

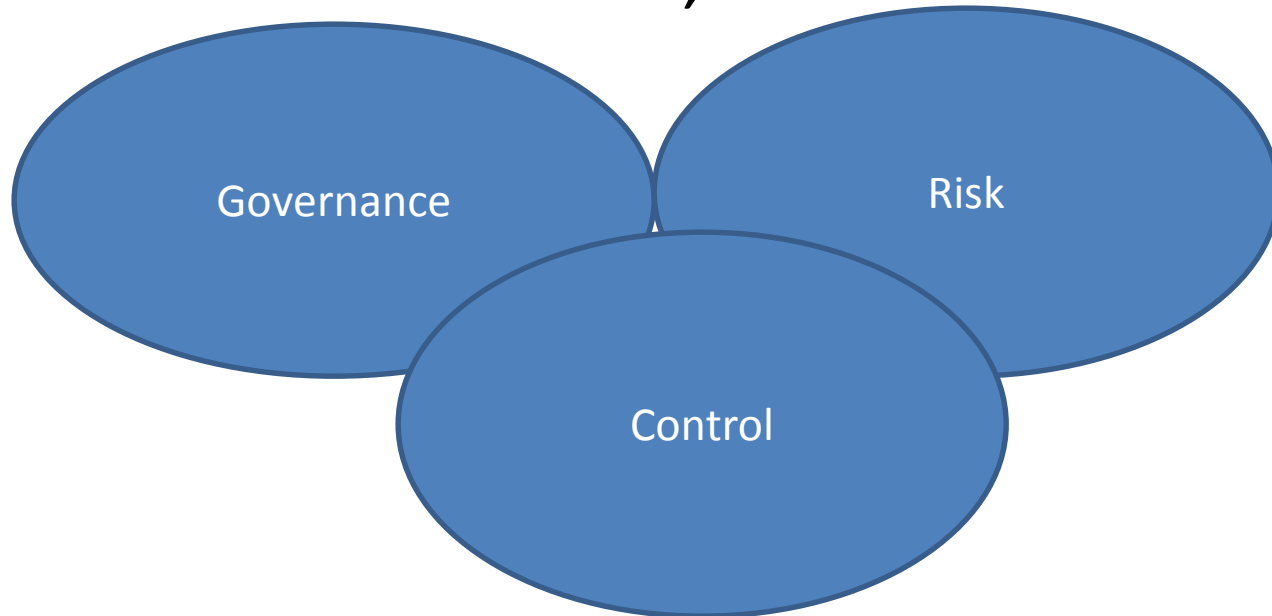
“THE PARADOX OF DUAL REPORTING
AND INTERNAL AUDITORS
INDEPENDENCE”

What is internal auditing?

- It is an independent objective assurance and consulting activity designed to add value and improve organizations 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 process.

