



**How can understanding independence and objectivity lead to more strategic third-party relationships?**

**5** insights for executives



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Kim, the Chief Audit Executive (CAE) at a multinational technology company, is juggling a coffee and overstuffed briefcase as she leaves the meeting, phone wedged on her shoulder while she listens to an urgent voicemail. As she hears the voice of John, the company's Chief Financial Officer (CFO), she stops in her tracks; she is drawn in by the details of the issue that just came up at the company's newest overseas location.

It's not the first time they have had suspected or actual fraud, but the complexity of the situation John describes captures her attention. She knows this is a situation the company cannot handle on its own. As her heartbeat quickens, she starts thinking about who can help. She knows that minimizing the company's response time is vital. There isn't time to bring someone up to speed on the uniqueness of this site's operations - never mind the complex political environment caused by the recent merger. Also, they need a proven provider they can trust.

As she gets to the end of the voicemail and hears John suggest reaching out to her internal audit co-sourcing provider, her first reaction is one of relief. But then she pauses. Can they do this without impairing objectivity and independence?

Of special interest to:

- ▶ Chief audit executives
- ▶ Chief financial officers
- ▶ Audit committees

# 1

## What's the issue?

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Over the last several years, stakeholders (e.g., audit committees, executive management and others within the organization) have been asking more of internal audit. In addition to assurance, they expect internal audit to provide business insights and strategic advice. These increased and evolving demands drive a need for knowledge, skills, and technical experience that is extensive and varied, and can be difficult to maintain in-house.

Many internal audit departments regularly bring in third parties to support a range of activities that include executing the internal audit plan, providing subject matter insight, and even transforming the department. However, internal audit isn't the only part of the company that needs external assistance. Companies are facing complex business issues that span the organization. The current business environment is

challenging and it is vital to select trusted advisors that are best equipped to help the company tackle its most important, pressing issues. When evaluating advisors, there may be a misunderstanding of whether, and to what extent, a service provider may support internal audit activities while providing other services to the organization.

These situations generate important questions: When is a third-party service provider allowed to provide internal audit co-sourcing support while helping the organization in other areas? How can independence and objectivity be maintained when using the same service provider? What considerations have to be discussed?

# 2

## Why now?

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The pace of change is increasing rapidly. Technology is becoming more complicated and many companies are grappling with issues and challenges that were unimaginable just a few years ago. The need for technical excellence, specialized resources, and up-to-date knowledge of the latest trends, business questions, and regulatory issues has never been more important.

In this environment, it is asking too much for a company, focused on its own operations and growth trajectory, to keep pace with ever-changing new developments and the requisite technical knowledge. Companies rely on connected, insightful professional services organizations to share their experiences and provide leading practices and strategic insights. These insights are crucial to helping companies grow, optimize, protect, and innovate their businesses to achieve sustainable competitive advantages.

# 3

## How does it affect you?

When independence and objectivity principles are understood and thoughtfully assessed, it opens the door for companies to more strategically leverage trusted advisors that have developed institutional knowledge and built connections across the organization.

Third parties that provide internal audit services often have additional capabilities and resources that can benefit other parts of the organization. As a result, companies have the opportunity to include the same third party who provides internal audit services when considering who to bring in to help with other business issues. The business knowledge and relationships gained through internal audit uniquely position them to support other activities across the company.

# 4

## What's the fix?

Professional standards provide guidance when making decisions related to independence and objectivity. It is important to familiarize yourself with the applicable guidance, apply thoughtful consideration by asking the right questions, and engage in open dialogue to learn how your service provider operates.

It is essential to understand the distinction between independence and objectivity, as defined by The Institute of Internal Auditors (IIA)<sup>1</sup>:

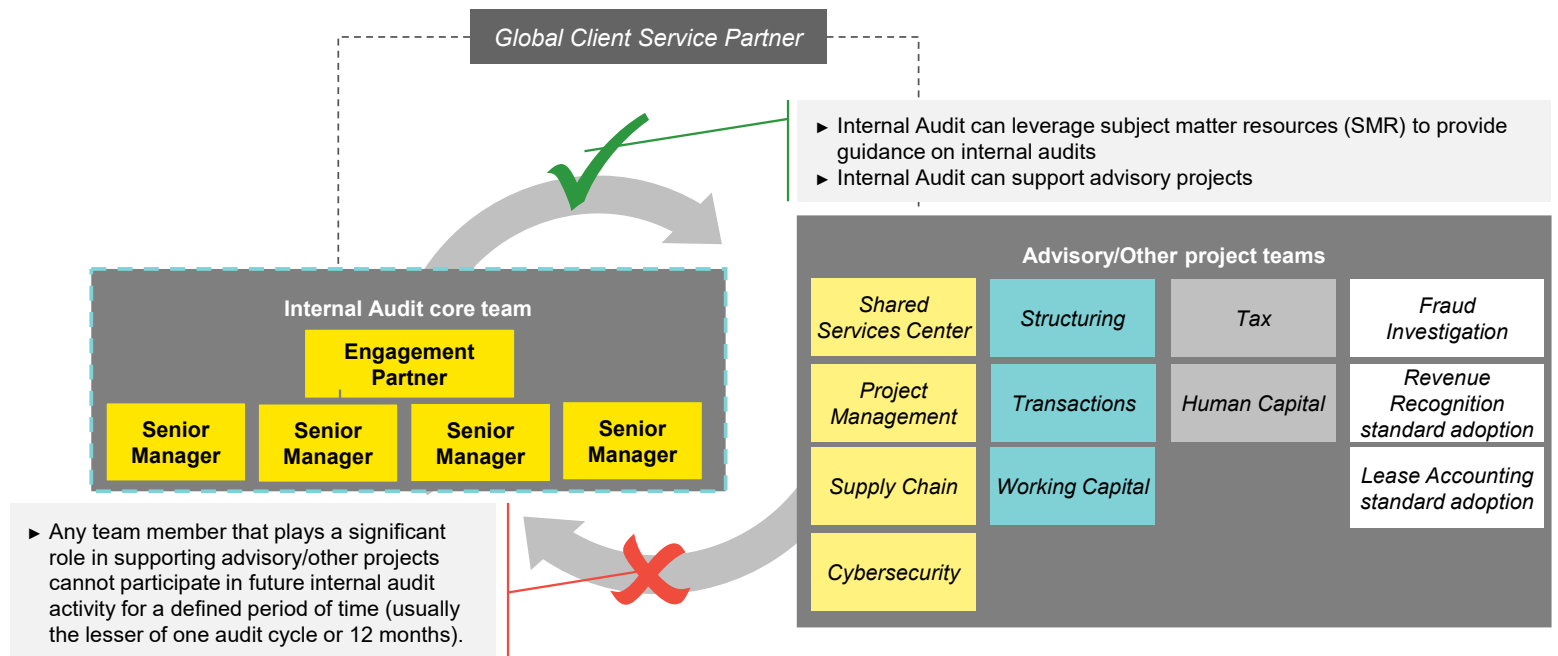
	Independence	Objectivity
Definition	<ul style="list-style-type: none"><li>Freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.</li></ul>	<ul style="list-style-type: none"><li>Unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Requires that internal auditors do not subordinate their judgment on audit matters to others.</li></ul>
Practical implications	<ul style="list-style-type: none"><li>To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board.</li></ul>	<ul style="list-style-type: none"><li>Internal auditors must refrain from assessing specific operations for which they were previously responsible.</li><li>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.</li><li>On the other hand, the standards specifically state that internal auditors may provide consulting services relating to operations for which they had previous responsibilities.</li></ul>

<sup>1</sup>Source: International Professional Practices Framework Standard 1100, *Independence and Objectivity*, The Institute of Internal Auditors, 2016.

Importantly, the professional standards and requirements for internal audit differ significantly from those that apply to external audit:

	External audit	Internal audit
Authoritative sources	<ul style="list-style-type: none"> <li>▶ Securities and Exchange Commission (SEC) independence standards</li> <li>▶ American Institute of Certified Public Accountants (AICPA) attestation standards</li> </ul>	<ul style="list-style-type: none"> <li>▶ Institute of Internal Auditors (IIA) independence and objectivity standards</li> <li>▶ American Institute of Certified Public Accountants (AICPA) consulting standards</li> </ul> <p><i>Neither standard precludes a firm from providing both internal audit and consulting services.</i></p>
How is independence and objectivity managed?	<ul style="list-style-type: none"> <li>▶ At firm level</li> <li>▶ Restriction at high levels (financial relationships, employment, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Individual auditor level</li> <li>▶ Engagement or project level</li> <li>▶ Functional and reporting levels</li> </ul>

