

# **INDEPENDENCE AND INDEPENDENT SCRUTINY**

The network of national audit experts have produced this non-binding reference document based on agreed good practices to provide guidance on how independence of auditors and independent scrutiny of the audit system, developed to implement the provisions of Regulation (EC) No 882/2004, can be assured.

## The National Audit Systems (NAS) Network

The NAS network is a network of officials (auditors) from national competent authorities, responsible for the performance of audits of official control systems as provided for by Article 4(6) of Regulation (EC) No 882/2004<sup>1</sup>. The networks meet regularly, under the chairmanship of, and facilitated by, the FVO to exchange experiences in implementing national audit systems on official control activities. During the course of these exchanges; discussions, workshops etc. good principles and practices are identified and agreed by the network.

To enable dissemination of information the network, working in plenary session and through sub-groups, facilitated by the FVO, consolidate agreed principles and good practices on specific topics into documents. These documents may be used as reference documents, however, they do not constitute an audit standard and are not legally binding.

## INDEPENDENCE AND INDEPENDENT SCRUTINY

### SCOPE

This document applies to internal<sup>2</sup> audits and independent scrutiny carried out under Article 4(6) requirements of Regulation (EC) No 882/2004 and under the guidance of Commission Decision 2006/677/EC<sup>3</sup>, Sections 5.3 and 5.4.

### OBJECTIVES

The objective of this document is to propose some general principles on independence and independent scrutiny to guide and support Competent Authorities (CA), audit bodies and auditors. The aim is to:

- Give some tools for those who are involved in the setting up audit bodies, conducting internal audits and independent scrutiny.
- Encourage consistent approach across Member States.
- Assist/support in building independence and independent scrutiny into the audit process.
- Describe elements for documenting and demonstrating independence.
- Provide structure and criteria for self-assessment.
- Assist independent scrutiny to evaluate independence of the audit body, audit process and auditors (in its general objectives to evaluate how the audit body is fulfilling its objectives).
- Help identify and manage the risks that could potentially influence and/or threaten the objectivity and impartiality of the audit body, audit process and auditors.

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<sup>1</sup> OJ L 191, 28.5.2004.

<sup>2</sup> In this document internal audits include external audits as mentioned in Article 4(6) of Regulation 882/2004.

<sup>3</sup> OJ L 278, 10.10.2006.

## INDEPENDENCE

Commission Decision 2006/ 677/EC states in Section 5.3 of the Annex:

*“Audit bodies should<sup>4</sup> be free from any commercial, financial, hierarchical, political or other pressures that might affect their judgment or the outcome of the audit process. The audit system, audit body and auditors should be independent of the activity being audited and free from bias and conflicts of interest. Auditors should not audit areas or activities for which they have direct responsibility.*

*All relevant competent authorities should introduce safeguards to ensure that responsibility and accountability for audit and control activities, such as the management and supervision of official control systems, are kept sufficiently distinct.”*

### So what is Independence?

**Definition:** *Independence* is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased and impartial manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive (the person in charge) of the audit body has direct and unrestricted access to top management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels<sup>5</sup>.

A sufficient degree of independence is difficult – if not impossible – to determine or quantify. The degree of independence to be achieved although difficult to quantify, should be sufficient to be accepted as objective by stakeholders. It is important to recognise that independence is a continuum rather than a binary condition. It is also a matter of perception rather than a score, which could be arrived at by using a mathematical formula<sup>6</sup>.

"Independence is not an absolute standard which statutory auditors must attain, free from all economic, financial and other relationships that could appear to entail dependence of any kind. Such a state is manifestly impossible as everyone has some dependency or relationship with another person."<sup>7</sup>

Independence can also be looked at from the opposite point of view; for example, the factors that may threaten an audit body's independence. Some threats to independence are detailed in the Annex. The level of risk that an internal auditor's independence might be compromised will be determined by reference to the significance of these threats, either individually or in combination.

