Institute of Internal Auditors
UK AND IRELAND

Hazel O'Sullivan
Project Director
The Auditing Practices Board Limited
5th Floor Aldwych House
71-91 Aldwych
London, WC2B 4HN

Sent by email to: **h.osullivan@frc-apb.org.uk**

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Dear Hazel

Non-audit services, in particular internal audit services

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Following our discussions last year, I attach the Institute's views on the question of audit firms providing internal audit services to their external audit clients.

Internal Audit and External Audit are two of the four cornerstones of corporate governance. If they are provided by the same entity, the corporate governance structure is likely to be weaker than it otherwise would be. In addition, there are significant differences in the "customers", scope and purpose of the two types of audit services. The Institute is, therefore, sceptical about the synergies and efficiencies to be gained by having the supplier of one service also supply a related but different service.

We are concerned about the impact on the independence of the external auditor – and on the quality, or on the perception, of the quality of the external audit – if the audit firm also provides internal audit services. In addition, we recognise that this practice may adversely affect the quality of internal audit services.

We, therefore, believe that it would be better for the standard of corporate governance in the UK and Ireland if audit firms did not provide both external and internal audit services to the same companies. However, we are not yet clear on how best to promote this good practice. We continue to consult our members on the method that we should recommend and we hope to report to you point by the end of February.

The following paper expands on all these points. If you have any questions, please let me know and I would happy to discuss the points further over the coming weeks.

Yours Sincerely

Jackie Cain MIIA ACA
Technical Director

The Institute of Internal Auditors – UK and Ireland Ltd
13 Abbeville Mews, 88 Clapham Park Road, London SW4 7BX
tel 020 7498 0101 fax 020 7978 2492 email info@iia.org.uk
www.iia.org.uk Registered in England and Wales No.1474735

Role of objective and independent assurance provided by internal audit

Professional internal audit provides those responsible for governance in an organisation with objective and independent assurance on the effectiveness of governance processes and on the management of the whole range of risks that the organisation faces. This involves competent internal auditors evaluating the processes and all the activities included in managing risks, including controls, and using various techniques to ensure that if improvements are required they are made. Internal auditors sit within the boundary of the organisation but should be independent of the areas they evaluate and free from undue influence from the views of management, other assurance providers and, indeed, anyone else, so that their judgments can be as objective as possible. Professional internal audit is critical to the success of the company.

The Institute categorises internal auditing as one of the four cornerstones of governance, together with non-executive directors, executive management and external audit. This idea demonstrates that good governance is not a simple commodity, but rather the result of a system of checks and challenges.

Differences between external audit and internal audit

The internal audit profession has made few pronouncements on the topic of audit firms' providing internal audit services to their external audit clients. In the Institute's view, the differences in objectives and scope of the two services mean that the reasons for one legal entity to provide them both are not self-evident. The Institute recognises, however, that the historical connections between providers of external and internal audit services mean that many stakeholders may not be as familiar with these differences. Therefore, this section provides an outline of the differences.

Main "customers" of the assurance

External auditors provide assurance to the shareholders or members of company, ie outside the company's governance boundary. It is vital to the quality of their work that they focus on this customer group.

Internal auditors, in contrast, provide assurance within the governance boundary, to the audit committee, the board in general and to senior management.

Purpose of the assurance

The external audit opinion, and the work that the external auditor performs in order to provide it, exist to add credibility and reliability to reports from the company to its shareholders.

Internal auditors provide members of the board and senior management with assurance that they can use to fulfil their own duties to the company and its shareholders.

Coverage or nature of work

External audit provides an opinion on financial statements and the related disclosures, on other forms of reporting from the company to shareholders as well as on financial reporting risks and their management.

Internal auditors cover all categories of risks and their management, starting from their identification, taking in various responses to risks, including traditional internal controls, and including the flow of information around the company about risk. Internal auditors also cover governance processes.

