



The Internal Auditor in the Netherlands

Position Paper Update 2008



**Instituut van
Internal Auditors**



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Content

1.	Introduction	4
2.	Developments in Governance	5
3.	How the IAF adds Value	6
4.	Developments in Internal Auditing	9
5.	The Internal Auditor as Advisor	11
6.	Quality Assurance of the IAF	13
7.	Frequently Asked Questions	14

BASIC PRINCIPLES

1. Introduction

Defining best practice

The world of internal auditing has changed rapidly over the past few years. The increased focus on good corporate governance by regulators, legislators and the wider public has come in the wake of high-profile failures of international businesses both in Europe and the US. Not only that, but globalization and advances in technology are creating new ways of working and new challenges. Stakeholder expectations of internal audit are at an all time high.

In 2005, the three Dutch professional organizations for internal auditors – the Institute of Internal Auditors (IIA), Royal NIVRA and NOREA – published the position paper “The Internal Auditor in the Netherlands”. It set out our views on internal audit best practice for organizations based in the Netherlands.

It is now time to update those views in light of the additional pressures and opportunities internal audit functions are facing across a range of areas, including corporate governance. Even in the short time that has passed since 2005, internal audit has become more proactive, has developed a greater focus on risks and on how they are managed, and pays more attention to “soft controls” within its organizations. The scope of services that internal audit offers has also widened. Internal audit increasingly provides tactical and even strategic advice to the board, as well as giving assurance on a business’s controls around its operational and financial risks. Boards are looking for internal audit to add tangible value to their operations.

This 2008 update on our original guidance gives our current view of best practice for internal audit functions (IAF).

Contents:

- Section 2: Developments in Governance
- Section 3: How the IAF Adds Value
- Section 4: Developments in Internal Auditing
- Section 5: The Internal Auditor as Advisor
- Section 6: Quality Assurance of the IAF
- Section 7: Frequently Asked Questions
- Section 8: Basic Principles

2 Developments in Governance

A world full of change and challenge

The management and control of organizations is going through significant change. For example, the dynamics and complexity of contemporary business operations are considerable. New and emerging markets at home and abroad present new challenges, not least working with other cultures. And there is a growing trend to work in partnership with other organizations, either on a permanent basis or on specific projects.

In addition, information technology is developing at a rapid pace, providing organizations with new ways of operating. In some instances, that has led to business activities taking place outside a company's traditional management and operational structures. Today, outsourcing, off-shoring or near-shoring are common ways of doing business. Mutual dependence on shared resources is also growing, with organizations making use of each other's systems and data. Strong competition in the market place has led to a demand for increased efficiency, shorter delivery times and clearer customer focus.

These changes have happened at a time when businesses are expected to comply with increasingly complex laws and regulations in a way that shows their commitment to corporate social responsibility (CSR). In addition, shareholders and other public interest bodies are demanding more transparency to guard against corporate malfeasance. Various corporate governance codes and the Sarbanes-Oxley Act legislation in the US now require organizations to report on their financial accounts and confirm that their internal controls are adequate and effective.

As a result of this increasing complexity, organizations face new risks. Companies need to find a balance between compliance with rules and procedures and a focus on entrepreneurship. The big challenge confronting organizations is to introduce the right level of risk management, control and governance, without over-burdening the business with bureaucracy.

The internal audit function helps directors and managers to meet this challenge. It provides assurance about the quality of business operations and acts as a catalyst for improvement. The international definition of internal auditing is:

“Internal auditing is an independent and objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”
(The Institute of Internal Auditors).

This position paper explores this definition from the perspective of Dutch practice.

3. How the IAF adds Value

Services to the various governance stakeholders

Stakeholder	Essence of the IAF role	Internal audit
Supervisory Board / Audit Committee	Assurance	
Executive Board	Assurance / Advisory	
Line Management	Assurance / Advisory	
Assurance functions	Coordination Effectiveness of Operations	
External auditors and Supervisors	Coordination Efficiency of Operations	

The role of the IAF

The IAF investigates whether the design and operation of processes in the areas of general management, risk management and internal control are adequate to achieve the objectives of the organization. In doing so, it provides assurance to management, the executive board and the audit committee.

