Internal Audit Independence
November 2021

An important aspect of an effective internal audit actvity is its independence from the undue influence of the areas under review. Internal Auditing Standard 1100 *Independence and Objectivity* in describing this independence says:

> *Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board.*
>
> *(International Internal Auditing Standards Board, 2016)*

Ordinarily the responsibilities of the 'board' in the Internal Auditing Standards are filled by an audit committee appointed by those charged with governance of the organisation.

The Institute of Internal Auditors - Australia surveyed Chief Audit Executives (CAEs) to explore these issues. 54 responses were received across a wide section of the economy (Exhibit 1) and different corporate structures (Exhibit 2).

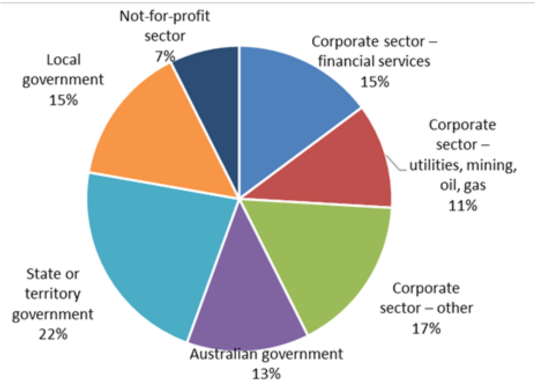


Exhibit 1 – Economic sector of respondents

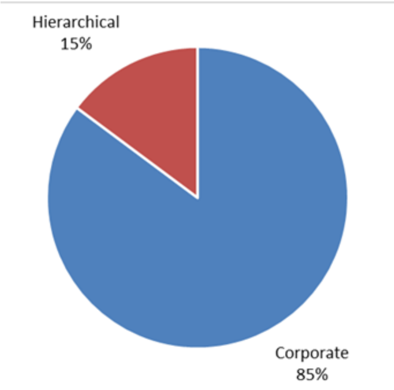


Exhibit 2 – Organisational structure of respondents[1]

All but three (6%) of these organisations had an audit committee. Those without audit committees were all corporate sector organisations.

Audit Committees

Accepted good practice is for organisations to have an audit committee and for that committee to be constituted of individuals who are not members of organisational management. Audit committee members would ordinarily be non-executive directors or individuals contracted by the governing body for the purpose of service on the audit committee.

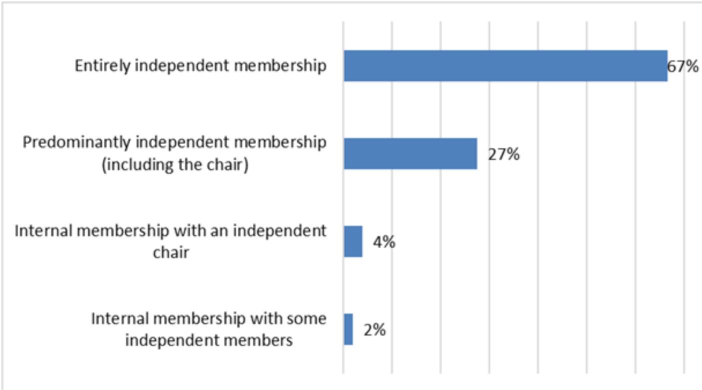


Exhibit 3 - Composition of Audit Committee

It is pleasing to see that most respondent organisations are following accepted international best practice. (Exhibit 3) The audit committees in more than half of the respondent organisations were comprised entirely of independent members. Only three (6%) of the respondents indicated that their audit committees were dominated by management members.

Two (4%) of the respondents who indicated that their organisation has an audit committee also indicated that the committee was not appointed by those charged with the governance of the organisation. This has the implication that while the board of these organisations does not regard the audit committee as significant, a senior member of management thinks that having such a committee is important to the organisation.

Chief Audit Executive[2] relationship to the audit committee

The Internal Auditing Standards recommend that the Chief Audit executive (CAE) report functionally to the board (audit committee). Standard 1110 *Organisational Independence* says the following:

1 In this context, "corporate" means that the organisation is governed by a board or similar structure and "hierarchical" means that the organisation is governed by a single individual.
2 As defined under the Internal Auditing Standards, the Chief Audit Executive is a person in a senior position responsible for effectively managing the internal audit activity. They are expected to be an executive of the organisation, but need not be a professional internal auditor.

CAE '60 Second' Survey

Organizational independence is effectively achieved when the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board:

- *Approving the internal audit charter.*
- *Approving the risk-based internal audit plan.*
- *Approving the internal audit budget and resource plan.*
- *Receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters.*
- *Approving decisions regarding the appointment and removal of the chief audit executive.*
- *Approving the remuneration of the chief audit executive.*
- *Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.*

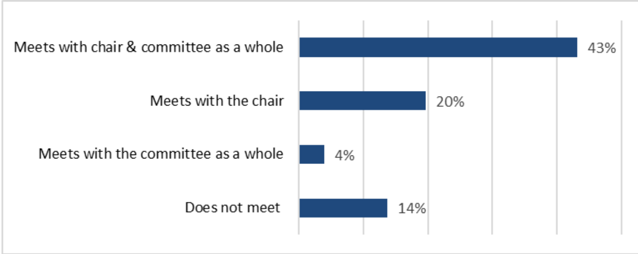
(International Internal Auditing Standards Board, 2016)

Forty-two (82%) of respondents who reported having an audit committee also indicated that the CAE reported functionally to that committee. Of these, the majority (32 respondents or 63%) also meet routinely with the audit committee chair outside of audit committee meetings. Interestingly, a number of respondents who indicated that the CAE did not functionally report to the audit committee, did indicate that the CAE had private meetings with the audit committee chair.

