

# Internal Audit's Role in Corporate Governance Frameworks

Including Survey Results

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## About this Session

The profession's IPPF suggests practices for aligning internal audit with the organization.

Real life looks different - we can observe a broad variety of constellations which do and do not work well.

What about corporate governance frameworks?

Looking at the diversity in Europe we analyzed key normative set-ups, gathered inputs from a pan-European group of governance experts and concluded on consequences for profession and practitioners.



# Internal Audit's Role in Corporate Governance Frameworks

- Why
- Setting
- Project
- Results
- What's next?



## Why: Many Key Players Seem to Have no Clear Perception of Internal Audit's Role

- What claims can/should CAEs make?
  - None ... board access and a powerful position
- What arguments do CAEs have?
  - None ... legally binding role models
- Who defines the role  
of the CAE and the audit team?
  - Law? Boards? CAEs? A matter of taste?
- What is right, what is wrong?
  - Different setups wherever you look

**Arguments**  
for communicating  
... to norm setters,  
boards, etc.

## Research Objectives

- A variety of Corporate Governance frameworks developed in the EU as well as globally throughout the last 15 years.
  - **Internal Audit's role** has been reflected in some of the Governance frameworks, whereas others only reference to the function in explanatory notes or do remain silent about internal audit and its role.
- After analysing **normative options** a selection of high-level Corporate Governance and internal audit experts had been surveyed to gather their understanding of **good practices** and **expectations** towards the **Governance frameworks**.



## The Setting

- Global governance principles
- Regional rule makers
- National law
- Sector law and regulation
- Soft law
- Best practices and practice frameworks
- Stakeholders, boards, and auditors



## Research Approach

- 10+ national and transnational corporate governance models had been analysed to determine generic structures and normative options governing the internal audit function
  - OECD, BIS, COSO, national CG codes, laws, industry regulation
- European corporate governance and audit experts had been contacted to provide opinion and comments on whether they judge the observed structures and normative options as best practice, good, or negative
  - Simplified Delphi approach was determined to be most suitable
- 30 experts responded between September and December 2007

## Approach: Governance Models Used for Determining Normative Options

- Transnational Corporate Governance Models
  - OECD Corporate Governance Principles
  - BIS Core Principles
  - EU Action Plan
- Corporate Governance Codices
  - Austria, France, Germany, Switzerland, The Netherlands, United Kingdom
- National Corporate Governance Frameworks
  - United States (COSO, SOX)
- Additional models (EU directives, US PCAOB)
  - Selective review did not render additional structural elements

## The IPPF - Internal Audit's Model

- IIAS 1100 - Independence & Objectivity
  - The internal audit activity must be independent ...
- IIAS 1100 - Independence & Objectivity - Interpretation
  - ... chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship. ...



## Organizational Interfaces

- IIAS 1110 - Organizational Independence
  - The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. ...
- IIAS 1110.A1 - Interference
  - The internal audit activity must be free from interference ...
- IIAS 1111 - Direct Interaction With the Board
  - The chief audit executive must communicate and interact directly with the board.



## What is the Issue?

- IPPF is one - Internal Audit's? - view point
- Law, regulation, and management practice may be different
- How does this fit together?
  - Structural/organizational elements
  - Normative/prescriptive elements
  - Good practices and outcomes
  - Gaps creating issues for all involved parties