Various types of audit are conducted for this purpose. The most common are:

- Operational audits: address the quality of the control around processes, departments or projects, including how reliable the information relating to those controls is;
- IT audits: deal with the design and implementation of IT governance and with the control of IT processes and systems;
- Compliance audits: address whether the organization is following internal and external regulations, and legislation;
- Financial audits: determine whether the financial information is fairly stated. In particular, within financial institutions, the audit of financial processes is often combined with an operational audit. Many organizations, however, have elected to have all or part of the audit of the financial statements performed by an external accountant.

Value added by the IAF

IAF adds value because it combines independence and objectivity in the performance of its audits with an in-depth knowledge of the business and its culture. To ensure its independence, the IAF should be positioned as high as possible within the organization. The annual internal audit plan and the report on its execution are, in principle, approved by the chair of the executive board and discussed with the audit committee.

How the services of the IAF are attuned to the specific role of each of the other stakeholders is described below.

Executive Board

The executive board is responsible for achieving the goals of the organization. Its management responsibilities include risk management and making sure the required systems of control are in place. This not only involves ensuring that the organization meets its strategic and operational targets, but that its financial reporting is reliable and that it complies with legal and regulatory requirements. In a growing number of business sectors, the executive board is asked to evaluate its success in these areas and to report on the design and operation of its systems in the annual report.

The IAF can provide significant support to the board. It can provide assurance about the extent to which the organization has control over the risks it faces and the extent to which laws and regulations are complied with.

Supervisory Board and Audit Committee

The supervisory board oversees and advises the executive board. In addition, many companies have an audit committee, which addresses the internal risk management and control systems and the process of financial reporting. In that context, the audit committee also assesses the role and performance of the IAF and of the external auditor.

The executive board evaluates the quality of these systems, and the audit committee discusses the results of this review on an annual basis. The IAF gives objective assurance on these systems.

Line management

It is, in the first place, line management that monitors whether targets are met and whether control measures are effective. Line management is often referred to as the first line of defense. The audits conducted by the IAF help to improve management's controls. In many organizations, audits are conducted not only upon instruction by the executive board but also at the request of line management.

Other assurance functions

In addition to an IAF, many organizations have other assurance-related units that address risk management and compliance, or implement special internal controls. These units have a relatively permanent operational role. They represent a second line of defense for the organization. They often share responsibility for the development of policy and for the implementation of the measures needed to achieve such policies and monitor their compliance.

Since these units constitute part of the internal control systems of the organization, the IAF evaluates their effectiveness in providing assurance. It can also identify gaps and duplications in their work and, in doing so, improve the effectiveness of the organization's risk management functions. This explains why the IAF is sometimes referred to as the organization's third line of defense.

External audit

External audit is the fourth line of defense. The primary role of the external auditor is to provide additional assurance to external stakeholders such as shareholders, lenders, suppliers and customers.

The external auditor issues an independent opinion for the general public as to whether the annual accounts are stated fairly. The audit also involves evaluating the internal controls over the relevant processes for financial reporting. The auditor publishes the conclusions in the management letter to the executive board.

But the external auditor does not issue an opinion on the quality of control measures. The auditor instead evaluates whether the statement of the executive board on the quality of the internal risk management and control systems in the annual report agrees with the auditor's own findings from the audit of the annual accounts.

The external auditor can fulfill the audit role more efficiently if the underlying control measures are properly designed and have already been tested by the IAF. There should be intense planning between the internal and external auditors so that their work is coordinated effectively.

Regulatory authority

Regulatory authorities provide extra assurance to external stakeholders. Their focus is compliance with specific laws and regulations, the accuracy of information provided to stakeholders, and the continuity and stability of the markets.

4. Developments in Internal Auditing

Risk across the enterprise

Enterprise Risk Management is today considered the most important tool in the management and control of risk. Various corporate governance codes require the executive board to report on how far they have implemented this approach in their organizations. The IAF has acted as the initiator of and advisor on implementing enterprise risk management.

In its assurance role, the IAF now puts more emphasis on the evaluation of the effectiveness of risk management processes and it issues recommendations on how these can be improved. The IAF does this in addition to evaluating the effectiveness of the internal control measures themselves. In other words, the focus of the IAF is currently not so much on assessing whether risks are properly controlled, but whether there are sufficient guarantees that the right risks are controlled. This means that IAF is concerned with current and future risks and the processes for controlling them.

This shift in focus corresponds directly to the importance of the **risk control self-assessments** that are now conducted in many organizations. These are part of the risk management system and contribute towards the organization's ability to issue an 'in control' statement. In a self-assessment, the management team assesses the quality of controls over day-to-day processes, including the design and operation of the internal control measures. If it can be shown that this self-assessment system functions well, the IAF can concentrate more on special projects, such as audits on strategic goals.

