

# CO-OPERATION BETWEEN INTERNAL AND EXTERNAL AUDITORS



HM TREASURY

## A GOOD PRACTICE GUIDE

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APA



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## FOREWORD

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The drive for achievement of value for money and effectiveness in public services has never been greater. Both internal and external auditors have distinctive and important contributions to make to this.

As part of this, they should endeavour to offer value for money and effectiveness in the delivery of audit services whenever opportunity presents itself. This guide offers guidance on ways in which that can be achieved whilst respecting the distinctive functions and professional requirements of both internal and external auditors

We commend this guide to all concerned with the audit of central government bodies. We encourage both managers in these bodies and those responsible for the leadership of internal and external audit teams to consider it carefully and to use it as a tool to help with the achievement of effective co-operation between auditors.

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## SECTION 1: INTRODUCTION

*This section sets out the purpose of this good practice guide and identifies the audience to whom it is addressed.*

**1.1** This guide is primarily addressed to internal auditors and to National Audit Office (NAO) staff engaged in the audit of central government departments, agencies and executive non-departmental public bodies (NDPBs).

**1.2** Some executive NDPBs may have private sector external auditors (either appointed by the relevant Secretary of State or by the Body's Executive) with a reporting line directly to the Secretary of State or to the body rather than through NAO to Parliament. These external auditors are asked to consider the content of this guide within the principles of SAS 500; the generic term "external audit" is used throughout the guide except where the provision relates to the particular or specific role assigned to NAO by Parliament.

**1.3** The guide is also relevant to senior management and to audit committees of central government organisations, who have a major interest in promoting and gaining benefits from effective co-operation between auditors.

**1.4** The guide offers good practice advice on internal and external audit co-operation. It recognises that internal and external auditors already co-operate in a variety of ways and draws on actual experiences of effective co-operation to promote development of co-operation and to help maximise the benefits to be gained for particular bodies.

**1.5** Although internal and external auditors have different and clearly defined roles (see Annex A), they do share the same broad purpose of serving Parliament and the public by helping to ensure the highest standards of regularity and propriety for the use of public funds and resources and in promoting efficient, effective and economic public administration. Good co-operation maximises the benefits which can be gained from working together in areas where there is an overlap in the work to be done.

## SECTION 2 : BENEFITS OF CO-OPERATION

*This section sets out the conditions necessary for effective co-operation and the benefits which can be gained.*

**2.1** A range of benefits may be obtained from co-operation. The specific benefits, and the scale to which they can be achieved, will depend on the particular organisation. They may include;

- more effective audit based on a clearer understanding of respective audit roles and requirements
- a reduced audit burden resulting in less disruption
- a better informed dialogue on the risks facing the organisation leading to more effective focussing of audit effort and consequently to more useful advice to management
- better co-ordinated internal and external audit activity based on joint planning and communication of needs
- a better understanding by each group of auditors of the results arising from each other's work which may inform respective future work plans and programmes
- increased scope for use by both internal and external auditors of each others work
- the opportunity for each party to draw on a wider and more flexible skills base

All these benefits enhance the effectiveness of audit and thus assist senior management to provide a high quality of public service.

2.2 The achievement of effective co-operation can be assisted in various ways;

### Structural

- senior management actively encourage and support co-operation
- there is an appropriately constituted audit committee taking active interest in internal and external audit issues and encouraging co-operation
- opportunities for co-operation are identified from respective audit plans, and documented along with the agreed procedures for co-operation

### Behavioural

- there is regular and structured dialogue between interested parties, particularly internal and external audit teams
- both sets of auditors adopt an active role in seeking opportunities for co-operation

## SECTION 3: BUILDING EFFECTIVE CO-OPERATION

Best practice co-operation is built on *Commitment, Consultation, Communication and Confidence*. The application of these concepts is fundamental to building effective co-operation and underpins all aspects of internal and external auditor relations. A number of the issues identified below are expanded on in Annex A.

### Commitment

**3.1** Effective co-operation between internal and external audit can only be achieved where both parties are committed to developing co-ordinated and effective audit services. Internal and external auditors have their respective roles, responsibilities and accountabilities. However, these roles often overlap and effective co-operation demands a willingness from both parties to work flexibly to ensure that work is properly co-ordinated in these areas. Co-operation is likely to be most successful where both parties take an active role in promoting co-operation and are willing to undertake changes to help bring it about. In short, commitment is an attitude of mind.