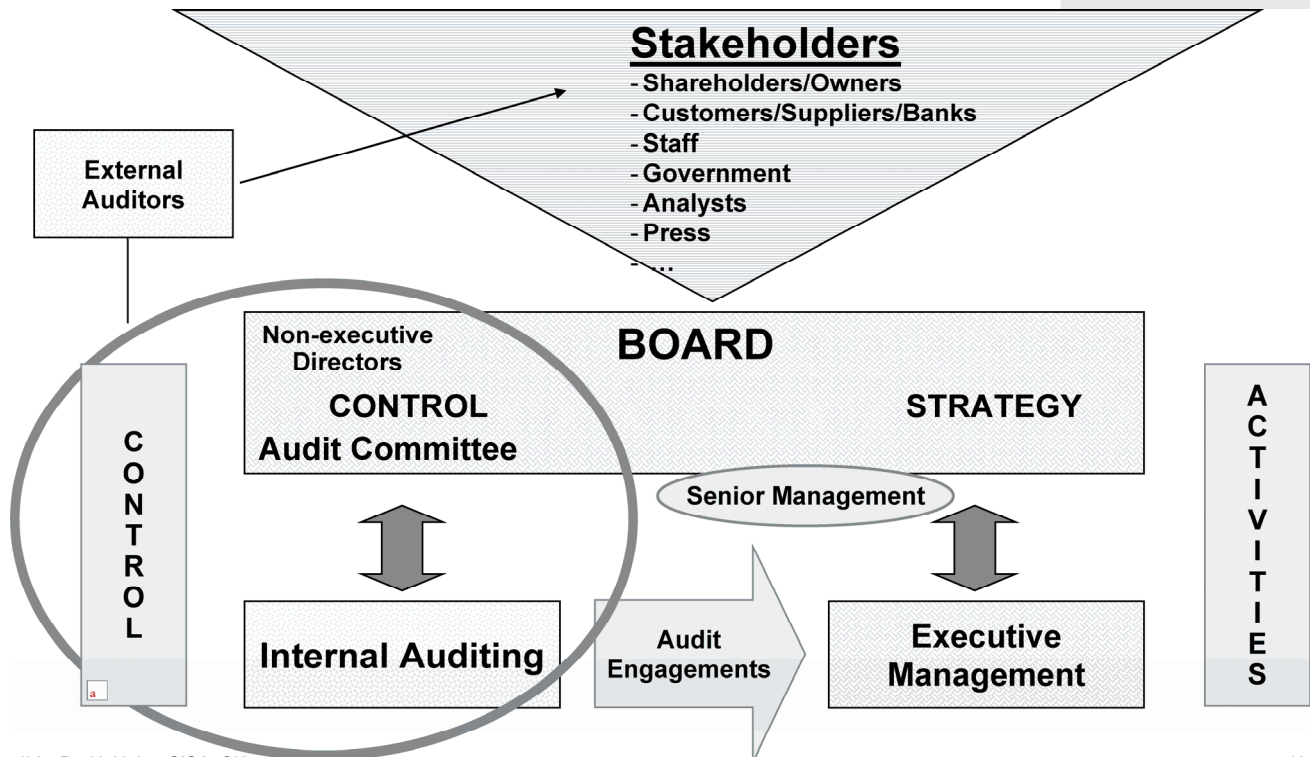


## Carving Out Key Roles and Common Terminology

- After analysing more than 10 major European CG models a generic set of relevant Governance roles had been defined, reflecting both single-tier and two-tier board systems:
  - Entire Board Structure
  - Chief Executive Officer
  - Supervisory Board/Non-executive Directors
  - Audit Committee
  - Audit Committee Chair
  - Management Board/Executive Directors
  - Chief Financial Officer
  - Internal Audit Function



# Internal Audit in the Governance System

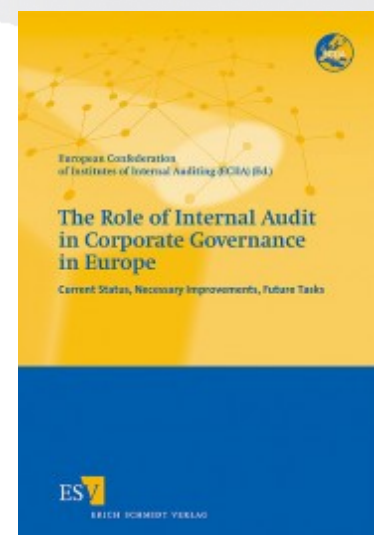


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## Working from General to Detail

- Advance through understanding, explaining and improving
  - This is a permanent, long-term process
- Example: Fundamental study on
  - Governance awareness
  - Source and scope of rules
  - Acceptance of governance rules
  - **Is an internal audit role defined?**



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# Digging One Level Deeper ...

Abbildung 1: INTERNE REVISION IN TRANSNATIONALEN MODELLEN

	ISO 37000	ISAF 6	ISO 37001	ISAF 1	ISAF 2	ISAF 3
Regelungs-kriterien	Möglich	Optional	Optional	Möglich	k.A.	Angemessen, unabhängig, dauerhaft, wirksam
Revisions-funktion	Möglich	Optional	Optional	Möglich	k.A.	Angemessen, unabhängig, dauerhaft, wirksam
Aufgaben des internen Revisions	Funktionsfähig, ISIRI, Vernetzung, laufende Überwachung	k.A.	k.A.	k.A.	k.A.	Angemessenheit und Unabhängigkeit, Vertrauen, Unabhängigkeit und Vertikalität, Kontrolle
Verantwortung für Einrichtung	Board	k.A.	Board ist Pflicht, unabhängig, jährlich zu kündigen	k.A.	k.A.	Überwachungs- und Berichterstattung
Überwachung des internen Revisions	Prüfungsausschuss	Prüfungsausschuss	Prüfungsausschuss für (Supervisory) Board, welches auch interne Aufsichtsinstrumente	Prüfungsausschuss	k.A.	Geschäftsbereich, Prüfungsausschuss
Konzeptions-schwerpunkte Revisionsplan	k.A.	k.A.	Prüfungsausschuss	k.A.	k.A.	Geschäftsbereich, Prüfungsausschuss
Prüfungsführung	Board oder Prüfungsausschuss	k.A.	k.A.	k.A.	k.A.	Angemessen, Optional, Prüfungsausschuss
Durchführungs-führung	k.A.	k.A.	k.A.	k.A.	k.A.	k.A.
Organisatorische Eingliederung	Unternehmensleitung	k.A.	k.A.	k.A.	k.A.	Unabhängigkeit, Vernetzung, Einbindung in die Geschäftsleitung
Einfluss der Geschäftsleitung	k.A.	k.A.	Prüfungsausschuss	k.A.	k.A.	Geschäftsbereich, Prüfungsausschuss
Einfluss der Geschäftsleitung	Geschäftsbereich, Vorstand, Aufsichtsrat, Prüfungsausschuss	Prüfungsausschuss	k.A.	k.A.	Prüfungsausschuss	Prüfungsausschuss
Einfluss der Geschäftsleitung	Geschäftsbereich, Vorstand, Aufsichtsrat, Prüfungsausschuss	Prüfungsausschuss	k.A.	k.A.	Prüfungsausschuss	Prüfungsausschuss
Einfluss der Geschäftsleitung	Geschäftsbereich, Vorstand, Aufsichtsrat, Prüfungsausschuss	Prüfungsausschuss	k.A.	k.A.	Prüfungsausschuss	Prüfungsausschuss
Einfluss der Geschäftsleitung	Geschäftsbereich, Vorstand, Aufsichtsrat, Prüfungsausschuss	Prüfungsausschuss	k.A.	k.A.	Prüfungsausschuss	Prüfungsausschuss

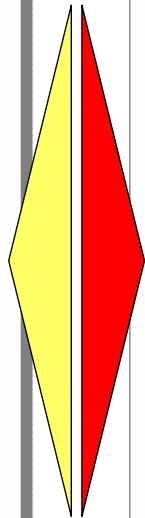
Source: Hahn/Quick/Mantre 2008, ST 9/2008, 695 | www.treuhaender.ch

