Discussion report regarding the relationship between the Internal Audit function and GRC

The internal auditor as spider in the GRC web

'Cooperating while maintaining independence'

NIVRA

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Foreword

Due to the global financial and economic crisis that has been raging since 2008, organisations are paying increasing attention to internal control and to the requirement to comply with legislation and regulations. Governance, Risk Management & Compliance (GRC) is hot.

This attention to GRC triggers questions:

- How can the GRC playing field be organised in an efficient and effective way?
- What degree of certainty does management and the Management Board wish to have regarding the management structure and where do responsibilities lie?

Internal Audit must assume its responsibility with regard to mapping out and performing, but most of all managing, various GRC activities within the organisation. Furthermore, Internal Audit has considerable interest in balanced, effective and efficient interplay between the various risk and control functions within the organisation.
Given the importance of the Internal Audit function on the GRC playing field, the Vakgroep Intern Acountants (INTAC – specialist group of internal auditors) of the Koninklijk Nederlands Instituut van Registeraccountants (NIVRA) (Royal Dutch Institute of Chartered Accountants) and the Institute of Internal Auditors the Netherlands (IIA) have commissioned a study and analysis of the relationship between GRC and Internal Audit. The present report is based on the outcome of this study, but goes one step further as well. The working group has (in close consultation and coordination with both principals) made a number of substantive choices in the form of good practices designed to provide continued direction and to enhance the performance of the Internal Audit function. A broader supporting report, which will become available in late 2010 on the websites of both organisations, will provide greater depth and elucidation. Another purpose of this project is to contribute to discussion in the private sector regarding optimum forms of cooperation between GRC and the Internal Audit function. A range of conclusions and recommendations are, therefore, formulated in the report.

The study, aimed at commercial organisations in the Netherlands, encompasses four steps. A study of relevant literature was the start, followed by an on-line survey with 67 respondents from among GRC professionals. These activities formed the basis of a round of interviews in which 28 interviews were held at 22 organisations. Finally, a debate session followed with experts and a large number of professionals.

For definitions of concepts used please refer to definitions as documented by the IIA.

We invite you to familiarize yourself with the contents of this report and challenge you to start to use them both with a view to enhancing GRC activities in your own organisation and to further intensifying the involvement of the Internal Audit function in these activities. And, in conclusion, we hope that this report provides subject matter for discussion with colleagues within and beyond your own organisation and thus a contribution to the professionalism of the exercise of our profession.

We wish to express our heartfelt thanks to everyone who responded to the survey and/or participated in the interviews and, of course, also to the editorial board, the steering committee and working group for their part in this study.

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Summary

The Internal Audit function operates in the broad arena that is known by the term GRC (Governance, Risk Management & Compliance). On the one hand it is part of the governance of the organisation; on the other it has its own (testing) responsibility regarding governance. This responsibility is shaped in part by guidelines issued by various professional organisations and by expectations from interested parties both within and beyond the organisation. The Internal Audit function thus becomes the spider in the GRC web: it oversees, checks, advises, must at times bare its teeth and is one of the few parts of the organisation that has access to all parts of the organisation.

Based on a study consisting of a literature study, an on-line survey of 67 professional practitioners, 28 interviews and a debating session, a series of good practices has been drawn up that can be used as a point of reference for professionals, interested parties and other stakeholders in GRC. These good practices can be a first step towards fleshing out guidelines and standards for Internal Audit functions so as to formulate them to the extent possible by (international) professional internal audit organisations.

The working group has formulated, in addition to good practices, a number of conclusions drawn up on the basis of the results, of discussions within the working group and of talks with several professionals:

- The approach of the Internal Audit function in arriving at an assessment regarding governance in an organisation can certainly be further professionalized.
- Distributing GRC responsibilities over several functions results in better control of the organisation.
- Risk management is still in the process of being developed and the Internal Audit function does not yet have a clear approach to its evaluation.
- The Internal Audit function is still focusing too much on risk management processes and too little on the outcomes of these processes.
- The activities arising from legislation and regulation, also called regulatory compliance, are increasing perceptibly and reinforce a rules oriented culture to the detriment of a principle based culture.

This report includes several concluding recommendations directed at various GRC stakeholders.

