



Chartered Institute of
Internal Auditors

21st January 2014

Catherine Woods
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

E-mail to riskreview@frc.org.uk

Dear Ms Woods

FRC CONSULTATION ON DRAFT GUIDANCE TO THE DIRECTORS OF COMPANIES APPLYING THE UK CORPORATE GOVERNANCE CODE AND ASSOCIATED CHANGES TO THE CODE

Please find attached the response of the Chartered Institute of Internal Auditors (IIA) to the above consultation, which was launched in November 2013.

In general we are content with the thrust of the proposed amendments. However:-

We believe that boards and audit committees need to be given a clearer understanding in both the Code and the Guidance of how boards should be supported in their role in challenging the executive on strategic risk, risk management, governance and internal control, and in particular the position of internal audit within the organisational structure in providing this support .

This reflects recent developments in understanding the role and position of internal audit, most notably in the IIA Financial Services Code published in July 2013 <http://www.iaa.org.uk/fscode>. This Code was welcomed by the financial regulators, who commented. In exercising their supervisory judgement, the regulators will consider the nature and extent of compliance with the guidance in any assessment of internal audit effectiveness within regulated firms". The Chairman of the independent Committee that drafted the recommendations in the Code, Roger Marshall, noted "We hope that some of the recommendations will be useful outside the financial services sector". He recommended that the FRC should consider whether additional guidance is needed on what should be expected from a good Internal Audit function.

We understand that, at present, there are no concrete plans to review the Guidance on Audit Committees (formerly Smith Guidance) in the near future, although the recommendations of the

Competition Commission on the rotation of external audit may cause the next review to be brought forward.

We believe that the current Guidance on Audit Committees, while it usefully fleshes out the relationship between the committee and the internal audit function, should in future give boards or their audit committees more specific advice on the role of internal audit and the potential support it offers them, and we look forward to the opportunity to contribute to that review.

We are happy for our consultation response to be published.

Yours sincerely

A handwritten signature in black ink, appearing to read 'I Peters', written in a cursive style.

Dr Ian Peters
Chief Executive

IIA RESPONSE TO THE FRC CONSULTATION ON DRAFT GUIDANCE TO THE DIRECTORS OF COMPANIES APPLYING THE UK CORPORATE GOVERNANCE CODE AND ASSOCIATED CHANGES TO THE CODE

About the Chartered Institute of Internal Auditors

1. Established in the UK and Ireland in 1948, the Chartered Institute of Internal Auditors (IIA) has over 8,000 members. It is the only professional body dedicated exclusively to training, supporting and representing internal auditors in the UK and Ireland. We are part of a global network of 185,000 members in 190 countries.
2. Members of the IIA work in all sectors of the economy: private business (including most FTSE 100 organisations), government departments, utilities, voluntary sector organisations, local authorities, and public service organisations such as the National Health Service. All members work to the same global International Standards and Code of Ethics, which are part of a globally agreed International Professional Practices Framework.
3. The IIA offers a postgraduate level professional qualification in two stages, leading to the designation "CMIIA" (Chartered Internal Auditor), with an ongoing requirement for professional development and adherence to professional standards.

What is internal audit?

4. All organisations face risks in everything they do. It is the role of senior management and the board to put in place frameworks and processes to manage all types of risks and to monitor how successful they are at managing them. Internal audit provides assurance to the board on the effectiveness of these frameworks and processes.
5. To perform their role effectively, internal auditors must build strong relationships with line managers, audit committee chairs and members, chief executives and board chairmen. These relationships enable the internal auditor to champion effective risk management, challenge those responsible for it on its success and use their knowledge of the business and the management of risk to act as a catalyst for improvement in an organisation's risk management practices.
6. Internal audit is a function that belongs to the organisation and sits within the governance structure; but it must be independent of the areas it evaluates and internal auditors must be free from undue influence from management, or indeed, anyone else, so that their judgments can be as objective as possible. To help safeguard their objectivity and independence, the head of internal audit should report directly to the audit committee
7. Internal audit is essential to the long term success of an organisation. This is because, alongside non-executive directors, executive management and external audit, internal audit is one of the four cornerstones of good corporate governance. Without it, the board would lack information and insight into how well the people within the organisation are managing their risks.

COMMENTS ON THE PROPOSED REVISIONS TO THE UK CORPORATE GOVERNANCE CODE

Reference

“The proposed revisions to Sections C.1 and C.2 of the Code are set out in full on the next page. The FRC would welcome views on whether the additions are required and, if so, on the detailed wording; and on whether the existing Provision C.1.3 (on the going concern statement) should be removed.”

Discussion

The importance of an independent and objective source of advice and assurance, separate from the management of a company, is so fundamental to board effectiveness that the IIA believes it needs to be expressed explicitly in the Code. We believe it is vital for Boards to reassure stakeholders not only that they have assessed the principal risks, but that their views have been informed and supported by advice that is independent of the executive. In this context, we believe that the Code also needs to address the question of who, independent of management, can support the board in its annual assessment of principal risks facing the company, the ongoing monitoring of risk management and internal control, and the annual review of their effectiveness. We believe the position of internal audit in fulfilling that role should be mentioned in the Code, hence our proposed amendment to C.2.1. below.

