



PUBLIC SECTOR
AUDIT COMMITTEE FORUM

Public Sector Audit Committee role in overseeing Internal Audit

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Introduction

The International Standards for the Professional Practices of Internal Auditing (Standards) that are issued by The Institute of Internal Auditors are mandatory guidance for internal audit practitioners as well as internal audit activity. The Standards (Standard 1110 - Organizational independence) require the chief audit executive (CAE) to report to a level within the organization that allows the internal audit activity to fulfil its responsibilities. This standard specifically requires the CAE to report functionally to the board and administratively to the Accounting Officer. The Audit Committee is the sub-committee of the Board and therefore is ideally positioned to oversee the functionality of the internal audit activity on behalf of the Board.

The Institute of Internal Auditors (IIA) has developed the globally accepted definition of internal auditing, as follows:

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.

The purpose of the internal audit activity as per the IIA is to evaluate risk exposures relating to the organisation's governance, operations and information systems, in relation to:

- Effectiveness and efficiency of operations;
- Reliability and integrity of financial and operational information;
- Safeguarding of assets;
- Compliance with laws, regulations and contracts.

Applicable Legislation

1. Public Finance Management Act no 1 of 1999 (PFMA)

In terms of the (PFMA) section 38 (1) (a) (ii), the accounting officer for a department, trading entity or constitutional institution must ensure that there is maintenance of a system of internal audit under the control and direction of an Audit Committee complying with and operating in accordance with regulations and instructions prescribed in terms of section 76 and 77 of the PFMA.

2. Municipal Finance Management Act no 56 of 2003

In terms of the (MFMA) section 166 (1), each municipality and each municipal entity must have an Audit Committee. Section 166 (2) states that an audit committee is an independent advisory body which must (a) advise the municipal council, the political office-bearers, the accounting officer and the management staff of the municipality, or the board of directors, the accounting officer and the management staff of the municipal entity, on matters relating to (i) internal financial control and internal audits.

3. Treasury Regulations

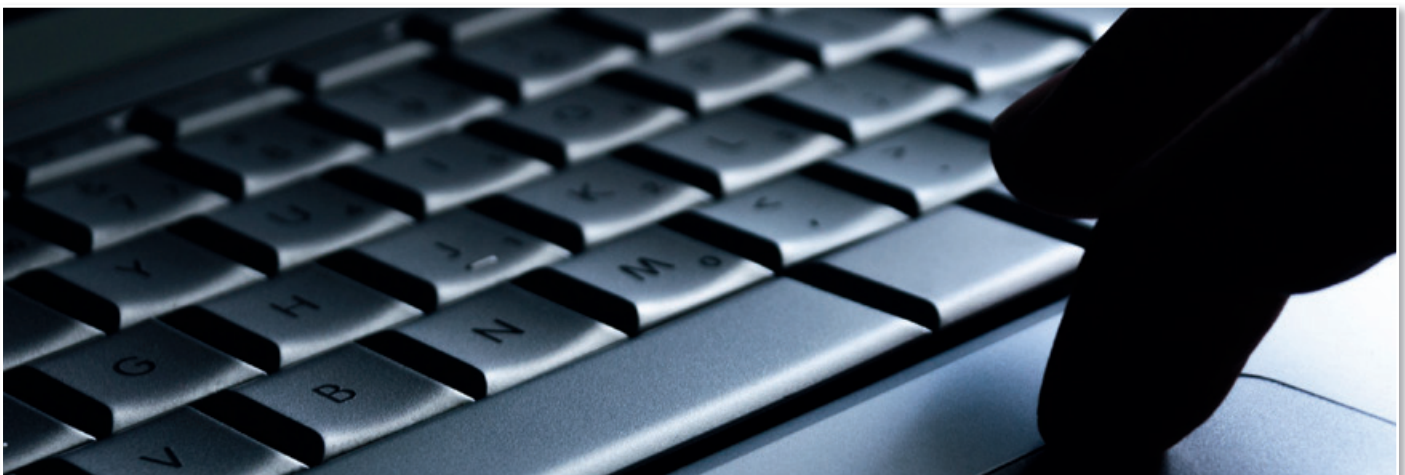
Treasury Regulations section 3.1.10 states that the Audit Committee must, amongst others, review the following:

