

INTOSAI



## *Internal Auditor Independence in the Public Sector*

*Exposure draft for comment  
1 July – 30 September 2009*

# INTOSAI



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## INTRODUCTION

Internal auditing is performed in diverse environments and within organizations that vary in purpose, size, and structure. In addition, the laws and regulations within various countries differ from one another. Particularly, public sector auditors are challenged to operate in organizational structures that are as complex and varied as the many forms of government that exist throughout the world today. The International Standards of Supreme Audit Institutions (ISSAI) and the *International Standards for the Professional Practice of Internal Auditing* present general terms to allow adoption in different national contexts with the understanding that implementation will be governed by the environment in which the internal audit activity carries out their responsibilities and in accordance with the applicable laws and regulations. The *Standards* referenced are universal and are intended to apply to all members of the internal audit profession and represent independence as it should be.

Internal auditing has become a key factor of the new accountability and control era. The manner in which public sector entities keep control and how they are held accountable has evolved to require more transparency and more accountability from those organizations that spend investor or taxpayer funds. This trend has significantly impacted how management implements, monitors, and reports on internal controls.

The role of internal audit has evolved from an administrative procedure with a focus on compliance, to a strategic partner with management and one of the cornerstones of good governance. In many cases, internal audit not only exists, but is mandatory.

In describing public sector auditing, the Lima Declaration calls for internal audit services to be functionally and organizationally independent as far as possible within their respective constitutional framework (ISSAI 1, section 3, par. 2)

The Institute of Internal Auditors (IIA) *Standards* and Code of Ethics recognizes the importance of internal auditors maintaining their independence and objectivity when performing their work; this applies irrespective of whether the internal auditors are engaged in public or private sector auditors. In addition, the IIA *Standards* advocate a strong system of internal controls that is monitored by a well-resourced internal audit activity as a fundamental feature of good governance. In the public sector, a strong system of governance is essential in ensuring appropriate service deliver to the public at large.

The potential conflicting requirements of an organization's governance structure's need for assurance, the increasing importance of integrated risk management and control processes, and the overall growth in the demand for internal audit services, leads to concerns regarding internal auditor independence. In this regard, it is critical that public sector audit activities are configured and positioned appropriately within the organization.

## **THE ROLE OF INTERNAL AUDITING**

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.

Internal auditing evaluates emerging technologies; analyzes opportunities; examines issues from a "local" and global perspective; assesses risks, controls, operations, ethics, efficiency, and effectiveness; and helps ensure controls are in place to manage risks. Internal auditing is a valuable partner with management and the oversight body, as such internal auditing can provide assistance and education regarding accomplishment of goals and objectives, strengthening controls, and improving the efficiency and effectiveness of operations. It is important to clarify that while internal audit can provide assistance and education, it should not perform management or operational duties.

## **PUBLIC SECTOR AUDITING**

As is true for all internal auditors, public sector internal auditors are called upon to assist organizations in improving their operations. Public sector internal auditing is an essential element of a strong public sector governance foundation. However, most public sector internal auditors also play a role in their agency's accountability systems – serving the citizens as part of the check-and-balance process that accompanies public activities.

The diverse nature of the public sector places increasing importance and value on a common understanding of independence as it is key to any auditor's credibility. As internal auditors are an integral part of the organization, the achievement and maintenance of independence is even more challenging.

## **DEFINING INDEPENDENCE**

Independence can be generally defined as freedom from dependence on, or influence or control by, another person, organization, or state. Specific to internal audit, independence is the freedom from conditions that threaten the ability of the internal audit activity or the chief audit executive to carry out internal audit responsibilities in an unbiased manner. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of engagements.

## **INDEPENDENCE AND OBJECTIVITY STANDARDS**

ISSAI 1610 defines the criteria to determine the independence of the internal audit function in the public sector.

Also the IIA *Standards* require, and leading practices dictate, that the internal audit activity is independent, and internal auditors are objective in performing their work. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the head of the internal audit activity (chief audit executive – CAE) has direct and unrestricted access to senior management and the board. Independence is achieved through organizational status and objectivity.

### ***Organizational Status***

The CAE must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The CAE must confirm to the board, at least annually, the organizational independence of the internal audit activity. The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

### ***Objectivity***

Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that the quality of their work is not compromised in any way.

Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels, and disclosed as necessary.

## **WHY IS INDEPENDENCE AND OBJECTIVITY VITAL?**

Whatever the form of government, the need for independence and objectivity in audit is vital (ISSAI 200, par. 2.3).

