

## **Internal Audit**

### **Background**

The Code (ED paragraphs 290.186 – 191) provides that providing internal audit services to an audit client may create a self-review threat and such services may be provided if safeguards are applied to reduce any threat to an acceptable level *and* all of the following safeguards are applied:

- The client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
- The client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
- The client, or those charged with governance, approves the scope, risk and frequency of internal audit work;
- The client is responsible for evaluating and determining which recommendations of the firms to implement;
- The client evaluates the adequacy of the internal audit procedures and the findings resulting from their performance by, among other things, obtaining and acting on reports from the firm; and
- The findings and recommendations resulting from the internal audit activities are reported appropriately to those charged with governance.

Internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements. In addition, services which involve an extension of procedures required to conduct an audit in accordance with ISAs would not be considered to compromise independence as long as the firm's personnel do not perform management functions.

The Code cautions that performing a significant portion of an audit client's internal audit activities may create a self-review threat and that a firm should consider the threats and proceed with caution.

The Code makes no distinction between entities that are of significant public interest and those that are not.

### **Comparative Positions**

Appendix A to this agenda paper contains text of positions taken by others in this area.

There are differences in the approaches taken:

- The US and Canada have more restrictive requirements for listed entities and prohibit internal audit services relating to internal accounting controls, financial systems or financial statements unless it is reasonable to conclude that the results of the services will not be subject to audit procedures;

- The EC recommendation is arguably more explicit than IESBA in that it states if the auditor is not satisfied that the client acknowledges responsibility for internal controls the auditor should not participate in the client's internal audit;
- The APB prohibits the provision of internal audit services (for all audit clients) where it is reasonably foreseeable that the auditor would place significant reliance on the internal audit work performed by the firm.

The IOSCO survey (Agenda Paper 4-D pages 21-22) also indicates differing approaches. It notes that overall, there were only a few specific internal audit services where there was a clear prevailing practice. It further notes that the rationales provided for "not-permitting" these services focused on the self-review threat created by the provision of internal audit services, given that there is a rebuttable presumption that these services will be subject to audit procedures during an audit of the clients' financial statements. Certain member jurisdictions indicated that safeguards may be available to reduce the self-review threat to an acceptable level.

## **Discussion**

Internal audit services comprise a wide range of services including:

- An extension of the firm's audit services beyond requirements of generally accepted auditing standards;
- Assistance in performing a client's internal audit activities;
- Providing occasional internal audit activities on an ad hoc basis; and
- Outsourcing of all internal audit activities.

Internal audit also encompasses operational internal activities that are unrelated to the internal accounting controls, financial systems or financial statements.

The Task Force (TF) has considered the nature of the threat created by the provision of internal audit services to an audit client.

## *Management Functions*

The ED states that performing management functions for an audit client creates threats to independence that are so significant that safeguards could not reduce the threat to an acceptable level. The ED, therefore, states that a firm that provides professional services to an audit client should not perform management functions (ED ¶290.158). The ED states that it is not possible to specify every function that is a management responsibility. It notes that management functions involve leading and directing an entity including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources. The ED provides the following examples of activities that would generally be considered management functions:

- Setting policies and strategic direction
- Authorizing transactions
- Deciding which recommendations of the firm or other third parties should be implemented

- Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
- Taking responsibility for designing, implementing and maintaining internal control.

Therefore, if a firm does provide any internal audit services to an audit client it is important that the firm does not perform management functions.

### *Self-review Threat*

The TF discussed the view that performing internal audit services creates a self-review threat and considered the following in relation to the loan department of a bank:

1. The bank has no internal audit department;
2. The bank has an internal audit department and during the year the department has performed a review of the effectiveness of the controls over the loan granting process; and
3. The bank has no internal audit department and management asks the firm to perform audit procedures related to the controls over the loan granting process and report the results of those procedures to management.

The TF noted that the distinction between internal and external audit services can be blurred. For example, in considering the above scenarios, the audit procedures performed by the firm could arguably be the same (or at least have substantial overlap) in scenarios 1 and 3. In both cases, the firm would perform audit procedures related to the controls over the loan granting process. In the first scenario, these procedures would be characterized as external audit services and in the third scenario they would be characterized as internal audit services. The TF is of the view that the fact that while they might be characterized in a different manner the services are in effect the same. Accordingly, the TF is of the view that self-review is not an issue with respect to internal audit service.