### Consultation

**3.2** Regular consultation between internal and external auditors provides the basis for identifying opportunities for beneficial co-operation and the mechanism for helping to bring it about. Even where internal and external auditors are not working together in a particular area there may be circumstances where they wish to consult with each other on particular issues or on specific audit findings. While auditors will consult directly on their work, management also has an important part to play in promoting consultation. Ideally this should be achieved through the Audit Committee. Where its remit extends to the consideration of external audit activity, the Audit Committee can be a useful forum for promoting co-operation between auditors.

## Communication

**3.3** Communication is a two-way process. Regular and open communication between internal and external auditors is essential to the success of co-operation. Auditors should establish common understanding on the timing and nature of such communications. Formal communication can include regular meetings, particularly to look at future plans to identify opportunities for co-operation; to avoid duplication of effort; and to agree methods for the sharing of audit findings and other information. There should also be a willingness to communicate less formally when issues arise which are of a mutual interest. The agreed procedures to facilitate effective co-operation should ideally be agreed by both parties, documented, and approved by the Audit Committee.

## Confidence

**3.4** There needs to be mutual confidence between both groups of auditors. This is based, most importantly, on recognition that internal and external audits are conducted within relevant professional standards. Where internal audit work offers the possibility of direct use by external audit, the external auditor may need to seek specific assurance about the standard of that particular work in order to comply with their professional standards. There also needs to be confidence that any information exchanged is treated professionally and with integrity.

## SECTION 4: OPPORTUNITIES FOR CO-OPERATION IN PRACTICE

*This section identifies practical opportunities for co-operation between internal and external auditors. A number of the issues identified below are expanded on in Annex B.*

### Internal Control

**4.1** Measuring and evaluating effectiveness of the system of internal control is the primary purpose of internal audit, as defined in GIAM. External auditors are required to make a preliminary assessment of the adequacy of the accounting system and the control environment as a basis for the preparation of the financial statements and the design of audit procedures. Exchange of information about internal control is therefore important. When internal audit can provide positive assurance that internal control is adequate, external audit can use that information in determining the extent of its audit procedures. In this respect external audit will need to be assured that appropriate methods of risk assessment are in place to inform decisions about the coverage of internal audit activity.

### Corporate Governance

**4.2** The role of internal audit in providing assurance to the Accounting Officer in respect of the content of the Corporate Governance statements required for accounts from financial year 1997/8 will inform external audit's view of the statement. Knowledge that an internal audit service to GIAM standards is in place, and the role of internal audit specifically in relation to the preparation of the Corporate Governance statement, should be considered by external audit in its review of the statement.

### Reporting and Financial Statements

**4.3** Elements of Internal Audit work can be of use to External Audit when reporting on financial statements. In addition to internal audit's opinion on control, any relevant specific testing work undertaken will be of use. There may also be opportunities to conduct joint testing work which can serve both the purposes of internal and external audit.

## Compliance with Laws and Regulations

**4.4** This includes compliance with the requirements internal to Government such as Parliamentary and Treasury approvals for expenditure. Internal auditors will routinely consider controls over compliance with laws and regulations as part of their systems audit work. The Comptroller and Auditor General gives a separate and explicit opinion on the regularity of transactions. There is consequently scope for NAO to place reliance on the work of internal audit. In addition internal audit activity will be relevant to NAO's consideration of *propriety*, and may be used by them in their consideration of whether or not activities and business have been conducted in accordance with Parliament's expectations.

## Fraud and corruption

**4.5** Internal and external auditors both have an interest in the prevention and detection of fraud. Internal audit has a wider role in this respect than external audit. Internal audit's role is defined in GIAM; External audit are concerned to assess the risk that fraud may cause material misstatement in the financial statements. External audit should consider the work of internal audit when assessing the risks of fraud in the context of the financial statements.

## Performance indicators

**4.6** Internal auditors may either consider performance measurement as part of routine systems audit work or may be asked to review systems for measurement of performance or to review performance measurement out-turns. External audit may also be invited to provide an opinion on reported out-turn of performance measures. Again, there is scope for external audit to rely on internal audit activity if they are assured about the standard of internal audit's relevant work.

## Developing systems and major initiatives

**4.7** Internal auditors may review the development of new systems through systems development audit. This work will be particularly relevant to the work of external audit when internal audit review new accounting systems. Knowledge that a new system has been subjected to adequate systems development audit can inform external audit's view of associated risk on the same basis as that explained at 4.1 above. This is particularly important in respect of the introduction of resource accounting and budgeting.

