



PUBLIC SECTOR
AUDIT COMMITTEE FORUM

The role of audit committees in relation to the external and internal audit process

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Introduction

It is important for an audit committee to have a good relationship and communication with internal and external audit to fulfil its role of improving governance in an institution. This is particularly true in the public sector in the broader interests of the country's citizens. An important part of this relationship is an understanding of the internal and external audit processes, the relationship between the two, and the role that the audit committee plays in these processes. This understanding will maximise the benefits to be derived from these audits and contribute positively to the audit committee's effectiveness. This paper details the internal and external audit processes and the audit committee's role in relation thereto.

The public sector audit environment is one in which government and other public sector entities exercise responsibility for the use of resources derived from taxation and other sources in the delivery of services to citizens and other recipients. These entities are accountable for their management and performance, as well as for the use of resources, relating to both those that provide the resources and those, including citizens, who depend on the services delivered using those resources. Public sector auditing helps to create suitable conditions and reinforce the expectation that public sector entities and public servants will perform their functions effectively, efficiently, ethically and in accordance with the applicable laws and regulations.¹

The objectives of external and internal audit can be defined as follows:

External Audit	Internal Audit
In general, external auditing can be described as a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria. Public sector auditing is essential in that it provides legislative and oversight bodies, those charged with governance and the general public with information and independent and objective assessments concerning the stewardship and performance of government policies, programmes or operations. ²	Internal audit is defined by the Institute of Internal Auditors (IIA) as 'an independent, objective assurance and consulting activity designed to add value and improve an institution's operations. It helps an institution accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.' ³

External auditors, internal auditors and audit committees are part of the assurance processes to maximise risk and governance oversight as well as control effectiveness. The audit committee should ensure that it maintains open lines of communication with the internal and external auditors to gain the best advantage from the assurance provided.

Cooperation and coordination of internal and external audit

The audit committee's awareness of the internal and external audit objectives, roles and processes, as well as that of other assurance providers, and their role in relation to those objectives and processes should form the basis of expectations of these assurance providers by the audit committee.

Based on the objectives of external and internal audit as defined above, it is clear that while there is synergy in their roles, they are nevertheless distinct from one another. The internal audit functions of many entities are established as part of their internal control and governance structures. The size and structure of the institution, in addition to the requirements of management and, where applicable, those charged with governance, have an impact on the objectives and scope of the internal audit function, the nature of its responsibilities and its organisational structure.

To obtain the most value from internal audit, it should focus on its main functions – which are largely preventative in nature – to improve the institution's operations by ensuring that risk management, control and governance processes are in place. This will ensure the stewardship of public funds and performance of government policies, programmes and operations; which are in turn evaluated by external audit.

External auditors are not required to use the work of internal audit, but may do so in a constructive and complementary manner under certain circumstances. The contributions by internal audit and external audit will only be optimised if there is no misunderstanding of their distinct but complementary roles.

Legislated responsibilities of audit committees regarding internal and external audit

Specific responsibilities of the audit committee pertaining to internal and external audit as contained in the Public Finance Management Act, 1999 (Act No. 1 of 1999) (PFMA), Treasury Regulations and the Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) include the following:

- Reviewing the effectiveness of the internal audit function.
- Reviewing the risk areas of the institution's operations to be covered in the scope of internal and external audits.
- Reviewing the activities of the internal audit function, including its annual work programme and coordination with the external auditors.
- Meeting at least annually with the external auditors to ensure that there are no unresolved issues of concern.

¹ ISSAI 100 Fundamental principles of public sector auditing

² The objective of external audit as defined by ISSAI 100 Fundamental principles of public sector auditing

³ The objective of internal audit as defined by the IIA

Facilitating the delivery of quality audits

A number of key attributes, including the ones listed below, should be in place to ensure that the environment is conducive to the delivery of quality audits. Those charged with governance, including the audit committee, play an important role in ensuring that these are in place.

- Governance arrangements that establish the appropriate 'tone at the top' and that aim to safeguard the auditor's independence.
- A strong commitment to honesty, integrity and objectivity by all.
- Ensuring full and timely access to relevant information and individuals to assist the auditor in gathering audit evidence.
- Effective two-way communication with the auditors.
- Creating an environment in which management is not resistant to being challenged by the auditors and is not overly defensive when discussing difficult or contentious matters.
- Strong corporate governance, which ensures that reliable information is produced by persons having the knowledge and skills to do so.