Traditionally, internal auditors mostly looked at operational risks and risks to the reliability of financial information. Increasingly, controls over **tactical** and **strategic risks** are now audited.

As a result of these trends, the IAF is entering new fields of activity:

- **Project and program management.** The IAF contributes increasingly to existing projects and programs. Programs are directed at achieving strategic changes in organizations; projects make those programs a reality. Such organizational changes are complex and often involve substantial risk. It is important, therefore, to have an idea of the extent to which critical programs link with strategic goals and what risk framework is used to control those programs. For that reason, they represent an important audit area for the risk-oriented IAF.
- **Integrity and compliance.** The public expects that organizations and their directors act with integrity. Integrity involves more than just compliance with laws and regulations. After all, some things are impossible to capture in rules. Dishonorable behavior can lead to a large loss of reputation and financial damage.
 - * Many organizations have a **compliance officer**, who has an important role as an advisor and someone who detects problems. The IAF provides the executive board with additional assurance that the compliance officer's work operates in a way that protects the organization's integrity. In organizations where the compliance structure is less mature, the IAF plays a more advisory role.

- * **Fraud:** The IAF plays an important role in many organizations in the set-up of an adequate system for fraud prevention and detection and for the identification of fraud risk.
- A growing number of business operations are audited that sit **outside the primary operational or financial systems**, such as the effectiveness of the marketing department.
- **Reliability of financial information.** Major financial scandals in multinational companies have made this a bigger priority for the IAF. Traditionally, the audit of internal, annual accounts has been an important task for many IAFs. External auditors have made considerable use of the work performed in this area by the IAF. Today the internal, annual accounts are audited less frequently by the IAF. Instead the IAF is often involved in helping to identify the key controls related to the process of financial reporting and in testing these. Due to the IAF's knowledge of business operations, it is better equipped for this than the external auditor.
- As a result of these changes, internal audit activity increasingly addresses the **'soft controls'** in an organization, such as the 'tone at the top' – the culture and style of leadership that produce the conditions for a well-functioning governance structure. A lack of adequate soft controls has led to major corporate disasters.
- **Sustainable business practices.** Many organizations wish to account for the extent to which their business practices are sustainable. This involves collating non-financial information that can be difficult to quantify and reporting to stakeholders. The IAF can help to develop key performance indicators (KPIs) that can be tested and design the necessary information systems. The IAF can also provide assurance on the extent to which this information is reliable.

The audit approach

- The introduction of risk management has great implications for the planning and scope of audits. The fact that audits have become increasingly risk-oriented is referred to as **risk-based auditing**. Instead of audit planning on a multi-annual basis, where controls are examined in a relatively standardized way, audits increasingly address specific risks and issues of concern. This means that the IAF reviews the risk profile on a frequent basis to coordinate its audits. The IAF thus contributes to more effective management.
- Increasingly, an **integrated auditing** approach is taken, in which the business's goals are taken as the starting point – rather than planning and executing audits by function (IT audit, operational audit, etc.). Next, the auditor examines the related risks and the control measures that have been implemented. This results in better coordination with management, and takes into account how interdependent various aspects of the business are.
- The risks that come to light during the IAF audits are increasingly being quantified in terms of their frequency of occurrence (likelihood) and the expected loss (impact).
- Today's IAF takes a more **proactive** approach. The auditor does not wait until changes in systems or processes have been implemented, but examines in an early phase whether there are sufficient guarantees that these changes will have the intended effect. This can be done by conducting an audit, but also by rendering advice about the necessary control measures (the control framework).

5. The Internal Auditor as Advisor

Evaluate and improve...

There is often confusion about internal audit's potential advisory role. Traditionally, the IAF has mainly fulfilled an assurance role through its independent audits. Now the IAF more often acts as advisor on internal controls in a broader sense. This consulting role is an accepted part of the IAF's function: "Internal auditing is an independent and objective assurance and consulting activity" (See section 2, above).

Common advisory activities include designing a risk management system, facilitating risk workshops, assisting in the implementation of control measures in a process, and participating in a computerization project as a project team member.