## Testing Programmes

**4.8** The interrogation of computerised systems for testing purposes can be expensive both in the preparation of the testing techniques and in the running of the testing programmes on computer systems. Where there is an overlap in testing plans, co-operation can allow more economic approaches to meet the needs of both parties. Co-operation over the design of embedded audit procedures in new computer systems is also beneficial.

## Audit of dispersed organisations

**4.9** If the audited organisation is dispersed geographically there is scope for co-operating in the planning of visits to these locations. Opportunities to work in joint teams, or for one party to ask the other to undertake work on their behalf during a visit offer improved economy in the delivery of audit services and minimise disruption to the audited organisation.

## NAO

**4.10** In addition to its certification work, NAO may decide to undertake specific value for money studies. When such a study is planned discussion between the Value for Money review team and internal audit may reveal opportunities for reliance on work already undertaken by internal audit or for improving the efficiency of the review through joint working. The detailed background knowledge which internal audit will have of the organisation may be of particular value in allowing the NAO team to understand the background and circumstances of the activity they are reviewing.

## SECTION 5: CONCLUSION

**5.1** Effective co-operation between internal and external audit leads to a range of benefits for both parties, and the clients they serve. Whilst their respective roles are different, co-operation helps both parties achieve their objectives and also helps them provide a better service to the bodies they work with and ultimately to Parliament and the public.

**5.2** To help with the assessment of co-operation, Annex C provides a checklist. This can be used to identify both the areas where satisfactory co-operation is already happening, and those in which greater benefits from co-operation could still be gained.

## ANNEX A -A MORE DETAILED VIEW OF FACTORS IN CO-OPERATION

| Factor                                   | Internal Audit  | External Audit  |
|--|---|---|
| Mutual understanding of respective roles | <p>IA is a service to management. Its functions include examining and evaluating internal control and providing assurance to the Accounting Officer. IA is itself part of the organisation's system of internal control and its scope includes ALL aspects of internal control, not just financial control. Accounting Officers are required by the Accounting Officer's Memorandum to make provision for internal audit. Standards for the practice of internal audit in Government are promulgated in the Government Internal Audit Manual (GIAM) and include standards on relations with external auditors.</p>    | <p>The Comptroller and Auditor General (C&amp;AG) has a statutory responsibility for certification audit of the financial statements of central government bodies. His work is carried out by the National Audit Office (NAO). He reports to Parliament, in practice through the Public Accounts Committee. As part of the certification of financial statements he may also draw Parliament's attention to irregularity, impropriety and poor financial control. He may also carry out separate investigations into value for money. The C &amp; AG has sole responsibility for the audit opinion on the financial statements and for determining the nature, timing and extent of audit procedures. This work is planned and performed in accordance with the Auditing Standards of the Auditing Practices Board. (NB - a number of NDPBs may have private sector auditors appointed under different provisions - see para 1.2 of the main text of this guide.)</p> |
| Management and Audit Committee role      | <p>The management role in promoting effective co-operation is best achieved through an Audit Committee. Audit Committees are a major tool in allowing effective management and review of the internal audit function. Its duties include advising the Accounting Officer on the plans and activity of IA, the provision of IA resources, the appointment of the head of IA, and following up outstanding audit recommendations. It is also encouraged under separate Treasury guidance to take lead responsibility for co-ordinating assurances in respect of the preparation of corporate governance statements.</p> | <p>Audit Committees should also give consideration to management letters and other findings from external audit and advise the Accounting Officer as appropriate. There is benefit to be gained from external audit attending meetings of the Audit Committee. This allows the Committee to take a broad view of audit activity in the organisation and allows members to discuss issues which external audit might wish to raise. Only by having this broad view of audit activity can the Committee be pro-active in encouraging and helping identify opportunities for co-operation between internal and external audit.</p>   |

|   |  |
|---|--|
| <p>Agreement on procedures which underpin co-operation</p>    | <p>There needs to be clear agreement on, and mutual understanding of, the procedures for promoting co-operation which are agreed between internal and external audit. Such procedures should be documented to avoid misunderstanding.</p> <p>They may include:</p> <ul style="list-style-type: none"> <li>* a programme of regular meetings</li> <li>* how planning information will be shared and discussed</li> <li>* consultation on risk assessment procedures and considerations</li> <li>* procedures for exchanging audit findings, in particular for the provision of copies of IA reports to the external auditors</li> <li>* agreement on procedures for documenting and reporting audit findings when these are to be shared</li> <li>* agreed methods by which external audit can be assured of the standard of internal audit work to facilitate reliance, in particular the quality assurance procedures which are used by IA</li> <li>* arrangements for the sharing of information</li> <li>* consultation procedures to help identify opportunities for joint working or the undertaking of work by one party for the other.</li> </ul> |
| <p>Agreement on the basis for placing reliance on IA work</p> | <p>Because of the wider scope of internal audit work reliance is most likely to be by external audit on internal audit. External auditors may rely on the work of internal audit but cannot hand over their own responsibilities. When external auditors plan to rely on the work of internal audit they are required to assess the quality and reliability of that work (SAS 500). This includes an overall assessment to determine whether internal audit continues to meet GIAM standards. GIAM requires internal audit units to make provision for an external quality assurance review at least once in every three years. External audit may use the results of these reviews to inform their own assessment of the internal audit function. It may be useful to invite a representative of external audit to be a member of the quality assurance review team.</p>  |