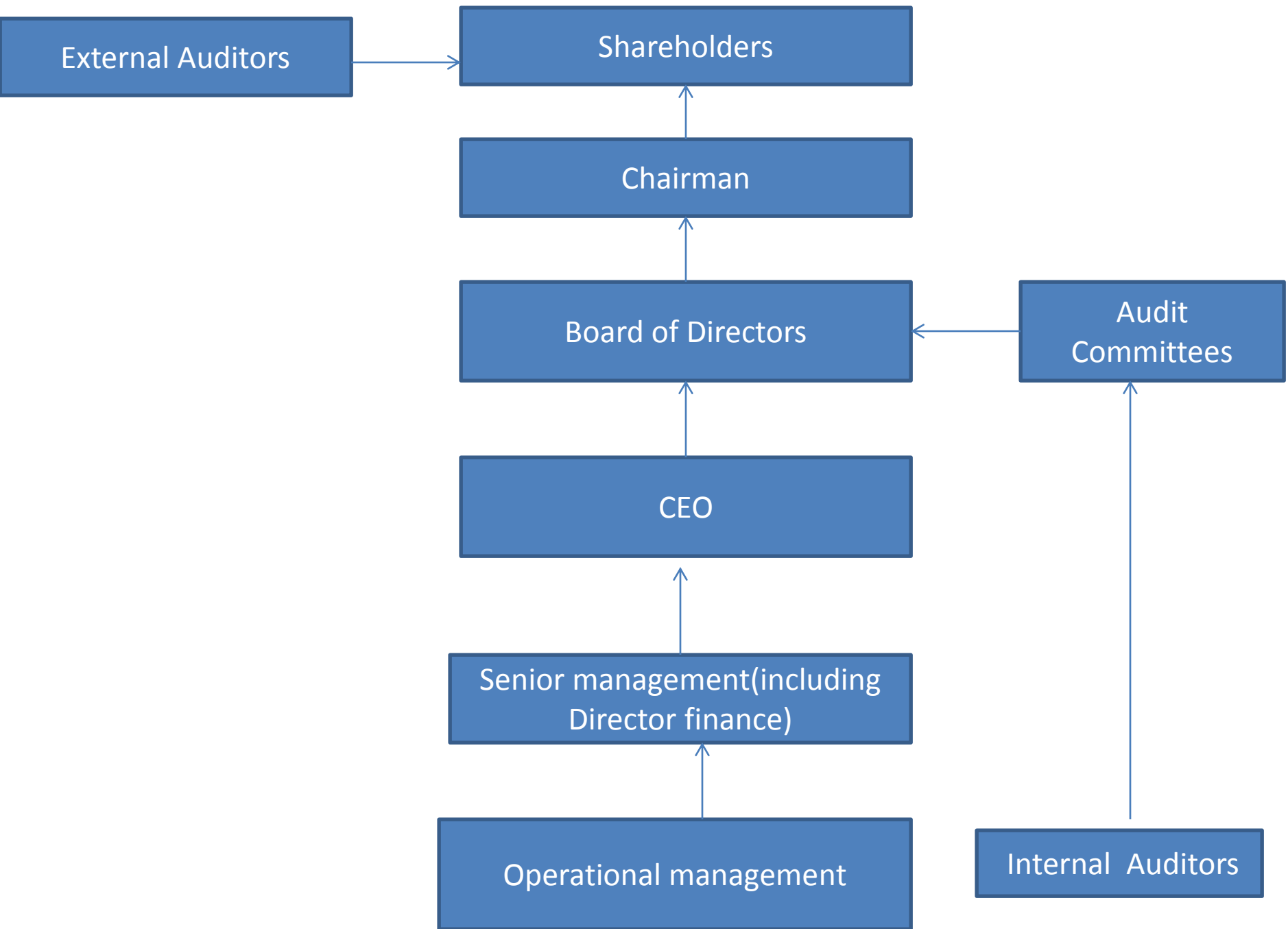
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- In summary it can be presented as follows
Assurance= Governance, Risk and control



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- With the three main functions of internal auditing functions it forces the office to report to different individuals at different capacities.
- Consider the simple organizational structure that most of the organizations use;



Cont....