- a) the effectiveness of the internal control systems;
- b) the effectiveness of the internal audit function;
- c) the risk areas of the institution's operations to be covered in the scope of internal and external audits;
- d) the adequacy, reliability and accuracy of the financial information provided to management and other users of such information;
- e) any accounting and auditing concerns identified as a result of internal and external audits;
- f) the institution's compliance with legal and regulatory provisions; and
- g) the activities of the internal audit function, including its annual work programme, coordination with the external auditors, the reports of significant investigations and the responses of management to specific recommendations.

4. Principle 3.7 of the King Report on Governance for South Africa (King III)

Principle 3.7 of King III states that the Audit Committee should be responsible for overseeing internal audit.

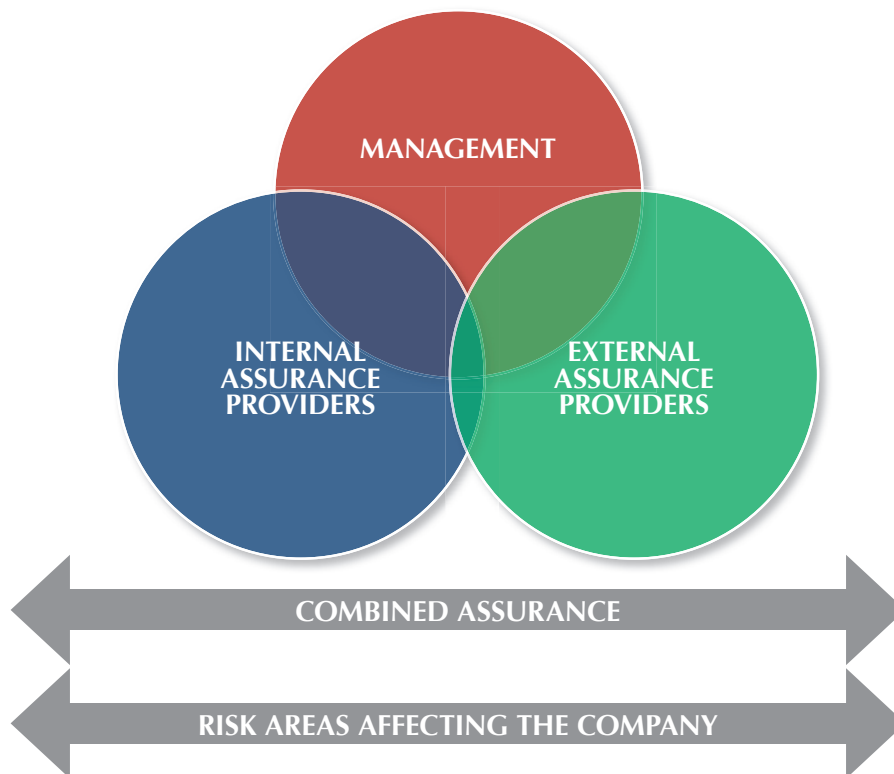
An internal audit function, designed and deployed effectively, can have a positive impact on the control environment of an entity and on the effective design and operation of internal controls. As an important aspect of its mandate, internal audit should provide the Audit Committee with a means of monitoring whether the controls management have put in place are reliable, functioning properly and are sufficient to address the risks relating to the organisation's governance, operations and information systems process.



Combined assurance

A combined assurance model aims to optimise the assurance coverage obtained from management, internal assurance providers and external assurance providers on the risk areas affecting the organisation.

Principle 3.5 of King III states that the Audit Committee should ensure that a combined assurance model is applied to provide a coordinated approach to all assurance activities. In terms of King III combined assurance is defined as "Integrating and aligning assurance processes in a company to maximize risk and governance oversight and control efficiencies, and optimize overall assurance to the audit and risk committee, considering the company's risk appetite."



