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function in an audit of financial statements
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Exposure draft (American Institute of Certified
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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S CONSIDERATION OF THE INTERNAL AUDIT FUNCTION IN AN AUDIT OF FINANCIAL STATEMENTS

MARCH 12, 1990

**Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting**

**Comments should be received by June 15, 1990, and addressed to
Judith Sherinsky, Technical Manager, AICPA Auditing Standards Division, File 4560,
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036-8775**

Why Issued

The Auditing Standards Board is considering the issuance of this proposed Statement to provide practitioners with expanded guidance when considering work performed by internal auditors. Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or others with equivalent authority and responsibility. Many of these activities are relevant to the audit because they provide evidence about the design and effectiveness of internal control structure policies and procedures or direct evidence about misstatements of financial data contained in financial statements. This proposed Statement contains factors to assist auditors in considering the extent of the effect of internal auditors' work on the audit and incorporates concepts of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, and the new terminology and concepts of SAS Nos. 53 through 61, issued in April 1988, particularly SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*.

What It Does

This proposed Statement provides guidance to assist the auditor in—

- Obtaining an understanding of the internal audit function.
- Assessing the competence and objectivity of internal auditors.
- Considering the effect of the internal auditors' work on the auditor's understanding of the internal control structure, assessment of control risk, and design of substantive audit procedures.
- Evaluating the extent of the effect of the internal auditors' work.
- Coordinating the audit work with internal auditors.
- Evaluating and testing the quality and effectiveness of internal auditors' work.
- Requesting internal auditors to provide direct assistance to the auditor.

How It Affects Existing Standards

This proposed Statement would supersede SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*.

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
 - *Members of AICPA Council and technical committees.*
 - *State society and chapter presidents, directors, and committee chairmen.*
 - *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
 - *Persons who have requested copies.*
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March 12, 1990

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board, of a proposed statement on auditing standards titled The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements. This proposed statement on auditing standards provides guidance to the auditor in considering the work of internal auditors in an audit performed in accordance with generally accepted auditing standards. The proposed Statement, if adopted, would supersede SAS No. 9, The Effect of an Internal Audit Function on the Scope of the Independent Audit.

In conducting an audit in accordance with generally accepted auditing standards, the auditor considers many factors in determining the nature, timing, and extent of auditing procedures to be performed. One of those factors is the existence of an internal audit function. An internal audit function is frequently one of an entity's most important means of monitoring performance of other controls.

This proposed Statement expands the guidance in SAS No. 9 about the auditor's consideration of the work performed by internal auditors. For example, the proposed Statement notes that the auditor, when obtaining an understanding of the internal control structure as required by SAS No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit, should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. The proposed Statement also contains guidance to assist the auditor in obtaining that understanding.

The proposed Statement also contains guidance to assist the auditor in determining how the work of internal auditors affects the audit. Specifically, the proposed Statement describes how the work of internal auditors may affect the audit procedures the auditor performs in obtaining an understanding of the entity's internal control structure and assessing control risk as required by SAS No. 55. It also describes how the work of internal auditors may affect substantive procedures the auditor performs.

This proposed Statement provides new guidance to assist the auditor in evaluating the extent of the effect of internal auditors' work on the audit. For example, if the inherent risk of material misstatements for an assertion is high, the proposed Statement indicates that the combination of the auditor's assessment of control risk and the work performed by the internal auditors cannot alone reduce audit risk to an acceptable level. In those instances, the proposed Statement requires the auditor to perform sufficient procedures for those assertions.

Finally, like SAS No. 9, this proposed Statement contains guidance when the auditor requests direct assistance from the internal auditors in performing an audit.

The flowchart that follows this letter summarizes the auditor's consideration of the work performed by internal auditors as described in this proposed Statement.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The Auditing Standards Board's consideration of responses will be helped if the comments refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers the differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the Board would particularly appreciate comments on those matters.

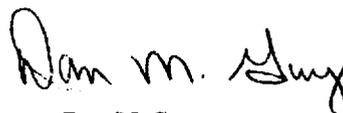
Written comments on the exposure draft will become part of the public record of the Auditing Standards Division and will be available for public inspection at the offices of the AICPA after July 15, 1990, for one year. Responses should be sent to the Auditing Standards Division, File 4560, in time to be received by June 15, 1990. For convenience in responding, a perforated response form is attached.

