Australian Institute of Company Directors

ORGANISATION

Managing relationships with auditors

The audit function for an organisation is vital to give assurance as to the truth, fairness and compliance with the law and accounting standards of an organisation's financial statements and as to the adequacy of the organisation's systems and controls in support of them.

The audit function may be divided into:

- external audit
- internal audit

For many organisations, especially larger public companies and charitable organisations, it is mandatory at law to appoint an independent and appropriately qualified accounting professional (*external auditor*) to undertake the external audit function. Many other organisations also commit to an external auditor to give their shareholders, members and other stakeholders assurance even though they may not be legally obliged to do so.

> It is important for there to be clarity of roles and relationships between the various key players involved in an organisation's audit, be it external or internal.

The internal audit function focusses more on the internal controls and compliance requirements generally for an organisation to assure integrity of its operations and affairs generally, not necessarily limited to financial matters. Larger organisations with more complex and diverse financial, operational and regulatory affairs, in addition to an external auditor also appoint a separate internal auditor to oversee this function. Often that *internal auditor* may be an employee of the organisation itself, although sometimes an external consultant may be appointed.

It is important for there to be clarity of roles and relationships between the various key players involved in an organisation's audit, be it external or internal. Those key players include: the board; the audit committee; the risk committee; the CEO and the CFO; the chairs of the audit and risk committees; the external auditor; the internal auditor (if one is appointed); and, the various other members of staff with interface to the organisation's audit functions.

The audit committee oversees the audit function[1] and plays a key role in assisting the board to fulfil its corporate governance and oversight responsibilities in areas including:

- corporate reporting, including external financial reporting, the directors' report and annual report;
- external audit;
- internal audit;
- risk management and internal control;
- compliance;
- ethics and organisation culture; and
- fraud and corruption.

The audit committee's responsibilities are typically documented in its charter. Ideally, the audit committee's annual work plan is derived from its charter to ascertain that the committee fulfils its responsibilities.

The audit committee can assist directors to fulfil their responsibilities and facilitate decision making by:

- facilitating open communication between board members and senior management, risk and compliance managers, internal and external auditors, and
- focusing on matters within the audit committee's charter, thereby allowing the full board to spend more time on other matters.

Note that delegation of activities to the audit committee does not absolve individual directors from their responsibilities.

What is the role of external auditors?

External auditors must be professionally qualified and registered company auditors, usually from a professional services firm, and are specifically engaged by a company to perform a statutory audit on the financial report. Their primary role is to undertake a series of audit procedures, in accordance with auditing standards which will form the basis of their audit opinion about whether a company's financial reports comply with the relevant legislative requirements (for companies, the *Corporations Act 2001*) and accounting standards, and give a 'true and fair' view of the organisation's financial position and affairs. As an outcome of this focus on financial affairs, the external auditor is well placed to provide some independent insights in to the financial reporting framework and internal controls of the company. They may during the performance of the audit identify material misstatements that may be the result of mere inadvertent error, deficient systems or negligence, or w even fraud by people within or outside the organisation.

> The external auditor is well placed to provide some independent insights in to the financial reporting framework and internal controls of the company.

An audit committee (if one is appointed) or the board, as the case may be, may instruct an external auditor to perform further audit procedures in addition to those procedures essentially necessary for the external auditor to express his/her professional opinion on the financial statements. These additional agreed upon procedures are usually set out in the audit engagement letter between the organisation and the external auditor.

The *Corporations Act 2001* (the Act) sets out the process for the appointment, reappointment and removal of external auditors for Australian Companies registered under that legislation. The board's process to engage with the external audit and meet the requirements in the Act should be outlined in the board's or audit committee's charter. While the board, perhaps on recommendation of the audit committee, decides on which auditor to recommend, it is the members/shareholders who ultimately vote on a resolution to appoint or remove external auditors during a general meeting of members/shareholders.

1. Auditing and Assurance Standards Board, Australian Institute of Company Directors and The Institute of Internal Auditors–Australia, 2017, *Audit Committees: A guide to good practice*, 3rd edition, AICD.

