

## **Discussion**

This agenda paper contains the complete text of the proposed revisions to ISA 610 *using the Work of the Internal Audit Function* which will be discussed by the IAASB at its March 2010 meeting. The complete text is provided for the information of the IESAB, so that members can see the paragraphs that have direct relevance to the Ethics and the Code, in context. The issues paper is provided in an appendix to this paper is provided for information purposes only.

### **Action Requested**

IESBA members are asked to consider the material addressing direct assistance provided by internal auditors. Members are asked to consider paragraphs 12a and 12 b and paragraph A7, and determine whether there are any matters pertaining to ethics which they wish to be passed on to the IAASB for its consideration.

**DRAFT INTERNATIONAL STANDARD ON AUDITING 610**  
**USING THE WORK OF THE INTERNAL AUDIT FUNCTION**  
**(EFFECTIVE FOR AUDITS OF FINANCIAL STATEMENTS FOR PERIODS**  
**BEGINNING ON OR AFTER [ ])**

**CONTENTS\***

*(\*Table of Contents to be updated upon finalization of revisions to the ISA)*

	Paragraph
<b>Introduction</b>	
Scope of this ISA .....	1
Relationship between the Internal Audit Function and the External Auditor .....	3–4c
Effective Date .....	5
<b>Objectives</b> .....	6
<b>Requirements</b>	
Determining Whether and to What Extent to Use the Work of the Internal Audit Function .....	9–10b
Using the Work of the Internal Audit Function .....	11–12
Obtaining the Direct Assistance of Internal Auditors .....	12a–12b
Documentation .....	13–14
<b>Application and Other Explanatory Material</b>	
Scope of this ISA .....	A1–A2
Relationship between the Internal Audit Function and the External Auditor.....	A2a–A3
Determining Whether and to What Extent to Use the Work of the Internal Audit Function .....	A3a–A5a
Using the Work of the Internal Audit Function .....	A5b–A6b
Obtaining the Direct Assistance of Internal Auditors .....	A7

International Standard on Auditing (ISA) 610, “Using the Work of the Internal Audit Function” should be read in conjunction with ISA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the external auditor's responsibilities relating to using the work of the internal audit function when the external auditor has determined, in accordance with ISA 315,<sup>1</sup> that the internal audit function is likely to be relevant to the overall audit strategy and audit plan. It also addresses the external auditor's responsibilities when using internal auditors to provide direct assistance under the direction and supervision of the external auditor. (Ref: Para. A1-A2)

### Relationship between the Internal Audit Function and the External Auditor

3. The objectives of the internal audit function are determined by management and, where applicable, those charged with governance and may include assurance and consulting activities within an entity aimed at evaluating and improving the effectiveness of the entity's risk management, internal control, and governance processes. Frequently, an entity's internal audit function performs audit procedures similar to those performed by the external auditor in an audit of financial statements. For example, the internal audit function might plan and perform tests or other procedures to provide assurance regarding the design, implementation and operating effectiveness of internal control relevant to the external audit. External auditors may be able to use such work rather than perform that work themselves in obtaining sufficient appropriate audit evidence on which to base the auditor's opinion. Internal auditors may also provide direct assistance on the engagement by performing audit procedures under the direction and supervision of the external auditor. (Ref: Para. A2a-A3)
4. Irrespective of the degree of objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor in an audit of financial statements in accordance with ISA 200.<sup>2</sup> The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function. For this reason, even if some of the internal audit function's activities appear relevant to the external audit, the external auditor may conclude that it is either not appropriate in the circumstances, or not efficient, to use the work of the internal audit function. This ISA addresses how the external auditor determines whether and to what extent to use the work of the internal audit function and the external auditor's evaluation of the adequacy of the work of the internal audit function for purposes of the audit. It also addresses relevant considerations when contemplating whether to use internal auditors to provide direct assistance, including the types of procedures needed in recognition of the fact that work performed by internal auditors is presumed to provide less reliable evidence.
  - 4a. In some jurisdictions, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function, from obtaining direct assistance from internal auditors, or from communicating with the internal audit function to the extent contemplated in this ISA. The ISAs do not override laws or regulations that

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<sup>1</sup> ISA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," paragraph 23.

<sup>2</sup> ISA 200, paragraph 14.

govern an audit of financial statements.<sup>3</sup> As this ISA does not require the auditor to use the work of the internal audit function or to obtain direct assistance from internal auditors, such prohibitions or restrictions will not prevent the external auditor from complying with the ISAs.

