after their interim and final audits. However, because of the nature of the work of external auditors, the information in these management letters is more likely to be limited to matters identified in their audit work and will not necessarily cover all the significant risks facing the company.

The degree of reliance that the external auditor may wish to place upon a professional and independent internal audit function should be optimised. This can be achieved by a continuous and meaningful dialogue between the auditors, and by mutual co-ordination of their respective responsibilities and (where relevant) through the scope of their work. Similarly, wherever possible, internal audit may wish to place reliance on the work of the external auditors in order to maximise effectiveness.

The scope of internal audit coverage should be approved independently by the audit committee or by the board. Although consultation with the external auditors may be a part of that process, it is not the primary role of internal audit to be used by management to reduce external audit fees, and the audit committee should resist such pressures.

Assessing the need for an internal audit function

Provision D.2.2: ‘Companies which do not have an internal audit function should from time to time review the need for one’. (The phrase ‘from time to time’ has been clarified by Turnbull to mean an annual requirement).

Assessing the need for internal audit is something that boards should undertake each year; failure to do this has disclosure implications. Where companies do not have an internal audit function and the board has not reviewed the need for one, the board is required to disclose these facts in their annual report.

In order to make its statement on internal control in the annual report, the board and its designated committee(s) (e.g. the audit committee) will need to obtain assurances on the effectiveness of the processes for the management of risk and of the related systems of internal control. Such sources of assurance, leaving aside that which can be provided by internal audit, may include:

- the views of, and representations from, the executive directors and senior/line management;
- the views of other employees through (say) some form of self-assessment process;
- results of management’s internal confirmation procedures;
- regular information on financial matters;
- regular information on operational matters;
- performance indicators;
- early warning mechanisms;
- external auditors’ management letters;
- reports of any relevant external regulators;
- reports (if any) from relevant internal compliance functions.

It should be noted that none of these individual sources of assurance is likely to provide complete assurance, but taken together they may provide the board with the reasonable, but not absolute, assurance that it seeks.

Turnbull states that “in the absence of an internal audit function, management needs to apply other monitoring processes in order to assure itself and the board that the system of internal control is functioning as intended. In these circumstances, the board will need to assess whether such processes provide sufficient and objective assurance.”

- As organisations grow management's time and attention can be very stretched

- Corporate reorganisation may have resulted in the delayering of middle management and removed established or potential control mechanisms

- The board's annual review of an existing internal audit function should also ensure that audit coverage and resources are sufficient to meet future growth and changes within the company

'Sufficient and objective' are key words that boards, especially the non-executive directors, need to carefully consider. Before making their public statements in the annual report, the directors will want to know to what extent they can rely on management's assurances and the sufficiency of those assurances.

In smaller listed companies where the board and senior management may be sufficiently close to the business and the systems are not so complex, they can more easily assure themselves of the effectiveness of the risk and control systems. In such cases there may be no immediate need for an internal audit function.

However, as organisations grow and:

- become more geographically diverse;
- business is undertaken in new environments (e.g. e-commerce);
- develop new products and competitive pressures increase;
- systems are ever more complex;
- change is the norm;

then management's time and attention can be very stretched. This is especially true if corporate reorganisation has resulted in the delayering of middle management, thereby removing established or potential control mechanisms.

The board, especially the non-executive directors, should consider the following three questions:

1. are the existing management processes adequate to (a) identify and monitor the significant risks facing the company, and (b) confirm the effective operation of the established internal control systems?
2. with the ever increasing pressures on management at all levels, can those who are responsible for managing risks and operating controls always take a wholly objective and systematic view of their own performance?
3. does the board receive the right quality of assurance and information from management and is it reliable?

Where a board seeks to enhance the effectiveness of issues raised by the above questions, then they should strongly consider the need for an internal audit function. In Appendix 1, we provide some additional matters that directors might consider.

The timing of a decision to establish an internal audit function will vary depending on company-specific factors. The requirements of corporate governance, although an important consideration, are not necessarily the prime drivers of the decision.