When outlining the role of the audit committee in respect to internal audit we believe it is important to stress the importance of the board establishing and preserving the independence and objectivity of the function so that it can provide the support needed by the board. The audit committee should also concern itself with the quality of the function, judging its performance against the International Standards for the Professional Practice of Internal Auditing. Although this consultation does not cover C.3 of the Code we believe changes need to be made there too. We propose that the first sentence of C.3.6 be amended as below.

Suggested changes

*“C.2.1. The board should carry out a robust assessment of the principal risks facing the company, including those that would threaten its solvency or liquidity. In the annual report the directors should confirm that they have carried out such an assessment, **including the extent to which the information on which the board places reliance is independently validated, for example by an internal audit function**, and explain how the principal risks are being managed or mitigated. They should indicate which, if any, are material uncertainties in relation to the company's ability to adopt the going concern basis of accounting.”*

*“C.3.6. The audit committee should monitor and review the effectiveness of **the internal audit function, activities, ensuring that it follows the International Standards for the Professional Practice of Internal Auditing, is independent from the company's management and able to make objective judgements.**”*

COMMENTS ON THE PROPOSED REVISIONS TO THE GUIDANCE TO DIRECTORS ON RISK MANAGEMENT, INTERNAL CONTROL AND THE GOING CONCERN BASIS OF ACCOUNTING

We believe that it is an anomaly that C.3.2 and C.3.6 of the Corporate Governance Code require the audit committee to monitor and review the effectiveness of the company's internal audit function but the Guidance does not give advice about what that function should be. We believe that this needs to be covered in the Guidance to Directors, in particular the role of internal audit (where this exists) in providing independent and objective advice to the board and its committees on strategic risk, governance, risk management and internal control.

Some of the elements that contribute to internal audit's achieving independence and objectivity are covered in the guidance on the role of audit committees. But even there the issue is only mentioned in passing in the section on using external auditors to undertake internal audit functions.

Reference

"The primary focus of the current guidance, reflecting the content of the Code at that time, is the board's role in establishing and monitoring the effectiveness of the internal control system. There is some reference to the board's other responsibilities for risk, in particular that "In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:

- ☐ the nature and extent of the risks facing the company;*
- ☐ the extent and categories of risk which it regards as acceptable for the company to bear;*
- ☐ the likelihood of the risks concerned materialising;*
- ☐ the company's ability to reduce the incidence and impact on the business of risks that do materialise; and*
- ☐ the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks".*

*The draft revised guidance seeks to address these aspects of the board's responsibilities in more depth. **The FRC would welcome views on whether the draft revised guidance achieves these objectives, and on the structure of, and level of detail in, the draft revised guidance.**"*

Discussion

We believe that the proposed revisions to the Guidance achieve the objective of alerting boards to the scope of their work on risk management and internal control, but do not adequately cover the need for them to receive accurate and independent information and advice to support their role of challenging the executive, and how they source that. Our following suggested changes to paragraphs 36, 37 and 40 address this need.

Reference

"Sections 2 to 4 of the draft revised guidance elaborate on the references in the current guidance, and respectively address the board's responsibilities for managing the principal risks facing the

company, the factors that boards should consider in order to exercise those responsibilities effectively, and how risks are assessed.

Sections 5 and 6 of the draft revised guidance address the design and process for reviewing the risk management and internal control system. They are largely unchanged from sections 2 and 3 of the current guidance (“Maintaining a sound system of internal control” and “Reviewing the effectiveness of internal control”), which the FRC considers remain fit for purpose. **Do you agree or are more substantive changes to these sections required?”**

Discussion

As noted above we believe that the current Guidance does not adequately reflect internal audit’s key role in providing objective assurance and advice to the board on risk and control. At present the Guidance says that:

“Management is accountable to the board for monitoring the system of internal control and for providing assurance to the board that it has done so”.

and only mentions internal audit in the context of the board’s annual assessment thus:

“31 The board's annual assessment should, in particular, consider:

- the scope and quality of management's ongoing monitoring of risks and of the system of internal control, and, where applicable, the work of its internal audit function and other providers of assurance;”*

While management has primary responsibility for setting up and operating the risk and internal control systems and providing information to the board on their workings and outcomes, the board still needs from internal audit and/or other providers separate assurance on the effectiveness of the systems that is independent of management.

The revised draft Guidance repeats this formulation in paragraph 40.

