

INTERNAL AUDIT'S REPORTING STRUCTURE

Presentation to the
Audit and Finance Committee
24 March 2016

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Purpose of the Reporting Structure

- Assure the Office of Internal Audit (OIA) maintains its independence
- Include OIA within the organizational structure of the San Diego Unified School District
- Provide visibility to the findings and recommendations included in the reports prepared by OIA for the Superintendent and the Board of Education (Governance Authorities)
- Provide management support to OIA and its operations

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Applicable Independence Standards

- American Institute of Certified Public Accountants.
 - *Overall Objectives of the Independent Internal Auditor and Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*
- Comptroller General of the United States
 - *Government Auditing Standards 2011 Revision (GAGAS or Yellow Book)*
 - Sections 3.02 – 3.05 and Sections 3.31 and 3.32
- Institute of Internal Auditors
 - *International Standards for the Professional Practice of Internal Auditing (Standards or Red Book)*
 - *Practice Advisory 1110-1 Organizational Independence*
 - *Practice Advisory 1130-1 Impairment to Independence and Objectivity*

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Who Does OIA Report To

- Current – as of 1 July 2015
 - Functionally – Superintendent of Public Education (Superintendent)
 - Administratively – Superintendent
 - OIA meets the Yellow Book's Independence Requirements
- Prior Reporting Structures
 - 1 July 2014 to 30 June 2015
 - Functionally – General Counsel through the Executive Director, Quality Assurance
 - Administratively – Same Reporting Relationship
 - Prior to 1 July 2014
 - Most recently to the General Counsel
 - Various functional reporting structures including the Superintendent, General Counsel and Chief of Staff

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Types of Reporting Relationships

- **Functional Reporting**
 - Provides a direct oversight function to OIA
 - Authorizes specific resources to be provided to OIA for continuing operations
 - Reviews the development of the annual work plans
 - Conducts performance evaluation of the Director, Internal Audit and may act as the approving official for OIA staff evaluations
 - Directs that specific projects be performed
 - Provides supervisory oversight to the Director, Internal Audit
- **Administrative Reporting**
 - Provides budget guidance and reviews the development of the OIA budget
 - Ensures that various administrative functions are executed

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Reporting to the Board of Education and/or the Audit and Finance Committee

- **Current Relationship**
 - OIA does not have a required reporting relationship to either the Board of Education (BOE) or the Audit and Finance Committee (AFC)
 - We provide copies of various reports to the AFC and BOE to fulfill their oversight responsibilities
- **Potential Reporting Relationships**
 - State law may prohibit OIA from functionally or administratively reporting to an advisory committee
 - OIA could report directly to the BOE — Administrative reporting to the Superintendent. This would require BOE approval.
 - BOE would need to designate a single individual to manage the reporting relationship and develop a public reporting process for the audit reports

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Reporting Relationships of Other Internal Audit Functions

- New York City Public Schools – Auditor General
 - Functionally and Administratively to the General Counsel
 - General Counsel reports to the Chancellor of New York City Schools
- Los Angeles Unified School District (LAUSD) – Inspector General
 - Functionally and Administratively to the BOE through the Budget, Facilities, and Audit Committee - All members are BOE members
 - Provides their reports to the Superintendent and LAUSD management
 - Inspector General's position created by State Legislation
- Chicago Public Schools (CPS) – Director of Internal Audit
 - Functionally and Administratively to the Chief Executive Officer

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Questions?

American Institute for Certified Public Accountants
Independence Standards for Audits and Attestation Engagements

AU-C Section 200

Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards

.15 The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise or (b) the auditor is required by law or regulation to accept the engagement and report on the financial statements. When the auditor is not independent and neither (a) nor (b) are applicable, the auditor is precluded from issuing a report under GAAS.

.A16 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include the following:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

.A17 In the case of an audit engagement, it is in the public interest and, therefore, required by this section, that the auditor be independent of the entity subject to the audit. The concept of independence refers to both independence in fact and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective, and to maintain an attitude of professional skepticism. Independence implies an impartiality that recognizes an obligation to be fair not only to management and those charged with governance of an entity but also users of the financial statements who may rely upon the independent auditor's report. Guidance on threats to independence is set forth in the AICPA's "Conceptual Framework for Independence" (ET sec. 1.210.010). [Revised, January 2015, to reflect conforming changes necessary due to the issuance of the revised AICPA Code of Professional Conduct, effective December 15, 2014.]