- 4b. Activities similar to those performed by an internal audit function may be conducted by functions within an entity with other titles. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are determinants of whether or not the external auditor can use the work of the internal audit function. Rather it is the nature of the activities, and the objectivity and competence of the function that are relevant.
- 4c. There may be individuals within an entity that perform ad hoc procedures similar to those performed within an internal audit function. However, unless performed within an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered control activities and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with ISA 330.<sup>4</sup>

### **Effective Date**

- 5. This ISA is effective for audits of financial statements for periods beginning on or after [ ].

### **Objectives**

- 6. The objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the overall audit strategy and audit plan, are:
  - (a) To determine whether, and to what extent, to use the work of the internal audit function; and
  - (b) If using the work of the internal audit function or obtaining direct assistance from internal auditors, to determine whether that work is adequate for the purposes of the audit.

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<sup>3</sup> ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing," paragraph A55.

<sup>4</sup> ISA 330, "The Auditor's Responses to Assessed Risks."

## Requirements

### **Determining Whether and to What Extent to Use the Work of the Internal Audit Function**

#### *Whether the Work of the Internal Audit Function Is Likely to Be Adequate for Purposes of the Audit*

9. The external auditor shall determine whether the work of the internal audit function is likely to be adequate for purposes of the audit by evaluating the following:
  - (a) The degree of objectivity of the internal audit function;
  - (b) The level of competence of the internal audit function; and
  - (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A3a-A4c)
- 9a. The external auditor shall not use the work of the internal audit function if it has:
  - (a) a low degree of objectivity, regardless of its level of competence; or
  - (b) a low level of competence, regardless of its degree of objectivity. (Ref: Para. A4a)

#### *Planned Effect of the Work of the Internal Audit Function on the Nature, Timing or Extent of the External Auditor's Procedures*

10. In determining the planned effect of the work of the internal audit function on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:
  - (a) The auditor's evaluation of the degree of objectivity and level of competence of the internal audit function;
  - (b) The nature and scope of work performed, or to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan; and
  - (c) The amount of judgment involved in:
    - (i) Planning and performing relevant audit procedures for particular classes of transactions, account balances and disclosures; and
    - (ii) Evaluating the audit evidence gathered by the internal audit function in support of the relevant assertions. (Ref: Para. A4d-A4f)
- 10a. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor shall plan to directly perform sufficient procedures to be able to conclude on the key audit judgments regardless of the external auditor's decision to use the work of the internal audit function. (Ref: Para. A4g)
- 10b. If the external auditor intends to use the work of the internal audit function, the external auditor shall discuss the planned use of their work with the internal audit function as a basis for coordinating the respective activities. (Ref: Para. A5-A5a)

### **Using the Work of the Internal Audit Function**

11. In order for the external auditor to use the work of the internal audit function, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. (Ref: Para. A5b-A6a)
12. To determine the adequacy of the work performed by the internal audit function for the external auditor's purposes, the external auditor shall evaluate whether:
  - (a) The work was properly planned, performed, supervised, reviewed and documented;
  - (b) Adequate audit evidence has been obtained to enable the internal audit function to draw reasonable conclusions; and
  - (c) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal audit function are consistent with the results of the work performed. (Ref: Para. A6b)

### **Obtaining Direct Assistance from Internal Auditors** (Ref: Para. A7-A8)

- 12a. If the external auditor plans to use internal auditors to provide direct assistance on the engagement, the external auditor shall evaluate the level of competence and degree of objectivity of the internal auditors who will be providing such assistance.
- 12b. The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220.<sup>5</sup> The level of direction, supervision and review shall recognize that internal auditors are not independent of the entity and therefore their work is presumed to provide less reliable evidence than work performed directly by the external auditor.

### **Documentation** (Ref: Para. A10-A11)

13. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:
  - (a) The evaluation of the objectivity and competence of the internal audit function, and whether it applies a systematic and disciplined approach, including quality control;
  - (b) The nature and extent of the work used and the basis for that decision; and
  - (c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used
14. The working papers prepared by the internal auditors who provided direct assistance on the engagement shall be included in the audit documentation.

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<sup>5</sup> ISA 220, "Quality Control for an Audit of Financial Statements."

## **Application and Other Explanatory Material**

### **Scope of this ISA** (Ref: Para. 1)

- A1. As described in ISA 315,<sup>6</sup> the entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.
- A2. Carrying out procedures in accordance with this ISA may cause the external auditor to re-evaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of the relevance of the internal audit function to the audit and whether further application of this ISA is necessary. Similarly, the external auditor may decide not to otherwise use the work of the internal audit function to affect the nature, timing or extent of the external auditor's procedures, or to receive direct assistance from internal auditors. In those circumstances, the external auditor's further application of this ISA is not necessary.

