THE IIA's CIA

LEARNING SYSTEM®

1 Essentials of Internal Auditing

The Institute of Internal Auditors

Section II: Independence and Objectivity

The IIA's CIA Learning System®
Access online study tools at www.LearnCIA.com

THE IIA's CIA LEARNING SYSTEM®

1 Essentials of Internal Auditing

The Institute of Internal Auditors

Section II: Independence and Objectivity

The IIA's CIA Learning System®
Access online study tools at www.LearnCIA.com

Section II: Independence and Objectivity

This section is designed to help you:

- Define independence and objectivity in terms of internal audit.
- Interpret organizational independence of the internal audit activity.
- Explain the importance of independence in an internal audit activity.
- Explain the reporting relationships for internal auditors.
- Identify whether the internal audit activity has any impairments to its independence.
- Assess and maintain an individual internal auditor's objectivity, including determining whether an individual internal auditor has any impairments to his/her objectivity.
- Analyze policies that promote objectivity.

The Certified Internal Auditor (CIA) exam questions based on content from this section make up approximately 15% of the total number of questions for Part 1. Two of the topics are covered at the "B—Basic" level, meaning that you are responsible for comprehension and recall of information. (Note that this refers to the difficulty level of questions you may see on the exam; the content in these areas may still be complex.) The other topics are covered at the "P—Proficient" level, meaning that you are responsible not only for comprehension and recall of information but also for higher-level mastery, including application, analysis, synthesis, and evaluation.

Section Introduction

Internal auditors are more than compliance reviewers and financial analysts. Broadened responsibilities range from assessing a gamut of risks, controls, ethics, and quality initiatives to evaluating emerging technologies, analyzing opportunities, and examining global issues. Internal auditors are responsible for assuring that the controls in place are adequate and effective in mitigating the risks to achieve the organization's objectives.

In providing such assurance and consulting activities, internal audit organizations must maintain independence and objectivity. These are the cornerstones of effective internal auditing.

The *Standards* Glossary defines **independence** as:

> The freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.

The Glossary defines **objectivity** as:

> An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no significant quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others.

Related *Standards* and Practice Guides

The *Standards* and Implementation Guides related to independence and objectivity are listed in Exhibit II-1. Additional recommended guidance includes The IIA's Practice Guide "Independence and Objectivity."

Exhibit II-1: Independence and Objectivity Standards and Related Guidance

Standard	**Related Guidance**
Attribute Standard 1100, "Independence and Objectivity" The internal audit activity must be independent, and internal auditors must be objective in performing their work.	Implementation Guide 1100, "Independence and Objectivity"
Attribute Standard 1110, "Organizational Independence" The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.	Implementation Guide 1110, "Organizational Independence"
Implementation Standard 1110.A1 (Assurance Engagements) The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results. The chief audit executive must disclose such interference to the board and discuss the implications.	
Attribute Standard 1111, "Direct Interaction With the Board" The chief audit executive must communicate and interact directly with the board.	Implementation Guide 1111, "Direct Interaction With the Board"

	Practice Guide, "Chief Audit Executives—Appointment, Performance Evaluation, and Termination"
Attribute Standard 1112, "Chief Audit Executive Roles Beyond Internal Auditing" Where the chief audit executive has or is expected to have roles and/or responsibilities that fall outside of internal auditing, safeguards must be in place to limit impairments to independence or objectivity.	Implementation Guide 1112, "Chief Audit Executive Roles Beyond Internal Auditing"
Attribute Standard 1120, "Individual Objectivity" Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.	Implementation Guide 1120, "Individual Objectivity"
Attribute Standard 1130, "Impairment to Independence or Objectivity" If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.	Implementation Guide 1130, "Impairment to Independence or Objectivity"
Implementation Standard 1130.A1 (Assurance Engagements) Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.	
Implementation Standard 1130.A2 (Assurance Engagements) Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.	
Implementation Standard 1130.A3 (Assurance Engagements) The internal audit activity may provide assurance services where it had previously performed consulting services, provided the nature of the consulting did not impair objectivity and provided individual objectivity is managed when assigning resources to the engagement.	

