Using Internal Auditors’ Work Requires Extra Steps

Executive Summary

The Auditing Standards Board (ASB) recently proposed a Statement on Auditing Standards (SAS) that would streamline and condense the criteria for using internal auditors in external audits. It also defines the conditions external auditors must consider to use the work of the internal audit function—including the new requirement to assess the internal audit function’s application of a systematic and disciplined approach, including quality control. The proposed SAS addresses the external auditor’s responsibilities when, based on the external auditor’s understanding of the internal audit function, the auditor expects to use the work of the internal audit function as part of the audit evidence obtained or to provide direct assistance.

The intent of the proposed standard is to prevent undue or overuse of the work of the internal auditors when modifying the nature or timing, or reducing the extent of audit procedures to be performed directly by the external auditor. The proposed SAS provides guidance to determine whether the work of the internal audit function is adequate for purposes of the audit and, if so, in which areas and to what extent. If using internal auditors to provide direct assistance, the SAS requires external auditors to appropriately direct, supervise and review their work.

The clarified SAS would be effective for audits of financial statements for periods ending on or after December 15, 2014.

Background, Scope & Overview

The proposed standard continues to allow external auditors to use internal audit work in partial substitution for audit evidence obtained directly by the external auditor, or to provide direct assistance under the direction, supervision and review of the external auditor when certain criteria are met. SAS No. 122, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, (primarily AU-C sec. 315), would be performed hand-in-hand with the proposed standard—meaning before external auditors perform an assessment of whether a client’s internal audit work should be considered for use, external audit first performs procedures to obtain an understanding of the entity’s internal control, which generally includes considering the existence of an internal audit function and its governance role in the organization.

The external auditors primarily will perform procedures to evaluate the internal audit department relevant to activities that provide evidence about the design and effectiveness of controls. These procedures pertain to the entity’s ability to record, process and report reliable financial data and provide direct evidence about potential misstatements of such data.

External auditors consider many factors when determining the nature, extent and scope of auditing procedures (in an audit performed in accordance with generally accepted auditing standards (GAAS) or Public Company Accounting Standards Board (PCAOB)). Understanding of the internal control system is just one of those factors. Another is external audit’s consideration of the use of the work of the internal audit function. Auditors consider using the work of the internal audit function for the positive effect that use can have on the nature, extent and timing of the audit.
In addition to performing procedures to understand the entity’s internal control, external auditors assess the risk of material misstatement at both the financial statement level and the account balance (or class-of-transaction) level and perform substantive procedures. External audit can consider internal audit’s work in all three areas. For example, internal audit’s tests of controls over accounts payable (risk assessment work at the account balance level) and confirmation of balances over accounts receivable or inventory (substantive work verifying an account balance), if used by external audit, may change the nature, timing and extent of testing the auditor would otherwise consider necessary.

The objectives of an internal audit function typically include assurance and consulting activities relating to the entity’s governance, risk management and internal control processes. In many cases, these internal audit functions overlap activities the external auditor performs as part of its audit engagement, such as understanding the means the entity uses to identify, recognize, measure, classify and report financial information and performing detailed testing of account balances. In addition, internal auditors may perform detailed testing of transactions and procedures—similar to testing performed by external auditors—to evaluate internal control and overall risk management, including the risk of material misstatement due to error or fraud. External audit’s consideration of the use of internal audit department’s work is, therefore, a viable option for many audits.

The external auditor’s extent of use of internal audit work in obtaining audit evidence, however, comes with significant judgment, including the degree of risk and subjectivity associated with the assertions related to the account balances, significant classes of transactions and disclosures. The internal audit function also must meet objectivity, competence and quality criteria demonstrated by use of a systematic and disciplined approach.

If, after performing procedures to evaluate the internal audit department, the external auditor determines either (a) the internal auditor’s work is not relevant to the financial statement audit or (b) based on this preliminary understanding, the external auditor does not expect to use the work of the internal audit function, the proposed statement would not apply. The ASB does not require the external auditor to use the work of the internal audit function.

**Summary of the Proposed Standard**

The practice of external audit departments using the work of internal audit departments is long-standing. Under the proposed standard, external auditors continue to have the option to evaluate the adequacy of the work used by the internal audit department and modify the nature, extent or timing of its procedures if the work is used.