### **Relationship between the Internal Audit Function and the External Auditor** (Ref: Para. 3-4c)

- A2a. As set out in ISA 315,<sup>7</sup> internal auditing refers to assurance and consulting activities within an entity aimed at evaluating and improving the effectiveness of the entity's risk management, internal control, and governance processes.
- A3. The objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:

#### Activities relating to risk management

- The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control.

#### Activities relating to internal control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the operating effectiveness of the entity's internal control.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, measure, classify and report financial

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<sup>6</sup> ISA 315, paragraph A102a.

<sup>7</sup> ISA 315, paragraph A101.

and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

#### Activities relating to governance

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

### **Determining Whether and to What Extent to Use the Work of the Internal Audit Function**

*Whether the Work of the Internal Audit Function Is Likely to Be Adequate for Purposes of the Audit* (Ref: Para. 9)

- A3a. The external auditor exercises professional judgment in determining whether the work of the internal audit function is likely to be adequate for the purposes of the audit, and the nature and extent to which it may be appropriate to use work of the internal audit function in the circumstances.
- A3b. The objectivity and competence of the internal audit function are particularly important in determining the nature and extent of the use of the work of the internal audit function that is appropriate in the circumstances. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional or business judgments. Competence refers to the attainment and maintenance of knowledge and skills at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.
- A4. Factors that may affect the external auditor's determination include the following:

#### Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal audit function to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal audit function has direct access to those charged with governance.
- Whether the internal audit function is free of any conflicting responsibilities.



- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance for example, in communicating internal audit findings to the external auditor.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

#### Competence

- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
  - Whether the internal auditors have adequate technical training and proficiency as internal auditors. Relevant criteria which may be considered by the external auditor in making the assessment may include for example, the internal auditors' possession of a relevant professional designation.
  - Whether the internal auditors are members of relevant professional bodies and are obligated to comply with the relevant professional standards and continuing professional development requirements.
- A4a. Objectivity and competence may be viewed on a sliding scale. The higher the degree of objectivity and level of competence, the more appropriate it would be for the external auditor to use the work of the internal audit function and in more areas. However, a high degree of objectivity cannot compensate for a low level of competence, and equally, a high level of competence cannot compensate for a lack of objectivity. If the external auditor evaluates the objectivity or competence of the internal audit function as low, it is not appropriate to use their work. (Ref: Para. 9a)
- A4b. The application of a systematic and disciplined approach is an important characteristic that distinguishes the activities of the internal audit function from other monitoring control activities that may be performed on an ad hoc basis within the entity.
- A4c. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:
- The existence and adequacy of internal audit manuals or other similar documents, work programs, and documentation and reports prepared by the internal audit function for determining whether its activities are properly planned, supervised, reviewed and documented.
  - Whether the internal audit function has appropriate quality control policies and procedures.

#### *Planned Effect of the Work of the Internal Audit Function on the Nature, Timing or Extent of the External Auditor's Procedures*

- A4d. Once the external auditor has determined that it is appropriate to use the work of the internal audit function, the determination of the nature and extent of the use of the work of the internal audit function that is appropriate in the circumstances will be influenced by whether

the work of the internal audit function is relevant to the overall audit strategy and audit plan and the amount of judgment needed in planning, performing and evaluating such work. (Ref: Para. 10)

- A4e. The greater the amount of judgment that is needed to be exercised in designing the audit procedures and evaluating the results thereof, the greater the likelihood that the work of the internal audit function may not be adequate for the purposes of the audit. In such circumstances, it is more likely that the external auditor may need to perform some procedures directly because consideration of the work of the internal audit function alone is unlikely to provide the external auditor with sufficient appropriate audit evidence. (Ref: Para. 10)
- A4f. In determining the nature and extent of using the work of the internal audit function in specific areas, and overall in the engagement, other factors, such as the assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances and disclosures, may also be relevant in determining the external auditor's overall audit strategy and audit plan. (Ref: Para. 10)
- A4g. Key audit judgments include assessments of inherent and control risks, materiality of misstatements, sufficiency of tests performed, appropriateness of management's use of the going-concern assumption, evaluation of significant accounting estimates, adequacy of disclosures in the financial statements, and other matters affecting the auditor's report. (Ref: Para. 10a)
- A5. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:
- The timing of such work;
  - The extent of audit coverage;
  - Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality;
  - Proposed methods of item selection;
  - Documentation of the work performed; and
  - Review and reporting procedures. (Ref: Para. 10b)
- A5a. Coordination between the external auditor and the internal audit function is effective when:
- Discussions take place at appropriate intervals throughout the period;
  - The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal audit function when such matters may affect the work of the external auditor so that the external auditor may consider the implications of such matters for the external audit; and
  - The external auditor informs the internal audit function of any significant matters that may affect the internal audit function. (Ref: Para. 10b)