Both private sector and government guidance recommends that the audit committee should meet privately with the CAE without organisational management present. Such a practice strengthens the independence of internal audit and allows for free exchange of information. This practice was common amongst the respondents with 27 (53%) indicating that this was the practice in their organisation.

This creates a complex picture of the way the CAE relates to the audit committee. We will assume that the respondents understood the distinction between functional and administrative reporting as they are defined in the Internal Auditing Standards. The picture that presents is shown in Exhibit 4.

CAE reports functionally to the audit committee



CAE does not report functionally to the audit committee

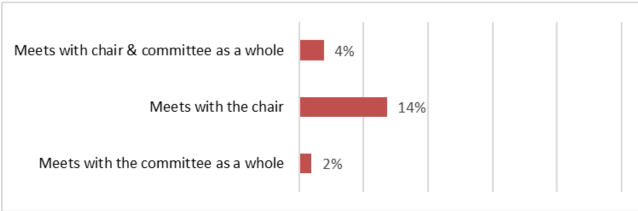


Exhibit 4 - Relationship between the CAE and their audit committee

While there are a number of audit committees that meet privately with the CAE in the absence of a requirement set out in their charter, eight respondents (16%) indicate that, in spite of the requirement set out in the audit committee charter and the guidance of best practice, the committee does not meet routinely with the CAE in private session without management present.

Chief Audit Executive administrative reporting

Administrative reporting encompasses routine housekeeping matters that do not relate to the delivery of the internal audit service. They are, for example, approval of leave, approval of purchases of goods or services for the personal use of the CAE, or the management of office accommodation, facilities and IT services. While the Internal Auditing Standards make no recommendation in relation to administrative reporting lines, the The Institute of Internal Auditors - Australia is of the opinion that such reporting should be to the Chief Executive Officer (CEO) or equivalent (The Institute of Internal Auditors - Australia, 2021).

The administrative reporting point of our respondent CAEs is shown in Exhibit 5. It is disappointing to note that there are still a number of organisations where the administrative report of the CAE may have a parochial or potentially conflicted interest in the outcome of internal audit activity and is in a position to influence the result. In particular, reporting to the head of Corporate, to the Chief Financial Officer (CFO), or to People and Culture places the CAE in a reporting relationship with a significant direct client of internal audit services. Reporting to the Chief Risk Officer (CRO) is also undesirable as it places line 3 activity in a position that is subordinate to a line 2 activity. (See the IIA's Three Lines Model).

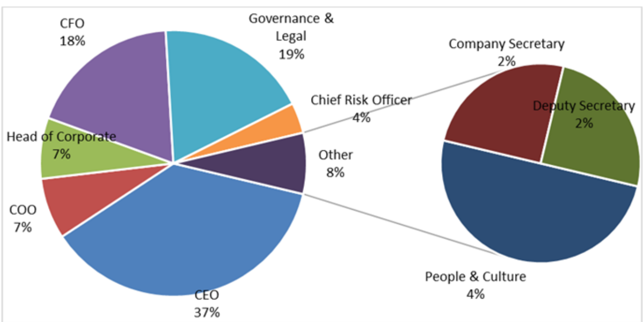


Exhibit 5 – CAE administrative report

Safeguarding the independence of internal audit

Eight (24%) of the 34 CAEs who reported that they did not report to the Chief Executive Officer (CEO) or equivalent, also reported that there were no safeguards in place to protect them from undue influence by their administrative report.

Pleasingly, where safeguards are relevant and in place, they are documented in an authoritative document such as a corporate policy or charter (see Exhibit 6). The nature of these safeguards is shown in Exhibit 7. It should be noted that an internal audit manual is not usually approved by the governance body and therefore has no authority outside internal audit.

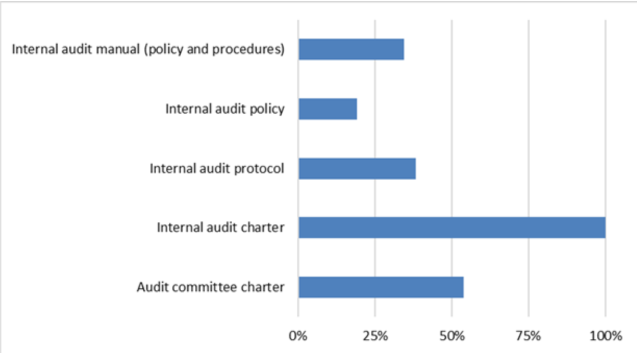


Exhibit 6 - Documentation of independence safeguards

Exhibit 7 - Nature of safeguards

A small number (11%) of respondent CAEs believed that their reporting arrangements allowed management to limit the internal audit scope of operations or selection of methodology. Seven (13%) of respondents reported that, in the last 12 months, the executive to whom they reported had attempted to influence the subject or results of internal audit activities. In one of these cases, the executive concerned was the CEO. An important aspect of the Three Lines Model is that those charged with governance can get the opinion of the internal auditor unmediated by management and regular private meetings between the CAE and the audit committee are a mechanism to minimise interference of this kind.