The TF was also recognized that the firm might be called on to provide internal audit capabilities for divisions or subsidiaries for which audit clients do not have their own internal audit resources. These engagements enhance the quality of financial reporting, and, if not performed by the internal auditors, may have to be performed by the external auditors as part of the audit engagement.

### *Use of Separate Teams*

The TF considered whether the use of separate audit teams was an effective safeguard. This safeguard is often suggested in Section 290 to address the self-review threat (for example in ED 290.168 with respect to bookkeeping services in emergency situations). Given the TF's view that self-review is not an issue with respect to internal audit services, the TF is of the view that the use of different audit teams is not a necessary safeguard.

To test this view the TF compared scenarios 2 and 3 above. In scenario 2 the review of the effectiveness internal control is performed by the internal audit department and, if firm intends to use specific work of the internal department, the firm performs procedures

to evaluate the adequacy of that work. The testing of the work may include one or a combination of the following: re-performance of work performed by the internal audit function, examination or other similar items; or observation of procedures performed by the internal audit function. (ED ISA 610 The Auditor's Consideration of the Internal Audit Function ¶10 and ¶A11). The TF considered whether independence was strengthened by the segregation of the functions. The TF concluded that it was not. The review of internal audit work is to determine whether it is appropriate for reliance i.e. to gain an understanding of the work which has been performed. If the work is performed directly by the firm the evaluation of the adequacy of the work is not necessary because the firm knows what work has been performed and whether it is adequate for the purposes.

#### *Entities of Significant Public Interest*

The TF considered whether Section 290 should contain a more restrictive requirement for an audit client that is an entity of significant public interest. The ED proposes more restrictive requirements for bookkeeping, valuation services, IT systems services and recruiting senior management. The first three of these services create self-review threats and certain recruiting services create self-interest, familiarity or intimidation threats. More restrictive requirements are provided to recognize the significant public interest.

The TF is of the view that more restrictive requirements are not necessary for entities of significant public interest because the provision of internal audit services does not create a self-review threat and such services can be provided as long as the firm does not perform management functions.

#### *Section 291 Other Assurance Engagements*

Section 291, which addresses independence requirements for assurance engagements that are not audit or review engagements, does not currently contain any guidance with respect to the provision of internal audit services to an "other assurance client". The TF is of the view this position continues to be appropriate.

#### *Conclusion*

The TF is of the view that performing internal audit activities does not create a self-review threat, rather the issue with respect to independence relates to performing management functions.

#### *Recommendation*

The TF recommends that Section 290 should contain the following with respect to the provision of internal audit services:

1. An explanation that internal audit services comprise performing audit procedures. The guidance would not state that internal audit services create a self-review threat.
2. A statement that internal audit services may be provided to an audit client provided the firm does not perform management functions. Guidance would be provided on what would be considered to be a management function. This would include:

- Designing and/or implementing internal accounting controls or controls related to the financial systems or financial statements;
  - Deciding which recommendations of the firm should be implemented;
  - Performing ongoing monitoring activities or control activities;
  - Approving audit work plan including the scope, risk and frequency of the internal audit work; and
  - Authorizing transactions.
3. Stating that if a firm performs a significant portion of the client's internal audit activities the firm should take particular care that it does not perform management functions. The client needs to dedicate sufficient resources to the internal audit function to ensure that it performs all the management decisions.
4. A statement that it would not be acceptable to perform an activity that would otherwise be prohibited by the Code as part of an internal audit activity.

The TF recommends that Section 291 does not address internal audit services – which is consistent with the existing position.

***Action requested***

Members are asked to consider the recommendations of the Task Force.

## **Appendix A**

### **Comparative positions – for information**

#### **SEC/PCAOB**

An accountant is not independent if the accountant provides the following non-audit service to an audit client:

“Any internal audit service that has been outsourced by the audit client that relates to the audit client’s internal accounting controls, financial systems, or financial statements, for an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.”