The Auditing Standards Board appreciates the assistance of the Institute of Internal Auditors with the development of this exposure draft.

Sincerely,

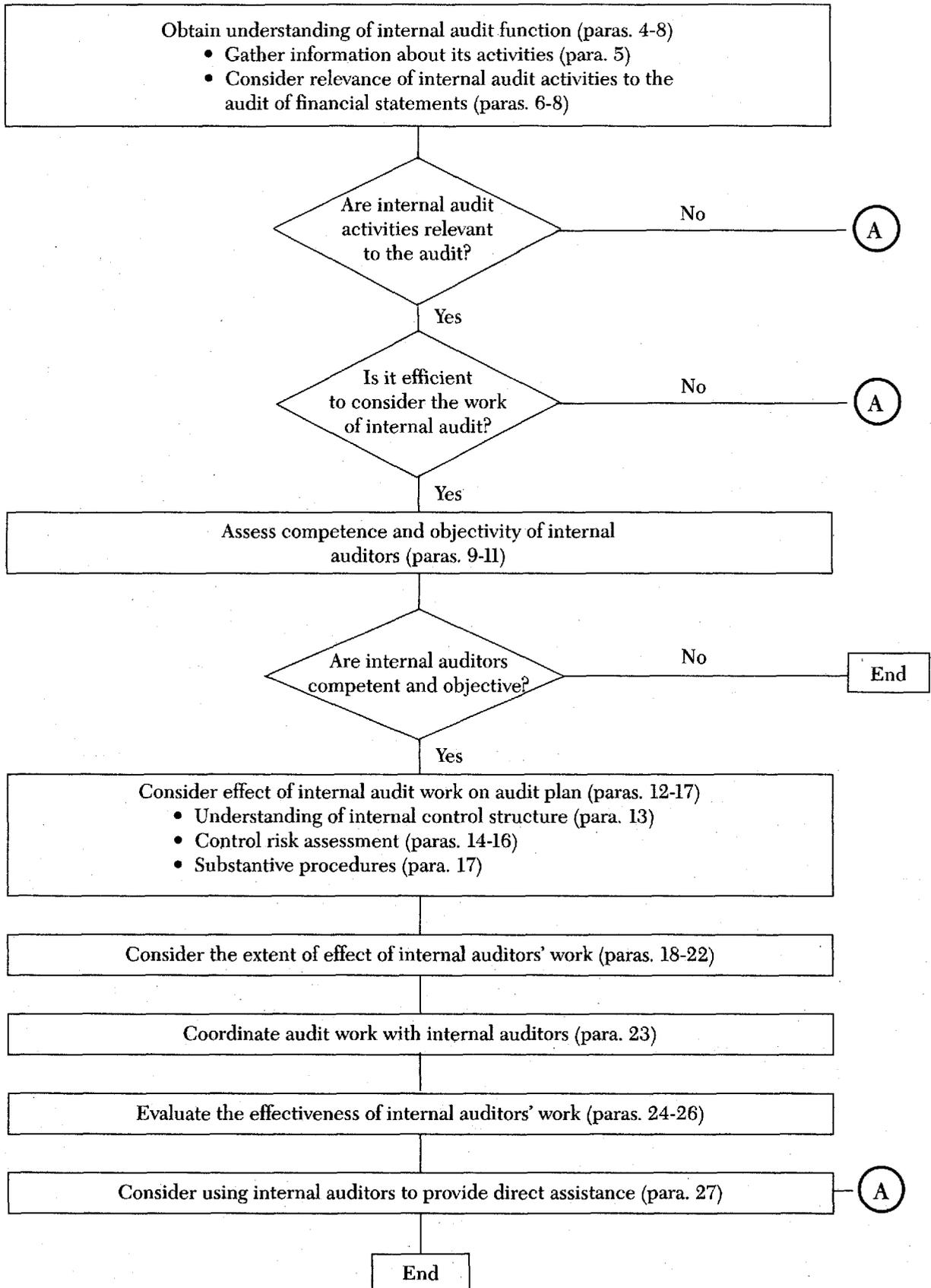


Donald L. Neebes
Chairman
Auditing Standards Board



Dan M. Guy
Vice President
Auditing

The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements



PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S CONSIDERATION OF THE INTERNAL AUDIT FUNCTION IN AN AUDIT OF FINANCIAL STATEMENTS

1. The auditor considers many factors in determining the nature, timing, and extent of auditing procedures to be performed in an audit of an entity's financial statements. One of those factors is the existence of an internal audit function.¹ This statement provides guidance to an auditor in considering the work of internal auditors in an audit performed in accordance with generally accepted auditing standards.

