

SIAAB Guidance #02

Internal Audit Independence- Interaction with Agency Head, Senior Staff and Placement Within the Organizational Structure

Adopted July 9, 2013

Revised In Accordance with 2017 Standards – Effective January 1, 2017

SIAAB Interpretation

**** Note: The terms “Chief Executive Officer” or “Agency Head” as utilized in this document are interchangeable and shall refer to the individual who has been designated by the Governor as the head of an agency under the Governor or the Constitutional Officer, in the case of those entities which do not fall under the direct jurisdiction of the Governor. The term “Agency” as utilized in this document, refers to an agency under the Governor or the Constitutional Office, in the case of those entities which do not fall under the direct jurisdiction of the Governor.*

“Chief Audit Executive (or Chief Internal Auditor) describes the role of a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the International Professional Practices Framework. The Chief Audit Executive (or Chief Internal Auditor) or others reporting to the Chief Audit Executive (or Chief Internal Auditor) will have the appropriate professional certifications and qualifications. The specific job title and/or responsibilities of the chief audit executive may vary across organizations.” [In Illinois, the Fiscal Control and Internal Auditing Act refers to this position as Chief Internal Auditor.]

Reporting Relationship

In order to ensure organizational independence and effectiveness within Illinois State Government, the Internal Audit function should be established within the organization as a separate function. Internal Audit must have neither any reporting responsibilities nor direct operational oversight of any program area nor may it report to any program area within the agency. The Chief Internal Auditor must report directly to the Chief Executive Officer or in the case of a Board, which has been established by Statute to oversee a State agency, the Chief Internal Auditor should have a dual reporting relationship directly to the Chief Executive Officer as well as the Board. The Chief Internal Auditor should be equivalent in stature to those on the executive team who report directly to the Chief Executive Officer. Proper status and recognition of the internal audit function within the organization ensures independence and places the internal audit function at a level within the organization that enables internal audit to effectively fulfill its responsibilities and mission. This reporting relationship is required by the Fiscal Control and Internal Auditing Act (FCIAA) (30 ILCS/10), as well as The International Standards for the Professional Practice of Internal Auditing (IIA Standards) published by the Institute of Internal Auditors (IIA). Section 2002 (b) of FCIAA states in part, “The chief internal auditor shall report directly to the chief executive officer and shall

have direct communications with the chief executive officer and the governing board, if applicable, in the exercise of auditing activities.” The IIA Standards refer to this as ensuring *Organizational Independence*. According to the IIA, “*Organizational Independence* is effectively achieved when the chief audit executive reports functionally to the board.” Within the context of this definition the IIA states that “board” refers to “the head of the organization” if it does not have a “board.” Therefore, for State agencies, except those with a Board authorized by statute, this means the Chief Executive Officer of the agency. For agencies which have a Board, it means dual reporting to both the Chief Executive Officer and the Board.

The IIA Standards recognize that a Chief Internal Auditor can report functionally to the Chief Executive Officer and administratively to the highest level within the Executive Office. An acceptable Administrative report within State of Illinois government operations would generally be a Chief of Staff or equivalent position. This administrative reporting must be to a level above the Chief Internal Auditor. This means for most responsibilities of the operations of the Internal Audit function, the Chief Internal Auditor must deal directly with the Chief Executive Officer of the agency. However, purely administrative functions, such as approval of time off, may be handled by a Chief of Staff. IIA Practice Advisory 1110 states in part, “At a minimum the CAE (Chief Audit Executive) needs to report to an individual in the organization with sufficient authority to promote independence and to ensure broad coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations. In Illinois State government, that individual is the Chief Executive Officer. Furthermore, evaluations and discussions of compensation must be between the Chief Internal Auditor and the Chief Executive Officer of the agency not a designee. The IIA defines certain tasks as typical “Functional Reporting” activities, which in the case of a State agency must be between the Chief Internal Auditor and the Chief Executive Officer or Board, if applicable. Those are provided below in IIA Standard 1110 *Organizational Independence*.

The IIA Standards require the responsibilities and authority of the Internal Audit function to be outlined in an Audit Charter approved annually by the Chief Executive Officer. IIA Standard 1000 *Purpose, Authority, and Responsibility* states, “The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework (the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *Standards*, and the Definition of Internal Auditing). The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.” In State of Illinois operations, such approval must come from the Chief Executive Officer or Board if applicable. The Internal Audit Charter is critical because it provides written direction from the Chief Executive Officer of the clear authority and responsibilities of the Internal Audit function.

