PEC Audit Committee

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Committee Meeting

~ Minutes ~

Monday, August 15, 2016 | **4:57 PM** | **PEC Headquarters Auditorium, 201 South Avenue F, Johnson City, TX 78636**

Open Session of this Committee was held in the PEC Auditorium immediately following the PEC Regular Board Meeting and was video recorded in accordance with Open Meetings Policy. Members were able to watch this meeting by live-stream from the PEC website at http://www.pec.coop/boardvideos.

1. Call to Order and Roll Call

4:57 PM Meeting was called to order at 4:57 PM on August 15, 2016 at PEC Headquarters Auditorium, 201 South Avenue F, Johnson City, TX.

Attendee Name	Title	Status	Arrived
Kathryn Scanlon	Committee Chairperson	Present	4:57 PM
Cristi Clement	Committee Member	Present	4:57 PM
Paul Graf	Committee Member	Present	4:57 PM

2. Member Comments (3 minute limitation or as otherwise directed by Committee)

There were no members present wishing to comment.

3. Educational and Reference Materials for International Internal Auditing Standards

A. Educational and Reference Materials for International Internal Auditing Standards

B. 20 Questions Directors Should Ask About Internal Audit

C. Audit Committee Purpose

D. Audit Committee Oversight Role

E. Definition of Internal Auditing

F. Internal Audit Core Principles

G. Code of Ethics

H. Implementation Guidance

I. Monitoring Guidance

J. Three Lines of Defense Model

Audit Committee Chairperson Kathy Scanlon stated that reference materials were included in the Audit Committee package, and that earlier today the Board approved the International Auditing Standards and the Audit Committee charter. Chairperson Scanlon stated that the two issues before the committee were when and how to hire a Chief Internal Audit Executive. CFO Tracy Golden reported that a job description for a Chief Internal Audit Executive was being reviewed by staff and would then be presented to the Audit Committee for review and determination of how to fill that position. In response to a director inquiry, Mr. Golden stated that the fraud assessment would be completed in approximately four months, and the procedures would need to be reviewed by the Audit Committee and approved by the Board in approximately two months. The committee members and staff discussed the reporting process for the position, and Human Resource's process for providing the slate of applicants for the committee's consideration. Chairperson Kathy Scanlon asked the committee to review the charter for any possible changes which could be presented at the September Board meeting for consideration. The committee did not go into Executive Session.

4. Executive Session

A. Personnel Matters

1. Personnel Matters

5. Adjourn

There being no further business to come before the Board of Directors, meeting was adjourned at 5:06 pm.

APPROVED:

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Kathy Scanlon, Audit Committee Chairperson

20 Questions

Directors Should Ask about

Internal Audit

Second Edition

John Fraser, CA, CIA, CISA
Hugh Lindsay, FCA, CIP

The Canadian Institute
of Chartered Accounta

How to use this publication

Each "20 Questions" briefing is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management — and themselves — tough questions.

In some cases, boards and audit committees may not want to ask the questions directly and prefer to ask the Chief Audit Executive or management to include the topics or answers to the questions in the annual audit plan or other presentations to the Committee. The questions are not intended to be a precise checklist, but rather a way to provide insight and stimulate discussion on important topics.

The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper as necessary. The comments summarize current thinking on the issues and the practices of leading organizations. The "Recommended Practices" may not be the best answer for every organization. Thus, although the questions apply to most medium to large organizations, the answers will vary according to the size, complexity and sophistication of each individual organization.

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The Canadian Institute of Chartered Accountants

INSTITUTE OF CORPORATE DIRECTORS

20 Questions

Directors Should Ask about

Internal Audit

Second Edition

The Canadian Institute
of Chartered Accountants

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Preface

The Risk Management and Governance Board has distributed more than 5000 copies of the first edition of this book, both in Canada and internationally in collaboration with the Institute of Internal Auditors. Board members have used the questions as a process to better understand and assess the internal audit function at the organizations they oversee.

Directors of organizations that have internal audit functions are expected to satisfy themselves that the internal audit function is effective. This briefing provides suggested questions for boards to ask the chief audit executive or others in an internal audit function. For each question there is a brief explanatory background and some recommended practices. We hope that directors and CEOs will find it useful in assessing their approach to the management of risk and internal control.

Since publication of this book there has been an increasing interest in the topic of internal audit and an evolving regulatory environment causing enhanced focus on internal audit in the boardroom. It is under these circumstances that the Risk Management and Governance Board decided to review the material of the first edition of this book to ensure it is relevant and up to date. We are pleased to find the concepts and processes continue to be applicable. We believe the questions asked and fundamental principles in this book align with recent regulatory initiatives and will continue to be helpful to readers.

The Board acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, the authors Hugh Lindsay and John Fraser, and the CICA staff who provided support to the project.

We are grateful as well to individuals who contributed to the first edition, including Frank Barr, Michel Doyon, Dr. Parveen Gupta, Michael Harris, Fred Jaakson, Colin Lipson, Mary Jane Loustel, and Josee Santoni, former members of the Risk Management and Governance Board. Also, Robin Korthals, former member of the Directors Advisory Group.

Tom Peddie, FCA
Chair, Risk Management and Governance Board

The Risk Management and Governance Board of the Canadian Institute of Chartered Accountants thanks the following for reviewing and providing comments on the first edition of this document.

Dan Swanson, former Assistant Vice President, Professional Practice of the Institute of Internal Auditors, who coordinated the review process.

Staff of the Institute of Internal Auditors

Institute of Internal Auditors Liaison Committee

Members of the Professional Issues Committee of the Institute of Internal Auditors

Why directors should ask questions about internal audit

National Policy 58-201, "Corporate Governance Guidelines" states that, as part of their stewardship role, boards of directors are responsible for:

- The identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks, and
- The integrity of the corporation's internal control and management information systems.

The internal audit function plays a key role in assessing and reporting on an organization's risk management, internal controls and management information systems. Directors of companies that have an internal audit function should have a general understanding of its role and contribution. In addition, the audit committee should confirm that the internal audit function is properly constituted, has the necessary resources, and operates professionally. Boards of medium to large organizations that do not have an internal audit function should assess the need at least annually.

The questions in this briefing are designed to help directors understand the contribution of internal audit and to provide guidance to audit committee members on what to ask their chief audit executives. With each question there is a brief discussion that provides background on the reasons for asking the question and, where appropriate, some recommended practices.

The questions are organized into six groups:

- Internal Audit Role and Mandate
- Internal Audit Relationships
- Internal Audit Resources
- Internal Audit Process
- Closing Questions
- Audit Committee Assessment

Asking questions is only the first step. Directors must satisfy themselves that the answers are appropriate and that the internal audit function is effective. The comments and recommended practices in this document provide a basis for assessing the answers. Experienced directors test the answers against their own personal observations, experience, general knowledge and good business sense. They also respect their "gut feelings"— their experienced-based intuition that warns them that something is wrong or requires further explanation. Intuition alone isn't enough to challenge answers, but it's valuable if it gets people's attention and prompts them to ask more probing questions or to seek independent advice.

Terminology
In this document the term **"internal audit function"** includes the internal audit department and/or any other departments, activities or outsourced services that fulfill an internal audit role. In some cases "internal audit function" is abbreviated as "internal audit".

The **chief audit executive** is the individual responsible for leading or coordinating all or most of the internal audit function, usually on a full-time basis. Alternative titles generally include the words "audit", "internal audit", "inspection" or "risk"; e.g., Vice President Audit and Risk; Vice President, Inspection; Director of Internal Audit; Manager Internal Audit Services, etc.

Internal Audit Role and Mandate

The audit committee is responsible for ensuring that management has implemented an effective system of internal control to manage the risks facing the organization. In larger and more complex organizations an internal audit function can provide cost-effective and independent assurance that internal control is effective, provided that it has an appropriate role and mandate.

These questions, together with related discussions with the CEO and professional advisors, will put the audit committee in a position to understand what internal audit functions they need and what they have in place.

1. Should we have an internal audit function?

Many medium and large organizations have an internal audit function. This is a requirement for companies listed on some stock exchanges and for banks and other financial institutions with major fiduciary responsibilities. Other companies have an internal audit function because it is considered to be a valuable element of management control which provides assurance to the audit committee and management and adds to the organization's credibility with investors and creditors.

Management is responsible for establishing and maintaining a system of internal financial controls and in some cases, may be required by regulators to provide written certification of the adequacy of the controls. Legal and regulatory requirements are changing fast and companies must make sure they are aware of the latest rules.

In smaller organizations, managers are usually close enough to daily operations that they can effectively supervise and monitor the activities of their staff. When the volume and/or complexity of transactions become too great, management may need to add people whose primary role is to check the work of others and thereby strengthen internal control. Financial institutions and other organizations that deal in cash and other liquid assets usually need some form of inspection or audit function.

Organizations that do not have an internal audit function should give strong consideration to establishing one if their size and type of business, source of capital and risk factors warrant it. The potential benefits of the internal audit function should be assessed and compared against the estimated costs.

The decision to establish an internal audit function should involve the CEO, CFO and audit committee. The following is a list of criteria they may consider:

- The audit committee wants to get independent and objective assurance on the adequacy of internal controls from someone other than the CEO or CFO.
- The CEO wants to get independent and objective assurance on the adequacy of internal controls from someone other than the CFO or line managers.
- The CFO wants to get independent and objective assurance on the adequacy of internal controls from someone other than the line managers.
- The organization gets too large or geographically dispersed for frequent and economical first-hand monitoring of controls by the audit committee, CEO or CFO.

The roles of internal audit and the external auditors differ substantially and provide very different assurance to the audit committee and management, namely:

- Internal auditors review and test controls at a significantly lower level of materiality than do external auditors and often review a much broader range of risks than those for external financial reporting.
- External audits are designed to report on historical data, whereas internal audits are generally focused on the efficiency and effectiveness of current and future operations.

Recommended practices:

In organizations that have no internal audit function the audit committee periodically requests from management a review of the need for an internal audit function and, on the basis of this review, determines whether such a function should be instituted.

The audit committee may consider contracting outside assistance to review the need for an internal audit function if the committee is concerned that management may not have the objectivity or qualifications to conduct the review.

2. What should our internal audit function do?

This is a more difficult question than it seems. Unlike external auditors, internal auditors do not always have a clearly defined role that is established by law or regulation. Each organization must identify its own audit needs and use them to define the role of its internal audit function. The Institute of Internal Auditors (IIA) has developed a definition of internal auditing (see page 7) that organizations may find useful in establishing the role of their internal audit function. In addition, there are numerous books on internal auditing.

Internal auditing is a valuable resource for management and the audit committee because of its objectivity, auditing skills and in-depth knowledge of the organization.

Internal audit functions, in many cases, are set up by corporate management to assess the internal control system that management is responsible for establishing. Internal audit does not perform the controls since this is a line management responsibility, but their role does provide another level of assurance to management and the audit committee that controls are effective. Historically, the emphasis was on compliance with company policy and the deterrence, prevention and detection of fraud and errors. These are still important roles for internal audit functions.

Over time, many internal audit functions have addressed broader aspects of control and provide services in areas other than the assessment of internal financial controls. These may include:

- Reviewing controls over major projects and new computer systems to help anticipate problems. This can allow corrective action to be timely and controls to be "built in" rather than retro-fitted after being detected by a subsequent audit or system failure.
- Conducting audits of the efficiency and effectiveness of operations.
- Assessing the risks related to reputation, customer service, the environment, privacy, etc.
- Providing consulting and advisory services on enterprise risk management, control and related matters.
- Participating in the investigation of fraud.

Occasionally, management may ask internal audit to assist with special projects. These may be appropriate and acceptable if done for staff development or some critical reason, but should be discouraged if the auditors are merely used as a "free" resource or if such projects distract from the internal audit function.

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 internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. This should include:

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

Institute of Internal Auditors—International Standards for the Professional Practice of Internal Auditing

Recommended practices:

The chief audit executive, in consultation with senior management and the audit committee, establishes the scope of activities of the internal audit function. The process takes into account the cost justification of each element of audit activity.

The role of internal audit is formally defined in a written internal audit charter (See Question 3) and the audit activities are set out in the annual audit plan (Question 9).

The audit committee approves the internal audit charter periodically and the audit plan annually.

3. What should be the mandate of the internal audit function?

Internal auditors need a mandate that provides the authority they need within a structure that supports their independence and objectivity. This can best be achieved though a written charter for the internal audit function that is aligned with the mandate and needs of the audit committee. The mandate should be compatible with the best current practices and approved by the board or audit committee. Any restrictions by management should be disclosed to, and approved by, the audit committee.

Internal audit should not have any operational accountability or perform functions that would be subject to subsequent internal audit review.

Recommended practices:

The mandate of the internal audit function is set out in a written charter that is compatible with the charter of the audit committee and consistent with the Standards of the Institute of Internal Auditors.

The internal audit charter is reviewed and updated regularly and includes:

- Role and responsibilities of the internal audit function;
- Functional reporting relationship to the audit committee;
- Administrative reporting relationship;
- Access to corporate employees, facilities and records (including those of contractors);
- Any restrictions of the scope or authority of internal audit;
- Requirement that managers cooperate with internal audit and respond to reports;
- Code of ethics;
- Internal audit standards;
- Relationship with external auditors;
- Distribution of audit reports and summaries;
- Follow up of recommendations;
- Specific mention of areas such as fraud, technology, safety, environment, etc. as may be required for clarification;
- The right of the chief audit executive to attend audit committee meetings.

Internal Audit Relationships

The chief audit executive's relationships with the audit committee and senior management are critical to the success of the internal audit function. The audit committee can use the following questions to confirm that the relationships give internal audit the support and access it needs and that the committee receives the range of services and support it needs to meet its own mandate.