Timing and frequency of audit work

Ideally, internal auditing is a permanent and ongoing presence in a company. Much of its work will be in the form of engagements scheduled in advance and, where appropriate, in such a way to support the smooth operation of the company. However, internal audit may also react to changes in circumstances and undertake unscheduled and, possibly, surprise pieces of work.

These engagements are small projects, which can be handled as self-contained pieces of work. However, the real value of internal auditing is in having skilled professionals evaluating and helping to improve the organisation's day-to-day activities. This is not always practical for smaller organisations but for large, listed companies the Institute expects that this style of internal auditing would be critical to their long-term success.

External audit work is tied into the company's cycle for financial reporting and designed to support the external auditor's opinion on the annual report and related items.

Focus of opinion

The external audit focus is predominantly on validating that the financial statements are a true and fair representation of past performance.

For internal audit, the focus ideally is on providing assurance that the governance and risk management processes are effective in managing risks that might happen. Therefore, the focus is also forward-looking.

Responsibility for improvement

External auditors have no explicit responsibility to improve their clients' governance or risk management processes. They have a duty to report problems that they come across as part of their work. In addition, the added-value service proposition of audit firms as businesses means that they want to assist their clients where they can.

In contrast, improvement is fundamental to the role of internal auditing. Professional internal auditing is an assurance and consulting service, dedicated to evaluating and improving the company. Working within the organisation on an ongoing basis allows internal auditors to advise, coach and facilitate managers' efforts to improve processes. At the same time, internal auditors have a professional duty to avoid usurping the responsibility of those managers to manage.

Status and authority

As a regulated profession, external audit's status and authority is provided by statute and supported by the framework of regulation provided by the Financial Reporting Council working with the appropriate professional bodies.

Internal auditing has a set of professional standards, the *International Professional Practices Framework*, including a *Code of Ethics* and the *International Standards for the Professional Practice of Internal Auditing* (*International Standards*). These require the person in the role of Chief Audit Executive, normally the head of internal audit, to establish an internal audit charter that sets out the authority of the function and to present this to the audit committee and senior management. Internal auditors rely on the support of the audit committee to maintain their status and authority.

The UK Code of Corporate Governance provided by the Financial Reporting Council (FRC) recognises that the audit committee is responsible for overseeing the effectiveness of internal audit. The Guidance for Audit Committees, also provided by the FRC, provides additional tasks and recognises the *International Standards* as a source of more detailed guidance.

For a self-regulating profession such as internal auditing, each audit committee bears a significant responsibility in ensuring its status and authority in their company.

Independence

A reflex reaction is often that external audit is more independent than internal audit. To counter that, there is also a view that no-one who engages with an organisation or person is entirely independent of them.

The internal auditor's professional standards draw a distinction between organisational independence and individual objectivity. Organisational independence leaves internal auditors free from interference in their work and supports them in an objective mental attitude when gathering and evaluating information in the course of their work.

For internal auditors, therefore, independence is about avoiding responsibilities for functions on which they provide assurance and having a reporting line that provides some degree of guarantee of their independence from the areas they evaluate. This is usually seen to be a reporting line to the audit committee and to the highest level of management, preferably one that has a similar overview of the entire company, rather than responsibility for one part of it. However, it is also necessary to be sure that internal auditors are independent of any other group, such as other assurance providers or regulators, in order to ensure that the assurance they can give is also independent.

For the external auditor, the profession's ethical standards and other regulations and rules seek to protect independence. The UK Code of Corporate Governance expects the company's audit committee to review and monitor the independence and objectivity of the external auditor. In addition, as is the case for the status of external audit, there is a need for a comprehensive regulatory regime to underpin the external auditor's independence.

