

Internal Audit Reporting Relationships: Serving Two Masters



The IIA Research Foundation

Your Key to the Future 

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The Professional Practices Framework for Internal Auditing (PPF) was designed by The IIA Board of Directors' Guidance Task Force to appropriately organize the full range of existing and developing practice guidance for the profession. Based on the definition of internal auditing, the PPF comprises Ethics, *Standards*, Practice Advisories, and Development and Practice Aids, and paves the way to world-class internal auditing.

This guidance fits into the *Professional Practice Framework* under the heading Development and Practice Aids.



Preface

This research report is part of a series of research projects that are being developed under the leadership of The IIA Research Foundation and the Research Department of The Institute of Internal Auditors. The Foundation welcomes input on important topics for investigation. The information gathered is designed to:

- Assist professional internal auditors in dealing with real issues they face on an every day basis.
- Provide input to important decision-makers, both within the profession and to bodies involved with corporate governance that will facilitate their debate on topical issues.
- Establish a database of internal audit activities that will be available to other researchers, including the academic community, that are interested in the practice of internal auditing.

The Trustees chose the topic of internal audit reporting relationships because there are few topics that are more influential on the nature of internal audit practice. Reporting relationships have been debated since the beginning of the internal audit profession. The evolution and changing demands of the profession can be seen in the various calls for an enhanced internal audit activity as an important part of corporate governance. These demands for expanded responsibilities range from the New York Stock Exchange and the Securities and Exchange Commission in the United States to the Turnbull Commission in the United Kingdom, or the King Report in South Africa, as well as a recognition of expanded governance roles in various Asian countries.

The establishment of initial data will allow researchers to monitor changes that take place over time, or differences that exist on either an industry or cultural basis. We also believe this report will provide insight on how internal audit activities are dealing with the dual issues of independence and objectivity as they seek to satisfy the needs of senior management, operational management, and audit committees or boards of directors.

We welcome your feedback and suggestions for future topics.

Reporting Relationships and Independence

When the internal audit profession was emerging in the 1940's, the scope of internal auditing and the reporting relationship was fairly simple. Very early in his textbook writing, Lawrence Sawyer described internal auditing as the "eyes and ears of management." Internal auditors would investigate operations to see that they were properly controlled and would make recommendations to management. It was presumed that the recommendations would be similar to what management would have done if management had the time to individually review all operations for adequate controls. Although the phrase "eyes and ears of management" implies that the reporting relationship would normally be to senior management, the early research shows that in most cases the reporting relationship was to the controller (or today's chief financial officer) because of the emphasis on evaluating control. Such a reporting relationship generally fit the existing, albeit narrow, understanding of the role of internal audit within an organization.

The evolution of internal auditing is best seen in the definition of internal auditing adopted by The Institute of Internal Auditors (IIA) in 1999:

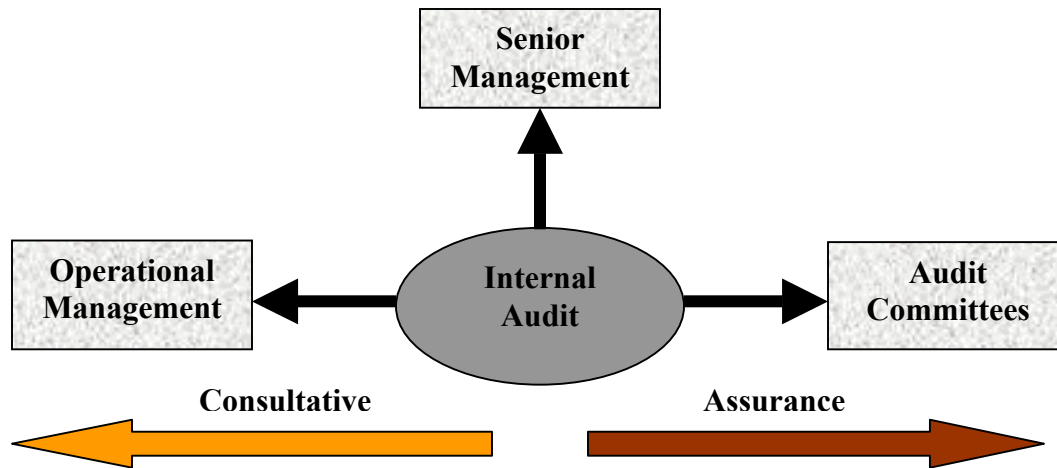
Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management,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

This definition recognizes a significant role for internal auditing that is based on the activities in which it has a defined expertise. At the same time, it recognizes that there are many different constituencies (customers) for internal audit services. For example, the definition clearly envisions important customers as:

- Senior management
- Operational management
- Audit committees and the board of directors.

