

**Using the Work of Internal Auditors—Issues and IAASB Task Force  
Proposals****I. Objectives of this Paper**

1. To consider:
  - (a) The significant issues that should be addressed in the revision of the clarified ISA 610;<sup>1</sup> and
  - (b) In light of those issues and the inputs already received, whether additional consultation is necessary prior to developing an exposure draft of the revised ISA 610.

**II. Introduction**

2. 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.
3. The specific issues the Task Force has considered are:
  - (a) Role of internal auditing in the external auditor’s risk assessments, in particular:
    - The definition of internal audit function, which influences the application of the requirements and guidance in ISA 610.
    - The relationship between internal auditing and the entity’s internal control.
    - How internal auditing may influence the auditor’s risk assessments and, in this regard, whether the work effort required by the existing requirements in the ISAs appropriately and effectively enables the external auditor to leverage the internal audit function’s knowledge of the entity and its environment, and its assessment of risks.
  - (b) Use of internal audit work, in particular:
    - The factors that influence the auditor’s judgments on the extent of use of internal audit work.
    - Determining how internal audit work may be used to achieve greater efficiency and effectiveness in the external audit.
    - The nature, timing and extent of the work necessary to support the external auditor’s decision to use specific internal audit work.
  - (c) The external auditor’s assessment of the competence and objectivity of the internal audit function.

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<sup>1</sup> ISA 610 (Redrafted), “Using the Work of Internal Auditors.”

- (d) Expansion of the scope of ISA 610 to address instances of internal audit staff providing direct assistance to the auditor.
- (e) Possible implications arising from national laws and regulations.

These issues are further discussed in the remainder of this Paper and the views of the IAASB on these matters are sought by the Task Force.

- 4. On balance, the Task Force is of the view that the overall structure of ISA 610 and its requirements generally remain sound, insofar as they currently extend. However, the Task Force believes that there is opportunity to enhance the application material to identify matters to be considered and introduce “rules of thumb” to guide external auditors in making appropriate judgments when applying the requirements of the ISA, thereby improving the overall quality of audits.

### **III. General Principles**

- 5. In considering the issues to be addressed in revising ISA 610, the Task Force arrived at some general underlying principles regarding the external auditor’s use of internal audit work. These principles shaped the Task Force’s deliberations and, accordingly, its proposals on several of the key issues in connection with the revision of ISA 610:
  - (a) In the context of the external audit, the decision of whether or not to use the work (or assistance) of internal auditors should rest with the external auditor; the ISA should not directly or indirectly encourage or discourage the use of the work (or assistance) of internal auditors. The Task Force was concerned that a presumption that internal audit work (or assistance) should be used whenever justified might inadvertently introduce pressures on the decisions of the external auditor which in turn could have a negative effect on audit quality.
  - (b) The external auditor must make an informed decision regarding whether to use the work of internal auditors and sufficient guidance should be provided by the ISAs to enable the external auditor to do so. However, the external auditor’s evaluation of the internal audit function for purpose of the financial statement audit is not designed to provide a sufficient basis for forming an opinion about the overall effectiveness of the internal audit function.
  - (c) Work performed by internal auditors that may be of relevance to the external audit generally falls into one of the following three categories:
    - Internal audit findings and insights may be a source of information about the entity and its environment that can assist the external auditor in the identification and assessment of the risk of material misstatement.
    - Specific work which the external auditor may be able to use in lieu of performing that work directly themselves (i.e., the internal audit function has performed audit procedures that obtained relevant audit evidence); typically this refers to assurance work performed by internal auditors, often in relation to the evaluation and testing of internal control.

- Direct assistance provided to the external auditor through performance of audit procedures as part of the external audit under the direction, supervision and review of the external auditor.

The Task Force felt that clear distinction between these three types of internal audit work is necessary because the nature of the work, its possible use in the audit, and the considerations the external auditor needs to make in relation to each of them are different. This is demonstrated in the discussion of a number of the issues in connection with the revision of ISA 610.

- (d) In deciding to use specific internal audit work, the external auditor is not “relying on internal control” in the same way that the auditor may obtain evidence from the effectiveness of a particular control activity. Rather, the external auditor is using that work in lieu of performing similar audit procedures directly. As a basis for determining whether it is appropriate to use that specific internal audit work as part of the external auditor’s evidence, the external auditor obtains evidence regarding the internal audit function *as a whole*.

#### **Matters for IAASB Consideration**

The IAASB is asked whether it agrees with the general principles outlined above in regard to the external auditor’s use of internal audit work?

### **IV. Significant Issues**

#### **A. Definition of Internal Audit Function**

6. Since extant ISA 610 was developed, there have been many developments in the internal audit environment. For example, in many entities, there have been changes in the organizational status of the internal audit function and the activities performed by internal auditors. Indeed, these changes prompted the release of a new definition of internal auditing by the Institute of Internal Auditors (IIA):

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Such developments justify a review of the definitions in ISA 610 for their continued relevance.

7. The definitions of “internal audit function” and “internal auditors” in ISA 610 are important in determining the relevance of the internal audit function to the external audit, and consequently when the external auditor needs to apply ISA 610 in the context of an audit of financial statements. It is therefore important for the revised definition of the internal audit function to appropriately reflect changes in the internal audit environment and, according, the intention of the ISA.