If the external auditor decides it would be efficient to consider how the internal auditors’ work might affect the nature, timing and extent of its audit procedures, the auditor is required under the proposal to first assess the competence and objectivity of the internal audit function based on its intended use of the internal audit function’s work, including direct assistance. New under the proposal, external auditors considering use of the work of an entity’s internal audit function also are required to evaluate whether the internal audit function is applying a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities, including quality control. The objective of the increased requirement is to obtain sufficient appropriate evidence that the work of the internal audit function is adequate for the purposes of the audit, as well as to prevent undue use of work of the internal audit function. The evaluation criteria are explicit but require judgment. Their objective is to ensure quality related to using internal auditors to obtain audit evidence or in a direct assistance capacity.
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The external auditors would consider using the work of internal audit if this use would be efficient, and its use would not negatively affect the quality of the audit considering the competency and objectivity of individuals planning, preparing and reviewing the audit work, including members of internal audit providing direct assistance.

External Audit’s Evaluation of the Internal Audit Function

External audit will evaluate the internal audit function using criteria as depicted in Exhibit 1, assessing the internal audit function’s objectivity, level of competence and application by the internal audit function of a systematic and disciplined approach, including quality control. The criteria is subjective, and external auditors will use their professional judgment to determine whether the work of the internal audit function or its auditors can be used for purposes of the audit, as well as the nature and extent to which the work can be used. External auditors perform the evaluation to ensure the work of the internal audit department would not detract from overall external audit quality. In other words, external audit avoids inappropriate use of internal audit-like work performed in an informal, unstructured or ad hoc manner.

The nature, extent and timing of external audit’s evaluation of the internal audit function will vary by entity based on the internal audit function’s size and complexity and the external auditor’s intended use. External audit should not use the work of the internal audit function if it determines the function lacks sufficient competence, the function’s objectivity is not adequately supported by the organization or the function does not apply a systematic and disciplined approach, including quality control.

Objectivity and Competence

In fulfilling the external auditor’s responsibility to perform an audit, it maintains independence from the entity. Along the same lines, the Institute of Internal Auditors’ (IIA) Standards for the Professional Practice of Internal Auditing requires internal auditors to be independent of the activities they audit. The internal audit function, however, is not independent of the entity. Because of the independence disparity between internal and external audit, external auditors, before using the work of internal audit, evaluate the internal audit function’s objectivity and the objectivity of the individual internal auditors providing direct assistance.

In performing this evaluation, external auditors may consider whether the internal auditors are members of relevant professional bodies whose memberships obligate their compliance with relevant professional standards relating to objectivity and competence, including professional development requirements.

An internal audit function or internal auditor’s lack of objectivity cannot compensate for the lack of competence, and vice versa.

Systematic and Disciplined Approach

External auditors will look for the application of a systematic and disciplined approach of the internal audit department—from the planning stage to performing, supervising and reviewing its activities—and will want to see adequate documentation supporting each stage and evidence of compliance through practical use.

Documentation requests may include policies, procedures and guidance covering such areas as risk assessments, work programs, documentation and reporting. External audit will determine the adequacy of the evidence based on the nature and size of the internal audit department relative to the complexity of the entity.
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The requirement to evaluate and determine whether the internal audit function applies a systematic and disciplined approach, based on exposure draft literature, addresses the risk that the auditor inappropriately uses internal audit-like work performed in an informal, unstructured or ad hoc manner.

The external auditor will also review documented quality control policies, procedures and guidance for adequacy. Adequate policies would cover, for example, such areas as internal audit function leadership, human resources, engagement performance and quality control requirements. The external auditor may determine the adequacy of engagement performance and quality control requirements, in particular, by considering the standards set by relevant professional bodies for internal auditors (e.g., IIA periodic external quality assessment standards).

In general, the more formal and structured the internal audit function’s approach, the higher the likelihood the internal audit function is applying a systematic and disciplined approach, including quality control.

**EXHIBIT 1**

<table>
<thead>
<tr>
<th>Definitions and Factors to Consider</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objective</strong></td>
</tr>
<tr>
<td>Factors that may affect internal auditor’s objectivity include whether the internal audit function’s organizational status, including its authority and accountability, supports objectivity and prohibits constraints or restrictions placed on the internal audit function (e.g., the internal audit function reports to those charged with governance or an officer with appropriate authority to ensure broad audit coverage and adequate consideration of, and action on, audit findings).</td>
</tr>
<tr>
<td><strong>Competence</strong></td>
</tr>
<tr>
<td>Factors that may affect the internal audit function’s competence include:</td>
</tr>
<tr>
<td>✓ Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations</td>
</tr>
<tr>
<td>✓ Whether the internal auditors have adequate technical training and proficiency in auditing—e.g., relevant professional designations, experience and knowledge of the entity’s specific industry</td>
</tr>
<tr>
<td>✓ Whether the internal auditors possess knowledge of the entity’s financial reporting and the applicable financial reporting framework, including industry-specific factors, to perform work related the entity’s financial statements</td>
</tr>
</tbody>
</table>
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| Systematic and disciplined approach | The internal audit functions are adequate, demonstrated by applying a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities, including quality control.
Factors that may affect internal audit’s application of a systematic and disciplined approach, including quality control, include:

- Whether documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting exist, are adequate and in use
- Whether appropriate quality control policies and procedures exist, are adequate and in use—quality control policies, for example, relate to internal audit function leadership and engagement performance in standards set by relevant professional bodies for internal auditors, such as the requirements for periodic external quality assessments

External auditors evaluate the appropriateness of the internal audit’s objectivity and competency on an ongoing basis. As such, external auditor’s assessment of whether it should use the work of the internal audit function may change throughout the audit. The external auditor may gain additional insight, for example, into whether the entity’s organizational structure and relevant policies and procedures adequately support the internal auditor’s objectivity. The external auditor may learn the internal auditor’s level of competence is not as planned. The external auditor’s evaluation may even indicate the risks to the quality of the work of the function are too significant and, therefore, it is not appropriate to use any of the work of the function as audit evidence.

Direct Assistance Versus Use of Audit Evidence

After evaluation of the internal audit function, external audit determines the planned level and type of use of the internal audit function’s work. In general, the more judgment involved in the audit area, the higher the risk of material misstatement and the more persuasive the audit evidence required by the external auditor will need to be. In other words, the more work the external auditor will need to perform directly, the less it will use the internal audit function either in providing direct assistance or use of its audit evidence.

Direct Assistance

Direct assistance relates to work the auditor specifically requests of the internal auditors to complete some aspect of the auditor’s work—under the direction, supervision and review of the external auditor. Direct assistance may include, for example, assisting the external auditors in obtaining an understanding of internal control or in performing tests of controls or account balances. When the internal audit function provides direct assistance, external auditors must supervise, review, evaluate and test the work as they deem appropriate.

The external auditor should not use an internal auditor to provide direct assistance if the internal auditor lacks the necessary competence to perform the proposed work, or if significant threats to the objectivity of the internal auditor exist where the external auditor determines the internal auditor lacks the necessary objectivity to perform the proposed work.

Use of Audit Evidence

External auditors should perform sufficient audit procedures on the body of work external audit plans to use. External audit determines the extent of testing necessary using judgment considering the nature and scope of the work that has been performed, or is planned to be performed, and its relevance and planned effect on the overall audit strategy and audit plan. External auditors will therefore focus on areas where the internal audit function exercised more judgment in planning, performing and evaluating the results of the audit procedures, and in areas of higher risk of material misstatement.
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When evaluating the adequacy and quality of the work performed and the conclusions reached by the internal audit function, external audit will perform testing such as inquiry and observation of procedures performed by internal auditors and inspection of the internal audit function’s work program, working papers and reports. External auditors are required to re-perform certain procedures to validate conclusions reached by the internal audit function.

External audit performs these procedures to assess whether the work of the internal audit function was properly planned, performed, supervised, reviewed and documented. From this testing, external audit will make a determination whether (a) sufficient appropriate evidence was obtained to enable the internal audit function to draw reasonable conclusions, (b) conclusions reached are appropriate in the circumstances, and (c) the reports prepared are consistent with the results of the work performed.

EXHIBIT 1

<table>
<thead>
<tr>
<th>External Auditor’s Procedures</th>
<th>Use the work of internal audit to provide direct assistance to the external auditor</th>
<th>Use the work of internal audit in obtaining audit evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Evaluate competence of the internal audit function</td>
<td>Yes a</td>
<td>Yes b</td>
</tr>
<tr>
<td>Evaluate objectivity of the internal audit function</td>
<td>Yes a</td>
<td>Yes b</td>
</tr>
<tr>
<td>Evaluate internal audit function’s application of a systematic and disciplined approach</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Direct, supervise and review work performed by internal auditors, including testing some of internal audit’s work</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Read reports relating to work the external auditor plans to use to obtain audit evidence</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Perform audit procedures on the work the external audit plans to use, including re-performance of some of the work</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

(a) An internal auditor should not be used to provide direct assistance if the internal auditor lacks the necessary competence to perform the proposed work, or significant threats to the objectivity of the internal auditor exist and the internal auditor lacks the necessary objectivity to perform the work.