It is certainly conceivable that there will be potential conflicts that may arrive in serving these different constituents. For example, operational management may be interested only in advice that will improve the efficiency or effectiveness of operations. Senior management may be interested in activities that may directly affect the bottom line, or potentially their bonuses. On the other hand, the audit committee may be more concerned with managing their own risk and request a greater focus on risk management and control activities. These competing demands can be visualized in Figure 1.

Figure 1
Major Constituents and Requests from Internal Audit



The demands from the various constituents are quite different. Audit committees are primarily interested in assurance services regarding risk and control. Operational management is primarily concerned with consultative help regarding the efficiency of operations and adequacy of control mechanisms. Senior management is concerned with both consultative advice and assurances regarding risk and control. However, there may be overlap, i.e. operational management may desire assurance about the effectiveness of controls that it has implemented to control the operations for which it is responsible. Audit committees may want consultation regarding risk assessment and control processes.

So, why does it matter to whom the chief audit executive (CAE) reports? An example may suffice to illustrate the conflict. In a recent survey on CFO.com, 38% of CFO's responded "yes" to the following question: "Have you ever engaged in 'aggressive accounting' practices to improve your company's reported financial results?" The large number of "yes" responses would indicate that some of the control processes relied upon by the audit committee to ensure the adequacy and transparency of financial reporting has been compromised. This is not to say that reporting to a CFO is always a wrong answer. It may work in some cases, but it may also stifle information that needs to flow to the audit committee.

IIA Standards on Reporting Relationships

The Internal Audit Standards Board and the Professional Issues Committee have anticipated potential conflicts associated with the audit reporting relationships. The scope of work is addressed in *Standards for the Professional Practice of Internal Auditing (Standards) 1000*:

1000 Purpose, Authority, and Responsibility. *The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the Standards and **approved by the board.** (emphasis added)*

1110 Organizational Independence. *The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities.*

1110.A.1 *The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.*

The *Standards* are clarified by Practice Advisories. The Practice Advisory on organizational independence is more explicit:¹

1. *...The Institute believes strongly that to achieve necessary independence, the CAE should report functionally to the audit committee or its equivalent. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the organization.*
2. *...Appropriate reporting lines are critical to achieve the independence, objectivity, and organizational stature for an internal audit function necessary to effectively fulfill its obligations. CAE reporting lines are also critical to ensuring the appropriate flow of information and access to key executives and managers that are the foundations of risk assessment and reporting of results of audit activities. Conversely, any reporting relationship that impedes the independence and effective operations of the internal audit function should be viewed by the CAE as a serious scope limitation, which should be brought to the attention of the audit committee or its equivalent.*

The *Standards* clearly indicate that the board must have a prominent role in setting the scope of internal audit activities. Further, the accompanying Practice Advisory suggests a prominent role of the audit committee in the reporting relationship. The *Standards* suggest a reporting relationship that includes the CEO and the board, but do not explicitly prohibit other reporting relationships such as the CFO. However, any other reporting relationship must meet the overall criterion of ensuring broad audit coverage, free from any interference in meeting the mandate stated in the internal audit charter including the scope of work, the choice of audit procedures, and the free and unfettered communication to any level within the organization needed to ensure adequate attention to the findings and appropriate follow-up action.

The recommended listing requirements of the New York Stock Exchange (NYSE) embrace a similar relationship with the board. More explicitly, the NYSE recommends that the audit committee meet separately with the internal audit function on a quarterly basis. It also encourages a company to establish a corporate code of conduct to guide its actions, and with sufficient controls to ensure that the code is effective in influencing actions.

The reporting relationship is likely to undergo change in response to the Sarbanes-Oxley Act of 2002. This research project was designed to determine the current reporting relationship before the implications of the Act had an effect on the internal audit profession. As such, it represents a base line to compare changes in the reporting relationship over time.

The reporting relationship is important for one other reason. The *Standards* require each audit activity to undergo a quality assessment at least once every five-years by an independent outside

¹ Practice Advisory 1110-2: *Chief Audit Executive (CAE) Reporting Lines*; Professional Practices Framework; December 2002; Altamonte Springs, FL; www.theiia.org.

review team. The research results will be helpful in preparing many of these organizations for a quality assurance review.

Research Questions: Reporting and Independence

Does the reporting relationship really matter? Clearly, if one was to examine the financial reporting and independence issues as faced by the independent public accounting profession, it does count. There is no reason to think that such relationships aren't equally important to the internal audit profession. However, before coming to any tentative conclusions we need to remember that the internal audit activity is designed to serve at least two, and possibly three, major constituent groups. We are interested in knowing how the reporting relationships have evolved over the past few years and which kind of relationships are likely, at least in the auditor's view, to potentially impair the auditor's independence.