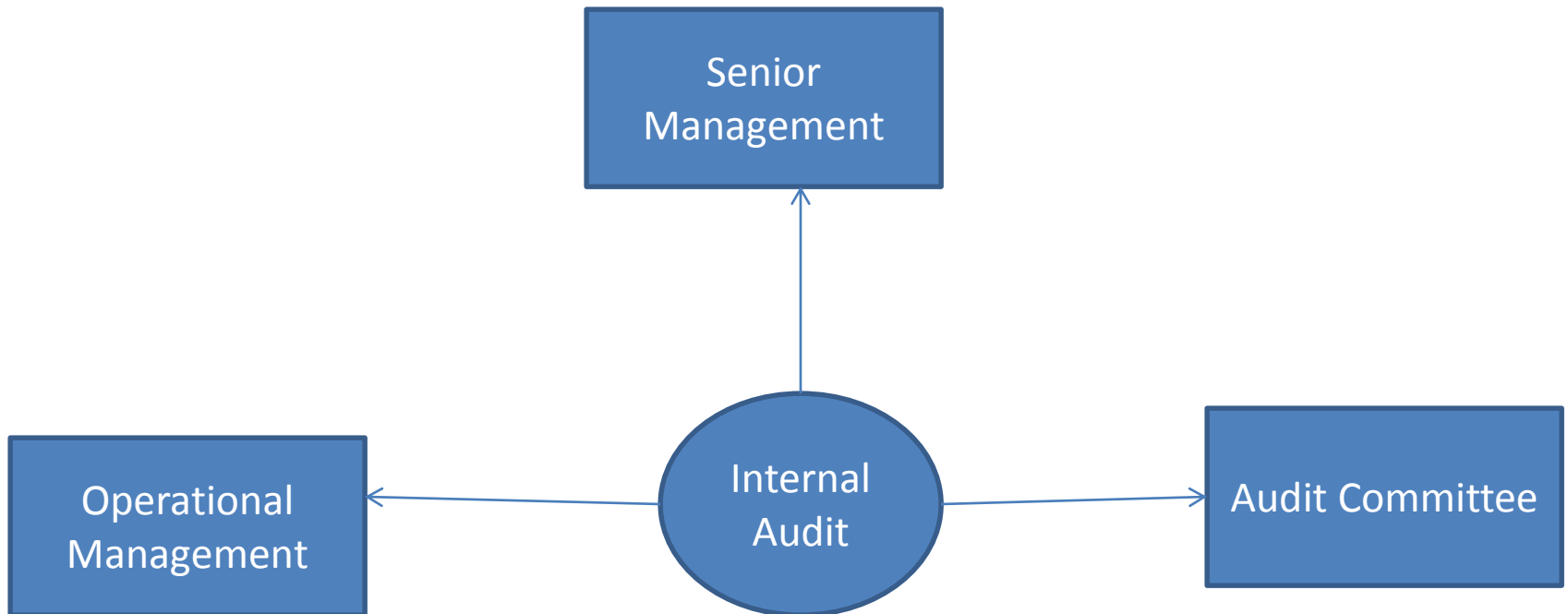
- From the organization structure its clear that the internal auditors can report to more than one authorities, namely to the
- Management(i.e to both senior management and the operational management)
- To the board(To the audit committees)

Cont.....

- Operational management; only interested in advice that may improve efficiency and effectiveness of their operations.
- Senior management may be interested with activities that may directly affect the bottom line or potentially their bonuses.
- Audit committees may be more concerned with managing their own risk and requests. A greater focus on risk management and control activities.

Cont.....

- All these competing demands can be visualized in the figure below;



Cont.....

- In reference to the agency theory, the main reason for introducing the thin layer of the BOD is to reduce the divergence of interest which precipitates the conflict between the owners of capital (shareholders) and the management.
- This role can effectively be done if the audit committees are able to effectively expedite their duties which entirely depends on reports from the internal auditors.

Cont.....

- The reports from Internal audit department can only be reliable if the internal audit officers are left to work independently
- **Independence** is the freedom from conditions that threaten the ability of the **internal audit** activity to carry out **internal audit** responsibilities in an unbiased manner.
- It involves both independence of mind and appearance.