It is important for external auditors to be independent and to be seen as independent of management and the organisation. Independence can be defined as being free from relationships with management and the organisation that can interfere with acting in the best interests of the organisation. Section 307C of the Act specifically requires that auditors make a written declaration that they have not contravened the independence requirements of the Act or any professional codes of conduct. Declaration of independence from external auditors are also usual practice even for organisations incorporated or registered under different legislation. There is a common law precedent that an external auditor's duty of care is to the organisation itself, and not to the management and staff who engage or deal with them. The external auditor's independence from the entity's governance means that external auditors cannot use internal auditors to provide direct assistance in an audit or review conducted in accordance with the Australian Accounting Standards.

It is important for external auditors to be independent and to be seen as independent of management and the organisation. Independence can be defined as being free from relationships with management and the organisation that can interfere with acting in the best interests of the organisation.

Professional standards may restrict the amount of non-audit work an external auditor can do without breaching the auditor independence requirements. The board or audit committee charter should outline any limitations on non-audit work. Such a restraint is designed to assure that the external auditor's independence is not compromised by the external auditor effectively having to audit their own work done elsewhere for the organisation, or by the external auditor becoming too dependent on the organisation for revenue generally, that they may be reluctant to raise issues of concern with management or the board.

For listed entities, and commonly in accordance with professional audit standards generally, the audit engagement partner should rotate every five years, however this can be extended by the entity up to a maximum of seven years (refer also s 324DAA of the Act). The board, or as appropriate, the audit committee will consider whether the extension of the audit rotation period would have an impact on audit quality or result in audit independence issues. The audit engagement partner is also required to approve the extension of the audit rotation period.

The audit engagement partner of a listed entity, and also as a constitutional requirement of many organisations, must also attend the organisation's annual general meeting (AGM) and take questions about the content of the audit report and/or the conduct of the audit. These questions may be submitted in advance by shareholders or members, or during the AGM proceedings themselves (refer also s 250PA of the Act).

Again, in the terms of the *Corporations Act 2001*, and commonly in accordance with professional audit standards generally, audit engagement partners previously involved in the audit of a company cannot be appointed to the board of that client within two years of ceasing to be the audit engagement partner (see ss 324CI and 324CJ).

Where a company has an audit committee, the external auditor will liaise primarily with this audit committee through its chair, and as a secondary liaison as the need or circumstance may warrant with the board directly. For the external auditor, communication and consultation with the audit committee helps to facilitate an effective and efficient audit and the communication of matters arising from the audit.

An audit committee can help the relationship with the external auditor by:

- being clear on their role and responsibilities regarding the audit, as defined in the audit committee's charter, and, ensuring that the preconditions for an audit are present;
- identifying what qualities and skills they require in an auditor;
- making recommendations to the board for selection and remuneration of a firm of auditors;
- reviewing the scope of the audit and understanding the expectations of the auditor: having an internal audit plan;
- approving and referring the audit engagement letter to the board that necessarily includes an agreement as to the terms of the audit engagement;
- being available to meet with the auditors during the year to discuss issues including through the chair of the audit committee;
- at least before the annual audit and also before any half year review of the organisation's financial statements and without management present, have a meeting with the auditors to provide them an opportunity to discuss any key audit matters or difficulties encountered with management;
- determining the elements of audit planning including understanding the auditor's expectations around the final report and any preliminary views the auditor holds;
- reviewing the independence of the auditor by considering the relationships and services with the company and other relevant organisations that may impair or appear to impair their independence and ensuring that the establishment and maintenance of auditor independence occurs;
- discussing significant related party relationships and transactions and in the context of corporate groups, engaging with the auditor on group engagement and potential conflict;
- communications and inquiries around fraud, including oversight of management process and communication with audit committee;
- reviewing reports received from the auditor and passing important information to the board as appropriate, including identifying and resolving matters that are significant and require the auditor's attention;
- reviewing the adequacy of external audit arrangements annually;
- ensuring there is appropriate coordination and cooperation between the external and internal auditors;
- ensuring that significant audit findings are communicated to the board and the audit committee and that any necessary changes are made including modifications in audit strategy, understanding and managing material risks and exposure within the financial report, adjusting for industry or regulatory change factors, and, rectifying material misstatements or informational inconsistencies around the financial reporting function.

