



Institute of Internal Auditors
UK AND IRELAND



A view from Smith

Five years on from the publication of the influential Smith Report on audit committees, what does its author Lord Robert Smith of Kelvin think internal auditors should be bringing to corporate governance in the troubled global economy?

Smith on Smith

Companies need professional internal audit now more than ever, the author of the Smith Report on audit committees tells the Institute of Internal Auditors – UK and Ireland

▶ It is now six years since Sir Robert Smith (now Lord Smith of Kelvin) started to write his seminal corporate governance guidance on the role of audit committees. The report, published by the Financial Reporting Council in 2003, did a great deal to enhance the status and role of both audit committees and internal auditors.

Now seems an excellent time to ask him to reflect on those issues again. Amid international financial market turmoil, and the searching questions being asked about the flawed strategies of certain financial powerhouses, the spotlight is on the quality of boardroom governance like never before. It is a topic that remains very close to Lord Smith's heart, which is one reason why he agreed to be the keynote speaker at the annual conference held by the Institute's Scottish District Society this October.

Returning to the ground covered by his report, Lord Smith, a chartered accountant and former President of the Institute of Chartered Accountants in Scotland, starts by making clear the distinction between the role of external auditor and internal auditor. "I think there is quite a way to go in some companies to explain to people what the external audit is actually doing – with its focus on financials and higher-level controls," he says. "They won't be looking at the non-financials and non-financial risk in depth, so you're depending on your internal auditors for that."

Boardroom credibility

The boardroom credibility of internal auditors has grown significantly since he wrote his report, Lord Smith says. The profession is held in higher regard by senior management, too. All understand that internal audit has a unique perspective on what is happening inside the business. However, his guidance stopped short of insisting that listed companies must have an internal audit function.

Has his view on this changed in today's fast moving business and tough economic environment?

"I would be more prescriptive," says Lord Smith. "I'd say that today you really ought to have an internal audit department. I think all FTSE 250 companies should now have an internal audit function."

So does entry into the FTSE 250 mark the point at which an organisation has grown enough for internal audit to be necessary? "I don't think it's just about size," says Lord Smith. "It is part of the evolution of the company and the culture within. You have to have some form of internal review. Whether you call this an internal audit function or not, you must have something because the external audit doesn't give you the sort of review and assurance over risk and controls across the spectrum of financial and non-financial aspects of the organisation." Of course, that is exactly what a good internal audit function provides, he adds.

"What I'm really referring to here is almost a cultural check or review," he explains. "If you are an internal auditor inside an organisation you have to keep your independence but you are also part of the total team. You can sense changes in culture. You can sense where people are fiddling their expenses, where there is a kind of slackness about recording things and you can see it. And, of course, that seeps right through an organisation once it starts."

More robust

Why has Lord Smith changed his view over the past few years? He is more robust in his convictions today about the need for internal audit, but he still believes – as he did when he wrote his report – that it is a development best encouraged as a point of principle, rather than as a mandatory rule.

"At that time of my report I was concerned, but things need to evolve and I felt that moving towards an internal audit function on a comply or explain basis was the right thing to do," he says. "I was worried that relatively small companies, even some of the FTSE 250 companies, struggling to make profits would be told 'You've got to have half of your board non-executives directors, you've got to do this or that.' If you are too prescriptive about this firms would be saying: 'I can't live with this regime'. I didn't want that."

Lord Smith also believes that by far the



majority of large organisations do now depend on the strength and independence of their internal auditors, working closely with the external auditors, to advise and provide assurance to management, the board and audit committees on the state of risk management and control. He believes that increasingly internal audit is an established and valuable part of corporate life.

So does Lord Smith see internal auditing stand on its own as a profession, separate from accountancy? "Definitely. Internal audit is an important profession, just as with accountancy, actuaries, lawyers or doctors. First of all you have a set of qualifications, then you gain post-qualification experience in business, keeping up standards and encouraging good practices around the place. That's the essence of a profession." (And to that end he adds that the Institute is a very important organisation in today's business environment, with a vital role to play the educating boards, audit committees and non-executive directors.)