The research report addresses the following major issues:

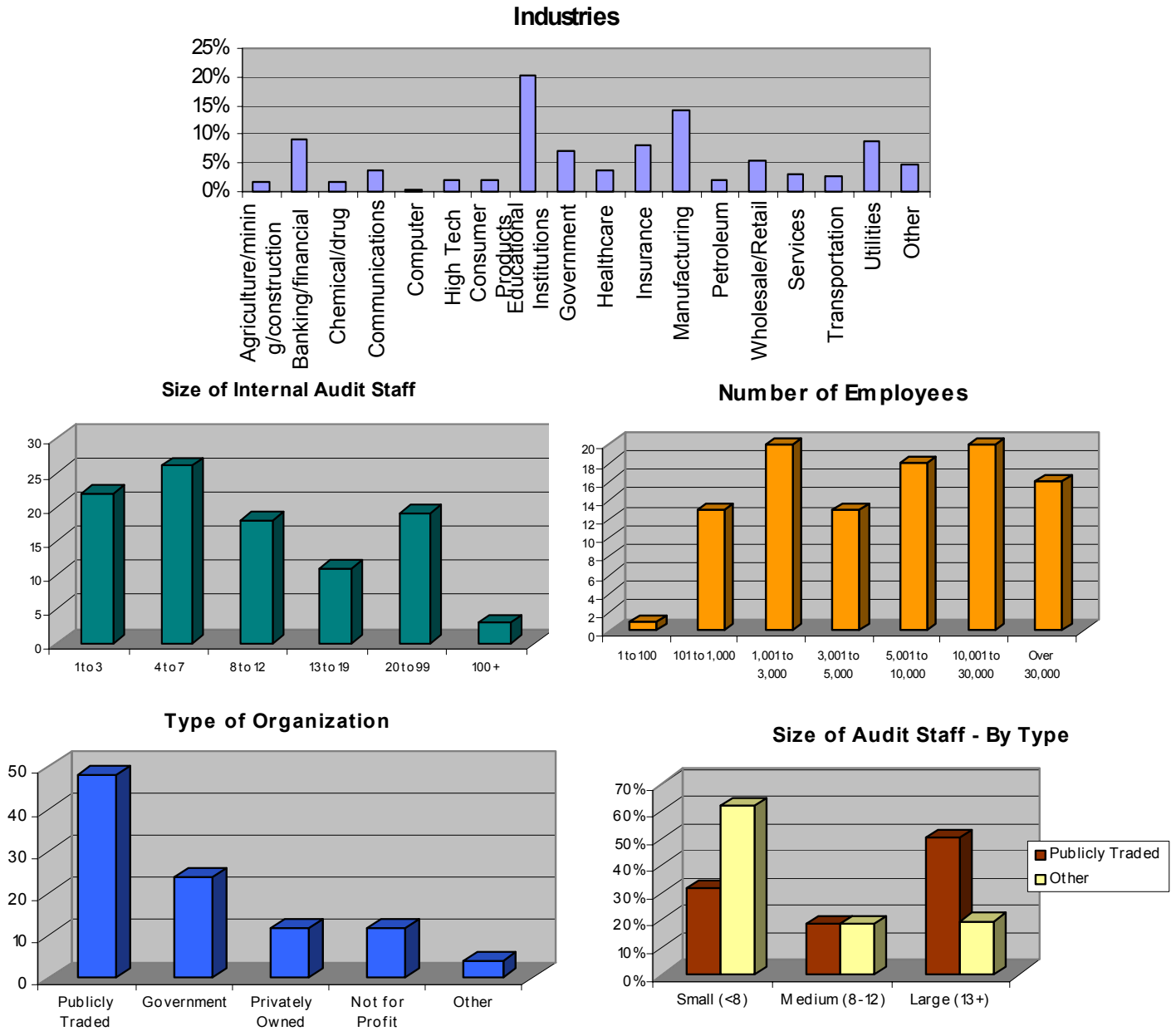
- What are the evolving internal audit reporting relationships on both a functional (direct) and an administrative basis?
- How do the reporting relationships differ across publicly-held versus governmental and not-for-profit entities?
- Does the reporting relationship differ by the size of the internal audit activity?
- What are the perceived problems with existing reporting relationships? How are CAE's addressing these problems?
- Are there major differences in the requests made of the internal audit activity by audit committees in comparison to those of senior management? How are CAE's effectively managing competing demands?
- To what extent are internal audit activities assuming added responsibilities in audit-related areas such as risk management, fraud detection, monitoring the company's code of conduct, etc?

Research Approach

The Institute of Internal Auditors has developed a rich resource for sharing information. The resource is referred to by the acronym GAIN, which stands for Global Audit Information Network. It is a network of chief audit executives who share benchmarking data and receive periodic benchmarks for similar audit activities. The audit functions pay a fee to belong to GAIN and therefore are not random members. However, The IIA has worked diligently to keep costs down and therefore the GAIN database is fairly representative of their member constituency.