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Abbildung 2: INTERNE REVISION IN NATIONALEN MODELLEN

	ISIRI	ISIRI	ISIRI	ISIRI	ISIRI	ISIRI
Regelungs-kriterien	Charakteristika	k.A.	Charakteristika	Institutionalisiert	k.A.	Institutionalisiert
Revisions-funktion	Charakteristika	k.A.	Charakteristika	Institutionalisiert	k.A.	Institutionalisiert
Aufgaben des internen Revisions	Kompetenz, Unabhängigkeit, Vernetzung	k.A.	k.A.	Revisionsmanagement und Kontrollsystem	k.A.	Revisionsmanagement und Kontrollsystem
Verantwortung für Einrichtung	Verwaltungsrat	k.A.	k.A. (Vorstand)	Board	k.A.	k.A. (Vorstand)
Überwachung des internen Revisions	Prüfungsausschuss, Vernetzung, Berichterstattung	k.A.	k.A.	Prüfungsausschuss, Berichterstattung, Kontrollsystem	k.A.	Prüfungsausschuss
Konzeptions-schwerpunkte Revisionsplan	k.A.	k.A.	Prüfungsausschuss	Prüfungsausschuss, Berichterstattung, Kontrollsystem	k.A.	Prüfungsausschuss, Berichterstattung
Prüfungsführung	Prüfungsausschuss oder Verwaltungsausschuss	k.A.	Vorstand	k.A.	k.A.	Vorstand
Durchführungs-führung	k.A.	k.A.	k.A.	k.A.	k.A.	k.A.
Organisatorische Eingliederung	k.A.	k.A.	Subsidiarität des Board	k.A.	k.A.	k.A.
Einfluss der Geschäftsleitung	k.A.	k.A.	Prüfungsausschuss	Prüfungsausschuss	k.A.	Prüfungsausschuss, Berichterstattung
Einfluss der Geschäftsleitung	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	k.A.	Compliance (Risikomanagement)
Einfluss der Geschäftsleitung	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	k.A.	Compliance (Risikomanagement)
Einfluss der Geschäftsleitung	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	k.A.	Compliance (Risikomanagement)
Einfluss der Geschäftsleitung	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	Compliance (Risikomanagement)	k.A.	Compliance (Risikomanagement)

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# Research Approach: Criteria for Analyzing Internal Audit's Role in CG Frameworks

- Role and objective of Internal Audit
- Responsibility for establishing Internal Audit
- Monitoring of Internal Audit
- Approval of the Internal Audit plan
- Administrative reporting of the Internal Audit function
- Functional reporting of the Internal Audit function
- Sourcing and management of Internal Audit
- Recipients of Internal Audit's activity report
- Disclosure on Internal Audit







## Example: Internal Audit in Regional Frameworks

- 2005 EU Recommendation on the Role of Non-executive or Supervisory Directors
  - ... the **audit committee** should assist the (supervisory) board to at least ... **ensure** the **effectiveness** of the **internal audit** function, in particular by making recommendations on the selection, **appointment**, reappointment and removal of the **head of** the **internal audit** department and on the department's budget, and by **monitoring** the **responsiveness of management** to its findings and recommendations. If the company does **not have** an **internal audit** function, the **need** for one should **be reviewed** at least annually.

(Appendix 4.2.1)

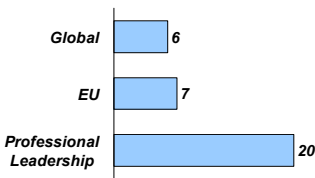
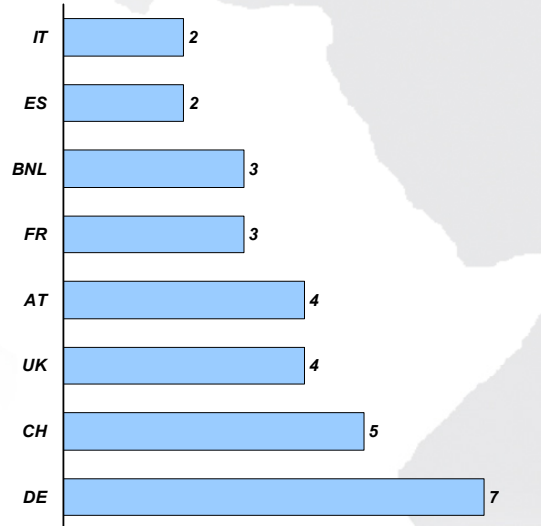
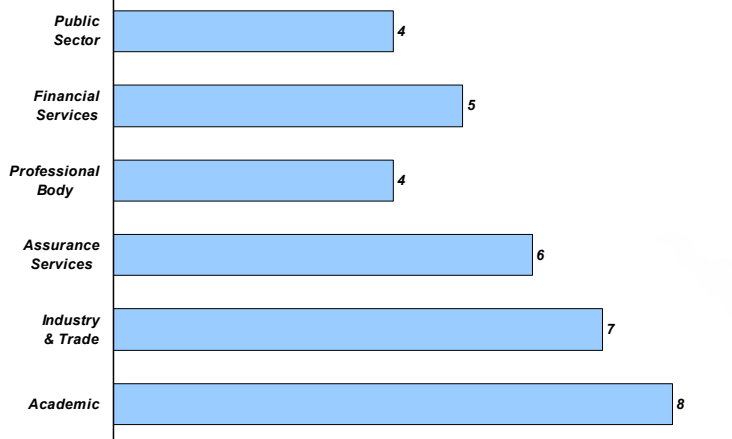


## Examples: Internal Audit in National Soft Law

- Swiss Corporate Governance Code
  - ... The company should set up an Internal Audit function which should report to the Audit Committee or, as the case may be, to the Chairman of the Board. (# 19)
- German Corporate Governance Code
- Austria
- UK Combined Code
  - Audit Committee monitors and reviews effectiveness of IA
  - Review and report if Internal Audit is not established