Free from Operational Duties

Internal Audit should have no “*Operational Duties*” outside those directly related to responsibilities of an Internal Audit function. This allows the Internal Audit function to retain proper independence in order to conduct independent evaluations of the various agency functions. Internal Audit must have this “*Organizational Independence*” in order to have the ability to independently and objectively evaluate all functions and activities of the agency. If Internal Audit is responsible for any operational activity, it would be unable to evaluate that activity because Internal Audit would not be independent, as no one can independently evaluate their own work. Therefore, Internal Audit must not be responsible for making any decision on behalf of management or be responsible for any operational or program area, development or authorization of operational policies and procedures, conduct grant or contract monitoring, quality assurance, construction overhead audits or other direct and indirect costs of external parties or be responsible for any direct audits or reviews of external parties, except in the capacity of conducting an Internal Audit of those functions and activities.

Proper organizational structure provides the “*Organizational Independence*” necessary for Internal Audit to function as intended allowing it to provide meaningful evaluations and information to management. Section 2002 (b) of FCIAA states in part, “All chief internal auditors and all full-time members of an internal audit staff, shall be free of all operational duties.” Therefore, it is not possible for the Internal Audit to functionally report directly to anyone who is responsible for managing any operational function, as that would create a lack of organizational independence issue for the Internal Audit function. IIA Standard 1100-“*Independence and Objectivity*” states, “The internal audit activity must be independent, and internal auditors must be objective in performing their work.” The IIA 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.” These controls are in place to ensure internal auditors maintain independence so that our audits of the agency’s functions may provide an independent assessment of management’s operations. If internal auditors fail to adhere to these requirements, the results of any audit performed may be questioned due to Internal Audit’s inability to independently evaluate a function. Independence in both fact and appearance is an integral part of a meaningful evaluation and is the heart of the Internal Audit profession and the services that are provided.

Periodic Meetings Between the Chief Executive Officer and Chief Internal Auditor

The Chief Internal Auditor should meet periodically with the Chief Executive Officer as well as the Board if applicable, to provide updates regarding the Internal Audit function. The frequency should be determined after the Chief Internal Auditor’s discussion with the Chief Executive Officer or Board, if applicable, regarding what is reasonable. However, it should be frequent enough to enable the Chief Internal Auditor to sufficiently keep the Chief Executive Officer and Board, if applicable, apprised of critical activities of the Internal Audit function. The Chief Internal Auditor must have unrestricted access to the Chief Executive Officer and Board if applicable, in order to retain independence and freely bring to their attention any important matters or concerns. It is only through

this kind of relationship that the Chief Internal Auditor can effectively communicate anything which they believe may have a negative impact on the agency. This is recognized in IIA Standard 1111, which requires the Chief Internal Auditor to have direct communication and interaction with the Chief Executive Officer or Board, if applicable.

In addition to periodic reporting to the Chief Executive Officer to provide updates regarding the Internal Audit activities, FCIAA also requires the Chief Internal Auditor to create a Two Year Internal Audit Plan which must be approved by June 30 every year and an Annual Report regarding the status of all Internal Audit findings by September 30 of every year. Section 2003 (a) states, “The chief executive officer of each designated State agency shall ensure that the internal auditing program includes, (1) A two-year plan, identifying audits scheduled for the pending fiscal year, approved by the chief executive officer before the beginning of the fiscal year. By September 30 of each year the chief internal auditor shall submit to the chief executive officer a written report detailing how the audit plan for that year was carried out, the significant findings, and the extent to which the recommended changes were implemented.”

IIA Standard 1110 *Organizational Independence*” requires the Chief Internal Auditor to confirm with the Chief Executive Officer and Board, if applicable, the organizational independence of the Internal Audit function on at least an annual basis. IIA Standard 1320 *Reporting on the Quality Assurance and Improvement Program* requires the Chief Internal Auditor to communicate directly to the Chief Executive Officer and Board, if applicable, the results of the quality assurance and improvement program. IIA Standard 1322 *Disclosure of Nonconformance* requires the Chief Internal Auditor to disclose nonconformance with the IIA’s Definition of Internal Auditing, the Code of Ethics or the Standards that impact the overall scope of operations of the internal audit activity to the Chief Executive Officer and Board, if applicable.

Senior Staff or Leadership Interaction

The Chief Internal Auditor serves in the capacity of advising management regarding the appropriateness and effectiveness of the agency’s internal controls. In order to execute their responsibilities effectively, it is critical that the Chief Internal Auditor have access to and receive cooperation from the most senior level management of the agency. Senior management is defined as the upper most level of management reporting to the Chief Executive Officer that is responsible for delivering the various programs of the agency. In furtherance of this status within the organization, and in order to be best informed about present and future operations, the Chief Internal Auditor should regularly attend periodic meetings held between agency senior management. This allows the Chief Internal Auditor to be better informed of the activities of the agency as well as any new developments. It also provides an opportunity for the Chief Internal Auditor to keep senior management informed of Internal Audit’s activities.

