

White Paper

Managing Your Service Provider - Independence and Objectivity

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Introduction

Purpose

This White Paper has been prepared to assist chief audit executives in managing the independence and objectivity of the internal audit activity when parts of that activity are delivered by individuals and entities that are not ongoing employees of the organisation (service providers).

Maintenance of independence and objectivity is complicated by the fact a service provider may provide a broad range of services to any given organisation. It is a joint responsibility of the organisation and its service providers to maintain independence and objectivity.

Background

There are a number of models that can be used to resource internal audit services to an organisation:

- › In-house.

- › Co-sourced.
- › Outsourced with in-house management.
- › Outsourced.

It has become commonplace for internal audit services to be provided by a combination of in-house and service provider resources, or to completely outsource the internal audit activity to a service provider.

Discussion

Issue

This White Paper discusses issues around independence and objectivity when service providers are procured to deliver internal audit services to an organisation.

History

In earlier days of internal audit practice, internal audit services were provided primarily by in-house staff. Later, service providers were engaged by some organisations to provide internal audit services either to supplement in-house resources or to provide a full-service internal audit capability.

Service Provider

Externally engaged service providers can perform a useful role in the delivery of internal audit services. For some organisations they provide surge capacity, dealing with unexpected workloads. For other organisations they provide a pool of resources that can be continuously called upon to deliver the internal audit services required. The use of service providers allows an organisation to access a range of skills and specialist services that could not be sustained in an in-house activity. It can allow small organisations to have an internal audit activity when the maintenance of even a single-person function would be uneconomic.

The firms themselves range from sole traders to large multinational entities. The common feature they have is that no organisation is their sole client. They provide their services into a broad marketplace and at different times may have different relationships with any given organisation. A service provider might at one time be a provider of internal audit services to an organisation and at another time be a technical adviser to an operational function.

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Many service providers are accounting firms bound by the ethical standards set out in APES 110 – ‘Code of Ethics for Professional Accountants’ issued by the Accounting Professional & Ethical Standards Board (APESB). APES 110 includes independence standards but allows individual firms to make judgements in this regard. These standards do not in themselves meet requirements of the Institute of Internal Auditors (IIA) ‘Code of Ethics’ contained in the ‘International Professional Practices Framework’ (IPPF).

Service firms have their own checks and balances to identify potential conflict situations and an organisation may be able to rely on them, but it is up to the procuring organisation to ensure appropriate processes are in place before they engage with a service provider.

Audit Foundations

Internal auditing is a service distinct from financial statement auditing. It is conducted in accordance with the IPPF which has a number of mandatory components and considerable guidance. The most significant mandatory component of the IPPF is the ‘International Standards for the Professional Practice of Internal Auditing’ (IA Standards).

The IPPF is distinct from the ‘Australian Framework for Assurance Engagements’ (Auditing and Assurance Standards Board, 2014) which is the document that describes the applicability of Auditing Standards (ASA) and Standards on Assurance Engagements (ASAE) published by the Australian Auditing and Assurance Standards Board (AUASB). The ‘Australian Framework for Assurance Engagements’ is not relevant to internal audit activity and the ASA and ASAE standards do not apply.

Responsibility for Internal Auditing

Good governance of an organisation remains the responsibility of the board or its equivalent (governing body). Not every organisation has a board, but every organisation has a group or an individual that is charged with the governance of the organisation. In the Australian public sector this is often referred to as the “accountable authority”. While expertise may be engaged to assist in the governance of the organisation, accountability remains with the governing body.

Part of this responsibility is to maintain an effective internal audit program. The primary loyalty of internal audit is (so far

as is consistent with ethical behaviour) to the organisation itself – not to its owners, its stakeholders, its governing body or its management.

The governing body may elect to engage external expertise to deliver internal audit services, but the service providers cannot take on the strategic responsibility for the function.

‘The IA Standards also assert that a service provider cannot undertake the role of CAE.’

An organisation must appoint an internal officer of sufficient status to provide strategic guidance to the internal audit activity. The IA Standards describe the organisational officer responsible for internal audit as the Chief Audit Executive (CAE):

Chief audit executive describes the role of a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the International Professional Practices Framework. The chief audit executive or others reporting to the chief audit executive will have appropriate professional certifications and qualifications.

(The Institute of Internal Auditors, 2016, p. 21 Glossary)

This description allows that the CAE need not be a specialist internal auditor, but that they must have direct access to resources who are. The CAE is permitted by the IA Standards to have other responsibilities provided appropriate safeguards are in place.

The IA Standards also assert that a service provider cannot undertake the role of CAE. The service provider may (and often does) provide high level internal auditing expertise to the organisation, but all decisions regarding the direction of the activity are the responsibility of the organisation.

IA Standard 2070 – External Service Provider and Organizational Responsibility for Internal Auditing

When an external service provider serves as the internal audit activity, the provider must make the organization aware that the organization has the responsibility for maintaining an effective internal audit activity.

(The Institute of Internal Auditors, 2016, p. 12)

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More information on the role of the CAE can be found in the IIA-Australia's Factsheet: Chief Audit Executive.

Internal Audit Independence and Objectivity

[An effective internal audit function] is objective and free from undue influence (independent).

