

ENHANCED UNDERSTANDING

LINES OF DEFENCE

Professor **Robin Pritchard** considers the critical role that audit committees and internal audit must play in the governance of a successful organisation



In today's digital environment, organisations obtain outcomes more quickly than ever before. The only occurrence is market leaders, customers and the media expect to see results. In this respect the audit committee, supported by the internal audit function, must be confident that:

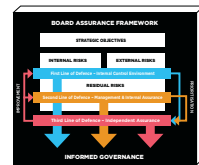
1 the organisation has a transparent and shared understanding of the inherent risks at board and senior executive levels;

2 an effective controls assurance framework is in place; and

3 there is a deep understanding and commitment by those involved as non-executive members of the audit committee and internal auditors to fulfil their statutory and professional roles.

The primary role of the audit committee must increasingly be to focus on the governance aspect. Whether we consider the triple line-reporting process in South Africa by the institution exposing governance report King III, Treasury advice, or the focus on risk reporting in the UK Code of Governance, the future is clear: organisations will be expected to evaluate the significant risks that threaten fulfilling corporate objectives with their stakeholders. The public board's role must be carefully considered by the audit committee to identify business-critical risks that undermine these objectives.

It is widely appreciated that an effective board will provide good governance and leadership. However, there is scant mention of the role of the audit committee in these codes. The board must search for its primary sub-committee to take the lead in risk given its accepted involvement in matters of governance, risk and control.



FUNDAMENTAL PURPOSE

It is clear many organisations view the audit committee role as having a financial focus, but this should not be so. All risks may have a financial outcome which ultimately may threaten financial stability. The source of the issues is most often operational or activity based and directly involves engagement with key stakeholder groups. Audit committees must ask the following: what are the organisation's most significant inherent risks and from where does the board receive assurance these risks are contained within the organisation's risk appetite?

The answer is relatively simple, although often overlooked. One well-recognised management theory, the three lines of defence model, would give continuous

In the February issue of *Finance & Management*, we published an article by Robin Pritchard, of the Centre for Internal Audit, Risk Management and Governance at Birmingham City University. The piece focused on the need for audit committees to demand more of their internal audit function, and for internal audit to take a more proactive role in the business. Here, two veterans of internal audit give their responses to Pritchard's views



MARTYN SCRIVENS

The thing that I came away with from reading the article was a sense of the need for internal audit as a function to get a little bit more proactive, a bit less passive – almost acting as an early warning system for the business. And I think it already happens in my industry, financial services. Everything that Robin Pritchard was talking about has already happened, in part thanks to regulatory pressure and also because of the pressures of the financial crisis.

That said, I think it is a general call to audit committees on one side and internal audit functions on the other. Outside my industry, internal audit has often focused on finance, but there are a number of industries – like finance – where internal audit doesn't focus on finance at all.

If I look at what my colleagues in some of the utilities do or don't do with internal audit, it's all very much focused on what I call the operational risks of the organisation rather than the financials.

In talking about the role of the audit committee, it's interesting that Pritchard uses finance as a hook to ask these questions. But the real thrust is that audit committees are about more than just finance. The audit committee actually works best when internal auditors align their responsibilities with that of the audit committee.

For internal audit functions now, the focus is on being generally proactive and less passive. That means the quality of resource you have in internal audit functions has to change, and the expertise those people bring has to change as well. It's no longer just sufficient to be a good auditor; you really have to understand how the business works and you have to understand its complexities; that is particularly

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Previously, he was a partner with Arthur Andersen, where he started his career in London in 1978, coming to specialise in audit and risk management services for clients in the banking, insurance and asset management sectors. He spent 14 years with the firm in Switzerland before managing the audit practice in Australia. He returned to the UK in 1999 to manage the firm's risk consulting practice. He is a chartered accountant in the UK and Australia.

relevant if you're in any type of regulated industry.

One problem we have in the internal audit world, certainly in my industry, is that there is a very small pool of resources to draw on in the market. A way of increasing the pool is to draw in other experts with different experiences which when you add them together makes internal audit a much more exciting area in which to work. Then I'd be able to sell my function as the only one in my organisation that lets you look at the whole organisation, top to bottom, left to right.