The combined assurance process should consider at least the following activities:

1. Coordination which refers to the process designed to optimise assurance coverage by taking into consideration the organisation's risk appetite and ensuring that a collectively sufficient and appropriate level of assurance resources and processes are applied in providing the required assurance by the audit committee.
2. Information and communication which refers to the process of the continuing sharing of information between members of the assurance community. This is important to supporting the goal of coordination as well as optimization of the effectiveness of assurance providers.
3. Assessment and evaluation refers to the process through which the assurance providers will be assessed to conclude on the extent of reliance that can be placed on the results of the assurance activities by the audit committee.
4. Reporting and monitoring refers to the process which enables the audit committee to monitor the appropriateness of the combined assurance model and conclude that significant risks facing the company are addressed.

Roles and responsibilities for combined assurance

1. Internal Audit

- The role of internal audit is an integral component of the combined assurance model. Internal audit should cover aspects of financial matters, operational, compliance and sustainability issues. The internal audit plan and coverage becomes that much more important in ensuring that it provides adequate coverage to support the combined assurance model.
- The results from the various assurance assignments should be accurately reported to the relevant stakeholders including the Audit Committee. The CAE is ideally positioned to consolidate the assurance results into a combined assurance report for the Audit Committee and to monitor that the reported issues and concerns are timeously and adequately resolved. If required by the Audit Committee, distinction should be made between assurances that adhere to the agreed criteria and those that do not.
- The combined assurance plan should be updated at least annually and it is recommended that this document is presented at the Audit Committee for approval. The risk register should be updated with the output from the combined assurance reviews. The updated risk register will then be used as the base for the combined assurance plan.

2. Audit Committee

- The Audit Committee should be involved in the development and approval of the combined assurance plan. The implementation of the combined assurance plan should be reported to the Audit Committee in a timely manner. The Audit Committee should uphold the independence of internal and external assurance providers to ensure that they carry out their functions effectively.

Oversight in relation to reporting lines

The Audit Committee has oversight responsibilities over the effective functioning of internal audit within a department (national and provincial), public entity, municipality and municipal entity. This oversight responsibility covers the planning, execution and reporting of internal audit against the approved internal audit plan and charter which are approved by the Audit Committee. The CAE ideally reports administratively within the entity to the Accounting Officer and functionally to the Chair of the Audit Committee. Reporting to the most senior officer in the department/entity has a positive effect on the independence of the internal audit function.

The internal audit function is occasionally combined with the risk management and compliance functions in the public sector. This may be perceived as an impairment to internal audit's independence, however to address this, actions and matters arising from these additional functions can be reported to the Accounting Officer and the internal audit activities reported to the Audit Committee.

The CAE reports administratively to the Accounting Officer. The Risk and Compliance functions both have functional and administrative reporting within the entity.

Reviews of the risk management and compliance activities would need to be outsourced to ensure independence of evaluation of such activities. It is preferable to segregate these operational management activities from internal audit.

Examples of functional reporting to the Audit Committee involves, but is not limited to, the following:

- **Approving the internal audit charter;**
- **Approving the risk based internal audit plan;**
- **Approving the internal audit budget allocation and resource plan;**
- **Receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters;**
- **Recommending and approving decisions regarding the appointment, removal of the chief audit executive, remuneration of the chief audit executive and performance assessments of the internal audit function;**
- **Making appropriate inquiries of management and the chief audit executive to determine whether there is inappropriate scope or resource limitations.**

The Audit Committee's minimum oversight role and responsibility

The Audit Committee should understand the environment within which the internal audit function operates. Audit committee members should also have an understanding of what the IIA requires of the internal audit function. Even if a quality review is done on an internal audit function and the results of the review are reported to the Audit Committee, the Audit Committee members should have sufficient knowledge to create and support an environment that enhances efficiency and compliance of the internal audit function, where functionality is concerned. As a minimum, the Audit Committee should oversee the following with regards to the internal audit function:

1. Review and approve the internal audit charter annually, or amend if there are any changes in legislation or the entity's operating environment. As a minimum, the internal audit charter should include:
 - a) The purpose of the internal audit function
 - b) Its status and its place in the organisational structure
 - c) Responsibilities
 - d) Relationship with management and external audit (combined assurance)
 - e) Operational issues
 - f) Assessment
2. Review and ensure that the internal audit function adheres to the Institute of Internal Audit Standards for the professional practice of Internal Auditing and the Code of Ethics at a minimum.
3. Ensure the internal audit activity reports annually on its quality assurance and improvement programme. Ensure that the internal audit function (in-house, co-sourced and outsourced) is subjected to an external independent quality review in line with IIA standards and as when the audit committee determines it appropriate, but at least within 5 years of the previous review, as a measure to ensure the function remains effective.
4. The audit committee should assess the options for sourcing internal audit and consider, amongst others, issues such as size of the organisation, complexity of the operations, available budget, and the ability of the audit committee to execute its duties suitably. Refer to the IIA SA documents on "How to employ an internal auditor" and the tender proposal guidelines (www.iasa.org.za).
5. Assess adequacy of skills and size of internal audit staffing versus complexity of entity and changes in the entity operating environment. Reviewing and approving the organogram for internal audit.
6. Review a 3 year training program for internal audit function to ensure that there is appropriate attention given to quality, report writing skills and keeping abreast of developments and changes in the field of internal audit and that staff are maintaining their on going professional development.
7. Ensure that there is a transfer of skills by contractors to employees if specified in the contractor's contractual obligations.
8. Assist in the recruitment process and performance appraisal of the CAE as well as compensation, performance assessment, retention or dismissal of the CAE which then reinforces the clear reporting line to the Audit Committee as opposed to management.
9. Approve the risk based internal audit plan through review and assess the coverage and adequacy of the internal audit plan when compared with the risks facing the entity and the effect of the combined level of assurance on the risks and the results of the external audit. As a minimum the risk-based internal audit plan should cover:
 - a) Operational effectiveness and efficiencies across processes
 - b) Financial reporting – prevention and detection of accounting errors, control weaknesses and fraud
 - c) Compliance with laws, regulations and internal policies
 - d) Information technology (IT) – systems and internal functioning of the IT department
 - e) Effectiveness of risk management within the entity
 - f) Assessment of strategy, business plans and budgets
 - g) Performance setting, monitoring and reporting
10. Review and approve the allocation of the budget of internal audit in line with the annual internal audit plan and the alignment of hours on the internal audit plan versus the budget being presented.



