

IPPF – Practice Guide

INTERACTION WITH THE BOARD

AUGUST 2011

Table of Contents

Executive Summary.....	1
Introduction	1
1000 – Purpose, Authority, and Responsibility	1
Internal Auditing’s Relationship with the Board.....	3
A. Frequent Communication with Board Members Between Meetings	3
B. Communicating Sensitive Matters.....	4
C. International and Industry Considerations.....	5
D. CAE Turnover.....	5
Communicating through a Risk-based Audit Plan	5
Board Reporting	6
A. Key Focus Areas	6
B. System of Internal Control.....	7
C. Status of Audit Plan and Audit Resources	7
D. Distribution of Audit Reports.....	7
E. Fraud/Investigations	7
F. Open Audit Issues	8
G. Quality Assessments.....	8
H. Board Education Opportunities	8
Administration and Coordination of Board Activities	8

Executive Summary

Boards and internal auditors have interlocking goals. A strong working relationship between the two is essential for the internal audit activity to fulfill its responsibilities to not only the board, but also senior management, shareholders, and other stakeholders, as appropriate. The chief audit executive (CAE) often reports directly to the board, depending on the organization's governance structure. An effective internal audit activity provides the board assurance and suggests improvement opportunities related to the organization's governance, risk management, and related internal controls. Board responsibilities encompass activities that are beyond the scope of this guide, and in no way is this guide intended to be a comprehensive description of those responsibilities.

There are several activities, primarily accomplished through the CAE, that are key to an effective relationship between the board and the internal audit activity:

- Maintaining effective communication with the board and the chair, including communicating openly and candidly with the board.
- Developing a risk-based audit plan that meets the relevant objectives of the board charter and communicating the internal audit activity's performance relative to the plan.
- Formally and informally reporting to the board regularly and timely.
- Assisting the board in ensuring that its charter, activities, and processes are appropriate to fulfill its responsibilities.
- Ensuring that internal auditing's charter, role, and activities are clearly understood and responsive to the needs of the board.
- Assisting the board in understanding changes in the regulatory and business environment relating to

governance, risk management, compliance, and related internal controls.

Introduction

The purpose of this practice guide is to assist the chief audit executive (CAE) in meeting the requirements of the International Professional Practices Framework (IPPF) as it relates to interacting and communicating with the board. The IPPF's Glossary defines the board as "an organization's governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees of a nonprofit organization, or any other designated body of the organization, including the audit committee to whom the chief audit executive may functionally report."

The IPPF outlines the following International Standards for the Professional Practice of Internal Auditing (Standards), the Practice Guides, and the Practice Advisories pertaining to interacting and communicating with the board:

1000 – Purpose, Authority, and Responsibility

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

1100 – Independence and Objectivity

The internal audit activity must be independent, and internal auditors must be objective in performing their work. This can be achieved through a dual-reporting relationship.

1110 – Organizational Independence

The CAE must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The CAE must confirm to the board, at least annually, the organizational independence of the internal audit activity.

1111 – Direct Interaction with the Board

The CAE must communicate and interact directly with the board.

Practice Guide: Chief Audit Executive – Appointment, Performance Evaluation and Termination.

The CAE will have a high degree of interaction with senior management and the board and thus needs to demonstrate the right attributes and skills for the position.

1300/1310 – Quality Assurance and Improvement Program

The CAE must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity. The quality assurance and improvement program must include both internal and external assessments.

2020 - Communication and Approval

The CAE must communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and the board for review and approval. The CAE must also communicate the impact of resource limitations.

Practice Advisory 2020-1 – Communication and Approval

1. The CAE will submit annually to senior management and the board for review and approval a summary of the internal audit plan, work schedule, staffing plan, and financial budget. This summary will inform senior management and the board of the scope of internal audit work and of any limitations

placed on that scope. The CAE will also submit all significant interim changes for approval and information.

2. The approved engagement work schedule, staffing plan, and financial budget, along with all significant interim changes, are to contain sufficient information to enable senior management and the board to ascertain whether the internal audit activity's objectives and plans support those of the organization and the board and are consistent with the internal audit charter.

Standard 2060 – Reporting to Senior Management and the Board

The CAE must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board.

Practice Advisory 2060-1 – Reporting to Senior Management and the Board

The frequency and content of reporting are determined in discussion with senior management and the board and depend on the importance of the information to be communicated and the urgency of the related actions to be taken by senior management or the board.

