

The decision to whom the CAE should report is vital for the effectiveness of the internal audit activity's independence. In practice we find that the CAE may report to any or a combination of the management functions listed below:

1. Governing body – board of directors/control board/committee
2. Top executive management
3. Chief Executive Officer (CEO)
4. Chief Financial Officer (CFO)
5. Audit Committee (as a subcommittee of the Board of Directors)

The advantages and disadvantages of each of these forms of reporting, as well as the compromise method of dual reporting, are discussed in greater detail below.

1. Governing body – board of directors/control board/committee AND top executive management

Direct reporting to the top executive management (board of directors or managing director) holds great advantages for the independence and accessibility of the internal audit activity. The following question, however, arises in this case: What is the primary purpose of the internal audit activity in an undertaking? Is it the rendering of assistance as a service to management or is it to serve as a control over management?

If the primary accent is on rendering assistance and a service to management, it is logical that the internal audit activity should fall under the guidance and control of management and should, therefore, report to them.

A compromise (dual reporting) could be agreed upon and the chief audit executive of internal auditing would then report to

- the board of directors regarding functional responsibilities
- executive management regarding (operational) matters

An important aspect to bear in mind when reporting to top executive management is that other members of management may mistrust the internal auditor because of his or her access to top executive management, and that he or she may therefore not be acceptable to them as a member of the management team. This distrust originates because other members of management might perceive the influence and authority of the internal auditor arising from his or her high status and level of reporting as a threat to their own positions. For this reason the internal auditor might face resistance as a fellow member of the management team. The importance of direct access to top executive management and the audit committee is, however, described in Standard 1110 of the International Standards for the Professional Practice of Internal Auditing, and the increased independence which the internal auditor obtains through direct access is also discussed.

2. Chief Executive Officer (CEO)

Initially, advantages of this level of reporting are that:

- It guarantees access to a high-level official.
- It provides a reasonable measure of independence for the internal auditor. (In big undertakings the CEO is not normally responsible for a particular department.)
- Management may feel less threatened because the accessibility of the internal auditor is at a lower level than if he were to report to the Board of Directors (see 1). The distrust with which management may regard the internal auditor might thus be reduced by this particular level of reporting.

However, there are the following disadvantages:

- If the influence and authority of the internal auditor is such that audit matters receive the attention of the CEO, to the detriment of other management matters, the efficiency of management will suffer and distrust might increase.
- Since a CEO is normally very busy, the CAE might find that he or she does not receive the guidance and support necessary to perform his or her task

effectively. Reporting to the CEO may, therefore, not be the ideal reporting structure for internal auditors.

3. Chief Financial Officer (CFO)

The internal audit activity traditionally reported to the CFO because approximately half the time spent in internal auditing was devoted to the auditing of financial aspects of the undertaking.

In practice this line of reporting works well. The most important to be considered in this case is the level of responsibility and authority of the CFO. If it is too low, the internal auditors will find it difficult to perform their duties free of interference and to obtain the cooperation of auditees. Low-level access does not afford the internal auditors the necessary status.

When referring to the CFO we do not mean the financial accountant. The organisational independence of the internal auditor would be affected if he were to report to the chief accountant because the chief accountant would be able to suspend the audit activities of the internal auditor as soon as weaknesses in activities under his control were pointed out. The internal audit activity would not have the necessary authority and status to deal effectively with other heads of departments.

Although reporting to the CFO is common, the disadvantage for the internal auditor is a certain loss of independence, because he or she could possibly be manipulated by the finance department, particularly if his or her involvement in financial matters is taken into account. Other departments, such as production, may feel that they are open to criticism, whereas the finance department is able to avoid this.

4. The audit committee

An audit committee is a committee comprising persons outside the organisation (directors from other companies, consultants, non-affiliated officials) with specialised knowledge, responsible for serving as a link between the governing body/top executive management and the external and internal auditors in all matters pertaining to auditing.

This level of reporting gives the internal audit activity a high degree of organisational independence and accessibility because it is reporting to a body with more authority

than top executive management, and the majority of members are not involved in the operational matters of the company (executive functions). The involvement of the audit committee with the appointment and discharge of the chief audit executive is also advocated in the professional standards. This will be dealt with in more detail in Topic 9.

In practice, however, the following problems are experienced with this channel of reporting:

1. Because the audit committee does not meet frequently enough, they do not have the time to support the internal audit activity on a day-to-day basis as an independent reporting facility. Audit committees meet on average four times a year.
2. Because of its function, the audit committee, by its very nature, is apart from the main stream of business activities. As a result, the internal auditor does not always receive necessary information and directives which might enable him to function effectively.
3. The audit committee also has a functional rather than an operational role and it is, therefore, undesirable that members should be involved with the operational or household details of the internal audit activity. Their proper functions would include the final authorisation of audit plans and audit findings, the coordination of audit efforts and the formulation of audit policy. Any restrictions placed on the internal auditor by management should, however, be brought to their attention by the internal auditor for final resolution. As a result of these problems, sole reporting to the audit committee is not currently common practice.

5. Dual reporting

Owing to the limitations of each of the reporting lines described above, a compromise arrangement is normally made in practice, whereby the chief audit executive has a dual level of reporting. The chief audit executive reports,

1. to the audit committee on **functional** responsibilities
2. to the CEO on **operational/household** tasks such as reviewing budgets, requests for salary increases and staff expansion.

Also refer to study unit 9.1.5 of the study guide with regard to the relationship of the internal auditor with the audit committee.

Dual reporting takes place when a particular management function reports to more than one management authority. Examples of dual reporting were discussed under 1 and 4 above.

The disadvantages of a divided line of reporting are the following:

1. The possibility of manipulation by all the parties.
2. It is essential to clearly demarcate and enforce the responsibilities of the parties to whom the audit activity reports, especially where the parties are not on the same organisational level and therefore do not have the same organisational status and authority.
3. There is a possibility that an internal audit manager with dual reporting responsibility may be pulled in two directions as a result of a difference of opinion between the parties to whom he or she reports.