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Agenda Item

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Committee International Ethics Standards Board for Accountants

Meeting Location: JICPA, Tokyo, Japan

Meeting Date: October 19-20 2009

Internal Audit

Objectives of Agenda Item

1. To receive and update on the activities of the IAASB Internal Audit Task Force and to comment on issues that relate to IESBA.

Background

At its February 2009 meeting the IESBA considered the International Auditing and Assurance Standards Board (IAASB) project to revise ISA 610 *Using the Work Of Internal Auditors*. The objective of the project as set out in the project proposal, is to “revise [the clarified] ISA 610 to reflect developments in the internal audit environment and changes in practice regarding the interactions between external and internal auditors.” The project proposal indicated that in enhancing the requirements and guidance on the external auditor’s use of, and interaction with, the internal auditors, it is important at the same time to ensure that external auditors only do so when appropriate so as to guard against undue reliance.

The issues the Task Force is considering include:

- The external auditor’s assessment of the competence and objectivity of the internal audit function; and
- Expansion of the scope of ISA 610 to address instances of internal audit staff providing direct assistance to the auditor.

Given the linkage with the Code of Ethics, the IAASB extended an invitation to the IESBA to appoint a task force member. At its February 2009 meeting, the IESBA determined that an IESBA member should serve on the Task Force and Bob Franchini was appointed to the Task Force.

The Task Force has met in May, July and August 2009 and the IAASB discussed issues and Task Force proposals at its meeting in September 2009. Extracts from the IAASB agenda papers are presented below. (The full text of the issues paper can be downloaded

from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0168&ViewCat=1143>).

The matters that are relevant to the IESBA relate to:

- Ethical principles of internal auditors; and
- Provision of direct assistance by internal auditors

Discussion

Ethical Principles of Internal Auditors

Paragraph 100.1 of the IFAC Code states that “a professional accountant shall observe and comply with [the] Code.” A professional accountant is defined in the IFAC Code as “an individual who is a member of an IFAC member body” who may be a professional accountant in public practice or in business. Accordingly, the IFAC Code may apply to professional accountants in business who may be internal auditors. For this reason, the Task Force believes that when making reference to ethical principles of internal auditors in ISA 610, endeavors should be made to maintain consistency with the IFAC Code.

Of the ethical principles referred to in ISA 610 which the external auditor may consider in evaluating the internal audit function, three have linkages to the IFAC Code. These are “objectivity,” “technical competence” and “due professional care.” In the IFAC Code, the equivalent principles are “objectivity” and “professional competence and due care.” Notably, professional competence and due care form a single ethical principle in the IFAC Code, whereas in ISA 610 these are listed separately. The Task Force proposes that the ethical principles in ISA 610 be made consistent with the IFAC Code. Accordingly, it recommends the amalgamation of the competency principle and due care principle in alignment with the IFAC Code.

ISA 610, ISA 620 *Using the Work of an Auditor’s Expert* and ISA 600 *Special Considerations – Audits of Group Financial Statements* share a common theme in that they address the auditor’s use of the work of others for purposes of the audit. In directing the auditor to obtain an understanding of the relevant parties, the ISAs mandate the evaluation of the relevant parties’ competence, specifically:

- ISA 610 requires the external auditor to evaluate the *technical competence* of internal auditors.
- ISA 620 requires the external auditor to evaluate whether the auditor’s expert has the necessary *competence*.
- ISA 600 requires the external auditor to obtain an understanding of the component auditor’s *professional competence*.

In the application material, ISA 600 indicates that the determinants of technical competence include professional body membership, adequate training and proficiency, and established hiring and training policies. In addition to the possession of professional body membership, ISA 620 makes reference to the competency of the external auditor’s expert in regard to the matters for which that expert’s work will be used, and relevant accounting and auditing requirements. ISA 600 refers to professional competency and states that it is determined by the component auditor’s understanding of the applicable

financial reporting framework, auditing and other standards, and special skills necessary to perform the work on financial information of the particular component.

