

**STATEMENT 3.281**  
**AUDITING GUIDELINE**  
**RELIANCE ON INTERNAL AUDIT**

**Introduction**

1. This guideline gives guidance on the matters that need to be considered and the procedures that need to be followed by external auditors when placing reliance on internal audit. It should be read in conjunction with Statement 3.101 "Audit approach", its related Auditing Guidelines, particularly Statement 3.240 "Internal controls", the Explanatory Foreword to the Auditing Standards and Guidelines.
2. In certain circumstances, the external auditor may have a responsibility to report on the internal audit function. Guidance is not given in respect of such a report, but many of the principles and procedures described in this guideline will also apply in those circumstances. References in this guideline to "management" are to the board of directors in the commercial sector.
3. Internal audit is an element of the internal control system set up by the management of a company to examine, evaluate and report on accounting and other controls on operations. It exists either because of a management decision or in certain circumstances because of a statutory requirement.
4. Certain of the objectives of internal audit may be similar to those of external audit, and procedures similar to those carried out during an external audit may be followed. Accordingly, the external auditor should make an assessment of the internal audit function in order to be able to determine whether or not he wishes to place reliance on internal audit as a means of reducing the work he performs himself in:
  - (a) the documentation and evaluation of accounting systems and internal controls;
  - (b) compliance and substantive testing.
5. The scope of internal audit's work will generally be determined in advance and a programme of work will be prepared. Where reliance is placed on the work of internal audit, the external auditor will need to take into account this programme of work and amend the planned extent of his own audit work accordingly. In addition, the external auditor may agree with management that internal audit may render him direct assistance by performing certain of the procedures necessary to accomplish the objectives of the external audit but under the control of the chief internal auditor.

6. This guideline does not deal with those cases where internal audit staff are seconded to work under the direct supervision and control of the external auditor. This is because the guideline addresses reliance on internal audit as a function, rather than reliance on individuals within that function. The work of seconded internal audit staff should be controlled by the external auditor in accordance with Statement 3.210 "Planning, controlling and recording", having regard to the position of internal audit staff as employees of the company.

### **Background**

#### *The internal audit function*

7. The scope and objectives of internal audit vary widely and are dependent upon the responsibilities assigned to it by management, the size and structure of the company and the skills and experience of the internal auditors. Normally, however, internal audit operates in one or more of the following broad areas:
  - (a) review of accounting systems and related internal controls;
  - (b) examination of financial and operating information for management, including detailed testing of transactions and balances;
  - (c) review of the economy, efficiency and effectiveness of operations and of the functioning of nonfinancial controls;
  - (d) review of the implementation of corporate policies, plans and procedures;
  - (e) special investigations.
8. Where internal audit staff carry out routine tasks such as authorisation and approval or day-to-day arithmetical and accounting controls, they are not functioning as internal auditors and these tasks are not dealt with in this guideline; this is because these tasks are recognised as other types of internal controls by the Appendix to Statement 3.240 "Internal controls". Moreover, objectivity may be impaired when internal auditors audit any activity which they themselves carried out or over which they had authority. The possibility of impairment should be considered when deciding whether to place reliance on internal audit.

*The relationship between external and internal audit*

9. Unlike the internal auditor who is an employee of the company or a related company, the external auditor is required to be independent of the company, usually having a statutory responsibility to report on the financial statements giving an account of management's stewardship.
10. Although the extent of the work of the external auditor may be reduced by placing reliance on the work of internal audit, the responsibility to report is that of the external auditor alone, and therefore is indivisible and is not reduced by this reliance.
11. As a result, all final judgements relating to matters which are material to the financial statements or other aspects on which he is reporting, must be made by the external auditor.

**Procedures**

*Planning*

12. Before any decision is taken to place reliance on internal audit, it is necessary for the external auditor to make an assessment of the likely effectiveness and the relevance of the internal audit function. The criteria for making this assessment should include the following:
  - (a) The degree of independence.

The external auditor should evaluate the organisation status and reporting responsibilities of the internal auditor and consider any constraints or restrictions placed upon him. Although an internal auditor is an employee of the company and cannot therefore be independent of it, he should be able to plan and carry out his work as he wishes and have access to the highest level of management. He would also be free of any responsibility which may create a conflict of interest when he attempts to discharge his internal audit function, or of a situation where middle management on whom he is reporting is responsible for his or his staff's appointment, promotion or remuneration. Furthermore, an internal auditor should be free to communicate fully with the external auditor, who should be able to receive copies of all internal audit reports that he requires.

- (b) The scope and objectives of the internal audit function.

The external auditor should examine the internal auditor's formal terms of reference and should ascertain the scope and objectives of internal audit assignments. In most circumstances, the external auditor will regard assignments as likely to be relevant where they are carried out in the areas described in paragraph 7(a) and (b) above. He will also be interested in internal audit's role in respect of specialist areas and those described in paragraphs 7(c), (d) and (e) above, when it has an important bearing on the reliability of the financial statements or other matters being reported on.