Implementation Standard 1130.C1 (Consulting Engagements) Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.	
Implementation Standard 1130.C2 (Consulting Engagements) If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting the engagement.	

Topic A: Organizational Independence of the Internal Audit Activity (Level B)

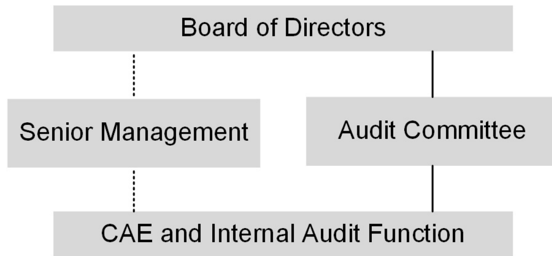
Internal auditors provide organizations' stakeholders with information the stakeholders need to effectively fulfill their responsibilities. The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results. Stakeholders must also have confidence that internal audit can review all activities and do so in an unbiased manner. As stated in the introduction to this section, independence allows for the freedom from conditions of interference. Often, such conditions stem from the organizational placement and assigned responsibilities of internal audit. For example, when internal audit reports within other functions in an organization, it is not considered independent of that function, which is subject to audit. Similarly, if the CAE has functional responsibilities broader than internal audit, such as risk management or compliance, internal audit is not independent of these additional functions, which are also subject to audit.

However, the CAE cannot solely determine the organizational independence and placement for internal audit. He or she needs help from the board and senior management to address independence effectively. Typically, the CAE, the board, and senior management reach a shared understanding of internal audit's responsibility, authority, and expectations, which lays the groundwork for a discussion of independence and organizational placement.

Independence and Reporting Relationships

Independence is established by the organizational reporting structure. Best practice suggests that the CAE (and, hence, the internal audit activity) should have dual reporting lines: administratively to the senior management level (CEO, etc.) and functionally to the audit committee. Exhibit II-2 visualizes this reporting structure.

Exhibit II-2: Internal Audit Dual Activity Reporting Structure



The internal audit activity charter should establish this dual reporting relationship as well as the principal activities directed up each line. Ideally, the CAE should report:

- Functionally to the board.
- Administratively (directly) to organizational senior management.
- Functionally to the audit committee or its equivalent.

Functional Reporting

Functional reporting provides the ultimate source of independence and authority. Organizational independence is effectively achieved when the CAE 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 CAE on the internal audit activity's performance relative to its plan and other matters.
- Approving decisions regarding the appointment or removal of the CAE.
- Approving the remuneration of the CAE.
- Making appropriate inquiries of management and the CAE to determine whether there are inappropriate scope or resource limitations (interpretation of Standard 1110).

Administrative Reporting

Administrative reporting facilitates the day-to-day operations of the internal audit function. Examples characterizing the administrative reporting relationship include:

- Budgeting and management accounting.
- Human resource administration, including personnel hiring and compensation.
- Internal communications and information flows.
- Administration of the internal audit activity's policies and procedures.

The Importance of Independence

The dual reporting relationships support internal audit activity independence and allow internal auditors to carry out their work freely and objectively and to render impartial and unbiased judgments. These reporting relationships also help to ensure:

- The appropriate flow of information across the organization.
- Access to key executives and managers.
- Appropriate reporting of internal audit activity results.

The CAE should monitor the reporting relationships. Any situation that impedes the independence and effective operations of the internal audit function should be brought to the attention of the audit committee (or its equivalent).

Proper Alignment to Achieve Independence

The *Standards* are designed to apply to all internal audit organizations regardless of size, nature of the organization, or other factors. As such, they are intentionally somewhat generic about reporting relationships; there is no one-size-fits-all approach.

The following are ways the CAE can ensure that the internal audit activity is properly aligned to achieve organizational independence.