ROLES OF THE AUDITOR AND THE INTERNAL AUDITORS

2. One of the auditor's responsibilities in an audit in accordance with generally accepted auditing standards is to obtain sufficient competent evidential matter to provide a reasonable basis for the opinion on the entity's financial statements. In fulfilling this responsibility, the auditor maintains independence from the entity.

3. Internal auditors are responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and board of directors or others with equivalent authority and responsibility. To fulfill this responsibility, internal auditors, while not independent from the entity, maintain objectivity with respect to the activity being audited.

OBTAINING AN UNDERSTANDING OF THE INTERNAL AUDIT FUNCTION

4. The internal audit function is frequently one of an entity's most important means of monitoring the performance of other controls. When obtaining an understanding of the

internal control structure,² the auditor should obtain an understanding of the internal audit function sufficient to identify those internal audit activities that are relevant to planning the audit. The extent of procedures necessary to obtain this understanding will vary depending on the nature of those activities.

5. The auditor should ordinarily make inquiries of appropriate management and internal audit personnel about the internal auditors—

- Standing within the entity.
- Activities.
- Application of professional standards (see paragraph 11).
- Audit plan, including the nature, timing, and extent of audit work.
- Access to records and whether there are limitations on the scope of activities.

In addition, the auditor might inquire about the internal audit function's charter, mission statement, or similar directive from management or the board of directors. This inquiry will normally provide information about the goals and objectives established for the internal audit function.

6. Certain internal audit activities may not be relevant to an audit of the entity's financial statements. For example, the internal auditors' procedures to evaluate the efficiency of certain management decision-making processes are ordinarily not relevant to a financial statement audit.

7. Relevant activities are those that provide evidence about the design and effectiveness of internal control structure policies and procedures that pertain to the entity's ability to record, process, summarize, and report financial data consistent

with the assertions embodied in the financial statements or that provide direct evidence about misstatements of such data. The auditor may find the results of the following procedures helpful in assessing the relevancy of internal audit activities:

- Consider knowledge from prior-year audits.
- Review how the internal auditors allocate their audit resources to financial or operating areas in response to their risk assessment process.
- Read internal audit reports to obtain detailed information about the scope of internal audit activities.

8. If, after obtaining an understanding of the internal audit function, the auditor concludes that the internal auditors' activities are not relevant to the financial statement audit, the auditor does not have to give further consideration to the internal audit function, unless the auditor requests direct assistance from the internal auditors as described in paragraph 27. Even if some of the internal auditors' activities are relevant to the audit, the auditor may conclude that it would not be efficient to consider further the work of the internal auditors. If the auditor decides that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of audit procedures, the auditor should assess the competence and objectivity of the internal audit function in light of the intended effect of the internal auditors' work on the audit.

ASSESSING THE COMPETENCE AND OBJECTIVITY OF THE INTERNAL AUDITORS

Competence of the Internal Auditors

9. When assessing the internal auditors' competence, the auditor should obtain or update information from prior years about such factors as—

- Educational level and professional experience of internal auditors.

¹An internal audit function may consist of one or more individuals who perform internal auditing activities within an entity. This statement is not applicable to personnel with the title *internal auditor* who do not perform internal auditing activities as described in this statement.

²Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the procedures the auditor follows to obtain an understanding of the internal control structure and indicates that the internal audit function is part of the entity's control environment aspect of such structure.

- Professional certification and continuing education.
- Evaluation of internal auditors' performance.
- Practices regarding assignment of internal auditors.
- Audit policies, procedures, and checklists.
- Quality of working paper documentation.
- Supervision and review of internal auditors' activities.

Objectivity of the Internal Auditors

10. When assessing the internal auditors' objectivity, the auditor should obtain or update information from prior years about such factors as—

- The organizational status of the internal auditor responsible for the internal audit function, including—
 - Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.
 - Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee, or the owner-manager.
 - Whether the board of directors, the audit committee, or the owner-manager oversees employment decisions related to the internal auditor.
- Policies to maintain internal auditors' objectivity about the areas audited, including—
 - Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions.
 - Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the internal audit function.