Table illustrating differences between internal and external audit

Item	**External audit**	**Internal audit**
Recipient of reports	Shareholders or Members	Board members and senior managers
Objective(s)	Add credibility and reliability to reports from the organisation to its shareholders by giving an opinion on them	Provide the assurance that members of the board and senior management use to fulfil their duties
Coverage	Financial reports and related disclosures, financial reporting risks and their management[1]	All categories of risks, their management[2] including the flow of information around the company, and governance
Timing and frequency	Project(s) tied into financial reporting cycle, focused on objective of audit opinion	Ongoing and pervasive
Focus	Mainly historical	Ideally forward-looking
Responsibility for improvement	None – duty to report problems	Fundamental to the purpose of internal auditing
Status and authority	Statutory and regulatory framework	International professional standards and Code of Corporate Governance
Independence	Professional ethical standards overseen by audit committee and regulatory framework	Professional ethical standards overseen by audit committee

[1] NB risk management starts with objectives/purpose, then includes identification, evaluation and assessment of the risk; selection and implementation of the appropriate responses; and monitoring to ensure that the responses are working as required.
[2] See footnote 1

Impact on the quality of external audit

The public debate in the 2009 about the issue of accountants providing non-audit services, in particular internal audit, for their external audit clients was mainly couched in terms of the effect on the independence of the external auditor and, therefore, of the quality of the external audit work.

The Institute supports measures to improve or maintain the quality of the external audit because we believe that a healthy external audit is good for governance. We believe that the issue of internal audit services raises more questions than just those of independence.

Firstly, the combination of external and internal audit services indicates a misunderstanding of the value that internal audit can bring to organisations. Internal audit is no longer simply a matter of accounting and financial skills as is suggested by its categorisation by the APB in their consultation paper.

Secondly, given the different natures of internal and external audit services, there is a risk that providing internal audit services will distract the external audit firm from its most important focus: providing assurance to the shareholder. This is not something that fits easily into the existing ethical debate, but it would reduce the quality of the external audit service.

Thirdly, the Institute does not wish to see the detailed discussion of the detail of potential threats posed by particular non-audit services to cause the leaders of the audit firms to lose sight of their overriding responsibility: to establish controls that ensure that professional ethics have a higher priority than commercial considerations. It is in the best interests of effective governance that the external audit profession does not lose the trust of shareholders. Independence and trust are characteristics that rely as much on perception as on objective fact and they can be undermined as much by the appearance of conflict as by an actual conflict.

Currently, the APB's *Ethical Standard 5 – non-audit services provided to audited entities* suggests that, of all the potential threats that may arise to external audit independence, performing internal audit services poses two: "self-review" and "management".

Our comment on the potential threat of "self-review" relates to the safeguards envisaged to address it. They require the internal audit work to be completed by a team separate from the external audit team and the external audit team to carry out the same procedures to assess the internal audit work as they would for any other internal auditor. This provides some protection against self-review but we believe that it also reduces the synergies that might first appear to be possible.

This safeguard also casts some doubts on one of the arguments, quoted on page 7 of the consultation document from the APB, that "their position as auditors can bring both quality and efficiency benefits to the delivery of non-audit services". This may be so in some cases but given the nature of modern internal auditing and the need for safeguards as above, it is possible and likely that the internal audit work will be performed by different people – perhaps even by a different business unit – from the external audit teams. In that case, the practical implementation or delivery of the service may not provide many quality or efficiency benefits.

In addition, Institute believes that there is a case for considering the potential threat of "self-interest". Whatever is the truth about the quality and efficiency benefits of using external audit firm resources for the internal audit work, it certainly does provide the firm with more billable hours. Depending on the incentive structures within the firm, this may pose a potential conflict of interest to those involved in the engagement. Even if the two types of work are performed by separate teams within the firm, if they are in the same profit pool, this creates a potential conflict.

In summary, the Institute believes that there are clear threats to external audit quality from the idea of using the external audit firm to provide internal audit services. Therefore, we recommend, as we have stated in previous submissions to the APB, that external audit does not provide internal audit services to its external audit clients.