Integrity

The theme for the Scottish conference is "professionalism". What are the characteristics of an effective internal auditor? "First of all, integrity is absolutely paramount," he says. "If they lack integrity then we don't have much chance. Secondly, they have to be strong people, because from time to time they will come across difficult situations and you have to be strong enough and able to stand up and say to top management and even the board: 'Hey, I'm going to have to take this to another place because you are not hearing me at all.'"

"Then strength of character and a high level of emotional intelligence; the ability to get along with people – it is not, as some people still think, a policeman role. I know some people still see internal audit in this way but this is a perception that is fast disappearing. It's not a matter of walking in and drawing a baton to batter a couple of heads to get attention, it just won't work. And you won't learn things about the business, which is vital."

This brings us to a favoured metaphor of Lord Smith: in business, like a craftsman shaping wood, you get a better result if you work with the grain. But the internal auditor has to work with the grain without losing their professional

integrity and independence, he says. "So integrity and strength of character are both key, along with an ability to talk to people."

Adding value

Lord Smith firmly believes there are plenty of opportunities for the internal auditor to make a difference to a company's bottom line, and that increasingly that happens. So is internal audit a value-adding function? "As an auditor I don't think you go in and say 'How can I improve the profitability of this division I'm auditing,'" he says, "that's the wrong approach. But when you discover things that are going wrong in a division, if you can help improve that – or even just point out what is going wrong – so the divisional guy can look at it and say 'I've got to address this and change it', then you do create value. If you can make things more efficient then that's of value, always remembering that you are in there to review what's happening in the business."

Business heavyweight

There are few business figures in Scotland with the stature of Lord Smith of Kelvin. He has scaled the giddiest heights in corporate life yet he remains a remarkably down-to-earth and sensible human being. One of his themes in business is the craftsman's metaphor of "working with the grain" and, in many ways, his common sense and practical approach to the reality of business have been the benchmarks of his remarkable career.

Now in his mid 60s, Lord Smith remains exceptionally busy, working from his neat and tidy personal office at Edinburgh Park, a stone's throw from Aegon UK, the Dutch-owned insurance and pension giant where he is a non-executive director. This location also allows him a quick getaway to Perth, where he chairs the board of Scottish & Southern Energy, and Glasgow, where he is chairman of the Weir Group, the global pumps and valves business. His hectic timetable also includes the chairmanship of the Glasgow 2014 Commonwealth Games, several academic appointments, a range of charitable work, and even a South African wine business.

About the Institute

The IIA is the only body focused exclusively on internal auditing and we are passionate about supporting, promoting and training the professionals who work in it. We have been leading the profession of internal auditing for over 60 years.

The IIA plays an active role in the public arena, building awareness of internal auditing, promoting members' interests and challenging organisations to reach the highest standards of corporate governance. Our *International Standards* and *Code of Ethics* unite a global community of 160,000 internal auditors in 165 countries.

We are committed to enhancing the recognition and professionalism of internal audit in the UK and Ireland, through:

- Dynamic leadership of the profession which maximises the reputation and influence of our members, both individually and collectively,
- Setting performance benchmarks and promoting professional integrity through our *International Standards* and *Code of Ethics*
- Continually developing our qualifications so that their high quality and reputation is maintained,
- Providing technical resources, networking opportunities and support to our members throughout their careers
- Maintaining our position as the market leader in internal audit training

The role of internal audit is to keep senior management, **informed** by challenging the business on risk and controls and telling them unequivocally how well the business is doing.

All staff and management, at all levels of the organisation can be **inspired** by their internal auditor team through its ability to champion excellence in governance, risk management and internal control processes, ensuring the success of the organisation.

An organisation's senior management is **assured** through the independent and objective reporting of internal auditors.

Be informed. Be inspired. Be assured.

www.iaa.org.uk

The Institute of Internal Auditors – UK and Ireland Ltd
13 Abbeville Mews, 88 Clapham Park Road, London SW4 7BX
tel 020 7498 0101 fax 020 7978 2492 email info@iaa.org.uk

Registered in England and Wales, no. 1474735
© October 2008. Information can be made available in other formats.