4. What is the relationship between internal audit and the audit committee?

The internal audit function is a major source of information and assurance to the audit committee on internal financial controls and other risk management activities. For this reason, most internal audit functions have a functional reporting relationship to the audit committee which is defined in the charters of internal audit (Question 3) and the audit committee. A key element of this relationship is a direct channel of communication between the chief audit executive and the audit committee. This typically includes provisions for the chief audit executive to have access to the chair of the audit committee and attend audit committee meetings to present the audit plan for approval and to report audit findings.

The CFO and chief audit executive are usually present at all audit committee meetings. Much of the work performed by the audit committee relates to the roles of these individuals and one or the other may take a role in supporting the committee's planning activities. There is generally no requirement for the CEO to be present at audit committee meetings but in many cases he or she may attend for information purposes.

Chief audit executives do not generally attend board meetings. At least annually the chair of the audit committee should include a reference to internal audit's effectiveness, capabilities, the results of its work and any concerns when reporting to the board.

Relationship with and expectation of the internal audit function
There are many operational aspects of the audit committee's relationship with the internal audit function that are important for the effective oversight of the internal control framework and culture. Where a corporation has an internal audit function, the audit committee should approve its mandate, be satisfied that it has adequate resources to perform its responsibilities, and ensure that the director of internal audit has direct and open communication with the committee. Where internal audit does not exist, the audit committee has an important oversight role that goes beyond the normal operational issues.

Beyond Compliance: Building a Governance Culture, Final Report, Joint Committee on Corporate Governance, November 2001

Recommended practices:

The audit committee charter includes provisions for:

- The audit committee to review and endorse the appointment or replacement of the chief audit executive;
- The internal audit charter to be compatible with that of the audit committee;
- The internal audit charter to be approved by the audit committee periodically (e.g., at least every three years);
- Internal audit to provide the audit committee members and senior management with independent, objective views on risk and internal controls within the organization;
- The chief audit executive to attend audit committee meetings.
- The audit committee to approve the internal audit plan annually;
- The chair of the audit committee to meet privately with the chief audit executive prior to audit committee meetings to:
  - — build the necessary trust between the two individuals,
  - — allow the chief audit executive to provide context informally about the function and its relationships with management that may not be possible in a formal report, and
  - — allow the audit committee chair to gain insights into issues that merit discussion at audit committee meetings but which may not otherwise get a high priority;
- The chief audit executive to report the results of major activities and key findings and issues to the audit committee;
- The chief audit executive to be expected to raise matters that have a material effect on controls, integrity of management and quality of financial reporting;
- The chief audit executive to meet with the audit committee periodically without management present;
- The chief audit executive to have unrestricted access to the chair of the audit committee at any time.

The external auditors are present when internal audit reports formally to the audit committee — except for in-camera sessions.

5. To whom does internal audit report administratively?

The chief audit executive reports functionally to the audit committee on the planning, execution and results of audit activities. However, like any other corporate employee, the chief audit executive must report to someone administratively for purposes of pay, performance, space, equipment and related matters. This person should be sufficiently highly placed to reinforce the organizational status of internal audit and to support its unrestricted access to corporate resources, but must not impair the independence of the internal audit function. In practice, the individual to whom the chief audit executive reports administratively should be selected on the basis of his or her ability to respect and give effective support to the independence of internal audit, rather than for the position he or she holds.

The role of internal audit is both internal and independent. Constructively evaluating the work of fellow members of the management team and providing advice to them can create tension — although this can be healthy when handled professionally by all parties. Relationships with management should be balanced — not too friendly but not hostile. Helping achieve this balance is part of the role of the audit committee and the CEO.

A major issue for the audit committee is the career risk to the chief audit executive of challenging or fully reporting serious and embarrassing deficiencies in the areas of accountability of the person who sets his or her salary, bonus and other benefits.

"The internal auditor occupies a unique position— he or she is "employed" by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management's actions, but the auditor's "dependence" on management for employment is clear. Recognizing this tension, the committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit committee and the internal auditor should lose its "taboo" nature and no longer imply treason against management.

The audit committee must establish and support a culture that promotes open disclosure on the part of the internal auditor and a recognition that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee. Management should more than acquiesce in this duty to disclose; management should encourage and support such disclosure by word and deed."

New York Stock Exchange—Report and Reccommendations of the Blue Ribbon Commitee on Improving the Effectiveness of Corporate Audit Committees—Guiding Principles for Audit Committee Best Practices, 1999

Reporting options, each of which has advantages and disadvantages, include:

Reporting to	Advantages	Disadvantages
CEO	Establishes audit status.	CEO may have too many direct reports.
CFO	Reinforces financial control. CFO often understands the role of internal audit and can provide advice.	Potential conflict of interest: • if audit findings reflect badly on CFO • if resources are diverted to lower priorities.
Other senior executive	Good for audit independence if the executive has no or few direct operational responsibilities subject to significant internal audit scrutiny.	Executive may lack knowledge of operations and internal controls, may not have a motivation for internal audit to be effective, or may lack the ability to influence.
Chair of audit committee	Good for audit independence.	Internal audit is no longer seen as supporting and partnering with management. Chief audit executive may lose status and acceptance as a member of the management team.

Recommended practices:

The internal audit function reports administratively to the CEO or other senior executive and has a functional reporting relationship to the audit committee to ensure objectivity in the planning and execution of internal audit work.

The CEO and senior management team includes the chief audit executive in senior meetings such as strategic planning sessions and operational committees where appropriate. This shows support by helping the chief audit executive understand what is going on at a senior level and exposes him or her to other executives in a more collegial environment.

The audit committee reviews this administrative relationship annually or whenever there is a significant reorganization within the senior management team. In some parts of the discussion, the views of the chief audit executive should be invited.

The individual to whom the chief audit executive reports, the chair of the audit committee and the CEO jointly approve the performance review, salary, bonus and other benefits of the chief audit executive.

Internal Audit Resources

Internal audit functions need an adequate complement of staff with the appropriate experience and qualifications for the risks and businesses they audit. Staff require continued training in their disciplines and must stay abreast of technological advances and changes in the organization's business. The internal audit function should also make full advantage of the work and resources of the external auditors by coordinating activities.

These questions are designed to be directed at the chief audit executive at an audit committee meeting as part of the process of understanding and assessing the quality of the internal audit function.

6. How is the internal audit function staffed?

Internal auditing activities can be conducted by:

- In-house resources—The organization may assign responsibility for audit activities to a corporate internal audit department or include some audit activities in the responsibilities of line functions (for risks such as safety, environment, etc.). The internal audit department may include staff from other departments as part of audit teams.
- A fully outsourced internal audit function reporting to a designated executive—The organization engages an external firm to perform the entire internal audit function. Some companies may be prohibited by statute or regulation from outsourcing internal audit work to their external auditors. Professional accounting standards may also restrict this activity.
- A combination of the above—The organization may outsource specific activities or projects to specialist firms or include one or more outside experts with internal audit staff on a project team.

To meet the needs of boards, management and regulatory requirements, a designated executive (who may be the chief audit executive) should be responsible for ensuring that all important internal audit activities are coordinated.

Recommended practices:

The staffing of the internal audit function is based on the number of skilled individuals required to cover the activities identified in the approved audit plan.

The chief audit executive, in consultation with senior management and the audit committee determines the most cost-effective mix of in-house and outsourced internal audit staffing.

The size of the internal audit function is benchmarked against similar organizations.

The audit committee reviews and assesses the appropriateness and expertise of the resources as part of the annual audit plan.

Where material, the audit committee reviews and approves the appointment of outsourced audit firms and subsequently monitors the effectiveness of this arrangement.

7. How does internal audit get and maintain the expertise it needs to conduct its assignments?

Internal auditing calls for a diverse set of knowledge, skills and experience. It is critical that the internal audit staff have the skills, industry knowledge and experience (supplemented where necessary by external resources) to provide the control assurance and related advice that the audit committee requires.

Chief audit executives should not plan or accept assignments unless they are able to staff them competently, as this can provide false assurance or weaken the function's reputation. Consideration should be given to using the expertise of other corporate staff, engaging outside experts or outsourcing where the necessary skills do not reside within internal audit.

Qualifications for internal auditors include:

- Professional accounting designations (CA, CGA, CMA, and CPA).
- Internal audit qualifications (Certified Internal Auditor (CIA) and Certified Information Systems Auditor (CISA)).
- Specialist qualifications, e.g., CA•CIA.
- Qualifications in specialized areas of audit such as Certified Environmental Auditors (CEA).
- Other disciplines: engineers, economists, environmentalists, etc.

Recommended practices:

The qualifications of internal auditors are established and included in job descriptions and postings.

Internal audit recruits only people with appropriate qualifications and/or experience in auditing, accounting, information technology, organizational analysis, industry knowledge, etc.

Internal audit promotes professional development and formal certification of audit staff.

Internal audit uses internal and outside experts when its staff lacks specialized expertise.

The internal audit budget includes adequate funds for professional development and the planned use of external experts.

Internal audit periodically reports to the audit committee on its staff capabilities, including academic and professional qualifications and years of audit, industry and organizational experience.

8. Are the activities of internal audit appropriately coordinated with those of the external auditors?

External auditors rely on the work of internal auditors to the extent that it confirms the quality of an organization's system of internal control. Before accepting the work of internal audit the external auditors review the scope, audit approach, standards and results of the internal audit function in accordance with their own professional standards.

The internal and external auditors should work cooperatively to achieve the best possible value in audit coverage. Any such cooperation must respect the legal obligations of the external auditors. These obligations are evolving rapidly and require close monitoring.

The committee should ask both internal and external auditors if they are satisfied with the extent of coordination and compare the answers.

Recommended practices:

As far as possible, the presentations of audit plans are developed and coordinated to help the audit committee members understand their combined scope.

The audit committee reviews the plans of the external and internal auditors and questions any situations where areas are apparently not covered or duplicated.

Internal audit staff are used on the external audit assignment only where it is beneficial to the organization and does not take them away from more valuable work. It should not merely be a way to reduce the external audit fees.

The committee determines whether the relationship of internal auditors and external auditors exhibits a mutual professional respect and appreciation for the other's role and contribution, and also recognizes that the audit committee's needs are paramount to each group.

Internal Audit Process

An effective internal audit function is run in a professional manner. Chief audit executives should demonstrate to their audit committees how they set priorities, plan, supervise and review the various internal audit projects and activities.

These questions are designed to be directed at the chief audit executive at an audit committee meeting. They deal with matters of organization and process and may be discussed in the presence of senior management.

9. How is the internal audit plan developed?

An annual internal audit plan is the key to matching the work of internal audit to the needs of and expectations of the audit committee, external auditors and senior management. It allows the audit committee to confirm that board priorities are addressed and provides a basis for evaluating internal audit performance.

Recommended practices:

The chief audit executive prepares an annual audit plan based on a comprehensive review and analysis of the organization's business activities and associated risks. Where an enterprise risk management process is already in place, this will provide a critical basis for developing an audit plan aligned with corporate priorities.

The chief audit executive seeks management input and agreement on the scope and priority of the proposed audit projects.

The audit plan includes all projected internal audits and other activities, including reviews of the development of major new computer systems and critical business projects, and the provision of consulting and advisory services, where appropriate.

The audit plan includes the budget and staff resources required to accomplish the plan.

The audit plan allows flexibility to respond to unforeseen issues and events during the year.

The external auditors are consulted and their input and audit scope considered in developing the plan. They also receive a copy of the final audit plan.

The audit committee reviews the audit plan and assesses its adequacy based on their knowledge of the industry and the organization. Before they approve the final audit plan they satisfy themselves that it covers the areas of risks for which they require independent assurance from internal audit.

The chief audit executive informs the audit committee of any significant changes to the audit plan during the year.

10. What does the internal audit plan not cover?

Omissions from the audit plan may expose the organization's CEO and board to unnecessary risk. Ideally, the committee, senior management and the chief audit executive should agree on those areas of risk that will not be audited and the reasons. Audit committee members should be alert to the possibility of under-funding of the internal audit function.

Recommended practices:

The internal audit plan includes a list of those areas of risk that ranked just below those selected for inclusion in the audit plan. This enables the audit committee to assess what risks management and the committee will accept by excluding them from the plan.

11. How are internal audit findings reported?

Boards, audit committees and senior management rely on internal audit reports to confirm the quality of the system of control. Where the volume of audit reporting is high, the chief audit executive may prepare summaries at an appropriate level of detail.

Recommended practices:

Audit reports, as historical records of audit work and findings, are in writing and include the scope and objectives of the audit, the findings and recommendations for improving control.

Reports are action-oriented and include comments and proposals for corrective action from the management of the audited business unit.

Reports are balanced — reporting the good risk and control practices as well as the weaknesses observed.

Reports identify the best practices observed throughout the organization.

Reports rate recommendations as high, medium and low in order to assist management in assigning priorities for action to the issues raised.

The chief audit executive provides summaries of audit reports to senior management and the audit committee. The level of detail depends on the size of the organization but is sufficient to allow the audit committee to understand the types and frequency of control issues that internal audit raises and how management is responding to them.

Periodically, the audit committee asks to see a detailed internal audit report to understand the methodology and quality of reporting.

12. How are corporate managers required to respond to internal audit findings and recommendations?

Internal audit reports are only of value when managers address the problems and deficiencies identified by the audits or make informed decisions to accept the risks. Audit committees and senior management play an important role by monitoring and enforcing commitments to take corrective action.

The CEO and senior management team establish the "Tone at the Top" that is critical to the success, value and credibility of the internal audit function. This means providing support in accordance with the internal audit charter, by:

- maintaining the independence of internal audit;
- ensuring line management's cooperation in the performance of audits;
- requiring prompt responses and action from management on audit reports;
- recognizing and promoting internal audit as a value added activity;
- refraining from using internal audit resources for non-audit purposes that cut into audit time or create a conflict of interest; and
- keeping internal audit informed of key plans and changes to the risk and control profile of the organization's policies and procedures.