If the board decides that it does not currently need an internal audit function but may at a future date, it can buy-in specialist expertise in the interim period.

As mentioned in the next section, where a company has an existing internal audit function, the board's annual review of internal audit should ensure that audit coverage and resources are sufficient to meet future growth and changes within the company. So when assessing the need for an internal audit function, the board should also consider the scope of work it is proposed that the internal audit function will undertake, and the related resource needs. The scope of work has an effect on the resources needed. Turnbull specifically refers to 'an adequately resourced internal audit function or its equivalent where, for example, a third party is contracted to perform some or all of the work concerned'.

Reviewing an existing internal audit function

Paragraph 46 of the Turnbull report states that, where a company has an existing internal audit function, the board should review annually:

- the scope of work of the internal audit function;
- the resources allocated to the function; and
- the authority of the function.

Appendix 2 expands on these three criteria.

The annual review of an existing internal audit function should also ensure that audit coverage and resources are sufficient to meet future growth and changes within the company.

Conclusion

In today's business environment, where change is constant and can be unpredictable, sound systems of risk management and control are critical pre-requisites.

If risks and opportunities are managed more effectively, then:

- the ability to achieve the company's objectives will be enhanced;
- the volatility of future earnings and cashflows should be reduced; and
- shareholder value is likely to improve.

Capital markets value such attributes and reflect them in lower costs of borrowing and stronger equity pricing.

It follows that, all other factors being equal, shareholder value will be better protected and enhanced in those companies that manage risk proactively and effectively, compared to those companies which do not.

The principal value of internal audit is that it offers a significant and objective service to the board and management assisting them to identify and evaluate risks, as well as the provision of advice on the management of risks. Internal audit also provides assurance that an adequate structure and process for the identification and management of risk is in place and operating effectively. Where this is not the case, internal audit can recommend solutions to help management build that assurance to an acceptable level.

- Where change is constant and can be unpredictable, sound systems of risk management and control are critical pre-requisites

- The principal value of internal audit is that it offers a significant and objective service to the board and management

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Assessing the need for an internal audit function

The board and especially the non-executive directors needs to consider three key questions.

1. are the existing management processes adequate to (a) identify and monitor the significant risks facing the company, and (b) confirm the effective operation of the established internal control systems?
2. with the ever increasing pressures on management at all levels, can those who are responsible for managing risks and operating controls always take a wholly objective and systematic view of their own performance?
3. does the board receive the right quality of assurance and information from management and is it reliable?

A number of other aspects that boards may wish to consider include:

- the structure of the company and the degree of autonomy of each of the business units;
- the overall culture of the company and management's philosophy;
- the company's appetite for risk or its ability to tolerate risk;
- the overall control environment in the company;
- changes in the organisational structure including delayering, reporting processes and/or underlying information systems;
- changes in key risks arising from changes in internal processes such as product or service lines or entry into new markets;
- changes in key risks arising from alterations in external factors such as regulatory requirements;
- complexity of the company's systems, especially IT systems;
- the number of moderate to high risk areas which are not appropriately controlled;
- deteriorating trends in internal control systems evident from the existing monitoring systems;
- concerns about the level of 'risk and control awareness' and the need to educate senior management, or middle management, or staff;
- an increased incidence of unexpected or unacceptable results or occurrences;
- the views of the company's external auditors.

The decision to establish an internal audit function is primarily a business led decision, and revolves around the board's need to obtain independent and objective assurance and advice regarding its risk management process.

Reviewing an existing internal audit function

Turnbull states that boards should review annually:

- (a) the scope of work of the internal audit function;
- (b) the resources allocated to the function; and
- (c) the authority of the function.

This appendix takes each of these three criteria in turn and expands upon them. Boards and senior management may wish to rephrase the comments as questions.

(a) Scope of work

The board needs to be sure that their internal audit resources are being focussed on the risks that matter to the business.