In Illinois State government, the most senior level of management is the cabinet for the Chief Executive Officer. They are charged with direct responsibility for ensuring appropriate internal

controls are in place and functioning effectively. The SIAAB believes when applying this requirement in the State environment, it is best accomplished if the Chief Internal Auditor attends the agency Senior Staff or Leadership meetings, since there is no “Board of Directors” or Board Meetings for most State entities, as that term is understood in the private sector. It is at these meetings where management discusses activities and plans for the agency, strategic operational and business developments, changes to laws, rules and requirements, programmatic issues and the agency internal controls and environment. We believe this is consistent with the meaning conveyed in IIA Practice Advisory 1111-1 which states in part, “Direct communication occurs when the chief audit executive (Chief Internal Auditor) regularly attends and participates in board meetings that relate to the board’s oversight responsibilities for auditing, financial reporting, organizational governance, and control. The CAE’s attendance and participation at these meetings provide an opportunity to be apprised of strategic business and operational development, and to raise high-level risk, systems, procedures or control issues at an early stage. Meeting attendance also provides an opportunity to exchange information concerning the internal audit activity’s plans and activities and to keep each other informed on any other matters of mutual interest.”

Fiscal Control and Internal Auditing Act (30 ILCS10)

FCIAA Section 2002(b) states in part, “The chief internal auditor shall report directly to the chief executive officer and shall have direct communications with the chief executive officer and the governing board, if applicable, in the exercise of auditing activities. All chief internal auditors and all full-time members of an internal audit staff shall be free of all operational duties.”

FCIAA Section 2003(a)(1) states, “A two-year plan, identifying audits scheduled for the pending fiscal year, approved by the chief executive officer before the beginning of the fiscal year. By September 30th of each year the chief internal auditor shall submit to the chief executive officer a written report detailing how the audit plan for that year was carried out, the significant findings, and the extent to which recommended changes were implemented.”

IIA Standards

IIA’s Performance Standard 2060 – *Reporting to Senior Management and the Board* states, “The chief audit executive must report periodically to senior management and the board on the internal audit activity’s purpose, authority, responsibility, and performance relative to its plan and on its conformance with the Code of Ethics and the *Standards*. Reporting must also include significant risk and control issues, including fraud risks, governance issues, and other matters that require the attention of senior management and/or the board.”

IIA Attribute Standard 1110 – *Organization Independence* states, “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 (See IIA’s Glossary for Board Definition, for most Illinois State agencies this is the Chief Executive Officer), at least annually, the

organizational independence of the internal audit activity.”

Interpretation - “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; and
- Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.

IIA Attribute Standard 1320 – *Reporting on the Quality Assurance and Improvement Program* states, “The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board. Disclosure should include:

- The scope and frequency of both the internal and external assessments.
- Conclusions of assessors.
- Corrective action plans.
- The qualifications and independence of the assessor(s) or assessment team, including potential conflicts of interest.”

Interpretation - “The form, content, and frequency of communicating the results of the quality assurance and improvement program is established through discussions with senior management and the board and considers the responsibilities of the internal audit activity and chief audit executive as contained in the internal audit charter. To demonstrate conformance with the Code of Ethics and the Standards, the results of external and periodic internal assessments are communicated upon completion of such assessments and the results of ongoing monitoring are communicated at least annually. The results include the assessor’s or assessment team’s evaluation with respect to the degree of conformance.”

IIA Attribute Standard 1322 – *Disclosure of Nonconformance* states, “When nonconformance with the the Code of Ethics or the *Standards* impacts the overall scope of operations of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.”

Interpretation –“The frequency and content of reporting are determined in discussion with senior management and the board and depend on the importance of the information to be communicated and the urgency of the related actions to be taken by senior management or the board.”

IIA Interpretation Practice Advisory

IIA Practice Advisory 1111-1

1. “Direct communication occurs when the chief audit executive (Chief Internal Auditor) regularly attends and participates in board meetings that relate to the board’s oversight responsibilities for auditing, financial reporting, organizational governance, and control. The CAE’s attendance and participation at these meetings provide an opportunity to be apprised of strategic business and operational development, and to raise high-level risk, systems, procedures or control issues at an early stage. Meeting attendance also provides an opportunity to exchange information concerning the internal audit activity’s plans and activities and to keep each other informed on any other matters of mutual interest.”
2. “Such communication and interaction also occurs when the chief audit executive meets privately with the board at least annually.”

IIA Glossary of Definitions:

- **Board-** “The highest level of governing body (e.g., a board of directors, a supervisory board, or a board of governors or trustees) charged with the responsibility to direct and/or oversee the organization’s activities and hold senior management accountable. If a board does not exist, the word “board” in the *Standards* refers to a group or person charged with governance of the organization. Furthermore, “board” in the *Standards* may refer to a committee or another body to which the governing body has delegated certain functions (e.g., an audit committee).”
- **Independence-** “The freedom from conditions that threaten the ability of the Internal Audit activity to carry out Internal Audit responsibilities in an unbiased manner.”