Reporting and Independence

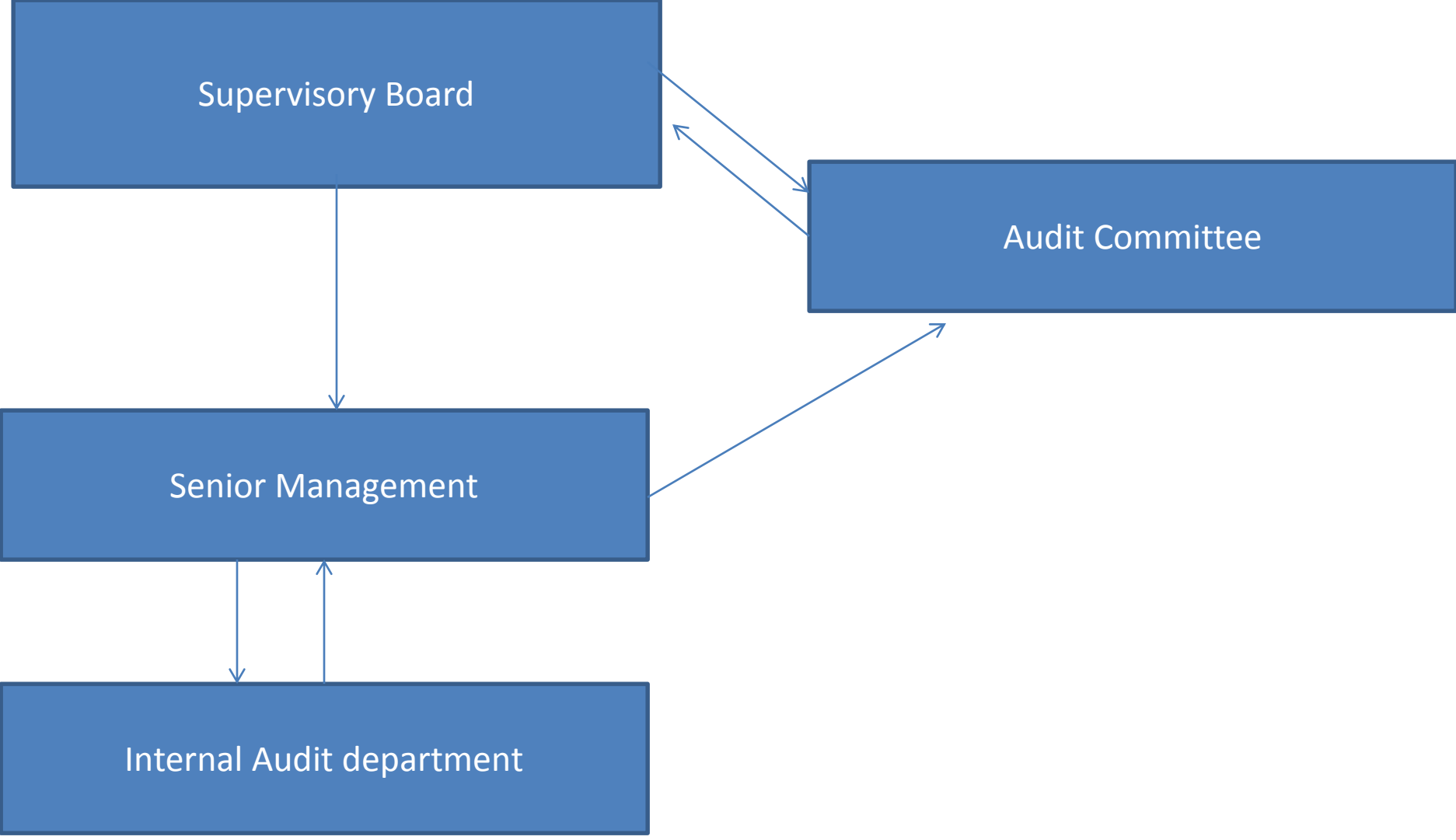
- The internal auditor occupies a unique position. He or she is employed by the management but is also expected to review the conduct of management which can create significant tension since the internal auditor's independence from management is necessary for the auditor to objectively assess the managements actions.