## Expert Responses



### Survey Population

- \* Major European economies
- \* Industry mix, academia, professional practice experts
- \* European and global professional leadership
- \* 30 responses
- \* Participation rate ca. 70 %



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## Key Findings

- Audit Committee responsibilities
- Internal Audit activity scope
- Internal Audit disclosures
- Internal Audit reporting lines
- Internal Audit sourcing options



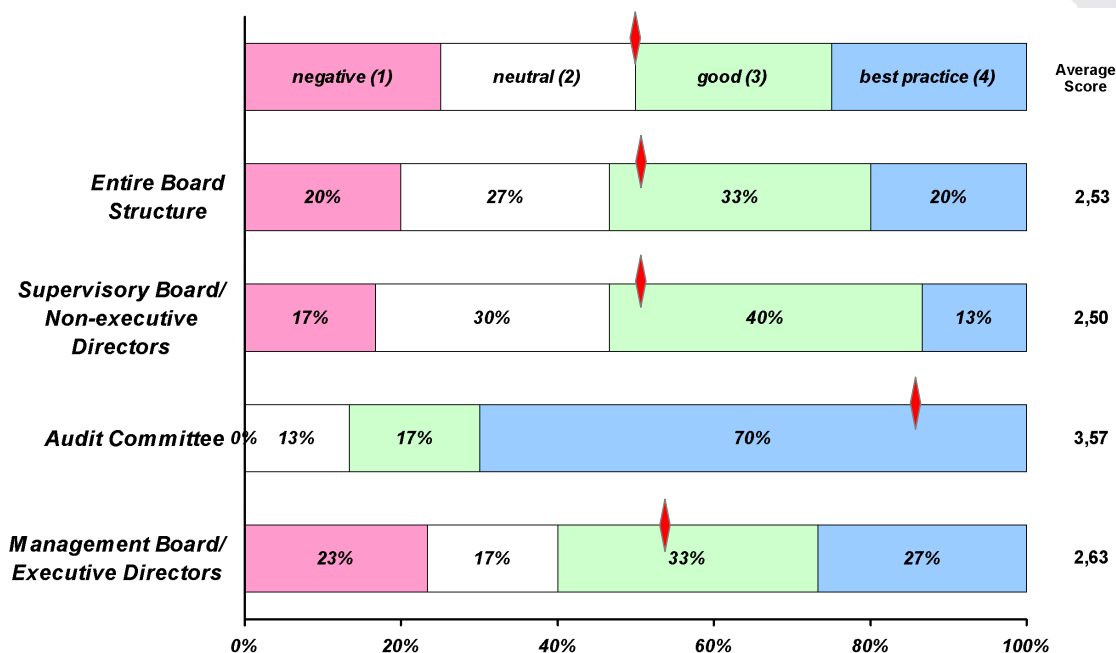
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## Audit Committees' Responsibility to Establish and Monitor an Internal Audit Function

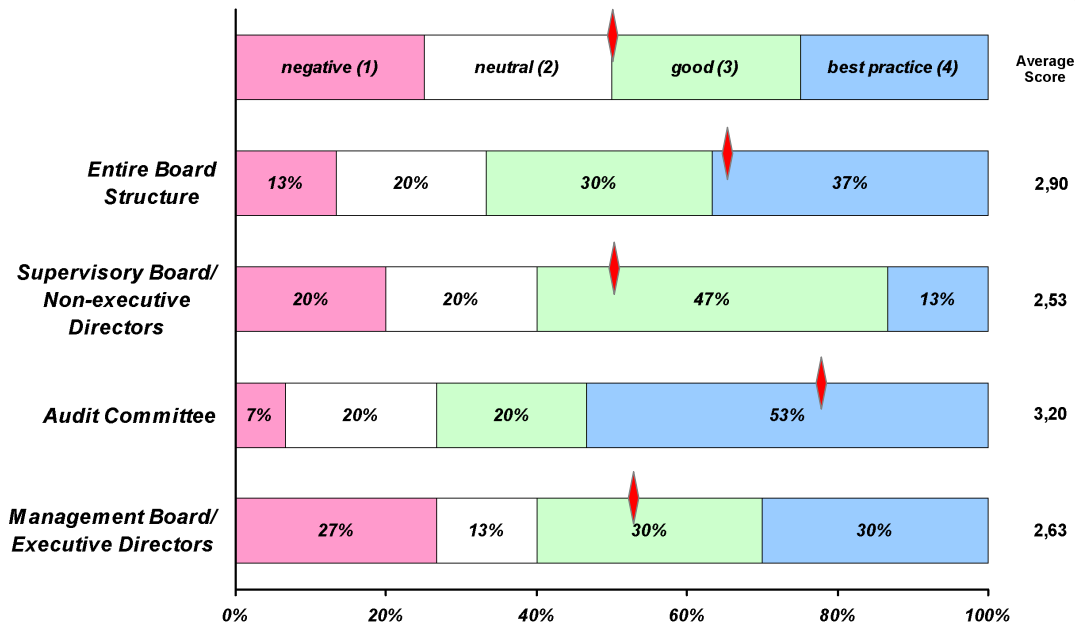
- Audit committees should monitor the internal audit function
  - 70 % best practice, 17 % good
- Audit committees have the primary responsibility for establishing an internal audit function
  - 53 % best practice, 20 % good
- Audit committees should approve the internal audit plan
  - 70 % best practice, 20 % good
- Internal audit should functionally report to audit committee
  - 57 % best practice, 30 % good