2420 – Quality of Communications

Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

Practice Advisory 2420-1 – Quality of Communications

1. Gather, evaluate, and summarize data and evidence with care and precision.
2. Derive and express observations, conclusions, and

recommendations without prejudice, partisanship, personal interests, and the undue influence of others.

3. Improve clarity by avoiding unnecessary technical language and providing all significant and relevant information in context.
4. Develop communications with the objective of making each element meaningful but succinct.
5. Adopt a useful, positive, and well-meaning content and tone that focuses on the organization's objectives.
6. Ensure communication is consistent with the organization's style and culture.
7. Plan the timing of the presentation of engagement results to avoid undue delay.

2440 – Disseminating Results

The CAE must communicate results to the appropriate parties.

Practice Advisory 2440-2 – Communicating Sensitive Information Within and Outside the Chain of Command

Once the internal auditor has deemed the new information substantial and credible, he or she would normally communicate the information — in a timely manner — to senior management and the board.

Internal Auditing's Relationship with the Board

A strong relationship between internal auditing and the board enhances the internal audit activity's ability to accomplish the objectives defined in the audit charter. The CAE generally is the primary conduit for developing and maintaining that relationship; however, other members

of the internal audit activity also may contribute through participation at board meetings and in preparing materials for the board. Furthermore, the entire internal audit activity contributes to the relationship by thoroughly and professionally executing projects and analyzing the results of those projects. A strong relationship is based on trust and credibility that should grow and strengthen through timely and relevant interactions and communications.

The CAE and board should establish a clear understanding of the expectations of the internal audit activity. These expectations are formally presented in the board and internal audit activity charters and annual plans, which should be periodically reviewed and approved. Most boards have additional expectations that evolve based on company performance, industry trends, and perspectives held by each board member. The CAE should understand these expectations so that he or she can take the appropriate steps to meet them. The tasks and responsibilities of a CAE from one organization to another vary widely based on the organization's governance structure and the nature of the CAE's functional reporting relationship to the board.

A. Frequent Communication with Board Members Between Meetings

Clear, relevant, and frequent communication between the CAE and members of the board is essential. Due to the complexity and significance of today's business and related risks, frequent discussions with the chair and other members of the board may need to supplement regular formal board meetings and communications. Depending on the organizations and individuals involved, it may be best for the communications to follow a predefined protocol, such as:

- Regular meetings with individual board members with a pre-set agenda.
- More frequent meetings between the board chair and CAE depending on the issues facing the organization and the preferences of the chair.

- Periodic communications on relevant issues.

In many organizations, the relationship between the CAE and board members is very cohesive, which tends to lead to more ad-hoc communications — not just about critical issues but also less pressing issues as well. Many CAEs find the interaction with board members on routine business issues to be helpful to building a relationship as a trusted business advisor and in maintaining awareness of what's going on in the organization.

- Regardless of the communication media used, basic guidelines include:
- Make sure information is timely, relevant, fact based, balanced, objective, and complete.
- Consider formality and tone of communications to ensure they are appropriate.
- Avoid making presumptuous comments without sufficient facts.
- Consider the repercussions that commentary on control weaknesses and other management failures can create.
- Document communications if required for professional or business reasons.
- Do not wait until there is a need to address a sensitive or contentious issue to start building a strong relationship with the board.
- Manage potential conflict between the board and management in accordance with the responsibilities established in the internal audit charter.

Standard 2420 – Quality of Communications and the related Practice Advisory 2420-1 – Quality of Communications provides guidance for good communications to the board whether in a formal meeting setting or a less formal face-to-face meeting.

B. Communicating Sensitive Matters

The necessity to deal with sensitive issues such as senior management's failure to manage strategic and/or opera-

tional risk, as well as ethically questionable behaviors and actions (including fraud) could arise at any time. Consequently, the CAE must possess highly developed oral and written communication skills to convey information to all concerned stakeholders in a timely and appropriate fashion. Effective communication of sensitive issues depends on the establishment of effective formal and informal communication channels and strong relationships with management and board members that are based on trust and credibility.

Depending on the facts and circumstances of the sensitive issue, the CAE should consider consulting with key members of management such as the general counsel (head of legal department). The following basic guidelines should be considered:

- Facts and details are available and documented.
- Findings can be verified and opinions and conjecture are clearly articulated as such.
- Communication is timely and urgent (and truly of a sensitive nature).