**Using the Work of the Internal Audit Function** (Ref: Para. 11)

A5b. Examples of work of the internal audit function that may be used by the external auditor include the following:

- Testing of the operating effectiveness of controls
- Substantive procedures (for example, checking reconciliations)
- Observations of inventory counts
- Tracing transactions through the information system relevant to financial reporting
- Audits or reviews of the financial information, or specified procedures on the financial information of subsidiaries (for example, components that are not significant components to the group)

A6. The nature, timing and extent of the audit procedures that the external auditor performs on the work of the internal audit function will depend on the external auditor's evaluation of the degree of objectivity and level of competence of the internal audit function, and the amount of judgment exercised by the function in planning and performing relevant audit procedures for particular classes of transactions, account balances and disclosures . Such audit procedures may include the following:

- Reperformance by examining items already examined by the internal audit function
- Examination of other similar items
- Observation of procedures performed by the internal audit function
- Review of the internal audit function's work program and working papers

A6a. While it is not necessary for the external auditor to do some reperformance on each individual piece of work of the internal audit function, reperformance of some of such work provides a strong form of evidence regarding the adequacy of the work of the internal audit function for purposes of the audit.

A6b. In determining the adequacy of the work performed by the internal audit function, the external auditor may consider whether any exceptions or unusual matters disclosed by the function such as misstatements or control deficiencies are properly addressed by the entity and in the event they are not, whether the internal audit function follow-up on these matters.

**Obtaining Direct Assistance from Internal Auditors** (Ref: Para. 12a-12b)

- A7. In addition to using the work of the internal audit function, the external auditor may receive direct assistance from the internal auditors in carrying out audit procedures. As individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, audit procedures performed by internal auditors in connection with the external audit are presumed to provide less reliable evidence than work performed directly by the external auditor themselves. Therefore, the direction, supervision or review of the audit procedures performed by the internal auditors will ordinarily be more extensive than if members of the engagement team had performed the work.

## **Appendix IAASB Issues Paper**

### **Provided for Information Purposes Only**

## **Using the Work of the Internal Audit Function—Issues and IAASB Task Force Proposals**

### **Objective of this Paper**

1. To consider the Task Force's proposals for revisions to clarified ISA 315<sup>8</sup> and ISA 610<sup>9</sup> in light of inputs received from the IAASB on significant issues at its September 2009 meeting.

### **Background**

2. At its September 2009 meeting, the IAASB considered significant issues in the revision of clarified ISA 610 and provided input and direction to the Task Force on the way forward. The IAASB indicated general agreement with the issues proposed by the Task Force for addressing in the revision of the ISA. There was also broad support for the proposed underlying principles regarding the external auditor's use of the work of the internal audit function applied by the Task Force in shaping its recommendations.
3. To recap, the main issues considered in September 2009 and direction provided by the Board are as follows:
  - (a) Role of internal auditing in the external auditor's risk assessments, in particular:
    - The definition of internal audit, which influences the application of ISA 610. The IAASB directed the Task Force to focus on the relevant characteristics of an internal audit function that the external auditor needs to consider as opposed to the precise wording of the definition.
    - The relationship between the internal audit function and the entity's internal control (ISA 315), which is important in explaining why the approach to using the assurance work of the internal audit function is different than the auditor's evaluation and testing of internal controls.
    - The effect of the internal audit function on the auditor's risk assessments. The IAASB agreed that introducing required inquiries of the internal audit function would enable the external auditor to effectively leverage the function's knowledge of the entity and its environment, and its assessment of risks. Additionally, the majority of board members agreed that while the review of reports produced by the internal audit function should not be mandatory, guidance should be included to emphasize the value such reviews may bring to the external audit under the relevant circumstances.

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<sup>8</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

<sup>9</sup> ISA 610 (Redrafted), "Using the Work of Internal Auditors."

