

PCAOB Auditing Standard 2605

IIA Perspective and Recommendations

Overview of The Institute of Internal Auditors

The Institute of Internal Auditors (The IIA) is an international professional and standard-setting organization – based in Lake Mary, Florida – with more than 245,000 members around the world. In North America, The IIA has over 70,000 members with 124 active chapters in the United States.

The IIA is recognized globally as the internal audit profession's leader in standards, certification, education, and technical guidance. The IIA confers the only globally recognized professional certification that ensures internal auditors operate competently, independently, and ethically:

- **Certified Internal Auditor (CIA)** – The CIA credential sets the standard for excellence within the profession and reflects the highest level of internal audit experience

The purpose of internal audit is to enhance the value of an organization and strengthen its credibility with stakeholders. Internal auditors achieve this purpose by providing objective assurance, insight, and advice.

Internal auditing strengthens:

- Effective governance, risk management, and control
- Responsible decision-making and oversight
- Sustainable value creation and protection
- Accountable stewardship of assets and reputation

The key to internal audit – and its defining characteristic – is complete independence from management. In order to preserve objectivity, credibility and trust, the internal audit function must report directly to the organization's governing body.

This autonomy enables internal audit to serve as the independent "eyes and ears" of an organization; thus, internal audit is uniquely equipped to objectively evaluate performance, risk management, and internal controls, including internal controls over financial reporting.

General Perspective on AS 2605

The Public Company Accounting Oversight Board's (PCAOB) standard, "Consideration of the Internal Audit Function (AS 2605)," establishes the procedures an external auditor must employ when engaging – or relying upon the work of – an organization's internal audit function. When confronted with this option, AS 2605 requires external auditors to assess the following:

*If the auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of audit procedures, **the auditor should assess the competence and objectivity of the internal audit function** in light of the intended effect of the internal auditors' work on the audit,¹ (emphasis added).*

¹ "AS 2605: Consideration of the Internal Audit Function," The Public Company Accounting Oversight Board:
https://pcaobus.org/oversight/standards/auditing-standards/details/as-2605-consideration-of-the-internal-audit-function_1528

While it is certainly appropriate for an external auditor to conduct due diligence when determining whether to utilize internal audit, The IIA believes AS 2605's evaluation of "competence and objectivity" should be measured against one criterion: Conformance with The IIA's *Global Internal Audit Standards (Standards)*².

According to The IIA, "Global Internal Audit Standards guide the worldwide professional practice of internal auditing and serve as a basis for evaluating and elevating the quality of the internal audit function."³ The *Standards*, in part, convey mandatory requirements designed to guarantee all internal auditors possess the aptitude and independence necessary to execute their responsibilities.

For example, Principle 2 of the *Standards* prescribes a series of requirements for establishing and maintaining internal audit objectivity. Specifically, the *Standards* provide internal auditors with uniform guidance regarding the preservation of individual objectivity and details a process for disclosing impairments thereto.

Moreover, Principle 3 is dedicated to demonstrating the competency of an internal audit function. The relevant standards included in this section promote internal audit competency by requiring:

- Knowledge, skill, and ability suited to a specific position
- Responsibilities commensurate with experience
- Understanding of the *Global Internal Audit Standards*
- Continuing professional development

Adherence to the *Standards* not only ensures consistent and reliable internal audits, but it also serves as an exemplar for measuring the true competence and objectivity of an internal audit function. As a result, The IIA believes greater emphasis on the *Standards* will enhance AS 2605 by replacing subjective judgement with an objective evaluation of internal audit.

The following proposals illustrate a few examples of how The IIA *Standards* may be leveraged to strengthen AS 2605:

Proposal #1

Role of the Auditor and Internal Auditors

- Amend Section .03 as follows:
 - *.03 Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or to others with equivalent authority and responsibility. To fulfill this responsibility, internal auditors must comply with The IIA's Global Internal Audit Standards to maintain objectivity with respect to the activity being audited.*

² The IIA released the updated *Global Internal Audit Standards (Standards)* on January 9, 2024. The *Standards* are presently in affect and will officially replace the *Standards for the Professional Practice of Internal Auditing* in January 2025.