The CAE may be faced with a situation where management attempts to delay reporting of an issue, leaves out some or all of the critical elements, or disagrees that the issue should be reported to the board. The CAE should carefully consider the significance of such issues and determine to what extent the issue should be elevated. The CAE should also consider his or her obligations with respect to the IIA's Code of Ethics, the internal audit charter, the organization's code of conduct, and applicable laws and regulations. The best approach will depend on the sensitivity and complexity of the issue, the culture of the organization, the governance structure, and applicable laws/regulations.

When it is determined that a sensitive issue should be elevated, it is essential that the CAE communicate directly with the board chair or similar person of authority depending on the governance structure. Communica-

tion, especially on significant or sensitive issues, is best handled when based on a professional, trusted relationship with the chair and other board members. The CAE should prepare documentation of the communication that includes relevant support. The CAE should recognize that formal or informal discussions of sensitive issues with individuals other than the chair might jeopardize the CAE's credibility with the chair and indirectly with other members of the board and management.

The *Practice Advisory 2440-2 – Communicating Sensitive Information Within and Outside the Chain of Command* provides additional guidance.

C. International and Industry Considerations

Governance and ownership structures differ from country to country and among industries. In some countries, there exists a two tier board system that differentiates between the supervisory function (supervisory board) and the operative management function (board of management). In such cases, the internal audit activity may not report directly to the board, but to the owner or even to senior management, such as the chief executive officer or financial officer or chief operating officer. Although basic organizational structures vary, the principles and practices outlined in this Practice Guide are still relevant. Most statements referring to the “board” in this practice guide should then be interpreted as the executive to whom the CAE reports (disciplinary / administratively). In addition, there should be a defined reporting relationship to the supervisory board. In most cases, the audit committee is the subcommittee of the supervisory board. Reporting to the audit committee should be coordinated with the executive to whom the CAE reports (if not the CEO) and the CEO.

The CAE should also ensure that the IIA activity appropriately coordinates with other internal functions, such as regulatory compliance, law, human resources, security and others.

D. CAE Turnover

The board typically has oversight of the turnover of the CAE, if not the responsibility to approve/direct the departure of a CAE and the hiring of a replacement. The role of the board in this activity helps ensure the CAE's independence and that he or she has the competencies necessary to perform in the position.

When first appointed to this position, or exiting this position, the CAE should work closely with the board to ensure complete transparency as to the reasons for the change.

The *Practice Guide: Chief Audit Executive – Appointment, Performance Evaluation and Termination* provides additional guidance.

Communicating through a Risk-based Audit Plan

One of the most important aspects of interacting with the board is gaining their confidence that the internal audit activity is fully engaged with senior management across the organization to monitor and mitigate risks, alert to emerging risks, aligned with stakeholders on risk view, and has an audit plan that demonstrates how Internal Audit is assisting the board in meeting their responsibilities for oversight of risk management, compliance, and related internal controls.

An audit plan can be a framework and mechanism for communication to the board as the CAE should provide the board with regular updates on its work and the status of the audit plan. The board should approve the audit plan and contribute to its development.

The CAE should use risk assessment techniques in developing the internal audit activity's plan and in determining

priorities for allocating internal audit resources. Risk assessment is used to select areas to include in the internal audit activity's plan. Also, the CAE should seek guidance on what the board and the company considers important to assist in assessing risks, prioritizing projects and allocating audit resources.

A significant part of laying the groundwork for preparation of a risk-based audit plan is having an understanding of the risk appetite of your primary stakeholders – generally the board and senior management. Risk appetite is the level of risk that the stakeholders are willing to accept in the course of doing business. It is a key factor in developing a risk-based audit plan. Understanding the risk appetite can be achieved by reviewing the organization's risk management philosophy or risk policy; holding discussions with the group responsible for risk management, the board, and senior management; and, with respect to financial reporting risk, meeting with the chief financial officer and the external auditor. The CAE incorporates these inputs, develops the audit plan, and presents the proposed audit plan to management for review and the board for approval.

Regularly, e.g. quarterly, brief discussions with the board on risk themes, their continued relevance, and emerging risks should be held. A review/update of the audit plan may be necessary to ensure that it continues to include the most relevant risks. The board should also understand which significant risks are not addressed, and whether sufficient resources are available to meet requirements. In short, the board needs to understand how Internal Audit is assisting the board to meet its responsibilities.

For further information on leveraging Enterprise Risk Management into the audit planning process, see PA 2010-2: Using the Risk Management Process in Internal Audit Planning (July 2009) and PA 2050-2: Assurance Maps (July 2009).

