

To:

Sir Adrian

From:

Nigel Peace

9 September 1991

MEETING WITH MR GROAG, HEAD OF INTERNAL AUDIT AT BP

I attach a short record of my lunch with Tony Groag, which was more interesting than expected. I think we would be advised to make sure that we have answers to his points before coming to conclusions in the areas concerned, and to be sure that we are familiar with the situation in the US on internal audit requirements. I will keep in touch with him.

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RECORD OF LUNCH WITH MR TONY GROAG, HEAD OF INTERNAL AUDIT AT BP,
ON 6 SEPTEMBER 1991

Present:

Tony Groag
Nigel Peace

Mr Groag enlarged on the recommendations in his letter of 28 August (attached).

2 Mr Groag emphasised that whilst he believed that Boards should be required to operate adequate systems of internal control, he did not think that external auditors should be responsible for reporting on such a requirement. He argued strongly that external auditors simply did not have the expertise to do so and that the only effect of requiring auditors to make such a report would be to enable them to earn higher fees. He pointed out that for these reasons a bill which would have placed such a requirement on external auditors had recently been defeated in the US (the Omnibus Crimes Bill, Oct/Nov 1990).

3 Mr Groag made clear his view, that expertise rested with the internal auditors, and that it was therefore the chief internal auditor who should join the Audit Committee Chairman in putting his name in the annual accounts to a statement about the adequacy of internal controls. He believed that legislation requiring internal audit would soon be enacted in the US.

4 Mr Groag was dismissive of the Institute of Internal Auditors. He said that although he was a member, the Chief Internal Auditors of the other top ten companies (with whom he met informally from time to time) mostly did not.

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Thoughts on Corporate Governance

The Role of Internal Audit

To date Legislators and Regulators of all persuasions have failed to identify a very significant ally in their quest for enhanced Corporate Governance, namely, the **Internal Audit profession**.

Over the past 15 months I have taken a keen interest in the subject of Corporate Governance and as a consequence have sought out those with similar interests in both the UK and USA. The results of my survey, though not extensive or rigorous, suggest that the Internal Audit profession is, in many small and medium sized public companies, basically a basement activity. However, even here it has its successes - was it not the BCCI Internal Auditor who first advised the British Government of the serious malpractices?

In the major international companies operating in the U.K. and the U.S., Internal Audit is a respected profession utilised by Executive Management to provide assurance that systems of internal control are in place, are efficient and are effective in practice. In such companies Internal Auditors are drawn from all parts of the business and appointments to Internal Audit invariably represent a significant element of career development. In such environments Internal Audit has knowledge and understanding of company strategy, business practices, commercial reality, ethics and accounting/reporting. It is the amalgam of these skills together with knowledge of the business culture and personalities that enables Internal Audit to report to Board Audit Committees on the efficiency, efficacy and probity of the internal control infrastructures. External Auditors have come to rely **very heavily** on the work and evaluations carried out by Internal Audit - such reliance should not be covert; cognisance should be overt and the shareholder etc made fully aware. However, in the pursuit of excellence in Corporate Governance there is a fundamental weakness associated with Internal Audit, namely; the senior position is filled by Executive Management and therefore changed at their discretion. The consequences of this may be obvious and therefore needs to be rectified to ensure truly independent actions.

Corporate Governance excellence is being demanded for the protection of shareholders, society and Government and in my **personal opinion** this requires the concerted and cohesive efforts, a marriage even, of Internal and External audit,

albeit they are; by their very nature somewhat different. For this to happen Internal Audit needs elevation and cognisance as follows:

- (a) The recommendations of the 1987 Treadway Commission should be implemented as follows:
- (i) All public quoted companies **must** have a Board Audit Committee made up of Non Executive Directors.
 - (ii) For all publicly quoted companies the annual accounts should contain a signed statement that the company's systems of internal controls are adequate ,efficient and effective.
 - (iii) This statement should be adjacent to the External Auditor's certificate (as to the reasonableness of the accounts) in the annual accounts and should be signed by the Chairman of the Board Audit Committee and the senior Internal Auditor.
 - (v) There should be a register of Non -Executive Director's interests which should be audited to ensure that there are no serious conflicts of interest between these directors and the company's Executive Management.
- (b) A senior Internal Audit position should exist and the candidate nominated by Executive Management for a period of no less than 4 years and no more than 10 years . The position and incumbent should be nominated by the Board Audit Committee and then approved at a meeting of the shareholders.
- The incumbent should report to the Board Audit Committee and for internal reporting purposes he/she should report to the Chairman or his deputy whichever does **not have responsibility for finance or the accounting and reporting functions.**

A.E.H.Groag.

Wednesday, August 28, 1991