8. In this regard, the Task Force believes that the following are important features of the internal audit function and, accordingly, should be captured in the definition:
- (a) The role of the internal audit function with regard to internal control is one of evaluating controls; in particular, to provide *assurance* on the operating effectiveness of internal control as distinct from being a control activity itself.
  - (b) For purposes of the ISAs, the focus should be on identifying internal auditing as a *function* as distinct from ad hoc *activities* performed by individuals within the entity. In addition to internal audit departments as they are traditionally understood, it is now common practice for internal audit functions in an entity to be performed through one or more groups within or outside (i.e., if outsourced) of the entity – although these functions may not always hold the title of “internal audit.”
  - (c) The internal audit function employs a *systematic and disciplined approach* to the conduct of the internal audit engagement. This is an important characteristic that distinguishes its work from other control activities that may be performed on an ad hoc basis within the entity. In this regard, for example, the IIA’s standards contain requirements relating to the managing, planning, performance and communication of the internal audit engagement.
  - (d) The internal audit function maintains *objectivity* in the performance of its work; this characteristic is of particular importance given its role to evaluate internal control. Notably, the IIA’s definition (see below) refers to internal auditing as being an *independent* function.)
9. The Task Force does not believe that adoption of the IIA’s definition verbatim is appropriate in the context of the ISAs. For example, it would be inappropriate to refer to the internal audit function as “*independent*” as this can never truly be the case given the definition of independence under the IFAC’s *Code of Ethics for Professional Accountants* (the IFAC Code). In addition, the Task Force thought it would be useful, in the context of the ISAs, to focus on the aspects of internal audit activities that are relevant to the external audit and to put less emphasis on internal audit function’s consulting/performance improvement role.
10. With consideration for the features discussed above, the definitions in the extant ISA 610 and the new IIA definition, the Task Force proposes the following revised definition of internal audit function:

An internal audit function (regardless of title) is an objective assurance and consulting activity that supports management and those charged with governance in accomplishing the entity’s objectives using a systematic, disciplined approach. Its activities include examining, evaluating and reporting on, for example, the adequacy and effectiveness of governance, risk management, and internal control.

#### A.1 INTERNAL AUDITING AND INTERNAL CONTROL

11. Typically, the role of the internal audit function includes performing procedures designed to evaluate the operating effectiveness of the entity’s internal control. This is a subtle but important difference that sets it apart from the entity’s control activities and other components of internal control. In this regard, the internal audit function performs audit

procedures to obtain assurance about the entity's controls (e.g., tests of controls). This distinction has implications for the definition of the internal audit function (as discussed in Section A above) and, thereby, the scope of ISA 610. If the objective of such internal audit work is considered to be work designed to provide assurance, it may be of relevance to the external audit and consequently may be used by the external auditor in lieu of performing that work directly themselves (i.e., as a form of audit evidence).

12. This provides a useful framework for the focus of the requirements and guidance in ISA 610. Others in the entity, not belonging to the internal audit function, may be involved in performing certain control-related activities – such as business performance reviews. The Task Force is of the view that such activities constitute internal control activities and should be addressed through applying the relevant requirements in ISA 315<sup>2</sup> and ISA 330.<sup>3</sup> Internal audit work is designed to provide assurance regarding the design and operating effectiveness of controls, whereas the other activities are designed to prevent or detect misstatements. This distinction may be of particular relevance in the context of small- and medium-sized entities as typically these entities do not have a separate internal audit function and, therefore, more often than not, ad hoc work done by individuals is more likely to be a control activity rather than an internal audit activity.
13. It was also brought to the Task Force's attention that in addition to internal audit departments as traditionally known, there may be other functions (although given a different title) that may also perform roles similar to that performed by the internal audit function. Examples include loan review departments in banks and teams set up in entities solely for the purpose of assessing the entities' compliance with the requirements of Section 404<sup>4</sup> of the Sarbanes-Oxley Act of 2002. The Task Force was of the view that these developments in the internal audit environment should be recognized and reflected in ISA 610 as appropriate. Admittedly, the scope of work of these functions is generally limited in comparison with the activities performed by internal audit. However, where:
  - (a) the organizational design of these functions results in comparable objectivity to that of the internal audit function, and
  - (b) the activities performed provide comparable assurance,these functions may be of relevance to the external auditor in the same way as the internal audit function.

#### *Extent of Use of Internal Audit Work*

14. As noted in paragraph 5(c), the work of internal auditors may be relevant to the external audit in different ways:
  - When obtaining an understanding of the entity and its environment, internal audit findings may provide relevant information and insights.

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<sup>2</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

<sup>3</sup> ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

<sup>4</sup> Section 404, "Management Assessment of Internal Controls."