(b) Whether and to what extent to use the work of the internal audit function, in particular:

- The external auditor's assessment of the objectivity and competence of the internal audit function. The IAASB supported the Task Force's proposal that the external auditor's assessment of both objectivity and competence are important in determining whether and to what extent the external auditor may use the work of the internal audit function.
- The factors that influence the auditor's judgments on the nature and extent of use of the work of the internal audit function. The IAASB agreed that the relevance of the work of the internal audit function to the external auditor's overall audit strategy and audit plan is another dimension that is likely to be central to the external auditor's consideration noting however that ISA 315 contains requirements and guidance in this regard.
- How the external auditor may use work of the internal audit function to achieve greater efficiency and effectiveness.
- The nature, timing and extent of the work necessary to support the external auditor's decision to use the work of the internal audit function. The IAASB agreed that re-performance is not necessary on each piece of internal audit work. However, the Task Force was asked to consider clarifying how the external auditor's procedures are used for purposes of refuting or verifying the adequacy of the work of the internal audit function for use in the external audit.

(c) Expansion of the scope of ISA 610 to address instances of the external auditor obtaining direct assistance from the internal auditors. The IAASB expressed broad support whilst recognizing that such practices may not be permitted in certain jurisdictions.

(d) Possible implications arising from national laws and regulations. The IAASB noted that the revised ISA should explicitly recognize that there may be certain restrictions on the use of internal audit by external auditors.

4. Based on the comments received from the Board, the Task Force recommends proposed revisions to extant ISA 315 and ISA 610. Drafts of the proposed revised ISA 315 and the revised ISA 610 are presented in **Agenda Item 7-B** and **Agenda Item 7-D** respectively. The remainder of this Paper sets out the Task Force's deliberations and its recommendations in regard to the key matters considered.

## Significant Issues

### Direct Assistance

5. At its September 2009 meeting, the IAASB considered and broadly supported an expansion of the scope of ISA 610 to address circumstances where internal auditors are asked to provide direct assistance to the external auditor in carrying out audit procedures on the engagement when not prohibited by local law or regulation. It was noted that a blanket prohibition on direct

assistance would unnecessarily restrict a practice that is already accepted in many jurisdictions. It was also observed that the line between direct assistance and using the work of the internal audit function is not necessarily clear in practice, and that, in general, arguments raised against direct assistance can generally also be applied to any case involving the use of the work of the internal audit function.

6. In light of the fact that internal auditors are not independent of the entity, however, the IAASB instructed the Task Force to give further consideration to the measures that can be put in place when internal auditors provide direct assistance on the external audit under the direction and supervision of the external auditor, and to seek the input of the International Ethical Standards Board for Accountants (IESBA).

#### *Expansion of the Scope of ISA 610*

7. A benefit of expanding the scope of ISA 610 to explicitly address direct assistance is that it will remove any ambiguity about whether direct assistance is allowed by the ISAs. Some have interpreted the paragraph in the scope of the extant ISA<sup>10</sup> that it “does not deal with” instances of direct assistance to imply that an audit conducted in accordance with ISAs cannot, therefore, use direct assistance. Others interpret it as simply an acknowledgment that the requirements and guidance in ISA 610 do not address that circumstance, but that it does not prohibit it in an ISA audit.
8. Importantly, addressing direct assistance in the revised ISA will also enable the IAASB to respond to some stakeholders’ concerns about such practices by emphasizing considerations that the external auditor would need to take in directing, supervising and reviewing their work in light of the fact that the internal auditors are not independent of the entity.
9. It is proposed that ISA 610 not require or encourage the external auditor to use, or even to consider using, internal auditors to provide direct assistance on the engagement. This is so as to avoid inadvertently introducing undue pressures on the external auditor to obtain or consider obtaining the direct assistance, which should remain the discretion of the external auditor taking into account the circumstances of the engagement. Equally, the Task Force believes it important that, in the scope of the ISA, acknowledgement is given to the fact that direct assistance may not be allowed in some jurisdictions and that it is not the intention of the ISA to override such prohibitions at the national level.
10. The Task Force proposes that the ISA include requirements and guidance setting out the external auditor’s responsibilities when considering whether to obtain the direct assistance of internal auditors. The objective of which is to guard against undue reliance and to ensure that the possible risks to audit quality arising from the lack of independence are guarded against by the external auditor’s planning, directing, supervising and reviewing the work performed by the internal auditors.

#### *Internal Auditors and the Engagement Team*

11. The views of the IESBA were sought on the matter of direct assistance at its October 2009 meeting; in particular, on the question of whether by performing audit procedures on the

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<sup>10</sup> ISA 610, paragraph 2.

external audit these individuals may, under the prevailing definitions in the ISAs and the Code,<sup>11</sup> be deemed to be members of the engagement team.<sup>12</sup> The IESBA indicated that the intention was not for the definition of engagement team in the Code to encompass internal auditors providing assistance to the external auditor, but also noted that some of the wording in the Code could inadvertently be interpreted to suggest that an internal auditor may not work under the direction of the external auditor.

