

# The Relationship Between Internal and External Audit

Local Government Operational Guidelines - **Number 13** April 2006



Department of Local Government  
and Regional Development  
Government of Western Australia

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# The Relationship Between Internal and External Audit

## 1. Introduction

1 Many local governments have recognised the need to improve their internal auditing processes, and some have moved to contract out the internal audit function. Some have raised the question as to whether the external auditor or their professional company can undertake both the external and internal audit functions without compromising the integrity of both processes.

2 For the purposes of this guideline:

- The external auditor is the person appointed by the local government under the *Local Government Act 1995* to undertake an audit of the accounts and financial report for each financial year.
- The internal auditor is the person appointed by the local government to undertake an audit of the adequacy and effectiveness of the internal control structure and may include financial controls, legislative compliance, information systems, employment practices and risk management.

3 This guideline is intended primarily to identify those principles that local governments need to consider before entering into a contract for the appointment of an internal auditor and for establishing the relationship between internal and external audit.

## 2. Background Principles

4 Members of the auditing and accounting professions are only too aware of the necessity for auditors to be scrupulously independent in fact and appearance. The current standard on independence is explicit in that it states -

5 *"A member in public practice must both be, and be seen to be, free of any interest which is incompatible with objectivity."*

6 Accepted standards dictate that an external auditor should not undertake work of an internal audit nature that compromises or could be perceived to compromise the objectivity and independence of the external audit.

## 3. The Role of the Internal Auditor

7 The primary role of the internal auditor is to report to the Chief Executive Officer (CEO) on the adequacy and effectiveness of internal control processes and procedures. The scope of an internal audit would be determined by the CEO, with input from the audit committee, on the size of the local government's internal operations and the level of compliance to be achieved. The role differs from that of the external auditor who is appointed by council on the recommendation of the Audit Committee, to report independently to it, through the mayor/president and the CEO, on the annual financial statements. The external auditor's primary role is to decide whether the annual financial statements of a local government are free of material misstatement.

8 There are certain functions of the internal audit that complement the external auditor's role. As the external auditor plans for an effective audit they need to assess and determine whether to include the scope, procedures and outcomes of the internal audit.

9 An internal auditor's activities may include the following:

- (a) review of the internal control structure, monitoring the operations of the information system and internal controls and providing recommendations for improvements;
- (b) examination of financial and operating information that includes detailed testing of transactions, balances and procedures;

- (c) a review of the efficiency and effectiveness of operations and services including non-financial controls of a local government;
- (d) a review of compliance with laws, regulations and other external requirements, and with management policies and directives and any other internal requirements;
- (e) a risk assessment with the intention of minimising exposure to all forms of risk on the local government; and
- (f) specific tasks requested by management.

10 The CEO should refer reports of the internal auditor to the Audit Committee for consideration.

11 If the size of the local government's operations warrant it, an independent internal audit may be undertaken via a member of staff or an external contractor. If management is of the view that the appointment of an independent internal auditor is not warranted it may request the council to expand the role of its external auditor. The expanded role could include certain functions that are normally of an internal audit nature that will complement and reinforce the external audit such as items (a) and (b) above.

12 Local governments that do not establish an internal audit process but require a review of the financial management systems and procedures, may decide to use the services of the external auditor for that purpose. Such reviews are to be undertaken every four years in accordance with regulation 5(2)(c) of the *Local Government (Financial Management) Regulations 1996*. The review of financial management systems and procedures provides the external auditor with greater assurance of systems and procedures used to prepare the annual financial statements, and whether they provide information free of material misstatement.

#### 4. Conclusions

13 In conclusion, it is recommended that the external auditor or his or her professional company only undertake internal audit functions that complement the external audit and do not cloud the objectivity and independence of the external audit. An external auditor must not audit information prepared by them or their accounting practice, as this is considered incompatible with the standard of independence.



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#### FURTHER INFORMATION

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