- (c) Due professional care.

The external auditor should consider whether the work of internal audit generally appears to be properly planned, controlled, recorded and reviewed. Examples of the exercise of due professional care by internal audit are the existence of an adequate audit manual, general internal audit plans, procedures for supervising individual assignments, and satisfactory arrangements for ensuring adequate quality control, reporting and follow-up.

- (d) Technical competence.

The external auditor should ascertain whether the work of internal audit is performed by persons having adequate training and proficiency as auditors. Indications of technical competence may be membership of an appropriate professional body or the possession of relevant practical experience, such as computer auditing skills.

- (e) Internal audit reports.

The external auditor should consider the quality of reports issued by internal audit and ascertain whether management considers, responds to and, where appropriate, acts upon internal audit reports, and whether this is evidenced.

- (f) Level of resources available.

The external auditor should consider whether internal audit has adequate resources, e.g. in terms of staff and of computer facilities.

13. The external auditor's assessment of the likely effectiveness and the relevance of the internal audit function will influence his judgement as to whether he wishes to place reliance on internal audit. Consequently, the external auditor should document his assessment and conclusions in this respect, and he should update his assessment year by year. Where the external auditor concludes that the internal audit department is weak or ineffective, then it should not be relied upon. Furthermore, the external auditor should inform management in writing of the significant weaknesses in the internal audit function, his reasons for not placing reliance on their work and his recommendations for improvement.
14. Where the external auditor decides that he may be able to place reliance on internal audit, he should consider in determining the extent of that reliance:
  - (a) the materiality of the areas or the items to be tested or of the information to be obtained;
  - (b) the level of audit risk inherent in the areas or items to be tested or in the information to be obtained;
  - (c) the level of judgement required;
  - (d) the sufficiency of complementary audit evidence; and
  - (e) specialist skills possessed by internal audit staff.
15. The external auditor should be involved in the audit of all material matters in the financial statements particularly in those areas where there is a significant risk of error or misstatement. High audit risk does not preclude placing some reliance on internal audit, but the external auditor should ensure that the extent of his involvement is sufficient to enable him to form his own conclusions.
16. Having decided that he may be able to place reliance on the work of internal audit, the external auditor should agree with the chief internal auditor the timing of internal audit work, test levels, sample selection and the form of documentation to be used.
17. The external auditor should record in his working papers the extent to which he intends to place reliance on internal audit, and the reasons for deciding that extent. Furthermore, the external auditor should consider confirming with management the overall arrangements that have been agreed, either in the engagement letter or in a separate letter.

*Controlling*

18. Where the external auditor places reliance on the work of internal audit, he should review that work and satisfy himself that it is being properly controlled. In this connection, the external auditor should:
- (a) consider whether the work has been appropriately staffed and properly planned, supervised and reviewed;
  - (b) compare the results of the work with those of the external auditor's staff on similar audit areas or items, if any;
  - (c) satisfy himself that any exceptions or unusual matters that have come to light as a result of the work have been properly resolved;
  - (d) examine reports relating to the work produced by internal audit and management's response to those reports.

In addition, the external auditor should determine whether internal audit will be able to complete, on a timely basis, the programme that it has agreed to undertake and, if it will not, he should make appropriate alternative arrangements.

19. At the conclusion of the audit, the external auditor should review the economy, efficiency and effectiveness of the basis of working and discuss with the chief internal auditor the significant findings and any means of improving the approach.

*Recording*

20. The external auditor will need to ensure that all work relating to his audit, whether performed by internal audit or the external auditor, is properly recorded. He should satisfy himself that the working papers relating to the work of internal audit upon which he is placing reliance are up to an acceptable standard. Consideration should be given to the method of recording so that relevant working papers are available and are of use to both the external auditor and internal audit.

*Audit evidence*

21. Where the external auditor places reliance on internal audit, whether by means of direct assistance or otherwise, he should satisfy himself that sufficient evidence is obtained to afford a reasonable basis for the conclusions reached by internal audit, and that those conclusions are appropriate to the circumstances and are consistent with the

results of the work performed. This may involve him in performing supplementary procedures. The extent of these procedures will depend on his assessment of the internal audit function, the materiality of the area or item to be tested and the risk of error or misstatement in the financial statements (see paragraph 15). The procedures may include re-examining transactions or balances that internal audit have tested, examining similar transactions or balances, or the performance of analytical review procedures, as well as discussing with internal audit the work they have performed.

*Internal controls*

22. Where the work of internal audit reveals weaknesses in internal controls, the external auditor should consider whether it is enough to draw management's attention to a report from internal audit or whether he should also report to management himself, particularly where he considers management response to internal audit reports is inadequate or where the weaknesses are significant. The external auditor should consider whether his own programme should be amended because of those weaknesses.