There is no legislation in the Netherlands that addresses the Internal Audit function in relation to the GRC sphere on the whole. Other than the Corporate Governance code additional legislation and regulation exists only in the financial sector of relevance to GRC, such as the Banking Code, Basel II and Solvency II.

1 Good practices

1.1 Introduction

Governance is the combination of processes and structures that the management of an organisation has implemented in order to provide information, to guide, to manage and to monitor the activities of an organisation with a view to achieving its objectives. [1] The Internal Audit function (IAF) is an integral component of the risk and control functions, in addition to such aspects as risk management, compliance and internal control. As a whole, these aspects are often termed GRC.

The point of departure for the responsibilities and tasks of the IAF are the International Standards, Practice Advisories and Position Papers formulated by the IIA, supplemented by NIVRA guidelines specific to internal auditors (intern accountants). The good practices we have drawn up can serve as a point of reference for practicing professionals, interested parties and other stakeholders in GRC. These good practices can be a first step towards fleshing out guidelines and standards for Internal Audit functions so as to formulate them to the extent possible by (international) professional internal audit organisations. Good practices are explicit good examples of specific actions and working methods in which practical experience plays a central role. Based upon these good practices professional colleagues can develop views with respect to GRC, for the benefit of their own practice which they can then apply, possibly with some adjustments. Good practices originate from the survey and interviews and are determined by project members based on broad consensus. Good practice for one organisation may not necessarily be good practice for another. A good understanding of context, preconditions and critical success factors is essential in this approach.

Establishing the responsibilities and tasks of the IAF, as well as other risk and control functions, is always the responsibility of the Management Board. This is monitored by the Supervisory Board (possibly delegated to a sub-committee such as the Audit Committee).

1.2 Set-up, responsibilities and scope

Our study reveals that frequently the three lines of defense model [2] is paramount in setting up risk and control functions. In the first instance, it is the responsible line management that monitors whether objectives are being achieved and whether the control measures in place to do so are effective. This is the first line of defense. In many organisations, in addition to the IAF, other risk and control functions, such as risk management, compliance and separate internal control, exist. They form the second line of defense. They are often (in part) responsible for developing policy and ensuring implementation of measures to apply policy, as well as monitoring of compliance with policy. IAF assesses the effectiveness of these risk and control functions, since they are part of the organisation's internal control system. During this process IAF can also identify gaps or redundancies among these functions and thus improve the effectiveness of the functions as a whole. This explains why the IAF is termed the third line of defense. In terms of positioning, we note also that IAF must be independent [3] in terms of both thought and action.

Good practices:

- *Positioning and interpretion of tasks of IAF and other risk and control functions are in line with the three lines of defense model.*
- *The IAF also reports on GRC to the Audit Committee of the Supervisory Board and the Chairman of the Management Board.*
- *The responsibilities of the Audit Committee of the Supervisory Board regarding GRC are clearly formulated and in line with provisions under the Dutch Corporate Governance Code.*
- *Even in international organisations the risk and control functions are set up in such a way as to be tailored to local legislation and regulation and take into account local good practices in the field of GRC.*
- *Performance of the IAF is assessed by the Audit Committee, which uses input from external quality investigations and external accountants and supervisors.*
- *The IAF focuses more on the performance and results of GRC processes than on the functions (departments) that perform these processes.*

1 Freely translated from the Glossary, International Standards, IIA, October 2008.
2 Refer to documents such as The Internal Auditor in the Netherlands (De internal auditor in Nederland), Position Paper, IIA/NIVRA, 2008. Refer also to section 2 in this report.
3 Refer also to Attribute Standards 1100 and 1110, IIA.

- *The chief of IAF is present at meetings of the Audit Committee and holds private meetings where management and others, such as external auditors, are not present.*
- *The IAF contributes actively to the implementation of automated control models (continuous monitoring and continuous assurance) in the organisation.*
- *The chief of IAF is present at meetings of risk committees, if applicable.*
- *The responsibility of IAF in risk assessments is limited; in principle, this responsibility lies with the first line and second line.*
- *The risk management function facilitates the creation of in control statements; IAF supplies certainty in this respect.*
- *The Management Board establishes the organisation's risk profile and risk appetite.*
- *All risk and control functions utilise an integrated organisation-wide risk management system (including the same conceptual framework) for risk detection and control.*
- *The IAF explicitly contributes to reducing the complexity of the risk management system.*

1.3 Performing work activities

The IIA Performance Standards include guidelines for performing IAF work activities: 2110 concerns Governance, 2120 concerns Risk Management, 2130 concerns Control and 2600 concerns the acceptance of risk by senior management. The IIA has not formulated specific guidelines with respect to the compliance function.