In interacting with the board or audit committee (as required) the external auditor function has the following key responsibilities:

- establishing whether the pre-conditions for an audit are present;
- agreeing the terms of the audit engagement;
- establishing and maintaining independence;
- discussing elements of audit planning;
- identifying matters requiring significant auditor's attention;
- communicating considerations of group audits;
- discussing significant related party relationships and transactions;
- enquiring about fraud; and
- communicating significant findings from the audit.

Audit Standards ASA 260 *Communication With Those Charged With Governance* requires that the audit committee in fulfilling its responsibility to oversee the reporting process will engage in effective two-way communication and that standard applies also to the auditor in obtaining information relevant to the audit from the audit committee. Board members are to expect that at times there may be some tension between senior management and the external audit team. This is a healthy feature of a rigorous external audit and both the audit committee and the auditor are expected to establish and maintain a constructive working relationship.

What is the role of internal auditors?

Internal audit assists the audit committee in its role with monitoring and oversight which typically falls into two distinct categories:

1. assurance services; and
2. consulting services

The effectiveness of the internal audit function depends to a large extent on the scope of its work and a reporting line that is independent from management.

> The audit committee has an important role in ensuring that all entity risks are considered, so that the internal audit effort is directed to those areas where examination of performance is most needed.

Internal audit activities should be conducted in a manner consistent with the International Professional Practices Framework (IPPF), including the *Core Principles for the Professional Practice of Internal Auditing*, the *Definition of Internal Auditing*, the *Code of Ethics* and the *Standards*. Internal audit requires professionals with an appropriate level of understanding of the business culture, systems and processes to provide assurance the controls in place are sufficient to manage risks, governance processes are adequate and organisational objectives are met.

Consulting services provide advisory and related client service activities, the nature and scope of which are agreed with management. When performing consulting services, internal audit must not assume management responsibility.

Internal auditors must communicate the results of engagements, and include their objectives and scope, as well as applicable conclusions, recommendations and action plans.

The scope of internal audit's work can vary between entities, depending on the authority and resources provided to the internal audit function. In some organisations, internal audit may comprise a separate division with autonomy, authority and resources to design an optimal work program. In other organisations, internal auditors may be third parties contracted to examine particular areas of the business or to provide an equivalent function to an in-house internal audit. Consequently, the effectiveness of internal audit will often depend on setting the appropriate scope, budget and reporting lines for their work programs.

The audit committee has an important role in ensuring that all entity risks are considered, so that the internal audit effort is directed to those areas where examination of performance is most needed.

Internal audit key responsibilities to the audit committee typically include:

- discussing elements of internal audit planning;
- communicating on independence;
- communicating matters arising from internal audit work;
- responding to requests;
- engaging with the audit committee on matters associated with governance, risk management, control and other matters; and
- annual reporting.

Key definitional differences between the external audit and the internal audit[2]

COMMONLY USED TERM	EXTERNAL AUDIT USAGE	INTERNAL AUDIT USAGE
Assurance engagement/ services	An engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. There are levels of assurance provided by assurance engagements/services namely limited or reasonable assurance. Reasonable assurance provides the greatest degree of assurance to users.	An engagement involving objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.
Independence/ Independent	Ensuring an objective mindset, avoiding appearance and/or perception issues and avoiding conflicts of interest occurring. Practitioners are required to comply with this definition. Professional services firms and the members of an external audit engagement must be independent of the client, considering such factors as the scope of services the firm provides to the client, as well as the employment history and personal financial holdings of the engagement team and others in the firm.	The freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. This refers to organisational independence or the hierarchical and reporting independence of the internal auditors from those whose work they are reviewing.
Internal audit	The internal audit function means a function of an entity that performs assurance and consulting services designed to evaluate and improve the effectiveness of an entity's governance, risk management and internal control processes.	Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.
Fraud	An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. External audit will (a) identify and assess the risks of material misstatement of the financial report due to fraud; (b) obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud; and (c) respond appropriately to fraud or suspected fraud identified during the audit.	Any illegal act characterised by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organisations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage. Internal audit is directly concerned with the prevention of fraud in any activity undertaken.

2. Ibid, p 95.

About us

The Australian Institute of Company Directors (AICD) is committed to strengthening society through world-class governance. We aim to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. Our membership includes directors and senior leaders from business, government and the not-for-profit (NFP) sectors.

For more information **t:** 1300 739 119 **w:** companydirectors.com.au

07236-3-7