



External Auditor Considerations

66. Can we use our external auditors to perform internal audit work?

The NYSE rule is reasonably clear: The answer is “no.” The rule states, “A company may choose to outsource this function to a third party other than its independent auditor.”

Non-NYSE companies attempting to answer this question should consult with their legal counsel. However, both the SEC and Sarbanes-Oxley provide guidance on this topic. Section 201(a) of Sarbanes-Oxley adds a new section 10A(g) to the Securities Exchange Act of 1934. This section states that it shall be unlawful for a registered public accounting firm that performs an audit of an issuer’s financial statements to provide that issuer, contemporaneously with the audit, any non-audit service, including nine services set forth in Sarbanes-Oxley. One of the nine listed and prohibited services is “internal audit outsourcing.”

Interpretation of the new law is complex, and legal counsel should be consulted on this topic. However, the SEC perhaps summed it up most clearly when it stated, “Since the external auditor typically will rely, at least to some extent, on the existence of an internal audit function and consider its impact on the internal control system when conducting the audit of the financial statements, the accountant may be placed in the position of auditing his or her firm as part of the internal control system. In other words, if the internal audit function is outsourced to an accountant, the accountant assumes a management responsibility and becomes part of the company’s control system.”

Now that the same external auditor is also responsible for expressing an opinion on the company’s ICFR under Section 404, the argument against such arrangements is even stronger.

67. Can external auditors rely on the work of internal auditors in connection with their financial statement audit?

Yes, but they are not required to do so. SAS 65 has long provided guidance on this issue. As noted in Question 53, the PCAOB slightly altered in AS5 the provisions of SAS 65 for application to internal control assessments, referring to AU 322. The guidance contained in the PCAOB’s AS5 is similar in concept to that of SAS 65.

Section AU 322 (SAS 65) was issued more than 15 years ago by the Auditing Standards Board to address how an auditor considers the work and direct assistance of an internal audit function when performing an audit of financial statements in accordance with generally accepted auditing standards (GAAS). AU 322 requires that the external auditor inquire about internal audit’s (1) organizational status within the company, (2) application of professional standards, (3) audit plan and (4) access to records. In addition, the external auditor is to inquire about any scope limitations in the internal auditor’s work. AU 322 also provides guidance on how the external auditor assesses the competence and objectivity of internal auditors.

In AS5, the PCAOB refers to AU 322 (SAS 65) to encourage using an integrated audit concept when completing the financial statement audit and audit of ICFR. The PCAOB believes “that a single framework for the auditor’s use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits.”

Under AS5, the auditor may evaluate the use of the work of others based on two fundamental principles relating to (1) the risk associated with the control being tested and (2) the competency and objectivity of the individuals performing the work the auditor plans to use. With respect to the first principle, the PCAOB states the following: “As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.” This principle replaces the “principal evidence” ceiling and explicit restrictions (such as testing the control environment) on using the work of others previously included in the now superseded AS2.

SAS 65 (AU 322) indicates that the external auditor considers many factors in determining the nature, timing and extent of auditing procedures to be performed in an audit of an entity’s financial statements. One of those factors is the existence of an internal audit function.

Procedures required under SAS 65 (AU 322) in order for the external auditor to ultimately rely on the work of internal auditors include:

- Obtaining an understanding of the entity’s internal audit function, including:
 - Organizational status within the entity
 - Application of professional standards
 - Audit plan, including the nature, timing and extent of internal audit work
 - Access to records and whether there are limitations on the scope of the internal auditing activity
- Assessing the competence and objectivity of the internal auditors

Areas related to competence:

- Educational level and professional experience of internal auditors
- Professional certification and continuing education
- Audit policies, programs and procedures
- Practices regarding assignment of internal auditors
- Supervision and review of internal auditors’ activities
- Quality of working-paper documentation, reports and recommendations
- Evaluation of internal auditors’ performance

Areas related to objectivity:

- The organizational status of the internal auditor responsible for the internal audit function, including:
 - Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors
 - Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee or the owner-manager
 - Whether the board of directors, the audit committee or the owner-manager oversees employment decisions related to the internal auditor

- Policies to maintain internal auditors’ objectivity about the areas audited, including:
 - Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions
 - Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function

Given today’s heightened sensitivity to internal control, financial reporting and governance issues, it is even more critical for the coordination and potential reliance on internal audit procedures by the external auditor to be properly understood, evaluated, considered and communicated among the audit committee, management and internal audit leadership.

We strongly encourage audit committees, management and internal audit leadership to work closely with their external auditors to develop an appropriate and effective plan regarding the work of and degree of reliance on internal audit in connection with their financial statement audit, as well as in connection with their audit of ICFR. Complying with professional standards in this area as they exist today, or as they are changed by the PCAOB, is a primary consideration.

68. Do all internal audit reports need to be reviewed by the external auditor?

In the past, the answer was no, as there are no formal requirements to do so. However, since internal and external audit should be collaborating and coordinating efforts, it has been accepted and, in fact, customary to share internal audit reports with the external auditor.

Today, this practice varies by company and by audit firm. External auditors certainly should be able to see any and all internal audit reports they choose. What they should review (or should request) are those reports that have a bearing on their work.

The PCAOB’s AS5 requires the external auditor to review all internal audit reports of a certain kind. As noted on Page A1-29, Paragraph 71 of AS5, “... the (external) auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to ICFR and evaluate control deficiencies identified in those reports.”

69. Can a company’s external auditors perform an external quality assessment review of the company’s internal audit function?

Yes. Practice Advisory 1312–1, *External Assessments* names external auditors as a possible qualified party for conducting an external quality assessment review of internal audit. However, when considering the organization’s external auditors as candidates for this review, the CAE – in consultation with the audit committee and board of directors – should consider any real or apparent conflicts of interest that might impact this assessment.