

THE VALUE OF INDEPENDENCE

Over the past decade, new corporate governance codes and stock exchange listing rules have placed greater focus on the composition of boards of directors and specifically highlighted the value that independent directors bring to the table. The New York Stock Exchange and NASDAQ listing standards, for example, call for a majority of board members to be independent, meaning that they have “no material relationship” with the company.

To comply with these regulations and win back investors’ confidence, many companies — both publicly listed and private — have reconstituted their boards to find the appropriate balance of nonindependent and independent directors. They have adopted their own exhaustive list of detailed scenarios that spell out exactly what constitutes impairment to independence, and they have publicized their board-revamping efforts in an attempt to regain public trust. Some have gone so far as to limit their boards to having just one nonindependent director.

The reasoning behind these changes is clear: Having more independent directors on the board helps to create a more autonomous and effective oversight

body, a body whose sole concern is to help the company run honestly and efficiently. Although non-independent directors may be needed on the board for their knowledge of the company, its business and its industry, it is independent board members’ unbiased commitment to the organization and its shareholders that helps to ensure the board of directors, as a whole, provides objective guidance and

direction and sound corporate governance.

The value of an independent perspective is apparent outside the boardroom as well. Consider how independent insight and recommendations add value to research projects, consulting ventures, and court cases. Likewise, independence is the key to unlocking the full potential of an organization’s valuable internal audit function.

This issue of *Tone at the Top* explores how boards of directors can leverage the internal business knowledge and

uniquely independent positioning of the internal audit function to add valuable insight into not only the traditional areas of finance and compliance, but also strategic decision-making and risk areas related to ethics, IT, sustainability, and company reputation. Indeed, the internal audit activity has its finger on the pulse of the organization’s risks and opportunities and knows just what may be standing in the way of achieving business objectives.



Top 6 Ways Internal Audit Supports the Audit Committee

1. Provides ongoing assessments.
2. Educates the audit committee on new developments related to its activities.
3. Conducts confidential investigations.
4. Assists in the development of audit committee meeting agendas and presentation materials.
5. In executive sessions, provides views on the performance of management in relation to controls or the adequacy of corrective actions.
6. Assists in the compilation and distribution of advanced information packages before meetings.

SOURCE: *The IIA's Audit Executive Center Pulse of the Profession: 2012 Global Insights, August 2012.*

Internal Auditor Independence

Because internal auditors are embedded within the company, they know its operations and risks from the inside. Yet it's the internal audit activity's independent reporting structure that grants unfettered access to an oversight body such as the audit committee, that empowers auditors to share their internal business knowledge freely — not just the good, but also the bad and the ugly.

Internal audit's requirement to comply with a code of ethics and professional standards that demand independence and objectivity distinguishes the function from other internal assurance providers. According to The Institute of Internal Auditors (IIA), the internal audit activity should have a written charter that not only establishes its purpose and responsibility, but also its independent position within the company. To achieve organizational independence, The IIA recommends a dual reporting structure, where the chief audit executive (CAE) reports primarily to the organization's most senior oversight group (usually the audit committee) for strategic direction, reinforcement, and accountability, and has "dotted line" reporting to the CEO for administrative purposes.

The internal auditors' direct communication with the audit committee reinforces the status of internal auditing, enables its full support and unrestricted access to resources, and ensures that there is no impairment to independence. This provides the internal audit function with sufficient authority to ensure broad audit coverage, adequate consideration of engagement communications,

and appropriate action on recommendations. The audit committee further safeguards the internal audit activity's independence by:

- Assuming responsibility for the CAE's appointment, removal, and compensation.
- Ensuring that the CAE has an adequate budget and staffing.
- Periodically approving the internal audit charter and mandate.
- Encouraging the CAE to report to the board through its audit committee on the planning, execution, and results of audit activities.
- Ensuring that the CAE receives appropriate support and cooperation from management.

Open Communication

Compared to other regions of the world, North American CAEs have the greatest communication with their audit committees. More than 90 percent of North American CAEs attend all audit committee meetings, and 78 percent have regular executive, or private, meetings with the audit committee throughout the year.

SOURCE: *The IIA's Audit Executive Center Pulse of the Profession: 2012 Global Insights, August 2012.*

Are Your Internal Auditors Independent?

Although most CAEs have the recommended functional reporting relationship to the audit committee, many do not. In some cases, the CAE reports solely to the CEO or chief financial officer. This type of reporting relationship may compromise the independence of the function, thereby weakening its effectiveness.