.A18 When the auditor is not independent but is required by law or regulation to report on the financial statements, section 705, *Modifications to the Opinion in the Independent Auditor's Report*, applies.

.A19 Due care requires the auditor to discharge professional responsibilities with competence and to have the appropriate capabilities to perform the audit and enable an appropriate auditor's report to be issued.

Considerations Specific to Audits of Governmental Entities

.A21 In addition to the AICPA Code of Professional Conduct and GAAS, *Government Auditing Standards*, which may be required by law, regulation, contract, or grant agreement in audits of governmental entities and entities that receive government awards, set forth relevant ethical principles and auditing

standards, including standards on auditor independence, professional judgment, competence, and audit quality control and assurance.

AT Section 101

Attest Engagements

.03 When a practitioner undertakes an attest engagement for the benefit of a government body or agency and agrees to follow specified government standards, guides, procedures, statutes, rules, and regulations, the practitioner is obliged to follow those governmental requirements as well as the applicable attestation standards.

Independence

.35 The fourth general standard is—*The practitioner must maintain independence in mental attitude in all matters relating to the engagement.*⁷ [As amended, effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006, by SSAE No. 14.]

.36 The practitioner should maintain the intellectual honesty and impartiality necessary to reach an unbiased conclusion about the subject matter or the assertion. This is a cornerstone of the attest function.

.37 In the final analysis, independence in mental attitude means objective consideration of facts, unbiased judgments, and honest neutrality on the part of the practitioner in forming and expressing conclusions. It implies not the attitude of an advocate or an adversary but an impartiality that recognizes an obligation for fairness. Independence in mental attitude presumes an undeviating concern for an unbiased conclusion about the subject matter or an assertion no matter what the subject matter or the assertion may be.

.38 The profession has established, through the AICPA's Code of Professional Conduct, precepts to guard against the *presumption* of loss of independence. Presumption is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code, they have the force of professional law for the independent practitioner.

General Standards

Introduction

3.01 This chapter establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under generally accepted government auditing standards (GAGAS). These general standards, along with the overarching ethical principles presented in chapter 1, establish a foundation for the credibility of auditors' work. These general standards emphasize the importance of the independence of the audit organization and its individual auditors; the exercise of professional judgment in the performance of work and the preparation of related reports; the competence of staff; and quality control and assurance.

Independence

3.02 In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.

3.03 Independence comprises:

a. Independence of Mind

The state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b. Independence in Appearance

The absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

3.04 Auditors and audit organizations maintain independence so that their opinions, findings,

conclusions, judgments, and recommendations will be impartial and viewed as impartial by reasonable and informed third parties. Auditors should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.

3.05 Except under the limited circumstances discussed in paragraphs 3.47 and 3.48, auditors should be independent from an audited entity during:

a. any period of time that falls within the period covered by the financial statements or subject matter of the audit, and

b. the period of the professional engagement, which begins when the auditors either sign an initial engagement letter or other agreement to perform an audit or begin to perform an audit, whichever is earlier. The period lasts for the entire duration of the professional relationship (which, for recurring audits, could cover many periods) and ends with the formal or informal notification, either by the auditors or the audited entity, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period of professional engagement does not necessarily end with the issuance of a report and recommence with the beginning of the following year's audit or a subsequent audit with a similar objective.

3.06 GAGAS's practical consideration of independence consists of four interrelated sections, providing:

a. a conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific environments;

Internal Auditor
Independence

g. statutory access to records and documents related to the agency, program, or function being audited and access to government officials or other individuals as needed to conduct the audit.

3.31 Certain entities employ auditors to work for entity management. These auditors may be subject to administrative direction from persons involved in the entity management process. Such audit organizations are internal audit functions and are encouraged to use the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* in conjunction with GAGAS. In accordance with GAGAS, internal auditors who work under the direction of the audited entity's management are considered independent for the purposes of reporting internally if the head of the audit organization meets all of the following criteria:

- a.** is accountable to the head or deputy head of the government entity or to those charged with governance;
- b.** reports the audit results both to the head or deputy head of the government entity and to those charged with governance;
- c.** is located organizationally outside the staff or line-management function of the unit under audit;
- d.** has access to those charged with governance; and
- e.** is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.

3.32 When internal audit organizations perform audits of external parties such as auditing contractors or outside party agreements, and no impairments to independence exist, the audit organization can be

Chapter 3
General Standards

considered independent as an external audit organization of those external parties.