## ANNEX B: A MORE DETAILED VIEW OF THE PRACTICE OF CO-OPERATION

| Area of co-operation  | Internal Audit  | External Audit   |
|---|---|--|
| <p>Internal control environment</p> <p><i>SAS 300</i></p>     | <p>The prime purpose of IA is the measurement and evaluation of the system of internal control. This is done by a programme of systems audits identified from a risk assessment process. EA assessment of the risk of financial systems in relation to risk to financial statements may be taken into account in preparing IA risk models. IA issue assignment reports and provide an annual opinion on the overall system of control to the Accounting Officer. When control is weak, IA make recommendations for improvement and follow up the implementation of recommendations. IA may test controls, either substantively or for compliance depending on their opinion of the control environment.</p> | <p>EA are required to obtain an understanding of the control environment and assess whether the environment is conducive to reliable accounting systems and effective internal control. The opinion of IA on the control environment can be used by external audit to inform its assessment of accounting and internal control. Where EA is proposing to rely on the entity's controls, it may use the results of IA testing of controls to inform the EA opinion.</p> |
| <p>Corporate governance</p> <p><i>AP Bulletin 1998/10</i></p> | <p>IA is a key player in the provision of assurance to the Accounting Officer in the preparation of corporate governance statements. IA may also review and report on the corporate governance process.</p>   | <p>EA are required to review the Accounting Officer's statement on the system of internal financial control. The role of IA in the preparation of corporate governance statements and the IA opinion of the system of control over corporate governance can provide information which may be used by EA in conducting its review. The existence of IA in accordance with GIAM standards also provides assurance about the corporate governance environment.</p>        |

| Area of co-operation   | Internal Audit   | External Audit  |
|--|--|---|
| <p>Reporting on the financial statements</p> <p><i>SAS 500</i></p>                       | <p>IA has no statutory role in the audit of financial statements. Nevertheless IA may have conducted work specifically aimed at assuring the Accounting Officer that the systems contributing to, and for preparing, the financial statements are well controlled. Where there are identified risks of material error or irregularity which may impact on the financial statements, IA may take account of these in its risk assessment.</p> | <p>EA is required to express an opinion on the audited entity's financial statements. In undertaking the work necessary to underpin that opinion, EA may seek to rely on the work of IA. If IA has conducted work examining specific risks affecting the financial statements the results of that work may be relevant to the EA opinion.</p> |
| <p>Compliance with laws and regulations</p> <p><i>APB Practice Notes 10 &amp; 17</i></p> | <p>In systems audit IA will normally consider controls in this respect, including European and UK legal requirements, specific Governmental requirements (eg - Treasury approval and other requirements), and the organisations own rules and regulations. Some of this work may also touch on propriety issues.</p>   | <p>In the central government sector the C &amp; AG gives a separate and explicit opinion on the regularity of transactions and may be able to rely on work carried out by IA in its systems audit activities.</p>   |
| <p>Fraud and corruption</p> <p><i>SAS 110</i></p>  | <p>GIAM defines IA's role in respect of fraud. IA may conduct systems audits into the controls to prevent and detect fraud as well as considering fraud risks as a routine risk in audits of financial/operational systems. IA may also be involved in any specific fraud investigations.</p>  | <p>EA may consider the activity of IA in relation to fraud when assessing the risk of material misstatement in the financial statements.</p>  |
| <p>Performance indicators</p>  | <p>IA may consider these as part of other systems audits, as part of corporate governance, or as a system in their own right. IA may also be asked to carry out inhouse certification work or to otherwise report on the results achieved.</p>   | <p>When EA is required to validate performance indicators consideration of any relevant work by IA may decrease the amount of new work which needs to be done and avoid duplication of audit activity.</p>  |