Line managers do not always view the role of internal audit positively and it can require great skill and diplomacy to obtain their cooperation on audits. Open support and monitoring of internal audit activities by the CEO and the audit committee can help ensure that all managers cooperate with the internal auditors.

Recommended practices:

Line management is required to review all audit findings and provide action plans and dates for implementation before or soon after the audit report is issued. Where management recommends that no action be taken, the decision to accept the related risk is approved at the appropriate level.

Management accepts responsibility for monitoring corrective action on weaknesses reported by internal audit.

The chief audit executive establishes and maintains a formal follow-up process for monitoring and ensuring that management actions have been effectively implemented.

Senior management, the CFO and the CEO periodically review high-risk outstanding audit recommendations as part of a management process.

The CEO (or whoever performs this role with the chief audit executive) meets periodically with the chief audit executive to review audit reports and outstanding recommendations, and to obtain input on risk and controls.

The audit committee receives periodic reports on high-risk audit recommendations that have not been resolved.

13. What services does internal audit provide in connection with fraud?

The prevention, deterrence and detection of fraud are the responsibility of management. The usual role of internal auditors is to develop audit programs and procedures to evaluate the internal controls that management has established to manage the risk of fraud. In practice, auditing sometimes deters employees from committing fraud and occasionally detects a fraud, but these are not usually the major objectives of auditors.

The term "fraud" covers a number of activities; principally:

- Property fraud — the theft or misuse of assets and, sometimes, the related information;
- Financial reporting fraud — the manipulation of information to mislead or deceive stakeholders.

Internal audit may participate in the investigation of fraud and provide forensic accounting services — provided that it is cost-effective to do so. The skills to investigate frauds may be within the internal audit function, or in a separate security department.

Recommended practices:

Internal audit includes fraud as a risk to be evaluated and included in the audit plan.

The organization has a system for investigating activities that appear to be fraudulent. The process involves individuals with legal and human resources expertise to ensure that individual rights to privacy are respected and that the investigation will support prosecution by the police and law courts.

14. How do you assess the effectiveness of your internal audit function?

Good internal audit functions have processes for assessing their own effectiveness. They use the results, together with feedback from the external auditors and other stakeholders, to monitor trends over time and achieve continuous improvement in their practices and performance.

Recommended practices:

The chief audit executive develops performance measures for the internal audit function and agrees them with the audit committee. Examples of measurement techniques include: customer satisfaction surveys, post audit debriefing and internal quality assurance reviews.

Internal audit evaluates its own performance against the agreed measures.

There is an external quality assurance review of internal audit at least once every five years. The quality assurance review is performed by qualified individuals in accordance with Institute of Internal Auditors standards.

Internal audit uses benchmarking to compare its operations and effectiveness with those of other organizations.

Evaluation results are reported to the audit committee.

Closing Questions

The questions in this section are designed to help the audit committee reach a conclusion on the effectiveness of internal audit. In most cases the audit committee may use them to sum up discussions of audit relationships, resources and process with the chief audit executive in the presence of the CEO and external auditors. The timing and venue for asking the questions are appropriate topics for the chair of the audit committee to discuss with the chief audit executive. Where there may be problems the audit committee may consider asking them in an in-camera meeting with the chief audit executive.

15. Does internal audit have sufficient resources?

This is a sensitive but important question. The answer from the chief audit executive and resulting discussion can provide the audit committee with valuable insight not only into the reliability of the audit work but also into potential problems with management. Chief audit executives who answer "no" must be prepared to provide the audit committee with a comprehensive analysis of the situation including the steps they have taken to resolve the problems with management.

Assessing the sufficiency of resources should generally include comparisons with similar organizations and the business risks and the degree of change within the organization. Internal audit resources may be insufficient because:

- Management does not respect the role and contribution of internal audit;
- Management includes internal audit in a general under-funding to meet short-term forecasts;
- Management diverts internal audit resources to manage short-term goals, operational crises and special projects.

Internal audit functions not only need an adequate budget, they must be able to attract and retain skilled people. The issue of attracting qualified staff can sometimes be a more challenging problem than budgetary constraints. The audit committee should be aware of reasons for excessive turnover that could indicate poor management or a lack of respect for the function in the organization. Depending on the function's staffing strategy, there may also be insufficient turnover when internal audit staff are not progressing in their careers and become stale or too close to management.

The audit committee should also ask the CEO about audit resources to get his or her perspective and recommendations. The committee should seek to understand management's explanations for any resource shortage and the risks the organization and committee accept as a result.

16. Does the internal audit function get appropriate support from the CEO and senior management team?

A critical part of the audit committee's role is to assess the relationship of the chief audit executive and the management team, whose support can greatly influence the effectiveness of the internal audit function and its value to the audit committee. There should be a good working relationship but also a mutual respect for the role of internal audit that includes:

- Support of audit findings — by addressing and requiring timely responses on audit reports including those that are justifiably critical of management controls;
- Inclusion of the chief audit executive, where appropriate, in the communications and forums of the senior management team to keep the chief audit executive informed of strategic and business plans.

This is another very sensitive question because chief audit executives who answer "no" may risk being seen as disloyal to their CEO and colleagues. Under normal circumstances the audit committee would expect to hear that the chief audit executive has no concerns or is in the process of resolving them.

If the audit committee has any concerns about the chief audit executive's response, the committee should respect the sensitivities involved, consider all the evidence and assess whether further action is required.

The audit committee should also ask the CEO about the level of support for internal audit within the organization to get his or her perspective and recommendations.

17. Are you satisfied that this organization has adequate internal controls over its major risks?

The audit committee is responsible for ensuring that management has designed and implemented an effective system of internal control. In preparing to report its conclusions to the board, the committee should seek information and opinions from a range of sources including the CEO, chief risk officer and chief legal officer as well as the external auditors and chief audit executive.

This question requires the chief audit executive to take a broad view of control and audit activities. The chair of the audit committee should discuss the committee's expectations with the chief audit executive in advance. The scope of the chief audit executive's response may involve integrating and summarizing the results of audit work and related activities such as risk and control self-assessments, internal control surveys, consulting projects and involvement in major projects and new systems.

18. Are there any other matters that you wish to bring to the audit committee's attention?

If there are any issues that affect controls, the integrity of management or the quality of financial reporting that are not addressed in the internal audit reports, the audit committee expects the chief audit executive to raise them with its chair or committee in accordance with the internal audit charter. The chief audit executive should be prepared to explain why these matters were not formally addressed in audit reports.

It is critical that the audit committee reach out and build a level of trust with the chief audit executive to permit honest and appropriate communication of sensitive issues and opinions related to risk and control. Generally, the chief audit executive would be wise not to raise issues that have not been already discussed with the CEO unless there are exceptional circumstances. Concerns raised at in-camera sessions should never be disclosed outside the in-camera session by the audit committee unless agreed to by the chief audit executive, or otherwise formally reported in internal audit reports. Chief audit executives must have trust and confidence that disclosures will follow agreed protocols and not damage their relationship with management.

19. Are there other ways in which internal audit and the audit committee could support each other?

This question provides an opportunity for the chief audit executive and audit committee to discuss such matters as improving audit reporting to the committee and using internal audit to provide training on risk and control aspects of the business either for new members to the audit committee or the committee as a whole.

The corporate governance committee may ask the chief audit executive a similar question as part of its periodic evaluation of the audit committee.

Audit committee Assessment

The audit committee is responsible for confirming that internal audit has the competence, independence, resources and corporate support to do its job properly, and is demonstratively effective in getting results. An effective internal audit function will usually have a senior reporting relationship. Its reports and opinions have high credibility and management frequently seeks its advice and consultation on risk and control issues within the organization.

The audit committee should consider asking the external auditors for feedback on the competence and support for the internal audit function within the organization. This may be most appropriate in an in-camera session.

20. Are we (the audit committee) satisfied with our internal audit function?

The following are some additional questions that audit committee members could ask themselves or use in a discussion following their meetings with the CEO, chief audit executive and external auditors:

- How well does the chief audit executive respond to probing by the audit committee?
- How well respected is the chief audit executive by senior management and how healthy is the tension between them?
- How well respected is the chief audit executive by the external auditors and how healthy is the tension between them?
- How often do we get surprises where something that the internal audit has audited subsequently reveals control problems that were not identified by their reports?
- Does the chief audit executive provide adequate assurance in areas requested by the audit committee?
- Does internal audit bring forward significant issues to the audit committee that might not otherwise be disclosed to the committee Ideally, these should have been raised first by management and thei identification attributed to the internal audit function.
- Is the chief audit executive respected within the auditing profession? (Examples would be as a frequent speaker, writing articles, industry organizations, etc.).

Where to find more information

Canadian Institute of Chartered Accountants publications

The 20 Questions Series[1]

20 Questions Directors should ask about Building a Board
20 Questions Directors should ask about Codes of Conduct
20 Questions Directors should ask about Crown Corporation Governance
20 Questions Directors should ask about Director Compensation
20 Questions Directors should ask about Executive Compensation
20 Questions Directors should ask about Governance Assessments
20 Questions Directors should ask about IT
20 Questions Directors should ask about Internal Audit
20 Questions Directors should ask about Management's Discussion and Analysis
20 Questions Directors should ask about Privacy
20 Questions Directors should ask about Risk
20 Questions Directors should ask about Strategy
20 Questions Directors should ask about their Role in Pension Governance
20 Questions Directors should ask about Not for Profit Governance

The CFO Series

Financial Aspects of Governance: What Boards Should Expect from CFOs
How CFOs are Adapting to Today's Realities
Risk: What Boards Should Expect from CFOs
Strategic Planning: What Boards Should Expect from CFOs

The Control Environment Series[2]

Internal Control: The Next Wave of Certification — Helping Smaller Companies with Certification and Disclosure about Design of Internal Control over Financial Reporting
Internal Control 2006: The Next Wave of Certification — Guidance for Directors
Internal Control 2006: The Next Wave of Certification — Guidance for Managers
Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

Related CICA publications

CICA Handbook — Assurance Recommendations
CICA Handbook — Agreed-upon Procedures Regarding Internal Control over Financial Reporting
CPR Alert, Issue 1, January 2004; Issue 2, January 2006; Issue 3, April, 2006[3]
Crisis Management for Directors, 2001
Guidance for Directors: Governance Processes for Control, 1995
Guidance for Directors: Dealing with Risk in the Boardroom, 2000
Integrity in the Spotlight: Audit Committees in a High Risk World, 2005
Learning about Risk: Choices, Connections and Competencies, 1998
Management's Discussion and Analysis — Guidance on Preparation and Disclosure, Revised 2004
Managing Risk in the New Economy, 2000
Risk Alert January 2007, Auditor Involvement with Management's Internal Control Certifications (AASB)
www.cica.ca

Securities Laws and Regulations — Canada

www.osc.gov.on.ca/Regulation/Rulemaking/rrn_index.jsp

Securities Laws and Regulations — United States

http://www.sarbanes-oxley.com/section.php?level=1&pub_id=Sarbanes-Oxley
United States Securities and Exchange Commission (SEC) www.sec.gov

[1] To order copies of the 20 Questions series or CFO series contact 416-977-0748 (Toronto) or 1-800-268-3793 (rest of Canada) or visit www.knotia.ca/store
[2] Available for free download from www.rmgb.ca/index.cfm/ci_id/3083/la_id/1.htm

Other

International Federation of Accountants

Internal Controls—A Review of Current Developments, Information Paper, August 2006
www.ifac.org

Institute of Chartered Accountants in England and Wales

Financial Reporting Council: Internal Control—Revised Guidance For Directors On The Combined Code (The Turnbull Report), October 2005
www.icaew.co.uk

Institute of Internal Auditors

Audit Committee Effectiveness—What Works Best, 3rd Edition -2005
Sarbanes-Oxley and the New Internal Auditing Rules, Robert R. Moeller, 2004
The Audit Committee Handbook, Fourth Edition, Louis Braiotta, Jr., 2004
Essential Project Investment Governance and Reporting: Preventing Project Fraud and Ensuring Sarbanes-Oxley Compliance, Steven C. Rollins, PMP and Richard B. Lanza, CPA, CFE, 2005
The Standards for the Professional Practice of Internal Auditing, 2007
www.theiia.org

Joint Committee on Corporate Governance

Final Report Beyond Compliance: Building a Governance Culture. Toronto, November 2001
www.cica.ca/index.cfm/ci_id/1878/la_id/1

New York Stock Exchange

Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees —Guiding Principles for Audit Committee Best Practices, 1999
www.nyse.com

Public Company Accounting Oversight Board (PCAOB)

Rulemaking Docket #21. Auditing Standard—An Audit of Internal Control Over Financial Reporting that is Integrated With and Audit of Financial Statements
www.pcaobus.org

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)

Internal Control—Integrated Framework, 1992
www.coso.org

[3] Available for free download from www.cica.ca/index.cfm/ci_id/247/la_id/1.htm

Notes

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John has served on several non-for-profit boards and is currently a member of Rosseau Lake College's Board of Directors. John is a member of the CICA Risk Management and Governance Board and was an advisor for the recently published *20 Questions Directors Should Ask about Risk*. He co-authored the Investment Dealers Association's book *Internal Controls*, was a project author of the CICA book *Information Technology Control Guidelines — 3rd edition*, and co-author of the Conference Board of Canada's ERM Case Study *Enterprise Risk Management at Hydro One Inc*.

Hugh Lindsay is a founder and president of FMG Financial Mentors Group Inc. He specializes in writing, training and consulting in corporate governance, risk management and strategic planning. In addition to being a Chartered Accountant, he is a Chartered Insurance Professional, a member of Financial Executives International and a past president of the Vancouver Chapter of the Institute of Internal Auditors. Prior to entering full-time consulting in 1992, he held senior financial and internal audit positions with a university and a major insurance company.

