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The Institute of  
**Internal Auditors**  
*Australia*

**Whitepaper**

# Internal Audit Independence Arrangements

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# Internal Audit Independence Arrangements

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## 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.

## 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 ‘Evolution of Internal Audit’ table on the following page.

## 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 an integrated assurance 3 Lines Model to define their assurance environment:

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

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

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

# Internal Audit Independence Arrangements

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
<b>Independence</b>	Independent of activities audited	Independent of activities audited	Independent of activities audited	Independent of activities audited	Independent of activities audited	Independent of activities audited
<b>Serving</b>	Finance	Finance	Finance / Business units	Business units	Organisation	Organisation
<b>Reporting to</b>	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
<b>Objective</b>	Assurance	Assurance	Assurance	Assurance	Assurance and advisory / Value-adding	Assurance and advisory / Value-adding / Proactive / Offer insights / Key agent of change
<b>Focus</b>	Historical	Historical	Historical	Historical	Forward-looking	Forward-looking / Insights
<b>Coverage</b>	Controls	Controls	Controls	Controls	Governance / Risk management / Controls	Governance / Risk management / Controls
<b>Outcome</b>	Detect mistakes	Detect mistakes	Improve controls	Improve business unit controls	Improve business units	Improve organisation / Actively seek innovation / Help organisation achieve strategic intent
<b>Fraud focus</b>	Detect fraud	Detect fraud	Detect fraud	Detect fraud	Prevent fraud	Prevent fraud
<b>Reports go to</b>	Management	Management	Management	Management / Emerged to Audit Committee	Management and Audit Committee	Management and Audit Committee
<b>Standards</b>	No	Internal Audit Standards in 1978	Internal Audit Standards	Internal Audit Standards	Internal Audit Standards	Internal Audit Standards
<b>Resourcing</b>	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
<b>Staff qualifications</b>	Financial	Financial	Financial	Financial	Some non-financial disciplines	Many non-financial disciplines
<b>Planning</b>	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
<b>Audit types</b>	Compliance	Compliance	System	Operational	Integrated	Service catalogue
<b>Management requested services</b>	No	No	No	Some	Yes	Yes - many

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## 3 Lines of Assurance

Line 1 Assurance	Line 2 Assurance	Line 3 Assurance
<i>Owns and manages risk</i>	<i>Monitors risk</i>	<i>Assures risk is managed</i>
<b>Management Controls</b>	<b>Management of Risk</b>	<b>Independent Assurance</b>
<i>Real-Time Focus</i>	<i>Real-Time Focus</i>	<i>Review Focus of Line 1 and Line 2</i>
<ul style="list-style-type: none"> <li>› Review governance and compliance</li> <li>› Implement improvements</li> </ul>	<ul style="list-style-type: none"> <li>› Confirm governance and compliance</li> <li>› Recommend improvements</li> </ul>	<ul style="list-style-type: none"> <li>› Independently confirm governance and compliance</li> <li>› Recommend improvements</li> </ul>

- › 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.

Under no circumstances should the Chief Audit Executive report to a Senior Executive in Line 1.

## How can Internal Audit be independent?

Internal Audit is a part of the organisation, and therefore must be independent of management 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 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:

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Non-conformance

Partial conformance

General conformance

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.			

## Conclusion

### Summary

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

- › 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. Regular meetings and right of direct access to the Chief Executive Officer should be preserved for the Chief Audit Executive in the internal audit charter.

### Conclusion

The independence of Internal Audit 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.

# Internal Audit Independence Arrangements

## Bibliography and References

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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'.

The 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.

# Internal Audit Independence Arrangements

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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