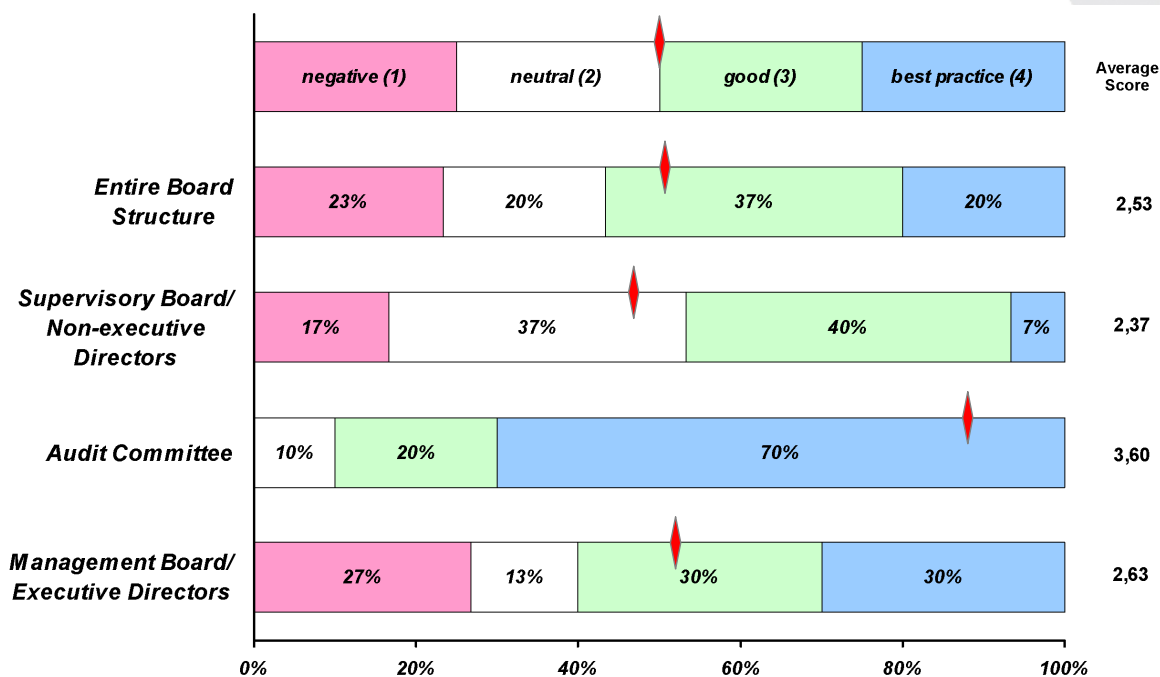
## Who Should Monitor the Internal Audit Function?



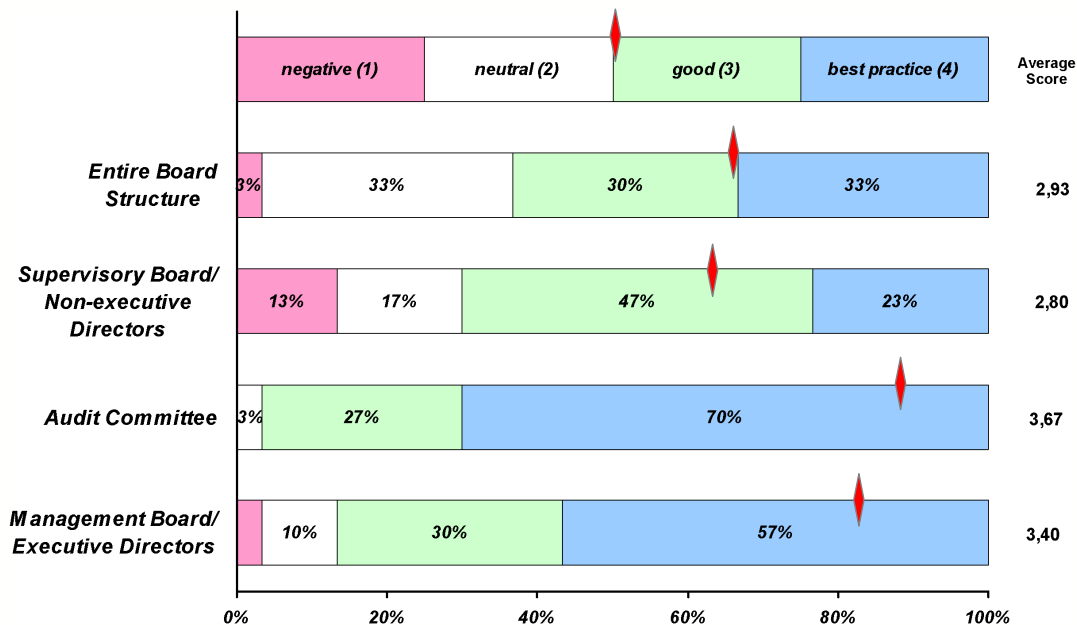
# Who Should be Responsible for Establishing the Internal Audit Function?