Good practices:

- *IAF work activities are derived from the organisation's objectives, its management philosophy and management framework; the guiding lights for the organisation are the guiding lights for the IAF, converted into risk and controls.*
- *In testing controls, the scope (i.e. which controls are to be tested) is determined by the reviewing party in coordination with management.*
- *The IAF determines in the case of its findings and recommendations whether management actually is committed to these points and takes any measures necessary if sufficient commitment is lacking.*
- *The IAF works continuously and actively on the base for its own function and for other risk and control functions.*
- *The IAF includes cost of control in its analysis and recommendations.*
- *The IAF regularly assesses aspects such as conduct, culture and management style as part of its work in relation to the governance and control environment.*
- *The IAF is aware of the different cultural backgrounds in its organisation and takes them into consideration in work methods and reporting.*
- *The IAF contributes proactively to achieving the intended effects in GRC of the European Transparency Directive regarding the provision of uniform information to stakeholders within and outside the organisation.*
- *The IAF takes measures, especially if the organisation has an integrated risk management system, to ensure that it can assess this system with sufficient objectivity and independence.*
- *The IAF and GRC functions continuously keep a sharp eye to ascertain that controls function well in practice.*
- *The IAF understands that compliance implies more than formally fulfilling legislative and regulatory requirements. Not just form, but substance, is important; this can be expressed in the conduct and pronouncements of management and employees.*

1.4 Risk assessment

Formal and informal risk analyses take place at a number of different places in the organisation. In truth every action in an organisation is based on a risk analysis, whether conscious or unconscious. It is the task of each manager to map the risks (the chance that an event might occur that may influence achievement of objectives) formally and consciously and to analyse and manage them. The Position Paper The Role of Internal Auditing in Enterprise-wide Risk Management by the IIA provides clear guidelines on which work activities the IAF must, may and must not undertake with regard to integral risk management.

Good practices:

- *The IAF assesses the risk management process (including the transformation of rough data into information) with regard to comprehensibility and aggregation level, as well with regard to aspects such as accuracy, reliability and completeness.*
- *The IAF assesses whether, in the context of integral risk management, the risk analysis is sufficiently substantiated and supplemented with sound financial analysis.*

- *The IAF provides certainty with regard to the outcomes of the risk management process; an assessment of outcomes is undertaken in addition to a process assessment.*
- *The IAF uses inventories and risk analyses of all (staff) functions (examples include – separately or not – functions that are geared to sustainability, quality control, innovation, safety and the like).*
- *The IAF remains critical and independent in spirit in its assessment of risk models and their outcomes; each model is only a possible reflection of the reality.*
- *The IAF encourages integrated analysis of risks that spring from various sources in the organisation in order to identify inter-relationships among the risks.*
- *The IAF encourages the inclusion of a step in integrated risk management in which risk analyses from responsible management and from operations (those substantively involved) are compared to one another (a combined top-down and bottom-up approach).*
- *The IAF encourages the assessment of risks from a strategic, operational and financial perspective.*
- *The IAF encourages a scenario approach (including worst case scenarios) as an essential component of risk analysis.*
- *The IAF plays a part in ensuring that both the Chief Financial Officer and the Chief Risk Officer are informed about risks in a consistent and integrated fashion.*

1.5 Communication and deliberation

A constant issue to be addressed by specialists of any nature is that of communication with stakeholders concerning their objectives, function, work methods and results. One potential pitfall is that the responsibility concerning the work method to be adopted and specialist jargon moves to the forefront; the fact that the recipient must understand the message is often forgotten. IAFs and other risk and control functions sometimes lose sight of this. Actively conveying the conceptual framework, empathizing with the mindset of the recipient and soft skills on the part of audit professionals play a key role in this process. Practice Advisory 1210-1 of the IIA explicitly mentions the need for internal auditors to develop skills in dealing with people, in understanding the interaction between people and in building relationships with stakeholders, in addition to having general written and verbal competencies. Communication by the profession to external stakeholders of the organisation in general is an inseparable component.

