Public Internal Control Systems in the European Union

Role of Audit Committees for Internal Audit in the public sector

Discussion Paper No. 4
Public Internal Control
An EU approach
Ref. 2014-4
Audit committees or comparable bodies have been set up in several EU Member States to support top management in public entities in overseeing the activities of executive management. This paper aims to fuel a discussion on how audit committees could be positioned and organised to contribute optimally to the independence and effectiveness of internal audit.
# TABLE OF CONTENTS

1. INTRODUCTION.................................................................................................................. 3

2. AUDIT COMMITTEES AND THEIR ROLE IN OVERSEEING INTERNAL AUDIT................................................................. 3
   2.1. Definition and key attributes of audit committees .................................................. 3
   2.2. Positions of international professional bodies....................................................... 4

3. TWO EXAMPLES.................................................................................................................. 5
   3.1. France .................................................................................................................. 5
   3.2. The Netherlands................................................................................................. 6

4. HURDLES TO OVERCOME WHEN SETTING UP AUDIT COMMITTEES.................................................................................. 6
   4.1. Clarifying the powers and responsibilities of audit committees ...................... 7
   4.2. Integrating audit committees in public governance.......................................... 7
   4.3. Composition of audit committees.................................................................... 7
   4.4. Administrative burden and cost of audit committees....................................... 8
   4.5. Committing Officers and governance bodies on audit committees.............. 8

5. CHALLENGES..................................................................................................................... 8
1. **INTRODUCTION**

This paper aims to fuel a discussion on how audit committees or comparable bodies could be positioned and organised to contribute optimally to the independence and effectiveness of internal audit. It provides a definition of audit committees, the positions of main professional bodies, two examples of MS practices and offers key points for peer-to-peer discussion.

Member States (MS) of the European Union (EU) have undertaken wide-ranging public management reforms in recent decades. To achieve public policy objectives efficiently and to deliver value for money, the public sector deploys performance and risk management systems. For these to be efficient and effective, a professionalised internal audit function must provide reasonable assurance and help management to improve operations.

Audit committees have been set up in about half of the EU Member States to support the top management of public entities in overseeing the activities of executive management. These strengthen the internal accountability of management. Such bodies can make a significant contribution to good public governance by reviewing and advising on risk management and internal control. They also play an important role in reinforcing the independence and effectiveness of internal audit activities, giving senior management further support to achieve the organisation's objectives.

According to the 2012 PIC Compendium\(^1\), 60% of MS say that audit committees or comparable bodies contribute to the effectiveness of internal audit activity. The others have not (yet) implemented a dedicated oversight structure even though they may have internal audit.

The Compendium reviews the current situation regarding audit committees that are in operation. However, it does not go into fine detail about implementation. The situation varies widely and poses a key question: why have half the Member States implemented audit committees within their governance system, while the other half have not?

2. **AUDIT COMMITTEES AND THEIR ROLE IN OVERSEEING INTERNAL AUDIT**

2.1. **Definition and key attributes of audit committees**

In business, an audit committee is: ‘a standing committee of the board of directors that is charged, at a minimum, with overseeing the integrity of the company’s financial reporting processes. The audit committee oversight responsibility typically includes internal and external financial reporting, risks and controls relating to financial reporting, and the internal and external audit processes’.\(^2\)

According to the Institute of Internal Auditors (IIA), the purpose of the audit committee is: ‘to assist the board of directors in its oversight responsibilities regarding financial

---

\(^1\) Compendium of the public internal control systems in the EU Member States.

reporting, risk management, internal control, compliance, ethics, management, internal auditors, and the external auditors.\(^3\)

The IIA positions audit committees as sub-bodies of the board of directors/governing body. Overseeing internal audit is, it says, one of the many important roles of audit committees.\(^4\) The IIA has published a ‘10-point oversight checklist’\(^5\) for audit committees to ensure adequate oversight of internal auditing.

### 2.2. Positions of international professional bodies

Prominent international professional bodies recognise the role of audit committees in the public sector in ensuring the independence and effectiveness of internal audit activity.