# Who Should Approve the Internal Audit Plan?



## Who Should Receive the Activity Report of the Internal Audit Function?



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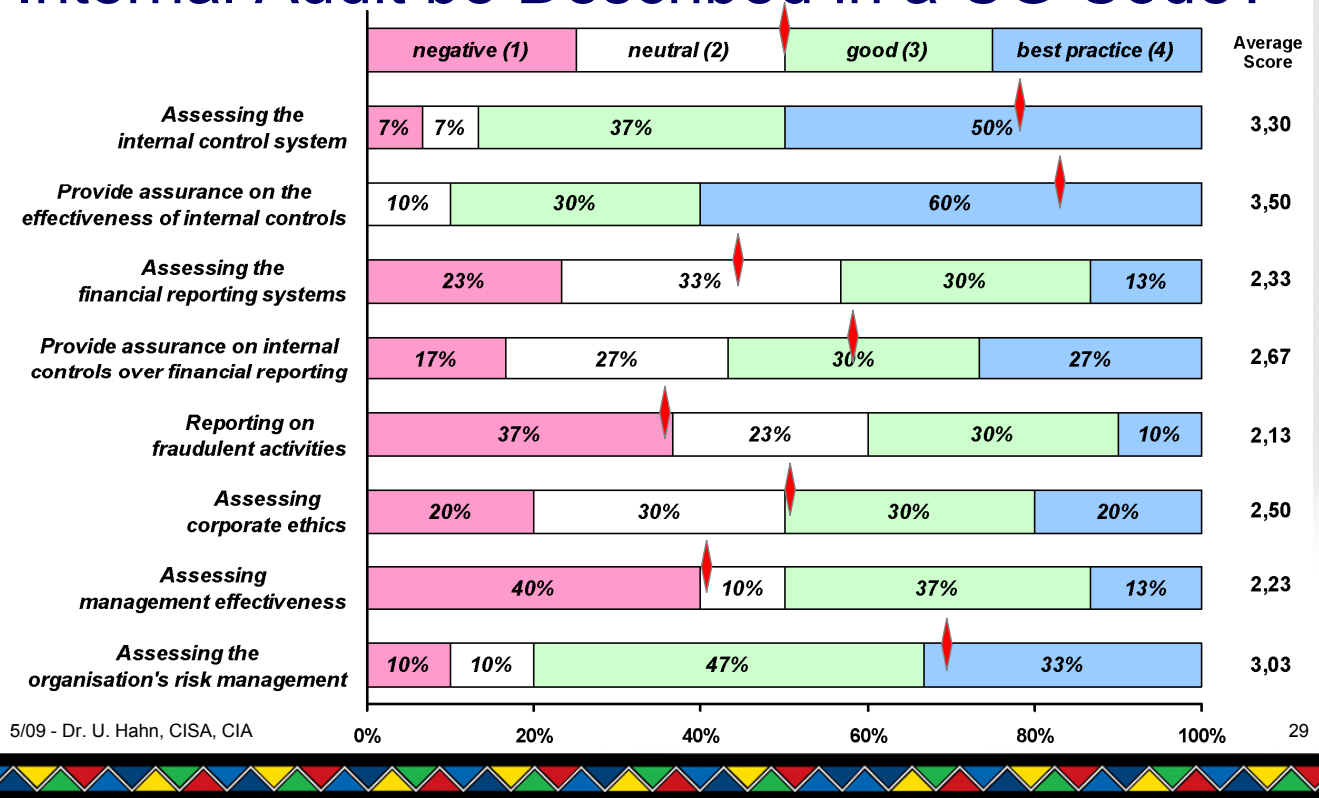
## Internal Audit's Main Activities

- Corporate governance codes should determine internal audit's main focus on internal control
  - Top priority are assessing the internal control system and its effectiveness
  - Assessing risk management and controls over financial reporting are secondary activities
  - Reporting on fraudulent activities and assessment of management effectiveness are not a core activity of internal audit

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## How Should the Main Task of Internal Audit be Described in a CG Code?

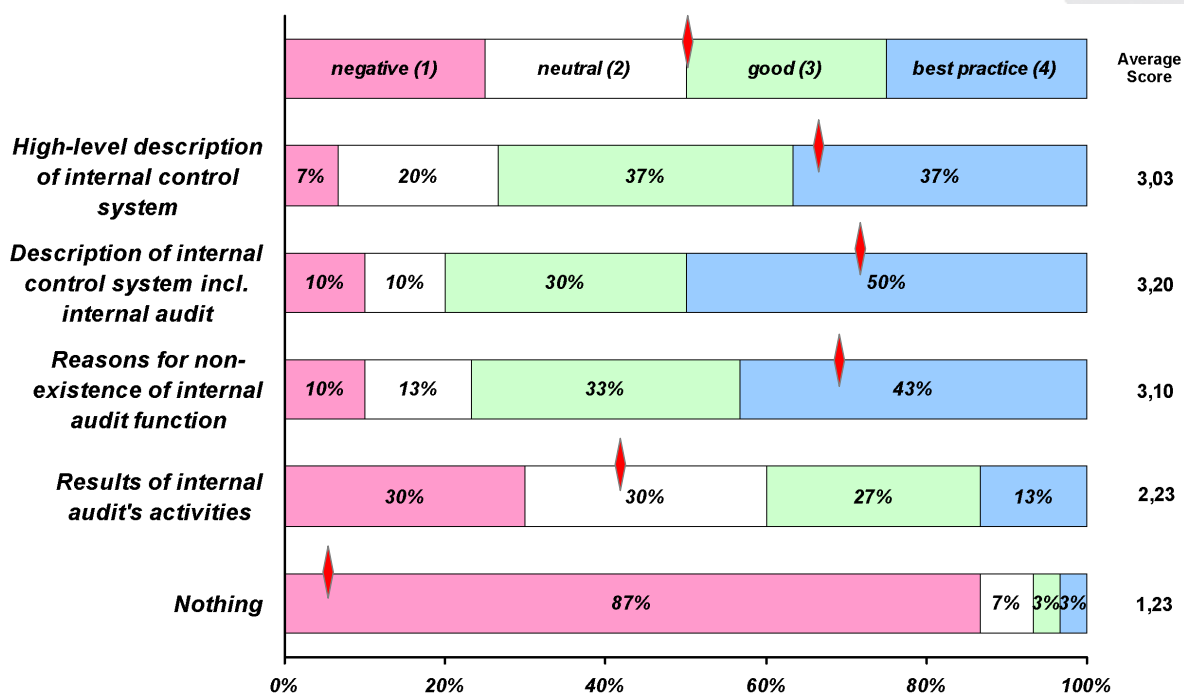


## Internal Audit-related Disclosures

- Experts agree on internal control disclosures
  - High-level description of internal control system incl. internal audit
  - Reasons for non-existence of internal audit