Furthermore, factors contributing to the delivery of quality audits specifically relating to the audit team include the following:

- Exhibiting appropriate values, ethics and attitudes.
- Knowledgeable, skilled and experienced staff.
- Sufficient time and resources to perform the required audit work.
- Rigorous audit procedures in compliance with applicable standards.
- Providing unbiased insights regarding the performance of management members in executing their reporting responsibilities.
- Providing constructive and timely recommendations for improvements in systems and processes, areas of performance and compliance.

In conclusion

Auditing is a discipline that relies on competent individuals using their experience and applying integrity, objectivity and professional scepticism to enable them to make appropriate judgements supported by facts and circumstances, and to report on their findings.

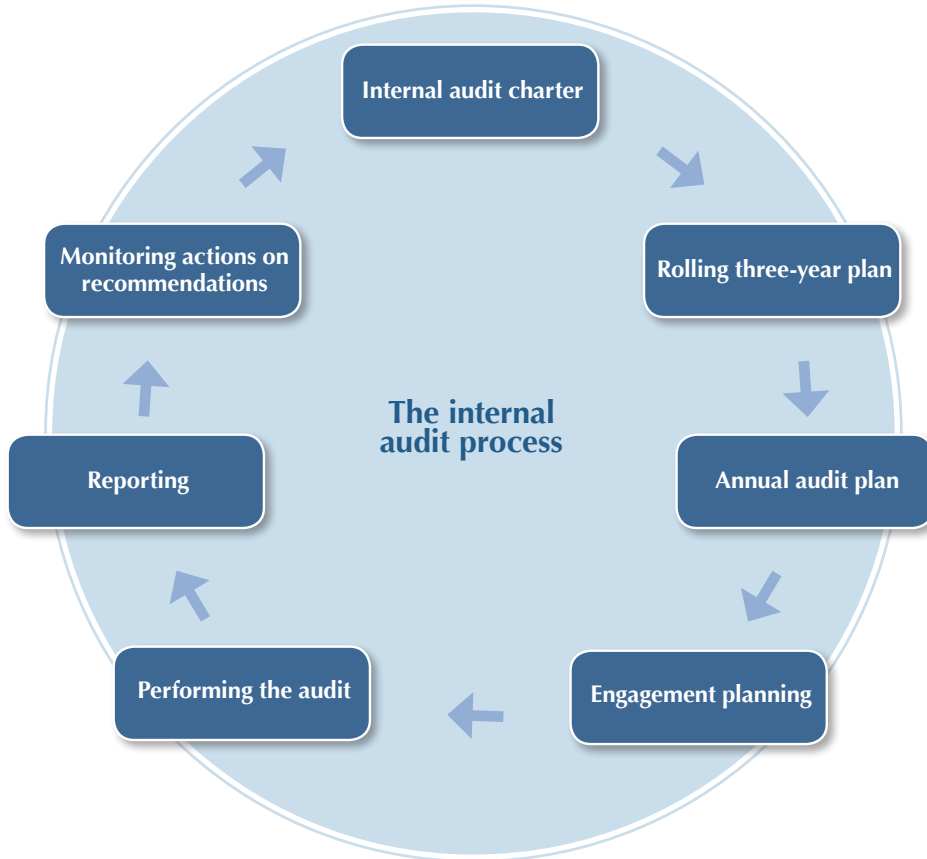
Audit committees are recognised as a valuable provider of independent oversight to ensure that all parties fulfil their roles in enhancing effective governance and reporting. The audit committee, however, does not displace or change management's accountability but rather enhances the existing governance framework, risk management practices and internal control environment.

As indicated in the table detailing the internal and external audit process included further on in this paper, the audit committee has an important role to play in ensuring the delivery of a quality audit and for facilitating the implementation of best practices in response to the matters raised by the auditors.