We believe that the current wording is misleading for boards and that the respective roles of management and independent sources of assurance such as internal audit need to be spelt out more clearly in the revised draft thus:

Suggested changes

*“36. Effective monitoring on a continuous basis is an essential component of a sound system of risk management and internal control. The board should form its own view on effectiveness based on the evidence it obtains, exercising the standard of care generally applicable to directors in the exercise of their duties. The board should define the processes to be adopted for its on-going scrutiny. This should encompass both the scope and frequency of the reports it receives and reviews during the year. **The board should rely not only on management for its information but commission independent and objective advice and assurance, for example from an internal audit function.***

*37. The regular reports to the board from management, and other **more independent and objective sources** of information and assurance **such as internal audit**, should between them provide a balanced assessment of the principal risks and the effectiveness of the system of risk management and internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the underlying reasons, the*

impact that they have had, or may have, on the company and the actions being taken to rectify them.”

40. The annual assessment should, in particular, consider:

.....

- ***the scope and quality of management's on-going monitoring of risks and its administration of the systems of risk management and internal control, and, where applicable, the work of internal audit function and other sources of assurance***
- ***the work of the board's independent sources of advice and assurance such as the internal audit function.***

Reference

“Section 7 of the draft revised guidance concerns the information boards are expected to disclose in the annual report and accounts. It covers reporting on principal risks and uncertainties in the Strategic Report – the text of this section is consistent with that in the FRC’s draft guidance on the Strategic Report, on which we are currently consulting - and reporting on going concern in the financial statements. The FRC considers that companies should make an explicit link between these two disclosures; its proposals for how this might be done are set out in the following sections of this consultation document.

Section 7 also includes guidance on the statement on the review of the effectiveness of the risk management and internal control systems, as required in order to comply with the Code and covered in the 2005 guidance. The FRC is proposing a change to the current guidance in relation to significant failings or weaknesses identified during the review.

*In 2005, a recommendation was added to the guidance that companies should “confirm that any necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from [the] review”. The intention behind this change was to encourage greater transparency about the outcomes of the review without placing companies in a position where they were asked to certify that the internal control system were effective. Many companies have simply cut and pasted the sentence from the guidance into their internal control statements. On its own, this does not indicate whether or not any significant failings or weaknesses have been identified. The FRC therefore proposes to amend the guidance to recommend more explicitly that the board should “explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review”. **The FRC would welcome views on this proposed change to the guidance.**”*

Comment

We can support this.

Reference

“Appendix A of the guidance summarises the relevant sections of the Code and other regulatory requirements of which directors should be aware, and updates the material in the introduction to the

current guidance. Appendices B and C provide further guidance on how to assess and report on the company's solvency and liquidity risks and their impact on determining whether the going concern basis for preparing the financial statements is appropriate and whether there are any material uncertainties thereto; these relate to Lord Sharman's recommendations and are accordingly discussed in more detail in the next section of this document, which sets out the questions for consultation.

Appendices D and E contain questions which boards may wish to consider in applying the guidance, and indicators that may assist them in assessing how they are carrying out their responsibilities, the culture of the company, and the effectiveness of the risk management and internal control system. Appendix D is an updated version of the appendix to the existing guidance, while Appendix E is new. The FRC would welcome views on whether these appendices are of use to directors and, if so, how they might be improved. "

Discussion

We recognise that the list of questions in Appendix D is not supposed to be exhaustive. In the section on "The risk management and internal control system" the appendix asks about the sources of assurance the board relies on and their effectiveness. We suggest that the sections on "Risk appetite and culture" and "Risk assessment" also need to ask the board whether it is receiving independent and objective information and advice that allows it to challenge management, who is giving it that information and advice, and what its quality is.

Suggested changes

Risk appetite and culture - Add after third bullet:

- **"Is the board receiving high quality independent and objective advice and support, for example from the internal audit function, that enables it to understand and challenge the information on risk being provided by management?"**

The risk management and internal control system – Amend fifth bullet to read:

- **"What sources of assurance does the board rely on? *Are they independent and objective, and operating according to the relevant international professional standards?* How has it assessed their effectiveness?"**

We believe that Appendix E is a valuable addition to the Guidance and hope that the FRC will retain it. Some more pointed questions to boards and committees on the independence and objectivity of the advice they are receiving would however be useful in helping them to assess how they are carrying out their duties.

Suggested changes

In Appendix E we suggest adding a new warning sign to the section on "Effectiveness of the board and committees" – indicators that might suggest failures or weaknesses.

"A lack of independent information and advice to the board from sources other than management that would allow the board to challenge strategies and decisions."

We suggest adding a new warning sign to the section on "The right culture":

“A culture that prevents assurance functions, such as internal audit, having unrestricted scope in assessing governance, risk management and controls, and a position in the company that prevents or discourages them from challenging senior management.”

We suggest adding a new warning sign to the section on “Effectiveness of the risk management and internal control system”:

“Internal audit and other assurance functions that are not operating according to the relevant international professional standards, appropriately positioned within the governance framework, adequately resourced, or properly structured to be able to meet their responsibilities to provide independent support and advice to the board.”

For follow up discussion, please contact:

David Lyscom, Policy and Technical Director. Email: david.lyscom@iaa.org.uk Tel: 02073409945