When audit body's funding, staffing, expertise, programming or audit process depends on an entity which may influence the audit results, the audit body's independence may be compromised. If the entity is capable of introducing bias or impartiality into the audit process it may compromise the objectivity of audit results, Examples of measures to mitigate these risks are detailed in Annex I.

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<sup>4</sup> "should" in this document means good/best practice, not a binding requirement.

<sup>5</sup> From IIA standard – modified for our purposes.

<sup>6</sup> "The level of independence risk can be expressed as a point on a continuum that ranges from 'no independence risk' to 'maximum independence risk'. Although it cannot be measured precisely, the level of independence risk for any specific activity, relationship, or other circumstance that may pose a threat to a internal auditor's independence can be described as being within, or at one of the endpoints, on the independence risk continuum." (Paraphrase from: Commission Recommendation 2002/590/EC).

<sup>7</sup> Commission Recommendation 2002/590/EC Statutory Auditors' Independence in the EU: A set of fundamental principles.

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The basic test for the effectiveness of the approach adopted by an internal auditor to mitigate threats and risks to his independence in respect of a particular audit engagement is whether a reasonable and informed third party, knowing all the relevant facts and circumstances about a particular audit engagement, will conclude that the internal auditor is exercising objective and impartial judgement on all issues brought to his attention (paraphrased from Commission Recommendation 2002/590/EC).

## IMPORTANCE OF INDEPENDENCE

Auditing is a management tool which supports management in achieving the goals of the organisation. It provides confidence to the management that organisation is doing the right things i.e. is effective in pursuing its goals. Provided that there is sufficient degree of independence from the operations to be audited, audits bring new perspectives and insights, allowing management to identify "blind spots". Independence can be viewed as an insurance against "group think" and "tunnel vision" and it promotes continuous improvement.

Added value created by audit reports depends on their objectivity<sup>8</sup>, which in turn depends on independence of the audit body and the audit process. Independence and objectivity are the most valuable assets of an audit body because they create and maintain credibility which is necessary to have confidence in audit results. **For all these reasons, independence is not only a benefit or just an optional feature – it is a pre-requisite for an audit body to be able to demonstrate that audit process has not been subject to any undue influence or bias and the results can be relied upon.**

The following quotes are from internationally recognised audit standards<sup>9</sup> and re-emphasise the importance of auditors' independence:

*"The credibility of auditors' opinions and reports depends, to a great extent, on public belief in the integrity, objectivity and independence of auditors and the quality of their work."*<sup>10</sup>

*"Auditor independence is one of the fundamental reasons for auditors in ... It is considered as a core feature of auditor performance and the success of the public... It inevitably adds credibility to published ... and value for the various interested parties."*

*"Independence and objectivity are two critical components of an effective internal audit activity."*<sup>11</sup>

*"The internal auditor occupies a unique position he or she is employed by the management but is also expected to review the conduct of management which can create significant tension since the internal auditor's independence from management is necessary for the auditor to objectively assess the management's action, but the internal auditor's dependence on the management for employment is very clear." (IIA)*

## PRINCIPLES

Independence does not come free – it is a feature that needs to be designed, incorporated and actively managed in the audit process. It is a function of a number of factors at four different levels, which all need to be taken into account to provide necessary conditions for

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<sup>8</sup> "**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. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels.

To maintain objectivity, internal auditors should have no personal or professional involvement with or allegiance to the area being audited; and should maintain an un-biased and impartial mindset in regard to all engagements." (IIA).

<sup>9</sup> EU Member States most frequently use the ISO or the Institute of Internal Auditors (IIA) standards, or both.

<sup>10</sup> Auditing: An International Approach By Bahram Soltani.

<sup>11</sup> European Confederation of Institutes of Internal Auditing.