The IIA Research Department sent an electronic survey to all members in the GAIN database asking them a number of questions regarding their existing reporting relationship and the nature of their interactions with audit committees. We thought it important to establish a base of current audit activity to compare with changes that emerge in response for increased internal audit roles in corporate governance. The survey and responses can be found at www.gain2.org.

Figure 2
Survey Demographics



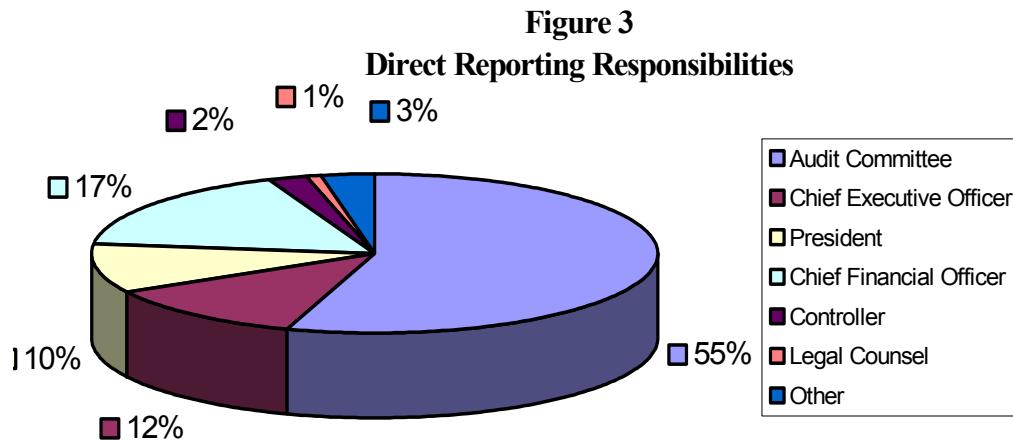
The survey was sent to 1,650 Chief Audit Executives (CAEs) and 379 responses were obtained for a response rate of 23 percent. The response rate is considered to be pretty good for most surveys and shows interest in the subject. As shown in Figure 2, most major industries were

represented in the survey responses, with educational institutions, manufacturing, banking, and utilities, among the most heavily represented. Additionally, most of the respondents were from publicly traded companies. The number of employees in each responding organization ranged fairly evenly from over 100 to over 30,000. The internal audit activities varied in size. However as shown in Figure 2, most of the respondents were from audit activities with an audit staff of 12 or less. Eighty-nine percent of respondents' organizations had an audit committee or its equivalent.

Research Results

Direct/Functional Reporting Responsibilities

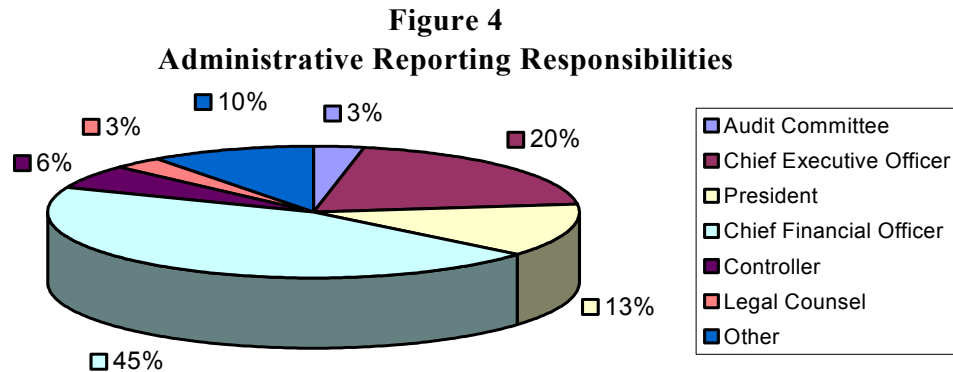
It has long been the recommendation of The IIA that the chief audit executive (CAE) should report directly to the audit committee, board of directors, or other appropriate governing authority, and administratively to the chief executive officer (CEO) of the organization. In this context, direct reporting means that the governing authority would set the direction and approve the policies of the internal auditing activity. As expected, the majority of CAE's reported that they reported directly to the audit committee or its equivalent. Banking, educational institutions, insurance, manufacturing, and utilities were most likely to report directly to the audit committee.



As shown in Figure 3, approximately 55 percent of CAEs responding to the survey report directly to the audit committee while another 22 percent report to the CEO or president. Although 77 percent indicate a direct reporting relationship to one of the highest levels in the organization, it is important to note that almost one quarter of the audit activities do not have such a relationship, instead reporting to the Chief Financial Officer (CFO) or Controller. Given the fallout of Enron, WorldCom, and other major failures, it is likely that a direct reporting relationship that focuses on the CFO and Controller would increasingly be called into question by shareholders and others in the governance process, and would likely be questioned as to whether such an audit activity met the *Standards*.