While comparisons of the three ISAs might seem to indicate a general lack of consistency in referencing the competency ethical principle, the terms used in ISA 620 and ISA 600 seem appropriate in their circumstances:

- (a) In the case of a component auditor, one would expect that they would be members of IFAC member bodies and subject to the IFAC Code.
- (b) In the case of an expert, they may or may not be a member of an organized professional body, and therefore reference to “competence” rather than “professional competence” seems appropriate.

In the case of internal auditing, the Task Force observed that internal auditors may or may not be a member of an IFAC member body (as per the definition of professional accountant in the IFAC Code). In this regard, the Task Force was concerned that if the word “professional” is used, it may inadvertently create the impression that the ethical principles are only applicable in the case of internal auditors who are affiliated to an IFAC member body. Accordingly, it is proposed that the reference not be made in ISA 610 to *professional* competence as is the case in the IFAC Code. On the other hand, the reference to *technical* competence in extant ISA 610 could be interpreted to suggest a focus more on subject matter expertise or skills rather than competence in assurance. For these reasons, the Task Force proposes that ISA 610 refer only to *competence* i.e., the ethical principle to be used in ISA 610 would be competence and due care.

Action requested

IEBSA members are asked whether they agree with the Task Force’s proposal regarding references to the internal auditor’s ethical principles in ISA 610.

Direct Assistance

The provision of direct assistance by internal audit staff to the external auditor on the external audit was a matter slated for consideration in the revision of ISA 610. The Task Force anticipates that there may be divergent views on this matter. Whilst direct assistance is recognized in national auditing standards in some jurisdictions (e.g., US and Canada) and a common practice in many, there are other jurisdictions where it is explicitly prohibited (e.g., Japan). In practice, work performed by internal audit staff directly on the external audit may often include substantive procedures rather than controls testing and, as noted above, this is of concern to those who question the internal audit function’s expertise outside of internal control testing. Some have also expressed concern that the work of internal auditors may not be subjected to more extensive review compared to those performed by engagement team members of the external auditor, and that typically no reperformance of that work is conducted by the external auditor despite the internal auditors’ lack of independence.

Given the widespread use of direct assistance of internal auditors in many jurisdictions, the Task Force is of the view that the scope of ISA 610 should be appropriately expanded to address circumstances where internal audit staff is engaged to provide direct assistance to the external auditor in carrying out audit procedures when not prohibited by local law or regulation. It does not, however, believe that it would be appropriate for the ISA to require or encourage the external auditor to use, or to consider using, internal auditors in this regard. This is so as to avoid inadvertently introducing pressures on the external auditor to use the internal audit work or using internal audit resources to a greater extent than may be warranted in the specific circumstances, both of which would be detrimental to audit quality. Notwithstanding this view, in circumstances where the external auditor intends to engage the direct assistance of internal auditors on the audit, and is not prohibited by law or regulations to do so, ISA 610 should provide the external auditor with the appropriate guidance. In particular, the Task Force proposes the provision of guidance in regard to the nature and extent of review and supervision that external auditors should exercise over internal audit staff in these cases.

In cases of direct assistance, the Task Force proposes that the requirements in ISA 610 relating to the external auditor's assessment of the internal audit function should be applied before internal auditors may be assigned to specific tasks. Similarly, if the external auditor is prohibited or discouraged from using the work of internal auditors in regard to certain types of audit procedures or particular areas of the audit, these should also apply to cases of direct assistance. Further, the external auditor will need to exercise skepticism given that internal auditors are not independent of the entity and, in accordance with the hierarchy of evidence set out in ISA 500 *Audit Evidence*, should therefore be presumed to provide less reliable evidence than work performed directly by the external auditor themselves. Accordingly, the level of supervision or review of audit procedures performed by internal audit staff will ordinarily need to be more extensive than if members of the external auditor had performed the work. Notwithstanding the above, the Task Force believes that overall the requirements in ISA 610 relating to the external auditor's use of internal audit work are generally applicable when the assistance of internal audit staff is engaged directly on the external audit.