Good practices:

- *The IAF and GRC functions formulate their opinions to the point, explicitly and clearly.*
- *The IAF has direct lines of communication with the Audit Committee, the Management Board and senior management.*
- *The IAF encourages the Supervisory Board (and particularly the Chief Executive Officer and Chief Risk Officer) to openly disseminate the importance of the risk and control functions within the organisation's governance.*
- *The IAF encourages clear language with respect to risks and controls.*
- *The IAF has a relationship that is characterized by openness and trust with line management.*
- *The IAF encourages management to actively spread the in control statement among all its stakeholders.*
- *The IAF has specific objectives aimed at mutual cooperation and information exchange with the other risk and control functions.*
- *The IAF has regular formal and informal consultations with various levels of the line organisation.*
- *The risk and control functions deliberate with one another on a regular basis; the agenda includes coordination of work activities and discussion of risk assessments.*
- *The risk and control functions are located in physical proximity, so as to reinforce informal communication.*

1.6 Reporting and documentation

Reports are an important product of the IAF and constitute a core component in communication by the IAF with its clients and stakeholders. The other risk and control functions generally also produce reports. The concern is that all these functions actually support the organisation and offer added value with their formulation of risks and actions for improvement; coordination with each other is essential in this process. Guidelines for IAFs are set out in Practice Advisories 2410-1 and 2420-1 of the IIA.

Good practices:

- *The organisation has a layered system of risk dashboards in which risks are shown at the correct level in the appropriate degree of detail.*
- *The IAF ensures that risks are clearly defined in its reports, including an estimate of the chance of the risk materializing and the possible impact of such an event.*

- *The IAF formulates specific findings in its reports, providing recommendations that offer sufficient guidance.*
- *The IAF reports in clear and straightforward language and tailors its reports to the target group.*
- *The risk and control functions and line management use one and the same tool for establishing important controls, risks and issues, so that a uniform use of language, transparency and coordination is fostered and facilitated.*
- *The risk and control functions report according to the principle risks that matter.*

1.7 Employees, competence and conduct

The quality of the risk and control professionals themselves is unmistakably crucial. This quality encompasses professional content, experience and competencies. The system of certification, which goes hand-in-hand with ongoing educational obligations, is a vivid example of how this quality is maintained. The IIA Code of Ethics explicitly details requirements with regard to integrity, objectivity, confidentiality and professional skills.

Good practices:

- *The IAF reports its findings in a straightforward manner.*
- *The IAF works actively to enhance both the soft skills and hard skills of its professionals and encourages other risk and control functions to do the same.*
- *The IAF obtains the specific knowledge and experience necessary for an investigation from beyond its own department or even beyond the organisation, taking into account professional standars, if it does not have the specific know-how in-house or cannot use it for other reasons. Not having specific know-how or experience can never be a reason not to undertake an investigation.*
- *The IAF is a centre of excellence in risks and control and actively makes its know-how and skills available to the organisation.*
- *The IAF has a training programme in which its employees are regularly updated with regard to knowledge of the organisation and its processes and systems.*
- *The IAF works continuously to develop its employees' know-how and skills regarding internal auditing.*
- *The IAF actively exchanges employees with the other risk and control functions.*
- *The IAF contributes actively to the development of know-how and competence of employees in the whole organisation regarding GRC.*
- *The IAF encourages intensive and frequent exchange of know-how and experience among the IAFs, whether facilitated by its professional organisations or not.*
- *The IAF uses an up-to-date knowledge management system with a specific focus on GRC.*

2 Conclusions and recommendations

2.1 Introduction

Based on the results of the study of relevant literature, the survey, the interviews and the debate session, the working group has formulated a number of conclusions. It became clear that we also needed to provide guidelines for further development and areas for attention. For this reason we have articulated one or more recommendations in conclusion, which are directed at the various stakeholders in the GRC arena.