- When designing further audit procedures to respond to identified and assessed risks of material misstatement, the internal audit function may have obtained evidence that the external auditor may be able to use in lieu of performing similar procedures.
  - Although not addressed in extant ISA 610, in many jurisdictions around the world, internal auditors may perform work under the direction, supervision and review of the external auditor.
15. The type of evidence that the external auditor needs to obtain to support its use of these specific types of internal audit work should be reflective of the unique nature of that work.
16. Some stakeholders have raised concerns that external auditors may implicitly factor effective internal audit functions into their risk assessments without obtaining sufficient evidence to support the effect of this conclusion on the audit. This may be of particular concern when specific internal audit work is not used and, therefore, the requirements of ISA 610 not performed. In addition, if the work of the internal audit function is viewed as an “internal control,” it may raise questions regarding how the requirements in ISA 330 to “test” internal controls that are taken into account in the auditor’s risk assessments should apply. Upon exploring whether and how current requirements in the ISAs might apply to internal audit work, the Task Force concluded that the nature of the internal audit work (and, thereby, how it is being used by the external auditor) needs to be considered in determining what the external auditor has to do to support using that work. This is further discussed in the remainder of this Paper.

#### **Matters for IAASB’s Consideration**

The IAASB is asked:

- Whether it agrees with the Task Force’s distinction between an internal audit function and the entity’s internal control?
- Whether it agrees with the proposed revised definition of “internal audit function” (see paragraph 10)?
- Whether it agrees that the definition of “internal audit function” should be expanded to include other functions (regardless of title) which, like internal auditing, provide assurance on internal control?
- Whether it agrees with the Task Force’s conclusion that the support needed to justify the use of internal audit work in the external audit is dependent on the nature of that work?

#### **A.2 ROLE OF INTERNAL AUDITING IN THE AUDITOR’S RISK ASSESSMENTS**

17. During the clarity redrafting of ISA 610, a number of changes were made to clarify the external auditor’s responsibilities in relation to internal auditing. The IAASB amended ISA 315 to require that the external auditor obtains an understanding of the nature of the responsibilities and activities of the internal audit function to determine its likely relevance to the audit. The corresponding requirement in ISA 610 was deleted and related guidance was transferred to, or repeated in, ISA 315.
18. The Task Force felt that it is important to reflect on these changes given their linkages to the applicability and scope of ISA 610. Specifically, they are relevant to the consideration

of whether external auditors should be *required* to use internal audit work, and how the internal audit function's knowledge of the organization and expertise in risk and control can be used by the external auditors. These questions are particularly relevant in the context of how the internal audit function and its work might influence the external auditor's understanding of the entity and its environment, and risk assessments of the entity – all of which are matters addressed in ISA 315.

19. The Task Force concluded that the current structure of requirements and guidance in connection with the internal audit function in ISA 315 and ISA 610 continues to be appropriate for the following reasons:
- The present structure clearly articulates the external auditor's responsibilities in obtaining an understanding of internal auditing necessary to achieve the objectives stated in ISA 315. The clarified structure provides greater emphasis on the aspects of the internal audit function that should be understood for purposes of informing the external auditor's assessment of risks and determination of the audit approach.
  - The present structure provides clarity on the applicability of ISA 610 according to the engagement's circumstances. The IAASB was careful to ensure that requirements are not imposed unless warranted and, therefore, wanted to make clear early in the ISAs the determinants for which further requirements would apply.
  - The present structure eliminates unnecessary duplication of requirements in regard to the internal audit function in ISA 315 and ISA 610.

Accordingly, the Task Force believes that the present structure of the ISAs in connection to internal audit function is appropriate and therefore does not recommend further changes.

### A.3 INQUIRY OF THE INTERNAL AUDIT FUNCTION

20. However, the Task Force debated whether the ISAs give sufficient recognition to the synergies that the external auditor may be able to obtain from the internal audit function's knowledge of the organization and expertise in risk and control insofar as informing the external auditor's own risk assessment. To this end, the Task Force reviewed the suite of ISAs to identify references to internal auditing. In its review, the Task Force noted that ISA 240<sup>5</sup> requires the auditor to *make inquiries* of the internal audit function to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. The ISA indicated that inquiries made by the external auditor to comply with ISA 315 and ISA 610 may help to meet that requirement.
21. Despite this, neither ISA 315 nor ISA 610 requires the auditor to make inquiries of the internal audit function about the risks of material misstatement due to error, or otherwise direct the auditor to seek to leverage the internal auditor's understanding of the entity and its environment. In view of the explicit requirement in ISA 240 for the auditor to inquire with the internal audit function about fraud, the Task Force felt that it was also appropriate 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 audit and the external auditor's risk assessments. In addition to bringing ISA 315 into alignment with ISA 240,

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<sup>5</sup> ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs 19 and A18.

introduction of such a requirement would provide a basis for the external auditor to consider whether and how the internal auditor's knowledge of the organization and expertise in risk and control can be used in the audit to achieve greater efficiency and effectiveness, a point made by a number of respondents in commenting on the Clarity exposure draft of ISA 610. As it is envisaged that such information will provide input to the auditor's assessment of risks of material misstatement, the Task Force believes that such a requirement should be placed in ISA 315. Also, given that this would be one of many sources of information obtained as part of the auditor's risk assessment procedures, the information obtained from internal auditors from these inquiries would subsequently be supported by the auditor's other risk assessment procedures and further audit procedures.