Assessing Competence and Objectivity

11. In assessing competence and objectivity, the auditor usually considers information obtained from previous experience with the internal audit function, from discussions with management personnel, and from a recent external quality review, if performed, of the internal audit function's activities. The auditor may also use professional internal auditing standards³ as criteria in making the assessment. The auditor also considers the need to test the effectiveness of the factors described in paragraphs 9 and 10. The extent of such testing will vary in light of the intended effect of internal auditors' work on the audit.

EFFECT OF THE INTERNAL AUDITORS' WORK ON THE AUDIT

12. The internal auditors' work may affect the nature, timing, and extent of the audit, including—

- Procedures the auditor performs when obtaining an understanding of the entity's internal control structure (paragraph 13).
- Procedures the auditor performs when assessing control risk (paragraphs 14 through 16).
- Substantive procedures the auditor performs (paragraph 17).

When there is an effect on the audit, guidance found in paragraphs 18 through 26 should be followed for considering the extent of the effect, coordination, and evaluation of the effectiveness of internal auditors' work.

Understanding of the Internal Control Structure

13. The auditor obtains a sufficient understanding of the design of internal

³Standards have been developed for the professional practice of internal auditing by the Institute of Internal Auditors and the General Accounting Office. These standards are meant to (1) impart an understanding of the role and responsibilities of internal auditing to all levels of management, boards of directors, public bodies, external auditors, and related professional organizations; (2) permit measurement of internal auditing performance; and (3) improve the practice of internal auditing.

control structure policies and procedures to plan the audit and determine whether they have been placed in operation. Since a primary objective of many internal audit functions is to review, assess, and monitor internal control structure policies and procedures, the procedures performed by the internal auditors in this area may provide useful information for the auditor. For example, internal auditors may develop a flowchart of a new computerized sales and receivables system. The auditor may review the flowchart to obtain information about the design of the related policies and procedures. In addition, the auditor may consider the results of procedures performed by the internal auditors on related policies and procedures to obtain information about whether the policies and procedures have been placed in operation.⁴

Control Risk Assessment

14. The auditor assesses the risk of material misstatement at both the financial-statement level and the account-balance or class-of-transaction level.

15. *Financial-Statement Level.* At the financial-statement level, the auditor makes an overall assessment of the risk of material misstatement. When making this assessment, the auditor should recognize that certain internal control structure policies and procedures may have a pervasive effect on many financial statement assertions. The control environment and accounting system often have a pervasive effect on a number of account balances and transaction classes and therefore can affect many assertions. The auditor's assessment of risk at the financial-statement level often affects the overall audit strategy. The entity's internal audit function may influence this overall assessment of risk and the auditor's resulting decisions concerning the nature,

⁴Testing of internal auditors' work that affects the auditor's procedures performed to obtain an understanding of the internal control structure to plan the audit may not be necessary. If the auditor determines that testing is necessary, the guidance in paragraphs 24 through 26 should be followed.

timing, and extent of auditing procedures to be performed. For example, if the internal auditors' plan includes relevant audit work at various locations, the auditor may coordinate work with the internal auditors (see paragraph 23) and reduce the number of the entity's locations at which the auditor would otherwise need to perform auditing procedures.

16. *Account-Balance or Class-of-Transaction Level.* At the account-balance or class-of-transaction level, the auditor performs procedures to obtain and evaluate evidential matter concerning management's assertions. The auditor assesses control risk about each of the significant assertions and performs tests of controls to support assessments below the maximum. When planning and performing tests of controls, the auditor may consider the results of procedures performed or planned by the internal auditors. For example, the internal auditors' scope may include tests of controls for the completeness of accounts payable. The results of internal auditors' tests may provide appropriate information about the effectiveness of internal control structure policies and procedures for assertions and change the nature, timing, and extent of testing the auditor would otherwise need to perform.

Substantive Procedures

17. Some procedures performed by the internal auditors may provide direct evidence about material misstatements in assertions about specific account balances or classes of transactions. For example, the internal auditors, as part of their work, may confirm certain accounts receivable and observe certain physical inventories. The results of these procedures can provide evidence that the auditor may consider in restricting detection risk for the related assertions. Consequently, the auditor may be able to change the timing of the circularization procedures, the number of confirmations of accounts receivable, or the number of locations of physical inventories to be observed.

