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White paper

Internal Audit independence arrangements

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Background

The evolution of Internal Audit outlined in the table on the following page shows how Internal Audit work has evolved over time.

Whilst Internal Audit traditionally may have reported to line management, over time it became obvious that Internal Audit needed to be independent of management if it was to successfully do its job.

For Internal Audit to report to the Chief Finance Officer or the Corporate Services Director is to place the Chief Audit Executive in an invidious situation, as many audits are usually conducted in finance and corporate areas of an organisation. The risk of actual, potential, or perceived interference and undue influence is great.

Refer the Evolution of Internal Audit table on the following page.

Background

Purpose

The purpose of this White Paper is to demonstrate how Internal Audit can be independent when it is part of an organisation.

The definition of internal auditing is:

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

This definition is contained in the International Professional Practices Framework (IPPF) issued by the Institute of Internal Auditors (IIA).

Where the term Chief Audit Executive (CAE) is mentioned in this paper, it relates to the generic term used in the IPPF to refer to the head of Internal Audit in an organisation.

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Evolution of Internal Audit						
Features	Checking Up to 1960s	Compliance 1960s – 1980s	System-based 1980s – 1990s	Risk-based 1990s – 2010s	Partnership 2010s –	Value-based Emerging
Independence	Independent of activities audited	Independent of activities audited	Independent of activities audited			
Serving	Finance	Finance	Finance / business units	Business units	Organisation	Organisation
Reporting to	Generally CFO	Generally CFO	Generally CFO	Emerged to CEO and then Audit Committee reporting	Audit Committee for operations; CEO for administration	Audit Committee for operations; CEO for administration
Objective	Assurance	Assurance	Assurance	Assurance	Assurance and advisory; value-adding	Assurance and advisory; value-adding; proactive; offer insights; key agent of change
Focus	Historical	Historical	Historical	Historical	Forward-looking	Forward-looking; insights
Coverage	Controls	Controls	Controls	Controls	Governance, risk management, controls	Governance, risk management, controls
Outcome	Detect mistakes	Detect mistakes	Improve controls	Improve business unit controls	Improve business units	Improve organisation; actively seek innovation
Fraud focus	Detect fraud	Detect fraud	Detect fraud	Detect fraud	Prevent fraud	Prevent fraud
Reports go to	Management	Management	Management	Management; emerged to Audit Committee	Management and Audit Committee	Management and Audit Committee
Standards	No	Internal Audit Standards in 1978	Internal Audit Standards	Internal Audit Standards	Internal Audit Standards	Internal Audit Standards
Resourcing	In-house	In-house	In-house	In-house; emerged to co-sourced	Co-sourced; subject matter experts and guest auditors	Co-sourced; subject matter experts and guest auditors
Staff qualifications	Financial	Financial	Financial	Financial	Some non-financial disciplines	More non-financial disciplines
Planning	Cyclical annual plan	Cyclical annual plan	Cyclical 5-year plan	Risk-based 3-year plan	Risk-based 3-year or annual plan	Risk-based rolling plan
Audit types	Compliance	Compliance	System	Operational	Integrated	Service catalogue
Management requested services	No	No	No	Some	Yes	Yes; many

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Discussion

Issue

The issue to be discussed is:

How can Internal Audit be independent when it is part of an organisation?

Discussion

Internal Audit is one assurance mechanism in a suite of assurance activities, with many organisations using a combined assurance 3 Lines of Defence model to define their assurance environment:

- The 1st Line of Defence originates or initiates risk, and is responsible for managing the risks and having in place mechanisms to demonstrate controls are working effectively.
- The 2nd Line of Defence monitors, reviews and tests effectiveness of 1st Line control and management of risks.
- The 3rd Line of Defence independently evaluates and gives an opinion on the adequacy and effectiveness of both 1st Line and 2nd Line risk management approaches.

The 3 Lines of Defence approach demonstrates how assurance activities co-ordinate to provide assurance to the Audit Committee and Executive Management.

The diagram below shows an example of the 3 Lines of Defence as it applies within an organisation. Note that external audit and regulators assurance activities are outside of the 3 Lines of Defence.

Combined Assurance – 3 Lines of Defence		
1st Line of Defence Owns and manages risk	2nd Line of Defence Monitors risk	3rd Line of Defence Assures risk is managed
Management Controls Real-time focus	Management of Risk Real-Time Focus + Review Focus of 1st Line	Independent Assurance Review Focus of 1st Line and 2nd Line
Management controls Internal controls Project controls	Risk management Legal compliance Technical compliance Regulatory compliance Security Inspection activities Quality activities Work health safety Environment	Internal Audit
Review governance and compliance Implement improvements	Confirm governance and compliance Recommend improvements	Independently confirm governance and compliance Recommend improvements

How can Internal Audit be independent?

Internal Audit is a part of the organisation, and therefore must be independent of management (1st and 2nd Lines of Defence) if it is to perform its role independently. This is achieved by the Chief Audit Executive reporting:

- Functionally for operations to the Audit Committee through the chair.
- Administratively to the Chief Executive Officer.