22. The Task Force also considered whether, in addition to inquiries, the external auditor should be required to read reports produced by the internal audit function. However, given the potential volume of such reports, and the likelihood that the scope of internal audit work ordinarily extends to operational and compliance matters which may not have direct relevance to the entity's financial reporting, the Task Force concluded that it would not be efficient to require the auditor to do so. On balance, the Task Force believes that the auditor will be able to efficiently and effectively leverage the value of the internal audit function's knowledge and findings through inquiries, at least in the first instance.

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

The IAASB is asked:

- Whether it agrees with the Task Force's conclusion regarding the appropriateness of the present structure of ISA 315 (in regards to internal auditing) and ISA 610?
- Whether it agrees with the Task Force's proposal for a requirement for the external auditor make inquiries of internal auditors to determine whether internal audit findings and work are likely to be relevant to the external audit and the auditor's risk assessments?
  - If so, whether it further agrees that the requirement should be placed in ISA 315?

## **B. Using Internal Audit Work**

### **B.1 EXTENT OF USE**

23. In determining the extent to which the external auditor may be able to use internal audit work without compromise to the quality of the audit, consideration was given to the following:
- (a) To what extent should external auditors be encouraged to, or possibly be required to, use work performed by internal auditors which otherwise would have been performed by members of the external audit engagement team; and
  - (b) Is there a threshold above which the use of internal audit work, in aggregate, would result in a threat to the ability of the external auditor to have a sufficient basis on which to form the external auditor's opinion?
24. Paragraph 4 of ISA 610 states that the external auditor has sole responsibility for the audit opinion and this is not reduced by the external auditor's use of internal audit work. Guided



by this, the Task Force concluded that the decision on whether or not to use specific internal audit work should remain that of the external auditor and therefore it would be inappropriate to *require* the external auditor to use specific internal audit work.

25. Once the decision to use internal audit work is made, however, the external auditor then needs to evaluate the appropriate level of use. In this regard, the Task Force considered two possible approaches namely, a bright-line threshold and a judgment-based model.

#### *Bright-Line Threshold*

26. The Task Force felt that a bright-line threshold was inappropriate as it seems inconsistent with principles-based ISAs. Notably, in the Clarity revision and redrafting of ISA 600<sup>6</sup>, a bright-line threshold was also considered but ultimately dismissed. In that regard, the IAASB debated whether there should be a threshold for the proportion of a group audit that the group engagement team needs to perform directly (e.g., a 50% or 60% threshold). The IAASB came to the conclusion that the requirements should focus, instead, on the involvement in the work of component auditors necessary to be able to have sufficient appropriate audit evidence on which to base the group auditor's opinion on the group financial statements. Although the Task Force does not believe that using the work of a component auditor and using the work of internal auditors are necessarily the same, the principle of defining the nature and extent of work necessary to support the use of the other auditor's work does seem to apply in both cases.
27. In addition, the Task Force believed that trying to set a threshold would not give sufficient acknowledgement to the fact that conditions differ from audit to audit. The appropriate nature and extent of the use of internal audit work will necessarily be contingent on the characteristics of the internal audit function and the external auditor's risk assessment and planned audit approach. Accordingly, it is unlikely that a bright-line threshold which is applicable in all circumstances can be reliably determined.

#### *Judgment-Based Approach*

28. Under a judgment-based approach, the Task Force concluded that the external auditor's decision regarding the nature and extent of the use of internal audit work should be based on the competence and objectivity of the internal audit function. Both these elements can be evaluated on a sliding scale (i.e., internal audit functions may be assessed by external auditors to be competent and objective to varying degrees). The extent of use of internal audit work that is appropriate in the circumstances will therefore be dependent on the external auditor's assessment in this regard. The higher the degree of competence and objectivity, the more appropriate it would be for the external auditor to use internal audit work and in more areas.
29. Another dimension considered by the Task Force to be relevant in determining the extent of use of internal audit work is the amount of judgment involved in performing such work. It believes that the greater the amount of judgment that is needed to be exercised in designing the audit procedures and in evaluating the results thereof, the more the external auditor needs to be directly involved and the less likely that the external auditor can use

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<sup>6</sup> ISA 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)."

internal audit work. The Task Force also noted that in determining the extent of usage of internal audit work in specific areas (i.e., for specific line items or assertions), other factors such as materiality and risk may also be relevant. In many ways, these factors are indicative of the level of judgment that is likely to be involved and, therefore, areas in which the external auditor is more likely to want to be directly involved in order to be satisfied that sufficient appropriate audit evidence is obtained. An illustrative diagram is provided in the Appendix to this paper in this regard.

30. ISA 610 appropriately uses the phrase “the external auditor’s *use* of internal audit work” to describe the relationship between the external auditor and internal audit work. This relationship is sometimes referred to as “the external auditor’s *reliance* on internal audit work” (emphasis added). The Task Force is of the view that use of the latter term is inappropriate. 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 auditors. In this regard, internal audit work is better viewed as contributing to the body of audit evidence *used* by the external auditor to support the audit opinion as opposed to being *relied* upon by the external auditor, which would suggest that the external auditor’s responsibility for that work in contributing to the basis for the audit opinion is reduced as a result.

