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Agenda Item

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Committee International Ethics Standards Board for Accountants

Meeting Location: AICPA, New York, USA

Meeting Date: February 17-18, 2010

Internal Audit

Objectives of Agenda Item

1. To receive an update on the activities of the IAASB Internal Audit Task Force and to comment on issues that relate to IESBA; and
2. To determine whether any modification is required to the Code.

Background

The International Auditing and Assurance Standards Board (IAASB) has a project to revise ISA 610 *Using the Work Of Internal Auditors*. The objective of the project 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 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. The IESBA accepted the invitation and Bob Franchini is a correspondent member on Task Force.

The IESBA receive an update on the project at its October 2009 meeting. The two issues discussed were:

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

During the discussion at the IESBA meeting, a question was raised about the interaction of paragraph 290.163 of the Code, regarding management responsibilities, and the provision of direct assistance by internal auditors. It was agreed that this paragraph would be discussed further by the IESBA at its next meeting.

The IAASB Task Force meets by conference call on February 9th when it will finalize the proposed wording of an exposure draft. The exposure draft will be discussed by the IAASB CAG at its March 2010 meeting and presented for a first read to the IAASB at its March meeting, with the view to obtaining approval for exposure at either the June 2010 or September 2010 meeting (depending upon the availability of agenda time).

Discussion

Proposed Redrafted ISA 610

At its October 2009 meeting, the IESBA discussed the IAASB Task Force's approach to addressing the provision of direct assistance by the internal audit function. The IESBA agreed that no change to the Code definition of engagement team seemed to be needed because the draft ISA referred to direct assistance on the engagement.

The IAASB Task Force approach with respect to direct assistance is broadly as follows:

- If the external auditor plans to use internal auditors to provide direct assistance, require an evaluation of the level of competence and degree of objectivity of the internal auditors;
- If obtaining direct assistance from internal audits, require the external auditor to direct, supervise and review the work, recognizing that internal auditors are not independent and therefore their work is presumed to provide less reliable evidence.

The exposure draft wording will be forwarded to IESBA members as soon as it is available. The IESBA will be asked to consider the wording, in particular the paragraphs addressing direct assistance, and comment on any issues that they believe relevant to ethics.

Management Responsibilities

The Code addresses management responsibilities and states that a firm shall not assume a management responsibility for an audit client (the complete text of the section is contained in the appendix to this agenda paper).

The relevant extracts are as follows:

“It is not possible to specify every activity that is a management responsibility. However, management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources. Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment. Examples of activities that would generally be

considered a management responsibility include ... [d]irecting and taking responsibility for the actions of the entity’s employees.”

At the October 2009 IESBA meeting, a question was raised as to whether the above guidance in the Code is consistent with the proposed revised ISA 620 which would require an external auditor, when obtaining direct assistance from internal auditors, to “direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220” and whether any clarification to the Code was necessary.

Points indicating no need for clarification

- The Code does not state that directing and taking responsibility for the actions of an entity’s employees would always be considered a management responsibility. It states that an assessment of whether an activity is a management responsibility depends upon the circumstances and requires the exercise of judgment;
- The external auditor is responsible for the audit, and planning to use internal auditors to provide direct assistance on the engagement does not relieve the external auditor from this responsibility; and
- The external audit is the responsibility of the external auditor - provision of direct assistance by an internal auditor is therefore part of the external audit and cannot be viewed as a management responsibility.

Points indicating a need for clarification

- The Code states that directing and taking responsibility for the actions of an entity’s employees would “generally be considered a management responsibility” – without clarification, some readers of the Code might inappropriately interpret this as including situations where the external auditor is obtaining direct assistance from internal audit.

The revisions to ISA 610 raise the question of whether the Code needs to be clarified to indicate that internal audit direct assistance on the audit is not a management responsibility. There is also a question as to whether clarification is needed that direct assistance on an engagement to provide a non-assurance service is not a management responsibility – for example, an internal auditor may provide direct assistance to the auditor on a fraud engagement.

Action requested

IEBSA members are asked whether they believe the Code needs to be clarified to indicate that internal audit direct assistance (which involves directing and supervising such staff) as part of the external audit is not considered a management responsibility.

If IESBA members are of the view clarification is required, they are asked to consider whether the clarification should be extended to engagements other than audit engagements – for example internal audit providing direct assistance to the external auditor on a permitted non-assurance service?

Possible clarification

Should the IESBA be of the view there is a need for clarification, there are three possible approaches:

- Revise the Code;
- Issue an interpretation; and
- Issue a staff Q&A.

Under all three options, it could be noted that the clarification was thought necessary because of the expansion of ISA 610 to address the situation where the external auditor obtains direct assistance from the internal auditor.

Revise the Code

This approach would require an exposure draft of proposed wording. The timing and exposure period could be linked with the IAASB ED.