Hugh has served on the boards of a number of organizations including the Insurance Institute of British Columbia and the Institute of Chartered Accountants of BC, and is currently a commissioner on the board of the Vancouver Museum. He was a member of the Criteria of Control Board of the Canadian Institute of Chartered Accountants and now writes for their Risk Management and Governance Board. His publications for CICA include *Managing Risk in the New Economy*, *Crisis Management for Directors*, *20 Questions Directors Should Ask about Risk, Strategic Planning: What Boards Should Expect from CFOs* and *Financial Aspects of Governance: What Boards Should Expect from CFOs*.

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20 Questions

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The Canadian Institute
of Chartered Accountants

The Audit Committee:
Purpose • Process • Professionalism

Clarifying what it takes to be responsible, knowledgeable, and effective

The Institute of Internal Auditors

A New World of Corporate Governance

Today's governance arena requires boards of directors and their committees to be proactive, informed, investigative, and accountable. This, indeed, is good news for stakeholders. After all, isn't it about time that somebody asks the tough questions, looks beneath the surface, and models accountability?

If there is a bad-news side to this new-world story, it's that the stakes are greater than ever. Gone is the day of the "figure-head" board member whose resumé proudly lists — in double digits — the prestigious boards on which he or she sits. And "sitting" hardly describes what takes place in today's boardroom . . .

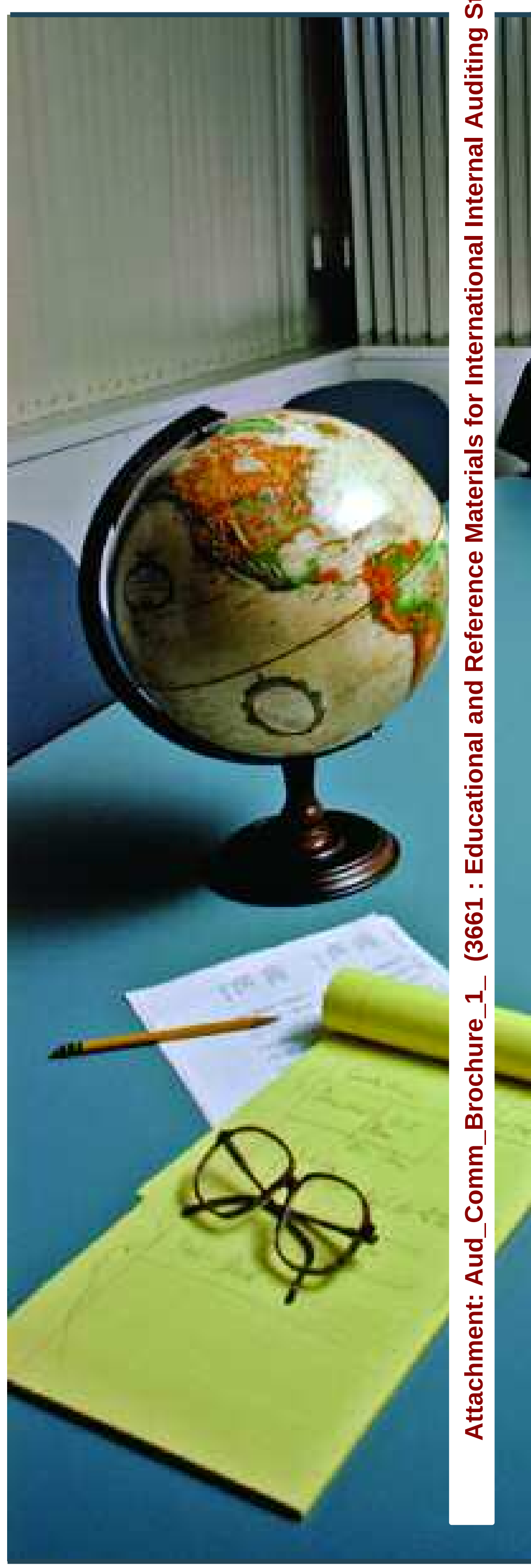
The public, still reeling from corporate shenanigans brought to light over the past few years, is more demanding and less trusting than ever, and rightfully so. Directors face greater challenges and more liabilities and must err on the side of caution in regard to risk management, ethics, policies, procedures, and organizational leadership. To say the least, their plate is full.

Clarifying Governance

Governance is the system by which organizations are directed and controlled. It includes the rules and procedures for making decisions on corporate affairs to ensure success while maintaining the right balance with the stakeholders' interest.

Responsibility for corporate governance is spread among several organizational entities. The cornerstones of effective governance are the board of directors, executive management, the internal auditors, and the external auditors. No single committee of the board is more focused on or better in tune with governance than the audit committee.

What is the audit committee's role in governance? In a nutshell, the audit committee should provide oversight of financial reporting, risk management, internal control, compliance, ethics, management, internal auditors, and the external auditors.



Clarifying Liability

Directors need to be realistic about their own personal liability under state and federal law, neither exaggerating nor ignoring their exposure.

Fiduciary duties — the duties of care and loyalty, and the expectation that directors will act in good faith — are still the primary source of director liability under state law. Although directors are not subject to significantly greater risk of being found liable for a breach of fiduciary duty, rising stockholder-plaintiff activism has increased the risk that directors may need to defend themselves in litigation alleging such a breach.

Board members who wish to become empowered guardians and builders of corporate value must learn and follow best practices, such as avoiding conflicts of interest and paying strict attention to board matters, drawing on appropriate expertise, including their own.

Source: DIRECTOR LIABILITY: MYTHS, REALITIES, AND PREVENTION
National Association of Corporate Directors

Some detailed audit committee responsibilities include:

- Ensuring that financial statements are understandable, transparent, and reliable.
- Ensuring the risk management process is comprehensive and ongoing, rather than partial and periodic.
- Helping achieve an organization-wide commitment to strong and effective internal controls, emanating from the tone at the top.
- Reviewing corporate policies relating to compliance with laws and regulations, ethics, conflicts of interest, and the investigation of misconduct and fraud.
- Reviewing current and pending corporate-governance-related litigation or regulatory proceedings to which the organization is a party.
- Continually communicating with senior management regarding status, progress, and new developments, as well as problematic areas.
- Ensuring the internal auditors' access to the audit committee, encouraging communication beyond scheduled committee meetings.
- Reviewing internal audit plans, reports, and significant findings.
- Establishing a direct reporting relationship with the external auditors.

The Tone at the Top

Management, the board, and the audit committee all play critical roles in an organization's tone at the top. Based on board expectations, executive management establishes the tone. It is the audit committee's responsibility, though, to monitor that tone as well as oversee the organization's ethical environment and compliance with laws and regulations.

Complimentary Subscription

Stay in the know about issues critical to audit committees, boards, and executive management. The Institute of Internal Auditors' corporate governance newsletter — *Tone at the Top* — is available both electronically and in hard copy, free of charge. Contact pr@theiia.org to ensure you receive this timely resource in the format of your choice. Please designate "Code ACB" when you make your request.

Leading audit committee practices in code-of-conduct oversight include:

- Ensuring that a code of conduct has been developed.
- Reviewing it, approving it, and each year, discussing whether revisions are needed.
- Ensuring that all employees receive the code of conduct, understand it, and obtain appropriate training regarding it.
- Ensuring that the board receives a copy of the code and related training.
- Ensuring that communications channels are working effectively.
- Receiving and reviewing a summary of reported violations and follow-up actions.
- Ensuring that management exhibits ethical behavior in its role of establishing the tone at the top.

Leading audit committee practices in overseeing compliance and ethics programs include:

- Ensuring compliance with laws and regulations.
- Staying informed about how management is monitoring program effectiveness and making changes as necessary.
- Meeting periodically with the program manager to discuss key risks, status, issues, and effectiveness.
- Staying informed on significant issues, investigations, and disciplinary actions.
- Recognizing trends and reviewing management's plans to address them.
- Ensuring management discloses in the financial reports the impact of significant issues.
- Ensuring the internal auditors include assessment of compliance and ethics risks in their audit plan.

Noses In. Fingers Out.

Balancing their role as advisor and counselor to management with their fiduciary duty to monitor and oversee management is, to say the least, challenging for most audit committees. They must communicate openly and often with management, carefully review information received, and challenge management as appropriate. They must not, though, play the management role. Some refer to this oversight responsibility as "Noses in; fingers out."

The lines of authority for audit committees and management should in no way be murky. There should be a clear understanding and consensus regarding where management ends and the audit committee begins. To ensure this clarity, strong communications are essential both during and outside of committee meetings. Management should view the audit committee as an asset and seek its input prior to, rather than after making key decisions.

Ongoing communication will help build a trusting relationship between the audit committee and management. However, it requires time and commitment of both parties. To clarify the level of communication that you as an audit committee member should expect, review the "Communications Checklist" below.

Communications Checklist

- ☐ Management is easily accessible.
- ☐ Management reaches out to you regularly.
- ☐ Management answers your questions fully and promptly.
- ☐ Management provides factual information to support responses.
- ☐ Management admits not knowing an answer.
- ☐ Management supports the audit committee by contacting additional resources and specialists.
- ☐ Management advises you of significant issues in a timely manner.
- ☐ Management seeks your input in advance of key decisions.

The audit committee also should ensure the financial leadership team is well-qualified and competent, succession planning issues are addressed, and the entire financial activity is strong.

The Audit Committee:
Purpose • Process • Professionalism

Key Issues of Concern

What keeps audit committee members awake at night? Among at least a dozen things they have (or should have) on their minds are five key issues: financial accuracy, risk management, control assessment, external auditor oversight, and the effective use of internal auditing.

Financial Accuracy

The primary concerns about financial accuracy include the completeness of financial disclosures, significant business and accounting policy changes, correct and truthful reporting, and interim reviews of financial statements. Audit committee members should know the right questions to ask to build their financial acumen. They should be aware of the thresholds of materiality, compare current accounting policies with other alternatives, review key estimates versus historical data, and discuss the areas most susceptible to fraud. They also should ask for the internal and external auditors' opinions, read and compare the narratives with other information, and use a checklist for meeting disclosure requirements.

Risk Management

An enterprise-wide risk management process, such as COSO's *Enterprise Risk Management – Integrated Framework* should be implemented, in which key risks to all areas of the organization (strategic, operational, reporting, and compliance) are identified. Enterprise risk management (ERM) is a structured and coordinated entity-wide governance approach to identify, quantify, respond to, and monitor the consequences of potential events. The organization should learn from the past by monitoring the risk realization history, as well as plan for the future by identifying emerging risks. NOTE: All risk is not bad. There must be discussions on the organization's "appetite" for risk, consensus on what is considered the acceptable level of risk, and a process for risk monitoring.

Control Assessment

For effective control assessment processes, the audit committee should have upfront involvement. It must have an understanding of management's process for assessing internal controls, applicable regulatory controls, and the greatest risks the organization faces. There should be in place a process for assessing and reporting on not only financial controls, but also controls throughout the enterprise. Also, a fraud prevention and detection program should be established. There should be clarification and agreement on terminology, definitions, and issues to be discussed. Inherent in the entire process should be transparency of disclosures, updates, discussions on control impacts, oversight monitoring, a review of the external auditors' assessment plan and discussion of their opinions, and

Clarifying COSO

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. COSO comprises the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA).

Web site: www.coso.org

review of the techniques in place for fraud identification.

NOTE: COSO's *Internal Control – Integrated Framework* is a helpful tool.

External Auditor Oversight

The audit committee should own the relationship with the external auditors, who provide an annual opinion on the financial statements. Ownership requires direct reporting, ongoing communication, frequent meetings, and robust discussions about audit scope and results. Oversight issues also include compensation, scope, selection criteria, independence, rotation, monitoring, and performance assessment. If management, rather than the audit committee, owns the relationship with the external auditors, the committee should take immediate steps to claim ownership.

Effective Use of Internal Auditing

Performed by professionals with an in-depth understanding of the business culture, systems, and processes, the internal audit activity provides assurance that internal controls in place are sufficient to mitigate the risks, that the governance processes are adequate, and that organizational goals and objectives are met.

The audit committee and the internal auditors are interdependent and should be mutually accessible, with the internal auditors providing objective opinions, information, support, and education to the audit committee; and the audit committee providing validation and oversight to the internal auditors.

The Certified Internal Auditor (CIA) demonstrates professionalism and competency, and the *International Standards for the Professional Practice of Internal Auditing (Standards)* outline the tenets of the internal audit profession. The internal audit activity should be conducted in accordance with the *Standards*, should have in place a Quality Assurance and Improvement Program, and should have and follow an internal audit charter. The work of the internal and external auditors should be coordinated for optimal effectiveness and efficiency.

CLARIFYING AUDITOR INDEPENDENCE

The external auditors are independent of the organization. By contrast, the internal auditors, who are integral to their organization, demonstrate organizational independence and objectivity in their work approach and are independent of the activity they audit. The internal auditors' reporting relationship to the audit committee is critical to independence of their activity.

Clarifying the Value of Internal Auditing

Having an in-depth understanding of internal audit objectivity, reporting structure, independence, staffing, prioritization, and how your internal audit activity adds value will help you stay on purpose.

Objectivity
To maintain objectivity, internal auditors should have no personal or professional involvement with or allegiance to the area being audited; and should maintain an un-biased and impartial mindset in regard to all engagements.

Reporting Structure
To ensure transparency and thwart collusion and conflicts of interests, best practice indicates that the internal audit activity should have a dual reporting relationship. The chief audit executive (CAE) should report to executive management for assistance in establishing direction, support, and administrative interface; and to the audit committee for strategic direction, reinforcement, and accountability.

