Chartered Institute of Internal Auditors

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The Chartered IIA Response to Ofwat's Water Governance Code Consultation

Question 1

Are there particular aspects of the existing Board Leadership, Governance or Transparency Principles or other sector codes which would be useful to consider?

The Chartered Institute of Internal Auditors (Chartered IIA) welcomes Ofwat's proposals to strengthen governance standards across the water sector and supports the objective of aligning the Water Governance Code with recognised governance best practice, including the UK Corporate Governance Code. We believe, however, that an important element of effective governance is currently absent from the proposals: clear expectations relating to internal audit and independent assurance.

The Chartered IIA is the professional body for internal audit in the UK and Ireland, representing more than 10,000 members, including members working within the water sector. Strong governance depends not only on effective boards, independent non-executive directors and robust committee structures, but also on the availability of independent assurance regarding the effectiveness of governance, risk management and internal control arrangements. Internal audit is the internationally recognised function established to provide this assurance. It supports boards and audit committees by providing independent and objective assurance, advice, insight and foresight across an organisation's most significant risks and controls.

The omission of internal audit from the consultation is notable given the central role that independent assurance plays in recognised governance frameworks and the consultation's stated objective of aligning the Water Governance Code with recognised governance best practice. The UK Corporate Governance Code requires audit committees to consider annually whether there is a need for an internal audit function where one does not exist and requires companies to explain the absence of internal audit and how internal assurance is otherwise achieved. Similarly, Ofgem's Financial Responsibility Principle requires energy suppliers to explain their internal audit arrangements and, where no internal audit capability exists, explain how independent assurance is obtained and whether the need for internal audit has been considered. Internal audit is also an established feature of governance and assurance arrangements in other regulated sectors. For example, financial services firms regulated by the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) are expected to maintain internal audit functions that are appropriate to the nature, scale and complexity of their activities.

The inclusion of such provisions within the governance and assurance framework of another regulated utility sector is particularly relevant. Both the water and energy sectors operate critical national infrastructure and face significant operational, financial, cyber, resilience and customer-service risks. In this context, it is difficult to see why boards in one critical infrastructure sector should be expected to explain how they obtain independent assurance, while boards in another are not. We therefore believe the Water Governance Code should establish similarly clear expectations regarding internal audit and independent assurance.

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Our research in 2024 found that three water-only companies in England did not maintain internal audit functions. While we are not suggesting that the absence of internal audit was the cause of any governance, operational or financial challenges experienced by those organisations, we believe this highlighted a gap in regulatory expectations regarding independent assurance across the sector.

We therefore recommend that the Water Governance Code includes a specific provision relating to internal audit and independent assurance. Drawing on the approaches adopted by the UK Corporate Governance Code and Ofgem's Financial Responsibility Principle, the Code should require boards to explain how they obtain independent assurance over governance, risk management and internal controls and, where no internal audit function exists, explain the reasons for its absence, how independent assurance is achieved, and whether the need for an internal audit function has been formally considered by the board. The Code could include wording along the following lines:

"Boards of companies within the scope of the Water Governance Code should explain how they obtain independent assurance over governance, risk management and internal controls. Where an internal audit function exists, the board should explain its role in supporting governance and oversight. Where no internal audit function exists, the board should explain the reasons for its absence, how independent assurance is achieved, and whether the need for an internal audit function has been considered, taking into account the nature, size and complexity of the organisation."

The Chartered IIA believes that, for most companies within the scope of the Water Governance Code, the most effective means of meeting such an expectation will be through the establishment and maintenance of an independent internal audit function operating in accordance with the International Professional Practices Framework (IPPF), including the Global Internal Audit Standards, and the Chartered IIA's Internal Audit Code of Practice. The audit committee should have responsibility for overseeing the internal audit function, including approving its mandate, resources and risk-based audit plan, safeguarding its independence, and reviewing its effectiveness.

The Water Governance Code presents a significant opportunity to strengthen accountability, transparency, board oversight and public confidence in the sector. We would welcome the opportunity to work with Ofwat as the Code develops and to provide technical input on the design and drafting of any provisions relating to internal audit and independent assurance.

Question 11

Do you agree with the principle that audit, remuneration and nomination committees of water companies should not also serve the boards of other companies?

The Chartered IIA does not have a set position on whether audit, remuneration and nomination committees should also serve the boards of other companies. Our comments therefore focus on audit committees and the importance of independent assurance in supporting effective oversight.

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Regardless of the committee structure adopted, audit committees require access to independent assurance to support effective oversight of governance, risk management and internal controls. For this reason, we believe the Water Governance Code should also include clear expectations regarding internal audit and independent assurance.

Where internal audit is present, the audit committee should be responsible for overseeing the function, including safeguarding its independence, approving its mandate and ensuring that it is appropriately resourced to provide effective assurance across the organisation. This is particularly important given the public interest responsibilities of water companies and the increasing regulatory, operational, financial and environmental challenges facing the sector.

Question 12

Do you have views as to whether any of the proposals set out above would reasonably take longer than 1 April 2028 to implement?

We do not have specific concerns regarding the proposed implementation timetable.

Should Ofwat decide to introduce provisions relating to internal audit and independent assurance within the Water Governance Code, we do not believe these would require implementation beyond 1 April 2028. Many companies already operate internal audit functions, and there are a range of delivery models available, including in-house, co-sourced and outsourced arrangements.

The key consideration is not the delivery model adopted, but whether arrangements provide boards and audit committees with independent assurance over governance, risk management and internal controls. We therefore consider the proposed implementation timetable to be reasonable.