12. Section 290.163 of the Code states that an example of activities that would generally be considered a management responsibility includes directing and taking responsibility for the actions of the entity's employees. In accordance with section 290.165 of the Code, the external auditor shall not assume a management responsibility for a client as the threats created would be so significant that no safeguards could reduce the threats to an acceptable level. In the event internal auditors are engaged to perform audit procedures under the direction, supervision and review of the external auditor, the external auditor could possibly be viewed as "directing and taking responsibility for the actions of the entity's employees" which if interpreted in the context of the section 290.163 of the Code would constitute a management responsibility.
13. The IESBA's discussion in October 2009 broadly indicated that the intent of the Code is not to prohibit the use of internal auditors by external auditors for direct assistance on the external audit. Further, the extent of the external auditor's direction of and responsibility for the internal auditors would be restricted to the ambit of the external audit and, as such, there can be no management responsibility. Notwithstanding this, the IESBA noted that there is a lack of clarity and that a literal interpretation may inadvertently result in the wrong conclusion. The IESBA will resume its consideration of the matter at its February 2010 meeting.
14. The Task Force proposes that the external auditor's procedures when planning to use internal auditors to provide direct assistance on the engagement will first and foremost involve evaluation of the level of competence and degree of objectivity of the individual internal auditors who will be providing assistance (similar to the consideration regarding the internal audit function as a whole when using their work). As internal auditors are not independent of the entity as is required of the external auditor in an audit of financial statements, the Task Force considered the additional measures that should be taken by the external auditor. ISA 500<sup>13</sup> observes that the reliability of audit evidence is increased when obtained from independent sources outside the entity and correspondingly, audit evidence obtained from internal sources would be deemed less reliable. Thus, there will always be some risk to the reliability of evidence obtained by staff of the internal audit function arising since these individuals are not independent of the entity. Therefore, it is proposed that there be more extensive direction, supervision or review of the audit procedures performed by the internal auditors than if members of the engagement team had performed that work.

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<sup>11</sup> The IESBA's *Code of Ethics for Professional Accountants*.

<sup>12</sup> 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 Code, the engagement team is defined as all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

<sup>13</sup> ISA 500, "Audit Evidence," paragraph A31.



15. The IESBA expressed its support in this regard at its October 2009 meeting, pointing out that these measures would further distinguish internal auditors providing direct assistance from members of the engagement team. See paragraphs 12a-12b and A7-A8 in the draft proposed revised ISA 610 presented in **Agenda Item 7-D**.

### **Matters for IAASB Consideration**

The IAASB is asked:

- Whether it agrees that the scope of the ISA should be expanded to address the matter of direct assistance?
- Whether it agrees that when obtaining the direct assistance of internal auditors, external auditor should:
  - Evaluate the level of competence and degree of objectivity of the internal auditors; and
  - Direct, supervise and review the internal auditors in a way that recognizes that they are not independent of the entity?

### **Using the Work of the Internal Audit Function**

16. At its September 2009 meeting, the IAASB considered and broadly supported a judgment-based approach to the external auditor's determination of whether and to what extent to use the work of the internal audit function. There was broad consensus that the external auditor's initial assessment of the adequacy of the work of the internal audit function is appropriately concerned with the internal audit function's objectivity and competence. The degree of judgment involved in performing the procedure would also be a key consideration. The IAASB instructed the Task Force to further develop the proposed risk-based approach in the context of ISA 610 with consideration for the comments provided by the Board. Importantly, consideration should be given to the deterrence of undue reliance on the work of the internal audit function by strengthening the assessment required of the external auditor in determining whether and to what extent to use the work of the internal audit function.
17. The Task Force has considered the viewpoints expressed by the Board in September 2009 and proposes the following:

#### *Determining Whether and to What Extent to Use the Work of the Internal Audit Function*

- Strengthening ISA 610's focus on the external auditor's evaluation of the internal audit function for determining whether the work of the internal audit function is likely to be adequate for the purposes of the audit. Specifically, emphasis is placed on the external auditor's evaluation of the internal audit function's objectivity, competence and application of a systematic and disciplined approach.
- Clarifying that the external auditor's assessment of the internal audit function's degree of objectivity and level of competence takes the form of a sliding scale i.e., the higher the degree of objectivity and level of competence, the more appropriate it would be for the external auditor to use the work of the internal audit function and in more areas. In this

regard, the Task Force also believes that it is appropriate to establish minimum thresholds under which it would not be appropriate for the external auditor to use any of the work of the internal audit function. Specifically, where either the objectivity or competence of the internal audit function is assessed as low, the work of the internal audit function should not be used for purposes of the audit. Applying this principle, a high degree of objectivity cannot offset a low level of competence, and similarly, a high level of competence cannot offset a low degree of objectivity. In doing so, the requirements will both provide a framework for determining the nature and extent of the work of the internal audit function that can justifiably be used in the external audit (i.e., the “sliding scale”), and set out clear boundaries to guard against the use of the work of the internal audit function in circumstances in which it would be inappropriate.