Obviously, internal audit's independence and objectivity must remain intact. After all, these are key drivers of the IAF's added value. The IIA Standards say that when an internal auditor has provided advisory services, the same person or team must not audit the results of that consulting project for one year. This also applies to the performance of line activities by an internal auditor. Measures must be taken to prevent internal auditors from examining their own work. Management must agree the extent and limits of the auditor's advisory role to ensure that the auditor does not assume management's responsibility.

The organization decides whether, and to what extent, the IAF is to carry out advisory activities. The activities, however, explicitly remain outside of the responsibilities that lie directly with management, such as the responsibility for risk management, control systems and the risk appetite of the organization.

The schedule below, while not complete, identifies internal audit's key responsibilities, the possible advisory roles they may assume, and tasks that they should not perform.

<p>Key role of IAF</p>	<ul style="list-style-type: none"> • Provide assurance on risk management systems, including compliance • Provide assurance on the control of major risks • Evaluate 'in control' statements and risk reports • Provide assurance on the reliability of financial and other management information • Provide assurance on compliance with laws and regulations
<p>Permitted advisory projects of IAF based on sufficient guarantees</p>	<ul style="list-style-type: none"> • Advise on the design of risk management systems • Assist with implementation of control systems • Facilitate risk control self-assessments • Assist/prepare controls for approval by management • Participate in projects as subject expert
<p>Tasks of directors and line management. Not to be performed by IAF</p>	<ul style="list-style-type: none"> • Determine objectives of organization and risk appetite • Ongoing monitoring of realization of objectives and mitigation of risks • Decide on whether to implement recommendations from audit reports • Issue 'in control' statements to external stakeholders • Carry responsibility for the quality of quality control systems

6. Quality Assurance of the IAF

Who audits the auditors?

The demands placed on internal auditors are heavy. This pressure forces them to keep their knowledge and skills at a continuously high level. They must keep up with new developments and reflect these in the way they perform their work.

Professional organizations, including the authors of this paper, assist in this by setting standards for performance, defining educational requirements, providing a system of mandatory, continuing education, and by producing professional publications. The members of professional organizations may also be subject to disciplinary proceedings, where appropriate.

Many IAFs apply the IIA's Standards in their professional practice. These standards require the IAF to arrange for an external quality assessment at least every five years. To do this, the IAF must have a system of quality assurance and testing in place and pay attention to the quality of its own work. The head of the IAF must share the results of the quality assessment with the executive board and the audit committee.

In the Netherlands there are four professional organizations, and related educational programs and titles, that are relevant for the various groups of internal auditors:

IIA (2.100+ members)	<i>Institute of Internal Auditors, Netherlands</i>	Affiliated to the worldwide IIA, which has 150,000 members. It has its own professional qualification which is recognized worldwide: Certified Internal Auditor (CIA). The Netherlands Registered Operational Auditors (ROs) are part of the IIA.
NIVRA (700+ members)	<i>Royal Dutch Institute of Chartered Accountants</i>	NIVRA has 14,000 members. Some 700 registered accountants (RAs) who work as internal auditors are organized within NIVRA in INTAC. Most INTAC members are also member of IIA.
NOREA (700 members)	<i>Dutch Association of Registered EDP Auditors</i>	In total, NOREA has over 1,300 members, with the title of Registered EDP-Auditor (RE). Some 700 of these work as internal auditors.
VRO (400+ registered RO's)	<i>Foundation of Registered Operational Auditors</i>	The VRO Association controls the Register of Registered Operational Auditors, accredits the university-level RO programs and stimulates the development of Operational Auditing. Most ROs are also member of the IIA.

Many internal auditors have two or more of these titles, so that a combination of a CIA designation with one or more postgraduate awards is common. With the increased number of integrated audits, high levels of expertise are set for internal auditors.

7. Frequently Asked Questions

Isn't having an IAF overkill? How many assurance functions do we really need?

An IAF is not just an extra control function, but it is a specialized unit that provides additional assurance to management regarding the governance of the principal risks of the organization. Its activities are coordinated with the other existing controls. If these controls are strong, and it is estimated that the level of risk is acceptable, then, strictly speaking, an IAF is not needed.

Why would a company choose to have its own IAF rather than outsourcing it?

An external provider is often a specialist who is familiar with the control measures that are in place in other companies. That is fine when examples and theoretical models are needed. The IAF, on the other hand, has a great deal of knowledge about the company itself, knows its culture and can respond proactively to developments. By having the IAF work together with various external specialists, a company experiences the best of both worlds.

