

PROPOSED INTERNATIONAL STANDARD ON AUDITING 610 (REDRAFTED) THE AUDITOR'S CONSIDERATION OF THE INTERNAL AUDIT FUNCTION

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Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the external auditor's considerations when obtaining an understanding of and determining whether to use the work of the internal audit function, and the extent to which the external auditor may use that work. This ISA does not deal with instances when internal audit personnel assist the external auditor in carrying out external audit procedures.

Relationship Between the Internal Audit Function and the External Auditor

2. The role of the internal audit function is determined by management¹. Management's objectives differ from those of the external auditor whose overall objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. The objectives of the internal audit function vary according to management's requirements. (Ref: Para. A1-A2)
3. The internal audit function may achieve its objectives in a manner similar to that of the external auditor. Accordingly, certain aspects of the internal audit function's activities may be useful to the external auditor in determining the nature, timing and extent of audit procedures to be performed.
4. Notwithstanding the degree of autonomy and objectivity of the internal audit function, it cannot achieve the same degree of objectivity required of the external auditor when expressing an opinion on the financial statements. The external auditor has sole responsibility for the audit opinion expressed. That responsibility is not reduced by the external auditor's use of the internal audit function.

Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after [date²].

Objective

6. The objective of the external auditor is to determine whether the activities of the internal audit function are relevant to planning and performing the audit and, if relevant, the effect, if any, on the procedures performed by the external auditor.

(Or, alternative as presented at the September 2006 IAASB meeting)

The objective of the external auditor is to determine the relevance of the activities of the internal audit function and their effect, if any, on external auditor's procedures.

¹ In some circumstances, the role of the internal audit function may be determined by those charged with governance.

² This date will not be earlier than December 15, 2008.

Requirements

Understanding and Assessment of the Internal Audit Function

7. The external auditor shall obtain an understanding of the internal audit function in conjunction with obtaining an understanding of internal control (as required by ISA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”). The understanding obtained by the auditor shall include an understanding of the organizational status of the internal audit function and the scope of the internal audit function’s activities. (Ref: Para. A3-A5)
8. The external auditor shall perform an assessment of the internal audit function when the external auditor is considering whether to use the work of the internal audit function. In those instances, the external auditor shall assess:
 - (a) The technical competence and objectivity of the internal audit function and its members;
 - (b) Whether the internal audit function is carried out with due professional care; and
 - (c) The effect of any constraints or restrictions placed on the internal audit function by management. (Ref: Para. A5)

Planned Use of the Internal Audit Function’s Work

9. In making judgments about the extent of the effect of the work of the internal audit function on the external auditor’s procedures, the external auditor shall consider:
 - (a) The materiality of the related financial statement amounts;
 - (b) The risk, consisting of inherent and control risk, of material misstatement of the assertions related to those financial statement amounts;
 - (c) The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the relevant assertions. (Ref: Para. A6-A8)

Evaluating the Work of the Internal Audit Function

10. When the external auditor intends to use the work of the internal audit function, the external auditor shall perform procedures sufficient to evaluate the adequacy of that work for the external auditor’s purposes. In making this evaluation, the external auditor shall test a portion of the internal audit function’s work and compare the results of the external auditor’s tests with the results of that work. (Ref: Para. A9-A10)
11. When evaluating specific work performed by the internal audit function, the external auditor shall consider the adequacy of the scope of work and related programs and whether the assessment of the internal audit function remains appropriate. The external auditor shall consider whether:
 - (a) The work is performed by persons having adequate technical training and proficiency as internal auditors;
 - (b) The work of assistants is properly supervised, reviewed and documented;

- (c) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;
- (d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
- (e) Any exceptions or unusual matters disclosed by the internal audit function are properly resolved.

Application and Other Explanatory Material

Scope and Objectives of the Internal Audit Function (Ref: Para. 2)

- A1. An internal audit function may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity's management and to those charged with governance. To effectively fulfill its responsibility, the internal audit function needs to maintain objectivity with respect to the activities it undertakes.
- A2. The scope and objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of its management. Internal audit function activities may include one or more of the following:
 - Monitoring of internal control. The internal audit function may be assigned specific responsibility by management for reviewing controls, monitoring their operation and recommending improvements thereto.
 - 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 and operating information, and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
 - Review of the economy, efficiency and effectiveness of operating activities including non-financial activities of an entity.
 - Review of compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Understanding and Assessment of the Internal Audit Function (Ref: Para. 7-8)

- A3. An effective internal audit function may affect the nature, timing, and extent of audit procedures performed by the external auditor, but cannot eliminate them entirely.
- A4. In obtaining an understanding of the internal audit function, the external auditor may conclude that the internal audit function's activities are not relevant to the financial statement audit. In such circumstances, the external auditor need not consider the internal audit function further. In other circumstances, the external auditor may conclude that it would not be effective to include the effect of the internal audit function in the external auditor's risk assessment, and the scope of the external auditor's understanding and assessment of the work of the internal audit function, would be determined accordingly.

- A5. Factors that may affect the external auditor's understanding and assessment of the internal audit function include:

Organizational status of the internal audit function: The status of the internal audit function within the entity and the effect such status has on the internal audit function's ability to be objective include:

- Whether the internal audit function reports to an officer of appropriate authority to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal audit function.
- Whether the internal audit function has direct access and reports regularly to the board of directors, those charged with governance, or the owner-manager.
- Whether those charged with governance oversee or the owner-manager oversees employment decisions related to the internal audit function.

Ideally, the internal audit function reports to the highest level of management, or to those charged with governance, and is free of any other operating responsibility. In particular, the internal audit function needs to be free to communicate fully with the external auditor.

Scope of the internal audit function:

- The nature and extent of internal audit assignments performed.
- Whether, and to what extent management acts on the recommendations of the internal audit function and how such action is evidenced.

Technical competence:

- Whether the persons performing the internal audit function have adequate technical training and proficiency as internal auditors.
- Whether there are established policies for hiring and training the internal audit staff.

Due professional care:

- Whether internal audit activities are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals, work programs and working papers.

The auditor's assessment of the objectivity of the internal audit function may be affected by all of the above considerations.

Planned Use of the Internal Audit Function's Work (Ref: Para. 9)

- A6. As the materiality of the financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases.
- A7. When planning to use the work of the internal audit function, the external auditor might review the internal audit function's tentative plan for the period and discuss that plan with the internal audit function. It also may be useful to agree in advance the following matters:

- The timing of such work;
 - The extent of audit coverage;
 - Materiality levels;
 - Proposed methods of sample selection;
 - Documentation of the work performed; and
 - Review and reporting procedures.
- A8. Liaison with the internal audit function is most effective when meetings are held at appropriate intervals throughout the period. It may be useful for the external auditor to be advised of and have access to relevant reports of the internal audit function and to be informed of any significant matters that come to the attention of the internal audit function when these matters may affect the work of the external auditor. Similarly, it may be useful for the external auditor to inform the internal audit function of any significant matters which may affect the internal audit function.

Evaluating the Work of the Internal Audit Function (Ref: Para. 10)

- A9. The nature, timing, and extent of the procedures to be performed when evaluating the work of an internal audit function are matters of professional judgment depending on the extent of the effect of the internal audit function's work on the external auditor's.
- A10. The external auditor's testing of the internal audit function's work may include one or a combination of the following:
- Re-performance of work performed by the internal audit function;
 - Examination of other similar items; or
 - Observation of procedures performed by the internal audit function.