EXTENT OF THE EFFECT OF THE INTERNAL AUDITORS' WORK

18. Even though the internal auditors' work may affect the auditor's procedures, the auditor should perform sufficient procedures to obtain evidential matter to support the auditor's report. Evidence obtained through the auditor's direct personal knowledge, physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.⁵

19. The responsibility to report on the financial statements rests solely with the auditor. Unlike the situation in which the auditor uses work of other independent auditors,⁶ this responsibility cannot be shared with the internal auditors. Because the auditor has the ultimate responsibility to express an opinion on the financial statements, judgments about assessments of inherent and control risks, the materiality of misstatements, the sufficiency of tests performed, the evaluation of significant accounting estimates, and other matters affecting the auditor's opinion should always be those of the auditor. In making these judgments, the auditor considers the inherent risk of material misstatement of assertions at the account-balance or class-of-transaction level.

20. For assertions where inherent risk of material misstatement is low, the auditor may decide, after considering the circumstances and the results of work performed by the internal auditors on those particular assertions, that audit risk has been reduced to an acceptable level and that direct testing of the assertions by the auditor is not necessary. Examples of assertions that might have a low level of inherent risk include those related to the existence of prepaid assets, fixed-asset additions, and deposit accounts at banks.

21. In contrast, for assertions where inherent risk of material

⁵ See SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.19c).

⁶ See SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors").

misstatement is high, the auditor's assessment of control risk combined with the results of work performed by the internal auditors cannot alone reduce audit risk to an acceptable level. In these instances, the auditor should perform sufficient procedures on these assertions to fulfill the responsibilities as described in paragraphs 18 and 19. Examples of assertions that might have high levels of inherent risk include those regarding the valuation of assets and liabilities involving significant accounting estimates and the existence and disclosure of related party transactions, contingencies, uncertainties, and subsequent events.

22. The auditor should also consider the nature of the assertions being tested to determine the sufficiency of the auditor's procedures. For some assertions, such as existence and occurrence, the evaluation of audit evidence is generally very objective. More subjective evaluation of the audit evidence is often required for other assertions, such as the valuation and disclosure assertions. The greater the extent of subjective judgment involved in evaluating audit evidence, the greater the need for the auditor to directly obtain audit evidence for the related assertions.

COORDINATION OF THE AUDIT WORK WITH INTERNAL AUDITORS

23. If the work of internal auditors is expected to have an effect on the auditor's procedures, it may be efficient for the auditor and internal auditors to coordinate their work in such ways as the following:

- Holding periodic meetings
- Scheduling audit work
- Providing access to internal auditors' working papers
- Reviewing audit reports
- Discussing possible accounting and auditing issues

EVALUATING THE EFFECTIVENESS OF THE INTERNAL AUDITORS' WORK

24. The auditor should perform procedures to evaluate the quality

and effectiveness of the internal auditors' work that significantly affects the nature, timing, and extent of the auditor's procedures. The nature and extent of the procedures the auditor should perform when making this evaluation are a matter of judgment depending on inherent risk considerations and on the effect of internal auditors' work on the auditor's procedures for significant account balances or classes of transactions.

25. In developing the evaluation procedures, the auditor should consider such factors as whether internal auditors—

- Scope of work is appropriate to meet the objectives.
- Audit programs are adequate.
- Working papers adequately document work performed, including evidence of supervision and review.
- Conclusions are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

26. In making the evaluation, the auditor should test some of the

internal auditors' work related to the significant financial statement assertions. These tests may be accomplished by either (a) examining some of the controls, transactions, or balances that the internal auditors examined or (b) examining similar controls, transactions, or balances not actually examined by the internal auditors. The auditor should compare the results of his or her tests with the results of the internal auditors' work in reaching conclusions about their work.

USING INTERNAL AUDITORS TO PROVIDE DIRECT ASSISTANCE TO THE AUDITOR

27. The auditor may request direct assistance from the internal auditors in performing an audit. Internal auditors may assist the auditor in obtaining an understanding of the internal control structure or in performing tests of controls or substantive tests, consistent with the guidance about the auditor's responsibility in paragraphs 18 and 19. When direct assistance is provided, the auditor should consider the

internal auditors' competence and objectivity and supervise, review, evaluate, and test their work.⁷ The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

EFFECTIVE DATE

28. This statement is effective for audits of financial statements for periods beginning on or after _____. Early application of the provisions of this statement is permissible.

⁷ See paragraphs 11 through 14 of SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. I, AU sec. 311.11 through 311.14), for the type of supervisory procedures to apply.