Direct involvement of internal audit staff in the external audit raises the question of whether by performing audit procedures on the external audit these individuals may, under the prevailing definitions in the ISAs and the IFAC Code, be deemed to be members of the engagement team.¹ This determination is relevant because if this is in fact the case, requirements of the ISAs and the IFAC Code relating to direction, supervision and performance of the engagement team would apply and, expectedly, so would requirements relating to independence. This creates an inconsistency with

¹ In the ISAs, the engagement team is defined as all partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes external experts engaged by the firm or a network firm. In the IFAC Code, the engagement team is defined as all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement. [Note from IESBA staff, the definition quoted here is from the existing Code, the definition in the revised Code is identical with the ISAs]

paragraph 4 in ISA 610 which states that the internal audit function is not independent of the entity. The Task Force, through its International Ethics Standards Board for Accountants (IESBA) representative, will seek the IESBA's view on whether and what clarification is required to be made to the definition of engagement team in the IFAC Code in this regard.

Notably, the UK Auditing Practices Board (APB) issued a consultation paper in March 2009 that includes a proposal for expanding the scope of ISA 610 (UK and Ireland) to address the matter of direct assistance. The APB posited that direct assistance creates threats to independence similar to those that may exist in the following circumstances:

- The external auditor uses work already undertaken by the internal audit function; or
- The external auditor agrees that the internal audit function should undertake certain work and then uses that work.

Accordingly, the APB proposed the application of safeguards in response to the threats that may be present. Specifically, it recommended that members of the audit team review the work performed by internal audit staff and that the agreement of those charged with governance be sought in advance of engaging internal audit staff. While support is offered by many of the respondents to the APB's consultation paper who submitted a response in this regard, some stakeholders, including the UK regulator, expressed reservations about the appropriateness of such arrangements due in part to the potential ethical issue.

The IFAC Code prescribes a conceptual framework approach to dealing with ethical issues which the external auditor may encounter during the course of the audit. When faced with threats to compliance with its fundamental principles, the auditor should apply the appropriate safeguards to eliminate these threats or reduce them to an acceptable level (i.e., "threats-and-safeguard" approach).

Guided by the approach prescribed in the IFAC Code, the Task Force is of the view that ISA 610 should provide external auditors with guidance on the appropriate safeguards to apply to deal with threats associated with engaging the direct assistance of internal audit staff. It does not, however, believe that the external auditor seeking pre-approval from those charged with governance of the entity is a necessary safeguard in all cases. The Task Force considered that such a safeguard may have unintended consequences, for example, it may introduce pressure on the external auditor to justify its use of internal audit resources which in turn may, inadvertently, introduce pressures on the external audit to use internal auditing to a greater extent when it may be inappropriate to do so. Furthermore, the allocation of internal audit resources is a matter more appropriately communicated by the internal audit function to those charged with governance. Rather than rely on those charged with governance as a form of safeguard, the Task Force believes that the IAASB needs to be satisfied that the external auditor can put sufficient safeguards (e.g., limiting the direct use of internal audit staff to low risk areas, ongoing direction and direct review, etc.) in place to overcome the threats arising from the fact

that internal audit staff are not fully independent. The requirements in ISA 610 should reflect this.

Action requested

IEBSA members are asked to consider whether they agree with the Task Force's view that a threats and safeguards approach should be taken when internal auditors provide direct assistance to the external auditor. IESBA members are also asked to consider whether changes should be made to the definition of the engagement team to clarify that internal auditors providing direct assistance are not members of the team.

Material Presented

Agenda Paper 7

This Agenda Paper

Action Requested

1. IESBA members are asked to consider the questions posed.