## B.2 NATURE OF INTERNAL AUDIT WORK AND RELEVANCE TO THE EXTERNAL AUDIT

31. While the internal audit function needs to be sufficiently competent and objective in order for the external auditor to use any of its work, the higher the level of competence and objectivity, the more likely that it will be appropriate for the external auditor to use internal audit work and, as will be discussed later, perhaps with lesser need to test or reperform the specific work once the competence and objectivity of the internal audit function has been determined. The Task Force anticipates that there will be discussion by the IAASB on whether it is appropriate for the external auditor to use internal audit work in regard to control testing and substantive procedures. Some stakeholders have questioned the appropriateness of using internal audit work in relation to substantive procedures. Arguments given for this view include that internal auditors’ skills and experience tend to be in relation to controls, and that most substantive testing involves a degree of judgment.
32. The Task Force discussed whether there are substantive differences in nature between substantive and compliance testing. It observed that it is common practice in many jurisdictions to use internal audit work in relation to at least some substantive tests. Examples of internal audit work that the Task Force identified as being used by external auditors in practice today included the following:
  - Testing of the operating effectiveness of controls
  - Substantive procedures (e.g., checking reconciliations and confirmations)
  - Observations of inventory counts
  - Walk throughs or checking of management’s documentation of their financial reporting process and internal controls
  - Audits of the financial statements of subsidiaries (e.g., components that are not significant components from the perspective of the group audit)

The Task Force concluded that the skills and expertise required to perform these sorts of procedures (which include both testing of controls and substantive procedures) are similar. The Task Force also observed that national auditing standards in most jurisdictions do not differentiate between when internal audit work can be used based on the nature of the procedures.

33. The Task Force is therefore of the view that the same principles should apply regardless of the type of internal audit work considered by the auditor (i.e., substantive procedures or controls testing) and that a prohibition based on the nature of the work is unnecessary. Notwithstanding this, the Task Force felt that guidance may usefully be provided on audit procedures or areas of the audit for which it is *generally not appropriate* for the external auditors to use the work of internal auditors. In particular, the Task Force is of the view that it is typically not appropriate to use work performed by internal auditors in areas involving *significant judgment* as these need to be made by the external auditor.
34. Another argument sometimes made is that it is generally not appropriate for the auditor to use internal audit work in areas of higher risk, particularly if there is low level of reperformance by the external auditor. The Task Force discussed whether the level of risk should be a deciding factor in the external auditor's decision regarding whether or not to use a specific piece of internal audit work; specifically, whether the auditor should be prohibited from using internal audit work in areas of significant risks. Whilst there is generally a relationship between the level of judgment involved and the level of risk (i.e., significant risks are often significant because of the inherent level of judgment associated with the related financial statement assertions), the Task Force believes that it is the degree of judgment involved in the procedure being performed that is the key consideration. Specifically, if internal audit work that does not require significant judgments to be made provided some evidence relevant to a significant risk, a prohibition on using that work appears to be unfounded.

### B.3 EVALUATING THE ADEQUACY OF INTERNAL AUDIT WORK

35. Before using specific internal audit work, the external auditor is required to evaluate the work and perform audit procedures to determine its adequacy for purposes of the external audit.<sup>7</sup> ISA 610 provides, in the form of guidance, examples of relevant matters which the auditor should evaluate.
36. The Task Force reviewed the guidance provided in ISA 610 to assist external auditors' in the determination of the nature, timing and extent of audit procedures to perform that would be appropriate in the circumstances. In particular, the Task Force discussed whether there is sufficient guidance on when and to what extent reperformance of internal audit work is needed. In this regard, the Task Force discussed the interpretation of the requirements of ISA 610 given by some that reperformance by the external auditor is required on each piece of internal audit work used. In this regard, concerns have been expressed that, in some cases, extensive reliance has been placed on testing of controls performed by internal auditors in areas of significant risk but on the basis of "low levels" of reperformance, or on the basis of similar tests being performed with similar findings (e.g.,

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<sup>7</sup> ISA 610, paragraph 11.

extending testing performed by internal auditors that was completed before year end, to the end of the year) without actually reperforming specific testing that internal auditors had done.