Why can't the external auditor take on internal audit activities as well?

Based on the engagement letter issued by a company, the external auditor mainly examines the controls over the financial and accounting processes of the organization. The scope of the IAF, however, is much broader. It looks at all risk areas, with particular attention to the primary processes, and all of the strategic, compliance and operational risks that these include. In addition, there is the danger of self-audit, where the external auditor might be examining his own activities.

Is the IAF really objective enough to support the Audit Committee? After all, who gives the IAF its remit?

The IAF knows the company, but is actually part of it.

The IIA's Standards explain how the IAF can support both the executive board and the audit committee. Open communication between the executive board, the audit committee and the IAF, via both formal and informal channels, is the foundation. Nobody benefits from an IAF that merely functions as a puppet on a string.

Can an internal auditor really understand my business?

The composition of the modern IAF is diverse. To carry out a range of audits requires knowledge and expertise in both business management and the social sciences. Today's internal audit teams are often cross-functional. Many auditors now have prior experience in management positions. The IAF is regularly used as a training ground for fast-track managers.

How can the IAF ensure that its staff is of high caliber? Would a chartered accountant not prefer to work for an external auditor?

There are several postgraduate programs for various internal audit disciplines. These educational programs produce many new internal auditors each year. In addition, experienced accountants who have worked as external auditors increasingly opt for an internal position not only to achieve a better balance between their working and private lives, but also because of the broad scope of the work and the chance to experience a more in-depth approach to specific subjects.

So what is the added value of an IAF?

Audits conducted by an IAF are confidential, so concrete examples may not be publicized. The added value of the IAF often lies in the prevention of error and the effective control of risks that could lead to damage and loss. The IAF is a key proponent and assessor of risk management across the business, and thereby supports the success of the organization. Nearly all large and medium-sized companies have an IAF, even though it is not mandatory.

BASIC PRINCIPLES

BASIC PRINCIPLES:

The following 16 principles apply as much as ever.

Role and task of internal audit

1. The role of the internal auditor consists of providing additional assurance to the executive board and managers of an organization regarding the effectiveness and control of business operations.
2. The task of the internal auditor is to evaluate the controls built in to the business operations. This is done by conducting audits, reporting and advising on these to the managers responsible for those business operations and reporting to the executive board and audit committee on the work performed.

Expertise and professionalism

3. The internal audit function complies with the standards of one or more officially recognized professional bodies in the Netherlands.
4. The internal audit function has sufficient specialized knowledge.
5. The internal audit function develops and maintains a quality control system that monitors compliance with the standards of the professional bodies on an ongoing basis.

Positioning and objectiveness

6. The executive board of the organization appoints the head of the internal audit function.
7. Following discussions with the audit committee, the executive board establishes the role and responsibilities of the internal audit function. This is based on the risk profile of the organization and is determined in conjunction with the responsibilities of the external auditor.
8. The role and responsibilities of the internal audit function is set out by the executive board in an audit charter and is announced to the management of the organization, after the executive board has informed the audit committee. This charter also sets out matters that are of importance for the performance of the internal auditor's brief.
9. The internal auditor attends the meetings of the audit committee and, if invited, the meetings of the supervisory board. The internal auditor is authorized to consult the chairperson of the audit committee and the supervisory board, when appropriate.
10. The internal auditor will facilitate the actual implementation of the audit recommendations, while remaining fully objective in his or her advisory role.

Supervision over the internal audit function

11. The internal auditor submits the audit planning and actual work performed to the executive director for evaluation and approval purposes.
12. The audit committee discusses the planning, work performed and reporting by the internal auditor in the presence of the executive board and the internal auditor.
13. The party that has engaged the external auditor specifically asks the external auditor to report in the management letter on the way the internal audit function has been conducted.

The relationship with other internal assurance functions

14. The internal audit function should evaluate the design and operation of other assurance functions.

Collaboration between the internal auditor and the external auditor

15. The external auditor and the internal auditor operate in conjunction with each other to the extent that this is possible, each taking into account their specific roles and responsibilities.

Internal certification

16. The executive board of the organization decides to what extent the internal auditor is to be involved in the financial audit. This involvement may be such that the internal auditor, in the capacity of officially certified accountant, issues an internal auditor's opinion.

The full position paper 2008 can be found on the IIA website:
<http://www.iaa.nl/SiteFiles/Vaktechniek/NL%20Position%20Paper%20008%20final.pdf>



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