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independence (some practical examples of the various factors are provided in Annex I). The principles to be followed at the four levels are:

1. *Organisational level*

"A clear, documented mandate affording adequate power to conduct the audit should be provided," is a pre-requisite for independent operation. This may be provided by a set of binding decisions or a formally approved document, often referred to as an "Audit Charter". This mandate must include at least the purpose, responsibilities, authority and accountability of the audit body, and any other aspects which are considered necessary to reach a satisfactory level of independence.

2. *Functional level*

The audit body should be provided with sufficient qualified and competent staff, funding, infrastructure, and other resources needed to execute the audit programme without being dependent on external decisions. It should be granted access to continuous professional development and independent technical experts.

The audit body should ensure that auditors and technical experts are aware of the concepts of objectivity, bias, impartiality, independence and that they are able to recognise and declare a conflict of interest when appropriate.

3. *Audit process level*

The audit body should be free of undue influence at all levels of the audit process, particularly approval of audit programme and reports should not be influenced or hindered by the auditee. The audit body should have the freedom to develop the audit scope and objectives into an appropriate audit plan and should have access to all premises and information that is necessary to achieve audit objectives.

4. *Auditor level*

An independent mind is a personal characteristic necessary for auditors and they should also be ethical, open-minded, diplomatic, observant, perceptive, versatile, tenacious, decisive, assertive, self-reliant and open to improvement<sup>12</sup>. They should also be competent auditors and have the necessary knowledge and skills to allow them carry out their duties. Auditors should behave objectively, impartially, independently, without bias, with fairness, intellectual honesty, integrity, and declare a conflict of interest when appropriate.

"The internal auditor should have a clear understanding of what is meant by objectivity, which is a state of mind, and independence as a matter of both fact and appearance."<sup>13</sup>

Demonstrating objectivity (freedom from bias and conflict of interest) is challenging:

- It needs to be considered particularly when carrying out each engagement, self-assessment and independent scrutiny.
- Absence of conflict of interest is difficult to prove but confidence is provided by describing various measures taken to manage conflict of interest.

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<sup>12</sup> 7.2.2 Personal Behaviour ISO 19011

<sup>13</sup> Commission Recommendation 2002/590/EC, Annex, point A, second paragraph.

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"In many cases, particularly in small organisations, independence can be demonstrated by the freedom from responsibility for the activity being audited or freedom from bias and conflict of interest." (ISO 19011:2011 – definition of audit, note 1)

"Auditors should be independent of the activities audited, wherever practicable and should in all cases act in a manner that is free from bias and conflict of interest. For internal audits auditors should be independent from the operating managers of the function being audited." (ISO 19011:2011 Clause 4 (e))

## INDEPENDENT SCRUTINY

Commission Decision 2006/677/EC states in Section 5.4 of the Annex:

*"In order to check whether it is achieving its objectives, the audit process should be subject to scrutiny by an independent person or body. Such independent person or body should have sufficient authority, expertise and resources to carry out this task effectively. The approaches to independent scrutiny may vary, depending on the activity or the competent authority. Where a body or a committee has been established with a view to independent scrutiny of the audit process, one or more independent persons should be members of such body or committee. Such independent persons should have access to the audit process and be empowered to contribute fully to it. Action should be taken to remedy any shortcomings identified in the audit process by the independent person or body."*

### So what is Independent Scrutiny?

**Definition:** A regular and planned process external to the audit body and the audited organisation with particular focus on the audit process to ensure that the process is capable of producing objective results and meeting its obligations under Regulation (EC) No 882/2004.

The objectives of independent scrutiny are to provide:

- An objective evaluation of the effectiveness and independence of the audit process and audit body.
- Feed-back for continuous improvement.
- Confidence to the audit body, CA management and other stakeholders<sup>14</sup> that the audit process is meeting the objectives of Article 4(6) of Regulation (EC) No 882/2004.