37. This was a matter considered during the IAASB's Clarity redrafting of ISA 610. It was felt that the intention of the extant ISA was not to imply that reperformance must be conducted on each individual piece of internal audit work (e.g., the testing related to a particular financial statement amount) and therefore the wording of the ISA was clarified accordingly. On reflection, the Task Force maintains the view that the external auditor should perform sufficient procedures to be satisfied as to the adequacy of the internal audit function *as a whole* to support:
- (a) the quality of internal audit work given that it would be used in lieu of performing that work directly themselves; and
  - (b) the nature and extent of that work that is appropriate to use in the circumstances.
38. In doing so, the external auditor needs to obtain evidence regarding the competence and objectivity of the internal audit function, both of which can be evaluated on a sliding scale, as discussed earlier. A further consideration is the amount of judgment involved in the work. Accordingly, the extent and type of internal audit work that would be appropriate to use in the external audit will be dependent upon the external auditor's assessment of competence and objectivity (supported by sufficient and appropriate evidence), and the amount of judgment involved. Having obtained evidence to support the quality of the work of the internal audit function and making an informed judgment on where internal audit work may be appropriately used, the Task Force does not believe that it is necessary for the external auditor to "test" each individual piece of internal audit work used in the same way that internal controls are tested in accordance with ISA 330. The underlying basis for using the work of internal auditors is obtained differently.
39. Notwithstanding this, for purposes of supporting the external auditor's planned use of internal audit work, reperformance of some internal audit work provides a strong form of evidence regarding the adequacy of that work. The Task Force believes that this point deserves greater emphasis in the ISA.
40. On a related note, when deciding on which internal audit work the external auditor will reperform in order to obtain evidence regarding the competence and objectivity of the internal audit function, it may well be appropriate to focus on areas of higher risk. However, once that basis is determined, the nature, extent and timing of audit procedures required to support the external auditor's use of specific internal audit work should be dependent on that overall assessment, i.e., the competence and objectivity of the internal audit function. The Task Force also noted that external auditors typically obtain audit evidence from several different sources (particularly in relation to areas of higher risk) and that this would also be taken into account in determining the extent to which internal audit work is being used and, thereby, whether or not the external auditor concludes that reperformance or other procedures on the specific work are necessary in the circumstances.
41. The Task Force believes that there should be clarity in ISA 610 with regard to the matters discussed above and accordingly proposes that the application material in ISA 610 can be enhanced to describe more fully the factors that should be considered in determining

overall the nature, timing and extent of procedures on internal audit work that would be appropriate in the circumstances, and how they would influence the judgments made.

### **Matters for IAASB's Consideration**

The IAASB is asked:

- Whether it agrees that external auditors should not be required to use specific internal audit work?
- Whether it agrees with the Task Force's proposal of a judgment-based approach to determining the external auditor's extent of use of specific internal audit work?
  - If so, whether it agrees that the extent of use of specific internal audit work should be dependent upon the external auditor's assessment of competence and objectivity (supported by sufficient and appropriate evidence), and the amount of judgment involved?
- Whether it agrees that more guidance should be provided on the following:
  - Audit procedures or areas of the audit for which it is generally not appropriate for the external auditors to use the work of internal auditors; and
  - Determining the nature, timing and extent of audit procedures which the external auditor needs to perform to support its use of specific internal audit work?
- Whether it agrees with the Task Force's conclusion regarding reperformance of internal audit work?

### **C. Ethical Principles of Internal Auditors**

42. 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.
43. 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.”<sup>8</sup> 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.

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<sup>8</sup> ISA 610, paragraph 9.

44. ISA 610, ISA 620<sup>9</sup> and ISA 600 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.<sup>10</sup>
  - ISA 620 requires the external auditor to evaluate whether the auditor's expert has the necessary *competence*.<sup>11</sup>
  - ISA 600 requires the external auditor to obtain an understanding of the component auditor's *professional competence*.<sup>12</sup>
45. 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.
46. 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.

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<sup>9</sup> ISA 620, "Using the Work of an Auditor's Expert."

<sup>10</sup> ISA 610, paragraph 9(b).

<sup>11</sup> ISA 620, paragraph 9.

<sup>12</sup> ISA 600, paragraph 19(b).

### **Matters for IAASB Consideration**

The IAASB is asked whether it agrees with the Task Force' proposal regarding references to the internal auditor's ethical principles in ISA 610?

#### **D. Direct Assistance**

47. 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.
48. 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.
49. 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,<sup>13</sup> should therefore be presumed to provide less reliable

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

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.

#### D.1 INTERNAL AUDIT STAFF AND THE ENGAGEMENT TEAM

50. 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.<sup>14</sup> 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 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.
51. 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)<sup>15</sup> 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.

52. 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

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<sup>14</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 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.

<sup>15</sup> ISA 610 (UK and Ireland), "Using the Work of Internal Audit."



appropriate safeguards to eliminate these threats or reduce them to an acceptable level (i.e., “threats-and-safeguard” approach).

53. 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.

## D.2 OTHER CONSIDERATIONS

54. The external auditor may use specific work performed by internal auditors designed to meet the internal audit function’s own objectives or work undertaken by the internal audit function that was agreed upon in advance with the external auditors in the knowledge that it will be used for purposes of the external audit. In this regard, most support coordination between internal auditors and external auditors to maximize efficiency. Depending on the circumstances, however, the latter scenario may be, in substance, akin to the external auditor using the direct assistance of internal auditors.
55. However, an important consideration in this regard is the extent to which internal auditors are subject to the direction and supervision of the external auditors. Generally in the case of direct assistance, internal auditors, similar to members of the engagement team, are normally subjected to the same principles of direction and supervision as members of the external audit engagement team. In contrast, where certain aspects of internal audit work (as addressed in paragraph A5 of ISA 610) are agreed in advance with the external auditors, in performing the audit procedures, internal auditors are usually subject to little or no direction and supervision by the external auditors (although the internal auditors will be subject to their own quality control procedures).
56. Accordingly, making a distinction between using the work of internal auditors, and direct assistance, may be seen to be somewhat arbitrary and there are advantages and risks to both. In the case of direct assistance, however, a key difference is that the review and other quality controls that would be performed by the internal audit function on its own work will be absent. Accordingly, the external auditor will need to factor this into its direction, supervision and review of that work.