- Introducing the consideration, by the external auditor, of whether the internal audit function applies a systematic and disciplined approach. This is an important underlying premise to the approach adopted in the ISA, which focuses on obtaining sufficient evidence about the function as a whole, rather than “testing” each individual piece of work. A key distinction between an entity’s internal audit function and its internal controls is that the former performs *assurance* work in observance of quality control policies and procedures, and, therefore, such work would be subjected to proper planning, supervision, review and documentation.

#### *Determining the Planned Effect of the Work of the Internal Audit Function*

- Strengthening ISA 610’s focus on the matters that need to be taken into account when determining the planned effect of the work of the internal audit function. It is proposed that the external auditor’s judgment be based both on the consideration of the internal audit function’s objectivity and competence, and on the amount of judgment involved in planning and performing the audit procedures, and in evaluating the evidence gathered. In this regard, supporting guidance is provided to explain that the greater the amount of judgment exercised, the greater the likelihood that the work of the internal audit function may not be adequate for the purposes of the audit on its own, and the more likely that the external auditor will need to be directly involved in order to be satisfied that sufficient appropriate audit evidence is obtained.
- Providing guidance to explain that in specific areas (for example, specific line items or assertions), and overall in the engagement, other factors such as the assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances and disclosures may also be relevant in the external auditor’s determination of the nature and extent of the use of the work of the internal audit function.
- Introducing a requirement for the external auditor to “stand-back” and consider whether there will be sufficient involvement by the external auditor to be able to conclude on the key audit judgments. The objective of such a requirement is to prevent overreliance on the work performed by the internal audit function collectively on the external audit. This draws on a similar premise to that in ISA 600 (in relation to other external auditors) that, regardless of the external auditor’s decision to use the work of the internal audit function, full responsibility for the audit opinion remains with the external auditor and therefore, the

external auditor needs to have sufficient basis in order to take ownership of the key audit judgments.

- Establishing the external auditor's obligation to discuss with the internal audit function the planned use of their work for the purpose of coordinating the relevant activities with the function. This is in response to the emphasis various stakeholders have given to the importance of effective and ongoing dialogue between the internal and external auditors.

*Using the Work of the Internal Audit Function*

- Expanding the guidance on the procedures the external auditor needs to perform on the body of work of the internal audit function as follows:
  - Providing examples of the work of the internal audit function that may be used by the external auditors;
  - Clarifying that the nature, timing and extent of audit procedures needed to be performed by the external auditor on the body of work of the internal audit function would vary depending on the degree of objectivity and level of competence of the internal audit function, and the amount of judgment exercised in the work of the internal audit function that the external auditor is considering using;
  - Clarifying that reperformance is not required on each individual piece of work of the internal audit function that the external auditor decides to use, but emphasizing that reperformance of some of such work provides a strong form of evidence on the adequacy of the work of the internal audit function for purposes of the external audit.

The premise underlying the proposed revisions is that the external auditor is obtaining evidence in relation to the body of work of the internal audit function as a whole.

18. See paragraphs 9-10b and A3a-A5a in the draft proposed revised ISA 610 presented in **Agenda Item 7-D**. A diagram illustrating the proposed judgment-based model is provided in the Appendix to this issues paper.

**Matters for IAASB's Consideration**

The IAASB is asked whether it agrees with the factors proposed to be evaluated by the external auditor in determining:

- Whether the work of the internal audit function is likely to be adequate for purposes of the audit?
- The planned effect of the work of the internal audit function on the nature, timing or extent of the external auditor's procedures?