Independence
The internal audit charter should establish independence of the internal audit activity by the dual reporting relationship. The internal auditors should have access to records and personnel as necessary, and be allowed to employ appropriate probing techniques without impediment.

Risk Management
Implemented by management, ERM is evaluated by the internal auditors for effectiveness and efficiency. Specifically, risk mitigation and residual risks should be reviewed, and the internal auditors should provide an opinion on the risk management process.

Staffing
A broad range of skills and expertise, and ongoing professional development are critical to the formation and maintenance of an effective internal audit activity. Essential elements include in-depth knowledge of the organization's industry, and internal audit *Standards* and best practices; technical understanding and expertise; knowledge on and skills for implementing and improving processes in both financial and operational areas; and strong communication and presentation skills.

Although some co-sourcing and outsourcing might be necessary when unique competencies and specialty skills are not affordable or available, the internal audit activity should be managed from within the organization.

Prioritization
Effective prioritization involves staying in sync with the organization's risk priorities and taking a risk-based approach to internal audit planning. By continuously monitoring organizational changes that might alter the plan, the CAE should be well equipped and positioned to make informed and educated recommendations to management and the board on the most effective use of internal audit resources.

Adding Value
Internal auditing serves management and the board, assesses the ethical climate and the effectiveness and efficiency of operations, and provides a safety net for organizational compliance with rules, regulations, and overall best business practices.

Asking the Right Questions

Because the audit committee is responsible to the board for oversight of management reporting on internal control, and because the internal auditors play a key role in assessing and reporting on risk management and internal controls, these two entities share a healthy interdependence. The critical connection between audit committee effectiveness and internal auditing mandates that committee members maintain an in-depth understanding of internal audit best practices and how their internal audit activity is functioning.

At the very least, every audit committee member should be able to correctly answer the 20 questions below. These questions will serve as a tool to trigger awareness of the areas for which committee members might need more information. For definitions, explanations on why each topic is important, and best-practice recommendations, please refer to www.theiia.org. Enter key words, Audit Committee, in the search engine and review "20 Questions." Based on the guidance included in the full document, you may determine the need for additional information on your specific organization. Many of the answers you seek will reside with the CAE. You may want to discuss others, however, with your organization's executive management team.

1. Should we have an internal audit activity?
2. What should our internal audit activity do?
3. What should be the mandate of our internal audit activity?
4. What is the relationship between the internal auditors and the audit committee?
5. To whom should the internal auditors report administratively?
6. How is the internal audit activity staffed?
7. How do the internal auditors get and maintain the expertise they need to conduct their assignments?
8. Are the activities of our internal auditors appropriately coordinated with those of the external auditors?
9. How is the internal audit plan developed?
10. What does the internal audit plan not cover?
11. How are internal audit findings reported?
12. How are our corporate managers required to respond to internal audit findings and recommendations?
13. What services do our internal auditors provide regarding fraud?
14. How are we assured of internal audit effectiveness and quality?
15. Does our internal audit activity have sufficient resources?
16. Does our internal audit activity have appropriate support from the CEO and senior management team?
17. Are we satisfied that this organization has adequate internal controls over its major risks?
18. Are there any other matters that should be brought to our attention?
19. Are there other ways in which we and our internal auditors might support each other?
20. Are we satisfied with our internal audit activity?

SOURCE: Adapted from "20 Questions," originally produced by the Canadian Institute of Chartered Accountants

Being On Purpose

As a member of the audit committee, you serve as a part of an independent oversight subset of the board of directors. Your role is critical to ensuring the organization has strong and effective processes relating to independence, internal control, risk management, compliance, ethics, and financial disclosures. Working toward goals that are consistent with those of the audit committee, the internal auditors aid in the execution of your committee's corporate governance responsibilities. In fact, their primary purpose is to help ensure that management and the board meet organizational objectives. To do this, their scope of work should include evaluation of risk in regard to legal and regulatory compliance, conflicts of interest, unethical behavior, and fraudulent activities; and investigation of such initiatives as company whistleblower hotlines.

Charting the Course

How does the audit committee go about living up to its significant governance responsibilities, achieving its goals, fulfilling its purpose, and meeting the high expectations of the board of directors, shareholders, and other outside parties?

The audit committee's charter is its blueprint for operations. Highly customized to best meet the needs of an organization's industry, mission, and culture, the charter should clearly delineate audit committee processes, procedures, and responsibilities that have been sanctioned by the entire board. In short, it "charts" the committee's course for the year.

The audit committee charter should define membership requirements, include a provision for a financial expert, allow for yearly reviews and changes, designate the minimum number of meetings to be conducted, accommodate executive sessions with appropriate entities, and allow for engaging outside counsel as needed. The charter also should outline the committee's responsibilities in regard to risk management, compliance issues, and review of its own effectiveness; identify the specific areas the audit committee should review as well as with whom those reviews will be conducted; and include such specific roles as annual report preparation oversight and yearly agenda planning.

In addition and very important, the charter should delineate the audit committee's relationships with the internal and external auditors, including responsibility for reviewing and concurring on the selection or dismissal of the CAE; appointing, evaluating, setting time limits for, and discharging (with the concurrence of the full board) the external auditors; and evaluating the independence of both the internal and external auditors.

No sample charter encompasses all activities that might be appropriate to a particular audit committee, nor will all activities identified in a sample charter be relevant to every committee. Accordingly, the following charter is a starting point and can be tailored to any committee's needs and governing rules. It is based on an audit committee charter issues matrix developed for The Institute of Internal Auditors Research Foundation by James Roth, Ph.D.,CIA, CCSA, and Donald Espersen, CIA.

Sample Audit Committee Charter

PURPOSE

To assist the board of directors in fulfilling its oversight responsibilities for (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors. The audit committee will also prepare the report that regulatory rules require be included in the company's annual proxy statement.

AUTHORITY

The audit committee has authority to conduct or authorize investigations into any matters within its scope of responsibility. It is empowered to:

- Appoint, compensate, and oversee the work of the public accounting firm employed by the organization to conduct the annual audit. This firm will report directly to the audit committee.
- Resolve any disagreements between management and the auditor regarding financial reporting.
- Pre-approve all auditing and permitted non-audit services performed by the company's external audit firm.
- Retain independent counsel, accountants, or others to advise the committee or assist in the conduct of an investigation.
- Seek any information it requires from employees – all of whom are directed to cooperate with the committee's requests – or external parties.
- Meet with company officers, external auditors, or outside counsel, as necessary.
- The committee may delegate authority to subcommittees, including the authority to pre-approve all auditing and permitted non-audit services, providing that such decisions are presented to the full committee at its next scheduled meeting.

COMPOSITION

The audit committee will consist of at least three and no more than six members of the board of directors. The board nominating committee will appoint committee members and the committee chair.

Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by applicable legislation and regulation. No committee member shall simultaneously serve on the audit committees of more than two other public companies.

MEETINGS

The committee will meet at least four times a year, with authority to convene additional meetings, as circumstances require. All committee members are expected to attend each meeting, in person or via tele- or video-conference. The committee will invite members of management, auditors or others to attend meetings and provide pertinent information, as necessary. It will meet separately, periodically, with management, with internal auditors and with external auditors.It will also meet periodically in executive session. Meeting agendas will be prepared and provided in advance to members, along with appropriate briefing materials. Minutes will be prepared.

RESPONSIBILITIES

The committee will carry out the following responsibilities

Financial Statements

- Review significant accounting and reporting issues and understand their impact on the financial statements. These issues include:
  - Complex or unusual transactions and highly judgmental areas
  - Major issues regarding accounting principles and financial statement presentations, including any significant

changes in the company's selection or application of accounting principles
  - The effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company.
- Review analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements.
- Review with management and the external auditors the results of the audit, including any difficulties encountered. This review will include any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management.
- Discuss the annual audited financial statements and quarterly financial statements with management and the external auditors, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."
- Review disclosures made by CEO and CFO during the Forms 10-K and 10-Q certification process about significant deficiencies in the design or operation of internal controls or any fraud that involves management or other employees who have a significant role in the company's internal controls.
- Discuss earnings press releases (particularly use of "proforma," or "adjusted" non-GAAP, information), as well as financial information and earnings guidance provided to analysts and rating agencies. This review may be general (i.e., the types of information to be disclosed and the type of presentations to be made). The audit committee does not need to discuss each release in advance.

Internal Control

- Consider the effectiveness of the company's internal control system, including information technology security and control.
- Understand the scope of internal and external auditors' review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.

Internal Auditing

- Review with management and the chief audit executive the charter, plans, activities, staffing, and organizational structure of the internal audit function.
- Ensure there are no unjustified restrictions or limitations, and review and concur in the appointment, replacement, or dismissal of the chief audit executive.
- Review the effectiveness of the internal audit function, including compliance with The IIA's International Standards for the Professional Practice of Internal Auditing.
- On a regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal auditing believes should be discussed privately.

External Auditing

- Review the external auditors' proposed audit scope and approach, including coordination of audit effort with internal auditing.
- Review the performance of the external auditors, and exercise final approval on the appointment or discharge of the auditors. In performing this review, the committee will:
  - At least annually, obtain and review a report by the independent auditor describing the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.
  - Take into account the opinions of management and internal auditing.
  - Review and evaluate the lead partner of the independent auditor.
  - Present its conclusions with respect to the external auditor to the board.
- Ensure the rotation of the lead audit partner every five years and other audit partners every seven years, and consider whether there should be regular rotation of the audit firm itself.
- Present its conclusions with respect to the independent auditor to the full board.
- Set clear hiring policies for employees or former employees of the independent auditors.
- On a regular basis, meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately.

Compliance

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.
- Establish procedures for: (1) The receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and (2) The confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.
- Review the findings of any examinations by regulatory agencies, and any auditor observations.
- Review the process for communicating the code of conduct to company personnel, and for monitoring compliance therewith.
- Obtain regular updates from management and company legal counsel regarding compliance matters.

Reporting Responsibilities

- Regularly report to the board of directors about committee activities and issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, and the performance of the internal audit function.
- Provide an open avenue of communication between internal audit, the external auditors, and the board of directors.
- Report annually to the shareholders, describing the committee's composition, responsibilities and how they were discharged, and any other information required by rule, including approval of non-audit services.
- Review any other reports the company issues that relate to committee responsibilities.

Other Responsibilities

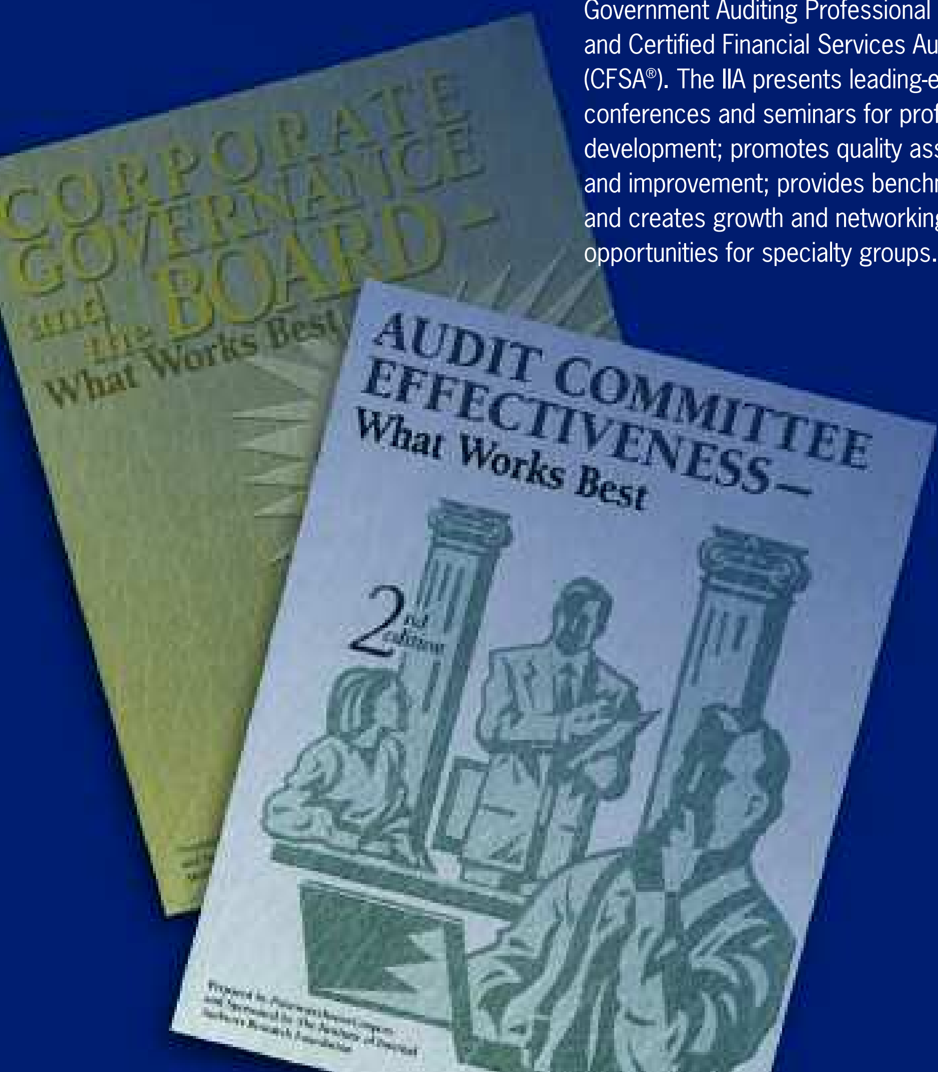
- Discuss with management the company's major policies with respect to risk assessment and risk management.
- Perform other activities related to this charter as requested by the board of directors.
- Institute and oversee special investigations as needed.
- Review and assess the adequacy of the committee charter annually, requesting board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.
- Confirm annually that all responsibilities outlined in this charter have been carried out.
- Evaluate the committee's and individual members' performance at least annually.