Administrative Reporting Relationships

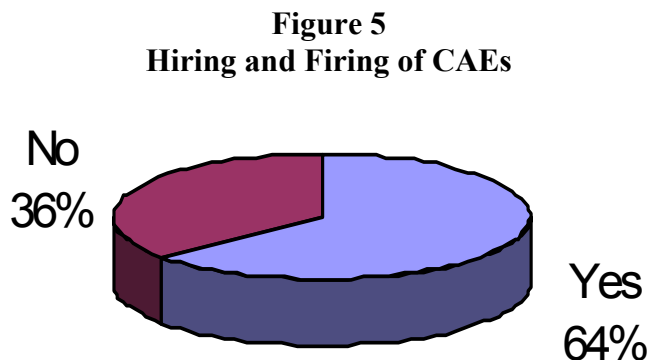
Administrative reporting is distinguished from direct reporting in the sense that the administrative unit facilitates the day-to-day operations of the internal audit activity, i.e., approving budgets and preparing performance evaluations. However, it should be noted that the *Standards* and many corporate governance reports are suggesting that overall responsibility for the internal audit budget be the responsibility of the audit committee.



As shown in Figure 4 the largest number of CAEs, 45 percent, report to the CFO and another 6 percent reporting to the controller. In other words, over half of the administrative reporting responsibility lies with an accounting function. CAEs in manufacturing, insurance, educational institutions, and utilities were most likely to have this reporting relationship. The next highest is the 33 percent reporting to the CEO or president.

Ability to Hire or Fire the CAE

As noted earlier, the *Standards* recommend that the audit committee be involved in decisions to appoint or dismiss the CAE. As shown in Figure 5, approximately 2/3 of the organizations involve the audit committee in decisions about appointing or dismissing the CAE.



CAE Satisfaction with Reporting Relationships

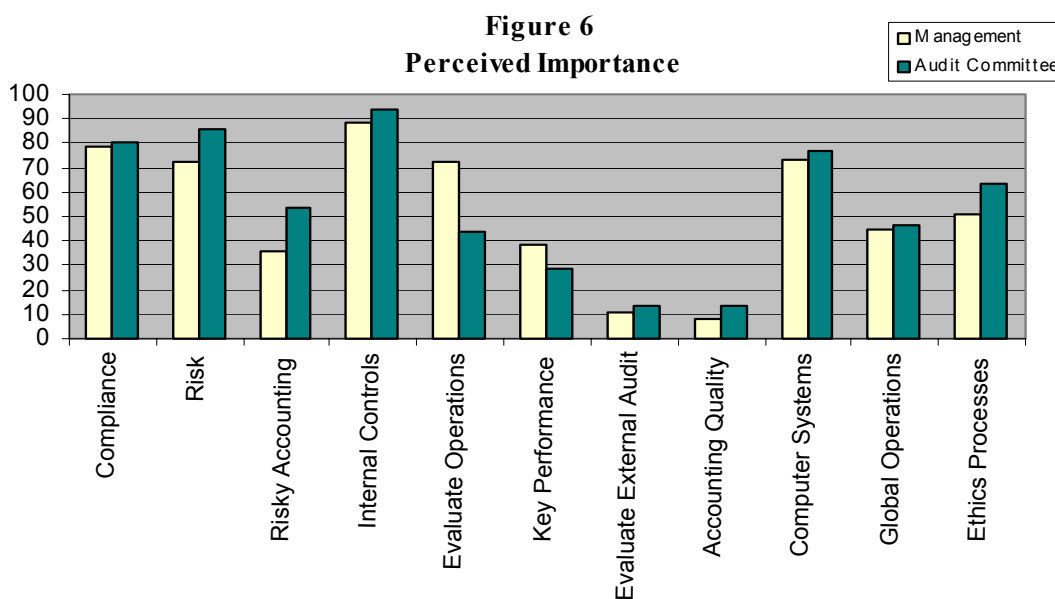
When asked, 90 percent of CAEs reported that they were satisfied with their functional or direct reporting relationships. Twelve percent said their reporting relationships did jeopardize their independence and that they had tried to resolve this issue, without success, with their audit committee, senior management, or both.

Overall 88 percent were satisfied with their level of access to the audit committee or board of directors. Sixty-seven percent responded that a private session with the audit committee was a regular agenda item; 28 percent said that a private session was available to them by request only; and six percent said that a private session was not available or allowed.

The NYSE proposed listing requirements state that audit committees are expected to “meet separately, at least quarterly, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors... These separate sessions, which must occur at least quarterly, may be more productive than joint sessions in surfacing issues warranting committee attention.”

Tension and Competing Demands

A major concern will arise if the audit activities performed by internal audit differ in importance as perceived by management and the audit committee. We did not address this question directly with either management or the audit committee. However, we did ask CAEs whether or not they saw significant differences in the importance of internal audit activities, as they believe senior management and the audit committee perceive the activities. Those results are presented in Figure 6.