³ "Global Internal Audit Standards," The Institute of Internal Auditors: <https://www.theiia.org/en/standards/2024-standards/global-internal-audit-standards/>

Since objectivity represents a core component of the internal audit profession – as evidenced by Principle 2 of the *Standards* – The IIA’s proposed amendment to Section .03 is intended to strengthen AS 2605 as follows:

- Provides external auditors with increased confidence in the objectivity of internal audit since it is derived from mandatory standards
- Reinforces to internal auditors that objectivity must be achieved in conformity with globally accepted internal auditing standards
- Ensures AS 2605 remains aligned with any future IIA standards or guidance enhancing requirements for internal audit objectivity

Although insertion of The IIA’s proposed clause may appear inconsequential, the reference to globally recognized standards grants external auditors a benchmark for properly validating the objectivity of internal audit.

Proposal #2

- Amend Section .05 as follows:
 - *The auditor ordinarily should ensure the internal audit function has undergone and passed an external quality assessment in conformance with Standard 8.4 of the IIA’s Global Internal Audit Standards. In addition, the auditor should make inquiries of appropriate management and internal audit personnel about the internal auditors’—*

Section .05 encourages external auditors to engage an organization’s management and internal audit personnel to ascertain the following characteristics of the internal audit function:

- Organizational status within the entity
- Application of professional standards
- Audit plan which includes the nature, timing, and extent of audit work
- Access to records and whether there are limitations on the scope of activities

While it is imperative an external auditor understands the positioning and activities of internal audit, Section .05 implies a subjective evaluation process that may not consistently measure the effectiveness of an internal audit function. Anecdotal evidence from management and/or internal audit staff may also fail to provide sufficient information when assessing the technical capabilities of internal audit.

In order to mitigate the subjectivity of Section .05, The IIA recommends that external auditors should “ensure” an internal audit function has passed an external quality assessment in conformity with the *Standards*. IIA Standard 8.4 requires, in relevant part, the following:

The chief audit executive must develop a plan for an external quality assessment and discuss the plan with the board. The external assessment must be performed at least once every five years by a qualified, independent assessor or assessment team. The requirement for an

*external quality assessment may also be met through a self-assessment with independent evaluation.*⁴

Inserting a reference to IIA *Standard 8.4*, therefore, has the potential to further strengthen AS 2605 as follows:

- Enables an external auditor to rely upon an independent quality assessment when determining the role of internal audit
- Eliminates subjective evaluations of internal audit
- Promotes confidence in the capabilities and independence of internal audit since it has been validated by an external entity

Proposal #3

Competence of the Internal Auditors

- Amend Section .09 as follows:
 - *.09 When assessing the internal auditors' competence, the auditor should obtain or update information from prior years about such factors as—*
 - *Educational level and professional experience of internal auditors.*
 - *Professional certification and continuing education (e.g. Certified Internal Auditor, Certified Public Accountant, etc.).*

Section .09 establishes the basic criteria external auditors must utilize when evaluating the “competence” of an internal audit function. It is important to note that adoption of IIA Proposal #2 has the potential to further enhance Section .09 by implicitly embracing Principle 3 of the *Standards* which states: “Internal auditors apply the knowledge, skills, and abilities to fulfill their roles and responsibilities successfully.”⁵

Therefore, reliance upon an external quality assessment – as required by IIA *Standard 8.4* – provides validation that an organization’s internal audit function possesses appropriate professional competencies.

From a technical perspective, The IIA also recommends including examples in Section .09 of relevant professional certifications germane to internal audit. Since internal audit is a specialized function, this proposed addition will ensure external auditors clearly understand the credentials that reflect genuine professional knowledge and experience.