Staff rotation can work too, but the difficulty is how you do it. If I'm part of a business that has a 'superstar' I think is going to be a great leader one day, I'll normally give that person important things to do. I'm probably not going to say "head off to work for internal audit so you see how that goes".

And a final, but important, thought: as you take more experienced people from the business into internal audit, you put a strain on the traditional brand, which is 'independence'. Internal audit is supposed to be independent from management; however, the more people you get coming in from the organisation who have worked in the organisation in other areas, the more prone you are perhaps to being on management side, rather than the board side. Practically you've got to do something to make sure that you still maintain that independence.





MARY HARDY

Robin Pritchard's article is right to say perceptions are important. In my last couple of internal audit jobs when you were out in the business doing some audit work in a non-finance department, you'd often get the response, 'Oh we're nothing to do with finance', to which my response was always 'Well neither are we. What's your problem?'

Away from finance and risk management and internal audit functions, when you get into trying to audit logistics or anything to do with operations, they hear the word 'audit' and instantly think it's something to do with the numbers; so I suspect a lot of people in a lot of organisations still don't really understand what internal audit is about.

But there will be organisations where people do have a very good understanding, mainly because you've got a head of internal audit who makes themselves known, and makes sure people do know what it involves. They will talk constantly to senior management and have a wide-ranging audit plan that touches upon lots of areas so people are much more familiar with what internal audit does. I recognise that will vary hugely from one organisation to another, but I would hope the general trend is that internal audit is looking at a broader agenda and people outside finance are beginning to understand what internal audit is there for.

Nowadays you come across very few organisations that can do internal audit successfully. Unilever was pretty good at it, and BP does it quite well. But a lot of other organisations struggle, and I think this is where the challenge is: if you are a little bit old-fashioned in your approach so all that you are doing is the boring compliance-type audits, then you're not going to attract people in; but if you are truly risk-based and you're truly looking at all operational areas, then it becomes more attractive.

A more innovative internal audit department is going to find it easier to attract people to the profession, whereas the ones that are a little old-fashioned or restricted in what they can do

are going to find it a struggle. Because you're not going to get high flyers in a business wanting to stay for more than twelve months at the absolute outside, you need an internal audit that can cope with someone who isn't a trained auditor coming in for a short time, adding value in some way and going again. If you're only a three-man department, you're never going to be able to do that.

Pritchard talked about the importance of audit committees, and there is a point here about the lack of understanding on audit committees of what internal audit does. Even if your audit committee has someone on it who's an external audit partner, they don't really understand the scope of what internal audit can do for them, so they don't use it properly.

What I've often found when I've gone to audit committees is that if an internal audit team turns up they get a pat on the head and a thank-you, but they don't really get challenged, or get asked questions like 'Why aren't you looking at X area, and what do you know about Y?' They don't understand how broad a knowledge of the organisation the head of internal audit will have and how they can help them with all sorts of other stuff - for example to build their assurance map, which I think every big company ought to have these days.

If you have someone on the audit committee who knows what internal audit can do, they can use and support internal audit better. This all helps internal audit's reputation. Having a friend on the audit committee can be a huge help in developing an internal audit function, because if your audit committee doesn't really understand what internal audit is then it becomes a very under-utilised resource. A good head of internal audit knows this, and can make a real difference when the right structures are in place.

You need all these things linking together to make internal audit work, but you have to recognise that every organisation is going to be different and it's never going to be the same everywhere. ■

Mary Hardy was head of directional group audit at alcoholic beverage company Diageo, before spending an eight-year stint at Transport For London. She then led the team on risk assurance at the London Organising Committee of the Olympic and Paralympic Games for three years. She now chairs the audit committee on the Royal Navy, and sits on the audit committee at the Ministry Of Defence and at the Treasury. Hardy recently completed terms of office at the Institute of Chartered Accountants on its audit committee and was also on the board for the Glasgow 2014 Commonwealth Games.