We had pre-chosen the potential areas to include:

- Determining compliance with company policies and procedures
- Identify, monitor, and report on risk.
- Examine risky accounting areas, such as auditing estimates, identifying related parties, and off-balance sheet transactions.
- Examine and report on the quality of internal controls.
- Evaluate operations and identify ways to improve organizational operations through improved processes (cost reductions, revenue enhancements, etc.)
- Monitor key operations for performance, such as inventory, financial instruments, etc.
- Evaluate the quality of work of the external auditor.
- Perform an independent review of the quality of accounting choices made for external reporting.

- Evaluate the risks and controls associated with computer systems and the organization's critical infrastructure.
- Visit global operations to determine consistency of compliance with policies and procedures.
- Monitor ethics processes and compliance with the organization's ethical code of conduct.

CAEs do perceive differences in the importance of these items. For the most parts, most CAE's are concentrating on areas of risks and controls, including computer controls. They also place a high emphasis on improving operations. However, internal auditors have not been as involved with assessing the quality of accounting or getting involved in special accounting investigations. This may change with the increased risk involved with substandard accounting disclosures. Finally, we see that most internal auditors are active in monitoring the organization's ethical climate and compliance with ethics codes of conduct.

We should caution that these are the perceptions of the CAEs and there is always a danger that the CAE may not perceive the relative importance of items correctly. We will monitor this in future research reports².

Compliance

Both management and the audit committees have very high rankings on the importance of compliance based audit work. We believe this is an important finding because it tends to reiterate much of the discussion during the last year in the sense that it is important to pay attention to basics.

Risk

The rankings clearly indicate that risk assessment and risk management have become an integral part of the internal audit activity and is believed to be important to both management and audit committees, although the audit committee has a stronger focus on risk than management. This is not surprising. However, it does require further research. We speculated that audit committees are concerned with overall risk management, including controls and financial reporting and a structure to make sure that management has a risk management philosophy that is consistent with those envisioned as part of the governance structure. In other words, we need to further explore whether the risk management concepts are the same for both parties.

Accounting and Financial Reporting Risk

The quality of accounting has frequently been called into question as a number of companies have failed after hiding poor operating results through distorted accounting. The accounting issues that have surfaced during the past few years include: off-balance sheet financing, use of special purpose entities, equity stakes that allow the company to exercise control but not consolidation, related party transactions, aggressive acquisitions, growth through serial acquisitions, swap transactions, premature revenue recognition, and so forth.

² We should also note that the form of the survey which allowed the respondents to rate perceptions on similar scales may have led to greater congruity than actually exists in practice. However, we did expect that CAEs would systematically indicate whether one item was more important or less important by each party and therefore believe the results do accurately indicate CAE's perception of relative importance.

The public accounting profession has also been called into question on various other accounting issues including swap transactions and extensive related party transactions. It is sometimes argued that the scope of the external audit is not sufficient to ensure that all related party transactions would be uncovered or that there are sufficient controls over the related party transactions. Thus, it is expected that there may be more demands for the internal audit activity to look at controls over these special accounting issues.

Not surprisingly, we find that audit committees place significantly higher emphasis on reviews of these special accounting issues (54 percent versus 36 percent). Thus, while there may have been a tendency of the internal audit profession to also delegate most financial reporting issues to the independent accounting profession, it is clear that audit committees want independent, objective assessments of the quality of controls over financial reporting issues. There clearly can be some tension here with management not wanting detailed reviews in these areas while audit committees want detailed reviews.

Assessment of Internal Controls

One constant throughout the development of the internal audit profession has been an emphasis on internal control. In response to the NYSE Corporate Accountability and Listing Standards Committee Report (CALs Report) issued in June 2002, The IIA stated that “Internal auditors are clearly the proper resource to support management and the audit committee in meeting requirements for assessing and reporting on internal controls.”

Not surprisingly, the CAEs perceive a strong emphasis from management and audit committees on the quality of controls, with a slightly stronger emphasis coming, not unexpectedly, from the audit committees.

Historically, the internal audit emphasis on controls has been at the transaction or operational level. However, the recent business failures indicate a serious break-down of controls at the control environment level (management example, code of conduct, board oversight, management override, and so forth). It could be that management and audit committees, while both rating internal control very high, might desire different levels of control reviews. We will examine these potential differences in a future research study.