- **Have regular and direct communication with the board.** Regular communication with the board helps assure independence and facilitates an open, two-way dialogue on matters of mutual interest. Direct communication occurs when the CAE regularly attends and participates in board meetings related to auditing, financial reporting, organizational governance, risk management, and control. The CAE's attendance and participation at these meetings (i.e., having a "seat at the table") provides an opportunity for the CAE to learn about strategic business and operational issues as well as share information concerning the plans and activities of the internal auditing function. The CAE should meet privately with the board at least annually. Attribute Standard 1111, "Direct Interaction With the Board," and Implementation Guide 1111 provide specific guidance for this communication.

- **Report to an individual at the senior management level with sufficient authority to promote independence and to ensure broad audit coverage.** The individual the CAE reports to should have sufficient authority and stature to ensure the effectiveness of the audit function. Further, this individual should have an appropriate control and governance mindset to assist the CAE in his or her role and the time and interest to actively support the CAE on audit issues. Lastly, this person should understand the nature of the functional reporting relationship and support it.

- **Report directly to the audit committee (or its equivalent).** The internal audit function provides information and assurance to the audit committee on internal controls, risk management activities, and governance processes. Best practices for the CAE to maintain an effective relationship between the audit committee and the internal auditing function are to:

  - Send periodic communications on risks faced by the organization to the audit committee (consistent with CAE communications sent to senior management).
  - Help the audit committee ensure that the committee's charter, activities,

and processes are appropriate.

- Ensure that the charter, role, and activities of internal auditing are clearly understood and responsive to the needs of the audit committee and the board.
- Maintain open and effective communications with the audit committee and the chairperson.
- Provide training, when appropriate, to the audit committee on risk and internal control.

Another essential component is a direct channel of communication with the audit committee. Provisions should be in place for the CAE to:

- Have open and direct access to both the audit committee chair and committee members.
- Attend audit committee meetings to present the audit plan, report on the results of major audits and key audit findings or other matters, and discuss internal auditing's observations on risk and internal controls in the organization.
- Have out-of-session communications with the audit committee chairperson, particularly in the case of critical circumstances such as serious fraud and other material risk events (emerging risks, safety).

To further reinforce the independence and nature of this reporting relationship, the CAE should be allowed to meet privately with the audit committee or its equivalent without management present and circulate confidential memos or reports only to the audit committee.

Ultimately, the CAE and the internal auditors, the audit committee, and the board of directors are all interdependent. They should be mutually accessible and supportive. With this reciprocity in place, the internal auditors can provide objective opinions, information, support, and education to the audit committee and the audit committee can provide appropriate oversight and validate internal auditing activities.

Topic B: Impairments to Independence (Level B)

Many factors, intentional or not, can be **impairments** to independence and/or objectivity. According to the *Standards* Glossary:

> Impairment to organizational independence and individual objectivity may include personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).

As stated in Standard 1130, if independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to the appropriate parties. Who is deemed as "appropriate parties" is dependent on the expectations of the internal audit activity as described in the charter, the CAE's reporting responsibilities, and the nature of the impairment itself.

Recognizing Impairments

To fully understand and appreciate independence, internal auditors need to consider the perspectives of their various stakeholders and the conditions that could be perceived as undermining independence. Often, the CAE will develop an internal audit policy manual or handbook that includes a discussion of organizational independence and internal auditor objectivity, the nature of impairments, and how internal auditors should handle potential impairments. It may also describe the types of situations that could create, or appear to create, impairments and may specify the actions the internal auditor should undertake if faced with a potential impairment.

Recommended guidance found in Implementation Guide 1130, "Impairment to Independence or Objectivity," states:

> Impairment situations generally include self-interest, self-review, familiarity, bias, or undue influence. Internal audit examples of organizational independence impairments include the following:
>
> - The CAE has broader functional responsibility than internal audit and executes an audit of a functional area that is also under the CAE's oversight.
> - The CAE's supervisor has broader responsibility than internal audit, and the CAE

executes an audit within his or her supervisor's functional responsibility.