## What Should be Disclosed in an Organization's Annual Report?



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## Functional Reporting of Internal Audit

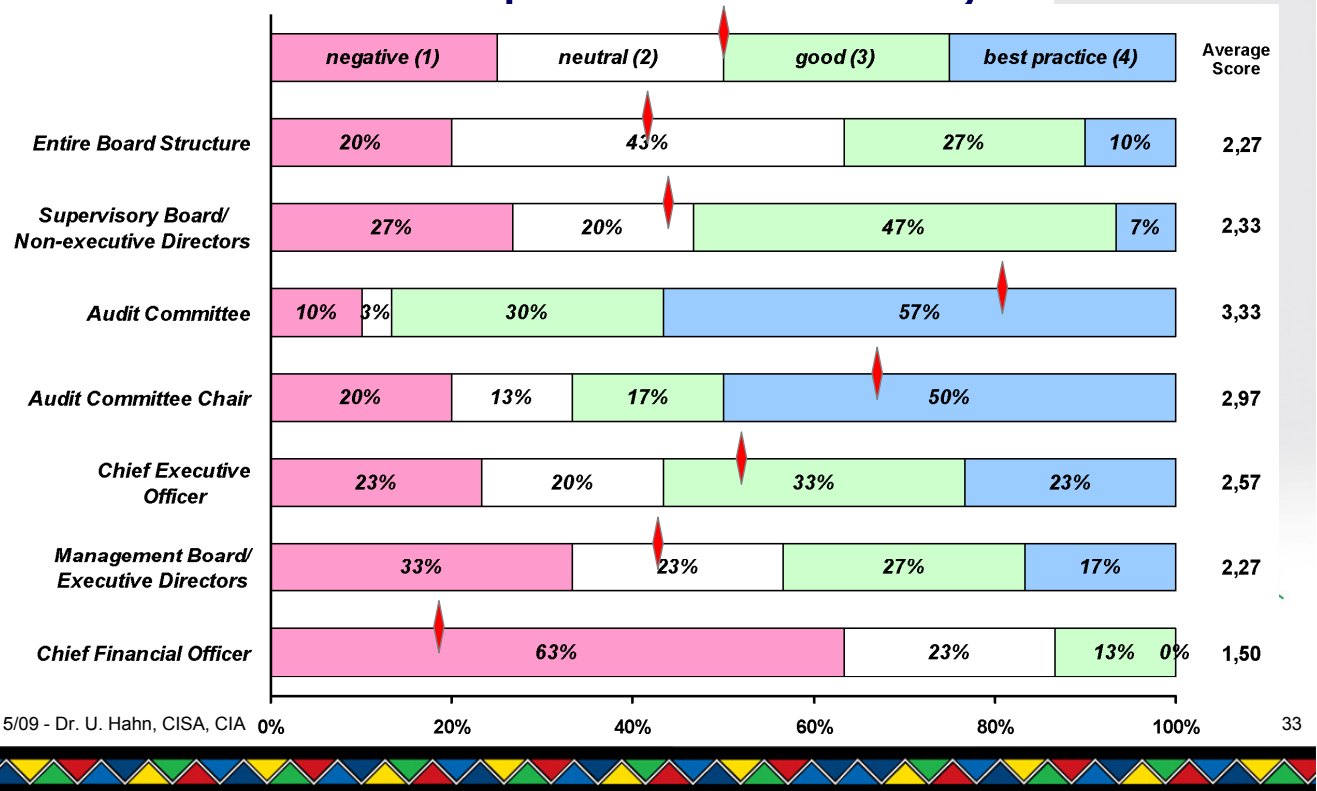
- Internal audit should functionally report to audit committee
  - 57 % best practice, 30 % good
- 2nd option audit committee chair
  - 50 % best practice, 17 % good
- CFO not regarded appropriate
  - 63 % negative, 23 % neutral

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## To Whom Should Internal Audit Report Functionally?