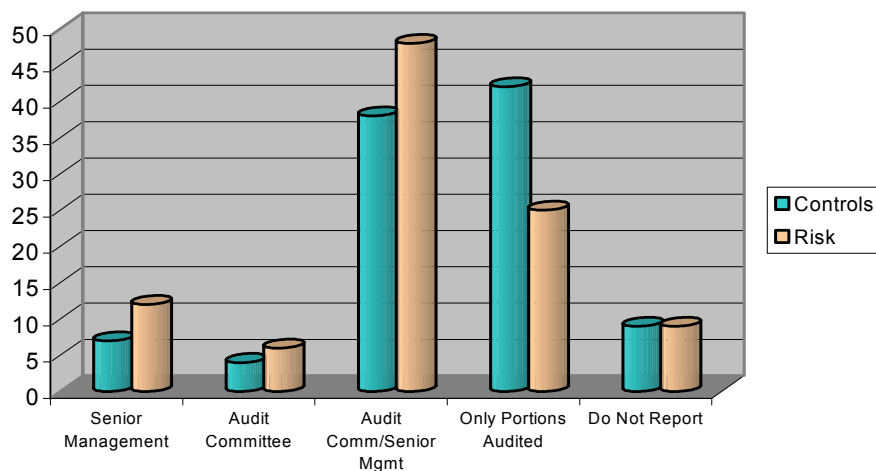
The IIA has long recommended that the boards of directors of all publicly held companies should be required to publicly disclose an assessment of the effectiveness of internal controls within their organizations³. The IIA further recommended that such disclosures should address internal controls broadly, rather than being limited to accounting controls over the recording and reporting of financial information.

The Sarbanes-Oxley Act requires each listed company to certify that it has established and is monitoring an internal control system. External auditors are now called upon to add an independent assessment of internal controls. Internal auditors are going to be called on to assist management and the audit committee in assessing the quality of its internal controls.

³ IIA response to NYSE Corporate Accountability and Listing Standards Committee Report (CALs Report) dated July 19, 2002.

Prior to the requirement of separate assessment, we found that very few CAE's were preparing comprehensive reports on internal control and providing such reports to management and the audit committee. For the most part, the audit reports covered areas audited, as might be expected. There is greater reporting of the auditor's risk assessment to audit committees than there is of control assessment.

Figure 7
Report on Internal Audit's Assessment



As shown in Figure 7, the responses to this survey indicate that 38 percent of CAEs are reporting on the overall system of internal control and 48 percent are reporting on internal audit's assessment of risk to both the audit committee and senior management. Forty-two percent report on internal controls only in relation to the audits performed during that period. Nine percent do not report on either internal controls or risks to either the audit committee or senior management.

Evaluation of Operations

Over 72 percent of the CAE's indicate that they report separate evaluations of operations to senior management, but only 44 percent report such evaluations to the audit committee. This may be tied into the consultative nature of the audit work to add value to the organization.

Key Performance

A little over 1/3 of the auditors report their evaluation of "key performance indicators" to management and approximately 30 percent report their assessment to the audit committee on a periodic basis.

Provide Evaluation of the External Audit Function

The internal audit activity is not actively involved in assessing the work of the external auditor. In only about 10 percent of the reported cases, does management or the audit committee ask for the internal auditor's evaluation of the external audit function.

Assess Quality of Accounting and Financial Reporting

Although the quality of accounting is an area of growing importance, the internal audit activity appears to have essentially delegated this to the external auditors. We believe this is likely to

change with the Sarbanes-Oxley bill and with the audit committee's increased interest in the quality of accounting.

Security and Control over Computer Systems

Complicated and integrated computer systems represent an increasing risk for most organizations. The internal audit activity plays a critical role in assisting both management and the audit committee in assessing the quality of its controls over these areas. Approximately 80 percent of the CAE's have specific reports on the quality of controls over information systems and information security.

Review of Global Operations

Approximately 50 percent of the CAE's report extensive monitoring of global organizations. Since the sample was comprised of only 50 percent publicly-traded companies, we can infer that virtually all of the publicly-traded companies monitor risks and controls associated with global operations.

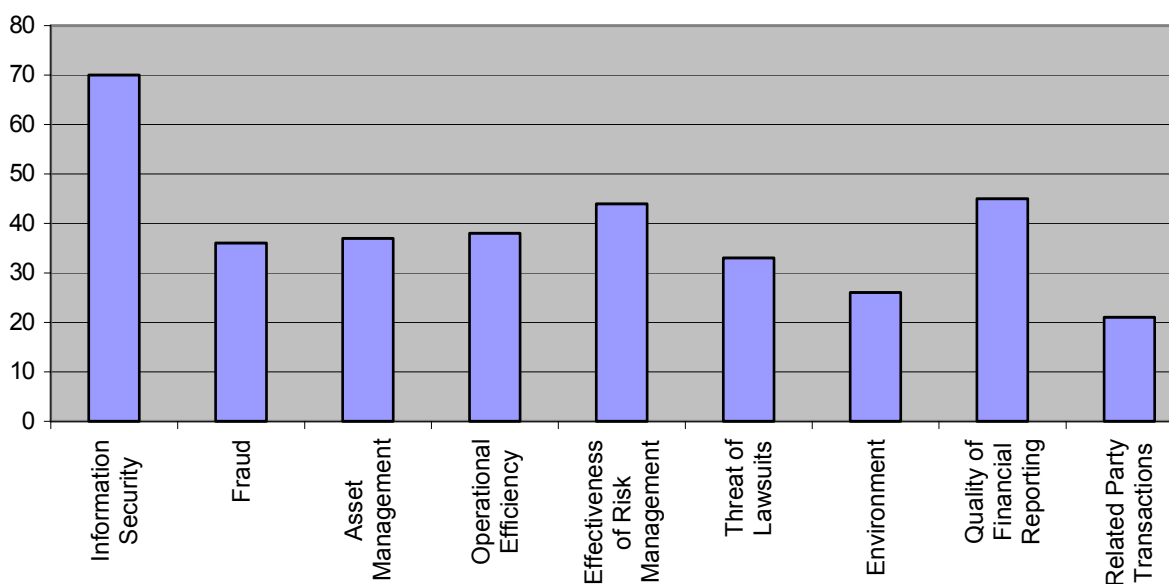
Review of the Effectiveness of Ethics and Code of Conduct