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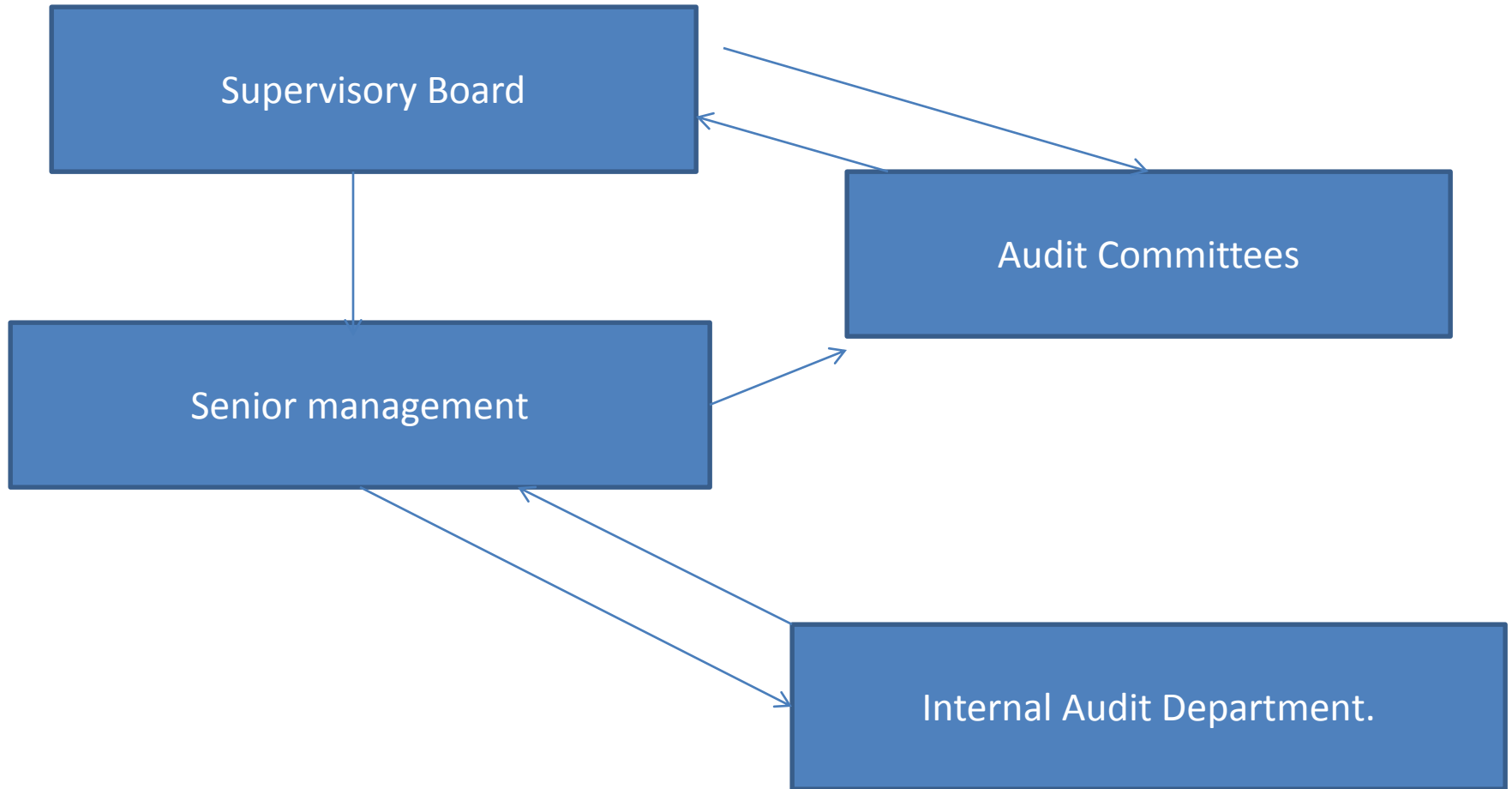
- Assume a scenario where the director finance engages in aggressive accounting practices to improve the company's reported earnings. This will indicate that some of the control processes relied upon by the audit committee to ensure adequacy and transparency of financial reporting have been compromised hence this may stifle the information that needs the flow of the Audit Committees.