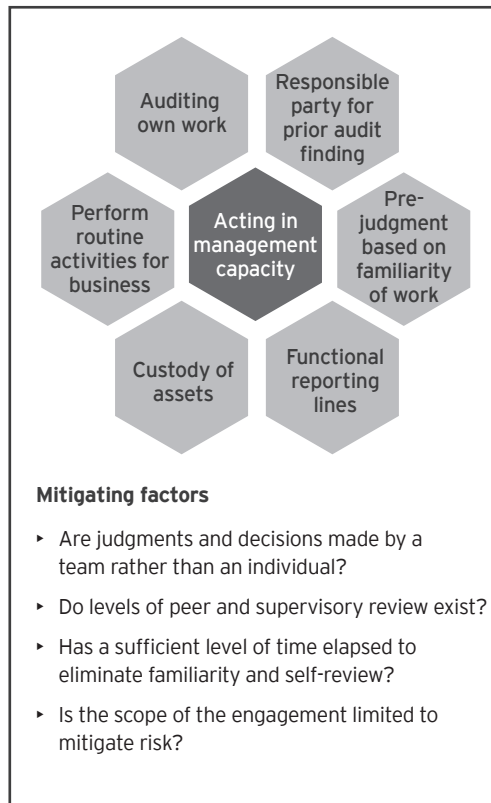
In our experience, there are several ways that service providers can structure engagements to provide the right level of objectivity. One common approach is to establish firewalls between the core internal audit team and other project teams that enable team members to remain objective while supporting a broad range of services:



Independence and objectivity are also enabled by clearly defining that while advice and recommendations are provided to assist management functions in making their decisions, the internal auditor or consultant will not assume management responsibilities or act in a management capacity.

Additionally, thoughtful consideration of the specific circumstances is important. These questions can be used to assess whether there are any risks to an individual's objectivity when assigning resources to audits:

### Independence and objectivity dimensions



### Sample internal audit objectivity assessment

#### 1. Will the individual be auditing their own work?

- ▶ Within the past year, has the individual performed ongoing control activities that affect the execution of transactions?
- ▶ Did the individual perform application development or configuration related to the scope of the audit?
- ▶ Was the individual responsible for any defect or problem arising out of or related to data processing in any systems?
- ▶ Did the individual perform routine activities in connection with the company's operating processes?
- ▶ Has the individual performed bookkeeping or other services related to the accounting records or financial statements within the scope of the audit?
- ▶ Did the individual authorize, execute or process transactions?
- ▶ Did the individual prepare source documents or transitions?
- ▶ Did the individual prepare the financial statements or related financial statement disclosures?
- ▶ Does the individual have custody of assets?

#### 2. Within the past year, did the individual act in any capacity equivalent to a member of management within the area being audited?

- ▶ Was the individual responsible for any key decision over financial information systems design and implementation?
- ▶ Was the individual responsible for deciding which, if any, recommendations for improving internal control should be implemented?

#### 3. Will the individual's familiarity of work cause prejudgments?

#### 4. Will the individual be working with a relative or close friend?

**If the answer to any of the questions in the assessment is yes, there are threats to objectivity and the team should document all mitigating factors and work with management to assess whether the mitigating factors are sufficient.**

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The following examples demonstrate how independence and objectivity can be applied:

**Scenario 1:** An internal auditor assists with an internal controls pre-assessment for a new acquisition and is scheduled to assist with an internal audit of the same business later in the year (within 12 months).

▶ **Answer:** Permissible because the pre-assessment was a risk and control engagement.

**Scenario 2:** A third party performs a consulting engagement related to revenue recognition implementation work and the third party is scheduled to perform an internal audit within the next 12 months for the same subject matter.

▶ **Answer:** Permissible as long as the third-party team members on the internal audit are not the same as the team members who assisted on the consulting engagement. If a subject matter resource (SMR) from the revenue recognition team is requested on the team, the permissibility of their involvement will depend on the depth of the role the SMR played in implementing the original services.

**Scenario 3:** A third-party internal auditor helps design and implement controls related to a new subsidiary company to be consistent with the acquiring company's SOX program and is scheduled on a subsidiary integration internal audit later that year.

▶ **Answer:** Not permissible for the internal auditor who participated in a consulting project in which they helped design and implement controls because the individual could be auditing their own work. A 12-month cooling-off period is necessary. Use of the same third-party provider is permissible as long as the team members on the internal audit team are not the same as the team members who assisted in the controls design engagement.

# 5

## What's the bottom line?

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Companies can use the same third party for internal audit and other services. In many cases, organizations benefit from this structure, as the business knowledge and relationships gained through internal audit uniquely position these providers to provide insight when supporting other activities across the company. Consideration should be given to the specific circumstances, and it is important to make sure protocols are discussed and put in place to maintain objectivity. Get to know your service providers through open dialogue to understand their capabilities, processes and protocols.

The business world is evolving and becoming increasingly complex, and the pace of change shows no sign of slowing. Organizations that employ a thoughtful approach have the opportunity to more strategically leverage trusted advisors with deep institutional knowledge. These trusted advisors, and their exposure to industry leading practices, can provide insights that help companies protect, grow, optimize, and innovate their businesses.

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