Internal auditors should:

- understand the key business risks, and assess the adequacy of the processes by which these risks are identified, evaluated and managed by the company;
- review the sufficiency of the information, and the adequacy and operation of controls, used to manage those risks;
- assess the reliability and integrity of key financial and operating information, and the means used to identify, measure, classify and report such information;
- review the processes and systems to ensure adherence with those policies, plans, procedures, laws and regulations which could have an impact on the company, and determine whether it is in compliance therewith;
- review the means of safeguarding assets and other key resources, especially information in hard copy or on computer systems, including business contingency plans and the security of computer systems;
- review operations or projects (including systems under development) to ascertain whether results are consistent with established objectives and goals and, whether the operation or projects are being carried out as planned;
- monitor corrective action plans to ensure that management implement them promptly and effectively;
- advise management on cost effective controls for new systems and activities; and
- liaise with the external auditors.

It should be noted that internal audit is not responsible for the prevention and detection of fraud; this is primarily a management responsibility. However, an effective internal audit function can advise and help management to enhance the company's control framework, and thereby help to prevent or limit fraud.

(b) Resources

An internal audit function is critically dependent on having an effective, clearly defined structure that is properly resourced in terms of people, skills, money and technology.

The effectiveness of the internal audit function is dependent on the quality, experience, competence and status of the Head of Internal Audit. It is also essential that the function be staffed with suitably experienced, qualified and well-trained people.

Internal auditors may need to 'partner' with other risk management functions in the company. Therefore, depending on the work that the internal audit function is required to do, and what is achievable by working with other functions in the company, the skills base in the internal audit function may need to include experience in:

- operations such as purchasing, production, marketing, sales, and distribution;
- project management;
- IT systems (including systems development and e-commerce);
- product knowledge;
- finance and treasury;
- regulatory compliance;
- environmental issues.

Consideration may also be given to 'partnering' with an external supplier to obtain people with specialist skills.

Skills need to be kept up to date. Members of the internal audit team should regularly receive relevant industry and internal audit related training. Internal auditors need to have good inter-personal and communication skills to be able to communicate problems of risk and control issues to management in a manner that is meaningful and relevant to the business manager. The use of control self-assessment also requires the really effective internal auditor to be a good facilitator.

It may also be possible to second high calibre individuals from within the different functions of the company. Secondees can provide a substantial source of expertise to the internal audit function, as well as significant benefits to the company when the individual returns to line management.

(c) Authority

The responsibility and authority of the function should be included in a charter which should be kept up to date, approved by the audit committee and formally endorsed by the board and senior management. The charter should clearly state:

- the independence of the internal audit function via its reporting line to the audit committee;
- that the function, working within its agreed scope of work, must not be restricted in its work on an assignment; and
- that the internal audit function has free and unfettered access to all parts of the organisation, including the Chairman of the audit committee and the Chief Executive.

The Head of Internal Audit should:

- have his/her appointment or removal ratified by the audit committee;
- have no executive powers outside their own function; and
- have dual reporting lines, one to a senior executive director (e.g. CEO or CFO) and one to the audit committee.

To supplement the three Turnbull criteria, boards/board committees can also consider a number of other criteria including:

- 'customer' relationships (including feedback from members of the audit committee, senior management, and from line management after individual assignments);
- quality assurance (for example an independent peer review of internal audit's own work), and
- performance management (based on appropriate key performance indicators).

Bibliography

The Turnbull report: *Internal Control: Guidance for Directors on the Combined Code* (ICAEW, September 1999). The report is also on the ICAEW's web-site at the following address:

www.icaew.co.uk/internalcontrol

We list below some publications (relating to risk management and internal control) issued after the Turnbull report by the ICAEW and the Institute of Internal Auditors – UK & Ireland.

- *Implementing Turnbull – A Boardroom Briefing* (ICAEW, September 1999)
- *Risk Management: Meeting the Turnbull Requirements* Business Digest No. 34 (ICAEW, March 2000)
- *Effective Governance* (IIA-UK, October 1999)

In addition, there are publications issued by the major accountancy firms that cover internal control, risk management and internal audit.



The Institute of
Chartered Accountants
in England & Wales

Audit Faculty

www.icaew.co.uk/internalaudit

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