

## From the IIA

William G. Bishop, III, CIA is President  
The Institute of Internal Auditors



# Five Principles Help Improve Audit Committee's Performance

By William G. Bishop III, CIA

The SEC's Blue Ribbon Committee (BRC) was formed last year in response to concerns that the quality of corporate America's financial reporting was eroding. BRC members from the business, financial, and accounting communities sought input from a wide variety of constituents through public hearing and open request before determining that quality financial accounting and reporting can only result from effective interrelationships among relevant corporate participants.

*The Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee* includes 10 Recommendations and five Guiding Principles. The IIA recommends that organizations carefully consider the BRC's Guiding Principles.

**PRINCIPLE 1:** *The Audit Committee's Key Role in Monitoring the Other Components of the Audit Process.*

The BRC states that the audit committee (AC), "oversees the work of the other actors in the financial reporting process — management, including the internal auditor, and the outside auditors — to endorse the processes and safeguards employed by each. In particular, the AC should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control; that the internal auditor objectively assesses management's accounting practices and internal controls; and that the outside auditors, through their own review, assess management, and the internal auditor's practices."

The IIA suggests that: The AC ensures that its organization has an adequately staffed, professional internal auditing function. The internal auditor provides the AC with an annual assessment of the effectiveness of the organization's system of internal controls.

**PRINCIPLE 2:** *Independent Communication and Information Flow Between the AC and Internal Auditors.*

According to the BRC, "responsible financial reporting is derived in large part from an effective system of internal controls. While management is responsible for internal controls, the internal auditor is in a position to evaluate and report on the adequacy and effectiveness of those controls."

The IIA believes that the AC must establish and support a culture of open disclosure so that if the internal auditor identifies a problem and cannot obtain the support of management, he or she has a duty to the AC, the full board, and shareholders to disclose the relevant information to the AC.

The AC should inquire as to whether its internal auditors practice according to The IIA's *Standards for the Professional Practice of Internal Auditing*, which provide the basis for their internal controls report.

The AC should review and approve the internal auditing charter, concur on the appointment or removal of the director of internal auditing, review (and pre-approve) audit plans and budgets, review audit results, and request audit projects. The director of internal auditing should have

direct, unrestricted communication with the AC, and should attend AC meetings and meet privately with the AC at least annually.

**PRINCIPLE 3:** *Independent Communication and Information Flow Between the AC and External Auditors.*

The BRC report indicates that if the AC is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance, and judgment of the outside auditor. Their *Recommendations* suggest that listing rules require companies to formally disclose information about outside auditor communications regarding independence. The Committee also states that every AC should adopt additional voluntary measures to ensure the outside auditors' objectivity.

The IIA believes that the AC should be empowered to select and manage all relationships with internal and external auditors in order to ensure the maintenance of independence.

**PRINCIPLE 4:** *Candid Discussions.*

This principle calls for management to report to the AC on the overall business environment, risks, and system for internal controls; to provide an explanation of the organization's financial statements; and to provide its response to assessments provided by the internal and outside auditors. The BRC states that ACs "should look to the internal auditor and the outside auditors to verify management's compliance with process and procedures and seek additional input on any significant judgments made."

The IIA believes that management is responsible not only for the accuracy of financial statements, but also for the system of internal controls. A requirement to report on the adequacy and effectiveness of the system of internal control would be one way of highlighting management's responsibility for reporting accurate financial information.

The 'partnership' among ACs, boards, regulators, external auditors, internal auditors, and management cannot be ignored and internal auditing is uniquely positioned to assist each of the partners in improving its effectiveness.

**PRINCIPLE 5:** *Diligent and Knowledgeable Membership.*

The BRC's *Recommendations* suggest qualification requirements regarding independence and financial literacy for all AC members. The BRC expects that ACs will carefully consider further qualifications for those who serve on the committee. This could include mechanisms to encourage

selection and retention of diligent and knowledgeable members, higher compensation for AC members, term limits and rotation, and education and training programs.

### **Conclusion**

It is apparent that the BRC values internal auditing's role in responsible financial disclosure and active and participatory oversight. The IIA, however, goes a step further to say that internal auditors should be deeply involved in the organization's processes and practices and should constantly observe the control environment. We believe that a strong and effective internal auditing function can have a significant impact on improving the effectiveness of audit committee performance.

*The IIA's Web site: [www.theiia.org](http://www.theiia.org), includes a link to the full BRC Report.*

*A version of this article appeared in The IIA's corporate governance newsletter, *Tone at the Top*.*

## **IIA Award to Recognize Exemplary Departments**

The Institute of Internal Auditors (IIA), has announced the creation of a new award designed to honor exemplary internal auditing departments.

The IIA Commitment to Quality Improvement Award will recognize audit shops that have made significant commitments to improve the quality and value of their internal auditing functions in each of the three categories of professional excellence, quality of services, and professional outreach.

To be considered, applicants must submit a letter of consideration from the chief auditing executive of their organization, describing in 100 words or less why the department is qualified to receive the award. Application deadlines are February 28 and August 31. For more information contact the IIA Customer Service Center via e-mail at [custserv@theiia.org](mailto:custserv@theiia.org), or phone (407) 830-7600, ext. 1.