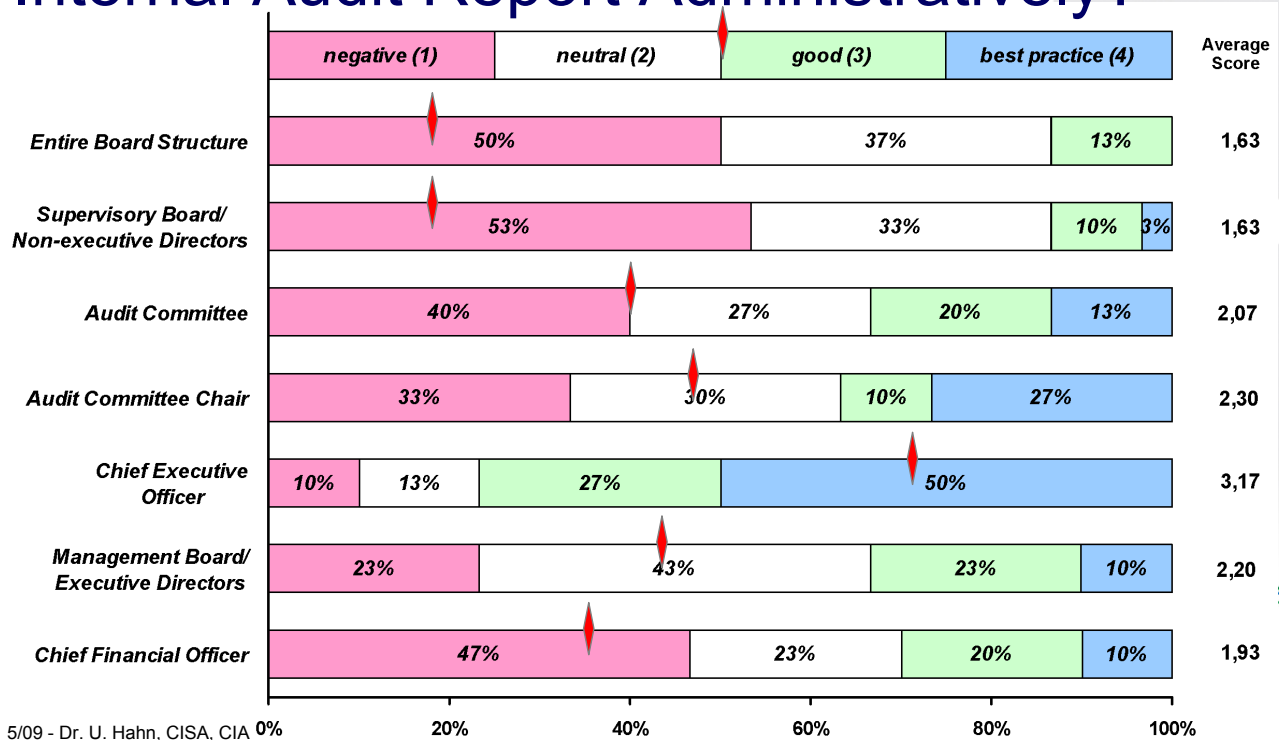


## Administrative Reporting of Internal Audit

- Preferably to chief executive officer
  - 50 % best practice, 27 % good
- Not recommended
  - 54 % ... 40 % negative opinions
  - Non-executives, entire board, CFO, and audit committee



## To Whom Should Internal Audit Report Administratively?

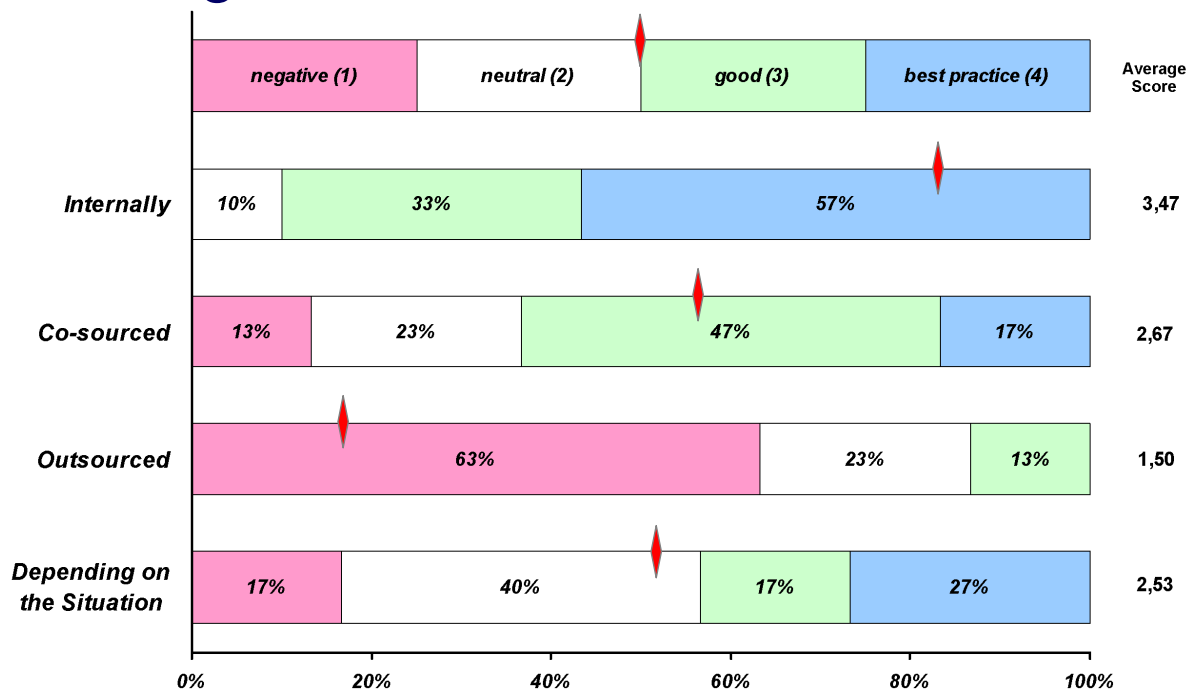


## Internal Audit Sourcing Options

- Internal audit should be provided primarily internal
  - 57 % best practice, 33 % good
  - 63 % see fully outsourced internal audit as negative
  - Co-sourcing and contingency approaches are supported



## Sourcing Internal Audit



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## Results

- Audit Committee interface
- Reporting lines
- Disclosures
- Key activities

### Survey

- \* 30 regional experts provided input to a Delphi study on internal auditing's role in corporate governance frameworks
- \* Major models were used to establish a generic set of normative options

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## Conclusion / Expert Expectations

- Audit committees would be responsible for establishing and monitoring an internal audit function
  - Functional reporting should be to audit committee or its chair
  - CEO is the preferred administrative report, alternatively the audit committee chair
  - Internal audit should be provided mainly internal or co-sourced
- Description of internal control system incl. internal audit should be disclosed
  - Reason for non-existence of internal audit should be explained
- Internal audit's primary task is assessing the internal control system and its effectiveness

## And Now ...

- What could stakeholders do?
- What would board members do?
- What do rule makers need to do?
- What can auditors do?
  - Support the development of sound positions
  - Be a good example
  - Spread the word

• Support  The Institute of Internal Auditors  
Research Foundation



## Acknowledgements

This study would not have been possible without the candid contribution of the European and global Internal Audit and Corporate Governance leaders commenting the questions.

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