(b) The nature and extent of internal auditor’s work used by external audit is based on the judgment of the external auditor considering the audit function’s level of competence and objectivity, as well as the external auditor’s evaluation of the amount of judgment involved and the assessed risk of material misstatement related to the work.
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**Will Your Internal Audit Function Be Used?**

When the internal audit function lacks sufficient competence, the function’s organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors, or the function does not apply a systematic and disciplined approach, including quality control, the external auditor should not use its work in either a direct capacity or to obtain audit evidence. Requiring more external auditor judgment are those situations where the internal audit function’s objectivity or competence is somewhat threatened or lacking, or the function lacks evidence of a consistently applied systematic and disciplined approach, including quality control. In these circumstances, the external auditor should carefully evaluate its use of the internal audit function’s work.

In general, the less the internal audit function’s organizational status and relevant policies and procedures support the objectivity of the internal auditors, and the lower the level of competence of the function, the less external auditors will plan to use the work of the internal audit function, and the more work they will plan to perform directly. Entity factors play a role as well. In circumstances when more judgment is involved in planning, performing and evaluating relevant audit procedures and evidence gathered, or the assessed risk of material misstatement (at the assertion level) is high, external audit generally would plan to obtain more of the audit evidence itself.

The more the materiality of the accounts involved or the significance of the risks, or the amount of auditor judgment necessary to do the work increases, the greater the need for the auditor to perform the work directly.

Internal auditors may be prepared for external auditors to use their work or provide direct assistance, but certain limitations do apply. Even with the best intentions, the proposed SAS is clear: As the materiality of the accounts involved or the significance of the risks or the amount of auditor judgment necessary to do the work increases, so does the need for the external auditor to perform the work directly. In addition, external auditors are required to adhere to laws and regulations of audits of U.S. public filers regarding using the work of the internal audit function or using internal auditors to provide direct assistance.

Where the external auditor is considering whether to use the work of the internal audit function, internal audit can ensure work is coordinated as early as possible, preferably before the internal audit function performs the work. Although a standard for external auditors, internal audit also should become versed in the proposed standard and its criteria for competency and objectivity of the internal audit function and its internal auditors, as well as evidence required to support the function’s performance of a systematic and disciplined approach, including quality control. In addition, internal audit should ensure it discusses planned use of the work of the internal audit function with the entity’s governing body, including the planned scope and timing.

Regardless of the proposed standard’s applicability to your entity, internal audit can assist external auditors in coordinating periodic meetings throughout the year, scheduling audit work and providing access to the internal audit function’s working papers and audit reports. Internal auditors can assist in avoiding delays and scheduling conflicts by bringing matters that may affect the work of the external auditor—such as significant possible accounting and auditing matters—to the external auditor’s attention. This helps the external auditors identify and assess the risks of material misstatement, including actual, suspected or alleged fraud, and adjust their audit plan accordingly in a timely manner.

**Conclusion**

The proposed statement is considered by some constituents a guide to assessing the quality of an entity’s internal audit function and is considered a must-read for internal audit functions and those in charge of an entity’s governance—regardless of whether external audit plans to use the work of the internal audit function.
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When the proposed criteria are met, however, internal auditors' work can have a direct, positive affect on the nature, timing and extent of the work performed by external audit. This includes coordinating with external audit procedures performed to obtain an understanding of the entity’s internal control, evaluating the adequacy and quality of the internal audit function’s work, procedures performed when assessing risk at both the financial-statement and account balance level, and other audit procedures, e.g., reviewing documentation to support a balance sheet account balance.

The title of the internal audit function, or whether it is performed by the entity or a third-party service provider, are not sole determinants of whether the external auditor can use the work of internal auditors. Rather, it is the external auditor's evaluation of whether the internal audit function is objective and competent relative to the activity being audited and uses a system and disciplined approach.

Internal auditors are increasingly expected to serve as strategic advisors to company stakeholders while still serving the traditional role as compliance specialists. They provide analyses and evaluations as well as assurances and recommendations. As a member of the external audit advisement or project management team, internal auditors can begin analyzing the proposed requirements and the integral role they can play in assisting the external auditors in a constructive and complementary manner. Refer to BKD’s article on the COSO framework to learn more about internal audit’s role in an entity’s internal control system.

For more information on the proposed auditing standard, contact your BKD advisor.

Contact Us

If you have questions or need additional guidance about the effects of these new proposed regulations, contact your BKD advisor. You also may contact one of these BKD professionals for more information:

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