### **Matters for IAASB Consideration**

The IAASB is asked:

- Whether it agrees with the Task Force’s proposal to expand the scope of the ISA to address direct assistance and, if so, whether it agrees with the following:
  - The requirements in ISA 610 relating to the external auditor’s use of internal audit work are generally applicable in the case of direct assistance
  - A threats and safeguard approach should be applied in cases involving direct assistance
- Whether there are other matters relating to direct assistance which should be considered?

## **E. Other Matters**

### **E.1 COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE**

57. Clear communication with those charged with governance of the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit is an integral part of any audit. The Task Force believes, however, that it is inappropriate to explicitly require the external auditor to communicate with those charged with governance its planned use of internal audit work and the reasons for the nature and extent of use planned. Such a requirement may, in some cases, inadvertently introduce pressure on the external auditor to use internal audit work or to increase its planned usage to a greater extent, both of which may not be appropriate outcomes in the engagement’s circumstances. It may also indirectly imply that the external auditor needs to obtain sufficient evidence to evaluate the effectiveness of the entity’s internal audit function, which is not the intent of either ISA 315 or ISA 610.
58. The Task Force notes that guidance is already provided in the ISAs on matters relating to the internal audit function which the external auditor may feel are suitable to be communicated with those charged with governance. Specifically, in requiring the external auditor to communicate with those charged with governance an overview of the planned scope and timing of the audit, ISA 260 indicates that the external auditor’s approach to internal control relevant to the audit, which may reference internal audit findings and insights as a source of information, is an example of matters that may be communicated.<sup>16</sup> ISA 260 further indicates that the extent to which the external auditor will use internal audit work, and the manner in which the external and internal auditors may cooperate, are matters relating to audit planning which may be relevant to be brought to the attention of those charged with governance.<sup>17</sup> On balance, the Task Force feels that guidance provided in the ISAs in this regard is appropriate and adequate, and therefore does not recommend any further additions or changes.

<sup>16</sup> ISA 260, “Communication with Those Charged with Governance,” paragraphs 15 and A13.

<sup>17</sup> ISA 260, paragraphs 15 and A14.

## E.2 NATIONAL LAWS AND REGULATIONS

59. There are cases at the national level where the extent of cooperation between internal and external auditors may be restricted, to some extent, due to local laws and regulations. For example, in the case of the European Union (EU), the auditor is prevented by legislation from communicating certain information with the internal auditors.<sup>18</sup> In this regard, the Task Force proposes the strengthening of ISA 610 to respond to these situations at the national level by the inclusion of a “law and regulations” exception clause. Such a clause will provide relief to auditors in the event local laws or regulations differ from, or conflict with, the requirements of the ISA. In these cases, the external audit should be conducted in accordance with local laws and regulations.

## E.3 DOCUMENTATION

60. To support its planned use of internal audit work, ISA 610 requires the external auditor to document its conclusions regarding the adequacy of the work of the internal auditors, and the audit procedures performed in response to this assessment.<sup>19</sup>
61. In the suite of ISAs, requirements relating to the external auditor’s responsibility to prepare engagement audit documentation are contained in ISA 230. In its discussions regarding other subject matter specific ISAs, the IAASB debated the need to include specific documentation requirements in addition to the general documentation principles in ISA 230. In some cases, the decision has been made to not include specific documentation requirements while in others, the IAASB decided that there are reasons to include specific documentation requirements.
62. The Task Force believes that it may be useful for ISA 610 to discuss, at a minimum, the internal auditor’s working papers. In particular, when using specific internal audit work, the external auditor needs to consider whether, and to what extent, evidence of such work will need to form part of the external auditor’s working papers.
63. Where internal audit staff is engaged to perform audit procedures on the external audit, the external auditor’s audit documentation will need to include the working papers of these individuals. On the other hand, an approach similar to that in ISA 600 might be adopted for the external auditor’s use of specific internal audit work (which does not require the component auditor’s working papers to be included in the group auditor’s working papers). In this regard, ISA 230 requires the retention of engagement documentation ordinarily for a period no shorter than five years from the date of the auditor’s report, or, if later, the date of the group auditor’s report.<sup>20</sup> In cases where the internal audit working papers do not form part of the external auditor’s documentation, coordination by the external auditor in this regard would be needed. The Task Force is of the view that additional guidance in connection with this may usefully be added to ISA 610.
64. The requirement for the documentation of the external auditor’s understanding of the organizational structure, responsibilities and activities of the entity’s internal audit function

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<sup>18</sup> EU’s 8th Company Law Directive on confidentiality and professional secrecy.

<sup>19</sup> ISA 610, paragraph 13.

<sup>20</sup> ISA 230, paragraphs 15 and A23.

is found in ISA 315.<sup>21</sup> A reference to this requirement could be made in ISA 610. Doing so would distinguish between these reporting requirements and may help to highlight the different roles played by internal audit work in the external audit and accordingly may contribute to making clearer the relationship between the internal audit function and internal control in the ISAs.