11. Encourage cooperation between external and internal audit. Review coverage and scope between external and internal audit to avoid duplication and possible cost savings from the alignment of the two functions. Timing of internal audits and the months during the financial period that the audit scope will cover must be aligned. In some cases reports from internal audit cannot be used by the external auditors as they do not cover a substantial portion of the financial year and are sometimes not completed timeously to inform the external audit and avoid the duplication of effort. This will ensure optimisation of the combined assurance obtained.
12. Review and track quarterly progress of the internal audit against the approved internal audit plan for the year and ensuring that reports are tabled timeously after completion. Targets should be set in the CAE performance contract on the achievement of the plan and the timeous submission of reports to the Audit Committee.
13. Review and approve reports from internal audit on a quarterly basis in line with the internal audit plan. When the Audit Committee reviews such reports attention should be paid to issues/findings and the impact on the overall risks facing the entity and any impact on the financial year-end external audit. It can be one of the early warning indicators to management and the Audit Committee.
14. Ensure open lines of communication between the Audit Committee and the internal audit function. This can be implemented by having an agenda point added for an in-camera session which can be scheduled at each of the quarterly Audit Committee meeting where internal audit meets separately with the Audit Committee and discusses issues.
15. Monitor and evaluate the effectiveness and quality assurance of the internal audit function. This can be performed by having an independent review being performed every 3 years with an implementation plan being drafted to address the issues/findings. Performance targets must be set for the CAE in his/her annual performance contract arising from such an evaluation so that there is alignment between the need for having an effective internal audit function and the allocation of such accountability and responsibility.
16. Review policies affecting the functioning of internal audit such as the internal audit charter in the entity as well as understanding the methodology for sampling techniques, audit tests, the use of computer assisted audit techniques to improve on coverage of populations being tested. Policies should create a flexible and dynamic environment that is able to address emerging business, organisational and operational assurance needs.
17. Understand the format of reports being presented by internal audit, the rating scales used to assess, rate and finally conclude on the overall functioning of the area being audited as well as the alignment and link in with the impact on the operational and strategic risk register. It is suggested that as part of the orientation for new members of the audit committee that internal audit should be able to disseminate their reports and workshop them so that members have a clear understanding of how a report is compiled and what information is being presented as this will aid in the members ability to make decisions from their review of reports being presented during their tenure.
18. Recommend the appointment of an external service provider if the internal audit function is outsourced. This would typically occur every 3 to 5 years and the sourcing of tenders should be started at least 12 months prior to the planned rotation. There is at times a level of confusion amongst management within the public sector on their role versus the role of the Audit Committee on the appointment of an external service provider for the provision of internal audit services. Management would participate in the process administratively by administering the procurement related aspects of the tender process. The Audit Committee would be involved in the evaluation of the submissions together with management by appointing at least 1 or 2 member/s of the Audit Committee to evaluate the tender submissions. All short listed service providers (at least 3) would then be required to do at least one presentation to the Audit Committee to allow for questions on approach, methodology, skills, staffing, training, budget, previous experience with the operating environment of the entity etc. The Audit Committee will be ultimately accountable and responsible for the selection and appointment of the successful service provider.
19. Review of any reports from internal audit on limitation of scope, extension of audit deadlines beyond 3 months by management, repeated cancellation of scheduled audits unnecessarily and decide on the way forward.
20. Preside over disagreements between management and internal auditors ensuring that open communication lines are promoted at all times. A formal process should be documented and circulate as part of the service level agreement from internal audit that covers how disagreements will be dealt with and the escalation processes to be followed.
21. Strive towards setting a tone where an internal audit function has the confidence and courage to report any significant issues even if it involves executive management. The Audit Committee must also protect internal audit functions who report such information from the possible falling out with the entities' executive management team.
22. Review and assess the written assessment prepared by internal audit regarding internal financial controls.

Questions the audit committee should ask

The internal audit function can add immense value to an organisation if there is proper oversight. In evaluating and being able to rely on and get the most out of the internal audit function, the Audit Committee should consider the following:

- Is internal audit aligned to the strategy and does its plan focus on areas that are most likely to impact stakeholder value?
- Is internal audit effective and frequent enough in its communications with the Audit Committee?
- When last was an objective assessment done to ascertain whether internal audit has the appropriate level of technical and analytical skills required to address the industry risk and risk requirements of the business?
- Is the internal audit function poised to lead/support a combined assurance initiative?
- Is there sufficient assurance of the ethics and risk management programmes?
- Does internal audit utilise technology in its processes and use existing systems and data effectively in the performance of its work?
- What were the most recent loss events and what comfort did internal audit provide on these?
- How does the internal audit function compare against its peers in benchmark studies?
- Is the chief audit executive subjected to a robust annual assessment based on key attributes relevant to our business?
- What is the true absorbed cost of internal audit?
- Is the internal audit agile enough to address emerging business issues?
- Does the internal audit function have the necessary and diverse skills required to give assurance to the Audit Committee on internal financial control?
- Has the internal audit function performed its work in accordance with its charter?
- Does it operate effectively and efficiently?
- Are the existing skills sets appropriate?
- Does it contribute to the improvement of organisational operations and is it perceived by stakeholders to add value?
- Does it have the tools and resources it needs to fulfil its duties and interrogate what these resources should be?
- Does the internal audit have a Quality and Assurance Improvement Programme in place and is progress reported on a yearly basis to the Audit Committee?
- Has the internal audit activity completed an external quality assurance review within the stipulated 5 year period in addition to the internal audit quality processes?

**Institute of Directors in Southern Africa
PSACF Secretariat**

National Office - Johannesburg | PO Box 908, Parklands 2121 | Johannesburg, South Africa
144 Katherine Street, Sandown, Sandton 2196

Tel: 011 430 9900 | Fax: 011 444 7907 | Email: IoDSA@IoDSA.co.za | Web: www.IoDSA.co.za