THE INSTITUTE OF INTERNAL AUDITORS (IIA) is the acknowledged leader, recognized authority, and chief educator for the profession worldwide. Established in 1941, The IIA has 246 affiliates around the world and serves more than 115,000 members in internal auditing, risk management, governance, internal control, IT audit, education, and security in 160 countries.

The world's leader in certification, education, research, and technical guidance for the profession, The Institute sets the *International Standards for the Professional Practice of Internal Auditing* and provides leading-edge guidance. Serving as internal auditing's global professional association, The IIA certifies professionals through the stringent Certified Internal Auditor® (CIA®) program and specialty certification programs, such as the Certification in Control Self-Assessment (CCSA®), Certified Government Auditing Professional (CGAP®), and Certified Financial Services Auditor® (CFSA®). The IIA presents leading-edge conferences and seminars for professional development; promotes quality assurance and improvement; provides benchmarking; and creates growth and networking opportunities for specialty groups.

The IIA Research Foundation produces forward-thinking educational products and works in partnership with experts from around the globe conducting valuable research projects on the top issues affecting the business world today. The IIA also brings great value to its members through *Internal Auditor*, the award-winning professional magazine, and other outstanding periodicals that address the profession's most pressing issues and challenges and present viable solutions and exemplary practices.

As the global voice of the profession, The IIA promotes quality, professionalism, effective governance, ethical business practices, and world-class internal auditing. Dedicated to providing extensive support and services to help internal auditors add value across the board, The Institute delivers best-practice guidance to internal audit practitioners, executive management, boards of directors, and audit committees all around the world.



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Implementing best practices and high standards

The Institute of Internal Auditors

The Audit Committee:

Internal Audit Oversight

Roles and Responsibilities

AUDIT COMMITTEE RESOURCES

- The Institute of Internal Auditors (IIA)
  www.theiia.org
- *Tone at the Top* newsletter from The IIA
  www.theiia.org/periodicals/newsletters/tone-at-the-top
- American Institute of Certified Public Accountants (AICPA) Audit Committee Effectiveness Center
  www.aicpa.org/audcommctr
- Committee of Sponsoring Organizations of the Treadway Commission (COSO)
  www.coso.org
- KPMG's Audit Committee Institute
  www.kpmg.com/aci
- Moody's Corporation
  www.moodys.com
- National Association of Corporate Directors (NACD)
  www.nacdonline.org
- The Conference Board
  www.conference-board.org

Over the years, the roles and responsibilities of boards of directors — specifically, of the board's audit committee, if in existence — have become increasingly demanding and scrutinized. While today's audit committee must encompass a level of financial literacy, independence, and knowledge about risk management and internal control; individual audit committee members must be deeply committed, highly experienced, and fully qualified in order to effectively carry out their varied responsibilities.

Among the many important roles the audit committee plays within an organization, is to provide internal audit oversight. This document focuses on a single aspect of audit committee performance: its oversight of quality-oriented internal audit activities. While — at first glance — this role might not appear to be terribly complex or time-consuming, further consideration reveals that the reality is the antithesis of simplicity. And as internal auditing's contribution to effective organizational governance has evolved and become increasingly acknowledged and revered, the audit committee's understanding of internal audit value, processes and procedures, strengths and weaknesses, and potential has escalated exponentially. As such, best practice indicates that the audit committee should define in its charter the scope of its relationship with the internal auditors, and should work to enhance its oversight ability — subsequently strengthening the internal audit activity.

Quality-oriented audit committees beget quality-oriented internal audit activities. But the return on investment goes both ways. The internal auditors also can be an important resource for audit committee enhancement. They do this by reviewing the audit committee charter, providing timely information on new legislation and regulations, and fulfilling the role of educator to audit committee members.

Empowerment and Expectations

In some organizations, internal auditing is not widely recognized for its invaluable role. It is critical that audit customers throughout the organization understand the value that internal auditors can bring to their operations by identifying opportunities for enhancing efficiencies and effectiveness. The audit committee, in concert with executive management, can play a critical role in empowering and elevating the image of the internal audit activity, ensuring that it is not misunderstood.

By routinely communicating its value throughout the organization, those at the top can and should promote the importance of the internal audit activity. They can position the function as fully empowered to provide a critical check for management, to be a knowledgeable provider of assurance and a revered consultant, and to add value to the organization's governance, risk management, and internal control processes.

10-POINT OVERSIGHT CHECKLIST

TO PROVIDE ADEQUATE OVERSIGHT OF INTERNAL AUDITING, AN AUDIT COMMITTEE SHOULD ENSURE THE FOLLOWING:

1. The audit committee engages in an open, transparent relationship with the chief audit executive (CAE).
2. The audit committee reviews and approves the internal audit charter annually.
3. As a result of discussions with the CAE, the audit committee has a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems.
4. The internal audit activity is sufficiently resourced with competent, objective internal audit professionals to carry out the internal audit plan, which has been reviewed and approved by the audit committee.
5. The internal audit activity is empowered to be independent by its appropriate reporting relationships to executive management and the audit committee.
6. The audit committee addresses with the CAE all issues related to internal audit independence and objectivity.
7. The internal audit activity is quality-oriented, and has in place a Quality Assurance and Improvement Program.
8. The audit committee regularly communicates with the chief audit executive about the performance and improvement of the CAE and the internal audit activity.
9. Internal audit reports are actionable, and audit recommendations and/or other improvements are satisfactorily implemented by management.
10. The audit committee meets periodically with the CAE without the presence of management.

INTERNAL AUDIT CHARTER

The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* recommend defining the internal audit activity's purpose, authority, and responsibility in a charter that is approved by the board. The internal audit charter is a useful tool for the board and management when evaluating the internal audit activity's performance.

DEFINITION OF INTERNAL AUDITING

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.

Reporting to executive management and having direct access to the audit committee well positions the internal audit activity within an organization. Internal audit independence is furthered by periodic private meetings between the audit committee and the CAE, during which time sensitive issues are discussed, without management's presence.

SHARING THE VISION

The audit committee and the CAE should agree on the internal audit charter. This requires them to share the same vision in regard to the internal auditors' scope of work, including how their attention and focus will be divided among assurance and consulting; operational, financial, and compliance auditing; and issues related to risk management, internal control, and ethics. This also requires agreement as to the internal auditors' role, as described in The IIA's official definition of internal auditing; as well as ensuring the internal auditors have the authority to access all company employees and to examine all company records and physical assets.

To provide effective internal audit oversight requires the audit committee to have an in-depth understanding of the business, the associated risks, and the internal control environment. The audit committee also must be diligent in reinforcing the importance of internal audit independence, as well as the CAE's accountability to senior management and the audit committee. Once the vision is aligned and the internal audit charter is in place, the audit committee periodically should assess the organizational structure to ensure the internal audit activity has the resources and skill sets necessary to effectively and efficiently accomplish its goals.

PLANNING AHEAD

Although insight provided by the audit committee during the development of the internal audit plan can be invaluable to the internal auditors, a well-developed and implemented plan also can bring great value to the committee in its oversight role. Audit committee members can review the scope, determine whether the internal audit plan addresses previously identified areas of risk, recommend changes to internal audit activities, and determine whether the plan supports the objectives of management and the board. Once this is determined, a budget must be developed to accommodate the audit plan. The IIA recommends that the budget be reviewed and approved by the audit committee.

COMMUNICATING CRITICAL INFORMATION

Few components of oversight are as critical to effective and successful audit committee oversight of internal auditing as is two-way communication with the internal audit activity. Because of their position and role within an organization, internal auditors possess a good and objective understanding of the culture, system of internal control, operations, and industry. Hence, the audit committee should rely upon them for important information about the organization's control environment and processes, including significant control process issues, potential improvements, and resolution; as well as the overall adequacy of internal controls.

BEST PRACTICES BEST PRACTICES

The Audit Committee: Internal Audit Oversight

Specifically, the audit committee should ensure the lines of communication are open with the internal auditors to discuss significant issues that have been brought to the attention of management and the resulting responses. Should management place limitations on the scope of internal audit processes that have been authorized by the charter, the audit committee should be informed by the CAE. Such discussions will provide valuable information that will help the audit committee in its role of management oversight.

BEST PRACTICES

The internal auditors should report to the committee risks that could hamper the achievement of strategic and operational objectives, and fraud risks that involve or could involve management or others who play a significant role in the internal controls. Other important areas for discussion include the reliability of operational information, safeguarding of assets, appropriate disclosures, and compliance with contracts, regulations, and laws. And because of their extensive knowledge and based on their observations of accounting decisions, policies, and any complex or unusual events, transactions, and operations, the internal auditors also can help the audit committee evaluate various policies and practices.

A DIFFERENT PERSPECTIVE

Full-time internal auditors have an advantage of witnessing the entire fiscal year with an ongoing view of revenue and expense cycles. They can bring to executive management and the audit committee an up-close and personal perspective on the results of the organization's operations as reflected in the financial statements. By doing so, the internal auditors can be an invaluable resource to the audit committee in its oversight role for financial completeness, accuracy, and disclosure.

Quality of Internal Audit Performance

OVERSEEING QUALITY

Inherent in the audit committee charter is its responsibility for monitoring and reviewing the performance of the internal audit activity. Because the input of the internal auditors is so critical to the success — and potentially, the very survival — of an organization, it is important for the audit committee to have a clear picture of the internal audit activity's performance, and ensure that it is functioning well.

Clearly, the CAE should report to the audit committee on the performance of the audit plan. But this is not sufficient to ensure quality of the entire internal audit activity. Every internal audit activity, regardless of size, should have in place a Quality Assurance and Improvement Program. Not only does such a program help ensure the activity is on the path to optimal quality, but it also sets an example of excellence for all audit customers and stakeholders, by demonstrating the activity's commitment to confronting areas in need of improvement, and taking steps to make the requisite changes.

IMPORTANT QUESTIONS TO ASK

QUESTIONS THAT SHOULD BE ANSWERED IN ORDER TO ADEQUATELY GAUGE AND PROVIDE TO VARIED STAKEHOLDERS REASONABLE ASSURANCE OF INTERNAL AUDIT QUALITY:

- ☐ Does the internal audit activity have in place a Quality Assurance and Improvement Program?
- ☐ Has the activity performed its work in accordance with its charter?
- ☐ Do the internal auditors adhere to The IIA's Code of Ethics?
- ☐ Are the internal audits conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*?
- ☐ Does the activity operate effectively and efficiently?
- ☐ Is the staff size adequate?
- ☐ Are the existing skill sets appropriate?
- ☐ Does the activity contribute to the improvement of organizational operations, and is it perceived by stakeholders to add value?
- ☐ Does the activity have the tools and other resources it needs?
- ☐ Does the activity engage in ongoing internal reviews and analysis of supervision, documentation, policies, and procedures?
- ☐ Does the activity engage in periodic reviews that include customer surveys, risk assessments, work paper reviews, review and analysis of performance metrics, and best-practice benchmarking?
- ☐ Do members of the team participate in professional development training?
- ☐ Have team members acquired professional designations that demonstrate their competency?
- ☐ Has the internal audit activity obtained an independent external quality assessment within the past five years?

SETTING THE STANDARD

As the internal audit profession's trustworthy global guidance-setting body, The Institute of Internal Auditors (IIA) promulgates the *International Standards for the Professional Practice of Internal Auditing (Standards)*. Professional internal audit activities work in conformance with the *Standards*, which — along with the Definition of Internal Auditing and the Code of Ethics — are a mandatory component of the International Professional Practice Framework (IPPF). Included in the *Standards* is a mandate for internal audit activities to obtain an external quality assessment every five years.

AUDITING THE INTERNAL AUDITORS

The internal audit activity is a part of an organization's risk universe, and should be assessed. Although the audit committee clearly is responsible for internal audit oversight, it is not the committee's role to "audit" the activity. The audit committee's oversight is at a much higher level. So who audits the internal auditors? That is the role of the external quality assessment (QA) team — an independent group of professionals who are well-versed in best internal audit practices, under the leadership of an experienced and professional project manager.

The objectives of an external QA team are to evaluate the efficiency and effectiveness of the internal audit activity within the organization, to make best-practice recommendations for improvement, and to determine whether the activity is in conformance with the *Standards*. This is especially important, as it sends the message to everyone that the internal audit activity systematically submits itself to the same level of scrutiny that the rest of the organization undergoes through internal audits. This represents the internal audit activity's commitment to excellence and dedication to quality.

In addition, the external QA validates — for the CAE, executive management, and the audit committee — the level of the internal audit activity's performance. It also provides assurance that enables the audit committee to report to the board with the highest level of confidence that internal auditing is functioning as it should.

REST ASSURED

The CAE's reports on the status of the activity's Quality Assurance and Improvement Program should provide to the audit committee assurance of the internal audit activity's quality. This assurance is derived from a variety of sources:

- Internal assessments — periodic and ongoing feedback on what's working and what gaps need to be filled to ensure effectiveness, efficiency, economy, and conformance with the *Standards*.

QUALITY RESOURCES

On The IIA's Web site at www.theiia.org/quality are a variety of resources for improving quality internal auditing, including a Quality Maturity Model and overview of what is entailed in a Quality Assurance and Improvement Program. "The Path to Quality" provides a step-by-step guide for getting to the next level.

- Action plans — documenting action needed and steps taken to fix issues and align goals and objectives in a changing environment with competing priorities.
- External QAs — independent validation that what you are hearing from the CAE about the activity is accurate.
- External auditors — the level to which they are comfortable relying on the work of the internal audit activity.