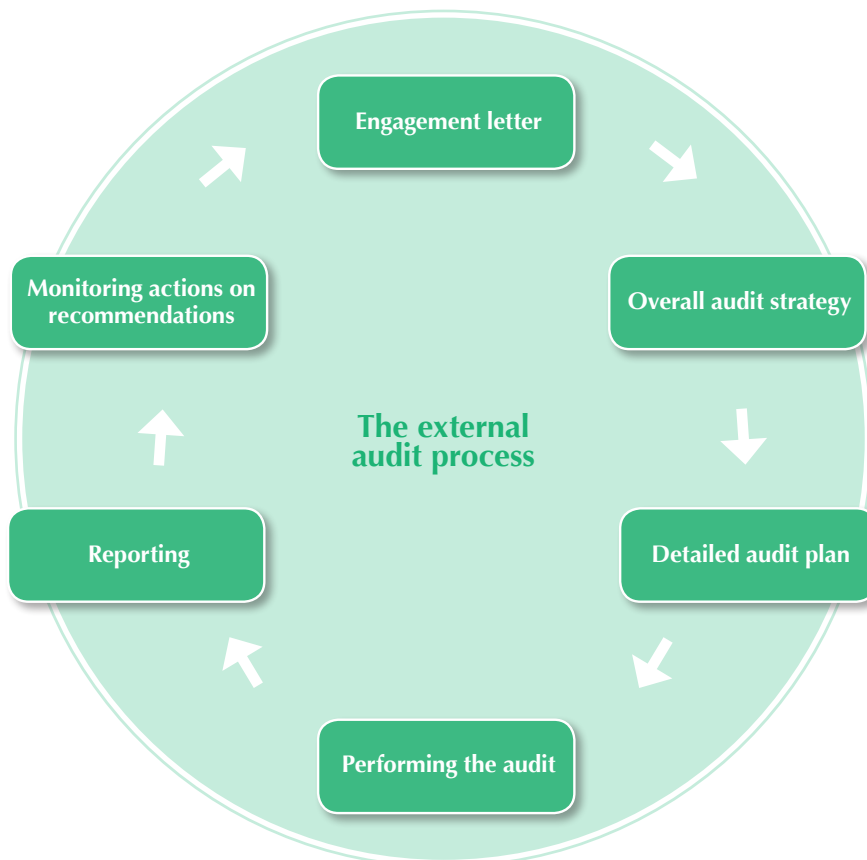
Depiction of internal and external audit processes and tabulation of the audit committee's role in relation to these processes

Diagrams A and B depict the internal and external audit processes. These processes and the audit committee's role in them are further explained in the table following the diagrams.

A. The internal audit process



B. The external audit process



C. The audit process and the role of the audit committee

Internal audit process		External audit process	
Internal audit charter	Audit committee role	Engagement letter	Audit committee role
<p>The internal audit charter outlines the mandate of internal audit and serves as the statement of purpose, authority and responsibility.</p> <p>The charter typically covers:</p> <ul style="list-style-type: none"> • the standards that need to be complied with • the position of internal audit within the institution • a description of the assurance and nature of consulting services • the periodic review of the charter • the appointment and dismissal of the chief audit executive • access to information, properties and personnel • the relationship with management and external audit • operational issues • the assessment of the internal audit function • quality reviews (once every five years). 	<p>The audit committee is responsible for reviewing and approving the internal audit charter and ensuring that it contains all the relevant information. Ideally, this should be performed by the committee on an annual basis.</p>	<p>The engagement letter is communicated to, and agreed with, those charged with governance (accounting officer or accounting authority). Its purpose is to ensure a clear understanding of the responsibilities of the parties (management and the auditors), the objectives of the audit, access to information, and the reports to be provided.</p> <p>The engagement letter will typically cover:</p> <ul style="list-style-type: none"> • the purpose of the audit • the responsibility of the accounting officer or accounting authority for the preparation of the financial statements, performance information, compliance with relevant legislation, internal control, prevention of fraud, and written representations to the auditors • the objective of the audit and the auditing standards to be applied • the form and content of reporting on the audit • how materiality is applied • the submission of information for the audit, access to information and persons, deadlines, and correction of identified misstatements. 	<p>The audit committee should familiarise itself with the content of the engagement letter and may advise the accounting officer on the terms of the engagement. The committee should also hold the accounting authority responsible for complying with the terms of the engagement.</p> <p>The audit committee should note the reporting dates stated in the engagement letter and use these dates to schedule audit committee meetings accordingly.</p>
Rolling three-year plan and annual audit plan	Audit committee role	Overall audit strategy	Audit committee role
<p>IIA standards require that internal audit set plans based on a risk assessment that is updated at least annually.</p> <p>Rolling three-year internal audit plan</p> <p>The internal audit units of institutions regulated by the PFMA are required to prepare a rolling three-year strategic internal audit plan based on their assessment of key areas of risk for the institution. This plan should take into consideration the current operations, those proposed in the strategic plan and the institution's risk management strategy.</p> <p>Although institutions regulated by the MFMA are not required to prepare this document, it would be good practice to adopt a similar process. This would ensure a long-term planning approach.</p>	<p>The audit committee should review and approve the risk-based annual audit plan before the start of the financial year to which the plan relates.</p> <p>The committee should provide oversight by reviewing the budget, expertise and staffing levels of the internal audit unit.</p> <p>The audit committee should monitor the quarterly progress of internal audit during the financial year against the approved internal audit plan for the year.</p>	<p>The overall audit strategy represents the external auditor's general approach to achieving the objectives of the audit. It is prepared at the start of the audit and determines the nature, timing and extent of audit procedures required. It details:</p> <ul style="list-style-type: none"> • the required experience and composition of the audit team • the involvement of other specialists in the audit; for example, valuation experts, using the work of internal auditors, and information technology specialists • the timetable of key events in the audit • the budgeted audit fee, including the allocation of time and cost to individual aspects of the audit • the expected audit effort and focus • the nature of the communication with the institution being audited. <p>The audit strategy further guides the development of the audit plan as the audit progresses.</p>	<p>The audit committee should be available to provide information to the auditors on the business and risks that will be considered in the development of the audit strategy.</p> <p>The audit committee should communicate with the auditors any matters relating to:</p> <ul style="list-style-type: none"> • the internal control environment and significant deficiencies, if any • non-compliance with legislation • fraud identified or investigated • unusual transactions and complex accounting policies and how they have been applied by the institution • the independence of auditors (if applicable). <p>The committee should read and understand the audit strategy and provide advice to the accounting officer where necessary.</p>