The following proposed change in wording is presented for consideration:

“290.164 Activities that are routine and administrative, or involve matters that are insignificant, generally are deemed not to be a management responsibility. For example, executing an insignificant transaction that has been authorized by management or monitoring the dates for filing statutory returns and advising an audit client of those dates is deemed not to be a management responsibility. Further, providing advice and recommendations to assist management in discharging its responsibilities or directing and taking responsibility for the work of internal auditors when obtaining their direct assistance on the audit engagement is not assuming a management responsibility.”

Under this approach, the IESBA could issue an ED at the same time as the IAASB and provide a cross-reference to that ED explaining that the change in the Code was to clarify that directing and taking responsibility for the work of internal auditors when obtaining direct assistance during the audit engagement is not considered to be a management responsibility.

If the IESBA is of the view the clarification should extend to all engagements the additional wording could be as follows:

“Further, providing advice and recommendations to assist management in discharging its responsibilities or directing and taking responsibility for the work of internal auditors when obtaining their direct assistance on the audit an engagement is not assuming a management responsibility.”

Issue an Interpretation

The IESBA has issued three interpretations (IT). Two ITs dealt with the implementation of the Code that was issued in 2001 (in effect transitional provisions that were not issued

when the Code was issued). These ITs were no longer applicable when the Revised Code was issued in July 2009 and, therefore, are not contained in the Revised Code. The one IT that remains is IT 2005-01 *Application of Section 291 to Assurance Engagements that are Not Financial Statement Audit Engagements*. The IT, as its name suggests, demonstrates the application of the Section, it does not interpret or clarify any of the wording in the Section.

Staff Question and Answer

To date IESBA has not issued any Q&As. Staff has issued some documents to assist in implementation and adoption of the Code. These documents are factual summarizations of the Code and do not contain any interpretations.

The IAASB has issued one Q&A “to highlight how the design of the ISAs issued under the Clarity Project enables them to be applied in a manner proportionate with the size and complexity of an entity.” The IAASB Q&As are described as follows:

“Staff Questions and Answers publication is a staff publication. Staff publications are prepared by staff of the IAASB, have no authoritative status and have not been subject to the IAASB's due process. Staff publications are not meant to be exhaustive and reference to relevant standards themselves should always be made. Reading such publications is not a substitute for reading the standards and other authoritative material, and practitioners should determine whether and how to respond to circumstances highlighted in a staff publication based on the specific facts presented. Statements contained in a staff publication are not rules of the IAASB and do not reflect any IAASB determination or judgment, and accordingly do not constitute authoritative or official pronouncements of the IAASB or IFAC. They are for information purposes only and are in all cases descriptive and not prescriptive.

Staff publications are used to help raise practitioners' awareness in a timely manner of significant new or emerging issues or other noteworthy circumstances relevant to engagements addressed by IAASB pronouncements, to direct their attention to relevant provisions of IAASB pronouncements, or to provide clarification to emerging questions by referring to existing requirements and application material and background information such as that contained in staff Basis for Conclusions documents.

Staff publications do not amend or override the standards or other pronouncements to which they relate that are currently effective, the texts of which alone are authoritative.”

Action requested

If IESBA members are of the view a clarification is needed, they are asked to consider which of the methods noted above they favour.

Material Presented

Agenda Paper 3

Agenda Paper 3-A

This Agenda Paper

Draft revised ISA 610 (will follow)

Action Requested

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

Appendix **Management Responsibilities**

Management Responsibilities

290.162 Management of an entity performs many activities in managing the entity in the best interests of stakeholders of the entity. It is not possible to specify every activity that is a management responsibility. However, management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources.

290.163 Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment. Examples of activities that would generally be considered a management responsibility include:

- Setting policies and strategic direction;
- Directing and taking responsibility for the actions of the entity's employees;
- Authorizing transactions;
- Deciding which recommendations of the firm or other third parties to implement;
- Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; and
- Taking responsibility for designing, implementing and maintaining internal control.

290.164 Activities that are routine and administrative, or involve matters that are insignificant, generally are deemed not to be a management responsibility. For example, executing an insignificant transaction that has been authorized by management or monitoring the dates for filing statutory returns and advising an audit client of those dates is deemed not to be a management responsibility. Further, providing advice and recommendations to assist management in discharging its responsibilities is not assuming a management responsibility.

290.165 If a firm were to assume a management responsibility for an audit client, the threats created would be so significant that no safeguards could reduce the threats to an acceptable level. For example, deciding which recommendations of the firm to implement will create self-review and self-interest threats. Further, assuming a management responsibility creates a familiarity threat because the firm becomes too closely aligned with the views and interests of management. Therefore, the firm shall not assume a management responsibility for an audit client.

290.166 To avoid the risk of assuming a management responsibility when providing non-assurance services to an audit client, the firm shall be satisfied that a member of management is responsible for making the significant judgments and decisions that are the proper responsibility of management, evaluating the results of the service and accepting responsibility for the actions to be taken arising from the results of the service. This reduces the risk of the firm inadvertently making any significant judgments or decisions on behalf of management. The risk is further reduced when the firm gives the client the opportunity to make judgments and decisions based on an objective and transparent analysis and presentation of the issues.