By establishing an open and trusting relationship with the CAE, clearly delineating your expectations of the internal auditors, being attentive to all reports provided, and asking the right questions, you and the entire audit committee can stay up to date on the internal audit activity. Following these practices will help ensure that the CAE has the tools, resources, and support necessary for optimal performance. It also will help keep you informed about the quality of your internal audit activity. And when it comes to effective organizational governance and oversight, this level of knowledge will go a long way toward ensuring you don't lie awake worrying at night!

BENEFITS OF EXTERNAL QUALITY ASSESSMENTS

As the internal audit profession's recognized authority, The IIA promulgates the accepted global methodology for assessing internal audit quality. The IIA also provides cost-effective external QA services to help organizations validate and strengthen their internal audit activities, and enhance their effectiveness, efficiency, and best-practice implementation.

In addition to ensuring the internal audit activity's conformance with the *International Standards for the Professional Practice of Internal Auditing*, the benefits of external quality assessments are well documented.

- ☐ **JCPENNEY**
  "Additional benefits qualified external parties can bring to your audit function include experiences, leading practices, and value-added processes they have been exposed to as a result of conducting QAs for other internal audit shops."

- ☐ **MERCK & CO.**
  "External quality assessments provide ... a critical opportunity to benchmark Merck against other companies following the same standards and guidelines."

- ☐ **CHINA NATIONAL OFFSHORE OIL COMPANY AND SHELL PETROCHEMICALS CO. LTD. (CSPC)**
  "Through the QA process ... we have embedded quality into the mindset and daily operations of our internal audit activity, and the company as a whole."

- ☐ **POST DENMARK**
  "We received great benefit from having an independent validator from The IIA challenging us on our processes. Moreover, the validator facilitated fruitful discussions with executive management and the chairman of the board on the role of our function."

- ☐ **GRUPO BANCOLOMBIA**
  "External quality assessments have been crucial in our continuous improvement process."

- ☐ **DELL INC.**
  "Quality assessment programs are foundational to performing and sustaining high-quality production."

- ☐ **DYNEGY, INC.**
  "To really benefit from a QA ... it is important to acknowledge your identified shortcomings and develop and implement plans to rectify them."

FULL CONTEXT OF TESTIMONIALS IS AVAILABLE AT WWW.THEIIA.ORG/QUALITY.

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Definition of Internal Auditing

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.

Source - The Institute of Internal Auditors

Internal Audit Core Principles

Core Principles for the Professional Practice of Internal Auditing:

Demonstrates integrity.
Demonstrates competence and due professional care.
Is objective and free from undue influence (independent).
Aligns with the strategies, objectives, and risks of the organization.
Is appropriately positioned and adequately resourced.
Demonstrates quality and continuous improvement.
Communicates effectively.
Provides risk-based assurance.
Is insightful, proactive, and future-focused.
Promotes organizational improvement.

{ CODE of ETHICS... }

// PRINCIPLES

Internal auditors are expected to apply and uphold the following principles:

- ***Integrity***
  The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

- ***Objectivity***
  Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

- ***Confidentiality***
  Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

- ***Competency***
  Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.

// RULES OF CONDUCT

1. *Integrity*

Internal Auditors:

1.1. Shall perform their work with honesty, diligence, and responsibility.

1.2. Shall observe the law and make disclosures expected by the law and the profession.

1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.

1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.

2. *Objectivity*

Internal Auditors:

2.1. Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.

2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment.

2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

3. *Confidentiality*

Internal Auditors:

3.1. Shall be prudent in the use and protection of information acquired in the course of their duties.

3.2. Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

4. *Competency*

Internal Auditors:

4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.

4.2. Shall perform internal audit services in accordance with the *International Standards for the Professional Practice of Internal Auditing.*

4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.

The Institute of Internal Auditors

International Professional Practices Framework

Implementation Guide 1010

Standard 1010 – Recognition of the Definition of Internal Auditing, the Code of Ethics, and the *Standards* in the Internal Audit Charter

The mandatory nature of the Definition of Internal Auditing, the Code of Ethics, and the *Standards* must be recognized in the internal audit charter. The chief audit executive should discuss the Definition of Internal Auditing, the Code of Ethics, and the *Standards* with senior management and the board.

Revised Standards, Effective 1 January 2013

Getting Started

Before writing or revising the internal audit charter, the chief audit executive (CAE) is advised to review The IIA's International Professional Practices Framework (IPPF) and refresh his or her understanding of the mandatory elements, including the Definition of Internal Auditing, the Code of Ethics, and *Standards*. The CAE is required to periodically review the internal audit charter and present it to senior management and the board for approval (Standard 1000: Purpose, Authority, and Responsibility). It is helpful if the CAE knows the organization's process to approve the internal audit charter and arranges a discussion of the charter with the board and senior management as part of the process.

Considerations for Implementation

To recognize the mandatory elements in the internal audit charter, the CAE may make specific statements. One example is:

> "The internal audit activity will govern itself by adherence to The Institute of Internal Auditors' mandatory guidance, which includes the Definition of Internal Auditing, the Code of Ethics, and the *International Standards for the Professional Practice of Internal Auditing* (*Standards*). This mandatory guidance constitutes the fundamental requirements for the professional practice of internal auditing and the principles against which to evaluate the effectiveness of the internal audit activity's performance."

An alternative to using any specific wording is to use language and content throughout the internal charter that requires conformance with the mandatory guidance.

The CAE's discussion of the internal audit charter with senior management and the board provides a good opportunity to explain the mandatory elements of the IPPF, as well as how the charter recognizes those elements.

After the charter has been adopted, it is important for the CAE to monitor The IIA's mandatory guidance and to discuss any changes during the next charter review.

Considerations for Demonstrating Conformance

Conformance with this standard is evidenced in the written and approved internal audit charter that recognizes the Definition of Internal Auditing, the Code of Ethics, and the *Standards* as mandatory elements. The minutes of meetings where these elements were discussed with senior management and the board and evidence of periodic reviews of the charter also demonstrate conformance.

About The IIA

Established in 1941, The Institute of Internal Auditors (IIA) is an international professional association with global headquarters in Altamonte Springs, Florida, USA. The IIA is the internal audit profession's global voice, recognized authority, acknowledged leader, chief advocate, and principal educator.

www.globaliia.org/www.theiia.org

About Implementation Guidance

Implementation Guidance, as part of The IIA's International Professional Practices Framework® (IPPF®), provides recommended (non-mandatory) guidance for the internal audit profession. It is designed to assist both internal auditors and internal audit activities to enhance their ability to achieve conformance with the *International Standards for the Professional Practice of Internal Auditing* (*Standards*).

Implementation Guides assist internal auditors in applying the *Standards*. They collectively address internal audit's approach, methodologies, and consideration, but do not detail processes or procedures.

For other authoritative guidance materials provided by The IIA, please visit our website at www.globaliia.org/standards-guidance or www.theiia.org/guidance.

Disclaimer

The IIA publishes this document for informational and educational purposes. This guidance material is not intended to provide definitive answers to specific individual circumstances and, as such, is only intended to be used as a guide. The IIA recommends that you always seek independent expert advice relating directly to any specific situation. The IIA accepts no responsibility for anyone placing sole reliance on this guidance.

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International Professional Practices Framework

Implementation Guide 2500

Standard 2500 – Monitoring Progress

The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

Revised Standards, Effective 1 January 2013

Getting Started

To fulfill this standard, the chief audit executive (CAE) starts by attaining a clear understanding of the type of information and level of detail the board and senior management expect with regard to the internal audit activity's monitoring of the results of engagements. Results typically refer to the observations developed in assurance and consulting engagements that have been communicated to management for corrective action.

Given that periodic interactions will be required with the management responsible for implementing corrective actions, it is generally helpful to solicit management's input on ways to create an effective and efficient monitoring process.

Further, the CAE may want to benchmark with other CAEs or compliance functions that monitor outstanding issues to identify leading practices that have proven effectiveness. These discussions may address areas such as:

- The levels of automation and detail.
- The types of observations monitored (i.e., all or just higher risk observations).
- How and with what frequency the status of outstanding corrective actions is determined.

- When internal audit independently confirms the effectiveness of corrective actions.
- The frequency, style, and level of reporting performed.

Considerations for Implementation

Monitoring processes can be sophisticated or rather simple, depending on a number of factors, including the size and complexity of the audit organization and the availability of exception tracking software. Whether sophisticated or simple, it is important for the CAE to develop a process that captures the relevant observations, agreed corrective action, and current status. For outstanding observations, the information tracked and captured typically includes:

- The observations communicated to management and their relative risk rating.
- The nature of the agreed corrective actions.
- The timing/deadlines/age of the corrective actions and changes in target dates.
- The management/process owner responsible for each corrective action.
- The current status of corrective actions, and whether internal audit has confirmed the status.

Often, the CAE will develop or purchase a tool, mechanism, or system to track, monitor, and report on such information. Based on information provided to internal audit by the responsible management, the status of the corrective actions is updated in the system periodically and often directly by management using a shared exception tracking system.

The frequency and approach to monitoring (the extent of audit staff work to verify that corrective action was taken) is determined based on the CAE's professional judgment, as well as the expectations set by the board and senior management. For example, some CAEs may choose to inquire periodically, such as quarterly, about the status of all corrective actions that were due to be completed in the prior period. Others may choose to perform periodic follow-up engagements for audits with significant recommendations to specifically assess the quality of the corrective actions taken. Others may choose to follow up on outstanding actions during a future audit scheduled in the same area of the organization. The approach is determined based on the adjudged level of risk, as well as the availability of resources.

Similarly, the form of reporting is determined based on the CAE's judgment and the agreed expectations. Some CAEs will report the status of every observation for every engagement in a detailed manner. Others will report only on observations rated higher risk, perhaps summarized by business process or executive owner, noting statistics such as percentage of corrective actions on track, overdue, and completed on time. In some instances, the CAE may be asked to report on not just whether the corrective action has been completed, but also whether the action taken has corrected the underlying issue. Capturing and measuring positive improvement based on the execution of corrective actions is considered a leading practice.

Considerations for Demonstrating Conformance

Conformance is typically evidenced by the existence of a routinely updated exception tracking system, which could be a spreadsheet, database, or other tool that contains the prior audit observations, associated corrective action plan, status, and internal audit's confirmation, as described above. Also, there are typically corrective action status reports prepared for senior management and the board.

About The IIA

The Institute of Internal Auditors (The IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 180,000 members from more than 170 countries and territories. The association's global headquarters are in Altamonte Springs, Fla. For more information, visit www.globaliia.org or www.theiia.org.

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PEDERNALES ELECTRIC COOPERATIVE

AUDIT COMMITTEE AND INTERNAL AUDIT

TRACY GOLDEN, CPA

CHIEF FINANCIAL OFFICER

AUDIT COMMITTEE & INTERNAL AUDIT

- 20 QUESTIONS
- AUDIT COMMITTEE PURPOSE
- DEFINITION OF INTERNAL AUDITING
- CORE PRINCIPLES
- CODE OF ETHICS
- ADOPT INTERNATIONAL STANDARDS?
- IMPLEMENTATION GUIDANCE
- MONITORING GUIDANCE
- THREE LINES OF DEFENSE
- MODEL AUDIT COMMITTEE CHARTER

20 QUESTIONS ORGANIZED INTO SIX GROUPS

- Internal Audit Role & Mandate
- Internal Audit Relationships
- Internal Audit Resources
- Internal Audit Process
- Closing Questions
- Audit Committee Assessment

INTERNAL AUDIT ROLE AND MANDATE

The Audit Committee is responsible for ensuring that management has implemented an effective system of internal control to manage the risks facin the organization. These questions, together with related discussions with the CEO and professional advisors, will put the Audit Committee in a position to understand what internal audit functions are needed and what is in place.

INTERNAL AUDIT ROLE AND MANDATE

1. Should we have an internal audit function?
   - This decision should involve the CEO, CFO and Audit Committee
     - Consider if you want to get independent and objective assurance on the adequacy of internal controls from someone rather than CEO or CFO.
     - CEO wants to get independent and objective assurance on the adequacy of internal controls from someone rather than the CFO or line managers.
     - CFO wants to get independent and objective assurance on the adequacy of internal controls from someone rather than the line managers.
     - The Co-op is too large or geographically dispersed

2. What should our internal audit function do?
   - Evaluate the adequacy and effectiveness of controls encompassing the Co-op's governance, operations, and information systems to include:
     - Reliability and integrity of financial and operational information
     - Effectiveness and efficiency of operations
     - Safeguarding of assets
     - Compliance with laws, regulations, and contracts

INTERNAL AUDIT ROLE AND MANDATE

3. What should be the mandate of the internal audit function?
   - The mandate provides the authority they need within a structure that supports their independence and objectivity, best achieved through a written charter that is reviewed and updated regularly and includes:

- Role and responsibilities
- Functional reporting relationship to committee
- Administrative reporting relationship
- Access to employees, facilities and records
- Restrictions of the scope or authority of IA
- Requirement of cooperation
- Code of Ethics
- Internal Audit Standards
- Relationship with External Auditors
- Distribution of audit reports and summaries
- Follow up of recommendations
- Specific mention of areas such as fraud, technology, safety, environment, etc.
- The right of the chief audit executive to attend audit committee meetings

INTERNAL AUDIT RELATIONSHIPS

The Chief Audit Executive relationships with the audit committee and senior management are critical to the success to the internal audit function. The following questions can confirm that the relationships give internal audit the support and access it needs and that the committee receives the range of services and support it needs to meet its own mandate.

INTERNAL AUDIT RELATIONSHIPS

4. What is the relationship between internal audit and the audit committee?
   - The internal audit function is a source of information and assurance to the Audit Committee on internal financial controls and other risk management activities. A key element of this relationship is a direct channel of communication to the Chief Audit Executive and the Audit Committee.

