

SA 610 (AAS 7)

RELYING UPON THE WORK OF AN INTERNAL AUDITOR

*(Effective for all audits relating to
accounting periods beginning on or after April 1, 1989)*

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Standard on Auditing (SA) 610*, "Relying upon the Work of an Internal Auditor" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"¹, which sets out the authority of SAs. This Standard on Auditing supersedes the Guidance Note on Co-ordination between the Internal Auditor and Statutory Auditors, issued by the Institute in 1979.

* Issued in January, 1989.

¹ Published in the July 2007 issue of the Journal.

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Introduction

1. Standard on Auditing (SA) 400^{**}, "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit", states (paragraph 8):

"Internal Control System means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated."

2. The purpose of this Standard is to provide guidance as to the procedures which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work.

3. With the introduction of the Manufacturing and Other Companies (Auditor's Report) Order, 1988^{***}, internal audit function has acquired special significance as the statutory auditor is required to state, in relation to a company having a paid-up capital exceeding Rs. 25 lakhs or having an average annual turnover exceeding Rs. 2 crore for a period of three consecutive financial years immediately preceding the financial year concerned to which the Order applies, whether the internal audit system is commensurate with the size and nature of its business.²

4. In this Standard, "financial information" encompasses financial statements.

^{**} Paragraph 6 of SA 400, "Risk Assessments and Internal Controls" is the paragraph corresponding to paragraph 8 of the erstwhile Standard, "Study and Evaluation of the Accounting System and Related Internal Controls in connection with an Audit", issued in May, 1988.

^{***} The Order has been replaced by the Companies (Auditor's) Report Order, 2003, issued by the Department of Company Affairs in June, 2003 under section 227(4A) of the Companies Act, 1956.

² Readers' attention is also drawn to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India, for a study of various factors to be considered by the auditor in evaluating the adequacy of the internal audit system for the purposes of reporting under the Order.

Relying Upon the Work of an Internal Auditor

5. While the external auditor has sole responsibility for his report and for the determination of the nature, timing and extent of the auditing procedures, much of the work of the internal audit function may be useful to him in his examination of the financial information.

Scope and Objectives of the Internal Audit Function

6. The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its management.

Normally, however, internal audit operates in one or more of the following areas:

- (a) Review of accounting system and related internal controls: The establishment of an adequate accounting system and the related controls is the responsibility of management which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.
- (b) Examination for management of financial and operating information: This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
- (c) Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation: Generally, the external auditor is interested in the results of such audit work only when it has an important bearing on the reliability of the financial records.
- (d) Physical examination and verification: This would generally include examination and verification of physical existence and condition of the tangible assets of the entity.

Relationship between Internal and External Auditors

7. The role of the internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor

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who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and, thus, much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures.

8. The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

9. By its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. The report of the external auditor is his sole responsibility, and that responsibility is not by any means reduced because of the reliance he places on the internal auditor's work.

General Evaluation of Internal Audit Function

10. The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

- (a) **Organisational Status:** Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, he reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.
- (b) **Scope of Function:** The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

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- (c) **Technical Competence:** The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
- (d) **Due Professional Care:** The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes, and working papers.

Coordination

11. Having decided in principle that he intends to rely upon the work of the internal auditor, it is desirable that the external auditor ascertains the internal auditor's tentative plan for the year and discusses it with him at as early a stage as possible to determine areas where he considers that he could rely upon the internal auditor's work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed, and review and reporting procedures.

12. Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work.

Evaluating Specific Internal Audit Work

13. Where, following the general evaluation described in paragraph 10, the external auditor intends to rely upon specific internal audit work as a basis for modifying the nature, timing and extent of his procedures, he should review the internal auditor's work, taking into account the following factors:

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- (a) The scope of work and related audit programmes are adequate for the external auditor's purpose.
- (b) The work was properly planned and the work of assistants was properly supervised, reviewed, and documented.
- (c) Sufficient appropriate evidence was obtained to afford a reasonable basis for the conclusions reached.
- (d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.
- (e) Any exceptions or unusual matters disclosed by the internal auditor's procedures have been properly resolved.

The external auditor should document his conclusions in respect of the specific work which he has reviewed.

14. The external auditor should also test the work of the internal auditor on which he intends to rely. The nature, timing and extent of the external auditor's tests will depend upon his judgement as to the materiality of the area concerned to the financial statements taken as a whole and the results of his evaluation of the internal audit function and of the specific internal audit work. His tests may include examination of items already examined by the internal auditor, examination of other similar items, and observation of the internal auditor's procedures.

Effective Date

15. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1989.