

Module 11: Internal audit

Module 11: What you will learn

In this module you will learn the following:

- The roles of the internal and external auditors
- How external auditors assess whether to make use of internal auditors' work.

Introduction

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Many companies have an internal audit function as part of their system of internal control. The internal auditors are often involved in the monitoring and testing of controls, and in other areas that could be relevant to the external audit.

The existence of an internal audit department does not reduce or change the responsibilities of the external auditor – the audit opinion is entirely the responsibility of the external auditor. Therefore, if the external auditor wants to rely on work done by the internal auditors, he must obtain assurance that the work has been performed to the same professional quality as if it had been performed by the external auditors. This module looks at some of the main areas of work of internal auditors, compares their role with that of external auditors and introduces the professional requirements that external auditors must follow if they want to rely on the work of internal auditors.

Using the Work of Internal Auditors (ISA 610)

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Objective

According to ISA 610 Using the Work of Internal Auditors (paragraph 13) the objectives of the external auditor are:

- To determine whether, and to what extent, to use specific work of the internal auditors or to use internal auditors to provide direct assistance
- If so, whether such work is adequate for the purposes of the audit and
- If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

For companies listed on a recognized stock exchange it is regarded as good practice to establish internal audit functions to undertake regular monitoring of key controls and procedures therefore listed companies might be expected to have them.

Relationship - external audit vs. internal audit

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	External	Internal
Role required by:	Statute (typically)	Management, usually in larger organisations
Appointed by:	Shareholders (usually) or directors	Management
Reports to:	Shareholders (primary statutory duty) and management (professional responsibility)	Those charged with governance, typically the audit committee
Reports on:	Financial statements	The entity's risk management and internal control processes
Forms opinions on:	"True and fair view" (or similar)	Adequacy of ICs as a contribution to the economic, efficient and effective use of resources
Status:	Independent of client company	Employee (therefore potentially less objective)
Qualification:	Usually ACCA, ICAEW, ICAI, ICAS, CPA or equivalent	May also be members of other professional bodies (eg. IIA) or unqualified
Scope of assignment:	Unlimited, to fulfil statutory obligation	Prescribed by management
Conduct of audit:	In accordance with ISAs	Similar stages - planning, evaluation of controls, evidence, reporting

Internal audit - determining whether to use the work of internal audit

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“The external auditor shall determine whether the work of the internal audit function can be used for the purposes of the audit by evaluating the following:

- (a) The extent to which the internal audit function's organizational status ... supports the objectivity of the internal auditors;
 - (b) The level of competence of the internal audit function;
 - (c) Whether the internal audit function **applies** a systematic and disciplined approach, including quality control.”
- ISA 610 paragraph 15

In short, internal audit must satisfy three assessment criteria - objectivity, competence and a systematic and disciplined approach.

In addition, **ISA 315** stresses the importance of effective communication between the external and internal auditors.

Effectiveness of internal audit is just one factor to be considered in the external auditors' assessment of the control environment.

Assessment Criteria

Factors to consider	
Objectivity	<ol style="list-style-type: none"> 1. Organizational status of internal audit within the entity 2. Whether those charged with governance oversee employment decisions related to internal audit 3. Whether management or those charged with governance place constraints or restrictions 4. Free of any conflicting responsibilities
Competence	<ol style="list-style-type: none"> 1. Technical training / proficiency 2. Established policies for hiring, training and assigning 3. Members of relevant professional bodies 4. <u>Knowledge relating to the entity's financial reporting</u> and the applicable financial reporting framework
Systematic and disciplined approach, including quality control	<ol style="list-style-type: none"> 1. Systematic and disciplined approach to planning, performing, supervising, reviewing and documenting (DEF.) 2. The existence, adequacy and <u>use of documented internal audit procedures or guidance</u> covering such areas as risk assessments, work programs, documentation and reporting 3. Appropriate quality control policies and procedures.

Internal audit - appraisal activities

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“Internal audit function - A function of an entity that performs assurance and consulting activities **designed to evaluate and improve** the effectiveness of the entity's governance processes, risk management and internal control processes.”

Scope and objectives

Operate in the following areas

Review of
systems

Examination of
financial and
operating info
(incl. detailed
testing of
transactions and
balances)

Review of the
economy,
efficiency and
effectiveness of
operations

Review of
compliance with
external and
internal
requirements
(e.g. laws and
management
policies)

Special
investigations

Of direct interest to the auditor

May impact on external audit

Internal audit - the effect on external auditor's procedures

In determining the planned effect of the work of the internal auditors **on** the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

- The nature and scope of specific work performed by the internal auditors
- The assessed risks of material misstatement for particular classes of transactions, account balances and disclosures
- The degree of subjectivity involved in the evaluation of the audit evidence obtained by the internal auditors in support of the relevant assertions.

Specific work

To determine the efficiency of specific work performed by the internal auditors **for** the external auditor's purposes, the external auditor shall evaluate whether:

- The work was properly supervised, reviewed and documented
- Sufficient appropriate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions
- Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed.

The external auditor performs procedures on the work of internal audit to determine its efficiency. The audit procedures may include:

- Making enquiries of appropriate individuals within the internal audit function
- Observing procedures performed by internal audit
- Reviewing work programs and working papers.

ISA 610 requires some reperformance of the work of internal audit by the external auditor as part of evaluating the adequacy of the work performed.

Internal audit - the effect on external auditor's procedures

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When the external auditor uses specific work of the internal auditors, the external auditor shall document the evaluation the internal audit function's *objectivity, competence* and whether the function uses an appropriate approach to its work, including *quality control*. The nature and extent of the work used, and the audit procedures performed to evaluate the adequacy of the work used should also be documented.

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal auditors.

Internal auditors - direct assistance

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Definition

“Direct assistance - the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.”

The **direction, supervision and review performed by the external auditor** distinguishes ***direct assistance*** from just the *use of the work of the internal audit function*, which is not subject to direction from the external auditor.

In determining the nature and extent of direct assistance that internal auditors can provide to external auditors the following matters should be considered:

1. The amount of judgment involved in the work
2. The assessed risk of material misstatement; and
3. The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors.

The external auditor shall **not use internal auditors to provide direct assistance to perform procedures that:**

1. Involve making significant judgments in the audit
2. Relate to higher assessed risks of material misstatement where the judgment required evaluating the audit evidence obtained.
3. Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
4. Relate to decisions the external auditor makes in accordance with this ISA regarding the internal audit function and the use of its work or direct assistance.

It should be noted that in some jurisdictions, national regulations **prohibit** direct assistance being given by internal auditors to external auditors.