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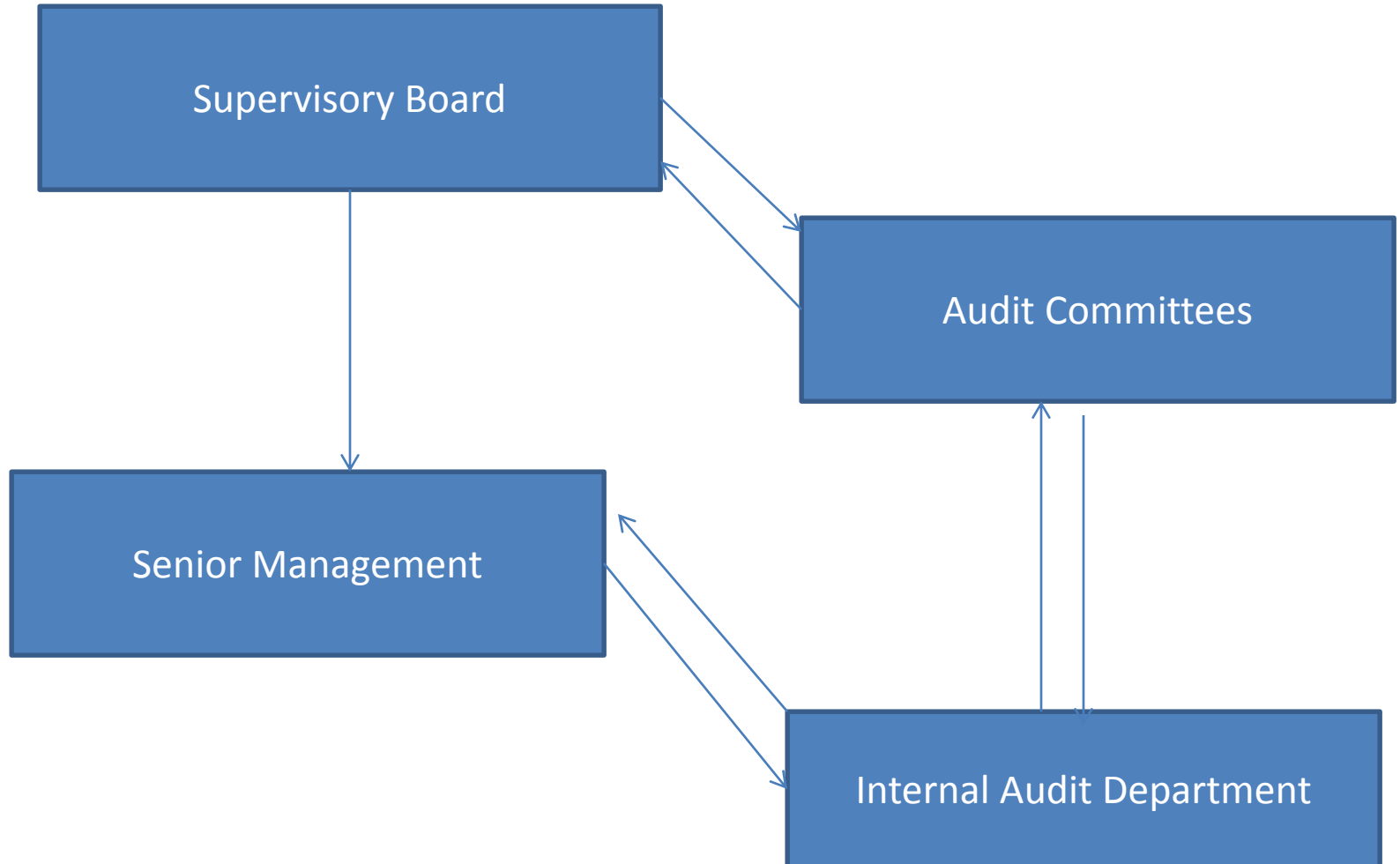
- Following Groff, Pietra & Sitar(2016) on contemporary role of internal auditing in corporate governance, its clear that, with the dynamic changes in business environment and the increase in corporate scandals, the reporting structure of the internal audit department, the operating management and the supervisory board keep on changing as shown below;