Internal audit process		External audit process	
Rolling three-year plan and annual audit plan	Audit committee role	Overall audit strategy	Audit committee role
<p>Risk-based annual audit plan Internal audit is responsible for developing an annual audit plan using a risk-based methodology to address any identified weaknesses in risks or controls. The annual plan flows from the rolling three-year audit plan and should reflect the most current strategies and direction of the institution.</p>		<p>The auditors <u>may make use of the work of internal audit</u> when it will result in efficiencies, except if:</p> <ul style="list-style-type: none"> • internal audit's organisational status and relevant policies and procedures do not adequately support the objectivity of the internal auditors • internal audit lacks sufficient competence • internal audit does not apply a systematic and disciplined approach, including quality control. 	<p>The audit committee should be aware of the scope of work undertaken by the external auditors as well as the extent of coordination with internal audit, and whether external audit intends using the work of internal audit or using internal audit for direct assistance.</p>
Engagement planning	Audit committee role	Detailed audit plan	Audit committee role
<p>Internal audit develops and documents a plan for each engagement. The plan typically addresses:</p> <ul style="list-style-type: none"> • objectives of the engagement • engagement scope (e.g. geographical area, period under review, business units affected, and systems being tested) • engagement resource allocation • engagement work programme • coordinating the audit plan with external audit as far as possible. <p>Internal audit will also provide an important source of information on the internal controls and business processes of the institution for use by the external auditors.</p>	<p>The audit committee should encourage cooperation between external and internal audit to obtain the best value and support of each other's assurance activities for the institution.</p>	<p>Risk assessment The detailed audit plan is the response of the external auditor to the risks identified during the risk assessment process. The auditor identifies risks by obtaining an understanding of the institution and the environment, including the relevant controls relating to the risks, such as:</p> <ul style="list-style-type: none"> • industry, regulatory and other factors • the nature of its operations • governance structures • the financial reporting framework and accounting policies applied • the institution's objectives and strategies. <p>Detailed audit plan The detailed audit plan is a record of planned procedures to address the assessed risks at a very detailed level. It includes the nature, timing and extent of procedures to be performed:</p> <ul style="list-style-type: none"> • Nature of procedure – refers to the purpose and type of procedure performed. • Timing of procedure – refers to when the procedure will be performed. • Extent of procedure – refers to the quantity to be performed. 	<p>The audit committee is a source of information for the auditors concerning knowledge of the business and the significant risks that it faces.</p> <p>It is recommended that the audit committee meet with the external auditors during the planning phase of the audit to address any areas of concern.</p>
Performing the audit	Audit committee role	Performing the audit	Audit committee role
<p>Internal audit documents information related to the objectives and scope of the audit, including:</p> <ul style="list-style-type: none"> • the timing of the work performed • the nature of the work performed • the extent of the audit coverage • methods of selection of items for testing • documentation of the work performed • review and reporting procedures 	<p>The audit committee should ensure that the methodology applied by internal audit is adequate to allow for the efficient and effective performance of the audit.</p> <p>The audit committee may be required to facilitate cooperation from management for the performance of the audit.</p>	<p>The performance of the audit includes:</p> <ul style="list-style-type: none"> • selecting items for testing • establishing audit procedures to address the identified risks • obtaining audit evidence (documentation) in support of these items • evaluating the documentation against the applicable assertions • identifying any matters that may indicate a misstatement or non-compliance. <p>As audit findings are identified, they are communicated to management and those charged with governance so that they may be addressed timely.</p>	<p>The audit committee should review the financial statements and performance report before they are submitted for auditing to ensure that they are complete and accurate.</p> <p>The audit committee should assist in ensuring that all information and personnel are available for the audit in a timely manner.</p> <p>If there are potential restrictions or limitations on the work of the external auditors, the chairperson should communicate the importance of cooperation with external audit to ensure that the restrictions or limitations are removed within a reasonable time.</p>