- The CAE does not have direct communication or interaction with the board.
- The budget for the internal audit activity is reduced to the point that internal audit cannot fulfill its responsibilities as outlined in the charter.

Mitigating Efforts

Certain actions can help to keep impairments from undermining auditor independence or resulting in compromised interests that influence an auditor's judgment or opinions.

Internal auditors are to report to the CAE any situations in which an actual or potential impairment to independence may reasonably be inferred or if they have questions about whether a situation constitutes an impairment to independence. They should report any offers of material fees or gifts immediately to their supervisors. If the CAE determines that impairment exists or may be inferred, he or she needs to reassign the auditor(s).

Another impairment situation that could occur and that should be mitigated is a **scope limitation**, which is a restriction placed on the internal audit activity that precludes the activity from accomplishing its objectives and plans. Among other things, a scope limitation may restrict the:

- Scope defined in the internal audit charter.
- Internal audit activity's access to records, personnel, and physical properties relevant to the performance of engagements.
- Approved engagement work schedule.
- Performance of necessary engagement procedures.
- Approved staffing plan and financial budget.

A scope limitation, along with its potential effect, needs to be communicated, preferably in writing, to the board. The CAE needs to consider whether it is appropriate to inform the board regarding scope limitations that were previously communicated to and accepted by the board. This may be necessary particularly when there have been organization, board, senior management, or other changes.

Topic C: Auditor Objectivity (Level P)

Objectivity refers to an internal auditor's impartial and unbiased mindset, which is facilitated by avoiding **conflicts of interest.** The interpretation of Standard 1120, "Individual Objectivity," states:

> *Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively.*

To implement this standard, the CAE will first want to understand policies or activities in the organization and in internal audit that could enhance or hinder an objective mindset.

The internal auditing activity has different constituencies for its services. Organizational executives, the board, operations management, and the audit committee are just some of the prospective customers (clients) in a single enterprise. Despite an organization's best intentions for strategic synergies across functions, different clients may have different interests. For example, senior-level executives may have bonuses tied to bottom-line performance. Operations may be focused on audit results that can help improve operational performance. The audit committee's principal focus may be on control activities and risk management. Further complicating the situation is the fact that the CAE (and by extension, the internal audit activity) reports administratively to senior management but must also review management. Despite these potentially conflicting interests, an internal auditor must maintain objectivity—an independent mental attitude—in performing engagements.

Recognizing Impairments

As noted previously in this section, the CAE should document expectations and requirements around maintaining objectivity. Many policy manuals or handbooks will include descriptions of the types of situations that could create impairments. Recommended guidance found in Implementation Guide 1130, "Impairment to Independence or Objectivity," provides examples of objectivity impairments, including situations in which:

- An internal auditor audits an area in which he or she recently worked, such as when an employee transfers into internal audit from a different functional area of the organization and then is assigned to an audit of that function.
- An internal auditor audits an area where a relative or close friend is employed.
- An internal auditor assumes, without evidence, that an area being audited has effectively mitigated risks based solely on a prior positive audit or personal experience.
- An internal auditor modifies the planned approach or the results based on the undue influence of another person, often someone senior to the internal auditor, without appropriate justification.

Often, the internal audit policy manual describes the appropriate actions for an internal auditor to take should he or she become aware of, or concerned about, such impairments. Typically, the first step is to discuss the concern with an internal audit manager or the CAE to determine whether the situation is truly an impairment and how best to proceed.

Maintaining Individual Objectivity

Policies and ongoing assessment of individual objectivity set the stage for an internal auditor to perform his or her duties objectively. Additional best practices for perpetuating individual objectivity include the following actions:

- The CAE should periodically query the internal auditing staff about potential conflicts of interest and bias.
- Internal auditor staff assignments should be rotated periodically whenever it is practical to do so.

- An internal auditor should not accept a fee, gift, or entertainment from an employee, client, customer, supplier, or business associate.