The prohibition does not restrict:

- The firm from making recommendations for improvements in internal control which were identified during the evaluation of the company’s internal controls as part of GAAS;
- The firm performing non-recurring evaluations of discrete items or other programs that are not in substance the outsourcing of the internal audit function;
- The firm performing operational internal audits unrelated to the internal accounting controls, financial systems or financial statements.

#### **US - AICPA**

Internal audit services involve assisting the client in the performance of its internal audit activities, sometimes referred to as "internal audit outsourcing." In evaluating whether independence would be impaired with respect to an attest client, the nature of the service needs to be considered.

Assisting the client in performing financial and operational<sup>1</sup> internal audit activities would impair independence unless the member takes appropriate steps to ensure that the client understands its responsibility for establishing and maintaining the internal control system<sup>2</sup> and directing the internal audit function, including the management thereof. Accordingly, any outsourcing of the internal audit function to the member whereby the member in effect manages the internal audit activities of the client would impair independence.

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<sup>1</sup> For example, a member may assess whether performance is in compliance with management's policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making

<sup>2</sup> As part of its responsibility to establish and maintain internal control, management monitors internal control to assess the quality of its performance over time. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of both. Ongoing monitoring activities are the procedures designed to assess the quality of internal control performance over time and built into the normal recurring activities of an entity; they include regular management and supervisory activities, comparisons, reconciliations, and other routine actions. Separate evaluations focus on the continued effectiveness of a client's internal control. A member's independence would not be impaired by the performance of separate evaluations of the effectiveness of a client's internal control, including separate evaluations of the client's ongoing monitoring activities.

In addition to the general requirements of this interpretation, the member should ensure that client management:

- Designates an individual or individuals, who possess suitable skill, knowledge, and/or experience, preferably within senior management, to be responsible for the internal audit function;
- Determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services;
- Evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services; and
- Evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member.

The member should also be satisfied that the client's board of directors, audit committee, or other governing body is informed about the member's and management's respective roles and responsibilities in connection with the engagement. Such information should provide the client's governing body a basis for developing guidelines for management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member is responsible for performing the internal audit procedures in accordance with the terms of the engagement and reporting thereon. The performance of such procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

The following are examples of activities (in addition to those listed in the "General Activities" section of this interpretation) that, if performed as part of an internal audit assistance engagement, would impair independence:

- Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client's approval process or reviewing customer credit information as part of the customer's sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function
- Determining which, if any, recommendations for improving the internal control system should be implemented

- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures
- Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications)

The foregoing list is not intended to be all-inclusive.

Services involving an extension of the procedures that are generally of the type considered to be extensions of the member's audit scope applied in the audit of the client's financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, are not considered internal audit assistance services and would not impair independence even if the extent of such testing exceeds that required by generally accepted auditing standards. In addition, engagements performed under the attestation standards would not be considered internal audit assistance services and therefore would not impair independence

#### **EC Recommendation**

Self-review threats may arise in certain circumstances where a Statutory Auditor, an Audit Firm or an entity within a Network provides internal audit services to an Audit Client.

7.2.4.2. To mitigate self-review threats when involved in an Audit Client's internal audit task, the Statutory Auditor should:

- (a) Satisfy himself that the Audit Client's management or Governance Body is at all times responsible for
  - (i) The overall system of internal control (i.e., the establishment and maintenance of internal controls, including the day to day controls and processes in relation to the authorisation, execution and recording of accounting transactions);
  - (ii) Determining the scope, risk and frequency of the internal audit procedures to be performed; and
  - (iii) Considering and acting on the findings and recommendations provided by internal audit or during the course of a Statutory Audit.

If the Statutory Auditor is not satisfied that this is the case, neither he, nor the Audit Firm nor any entity within its Network should participate in the Audit Client's internal audit.

- (b) Not accept the outcomes of internal auditing processes for statutory audit purposes without adequate review. This will include a subsequent reassessment of the relevant



statutory audit work by an Audit Partner who is involved neither in the Statutory Audit nor in the internal audit engagement.