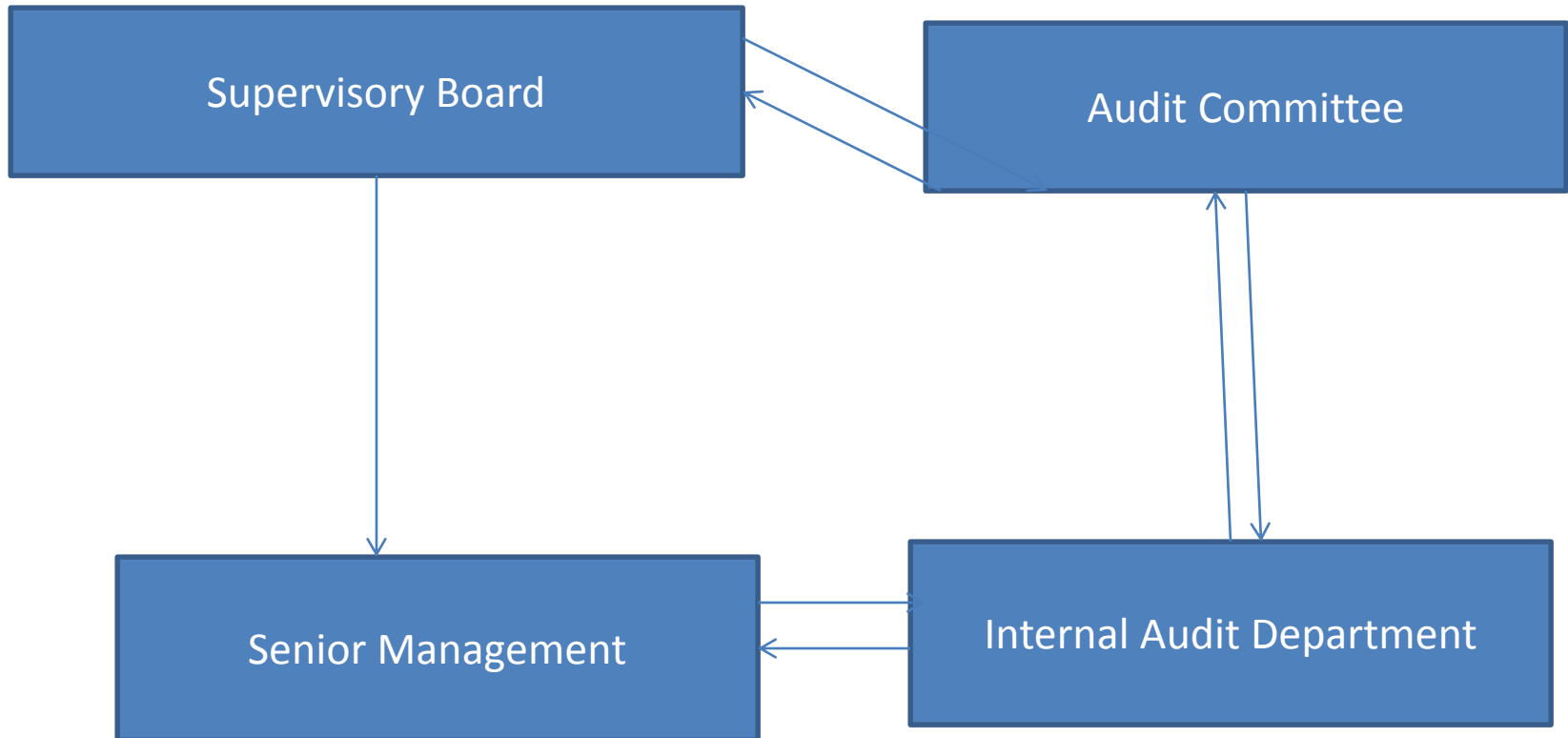
Reporting structures in 2000,s



Reporting structures in 2010,s



Future Reporting structure



Suggested ways of resolving the paradox of dual reporting and internal auditors independence;

To ensure this independence, best practices suggest that;

- The Internal Audit department should report directly to the audit committee or its equivalent.
- For day to day administrative purposes, the CAE should report to the most senior executive (i.e., the chief executive officer [CEO]) of the organization.

Cont....

- The CAE should have direct communication with the audit committee 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 actions on recommendations.

Cont.....

- Independence is further enhanced if the CAE reports to the board through its audit committee on the planning, execution, and results of audit activities.

Cont.....

- The audit committee is also responsible for the appointment, removal, and fixation of compensation of the CAE.
- The committee should safeguard the independence by approving the internal audit charter and mandate periodically.

Cont.....

- The internal auditor should have an impartial, un-biased attitude and avoid conflict of interest situations, as that would prejudice his/her ability to perform the duties objectively.
- The results of internal audit work should be reviewed before they are released in order to provide a reasonable assurance that the work has been performed objectively.

Cont.....

- Internal auditors should not accept gifts or favors from others such as employees(senior staff) clients or business associates.
- The internal auditors should adopt a policy that endorses their commitment to abiding by the Code of Ethics, avoiding conflicts of interest, disclosing any activity that could result in a possible conflict of interests.

Cont.....

- Staff assignment of internal auditors should be rotated periodically whenever it is practicable.

FORUM FOR QUESTIONS

•THE END