Board Reporting

The board, like everyone else, has limited time and increasing responsibilities. The CAE's communication, handouts, and reports to the board should be risk-focused. A good guideline for interacting with the board is to understand where its interests lie and to set expectations to report on those areas on an exception basis. Additionally, the reporting requirements of the internal audit charter should be considered.

For formal board meetings, all parties can be better served if read-only materials are relevant, complete, and risk-based, leaving the face-to-face meeting time for further discussions of meaningful items or questions.

Listed below are areas to consider for formal board communications.

A. Key Focus Areas

Key focus areas are a combination of critical matters that warrant board attention — the risk themes established during audit planning, any emerging risk themes that come up during the year, and issues related to special assignments. The CAE should ensure that communications are appropriately calibrated to enable the board to understand the severity or significance of issues.

The board should be kept current on what has been done: results to date, improvement plans, progress against improvement plans, current assessment of the risk area, and what has been planned in all key areas/themes.

Although this document advocates limiting reporting to the board to significant items and on an exception basis, the board needs insight into what is going on throughout the organization, even in lower risk areas. Today's developing trend may be tomorrow's emerging risk issue. Trend analysis of audit results can often reveal areas where management attention is warranted, and only a slight change

in emphasis may stop a trend from becoming an emerging issue.

B. System of Internal Control

One of the elementary measures of the fundamental soundness of an organization is the maturity and efficacy of the system of internal control. Similar to trends, internal auditing's analysis of and thoughts on the system of internal control can serve to both keep the board informed and provide the impetus for management to draft and implement improvements. It is particularly important for management, through effective monitoring activities, to ensure that the system of internal control continues to operate effectively over time. Internal audit should report to the board on the effectiveness of monitoring activities undertaken by management.

The CAE should understand if the board values an opinion on governance, risk management, and internal controls and the scope of work required to provide such assurance.

C. Status of Audit Plan and Audit Resources

The CAE should discuss the status of the audit plan with the board on a regular basis. The CAE should inform the board of changes to the audit plan and the rationale behind them. The CAE and the board should establish an understanding regarding changes to the plan and the protocol for seeking board approval of such changes. Generally changes to the audit plan should be expected, depending on the dynamics of each organization and changes in its industry and operating environment.

The audit plan may contemplate internal auditing's participation in organization initiatives in an advisory or consulting capacity. In such cases, the board should be aware of the scope of these projects, and the CAE should determine the most appropriate content for reporting to the board. Such reporting should consider addressing the nature of these services in the context of the internal au-

dit activity's charter and the impact on independence and objectivity.

The CAE should also discuss the internal audit activity's ability to complete the audit plan, including whether internal auditing has appropriate resources and whether management has imposed any scope limitations on the work of the internal auditors. Additionally, the CAE should provide the board with visibility into qualifications of the audit personnel so it can evaluate whether adequate resources are allocated to the activity.

D. Distribution of Audit Reports

The decision to distribute audit reports to the board depends on board preferences. The CAE should, however, provide the board with an explanation of the scope and findings of the audits performed. This could be accomplished by providing the board with the audit reports, an executive summary of each audit, or a summary of the findings on a periodic basis. The CAE should consider the input of senior management and consult with the board to determine the most appropriate approach to providing this information.

E. Fraud/Investigations

Fraud/Investigations are often the responsibility of the internal audit activity. In such a situation, internal auditing should bring to the attention of the board fraud/investigations of a significant nature, or those including personnel who are critical to the control structure. The CAE should understand the board's expectations regarding the types of investigations and depth of information that should be communicated.

The board should be aware (similar to Key Focus Areas) of the nature of a potential incident, what is being done to investigate and understand both the impact of the incident and ultimately what allowed it to occur, corrective action plans and implementation progress, and disciplinary actions.

F. Open Audit Issues

Although management is generally responsible for resolving issues, in accordance with IIA Standard 2500 – Monitoring Progress, the internal audit activity should monitor the resolution of open audit issues. Significant open audit issues that are not expected to be resolved on schedule, or have fallen behind their due date, should be reported to the board along with a recovery plan and a view as to the viability of the recovery plan. Future meetings should include a report on monitoring of the progress of the improvement plan.

G. Quality Assessments

The internal audit activity should develop an appropriate internal assessment program and should identify appropriate Key Performance Indicators (KPIs). KPIs of the internal audit activity provide a platform to discuss issues relative to the internal audit activity and potentially gain board support in making necessary changes. Establishment of KPIs should be done in a group that includes senior management, as well as the board, and there should be consensus that the KPIs chosen are meaningful and appropriate.