⁴ “Global Internal Audit Standards,” The Institute of Internal Auditors: <https://www.theiia.org/en/standards/2024-standards/global-internal-audit-standards/>

⁵ “Global Internal Audit Standards,” The Institute of Internal Auditors: <https://www.theiia.org/en/standards/2024-standards/global-internal-audit-standards/>

Proposal #4

Objectivity of the Internal Auditors

- Amend Section .10 as follows:
 - .10 When assessing the internal auditors' objectivity, the auditor should obtain or update information from prior years about such factors as—
 - The organizational status of the internal auditor responsible for the internal audit function, including—
 - Whether the internal auditor has direct access and reports regularly to the organization's governing body (e.g. board of directors, the audit committee, or the owner-manager).
 - Whether the internal auditor administratively 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 governing body (e.g. board of directors, the audit committee, or the owner-manager) oversees employment decisions related to the internal auditor.

Section .10 of AS 2605 enumerates certain conditions an external auditor must evaluate when determining the objectivity of an internal audit function. While The IIA does not dispute the premise of this assessment, the listed requirements seemingly misrepresent two fundamental aspects of the internal audit profession:

- Implies that an internal audit function maintains a direct reporting relationship with management
- Suggests internal audit may have direct access to the board but engagements are limited to regular reports

Principle 7 of The IIA Standards, states:

*The internal audit function is only able to fulfill the Purpose of Internal Auditing when **the chief audit executive reports directly to the board**, is qualified, and is positioned at a level within the organization that enables the internal audit function to discharge its services and responsibilities without interference (emphasis added).*

The direct reporting relationship between a chief audit executive and the board, as defined by Principle 7, is a central tenet of the internal audit profession. The existence of such a critical paradigm enables internal audit to act with independence, objectivity, and organizational support. Moreover, this structure promotes a continuous dialogue between internal audit and the board concerning risk management, internal controls, and governance.

Since this reporting structure is a fundamental component of internal audit, The IIA proposes the following technical amendments to Section .10:

- Reorder the sub-bullets in Section .10 – and delete the work “regularly” – to highlight internal audit’s direct reporting relationship with an organization’s board of directors
- Modify the subsequent bullet in Section .10 to reflect that an internal auditor may “administratively” report to an officer in the organization

NOTE: This reporting relationship does not have a material impact on the strategy or provision of internal audit services; rather it is needed to facilitate organizational processes such as reimbursements, approval of leave, and other administrative actions

The IIA believes these recommended updates to Section .10 will further strengthen AS 2605 by correctly characterizing a core element of internal audit’s objectivity and independence.

Proposal #5

Footnotes (AS 2605 – Consideration of the Internal Audit Function):

- Update Footnote (2) as follows:
 - (2) Although internal auditors are not independent from the entity, The Institute of Internal Auditors’ ~~*Standards for the Professional Practice of Internal Auditing*~~ *Global Internal Audit Standards* defines internal auditing as an independent, ~~appraisal objective assurance and advisory service function~~ and requires internal auditors to be independent of the activities they audit. This concept of independence is different from the independence the auditor maintains under the PCAOB Rule 3520, Auditor Independence.

As noted in IIA Footnote 2 (located on page 2 of this document), The IIA published a comprehensive update to the standards governing the internal audit profession on January 9, 2024. The new *Global Internal Audit Standards* – which are currently in effect – will officially replace the *Standards for the Professional Practice of Internal Auditing* at the beginning of 2025.

Based upon the newly adopted IIA *Standards*, the proposed amendment to PCAOB Footnote 2 is intended to accomplish two objectives:

- Update the title of The IIA *Standards* from the *Standards for the Professional Practice of Internal Auditing* to the *Global Internal Audit Standards*
- Modify the paraphrased definition of “internal audit” to align with updated language in the *Global Internal Audit Standards*

Conclusion

Should you have any questions regarding The IIA, or the material presented in this document, please contact Michael Downing, IIA Senior Director for North American Advocacy, at Michael.Downing@TheIIA.org.