The quality of internal audit

Despite the issue not featuring greatly in the recent public debates, the Institute is more concerned about the effect on the quality of the internal audit that the external auditor performs than of the external audit opinion. The person who is responsible for the quality of the internal audit work is the person who has the role of Chief Audit Executive. In many organisations, particularly in the listed company sector, this will be the head of internal audit, whatever their title. The International Professional Practices Framework maintained by the Institute of Internal Auditors provides the head of internal audit with guidance on how to establish, maintain and assess the quality of the internal audit function. Below we have selected some key factors that might be affected by using the company's external auditor to provide internal audit services.

Different scenarios

One of the difficulties in discussing this issue is that there are different scenarios that might be in place for outsourcing internal audit services and the effect on the quality of internal audit services provided by the company's external auditor may vary with the scenario. So, below we outline the main types of scenario. This discussion is not intended to be a general discussion of the pros and cons of outsourcing internal audit services in general, just of outsourcing them to the company's external audit firm.

External auditor provides all internal audit services

This means that there is no company employee in the role of Chief Audit Executive and the management of the internal audit activity will rest with the external audit firm. The firm may attempt to ensure that someone in the company is accountable for internal audit quality but it will be difficult to identify someone who is competent to do that and who has sufficient independence. The audit committee is likely to be forced to play a more active, even executive, role, which may undermine their ability to oversee the governance activities.

From the point of view of the external audit quality, it would seem unlikely in this scenario that the external auditor could avoid relying on at least some of the internal audit work or making some management decisions.

External auditor is a co-sourcing partner providing resources for some internal audit services

This means that there is a competent individual in the company who is able to play the role of Chief Audit Executive, responsible for the quality of internal audit work.

Thereafter, there are several options for how much and what type of resource the external auditor provides. It can be specialist skills to deliver one part of the internal audit plan; internal auditors to work for in-house managers or supervisors; managers to supervise; or teams to deliver one discrete part of the internal audit function. Clearly, these options will have different implications for the external audit quality.

Factors to consider in determining the quality of internal audit

The duty of confidentiality

The *Code of Ethics* requires internal auditors to respect their employer's confidentiality.

Employees of an external audit firm of course follow their own professional ethics and would expect to respect their clients' confidentiality. However, company senior managers and directors may perceive a potential threat. They may worry that internal auditors sourced from the external audit firm may share, perhaps unwittingly, information with their external audit colleagues and breach confidentiality.

The independence and objectivity of internal audit

The internal auditors' *Code of Ethics* demands that they are objective in completing their work and requires internal auditors to avoid "any ... relationship that impair ... their unbiased assessment", including "relationships that may be in conflict with the interests of the organisation."[3]

The attribute standard series 1100 provides extra guidance on objectivity and independence. The interpretation to 1100 states: "objectivity requires that internal auditors do not subordinate their judgment on (internal) audit matters to others."

In addition, the interpretation to 1120 defines a conflict of interest as "a situation in which an internal auditor … has a competing professional or personal interest." It goes on to say: "Such competing interests can make it difficult to fulfil … duties impartially. A conflict of interest exists even if no … act results. A conflict of interest can create an appearance of impropriety ..."

Objectivity and conflicts of interest are matters for individual internal auditors. One of the roles of the head of internal audit, if there is one, is to support the internal auditors, whether employees of the company or of an external service provider, in identifying and managing threats to objectivity.

Internal auditors consider independence, on the other hand, to be about the organisational independence of the internal audit function as a whole. Usually concerned with ensuring that internal audit is independent of the operations it evaluates, it requires the head of internal audit to have an effective working relationship with senior management and those responsible for governance, such as the audit committee.

The interpretation to 1100 states: "To achieve the degree of independence necessary …, the chief audit executive has direct and unrestricted access to senior management and the board." In the case of internal audit services provided by the external audit firm, it will be important to ensure that the head of internal audit retains "direct and unrestricted access" and to avoid funnelling communications through a single audit partner.

In summary, internal auditors who are employees of an accounting firm that also provides external audit services – or, indeed, other services that are important to that firm's reputation or revenue – must ensure that this does not present them with a conflict of interest. Those responsible for the governance of the company, meanwhile, must ensure that they actively support the objectivity and independence of the internal auditors.