Chief Audit Executive access to the Chief Executive Officer

Regardless of reporting arrangements, it is accepted good practice that the CAE has unrestricted access to the CEO. It is the opinion of the Institute of Internal Auditors-Australia that this access should include regular scheduled meetings without other organisational management present.

Thirty-five (65%) respondents indicated that such meetings take place in their organisation. They are not usually mandated by any form of charter or policy. Where such mandates are in place they are within the audit committee charter and/or the internal audit charter. In a small number of organisations, the board and/or audit committee has written such a requirement into the relevant charters, but the meetings are not taking place. We would encourage those charged with governance in all organisations to encourage regular scheduled meetings between the CAE and CEO.

Chief Audit Executive relationship with the organisational executive

There are advantages in the communication of organisational strategies and of control and governance issues if the CAE is a regular attendee at meetings of the organisational executive. There are also potential disadvantages in the appearance that the CAE is involved in the making of corporate policy decisions. Different organisations approach this differently. It is increasingly common for the CAE to attend executive meetings to discuss significant issues arising from the internal audit program, to provide early warning of potential issues, or to report on unaddressed items from past internal audits. It is not usual for the CAE to be a regular member of the executive. (See Exhibit 8).

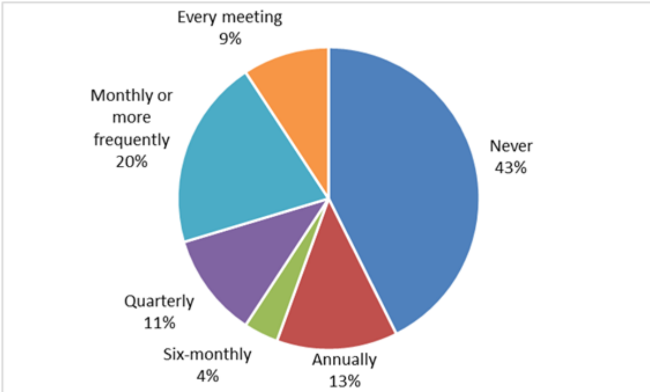


Exhibit 8 - How frequently does the CAE attend meetings of the organisational executive team

Conclusion

Internal audit activities within Australia are generally established with the recommended dual reporting line, although for many internal audit activities the administrative report is still a second level, or even third level, executive. Reporting to the most senior levels in the organisation signals that the internal audit service is seen as important and valued. To obtain maximum value from their internal audit activity, organisations should keep these reporting points at the most senior levels.

There is ongoing impulse in some managers to influence internal audit outcomes to promote particular outcomes. This can only be prevented by the vigilance of a skilled audit committee and best practice independence and reporting arrangements for the internal audit activity.

Useful References

ASX Corporate Governance Council. (2019). Corporate Governance Principles and Recommendations, 4th Edition. Retrieved from ASX: https://www2.asx.com.au/about/regulation/asx-corporate-governance-council

Auditing and Assurance Standards Board, Australian Institute of Company Directors and the The Institute of Internal Auditors - Australia. (2017). Audit Committees: A guide to good practice (3rd ed.). Sydney: The Auditing and Assurance Standards Board, the Australian Institute of Company Directors, The Institute of Internal Auditors–Australia.

Cox, A. (2020, Feb). White paper: Internal Audit independence arrangements. Retrieved from IIA-Australia: https://iia.org.au/sf_docs/default-source/technical-resources/2018-whitepapers/iia-whitepaper_internal-audit-independence-arrangements.pdf

International Internal Auditing Standards Board. (2016). International Standards for the Professional Practice of Internal Auditing. Lake Mary, FL, USA: Internal Audit Foundation. Retrieved from https://global.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx

NSW Government. (2020, Dec). Internal Audit and Risk Management Policy for the General Government Sector. Retrieved from NSW Treasury: https://www.treasury.nsw.gov.au/sites/default/files/2021-01/tpp20-08_internal_audit_and_risk_management_policy_for_the_general_government_sector.pdf

The Institute of Internal Auditors - Australia. (2021). Factsheet: Chief Audit Executive Reporting. Retrieved from IIA-Australia: https://iia.org.au/sf_docs/default-source/technical-resources/2018-fact-sheets/factsheet-chief-audit-executive-reporting.pdf

The Institute of Internal Auditors. (2020). The IIA's Three Lines Model: an update of the three lines of defense. Lake Mary, FL., USA: The Institute of Internal Auditors. Retrieved from https://global.theiia.org/about/about-internal-auditing/Public%20Documents/Three-Lines-Model-Updated.pdf