Approximately 2/3 of the sample respondents indicate they are active in monitoring and reporting on the effectiveness of an organization's code of conduct and methods to ensure compliance therewith.

Audit Committee's Risk Emphasis

The NYSE proposed listing regulations require the audit committee to discuss guidelines and policies to govern the process by which risk assessment and risk management are handled. The audit committee should also discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures.

Figure 8
Audit Committee View of Risks



Remember, the responses shown in Figure 8 recognize the CAE's perception of major risks. It is interesting because it does indicate a gap between the audit committee's perceptions of risk areas and where internal auditors are spending their time. To some extent, it does indicate some disconnect between what the audit committee perceives is important and the CAE's assessment of where to spend time, or at least to spend time relative to others that might report to the audit committee.

We offer the following observations that can be gleaned from the data:

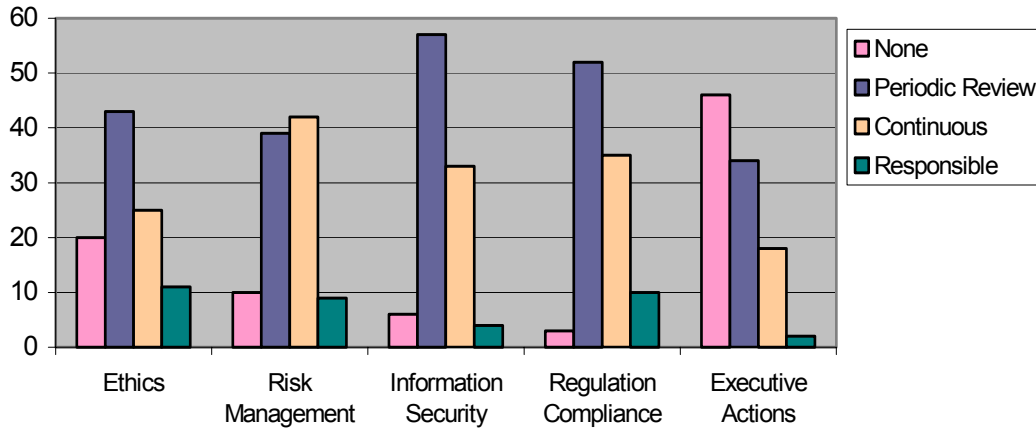
- The CAE and audit committee are consistent in viewing information systems as a major area of risk.
- The audit committee would like an overall assessment of the quality of the organization's risk management process, as opposed to separate evaluations of risk by the internal auditor, i.e. the audit committee is more interested in the process than it is in any particular risk report.
- The audit committee is very concerned about the quality of financial reporting. As noted earlier, this seems to be an area in which many internal auditors had delegated to the external audit function.
- The audit committee is concerned with both asset management and operational efficiency. While they are concerned with overall operations, they are more concerned that there is a risk management process in place that clearly conveys to them unmitigated risks that might be associated with management choices regarding asset allocation and/or management, as well as risks that are associated with less effective operational activities.
- The audit committee will continue to be concerned about fraud and related party transactions.

While the results in any one particular organization may be unique, we believe that the continuous assessment of both management and the audit committee's assessment of risk areas should be considered in allocating audit activities.

Evolution of Internal Audit into New Areas

More and more CAEs are being given functional responsibilities for areas that they formerly audited. There is some concern that these responsibilities may constitute a conflict of interest. As shown in Figure 9, eleven percent responded that they have responsibility for ethics; nine percent for risk management; four percent for information security; and ten percent for regulatory compliance. While two percent have responsibility for reviewing executive committee actions for compliance with organizational policies, 46 percent have no oversight in this area at all.

Figure 9
Internal Auditing Responsibility



Summary

This is the first in a series of reports in which we develop baseline information about the practice of internal auditing. We plan on monitoring changes in the profession and developing a more comprehensive database of internal audit activities over time.