INTERNAL AUDIT – ISSUES PAPER

Introduction
1. The following summarizes the significant concerns raised at the March 2008 IAASB meeting and the Task Force’s response and proposed changes to proposed ISA 610 (Redrafted) to address those concerns.

Significant Concerns

A. SPLIT BETWEEN PROPOSED ISA 610 (REDRAFTED) AND ISA 315 (REDRAFTED)

2. In response to comments received on the exposure draft of proposed ISA 610 (Redrafted) (ED-ISA 610) that the distinction between ISA 315 (Redrafted)\(^1\) and paragraph 7 of ED-ISA 610 is not clear, the Task Force proposed an amendment to ISA 315 (Redrafted) to require that the auditor obtain an understanding of the internal function as part of obtaining an understanding of the entity. The IAASB generally agreed that such a split was appropriate, however concern was expressed that there was some overlap between the proposed amendment to ISA 315 (Redrafted) and the requirement of proposed ISA 610 (Redrafted). The Task Force was also asked to consider whether the auditor’s consideration of the effectiveness and efficiency of the internal audit function is appropriately included in the proposed amendment to ISA 315 (Redrafted).

“Relevant to the Audit”

3. The Task Force is of the view that the internal audit function is generally likely to be a component of the entity’s monitoring activities. As such, the auditor is required to obtain an understanding of the internal audit function in order to determine whether the internal audit function is likely to be relevant to the audit.

4. To clarify the meaning of “relevant to the audit” the Task Force has added application material in paragraph A96a in the proposed amendments to ISA 315 (Redrafted). Whether the internal audit function is likely to be relevant to the audit has been linked to whether the nature of the internal audit function’s responsibilities and activities are related to the entity’s financial reporting. (See proposed wording in paragraph 9 below).

Effectiveness and Efficiency

5. The Task Force also considered whether the effectiveness of the internal audit function and/or efficiency are appropriate criteria in determining whether the internal audit function is likely to be relevant to the audit. Concern was expressed that, as currently drafted, the auditor can determine for efficiency reasons not to use the work of the internal auditor in informing the risk assessment.

6. The Task Force believes that it is not appropriate to permit the auditor to disregard information that may be obtained from the internal audit function due to efficiency considerations. Accordingly, the requirement expressed in paragraph 8 of proposed ISA 610 (Redrafted) in the

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\(^1\) ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.”
March IAASB agenda papers, that the external auditor obtain an understanding of the nature and scope of the specific work performed, or to be performed, by the internal auditors, has now been incorporated into the proposed amendment to ISA 315 (Redrafted). The Task Force believes that in order to inform the auditor’s risk assessment, it is necessary for the auditor to consider the nature and scope of the work to be performed by the internal auditors (that is, what the internal auditor does) before determining whether the work of internal auditors is effective or whether using the work of the internal auditors will be efficient.

7. Once the auditor has obtained the understanding required by ISA 315 (Redrafted), if the auditor intends to use the work of the internal auditors ISA 610 (Redrafted) applies.

8. The Task Force believes that this is more consistent with extant ISA 610 paragraphs 9 and 11 and addresses concerns expressed by some members that the split between ISA 315 (Redrafted) and proposed ISA 610 (Redrafted) is not clear.

9. The proposed amendment to ISA 315 (Redrafted) is presented below:

315.22x If the entity has an internal audit function, the auditor shall obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit: (Ref: Para. A96a-A96c)

(a) The nature of the internal audit function’s responsibilities and how fits in the entity’s organizational structure; and

(b) The nature and scope of the specific work performed, or to be performed, by the internal auditors. (Ref: Para. A96d)

A96a. Many entities establish an internal audit function. The objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and those charged with governance. The activities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. The internal audit function is likely to be relevant to the audit if, based on the understanding obtained in accordance with paragraph 22x, the nature of the internal audit function’s responsibilities and activities are related to the entity’s financial reporting.