The IIA outlines that ‘audit committees can greatly strengthen the independence, integrity, and effectiveness of government audit activities by providing independent oversight of the internal (and external) audit work plans and results, assessing audit resource needs, and mediating the auditors’ relationship with the organisation. Audit committees also ensure that audit results are aired and any recommended improvements or corrective actions are addressed or resolved.\(^6\)

Where an audit committee is established, it should:\(^7\):

- Operate under a formal mandate, preferably legislation, with sufficient authority to complete its mandate.
- Include independent members who collectively possess sufficient knowledge of audit, finance, risk, and control.
- Be chaired by a member who is not the individual to whom a Chief Audit Executive (CAE) reports administratively.
- Assess the effectiveness of the organisation’s governance, risk management, control frameworks and legislative and regulatory compliance.
- Provide oversight of the organisation’s internal and external audit activities, including ensuring adequate coverage and resources, approving the internal audit charter and audit plans, reviewing the performance of audit activities, and approving the appointment or termination of internal and external auditors.
- Oversee the organisation’s financial reporting and accounting standards.
- Provide a direct link and regular reporting to the organisation’s governing board, council, or other authority.

---

\(^3\) The IIA, ‘The Audit Committee: Purpose, process, professionalism’ and ‘Model Audit Committee Charter’.


\(^5\) Cf. “The Audit Committee: Internal audit oversight” - The IIA.


\(^7\) See footnote 6.
The Committee of Sponsoring Organisations of the Treadway Commission (COSO) includes audit committee inquiries into the activities of internal auditors as regards monitoring procedures in organisations.\(^8\)

According to the International Organisation of Supreme Audit Institutions (INTOSAI), audit committees have a role to play in ensuring internal audit independence: ‘Those charged with governance (e.g. the audit committee) should safeguard the independence by approving the internal audit charter and (where applicable) the mandate.’\(^9\)

The International Federation of Accountants (IFAC) says that governing bodies in public sector entities need to ensure that an effective internal audit function is set up as part of the monitoring system. They also need to establish an audit committee, comprising non-executive members, with responsibility for carrying out independent reviews of the monitoring system and of the external audit process. The internal audit function needs to have the respect and cooperation of the governing body, management and the audit committee. The CAE should bring all significant findings arising from internal audit activities to the attention of the audit committee, and, if necessary, the governing body. He/she needs to be accountable to and/or have direct access to the chair of the audit committee or other senior non-executive director. The terms of reference\(^10\) of the audit committee need to be written and confirmed by the governing body.

3. TWO EXAMPLES

France and the Netherlands, among others, have established audit committees with responsibilities including overseeing internal audit.

3.1. France

According to the regulation on internal audit for the State public administration\(^11\) (including the public agencies), the internal audit function is set up at ministerial level. It has an audit committee and an internal audit service. In each ministry, the audit committee is the oversight body for internal audit. The committee’s responsibilities cover the full scope of public policies and the entity’s activities performed under the authority of the minister and include all associated risks. The audit committee is in charge of defining internal audit policy on the entire scope of a minister’s responsibilities. It also oversees the quality of the risk management system.

As a key governance body for internal audit, the audit committee guarantees the independence of the internal audit and the effectiveness of internal audit operations. Its role in the oversight of internal audit is focused on risk-based audit analysis, strategic and annual audit plans, audit results and performance, and follow-up of recommendations.

---


\(^11\) Regulation of the Prime Minister on internal audit within the State administration, Decree n° 2011-775 of 28 June 2011 and circular letter n°5540 of 30 June 2011.
According to the regulation, audit committees are chaired by ministers and composed of a few members; the majority of the members being external, or internal without any executive powers.

To ensure the coherence and the credibility of internal audit at state level, the Internal Audit Harmonisation Committee is in charge of an annual assessment of internal audit policy implemented by the ministries and the organisation of internal audit function (internal audit committee and internal audit service).

3.2. The Netherlands

The Minister of Finance published a new by-law\textsuperscript{12} on audit committees within central government in 2012.

In each ministry, an audit committee advises top management (SG, DGs) on operational management, risk management and the internal audit function, which is executed by the Central Government Audit Service (CGAS). Audit committees advise on matters including the annual audit plan and management responses to audit findings and recommendations.

Audit committees are functional bodies, composed of representatives of the top management and at least two independent external members. The chair of an audit committee, who may be an external or an internal member, is appointed by the minister. Ministries may opt for an audit committee consisting of external members only. At least one external member in every audit committee should have expertise in public finance. The heads of the Financial Economic Affairs Departments and a representative of the board of CGAS support the members of the audit committees in their work.

In 2014, there will be an evaluation of the way in which the by-law has been applied. There are plans to regulate the legal basis for audit committees in the Government Account Act (Basic budget law).

4. Hurdles to overcome when setting up audit committees

According to internationally recognised standards, ‘internal audit activity must be independent, and internal auditors must be objective in performing their work\textsuperscript{13}. The CAE must report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. The CAE must confirm to the board, at least annually, the organisational independence of the internal audit activity’\textsuperscript{14}.