The CA should ensure that the process of independent scrutiny is documented – this documentation should include:

- Terms of reference including frequency of the scrutiny and transparency of the process.
- Membership, including selection criteria, qualifications and expertise.
- Roles and responsibilities of the CA and the body providing scrutiny.
- Management of conflicts of interest.
- Confidentiality, code of ethics, rights and obligations for both the CA and the body providing for the scrutiny.
- The right of access to the audit body and the entire audit<sup>15</sup> process.
- Reporting and dissemination of results of the scrutiny.

Examples of factors affecting independent scrutiny are provided in Annex II.

### INPUT

The data/information used as an input by the scrutiny process should include, but not be limited to:

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<sup>14</sup> For the purposes of this document, stakeholder means: Interested parties or individuals and other entities interested in, or affected by the activities of the internal audit. For example, Competent Authorities, consumers, Food Business Operators, FVO, European Commission, taxpayers, Ministries, Non-Governmental Organisations.

<sup>15</sup> Section 5.1, figure 1, ISO 19011:2011 and Section 5.1 of the Annex of Commission Decision 2006/677/EC.

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- Audit charter and organisational arrangements.
- Documentation on risk-based planning.
- Audit programmes, documentation of audit process including reports and follow up.
- Level of auditor qualifications, experience and training.
- Results of audit body self-reviews and external reviews or audits (as available).
- Previous scrutiny reports and corrective actions taken.

## THE PROCESS

The process of independent scrutiny should be carried out by (a) person(s) from outside both the audit body and the organisation subject to internal audits. This(ese) person(s) should have sufficient level of independence and expertise to scrutinise the **audit process**. While some degree of expertise in the subject area is beneficial, expertise in auditing is essential. Extensive experience and/or well recognised body or person with good reputation will increase the weight of the opinions, conclusions, recommendations and impact of the scrutiny.

Independent scrutiny is not necessarily an audit of the audit body but rather, a critical evaluation of documentary evidence with a specific focus on objectivity of the audit body. The scrutiny can vary in scope, level of detail and intensity. In many cases a "desktop evaluation" may be sufficient; however, in some cases on site verification may be considered appropriate.

The process should be regular but the frequency may vary from annual to a 5-year cycle, depending on the results of previous scrutiny and the internal controls applied by the audit body. If the scrutinising body is using varying levels (of detail) of scrutiny, those levels may be applied with different frequency. For example, a full scrutiny every five years with lighter scrutiny – with narrower scope in between – say, every second year.

The process should cover the whole audit process, including programming, planning and executing audits, reporting (including approval of reports), corrective action and follow-up. It should also cover the different threats to independence and mechanisms to manage them.

## OUTPUT

- An opinion on effectiveness of the audit process.
- An opinion on independence of the audit body/auditors.
- A report identifying best practices and areas for improvement.

## OUTCOME

- Confidence for the audit body, CA management and other stakeholders that the internal audit through the audit process is meeting the objectives of Article 4(6) of Regulation (EC) No 882/2004.