2.2 The IAF approach for arriving at an assessment concerning governance can certainly be further professionalized

A number of parties play a role in the governance of an organisation and they are often uncertain of their inter-relationships. The global credit crisis has served only to increase the attention paid to governance. Risk management and compliance are constantly in the forefront and governance acts as the lubricant in top management's capabilities regarding fleshing out and bearing their responsibility. This also implies that senior management must clearly express what is considered to be desirable conduct and must exemplify this conduct (tone at the top). Furthermore, top management must specifically indicate how governance processes and structures are to be designed. The very top management of the organisation is thus primarily responsible for setting up, implementing and maintaining governance. No generally accepted approach is available as to how the IAF can (or must) provide assurance concerning governance, what sort of consultancy assignments it may or may not accept and how it should deal with setting up governance (what the responsibility is for top management to which IAF itself reports as well).

Recommendations:

- *We recommend to Audit Committees that they develop a vision of governance that is in line with the nature, industry, size and complexity of the organisation, in order to determine the extent to which governance is complied with and then to initiate discussions with the organisation's management in this respect.*
- *We recommend to professional internal audit organisations to devote greater attention to the auditing of governance and to develop (or commission development of) and disseminate more detailed instructions for practitioners of the profession.*

2.3 Distributing GRC responsibilities over several functions results in better control in the organisation

The three lines of defense model is generally viewed as a guideline for shaping GRC within the organisation. This model is frequently seen in the financial sector in particular with separate functions for internal audit, risk management and compliance, in which the IAF is perceived as the third line and risk management and compliance as the second line. Legislation in the financial sector even stipulates this split - to the satisfaction of the sector. In general this model functions well, although considerable attention still needs to be devoted to elaborating and operationalising it. There are, however, departments in which several GRC responsibilities are combined and these departments have no problems with this. Potential drawbacks in this separation are the one-sided focus on one's own specialist area and the possibility of developing an isolated perspective. This may have to do with the degree of maturity of GRC in the organisations, but of course the size of the organisation plays a part here, too.

As greater distance develops between the IAF and the other risk and control functions, the importance of good communication between these functions grows. Strengthening communication among these functions still requires considerable attention in many organisations. Part of this communication consists of a clear and uniform system of concepts, which is at present not shared property in a number of organisations.

Recommendations:

- *We advocate more detailed guidelines from the professional internal audit organisations as to the special cases in which the combination of GRC responsibilities is possible in a single function, taking into account the principles of the three lines of defense model.*
- *We advocate the widespread use of in control statements in organisations in order to sharpen the responsibilities and transparency concerning risks and their control within the organisation.*
- *We advise Management Boards and Supervisory Boards to explicitly take responsibility for implementing the governance they wish in the organisation and to use the three lines of defense model as a guideline in this endeavour.*

2.4 Risk management is still in the process of development and IAF does not yet have a clear approach for how to assess it

Great importance is ascribed to risk management, but it is still far from fully developed. Further professionalization of risk management is necessary, if only to ensure that controls exist to cope with variety of product innovations in the financial sector. Organisations are still fully engaged in incorporating existing and upcoming regulations into a comprehensive control framework in the financial sector for sure. There are many ways in which to map risks; a variety of analysis models exists, quantification of risks is used in a number of ways and no clear method of reporting exists. These are classic features of a professional area that is still in development and that is, for instance, neither subject to guidance and coordination from professional organisations nor to stimuli from universities in the sphere of professional development. Each organisation does it its own way. The IAF itself does not yet have a clear approach to assessing risk management, but we should also note that development of knowledge regarding risk management within the IAF also needs additional attention. Furthermore, building a strong control framework and incorporating it into an organisation's governance is a complex and time-consuming process. But the urgency is great – the question is whether the IAF and other risk and control functions will still have much time to actually generate added value.

Recommendations:

- *We advise risk managers, as a professional group, to further professionalize this area by means of coordination, guidance, certification and education.*
- *We advise risk and compliance managers in the Netherlands to devise good practices and recommendations regarding the tasks and responsibilities in the organisation's governance from their perspective.*
- *We ask for more detailed initiatives from the professional internal audit organisations and from the IAFs themselves in order to disseminate knowledge of risk management among internal auditors; these might include providing incentives for doctoral theses, professional studies, developing position statements and the like.*
- *We recommend that IAFs contribute within their organisations to a broad awareness of the inadequacy and limitations of the current range of instruments for risk management and to stimulate development of this range of instruments.*

2.5 The Internal Audit function still focuses excessively on risk management processes and not sufficiently on the outcomes of these processes

Current assessment of risk management by IAF is formed by assessing the design and functioning of risk management processes. The outcomes of these processes, such as risk registers and risk reports, are a more complex topic for investigation. There is no clarity within the professional field as to whether providing an assessment on the outcomes of GRC processes is one of the tasks of the IAF. This is striking, since outcomes in the vein of the operation was a success, but the patient died are not enough now. This could well be one of the factors why the IAF plays such a small role in the discussions on the credit crisis. The fact that the De Wit commission explicitly mentions the IAF several times in its reports perhaps shows a reversal.