Internal audit process		External audit process	
Reporting	Audit committee role	Reporting	Audit committee role
<p>Internal audit has a responsibility to communicate the results of engagements by issuing an audit report to management. Once these have been discussed with management, the final report should be given to the audit committee and external auditor.</p> <p>The findings should detail:</p> <ul style="list-style-type: none"> • criteria – what is expected • condition – actual condition • cause – reason for difference between what is expected and actual condition • effect – impact of actual condition not being what is expected • recommendation for improvement. <p>The audit reports are presented and discussed at audit committee meetings.</p>	<p>The audit committee is responsible for reviewing any accounting or auditing issues identified as a result of the internal audit. This includes reviewing and analysing the findings in the audit report and supporting recommendations on how the findings should be addressed.</p> <p>Attention should be paid to the findings identified and their impact on the risks facing the institution.</p> <p>If there are disagreements between management and the internal auditors relating to the findings identified, the committee should assist with resolutions.</p> <p>Treasury regulations 3.1.14 and 27.1.11 require that where a report is received from internal audit implicating the accounting officer or any member(s) of the accounting authority in fraud, corruption or gross negligence, the chairperson of the audit committee must report this to the relevant executive authority.</p> <p>The audit committee has explicit authority to investigate the matter further and should be given the required resources to do so.</p>	<p>Misstatements that are identified and uncorrected are accumulated and evaluated against materiality – individually and in aggregate – to form an overall opinion on the information audited.</p> <p>Materiality is a measure of the extent to which errors and other misstatements may be tolerated by the users of the reported information. It is determined based on the professional judgement of the auditor, and may be quantitative or qualitative in nature.</p> <p>Management report The management report is provided to the management and executive authority of the institution at the end of the audit. It details the findings from the procedures performed, identifies the root causes of these findings, and makes recommendations for improvement.</p> <p>Audit report The audit report is published in the institution's annual report. It informs those responsible for oversight, the public and others of:</p> <ul style="list-style-type: none"> • material misstatements in the financial statements • material findings on the usefulness and reliability of the performance report • material non-compliance with key laws and regulations in specific focus areas. <p>An audit opinion or conclusion may take different forms:</p> <ul style="list-style-type: none"> • Unqualified opinion – no material misstatements are identified. • Qualified opinion – where uncorrected misstatements are material but not prevalent to the financial statements as a whole; OR where insufficient audit evidence is obtained and the effect on the financial statements is material but not prevalent or pervasive. • Adverse opinion – where uncorrected misstatements are material and pervasive to the financial statements. • Disclaimer of opinion – where the auditor is unable to obtain sufficient audit evidence and the effect on the financial statements is material and pervasive. 	<p>The committee should review the management and the audit report thoroughly in the audit committee meeting. The presence of the external auditor during the meeting is encouraged to answer any questions that the audit committee may have.</p> <p>These findings may be compared to findings already raised by other assurance providers, such as internal audit. The audit committee should provide recommendations on how the findings should be addressed and assist management in setting up action plans.</p> <p>The committee members should avail themselves to provide advice to the accounting officer and senior management of the institution on actions to be taken when significant matters with an impact on the audit have been identified.</p> <p>Attention should be paid to the findings identified and their impact on the risks facing the institution.</p>
Monitoring	Audit committee role	Monitoring	Audit committee role
<p>A method to monitor the implementation of internal and external audit recommendations should be in place.</p> <p>The progress on implementation should be reported at all audit committee meetings.</p>	<p>The audit committee should monitor the implementation of internal and external audit recommendations through internal audit.</p>	<p>The external auditors undertake quarterly visits during which a high-level review of the status of internal controls is assessed using a dashboard report.</p>	<p>The audit committee should ensure that they receive copies of these reports and follow up on action taken to address any negative assessment.</p>

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