## Annex I Threats to the independence of the Audit body and auditor(s)

<i>Type of threat</i>	<i>Examples</i>	<i>Mitigating measures</i>
Political pressure	<ul style="list-style-type: none"> <li>• CAE (chief audit executive) appointment based on political interests rather than merit</li> <li>• Audit programme and priorities decided at political level.</li> </ul>	<ul style="list-style-type: none"> <li>• Audit charter</li> <li>• Legislation</li> <li>• Nomination of CAE &amp; auditors</li> <li>• Reporting to the highest level of CA</li> <li>• Audit board or committee composed of external stakeholders providing overview/oversight to the audit process</li> <li>• Independent scrutiny</li> </ul>
Financial pressure	<ul style="list-style-type: none"> <li>• Money coming from the organisation being audited</li> <li>• Money allocated on the basis of audit results (or some bizarre KPI)</li> <li>• Insufficient budget for remuneration, daily allowances, travel compensation etc. made by CA</li> </ul>	<ul style="list-style-type: none"> <li>• Dedicated Budget commensurate with the needs of the audit body – both fixed and variable costs...</li> <li>• Resources (fixed and variable)</li> <li>• Freedom to decide and how to use the budget and resources</li> </ul>
Commercial pressure	<ul style="list-style-type: none"> <li>• Sub-contracted audit body also providing consultancy to the CA</li> <li>• Sub-contracted audit body also providing certification of industry and/or Competent Authority</li> <li>• Sub-contracted audit body also carrying out official controls and/or consultancy to the industry.</li> </ul>	<ul style="list-style-type: none"> <li>• If sub-contracted --&gt; audit body solely responsible for carrying out article 4(6) audits</li> <li>• Genuine open tender on a regular basis.</li> <li>• Declaration of interest</li> <li>• N.B. Audit body within the CA is not susceptible to commercial pressure.</li> </ul>
Hierarchical pressure	<ul style="list-style-type: none"> <li>• Programmes, findings and recommendations subject to influence by top management</li> <li>• Career path – limitations to promotions or other job opportunities e.g. part-time auditors left with irrelevant tasks after audit assignment...</li> <li>• Selection procedures and criteria not related to audit competencies.</li> <li>• Technical expertise not available, when necessary.</li> </ul>	<ul style="list-style-type: none"> <li>• Freedom to propose/decide programmes</li> <li>• Career path</li> <li>• CA recognises audit body and auditors as adding value within the CA</li> <li>• Access to sufficient technical expertise is available, when necessary</li> <li>• CAE free to select audit teams for specific audits.</li> </ul>

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	<ul style="list-style-type: none"> <li>Auditee management can obstruct the audit by (silently) refusing cooperation with the audit body.</li> </ul>	
Self-review	<ul style="list-style-type: none"> <li>A member of the audit team works in the area/activity to be audited</li> <li>A limited number of technical experts</li> <li>Prior to joining the audit unit, the auditor worked with the auditees.</li> <li>Auditee selects the audit team members</li> <li>The audit body performs a executive/management function which needs to be audited e.g. a counter-fraud function, which at some point might be subject to audit</li> <li>The audit body is responsible for both developing the MANCP and auditing the delivery of the MANCP</li> <li>The auditor and/or audit body is responsible for issuing guidelines/instructions and auditing the same activities.</li> </ul>	<ul style="list-style-type: none"> <li>Clearly defined roles for audit team members e.g. technical experts may come from the auditee but the audit body must have the responsibility to manage independence of the audit team</li> <li>Clear guidelines on how to select audit teams and ensure a balanced mix of team members</li> <li>Establish a minimum period before auditors can audit an auditee from which they came</li> <li>Rules for declaration of interests</li> <li>Separation of functions – persons holding a managerial or supervisory role in the areas to be audited should be disqualified from auditing that area.</li> <li>Recruitment of auditors with suitable characteristics i.e. independence of mind</li> </ul>
Self interest	<ul style="list-style-type: none"> <li>The auditor is planning to apply for a post within the audited organisation.</li> <li>Gifts and/or hospitality that may be perceived as influencing the objectivity of the auditor</li> <li>The audit body has executive functions which may conflict with its independent audit role e.g. preparing a case for prosecution</li> </ul>	<ul style="list-style-type: none"> <li>Rules for declaration of interests</li> <li>Auditors need to be conscious of objectivity and perceived conflict of interest</li> <li>Rules on what an auditor may or may not accept as gifts</li> <li>Record gifts and hospitality received</li> </ul>
Familiarity	<ul style="list-style-type: none"> <li>The auditor has audited the same auditee for a number of years in a row.</li> </ul>	<ul style="list-style-type: none"> <li>Auditors work in teams, where rotation of auditors is ensured.</li> <li>Sufficient pool of auditors to allow rotation</li> </ul>
Intimidation	<ul style="list-style-type: none"> <li>The auditee has good relations with the superior(s) of the auditor</li> <li>Auditor unable to deal with the strength of character of the auditee (lack of assertiveness).</li> <li>Auditee has the power to limit the auditors career prospects</li> </ul>	<ul style="list-style-type: none"> <li>The auditors enjoy full support of their superiors and have mechanisms to report and act upon any undue attempt to influence the outcome of the audit.</li> <li>Awareness programmes, training on assertiveness and/or conflict management</li> </ul>
Advocacy	<ul style="list-style-type: none"> <li>The auditor is promoting and/or representing the control system in some forum and at the same time being responsible for auditing the system.</li> </ul>	<ul style="list-style-type: none"> <li>Separation of functions</li> <li>Being aware of perceived conflicts of interest</li> <li>Audit charter, defining roles that may be performed e.g. presentations, publications</li> </ul>