## **Inquiry of the Internal Audit Function**

19. At its September 2009 meeting, the IAASB discussed the importance of leveraging the internal audit function's knowledge of the organization and expertise in risk and control insofar as informing the external auditor's understanding of the entity and its environment as a basis for the external auditor's risk assessment. In this regard, there was support for the introduction of a requirement in the ISAs for the external auditor to make inquiries of the internal audit function about its findings and work performed that are likely to be relevant to the external auditor's overall audit strategy and audit plan. In connection with this, the IAASB also considered whether the external auditor should be required to read reports issued by the internal audit function.
20. Whilst some felt that this should be a required procedure, the majority of Board members were concerned that this could result in significantly more audit effort given the possible nature and extent of internal audit reports and that, therefore, it would not be appropriate to mandate such a procedure since costs may often outweigh benefits. Whilst the requirement could be more specific about the reports that are likely to be of relevance to the external auditor, it was pointed out that such judgments could only be made upon reading all reports. Notwithstanding this, the IAASB instructed the Task Force to give consideration to whether in the application guidance, the external auditor could be encouraged to review reports of the internal audit function in appropriate circumstances.
21. The Task Force has considered the viewpoints expressed by the Board in this regard and proposes the following revisions to extant ISA 610:
  - *Placement of the requirement (and its supporting application material).* Extant ISA 315 deals with the external auditor's responsibility to obtain an understanding of the entity and its environment so as to identify and assess the risks of material misstatement. Paragraph 6 of the ISA requires the external auditor's risk assessment procedures to include making inquiries of management and of others within the entity. It is proposed that the requirement for inquiries to be made by the external auditor with the internal audit function is appropriately placed therein.
  - *The appropriate individuals with whom to inquire.* It is proposed that guidance regarding where to direct inquiries of the internal audit function (i.e., to which individuals within the function) be included in support of the proposed requirement. In this regard, the Task Force was of the view that the knowledge, experience and authority of the individuals within the internal audit function are relevant considerations, and that the chief internal audit executive be provided as an example of an appropriate individual.
  - *Guidance on reading reports issued by the internal audit function.* The Task Force continues to believe that because of the volume and scope of the reports produced by the internal audit function given the range of activities performed by the function, it would not be efficient to require the external auditor to read all the reports produced. However, the Task Force proposes that guidance be provided in ISA 315 that as a result of the external auditor's inquiries of internal audit function, the external auditor may decide that it would

be useful to follow up by reading about certain of the findings in the relevant reports of issued by the internal audit function.

22. See paragraphs 6 and A6-A6d in the draft proposed revised ISA 315 presented in **Agenda Item 7-B**.

#### **Matters for the IAASB's consideration**

The IAASB is asked:

- Whether it agrees with the inclusion of a requirement for the external auditor to make inquiries of appropriate individuals within the internal audit function?
  - If so, whether it agrees that such a requirement is appropriately placed in ISA 315?
- Whether it agrees with the Task Force's proposal regarding the external auditor's reading of reports produced by the internal audit function?

#### **Impact Analysis Consideration**

23. IFAC is currently developing an impact analysis framework for its standard setting bodies. At its June 2009 meeting, the IAASB approved the proposed impact analysis for testing the practical application of the proposed analysis on one or more IAASB projects. This project was identified as a test case for this purpose.
24. In June 2009, the IAASB was briefed on the proposed process for informing, developing and documenting the impact analysis. In brief, the proposed framework indicates the following:
- The impact analysis is informed throughout the development of the proposed new standard and documented in the Explanatory Memorandum that accompanies the Exposure Draft. The final impact analysis is documented in the Basis for Conclusions. In this regard, it was highlighted that documenting the impact analysis in the Explanatory Memorandum is particularly important for obtaining feedback from external stakeholders.
  - The impact of both the proposed standard and the preferred option for each key issue addressed during the development of the standard would be analyzed. Narrative descriptions of these analyses are included in the Explanatory Memorandum. These analyses are scalable; that is, their scope and depth depend on the nature and magnitude of the problem being addressed.
  - The Explanatory Memorandum and Basis for Conclusions would include the impact analysis template.
25. The Task Force gave consideration to the issues addressed in the revision of ISA 610 and proposes that the following three key matters be highlighted in the impact analysis that accompanies the Exposure Draft:
- (a) Proposed expansion of the scope of ISA 610 to address the matter of internal auditors providing direct assistance to external auditor on the engagement.

- (b) Proposed judgment-based approach to the external auditor's determination of whether and to what extent to use the work of the internal audit function.
  - (c) Proposed requirement in ISA 315 for the external auditor to make inquiries of the internal audit function about its findings and work performed that are likely to be of relevance to the external audit as a basis for leveraging the knowledge and experience of the internal audit function to inform the external auditor's risk assessments.
26. Subject to the IAASB's views on the key matters proposed above, it is the Task Force's intention that a draft impact analysis will be prepared for the next IAASB meeting at which this project would be considered for purposes of seeking preliminary feedback from the Board.

**Matters for IAASB Consideration**

The IAASB is asked for its views on the key issues proposed for inclusion in the impact analysis for this project.

## APPENDIX

### Factors Influencing the External Auditor's Use of the Work of the Internal Audit Function