(The Institute of Internal Auditors, 2015)

Professional internal audit provides the kind of insights that governing bodies need to make effective decisions. Internal audit provides a view of how well the business is managing its risks, taking advantage of fast-moving opportunities and whether corporate governance processes are operating effectively (Chartered Institute of Internal Auditors, 2019). To be useful to the governing body, the perspective of the internal auditor should not be unduly influenced by the partisan perspective of management or the interests of any external entity. The internal audit activity must remain free from the undue influence of any particular stakeholders and the internal auditor must approach their work with objectivity.

The IPPF

The IPPF provides advice on independence and objectivity to all practitioners of internal audit, whether they be in-house or procured resources.

These related concepts are critical to the delivery of effective internal audit services. They are distinguished by the IIA as follows:

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.

Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made.

(The Institute of Internal Auditors, 2016, pp. 3-4 AS1100)

Objectivity is about mindset and applies to the individual internal auditor. Independence is about the exercise of power or influence through organisational structures.

Threats to Independence and Objectivity.

The IIA guidance indicates a number of factors that impair independence or objectivity:

personal conflict of interest; scope limitations; restrictions on access to records, personnel, and properties; and resource limitations, such as funding.

(The Institute of Internal Auditors, 2016, p. 5 AS1130)

In particular,

IA Standard 1130.A1 – Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.

(The Institute of Internal Auditors, 2016, p. 5)

A close personal relationship between an internal auditor and an internal audit client or member of the client team may give rise to the perception of conflict of interest. This possibility exists for any individual internal auditor, but the structural relationships between members of the same firm mean that there may be a perception of conflict if a service provider firm is providing internal audit services where the firm has also provided advisory services or operational support.

It is for the organisation's CAE to address this possible conflict, but this requires the individual auditor or the firm to identify and declare it. Where a service provider is involved, a two-pronged approach is useful – using the organisation's internal processes to flag activities that might give rise to conflict and using the service provider's internal processes to similarly identify such situations.

Organisational best practice

Organisations should actively manage all outsourced services. When outsourcing internal audit services, there are some specific steps that should be taken. It should be noted that major service providers have processes in place to enable them to support their client organisations to meet these requirements.

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Audit Committee

- › Establish an appropriately skilled and vigilant audit committee. Refer guidance in IIA-Australia's 20 Critical Questions series (Institute of Internal Auditors - Australia, 2019).

Chief Audit Executive

- › Appoint an executive level officer to fulfill the role of Chief Audit Executive.
- › Give the CAE unmediated access to the Chief Executive Officer.
- › Where the CAE is not a professional internal auditor, provide them with upskilling and resources with such expertise.

Where a service provider is engaged on an ongoing basis

- › Establish contractual arrangements that:
 - › Require the service provider to obtain prior written permission of the CAE before undertaking engagements that are not part of the approved internal audit program.
 - › Require adherence to the IPPF in the delivery of the internal audit services.
 - › Establish rules for retention of and access to work papers that provide for both organisational security and service provider quality assurance requirements.
 - › Where a service provider retains the work papers, establish the right of the procuring organisation or its agents to perform periodic file reviews of the internal audit work papers.
- › Advise organisational management of the fact that the service provider has been engaged for internal audit services and is not permitted to undertake other work without the prior written permission of the CAE.
- › Report all such engagements to the audit committee.
- › Seek annual affirmation from the service provider that the IPPF has been complied with and that all associated independence and objectivity requirements have been fulfilled.

Where a service provider is engaged on an ad hoc basis

- › Establish base standards for the content of work papers.
- › Seek specific assurance that the internal audit work proposed does not encompass other work that has been undertaken by the firm.
- › If such an affirmation cannot be obtained, the CAE should determine whether it is appropriate to engage the firm.
- › In the contract or work order:
 - › Require adherence to the IPPF in the delivery of the internal audit services.
 - › Establish rules for retention of and access to work papers that provide for both organisational security and service provider quality assurance requirements.
- › At conclusion of the engagement:
 - › Seek affirmation the IPPF has been complied with and that all associated independence and objectivity requirements have been fulfilled.
 - › Require the delivery of work papers to the procuring organisation.

Conclusion

Summary

This White Paper has been prepared to assist chief audit executives in managing the independence and objectivity of the internal audit activity when parts of that activity are delivered by individuals and entities that are not ongoing employees of the organisation (service providers).

There are various steps that organisations should establish to ensure their internal audit activity is independent and objective.

Conclusion

It is important that organisations have an internal audit activity that is independent and objective. To ensure internal audit independence and objectivity, organisations should have defined in-house processes around management of service providers delivering internal audit services that are driven by the organisation itself.

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Purpose of White Papers

A White Paper is a report authored and peer reviewed by experienced practitioners to provide guidance on a particular subject related to governance, risk management or control. It seeks to inform readers about an issue and present ideas and options on how it might be managed. It does not necessarily represent the position or philosophy of the Institute of Internal Auditors–Global and the Institute of Internal Auditors–Australia.

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Michael is an internal auditor and risk management consultant in private practice. He has more than 30 years of experience in a range of government and non-government environments. He has been active in the development of risk management and internal auditing standards and guidance for more than 10 years. Michael has practiced in Australia and South East Asia and currently serves on a number of Audit and Risk Management Committees. Michael has been the recipient of the IIA-Australia Bob McDonald Award and the IIA–Global Victor Z Brink Award for services to the profession of internal auditing.

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About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

The IIA-Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 200,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

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