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	<ul style="list-style-type: none"><li>• The auditor or the audit body has been an advocate for a stakeholder opposing the auditee e.g. the auditor is a prominent member of an animal welfare society and is auditing the animal welfare control system.</li></ul>	outside the audit body
Lack of competence	<ul style="list-style-type: none"><li>• The auditor/audit team does not have access to e.g. scientific opinion and has to rely on the auditees' expertise.</li><li>• Recruitment not based on qualifications, experience and competences</li></ul>	<ul style="list-style-type: none"><li>• CAE/audit body free to recruit auditors solely on the basis of competence</li></ul>

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## Annex II - Threats to independent scrutiny

<i>Examples</i>	<i>Mitigating measures</i>
<ul style="list-style-type: none"> <li>• The CA specifies the scope and objectives of the scrutiny in such a way that leads to bias</li> <li>• The CA selects a scrutiny body who is likely to provide favourable opinion</li> <li>• Independent scrutiny is used as a tool for meeting internal political needs e.g. getting rid of a manager</li> <li>• A body (e.g. contracted company) that has an interest in providing services to the CA is appointed as the scrutiny body</li> <li>• The CA deliberately chooses a scrutiniser who is not competent enough</li> </ul>	<p>Specification of scope and objectives of the scrutiny body</p> <p>Transparency of the selection process</p> <p>Have other external and internal stakeholders and/or professionals involved in the selection of the scrutiny body</p> <p>Stakeholders review terms of reference and selection process</p> <p>Take account of linked services offered by the body / company and exclude such organisations</p> <p>Standard terms and conditions which exclude conflict of interest for example, bodies with linked services</p> <p>Declaration of interests</p>
<ul style="list-style-type: none"> <li>• Unreasonably limited budget allocated to attract sufficiently qualified scrutiny body</li> </ul>	<p>Benchmark cost and net value</p> <p>Use of comparable peer review</p>
<ul style="list-style-type: none"> <li>• CA management obstructs or otherwise interferes to influence the results of the scrutiny body</li> </ul>	<p>The scrutiny body has right of access to the stakeholders</p> <p>Specification of powers and rights of the scrutiny body, and support from stakeholders</p> <p>Transparency of the process</p> <p>Contract specifies full co-operation of management</p>
<ul style="list-style-type: none"> <li>• The scrutiny body behaves in a manner to encourage their reappointment...</li> </ul>	<p>Transparency, try to select people of sufficient seniority who will not have such interest,</p> <p>Fixed non-renewable term</p> <p>Code of conduct/ethics (objectivity, integrity, due professional care, confidentiality etc.)</p>
<ul style="list-style-type: none"> <li>• The same person(s) conduct the scrutiny for an extended period of time</li> </ul>	<p>Change or rotate people, introduce a time-limit for individuals providing scrutiny</p>
<ul style="list-style-type: none"> <li>• The body who is selected as the scrutiniser sends people who are not competent</li> <li>• The competencies required of the scrutiniser have not been properly identified and specified for their selection</li> </ul>	<p>Ensure qualifications and competencies are specified in contract</p> <p>Strictly enforce the terms of the contract</p> <p>Possibility of terminating the contract – opens the risk that contractor behaves in a way that the contract will continue</p>