The nature of internal auditing and the role of providing unbiased and accurate information on the use of public resources and services delivered require the internal audit activity to perform their duties without restrictions - free from interference or pressures from the organization being reviewed or the area under audit.

Development of sound working relationships with management and staff at all levels of the organization is fundamental to the effectiveness of the internal audit function. The internal audit activity's knowledge and understanding of the organization assist in building effective relationships and in evaluating and improving the effectiveness of risk

management, internal control, and governance processes. Ideally, and as appropriate, the organization's employees should bring concerns, information, and important matters to the attention of the internal audit activity. In addition, an effective and well-run audit activity will be sought out for services, information, and guidance.

By providing unbiased, objective assessments of whether public sector operations and resources are responsibly and effectively managed to achieve intended results, the auditor can help the public sector organization achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders.

Independence and objectivity are vital in ensuring that stakeholders view the audit worked performed, and the results, as credible, factual, and unbiased.

## **CONCERNS RELATED TO INDEPENDENCE AND OBJECTIVITY**

The appearance or perception of a lack of independence and objectivity could be as damaging as the actual condition. Generally, if internal auditors are too occupied in developing the internal control systems, it may become difficult to maintain independence when auditing these systems. The public entity should help to ensure the appearance of a lack of independence and objectivity does not arise.

Although the internal audit activity can add significant value to the organization given of its in-depth knowledge and understanding of operational conditions, it may be hindered in upholding the public trust if measures to protect to its independence are not developed, implemented, and maintained. These measures include provisions to ensure that the internal audit activity is empowered to report significant issues to the appropriate oversight authorities; is supported by management formally and in practice; and is provided with sufficient resources to effectively perform its duties.

An internal auditor occupies a unique position within the organization. He or she is employed by the organization but is also expected to review the conduct of operations management. This has a potential to create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management's actions.

## **METHODS TO ACHIEVE INDEPENDENCE**

Clearly, independence is one of the key elements of an effective public sector internal audit activity. Methods to help achieve independence include:

### ***Reporting Relationship and Appointment of the Head of the Internal Audit Activity***

The CAE should be part of the senior management team. To avoid possible conflicts of interest, the CAE should report to a level in the organization that would allow the internal audit activity to effectively carry out its responsibility.

The CAE should report to executive management for assistance in establishing direction, support, and administrative interface; and typically to the oversight body for strategic direction, reinforcement, and accountability. The oversight body should safeguard the independence by approving the internal audit charter annually and (where applicable) the mandate.

The CAE should have direct communication with the oversight body which reinforces the organizational status of internal auditing, enables full support and unrestricted access to organizational resources, and ensures that there is no impairment to independence. This provides sufficient authority to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on recommendations.

Where practicable, the oversight body, should exercise direction and at least be consulted for the appointment, removal, and compensation considerations of the CAE. Consideration may also be given to appointing an appropriately organized, independent body to appoint the CAE.

### ***The Internal Audit Activity***

The ability to achieve internal audit activity independence is contingent on the appropriate placement and/or organizational status of the internal audit activity within the organization.

The IIA *Standards* require, and other guidance strongly recommends, that to adequately provide for the independence of the internal auditing activity, its personnel should report to the CAE, who reports administratively to the chief executive officer or equivalent and functionally to the board or other oversight body.

The organizational status of the internal audit activity should be sufficient to allow it to accomplish its activities as defined by its charter. The audit activity must be positioned in such a way that it may obtain cooperation from the area being audited, and have free, unrestricted access to all functions, records, property, and personnel – including the board or other oversight body.

### ***Competency***

The IIA's Code of Ethics require, and leading practices dictate, that internal auditors engage in those services for which they have the necessary knowledge, skills, and experience; perform duties in accordance with the *Standards*; and continually improve their proficiency and effectiveness. The *Standards* require that internal auditors, and the internal audit activity, collectively possess or develop the knowledge, skills, and other competencies needed to perform their responsibilities. Competent and professional internal audit staff, in particular those that adhere to the *Standards*, can help ensure the internal audit activity's success. This success can demonstrate that the internal audit activity can responsibly perform its duties; reinforce the need for independence; and help alleviate any fears that independence of the internal audit activity will lead to abuse.

### ***Legislative Requirements***

Legislative requirements to establish an internal audit activity may be important to guarantee the funding and independence of the internal audit activity. This would be considered a positive development for the future as it would assist in ensuring that internal audit is given the required recognition in the public sector.



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