[3] Rule of conduct 2.1

Adequate resources

There may be conflicts for resources if the external auditor is providing some to internal audit. The external auditor is always going to have most concern in relation to the opinion for which they can be held to account. Therefore, in the case of a shortage of resources, the external audit firm may feel an incentive to shift resources from internal audit activity to external audit activity.

Resource constraints occur in other scenarios of course – staff may leave at key moments; third party service providers may have equal difficulties in providing promised resources. However, by relying on one firm – the external auditor – to provide resources to two key functions, the company is opening itself to the risk of a single source of supply.

Joined up assurance – cooperation between internal and external audit

Despite the issues for internal audit quality, the Institute does not intend to suggest that internal audit should be kept at arm's length from external audit. Just the opposite, in fact: the *International Standards* require the head of internal audit to coordinate the internal audit activity with other assurance providers, "to ensure proper coverage and minimise duplication of efforts." (Performance standard 2050). This means that the head of internal audit is under an obligation to work with external audit and other assurance providers. However, this working together and coordination should be conducted in an environment where the objectives and scope of each provider is properly understood and their professional standards respected.

Recognition of the value of checks and balances

Earlier in the document, we presented the Institute's simple model of governance, in which external audit and internal audit are shown as cornerstones. At this simplistic level it can be seen that if these two assurance providers become one, it will make the edifice that sits on it less stable.

To expand the thought, the recent reviews of governance in the UK have discussed at great length the importance of challenge. When a company has available to it, two high quality sources of assurance such as an external auditor and internal auditors who are knowledgeable, objective and independent both from what they are auditing and from each other, this provides the directors with much readier sources of challenge and informed debate. It reduces the likelihood of "groupthink".

As we have noted elsewhere, the Institute does not think that efficiency savings from using external audit firm resources to perform internal audit services are as clear-cut and obvious as others have suggested, but, even if they were, we believe that this might be one of those places where some duplication or "overlap" might be a benefit to the stakeholders in the company, rather than something to eliminate.

Conclusion

The Institute of Internal Auditors believes that internal auditing is critical to the success of the company and that, together with the audit committee, management and external audit, it forms the cornerstones of healthy governance. If two of those cornerstones are provided by the same entity, it is likely that the entire corporate governance structure will be weakened. Therefore, we recommend strongly that an audit firm does not provide internal audit services to its external audit clients.

The Institute is sceptical about the synergies and efficiencies to be gained by having the supplier of one service also supply a related but different service. The Institute calls on the external audit profession to concentrate on delivering value to the company's shareholders and to support the Institute's call for a well resourced professional internal audit service that is independent of the functions on which it provides assurance and of other assurance providers.

The Institute believes that where the external auditor undertakes internal audit work there are – or there appear to be – potential threats to the quality of external audit work from self-interest, self-reliance and management.

The Institute believes that relying on the external auditor to provide internal audit services may pose threats to the quality of internal audit services as well. The audit committee needs to satisfy itself in relation to competency, confidentiality, independence, objectivity, security of resources and the effectiveness of the relationship between internal audit and the audit committee.

For all these reasons the Institute firmly believes that corporate governance is stronger if external audit and internal audit services are provided by different groups. At the moment, the APB, in Ethical Standard 5 (ES5) prohibits audit firms from providing internal audit services to their external audit clients under certain circumstances. It seems to us that there are various actions that we could ask the FRC to take better to reflect our views:

- The APB could make the prohibition in ES5 absolute;
- The APB could add to the circumstances under which the practice is prohibited; or
- The FRC could recognise the separation between external audit and internal audit as a provision in the Code of Corporate Governance. This would allow companies to consider the issue and, if they still wanted to use their external audit firms for internal audit services, to explain their rationale to their investors.

We are consulting with our members on this question during February 2010 and will forward our conclusions in due course.

- ENDS -