As a practical approach, to maintain organisational independence and to enable the internal audit activity to be carried out, good practice recommends that the CAE reports functionally to the board\textsuperscript{15}.

\textsuperscript{12} Regulation of the Minister of Finance on the Audit Committees in Central Government (Regulation on Audit Committees 2012), Staatscourant No. 8252, 1 May 2012.
\textsuperscript{13} The IIA – IPPF 1100 – Independence and objectivity.
\textsuperscript{14} The IIA – IPPF 1110 – Organisational independence.
\textsuperscript{15} The IIA – IPPF 1110 – Organisational independence – Interpretation.
Two points are worth making on this.

First, international standards do not explicitly require an audit committee for internal auditing. The audit committee has emerged in the business sector as a sub-body of the board of directors. Although position papers and guidelines have been published in this field, there is still no precise, practical modus operandi proposed for setting up audit committees, especially within public entities.

Second, international standards refer to the ‘board’ in terms of a functional reporting line for internal audit. However, in public sector entities, there may not always be a ‘board’.

That is why it may not be easy to set up an audit committee in public entities. There may be several challenges when setting up this kind of oversight body for internal audit activity.

4.1. Clarifying the powers and responsibilities of audit committees

In the absence of clear guidance on audit committees in the public sector and without specific legal anchorage, it may be difficult to define the scope, powers and responsibilities of such committees. These might be limited and their tasks might be interpreted as focusing mainly on advising or on supervising. The same issue may arise when determining the relationship between the audit committee and the internal audit service.

4.2. Integrating audit committees in public governance

In most EU Member States, internal audit is linked to and reports directly to the top/higher levels of their public entities. Depending on the entity, internal audit may report to the (deputy) minister, the general secretary, the general director or the mayor.

Such a reporting line is necessary to ensure adequate organisational independence for internal audit and to demonstrate its effectiveness and needs to be formally established, particularly with a view to avoiding conflicts of interest.

Existing governance structures could be an alternative to audit committees as a functional reporting line for internal audit, depending on the administrative organisation and the administrative culture of the country and of public entities (ministry, institutions, local community). If the governance structures cover the entire scope of responsibilities of the entity, such structures could actually take the role of oversight body.

In such cases, it may be a challenge to integrate the specificities of overseeing internal audit activity into the governance structures, while fulfilling the preconditions assigned to audit committees. Moreover, it is important to ensure that the members of the governance body responsible for functional organisational independence have the required level of knowledge, skills and qualifications.

4.3. Composition of audit committees

It can be difficult to find members with the right kind of experience, skills and independence for audit committees.

The qualifications and independence of the members of an audit committee are crucial because the committee’s collective composition will determine its credibility, and
therefore its acceptance by top and operational management and external stakeholders. The same factors determine a committee’s capacity to deliver added value.

Some basic criteria apply to the composition of an internal audit oversight body or an audit committee. As well as finding the right people, there has to be the right balance among members. The optimal audit committee has sufficient knowledge of the entity, its businesses, functions and environment, as well as technical know-how in the field of auditing and risk management. Moreover, some members should be external to the entity or at least not have any executive responsibilities within it. Yet another challenge is to avoid conflicts of interests between a member and the activities of the public entity.

4.4. Administrative burden and cost of audit committees

The effectiveness and independence of internal audit may be jeopardised if a functional reporting line for internal audit is not clearly established or inadequate, or the composition/functioning of the audit committee is not credible. Such weaknesses would make it very unlikely that the committee could offer added value. Instead, audit committees might be perceived as an unwelcome added layer of bureaucracy and be rejected by managers and other stakeholders. Moreover, the time-consuming nature of such committees and the costs of operating them might be controversial, especially in times of public spending cuts.

It may be too costly for small entities to set up and staff an audit committee. To address this specific problem, DG Budget has recommended the setting up of regional audit committees with ‘exception only reporting’ responsibilities as a cost-friendly option.

4.5. Committing Officers and governance bodies on audit committees

Officers and governance bodies in public entities may see it as unnecessary or even undesirable to set up an audit committee. They may, for instance, see the tasks of an audit committee as being part of their own oversight responsibilities, and perceive a newly-created audit committee as a blurring of responsibilities. In countries where audit committees are not mandatory, some might argue that they are not obliged to establish such committees.

5. Challenges

- Are the hurdles regarding audit committees recognisable? Are there additional disincentives?
- Are audit committees only appropriate in large entities?
- Audit committees are a way to safeguard the independence of internal audit activity. What other ways are there to achieve this objective?