# THE IMPORTANCE OF BEING EARNEST

**New US legislation and a series of proposals to amend the UK Combined Code are throwing the spotlight on the relationship between internal and external auditors and the audit committee. The ICAEW has provided some guidance.**

UK-listed companies now have to contend with a great number of reports, proposals and legislation that affect the relationship between internal and external auditors and the audit committee:

- Smith Report, audit committees
- Higgs Report, non-exec directors
- APB briefing paper on effective communication between audit committees and external auditors
- Sarbanes-Oxley Act

*The Power of Three*, a new report from the ICAEW's Audit and Assurance Faculty, has produced what it calls "interim guidance". This is a summary of the report.

**Principle 1: internal audit**

*Understand internal audit's relationship to those charged with governance*

The first section of the report looks at the role of internal and external auditors in relation to the governance of the organisation. Drawing on Smith, it says the audit committee should ensure that the internal auditor has direct access to the board chairman and to the audit committee – and that it is accountable to the audit committee. The audit committee should also determine whether the internal auditors are following any particular standards, such as those set by the Institute of Internal Auditors (IIA), which are mandatory for individual members but not for organisations. The audit committee should support the internal auditors by providing adequate resources, appropriate reporting lines and ensuring they are accorded the right status. Where there are no internal auditors, the Turnbull report suggests an annual consideration as to whether there should be.

**Principle 2: external audit**

*Understand external audit's relationship to those charged with governance*

Audit committees should consider:

- whether the external auditor is independent and objective
- what the external auditor is required to report on
- whether the proposed scope of the external audit is appropriate
- how often this scope is reviewed
- the appropriateness of any non-audit services provided by the external auditor (and pre-approved any, if necessary)
- whether the audit committee is being kept informed of key issues and developments in the audit

**Principle 3: framework**

*Consider assurance framework*

Internal and external auditors have different responsibilities and duties, and work to different standards. External auditors, for example, have legal and professional responsibilities; internal auditors play an important part in risk management. People issues between the two sets of auditors should be given consideration, as well as the planned audit coverage of each. Both sets of auditors should understand each other's responsibilities. The audit committee needs to think carefully about whether there are gaps in audit coverage.

**Principle 4: risks**

*Understand and assess key business risks*

The audit committee needs to understand and confirm the key risks facing the organisation, and these need to be adequately reviewed, but risk management should be regarded as a core and continuous part of managing the organisation. Management must ensure there are processes in place to identify, assess, monitor and control these risks. Identified risks will have to be discussed by the audit committee with both sets of auditors. But while external auditors need an understanding of these risks (which are likely to affect the way they conduct their audit) they will be primarily concerned with the risk of material misstatement in the financial statements, while internal auditors are more likely to be concerned with detailed business risks.

Internal auditors of companies that are subject to the US Sarbanes-Oxley Act will have to give consideration to section 404 and the draft guidance produced by the American Institute of Certified Public Accountants. The section requires management to assess the effectiveness of internal controls and the procedures used to prepare and report financial information in the annual accounts. Internal auditors will also be concerned with reviewing codes of ethics disclosures. External auditors will audit and report on the assessment.

**Principle 5: liaison**

*Establish arrangements for effective liaison between audit committees and auditors at all key stages in the audit cycles*

Internal and external auditors work to different cycles. Audit committee meetings held throughout the year should foster closer links between the two sets of auditors and require both to attend (whenever possible) all relevant meetings. The Statement of Auditing Standards SAS610, which covers communication between the external auditors and the company, has guidance on how external and internal auditors can work together more effectively on a constructive and complementary basis. By law, external auditors have right of access to all information and explanations, including internal auditors' reports and working papers. There is no reciprocal right of access to external auditors' papers. If the external auditors rely on work carried out by the internal auditors, SAS500 says that external auditors need to evaluate the internal auditors' work.

**Principle 6: evaluation**

*Continuous evaluation and improvement*

The audit committee should, according to the Smith report, monitor and review the internal audit activities and have procedures to ensure the independence and objectivity of the external auditors and evaluate their effectiveness. Monitoring progress against audit plans by both sets of auditors can help identify ways of improving the working relationships.

*Andrew Sawers*

*A wide range of Briefings can be found at www.financialdirector.co.uk/briefing*

**Useful links**

- **A full reading list is contained in this report at www.icaew.co.uk**
- **Higgs: www.dti.gov.uk/cld/non_exec_review**
- **Smith: www.frc.org.uk/publications**
- **Turnbull: www.icaew.co.uk/internalcontrol**