Still, independence can be achieved with appropriate safeguards in place. In his blog “Chambers on the Profession,” available at www.InternalAuditorOnline.org, IIA President and CEO Richard Chambers offers a five-point litmus test to assess the independence of an internal audit activity that reports to someone other than the CEO:

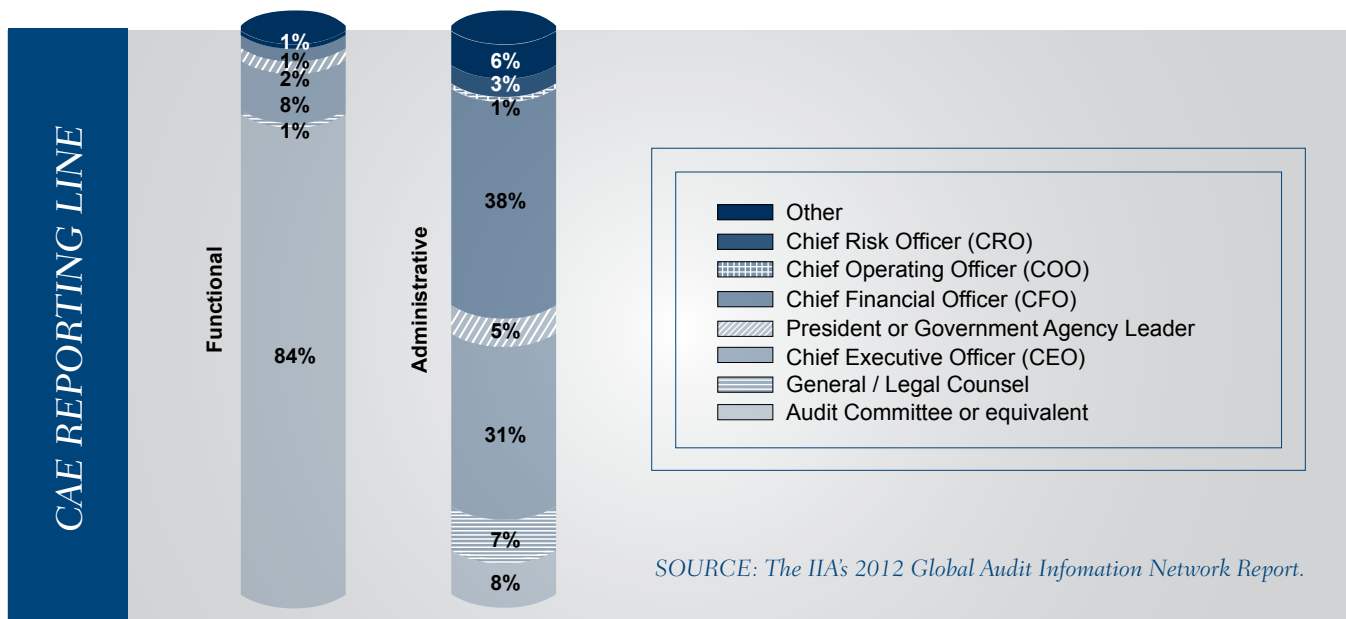
- **Attitude.** The individual to whom the CAE reports administratively takes the independence of internal audit seriously and never interposes his or her judgment in terms of internal audit coverage or results. The strongest message I typically would hear from such an individual is “internal audit does not really work for me — it works for the audit committee.”
- **Stature.** The individual to whom the CAE reports administratively possesses sufficient authority to promote independence and appropriate action on engagement recommendations.
- **Perception.** The CEO and other executives within

the company genuinely believe that internal audit works for the audit committee.

- **The Charter.** The internal audit charter is very clear on the significance of the functional reporting relationship to the audit committee and includes specific audit committee responsibilities for internal audit such as hiring, evaluating, and determining the CAE’s compensation.
- **Actions.** The actions of the audit committee reflect that it views internal audit as reporting directly to it.

Unlock the Value

Today’s internal auditors are being asked more frequently to provide assurance to parties outside the organization. For example, in certain industries regulatory agencies often require copies of internal audit reports. Some regulations mandate the establishment of an internal audit function. In addition, customers and suppliers sometimes request assurances about such matters as the organization’s controls over the confidentiality of electronically shared information. External auditors, too, often rely on the work performed by the internal auditors if they know that the internal audit activity is competent and independent. Providing credible assurance to these outside parties requires the highest degree of organizational status and autonomy on the part of the internal audit activity.



SOURCE: The IIA’s 2012 Global Audit Information Network Report.



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About *Tone at the Top*

Tone at the Top is a complimentary bimonthly publication that provides executive management, boards of directors, and audit committees with concise, relevant information and guidance on establishing the appropriate tone at the top concerning governance-related topics such as ethics, risk management, and corporate culture.

About The IIA

The Institute of Internal Auditors Inc. (IIA) is an international professional association and standard-setting body that serves as the internal audit profession's global

voice, chief advocate, and principal researcher and educator. The IIA has more than 175,000 members in 165 countries around the world. www.globaliia.org.

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We want to hear from you. Let us know what you think of this issue. Reach us via email at PR@theiia.org.

Ultimately, internal auditors exist to help ensure that organizational goals and objectives are met. They are well positioned to offer strategic and risk insights, identify enterprisewide cost efficiencies, and provide recommendations that improve business performance. However, the internal audit function's ability to add real value hinges on its independence, which is essential for auditors to render impartial and unbiased judgments in the conduct of their engagements. When their independence is supported and ensured by those at the top, internal auditors are empowered to reach their full

potential and fulfill their valuable role in organizational success and sustainability.

READ MORE

To explore this topic in greater detail, read *The IIA's Practice Guide: Independence and Objectivity*, which can be downloaded from www.theiia.org. Practice Guides are strongly recommended guidance under The IIA's International Professional Practices Framework.