Provision of
Nonaudit Services to
Audited Entities

3.33 Auditors have traditionally provided a range of nonaudit services that are consistent with their skills and expertise to entities at which they perform audits. Providing such nonaudit services may create threats to an auditor's independence.

Requirements for
Performing Nonaudit
Services

3.34 Before an auditor agrees to provide a nonaudit service to an audited entity, the auditor should determine whether providing such a service would create a threat to independence, either by itself or in aggregate with other nonaudit services provided, with respect to any GAGAS audit it performs. A critical component of this determination is consideration of management's ability to effectively oversee the nonaudit service to be performed. The auditor should determine that the audited entity has designated an individual who possesses suitable skill, knowledge, or experience, and that the individual understands the services to be performed sufficiently to oversee them. The individual is not required to possess the expertise to perform or reperform the services. The auditor should document consideration of management's ability to effectively oversee nonaudit services to be performed.

3.35 If an auditor were to assume management responsibilities for an audited entity, the management participation threats created would be so significant that no safeguards could reduce them to an acceptable level. Management responsibilities involve leading and directing an entity, including making decisions regarding the acquisition, deployment and control of human, financial, physical, and intangible resources.

3.36 Whether an activity is a management responsibility depends on the facts and circumstances and auditors

Practice Advisory 1110-1: Organizational Independence

Primary Related 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.

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.*

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1. Support from senior management and the board assists the internal audit activity in gaining the cooperation of engagement clients and performing their work free from interference.
 2. The chief audit executive (CAE), reporting functionally to the board and administratively to the organization's chief executive officer, facilitates organizational independence. At a minimum the CAE needs to report to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations.
 3. Functional reporting to the board typically involves the board:
 - Approving the internal audit activity's overall charter.
 - Approving the internal audit risk assessment and related audit plan.
 - Receiving communications from the CAE on the results of the internal audit activities or other matters that the CAE determines are necessary, including private meetings with the CAE without management present, as well as annual confirmation of the internal audit activity's organizational independence.
 - Approving all decisions regarding the performance evaluation, appointment, or removal of the CAE.
 - Approving the annual compensation and salary adjustment of the CAE.
 - Making appropriate inquiries of management and the CAE to determine whether there is audit scope or budgetary limitations that impede the ability of the internal audit activity to execute its responsibilities.

4. Administrative reporting is the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the internal audit activity. Administrative reporting typically includes:
- Budgeting and management accounting.
 - Human resource administration, including personnel evaluations and compensation.
 - Internal communications and information flows.
 - Administration of the internal audit activity's policies and procedures.

Issued: January 2009

Practice Advisory 1130-1: Impairment to Independence or Objectivity

Primary Related 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.

Interpretation:

Impairment to organizational independence and individual objectivity may include, but is not limited to, personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding.

The determination of appropriate parties to which the details of an impairment to independence or objectivity must be disclosed is dependent upon the expectations of the internal audit activity's and the chief audit executive's responsibilities to senior management and the board as described in the internal audit charter, as well as the nature of the impairment.

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1. Internal auditors are to report to the chief audit executive (CAE) any situations in which an actual or potential impairment to independence or objectivity may reasonably be inferred, or if they have questions about whether a situation constitutes an impairment to objectivity or independence. If the CAE determines that impairment exists or may be inferred, he or she needs to reassign the auditor(s).
 2. A scope limitation 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.
 3. 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.

4. Internal auditors are not to accept fees, gifts, or entertainment from an employee, client, customer, supplier, or business associate that may create the appearance that the auditor's objectivity has been impaired. The appearance that objectivity has been impaired may apply to current and future engagements conducted by the auditor. The status of engagements is not to be considered as justification for receiving fees, gifts, or entertainment. The receipt of promotional items (such as pens, calendars, or samples) that are available to employees and the general public and have minimal value do not hinder internal auditors' professional judgments. Internal auditors are to report immediately the offer of all material fees or gifts to their supervisors.

Issued: January 2009

Should Internal Audit Report to the CFO?

Moody's recommends that the chief internal auditor report to the CEO and the audit committee, not the CFO.

Sarah Johnson

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Can an internal auditor examine a company's books and controls with an objective eye if the person ultimately responsible for those books and controls is his or her boss? Increasingly, audit committees — whose job includes protecting the independence of internal auditors — are hearing that the answer to that question is no.

The majority of public companies' top internal auditors split their reporting duties between the audit committee and the CFO, with their strategy and functionality falling under the committee's purview and their administrative duties falling under the finance chief's. While having direct access to the CFO exposes the head auditor to a company's financial reporting process, it also can undermine that auditor's independence, according to Moody's Investors Service's recently released best practices for audit committees' oversight of internal auditors.