Internal Audit is an important element of an entity's internal control system. In companies, particularly small and medium sized ones, which cannot afford an internal audit department or where such a department lacks certain facilities (e.g. access to specialists in information technology or treasury management), participation by the Statutory Auditor in the internal audit may strengthen management control capacities. However, self-review threats can arise if, for example, there is not a clear separation between the management and control of the internal audit and the internal audit activities themselves, or if the Statutory Auditor's evaluation of his Audit Client's internal control system determines the kind and volume of his subsequent statutory audit procedures. To avoid such threats, the Statutory Auditor, the Audit Firm or its Network member must be able to show that it is not involved in management and control of the internal audit. Furthermore, in his capacity as the statutory auditor of the client's financial statements the Statutory Auditor must be able to demonstrate that he has taken appropriate steps to have the results of the internal audit work reviewed and has not placed undue reliance on these results in establishing the nature, timing and extent of his statutory audit work. In order to ensure that the Audit Firm's statutory audit work meets required auditing standards and that the Statutory Auditor's independence is not compromised, an appropriate review of these matters should be performed by an Audit Partner who has not been involved in either the Statutory Audit or any of the internal audit engagements which may impact the financial statements.

In companies where the internal audit department reports to a Governance Body rather than to management itself, the internal audit function performs a role that is complementary to the statutory audit function. It can therefore be seen as a separate element of the corporate governance framework. If the Statutory Auditor is asked to perform internal audit work in these circumstances, he must still be able to demonstrate that he has adequately assessed any threats to his independence, and has applied any necessary safeguards.

#### **UK – APB**

- 39 The range of “internal audit services” is wide and they may not be termed as such by the audit client. For example, the audit firm may be engagement:
- To outsource the audit client's entire internal audit function; or
  - To supplement the audit client's internal audit function in specific areas (for example, by providing specialized technical services or resources in particular locations); or
  - To provide occasional internal audit services to the audit client on an ad hoc basis.
- 40 The main threats to the auditors' objectivity and independence arising from the provision of internal audit services are the self-review threat and the management threat.

- 41 Engagements to provide internal audit services - other than those prohibited in paragraph 43 - may be undertaken, provided that the auditors are satisfied that 'informed management' has been designated by the audit client and provided that appropriate safeguards are applied.
- 42 Examples of safeguards that may be appropriate when internal audit services are provided to an audit client include ensuring that:
- internal audit projects undertaken by the audit firm are performed by partners and staff who have no involvement in the external audit of the financial statements;
  - the audit of the financial statements is reviewed by an audit partner who is not involved in the audit engagement, to ensure that the internal audit work performed by the audit firm has been properly and effectively assessed in the context of the audit of the financial statements.
- 43 The audit firm should not undertake an engagement to provide internal audit services to an audit client where it is reasonably foreseeable that:
- (a) for the purposes of the audit of the financial statements, the auditors would place significant reliance on the internal audit work performed by the audit firm; or
  - (b) for the purposes of the internal audit services, the audit firm would undertake part of the role of management.
- 44 The self-review threat is unacceptably high where the auditors cannot perform the audit of the financial statements without placing significant reliance on the work performed for the purposes of the internal audit services engagement. For example, the provision of internal audit services on the internal financial controls for an audit client which is a large bank, is likely to be unacceptable as the external audit team is likely to place significant reliance on the work performed by the internal audit team in relation to the bank's internal financial controls.
- 45 The management threat is unacceptably high where the audit firm provides internal audit services that involve audit firm personnel taking decisions or making judgments, which are properly the responsibility of management. For example, such situations can arise where the nature of the internal audit work involves the audit firm in taking decisions as to:
- the scope and nature of the internal audit services to be provided to the audit client, or
  - the design of internal controls or implementing changes thereto.
- 46 During the course of the audit the auditors generally evaluate the design and test the operating effectiveness of some of the entity's internal financial controls, including the operation of any internal audit function and provide management with observations on matters that have come to their attention, including comments on weaknesses in the internal control systems (including the internal audit function) and

suggestions for addressing them. This work is a by-product of the audit service rather than the result of a specific engagement to provide non-audit services and therefore does not constitute internal audit services for the purposes of this Standard.

- 47 In some circumstances, additional internal financial controls work is performed during the course of the audit in response to a specific request for an extended scope to the external audit. Whether it is appropriate for this work to be undertaken by the audit firm will depend on the extent to which it gives rise to a management threat to the auditor's objectivity and independence. The audit engagement partner reviews the scope and objectives of the proposed work and assesses the threats to which it gives rise and the safeguards available.