| Area of co-operation                                       | Internal Audit   | External Audit  |
|--|--|---|
| Developing systems   | IA will normally be advised of all significant new systems being developed and will select those which they wish to be involved with in order to provide assurance that the new systems are well controlled before they are implemented.   | IA activity on developing systems can contribute to EA assessment of the overall control environment. If the new systems are relevant to the preparation of financial statements, EA may also be asked to contribute to the systems development audit, in which case a joint IA/EA team may be appropriate. |
| Testing programmes<br><br>Audit of dispersed organisations | <p>When either IA or EA are planning significant testing programmes there is benefit in consulting the other party to ask if the work is likely to be relevant to them. If so the test programmes can be designed to cover the needs of both parties in one programme avoiding duplication of effort. In such circumstances joint working teams may be appropriate.</p> <p>Many organisations are geographically dispersed with a number of local or regional offices. Work on any particular system or for any particular purpose may entail visits to a number of offices. If either IA or EA are planning a visit to an office for any purpose it can be sensible to consult with the other party to as if they have any audit work to be carried out in that location, and for the visiting team to incorporate that work into their programme, or for a joint visit to be planned. This leads to more economical use of audit resources and minimises disruption to the auditees.</p> |   |
| Value for money  | IA may consider value for money issues in the conduct of systems audits.   | When EA is planning a value for money study, useful background material may be available from IA to minimise the need for background research and to contribute to identification of issues to be examined in more depth.   |

## ANNEX C: CHECKLIST FOR ASSESSING CO-OPERATION

| Co-operation promoted through management and the audit committee  |  |
|---|--|
| Do management and the audit committee (where this exists) actively promote effective co-operation between the internal and external audit?                                  |  |
| Do internal audit attend audit committee meetings?  |  |
| Do external audit attend audit committee meetings?  |  |
| Does the audit committee consider and advise on opportunities for co-operation?   |  |
| Professional confidence   |  |
| Has an External Quality Assurance (EQA) review of internal audit been carried out either by an independent third party or by external audit?                                |  |
| Has external audit given relevant feedback on the results of the review and how it affects opportunities for co-operation?  |  |
| If the assessment concludes that reliance on internal audit is not possible, has external audit made recommendations for improvement and has an action plan been developed? |  |
| Has management considered any need to revise the specification for internal audit services in the light of EQA?   |  |
| Reliance on Internal Audit  |  |
| Is reliance on internal audit clearly built into the external audit plan?   |  |
| Do external audit discuss the results of their evaluation of individual pieces of internal audit work on which they intend to place reliance?                               |  |
|   |  |

| Co-operation and consultation  |  |
|--|--|
| Do internal and external audit meet on a regular basis to give feedback, discuss progress and resolve problems?  |  |
| Do internal and external audit report to the Audit Committee on the arrangements established for routine liaison, the results of past co-operation, and their plans for future co-operation? |  |
| Is there a written agreement for co-operation and reliance arrangements between internal and external audit?   |  |
| Have all areas for potential co-operation between internal and external audit been explored?   |  |
| Do internal and external audit co-ordinate the timing of their work effectively in order to maximise co-operation and reliance?  |  |
| Do management or the audit committee discuss audit plans with both sets of auditors?   |  |
| Are there any potential problems acting as a barrier to co-operation between internal and external audit?  |  |
| Has a joint action plan been drawn up to help address these problems?  |  |
| Have external and internal audit considered joint training in each other's methodology?  |  |
| Have external and internal audit considered joint working on specific projects with the objective of ensuring skill's transference between the two sets of auditors?                         |  |
| Do internal and external auditors consult and agree on the timing of work in which they have a mutual interest?  |  |
| Have auditors discussed and agreed minimum standards of documentation to be adopted?   |  |
| Have auditors discussed and agreed arrangements for sharing relevant files and working papers?   |  |

| Communication  |  |
|--|--|
| Is there two-way communication between internal and external auditors on matters of mutual interest and concern at all times?    |  |
| Have procedures been agreed with management and internal audit for providing copies of internal audit reports to external audit? |  |
| Does external audit discuss its plans with management and internal audit?  |  |
| Does external audit communicate its findings to management and internal audit?   |  |

## ANNEX D: CONTACT POINT AND USEFUL REFERENCE

### HM TREASURY CONTACTS

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### USEFUL REFERENCES

Government Internal Audit Manual

Institute of Internal Auditors Standards

Auditing Practices Board : Auditing Standards

Auditing Practices Board : Practice Note 10 -      The Audit of Central Government  
Financial Statements

Auditing Practices Board : Practice Note 17 -      The Audit of Regularity in the Central