### **Matters for IAASB Consideration**

The IAASB is asked:

- Whether it agrees with the Task Force’s conclusion in regard to communication by the external auditor to those charged with governance on its planned use of internal audit work?
- Whether it agrees with the Task Force’s proposal for introduction of a “law and regulation” exception clause?
- Whether greater guidance should be provided on the application of the documentation requirements in the ISAs in the context of the external auditor’s use of internal audit work?
- Whether documentation requirements in addition to those in ISA 230 are required in ISA 610?

## **IV. Consideration of the Need for Consultation**

65. As part of due process, the Task Force is required to consider specifically whether further consultation would be appropriate to obtain necessary input before the development of an exposure draft on the proposed revised ISA 610.
66. The membership of the Task Force consists of representatives from the IIA and the IESBA—two important stakeholder groups of the project. In addition, cognizant of the likely interest of the regulatory and banking communities in the project’s developments, the Task Force has and continues to make a conscious effort to engage with these stakeholder groups early in the process where possible. In this regard, representatives of the Task Force have met with staff of the UK’s Audit Inspection Unit (AIU) of the Financial Reporting Council with the objective of obtaining an understanding of the AIU’s views on key issues considered by the project.
67. Further, timely inputs from specific constituencies have and will continue to be obtained through other key IAASB consultative, liaison and promotional channels, including:
  - IAASB CAG meeting in September 2009 and March 2010
  - Annual IAASB-National Standard Setters meeting in April 2009
  - International Forum of Independent Audit Regulators meeting in September 2009 (through the IAASB Chair)
  - Forum of Firms meetings (on-going)

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<sup>21</sup> ISA 315, paragraph 32.

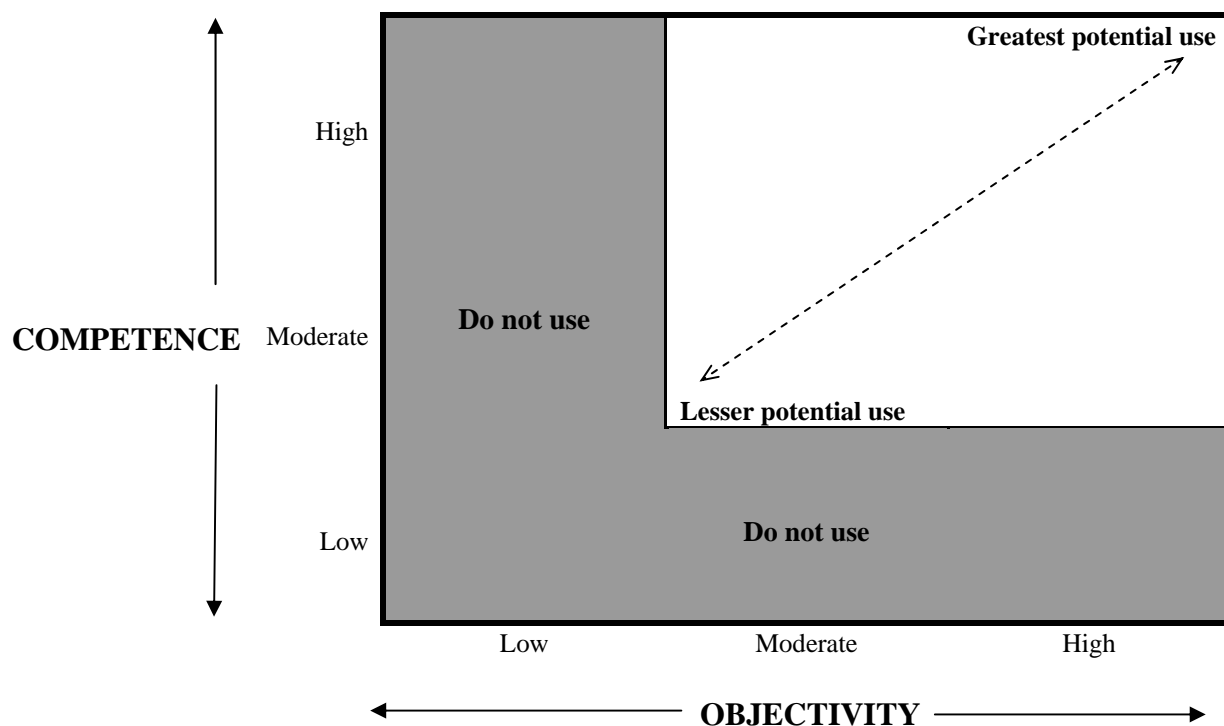
68. In view of the above, the Task Force believes that further consultation in addition to that outlined above (e.g., issuing a public consultation paper that would deal with the issues discussed in this Paper) is not likely to elicit new information of any significant extent and therefore not needed at this stage of the project.

**Matters for the IAASB's consideration**

The IAASB is asked whether it agrees with the Task Force's conclusion regarding further consultation in advance of development of an exposure draft on the revised ISA 610?

**APPENDIX** (Ref: Para 28-29)

**Factors Influencing the Use of Internal Audit Work**



Other factors that may influence the external auditor's decision regarding the specific areas in which internal audit work may be used (e.g., specific line items or assertions) in order for the external auditor to be satisfied that overall it has been sufficiently involved in the audit work performed may include the following:

- Materiality
- Risk