5. To whom does the internal audit report to administratively?
   - Recommended practices have the internal audit reports administratively to the CEO or other senior executive and has a functional reporting relationship to the audit committee

REPORTING OPTIONS

REPORTING TO	ADVANTAGES	DISADVANTAGES
CEO	Establishes audit status.	CEO may have too many direct reports.
CFO	Reinforces financial control. CFO often understands the role of internal audit and can provide some advise	Potential conflict of interest: • If audit findings reflect badly on CFO • If resources are diverted to lower priorities
Other Senior Executive	Good for audit independence if the executive has no or few direct operational responsibilities subject to significant internal audit scrutiny	Executive may lack knowledge of operations and internal controls, may not have a motivation for internal audit to be effective, or may lack the ability to influence
Chair of Audit Committee	Good for audit independence.	Internal audit is no longer seen as supporting and partnering with management. Chief audit executive may lose status and acceptance as a member of the management team.

INTERNAL AUDIT RESOURCES

Internal Audit functions need an adequate complement of staff with the appropriate experience and qualifications for the risks and businesses they audit. These questions are designed to be directed at the Chief Audit Executive at an audit committee meeting as part of the process of understanding and assessing the quality of the internal audit function.

INTERNAL AUDIT RESOURCES

6. How is the internal audit function staffed?
   – The staffing of the internal audit function is based on the number of skilled individuals required to cover the activities identified in the approved audit plan and can be conducted by:
     - In-house resources
     - A fully outsourced internal audit function reporting to a designated executive
     - A combination of the above

7. How does internal audit get and maintain the expertise it needs to conduct its assignments?
   – Calls for a diverse set of knowledge, skills and experience to provide the control assurance and related advice to the audit committee

INTERNAL AUDIT RESOURCES

8. Are the activities of internal audit appropriately coordinated with those of the external auditors?
   - External auditors rely on the work of internal auditors to the extent that is confirms the quality of an organization's system of internal control.
   - The internal and external auditors should work cooperatively to achieve the best possible value in audit coverage.
   - The committee should ask both internal and external auditors if they are satisfied with the extent of coordination and compare the answers

INTERNAL AUDIT PROCESSES

Chief Audit Executives should demonstrate to their Audit Committees how they set priorities, plan, supervise and review the various internal audit projects and activities. These questions are directed at the Chief Audit Executive in dealing with matters of the Co-op and process.

INTERNAL AUDIT PROCESS

9. How is the internal audit plan developed?
   – Recommended practices have the Chief Audit Executive prepare an annual audit plan based on a comprehensive review and analysis of the Co-op's business activities and associated risks. The Chief Audit Executive seeks management input and agreement on the scope and priority of the proposed audit plan. The audit plan includes the budget and staff resources required to accomplish the plan

10. What does the internal audit plan not cover?
    – The committee, senior management and Chief Audit Executive should agree on those areas of risk that will not be audited and the reasons. The committee should be alert to the possibility of under-funding of the internal audit function.

11. How are internal audit findings reported?
    – Audit reports, as historical records of audit work and findings, are in writing and include the scope and objectives of the audit, the findings and recommendations for improving control.

INTERNAL AUDIT PROCESS

12. How are corporate managers required to respond to internal audit findings and recommendations?
    – Line management is required to review all audit findings and provide action plans and dates for implementation before or soon after the audit report is issued.

13. What service does internal audit provide in connection with fraud?
    – The prevention, deterrence and detection of fraud are the responsibility of management. The usual role of internal auditors is to develop audit programs and procedures to evaluate the internal controls that management has established to manage the risk of fraud.

14. How do you assess the effectiveness of your internal audit function?
    – The Chief Audit Executive develops performance measures for the internal audit function in agreement with the Audit Committee. Measurement techniques include customer satisfaction surveys, post audit debriefing and internal quality assurance reviews

CLOSING QUESTIONS

The questions are designed to help the Audit Committee reach a conclusion on the effectiveness of internal audit and the committee may use them to sui up discussions of audit relationships, resources and process with Chief Audit Executive.

CLOSING QUESTIONS

15. Does internal audit have sufficient resources?
    - Assessing the sufficiency of resources should generally include comparisons with similar organizations and the business risks and the degree of change with the Co-op.
    - Internal audit functions not only need an adequate budget, they must be able to attract and retain skilled people.

16. Does the internal audit function get appropriate support from the CEO and Senior Management team?
    - The prevention, deterrence and detection of fraud are the responsibility of management.
    - There should be a good working relationship and mutual respect for the role of internal audit that includes support of audit findings and inclusion of the Chief Audit Executive in the communication and forums of Leadership Team.

17. Are you satisfied that this organization has adequate internal controls over its major risks?
    - The Audit Committee is responsible for ensuring that management has designed and implemented an effective system of internal controls.
    - In preparing to report its conclusions to the board, the committee should seek information and opinions from a range of sources including CEO, Chief Risk Officer, Legal Services, Chief Audit Executive and external auditors

CLOSING QUESTIONS

18. Are there any other matters that you wish to bring to the Audit Committee's attention?
    - Any issues that affect controls, the integrity of management or the quality of financial reporting not addressed in the internal audit report, the Chief Audit Executive is expected to bring them to the Audit Committee and be prepared to explain why these matters were not formally addressed in the audit reports.

19. Are there other ways in which internal audit and the audit committee could support each other?
    - This is an opportunity for the Chief Audit Executive and the Audit Committee to discuss matters as improving audit reporting to the committee and using internal audit to provide training on risk and control aspects of the Co-op

AUDIT COMMITTEE ASSESSMENT

The Audit Committee is responsible for confirming the internal audit has the competence, independence, resources and corporate support to do its job properly, and is demonstratively effective in getting results.

AUDIT COMMITTEE ASSESSMENT

20. Are we (the Audit Committee) satisfied with our Internal Audit function?
    - The following are some additional questions the Audit Committee could ask themselves or use in a discussion following their meetings with CEO, Chief Audit Executive and external auditors:
        - How well does the Chief Audit Executive respond to probing by the Audit Committee?
        - How well respected is the Chief Audit Executive by senior management and external auditors and how healthy is the tension between them?
        - How often do we get surprises where something that the internal audit has audited subsequently reveals control problems that were not identified in the formal reports?
        - Does internal audit bring forth significant issues that might not otherwise be disclosed to the committee?
        - Does the Chief Audit Executive provide adequate assurance in areas requested by the Audit Committee?

AUDIT COMMITTEE PURPOSE

The Tone at the Top

Management, the Board, and the Audit Committee all play critical roles in an Co-op's tone at the top. Based on Board expectations, executive management establishes the tone. It is the Audit Committee's responsibility, though, to monitor that tone as well as oversee the Co-op's ethical environment and compliance with laws and regulations.

DEFINITION OF INTERNAL AUDITING

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.

CORE PRINCIPLES

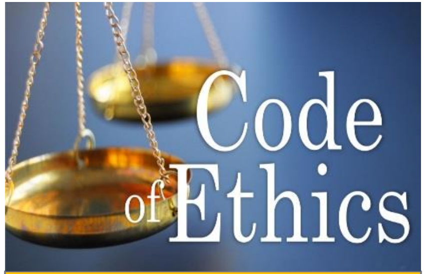
- Demonstrates integrity
- Demonstrates competence and due professional care
- Is objective and free from undue influence (independent)
- Aligns with the strategies, objectives, and risks of the organization
- Is appropriately positioned and adequately resour d
- Demonstrates quality and continuous improveme
- Communicates effectively
- Provides risk-based assurance
- Is insightful, proactive, and future-focused
- Promotes organizational improvement

*Source – The Institute of In

CODE OF ETHICS

PRINCIPLES

- Integrity
- Objectivity
- Confidentiality
- Competency



RULES OF CONDUCT

- Integrity
- Objectivity
- Confidentiality
- Competency

ADOPT INTERNATIONAL STANDARDS

PROS

Standards are principle-focused and provide a framework for performing and promoting internal auditing.

CONS

Requires more Audit Committee time.

IMPLEMENTATION GUIDANCE

Implementation Guides assist internal auditors in applying the Standards. They collectively address internal audit's approach, methodologies, and consideration, but do not detail processes or procedures.

Considerations for Implementation

"The internal audit activity will govern itself by adherence to The Institute of Internal Auditors' mandatory guidance, which includes the Definition of Internal Auditing, the Code of Ethics, and the *International Standards for the Professional Practice of Internal Auditing* (*Standards*). This mandatory guidance constitutes the fundamental requirements for the professional practice of internal auditing and the principles against which to evaluate the effectiveness of the internal audit activity's performance."

MONITORING GUIDANCE

Whether sophisticated or rather simple, it is important or the Chief Audit Executive to develop a process that captures the relevant observations, agreed corrective action, and current status.

For Outstanding Observations, the Information Tracked and Captured Typically Includes:

- The Observations communicated to management and their relative risk rating
- The nature of the agreed corrective actions
- The timing/deadlines/age of the corrective actions and changes in target dates
- The management/process owner responsible for each corrective action
- The current status of corrective actions, and whether internal audit has confirmed the status

3 LINES OF DEFENSE MODEL

1ST LINE OF DEFENSE

OPERATIONAL MANAGEMENT

2ND LINE OF DEFENSE

INTERNAL MONITORING & OVERSIGHT FUNCTIONS

3RD LINE OF DEFENSE

INTERNAL AUDITOR

1st LINE OF DEFENSE – OPERATIONAL MANAGEMENT

1st Line of Defense

Management Controls	Internal Control Measures

Risk Owners, PEC Employees, Own and Manage Risk and Control Management Controls and Internal Control Measures

Risk Assessment

6. Specifies suitable objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change

Control Activities

10. Selects and develops control activities
11. Selects and develops general controls over IT
12. Deploys through policies and procedures

Information & Communication

13. Uses relevant information
14. Communicates internally
15. Communicates externally

Monitoring Activities

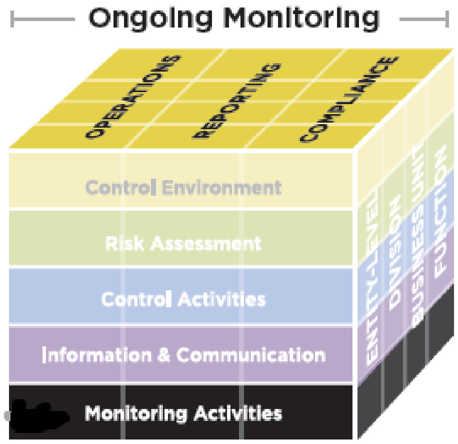
16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficienci

2nd LINE OF DEFENSE – INTERNAL MONITORING & OVERSIGHT FUNCTIONS

Risk Management, Inspection, Control, and Compliance – Compliance Officer, Quality Manager and others assigned to support compliance reporting, investigate potential wrongdoing, or perform other duties related to integrity and ethical values.

Monitoring Activities

16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies



2nd Line of Defense

- Financial Control
- Security
- Risk Management
- Quality
- Inspection
- Compliance

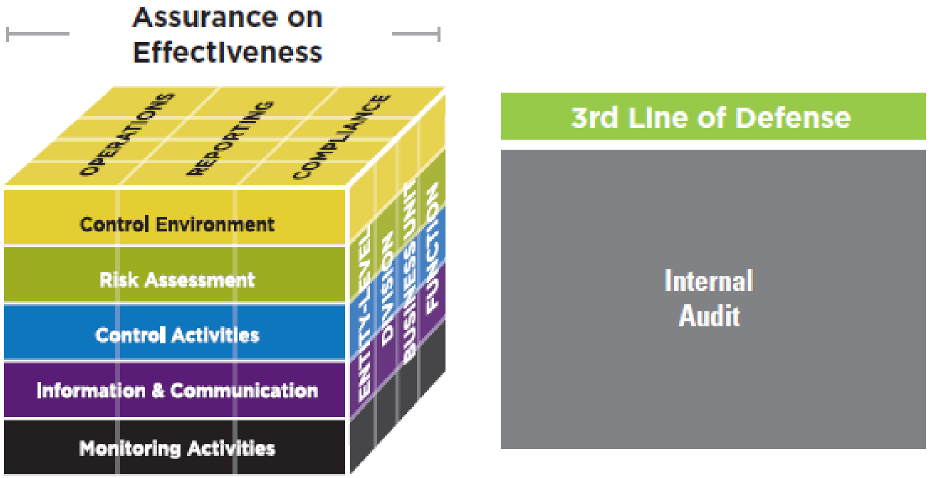
TYPICAL 2ND LINE FUNCTIONS INCLUDE SPECIALTY EXPERTISE GROUPS SUCH AS:

- ✓ Risk Management
- ✓ Information Security
- ✓ Financial Control
- ✓ Physical Security
- ✓ Quality
- ✓ Health and Safety
- ✓ Inspection
- ✓ Compliance
- ✓ Legal
- ✓ Environmental
- ✓ Supply Chain
- ✓ Other (industry/company specific)

The composition of the second line can vary significantly depending on the organization's size and industry.

3rd LINE OF DEFENSE – INTERNAL AUDITOR

Assess, Evaluate, Provide Independent Assurance to the Board and Senior Management, and Provide Consulting. Does not have any management functions.



MODEL AUDIT CHARTER

Purpose is to assist the Board of Directors in fulfilling its oversight responsibilities for the financial reporting process, the system of internal controls, the audit process, and the Co-op's process for monitoring compliance with laws and regulations and the code of conduct.

- The Audit Committee has the authority to conduct or authorize investigations into any matters within its scope of responsibility
- The Audit Committee will consist of at least three (3) and no more than six members of the Board of Directors. The Board or its nominating committee will appoint committee members and the committee chair
- Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert", as defined by applicable legislation and regulation
- The Audit Committee will meet at least four (4) times a year, with authority to convene additional meetings, as circumstances require

PEDERNALES ELECTRIC COOPERATIVE

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