"It creates a potential conflict if the internal auditors report directly to the CFO," says Dave Richards, president of the Institute of Internal Auditors and a member of the city of Orlando's audit committee.

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Moody's recommends that the audit chief's dual reporting relationship include the CEO, rather than the CFO, in order to empower the audit team and make it clear to the rest of the company that senior management considers the audit function a high priority.

This, of course, leaves audit executives still with the tough job of reporting to two bosses, one of whom reports to work only about six times a year during audit-committee meetings. Because of that, the audit-committee chairman should be readily available to the audit head by phone and at informal meetings, says Jim Key, principal partner of consultancy The Shenandoah Group and a member of two audit committees, including that of Coastal Banking Co. in South Carolina. The audit committee should be involved in the chief auditor's performance evaluations and salary negotiations, he adds. At the same time, auditors' compensation incentives should not be linked to corporate performance, says Moody's.

In recent years, as audit committees' prominence has risen and their importance emphasized by Sarbanes-Oxley regulations, "the heads of internal audit teams feel more accountability to audit committees than they ever have," says Mark Watson, Moody's senior vice president of corporate governance, who wrote the report. At the same time, because of Sarbox and pressures from investors wanting sound governance, companies are increasingly adding people to their audit teams, he adds.

The result has been audit-committee meetings that are more frequent, last longer, and are conducted more professionally, Moody's says. In addition, audit committees have gained more control over relationships with both external and internal auditors.

Audit committees also should strengthen their relationship with executives by having frequent, off-the-record meetings, says the Moody's report. That way, if a sensitive issue comes up, the executive involved can feel comfortable talking about it in a setting that has already been established.

Key, who once served as IBM's director of internal audit, also emphasizes the importance of audit committees having routine one-on-one meetings with the CFO and other executives. These informal "executive sessions" give the audit committees an inside look into management's concerns. "The executive sessions provide nuance that written reports can't always capture," says Key. Moody's recommends that these meetings take place at least every quarter.

Although Coastal Banking has these meetings, conducted around the same time as the regular audit-committee meetings, many companies do not, says Watson, because of scheduling conflicts, among other reasons.

The following are some additional highlights from Moody's best practices for audit committees, based on interviews with more than 400 audit-committee chairmen of large U.S. and Canadian companies, along with internal audit professionals.

- **The auditing strategy should be timely and comprehensive, covering all auditable units.** Moody's agrees with companies that categorize their auditable areas by level of risk (such as high, medium, low) to decide how often to conduct an audit (high-risk areas should be audited at least annually). At the same time, companies need to audit their low-risk areas at least once within a four-year period, Moody's recommends, to avoid any problems. For example, many companies figured their process of administering stock-options grants was a low-risk area, although it turned out not to be: in the past year, questionable grant dates of stock options have resulted in financial restatements and dozens of investigations by the Securities and Exchange Commission.

- **The audit plan should be holistic and risk-based.** The audit team needs to go beyond focusing solely on financial reporting risks, the main concern of external auditors, Moody's says. Audit committees should evaluate current and prospective risks, including reputational, operational, financial, legal, IT, and compliance risks. From executives, audit committees need an inventory of all risks, Key says, as they need to consider the risk areas no one is considering, such as how a health pandemic would affect a company.

- **Audit committees should make sure audit reports are followed up on effectively and in a timely way.** Moody's recommends that executives' pay be docked if they take too long to respond to an audit evaluation that is critical of their department.

- **Companies should keep their internal audit function in-house.** While acknowledging that using third-party audit professionals can have its benefits, such as ensuring the auditors' independence within the organization, Moody's believes doing so brings up too many corporate-governance issues: outsourced auditors do not have enough access to the audit committee, they have less stature within the company to do their job effectively, and their work may be cut back because of budget constraints since they are paid on an hourly basis, Moody's says.

In addition, outsourced auditors will likely miss connecting the dots between the many issues and risks that can pop up at a company, according to Richards. Internal auditors who actually work inside the company day-to-day are more aware of the inner-workings and see the interrelationships between processes and departments, therefore strengthening an organization's risk-management strategy, he says.

- **Audit committees should agree on the audit function's role with regard to Sarbanes-Oxley's Section 404.** Audit teams, warns Moody's, should not be so entrenched in 404 that they are not concentrating on their traditional duties, and they should not play a role in designing controls or becoming part of the control process.