A96b. In some cases, even if the activities of the internal audit function are relevant to the audit, the external auditor may decide that the work of the internal auditors will have no effect on the nature, timing and extent of audit procedures to be performed.

A96c. When the auditor determines that the internal audit function is likely to be relevant to the audit and the auditor intends to use the work of the internal auditors, ISA 610 (Redrafted), “Using the Work of Internal Auditors” applies.

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2 The term “internal audit function” is defined in ISA 610 (Redrafted) as, “An appraisal activity established as a service to the entity. Its functions include, amongst other things, monitoring internal control.”
**Nature and Scope of Specific Work of Internal Auditors** (Ref: Para. 22x(b))

A96d. The external auditor’s consideration of the nature and scope of the specific work to be performed by the internal auditors may include review of the internal audit function’s tentative audit plan for the period, if any, and discussion of that plan with the internal auditors. It may also be useful to agree in advance the following matters with the internal auditors:

- 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

**B. MANAGEMENT VS. THOSE CHARGED WITH GOVERNANCE**

10. At the March IAASB meeting, concern was expressed that the proposed ISA is biased towards situations where the role of the internal audit function is determined by management. There are many situations where the role of the internal audit function is determined by those charged with governance and where the internal audit function reports directly to those charged with governance. In particular, concern was expressed about the statement in paragraph 3 of proposed ISA 610 (Redrafted) presented in the March 2008 agenda papers, which stated “Although the internal audit function is not independent of management, those charged with governance, or the entity, the internal audit function may, nevertheless, achieve a degree of autonomy and objectivity such that aspects of the work of internal auditors may be used by the external auditor as audit evidence.” It was also noted that in the public sector, internal auditors are not always appointed by management and may report to an audit committee. In such cases, there is a degree of independence in relation to management.

11. The Task Force agreed to remove the perceived bias that the role of the internal audit function is always determined by management. The wording in paragraph 4 of proposed ISA 610 (Redrafted) has been more closely aligned with paragraph 8 of extant ISA 610. Paragraph 4 states:
“Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. 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 internal auditors.”

C. REQUIREMENT TO REPERFORM

12. Concern was expressed by some Board members that the proposed ISA appears to require the external auditor to retest the work of the internal auditors. The view of the Board was that there should be some flexibility allowed for the external auditor to determine the appropriate procedures to be performed rather than mandating reperformance, examination or observation.

13. The IAASB directed the Task Force to use the wording the extant ISA 610 paragraph 18 and that such procedures should not be mandated. The requirement and related application material is presented below.

10. If the external auditor intends to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor’s purposes. (Ref: Para. A4)

A4. The nature, timing and extent of the audit procedures performed on the specific work of the internal auditors will depend on the external auditor’s assessment of the risk of material misstatement of the area concerned, the evaluation of the internal audit function, and the evaluation of the specific work of internal auditors. Such audit procedures may include:

- Examination of items already examined by internal auditors;
- Examination of other similar items; and
- Observation of procedures performed by internal auditors.

D. CONSIDERATION OF THE NEED TO RE-EXPOSE

14. Agenda Item 6-D presents a mark-up of the revised draft of proposed ISA 610 (Redrafted) showing changes from ED-ISA 610.

15. It is the Task Force view that the proposal to move the requirements and guidance relating to the auditor’s understanding of the internal audit function is a clarification of the relationship between ISAs 315 and 610, in response to comments. The Task Force believes that the redrafting is consistent with both extant ISAs and does not introduce new principles or represent other changes of substance compared with the ED or the existing standards.

16. Accordingly, the Task Force is of the view that re-exposure is not necessary.3

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3 IAASB Working Procedures regarding re-exposure state: “Situations that constitute potential grounds for a decision to re-expose may include, for example: substantial change to a proposal arising from matters not aired in the exposure draft such that commentators have not had an opportunity to make their views known to the IAASB before it reaches a final conclusion; substantial change arising from matters not previously deliberated by the IAASB; or substantial change to the substance of an International Standard or Practice Statement.”