Functional reporting generally involves the Audit Committee:

- Reviewing and approving the Internal Audit Charter.
- Approving decisions regarding appointment and removal of the Chief Audit Executive and their performance assessment.
- Reviewing and approving the strategic and annual internal audit plans, including approving any changes.
- Reviewing reports on the results of internal audit engagements, audit-related activities, audit team capability, audit performance and other important matters.
- Monitoring compliance with standards, together with quality and improvement arrangements.
- Meeting privately with the Chief Audit Executive at least once a year without the Chief Executive Officer or other management present, though many Audit Committees do

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this more frequently.

- Making enquiries of the Chief Audit Executive to determine any scope or budget limitations that may impede the execution of Internal Audit responsibilities.

Administrative reporting to the Chief Executive Officer generally includes:

- Internal Audit resources and annual budget.
- Provision of corporate services to Internal Audit including office accommodation, computers and equipment.
- Human resource administration.

Internal Audit Reporting Models

The IPPF prescribes 10 Core Principles for the Professional Practice of Internal Auditing. The following table shows anticipated conformance to the various reporting models:

- Model 1 – Chief Audit Executive reports functionally for operations to the Audit Committee through the chair, and administratively to the Chief Executive Officer.
- Model 2 – Chief Audit Executive reports functionally for

operations to the Audit Committee through the chair, and administratively to a line manager such as the Chief Finance Officer or Corporate Services Director.

- Model 3 – Chief Audit Executive reports functionally and administratively to a line manager such as the Chief Finance Officer or Corporate Services Director.

The following table shows how the various reporting models conform to the Core Principles.

Model 2 and model 3 do not conform to good practice internal auditing.

Where busy Chief Executive Officers may decide to delegate administrative responsibility for Internal Audit, and this does not conflict with mandated requirements in their jurisdiction, it is usually to the next most independent Senior Executive who should be in an area where there is little internal audit activity, for example General Counsel or Company Secretary. Should this occur, safeguards need to be built-in to the Internal Audit Charter, such as regular meetings and right of direct access to the Chief Executive Officer preserved.

Non-conformance	Partial conformance	General conformance
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Internal Audit Core Principles		Model 1	Model 2	Model 3
1	Demonstrates integrity.			
2	Demonstrates competence and due professional care.			
3	Is objective and free from undue influence (independent).		Undue influence	Undue influence
4	Aligns with the strategies, objectives, and risks of the organisation.			
5	Is appropriately positioned and adequately resourced.		Positioning	Positioning
6	Demonstrates quality and continuous improvement.			
7	Communicates effectively.			
8	Provides risk-based assurance.			
9	Is insightful, proactive, and future-focused.			Can be inhibited
10	Promotes organisational improvement.			

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Conclusion

Summary

Good practice Internal Audit independence arrangements will have the Chief Audit Executive reporting to:

- Functionally for operations to the Audit Committee through the chair.
- Administratively to the Chief Executive Officer.

Where busy Chief Executive Officers decide to delegate administrative responsibility for Internal Audit (where permitted) it is usually to the next most independent Senior Executive who should be in an area where there is little internal audit activity, for example General Counsel or Company Secretary. Regular meetings and right of direct access to the Chief Executive Officer should then be preserved for the Chief Audit Executive in the internal audit charter.

Conclusion

The independence of Internal Audit functions is of interest to regulators, external scrutineers, and governments, for instance all institutions regulated by the Australian Prudential Regulation Authority (APRA) are required to comply with Prudential Standard CPS 510 Governance. Among other requirements, an APRA-regulated institution must have an independent and adequately resourced Internal Audit function.

Similar provisions are in place within the public sector through government policy across most Australian jurisdictions, and for private sector listed entities through the ASX Corporate Governance Council Principles and Recommendations.

The Australian Security and Investments Commission (ASIC) Information Sheet Internal Audit encapsulates what is required for Internal Audit independence:

In order to ensure independence of the Internal Audit function from management:

- *The Internal Audit function should report directly to the Audit Committee, rather than the management of the organisation.*
- *The Internal Audit Charter and plan should be reviewed and approved by the Audit Committee, who should also receive and review reports on Internal Audit engagements, and monitor the performance and*

independence of the Internal Audit function.

- *While the Internal Audit budget may be set with the Chief Executive Officer, the appropriateness of the budget should be reviewed by the Audit Committee.*

Organisations that take Internal Audit seriously will implement these independence arrangements; those that do not are merely paying 'lip service' to good governance.

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Purpose of White Papers

A White Paper is a report authored and peer reviewed by experienced practitioners to provide guidance on a particular subject related to governance, risk management or control. It seeks to inform readers about an issue and present ideas and options on how it might be managed. It does not necessarily represent the position or philosophy of the Institute of Internal Auditors—Global and the Institute of Internal Auditors—Australia.

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About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

IIA–Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 200,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing,

risk management, governance, internal control, information technology audit, education, and security.

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