In addition to being a driver in the discussion of issues relative to the department, KPIs are relevant in the evaluation of the CAE's performance. Once the KPIs are understood and agreed to by the board, frequent reporting of actual versus desired performance with detailed explanations is essential. In cases where the relevant KPIs cannot be met, timely notification to the board should be prepared and include:

- Type of performance indicator involved.
- Discrepancy between desired performance and actual performance.
- Reason for the divergence.
- Plans for closing the gap.

The KPIs should provide some indication as to improve-

ments being made to the internal audit activity resulting from the KPI analysis. Also, results of the external and internal assessments (as referred to in IIA Standard 1300) should be communicated to the board, and the CAE should indicate how the recommendations will be implemented. Additional information on developing and using KPIs as part of an internal assessment program (IIA Standard 1311) can be found in the Practice Guide, Measuring Internal Audit Effectiveness and Efficiency.

H. Board Education Opportunities

The CAE can play a critical role in ensuring that the board is aware of current topics to help it accomplish its obligations as described in its charter. The CAE should consider the needs of the board by helping it stay current on issues that impact its ability to accomplish its duties, such as assisting the board in understanding changes in the regulatory and business environment relating to governance, risk management, compliance, and related controls. The CAE should consider providing the board with relevant educational materials to help it understand the risks of its environment (e.g., industry risks, regulatory changes, accounting rule changes).

Administration and Coordination of Board Activities

The CAE may play a direct role as a valued adviser to the board by assisting with its administrative and governance responsibilities, reviewing its activities, and suggesting enhancements. Examples of activities that the CAE can undertake, depending on the governance structure of the organization, are:

- Encourage the board to conduct periodic reviews of its activities and practices to evaluate whether its activities are a) accomplishing the board's charter, and b) consistent with leading practices. This may

involve facilitating a self-assessment using surveys, benchmarking against external guidelines, etc.

- Review the charter for the board at least annually and advise the board whether the charter addresses all the responsibilities expected by relevant regulatory bodies.
- Maintain a planning agenda for board meetings that details all required activities to ascertain whether they have been completed and facilitates reporting to the board annually that it has completed all required duties.
- Draft the board meeting agenda for the board chair, or equivalent, facilitate distribution of the material to the board members, and review or prepare the minutes of the board meetings.
- Meet periodically with the board chair, or equivalent, to discuss whether the materials and information being furnished to the board are meeting its needs.
- Work with the board to determine if any educational or informational sessions or presentations would be helpful; for example, sessions on risk and controls for new board members or updates on regulatory changes impacting board responsibilities.
- Inquire of the board whether the frequency of the meetings and the time allotted to the board are sufficient.
- Review with the board the functional and administrative reporting lines of the internal audit activity to ensure that the organizational structure in place allows adequate independence for internal auditors in accordance with IIA Standard 1110.
- Assist the board in evaluating the adequacy of the audit personnel and budget, and the scope and results of the internal audit activities, to ensure there are no staffing, budgetary or scope limitations that impede the ability of internal auditing to execute its responsibilities.
- Provide information on the coordination with and oversight of other control, assurance, and monitoring functions (e.g., risk management, compliance, security, business continuity, legal, ethics, environmental, and external auditing).

Authors:

Richard A. Schmidt, CIA

Kevin D. Lacy, CIA

Erich Schumann, CIA

Reviewers and Contributors

Douglas J. Anderson, CIA

James Rose, CIA

Steven E. Jameson, CIA, CCSA, CFSA

About the Institute

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

About Practice Guides

Practice Guides provide detailed guidance for conducting internal audit activities. They include detailed processes and procedures, such as tools and techniques, programs, and step-by-step approaches, as well as examples of deliverables. Practice Guides are part of The IIA's IPPF. As part of the Strongly Recommended category of guidance, compliance is not mandatory, but it is strongly recommended, and the guidance is endorsed by The IIA through formal review and approval processes. For other authoritative guidance materials provided by The IIA, please visit our website at 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.

Copyright

Copyright © 2011 The Institute of Internal Auditors. For permission to reproduce, please contact The IIA at guidance@theiia.org.



GLOBAL HEADQUARTERS

247 Maitland Ave.
Altamonte Springs, FL 32701 USA

T: +1-407-937-1111
F: +1-407-937-1101
W: www.theiia.org