Objectivity must be maintained in fact and in appearance. Promotional items (such as pens, calendars, or samples) that are available to employees and the general public and that have minimal value should not hinder internal auditors' professional judgments. Likewise, accepting a lunch invitation or allowing someone to buy lunch should not compromise an internal auditor's objectivity. In assessing objectivity, consider what is "reasonable" versus what could be perceived as a conflict of interest.

Topic D: Promoting Objectivity (Level P)

To manage internal audit objectivity effectively, the CAE should establish expectations and requirements for every internal auditor, including:

- Understanding of the critical importance of objectivity to the internal audit profession.
- Typical situations that could undermine objectivity.
- Actions the internal auditor should take if he or she becomes aware of a current or potential objectivity concern.
- Reporting requirements (for example, requiring each internal auditor to periodically consider and disclose conflicts of interest).

Policies That Promote Objectivity

Many organizations have employee conflict-of-interest policies. Internal audit will often customize such policies to address internal audit roles specifically and may have other relevant departmental policies. The CAE will want to understand the nature of relevant policies and consider their potential impact on internal audit objectivity.

Internal auditors should have no personal or professional involvement with or allegiance to the area being audited and should maintain an unbiased and impartial mindset in regard to all engagements. Establishing the following policies can help to promote such objectivity:

- Standard 1130.A1 states that "internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year." Creating a policy that restricts these assignments can eliminate situations that could influence auditors' judgment or opinion.
- A policy should be in place that endorses the internal auditor's commitment to abiding by the Code of Ethics, avoiding conflicts of

interest, and disclosing any activity that could result in a possible conflict of interest.

- Internal auditors should not subordinate their judgment on audit matters to that of others.
- Internal auditors should perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made.
- Internal auditors should not be placed in situations in which they feel unable to make objective professional judgments.
- Staff assignments should be made so that potential and actual conflicts of interest and bias are avoided.

Reinforcing Policies Through Training

To reinforce the importance of these policies and help ensure that all internal auditors internalize this importance, many CAEs hold routine workshops or training on these fundamental concepts. Such training sessions will often allow internal auditors to better understand objectivity by considering objectivity-impairing scenarios and how best to address them. For example, more-senior auditors and managers may share personal experiences where objectivity was called into question or where they self-disclosed a relationship or experience that was a conflict.

Another common training topic is professional skepticism. Such training reinforces the nature of skepticism and the criticality of avoiding bias and maintaining an open and curious mindset. Maintaining professional skepticism ensures that internal auditors don't make undue assumptions about the validity of "support" such as verbal explanations from management or other information received without an appropriate level of objective verification of such support.

Ongoing Assessment of Individual Objectivity

However well-intended, policies and training cannot provide total assurance of objectivity. Ongoing assessment can help to ensure that objectivity has not been compromised during an engagement. A best practice is for the CAE, or another individual in a supervisory capacity for the internal audit activity, to review the results of the internal audit work before the related engagement communications are released.

For example, consider appropriate actions for an auditor who has been promoted within an operating department but soon thereafter moves to the internal audit activity and then is asked to complete an internal audit of that department. If the timing and logistics allow, or a conflict of interest or bias may be reasonably inferred, Implementation Guide 1130 recommended guidance is that the auditor should not continue on an audit of that department and the CAE should reassign the auditor.

Next Steps

You have completed Part 1, Section II, of The IIA's CIA Learning System®. Next, check your understanding by completing the online section-specific test(s) to help you identify any content that needs additional study.

Once you have completed the section-specific test(s), a best practice is to reread content in areas you feel you need to understand better. Then you should advance to studying Section III.

You may want to return to earlier section-specific tests periodically as you progress through your studies; this practice will help you absorb the content more effectively than taking a single test multiple times in a row.

Index

The numbers after each term are links to where the term is indexed and indicate how many times the term is referenced.

training 1

Build 08/24/2018 15:39 p.m.

Contents