Recommendation:

- *We advocate that the IAFs devote more attention to assessing the outcomes of risk management processes.*

2.6 Activities arising from legislation and regulation, also termed regulatory compliance, are increasing perceptibly and result in a strengthening of a rules-oriented culture to the detriment of a principle-based culture

While we continue to advocate a principle-based culture, we see growing attention to legislation and regulation. Government and the public, given developments abroad, demand stricter application and compliance of legislation and regulation; the government wishes to assign this burden via methods including horizontal supervision principles to the organisations that are themselves under supervision. The manner in which organisations deal with this varies. Highly regulated sectors, such as the financial sector, the food sector, health care or the chemicals industry, have functions specifically designed for this, which for purposes of simplification we can call regulatory compliance functions. A greater number of rules, however, brings about growing pressure within organisations to comply with these rules, to monitor them, to define the effects on culture and conduct and, of course, to explore how the regulatory compliance activities can in turn be audited. From the working environment, however, it is very clear that additional legislation and regulation is not perceived as a strengthening of GRC and organisational management. This is due to the fact that detailed rules result in false security, trigger problems in application and suppress broad independent responsibility.[4]

4 Refer also to the risk-rule reflex of Margot Trappenburg in NRC Handelsblad, May 15, 2010

Recommendations:

- *We advocate that the professional internal audit organisations show themselves as active stakeholders in developing new legislation and regulation.*
- *We recommend that professional internal audit organisations provide a vision regarding auditing compliance and the compliance function.*

3 Legislation and regulation governing GRC

3.1 General legislation and regulation

The Dutch Corporate Governance Code, signed into law in December of 2009, applies to every publicly quoted company, including financial institutions. It includes a number of good practice provisions regarding the role of the IAF, as well as responsibilities of the Management Board and Supervisory Board with respect to risk management. In practice the Dutch Corporate Governance Code is also used by large institutions that are not publicly quoted in the spirit of good practice.

In March of 2010 the Royal NIVRA (Dutch Institute of Chartered Accountants) published a practical guide in order to clarify the role of the external auditor in auditing the corporate governance information contained in the annual report (Practical Guide 1109). In 2009 the IIA published its Position Paper The Role of Internal Auditing in Enterprise-wide Risk Management.

3.2 Legislation and regulation in the financial sector

The Financial Supervision Act (Wet op Financieel Toezicht) has been in force since January 1 of 2007. It consists of a combination of eight supervisory acts and its purpose is to ensure that legislation for the financial markets is adapted to the market, purposeful and comprehensible. More general good governance requirements are also derived from this principle-based law.

The Banking Code (Code Banken) has been in effect since January 1 of 2010. A number of principles in the Banking Code relate to the performance and role of the Management Board and the Supervisory Board in the context of banking. Considerable attention is paid to risk management in the Code, which relates closely to the Dutch Corporate Governance Code and existing legislation and regulation.
According to the Code the IAF must check annually whether the risk analysis process has been set up, is in existence and is functioning effectively. The principles also stipulate that the IAF must document the set-up, existence and effective functioning of the bank's governance, risk management and control processes. It should report on these topics to the Management Board and the Audit Committee.

Other important laws that relate to financial institutions include the Banking Act, the Sanctions Act, the Anti-Money Laundering and Anti-Terrorist Financing Act, the Foreign Financial Relations Act and the Basel II Capital Accord. Starting in 2012, the Solvency II directive covering minimum capital requirements, risk management and internal control has been in effect for European (re)insurers. This list is not exhaustive, but does show how important effective corporate governance and risk management are.

In March of 2010 the Royal Dutch Institute of Chartered Accountants (Koninklijk NIVRA) further elucidated the role of the external auditor and the internal auditor in its Practical Guide 1110, Banking Code: tasks of the internal audit function and the external auditor.

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