PROPOSED INTERNATIONAL STANDARD ON AUDITING 610 (REDRAFTED)
THE AUDITOR’S CONSIDERATION OF THE INTERNAL AUDIT FUNCTION USING
THE WORK OF INTERNAL AUDITORS
MARKED FROM EXPOSURE DRAFT

(Effective for audits of financial statements for periods beginning on or after December 15, 2009)

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Conforming Amendments
ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment”

Prepared by: XXXXXXXXX (Month 2008)
International Standard on Auditing (ISA) 610 (Redrafted), “Using the Work of Internal Auditors,” should be read in conjunction with [proposed] ISA 200 (Revised and Redrafted), “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 considerations when obtaining an understanding of and determining whether to use the work of internal auditors when the internal audit function is likely to be relevant to the audit as determined in accordance with ISA 315 (Redrafted), and the extent to which the external auditor may intend to use that work of the internal auditor.

2. This ISA does not deal with instances when internal audit personnel assist auditors provide direct assistance to the external auditor in carrying out external audit procedures.

Relationship Between the Internal Audit Function and the External Auditor

2. The role and objectives of the internal audit function are determined by management and those charged with governance. The objectives of management and those charged with governance 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 and the external auditor are different, some of the ways in which the internal audit function vary according to the requirements of management or those charged with governance, and the external auditor achieve their respective objectives may be similar. (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 its degree of autonomy and objectivity, of the internal audit function, such function is not independent of management or 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 accordingly, that responsibility is not reduced by the external auditor’s use of the work of the internal audit function—auditors.

Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.

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2 In some circumstances, the role of the internal audit function may be determined by law or regulation.

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

Objectives

6. The objective of the external auditor is to obtain an understanding of the internal audit function and determine whether the activities of the internal audit function are relevant to planning and performing the audit and, if relevant, the effect, on the procedures performed by the external auditor, of 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 audit, and the external auditor intends to use the work of the internal auditors, are to determine:

   (a) How to use specific work of internal auditors; and

   (b) Whether such work is adequate for the purposes of the audit.

Requirements

Obtaining an Understanding 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 responsibilities. (Ref: Para. A3-A5)

Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:

   (a) Internal audit function – An appraisal activity established as a service to the entity. Its functions include, amongst other things, monitoring internal control.

   (b) Internal auditors – Those individuals who perform the activities of the internal audit function. (Ref: Para. A2)

Requirements


8. When the external auditor intends to use in determining the effect of the work of the internal audit function, the external auditor shall evaluate:

   (a) The objectivity and technical competence of members of the internal audit function;

   (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 or those charged with governance. (Ref: Para. A6)
about the effect of the internal audit function’s work on auditors on the nature, timing and extent of the external auditor’s procedures, the external auditor shall consider:

(a) The materiality of the related financial statement amounts;

(b) The risk assessed risks of material misstatement of the assertions related to those financial statement amounts at the assertion level for particular classes of transactions, account balances, and disclosures; and

(e) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

Evaluation of the Internal Audit Function

9. If the external auditor intends to use the work of the internal auditors, the external auditor shall obtain an understanding of:

(a) The objectivity of the internal audit function;

(b) The technical competence of the internal auditors;

(c) Whether the work of internal auditors is likely to be carried out with due professional care; and

(d) Whether there is likely to be effective communication between internal auditors and the external auditor,

in order to determine whether the work of the internal auditors is likely to be adequate for the purposes of the audit. (Ref: Para. A7-A93)

Using the Work of the Internal Audit Function Auditors

10. When the external auditor intends to use specific work of the internal audit function auditors, the external auditor shall evaluate and perform audit procedures to evaluate the adequacy of that work to confirm its adequacy for the external auditor’s purposes. (Ref: Para. A40-A44)

11. When evaluating specific work performed by the internal audit function, the external auditor shall consider the adequacy of the scope of work and whether the evaluation of the internal audit function remains appropriate. The auditors in accordance with paragraph 10, the external auditor shall evaluate whether:

(a) The work was performed by persons having appropriate skills and expertise internal auditors having adequate technical training and proficiency;

(b) The work was properly supervised, reviewed and documented;

(c) Sufficient appropriate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(d) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

As required by ISA 315 (Redrafted), paragraph 22x.
(e) Any exceptions or unusual matters disclosed by the internal audit function are properly resolved.

Documentation

12. When the external auditor uses specific work of the internal auditors, the external auditor shall document conclusions regarding the evaluation of the adequacy of the work of the internal auditors, and the audit procedures performed by the external auditor on that work, in accordance with paragraph 10.

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Application and Other Explanatory Material

Scope and Objectives of the Internal Audit Function (Ref: Para. 23)

A1. An internal audit function may be responsible for providing analyses, evaluations, assurances, recommendations, and other information to the entity’s management and those charged with governance. 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 management and those charged with governance. Internal The activities of the 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 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 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.

- 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 control systems.

- 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.

Obtaining an Understanding of the Internal Audit Function (Ref: Para. 7)

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. As a result of 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 work of the internal audit function in the external auditor’s
risk assessment, and the scope of the external auditor’s understanding of the work of the internal audit function would be determined accordingly.

A5.

Definitions (Ref: Para. 7(b))

A2. Internal auditors may belong to an internal audit department or equivalent function. Internal audit services also may be contracted from an external service provider.

Evaluation of the Internal Audit Function (Ref: Para. 9)

A3. Factors that may affect the external auditor’s understanding of the internal audit function include: determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity:

- **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 of internal auditors to be objective.

- Whether the internal audit function reports to those charged with governance or 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 with appropriate authority, and whether the internal auditors have direct access to those charged with governance.

- Whether the internal audit function has direct access and reports regularly to the board of directors, those charged with governance, or the owner-manager; auditors are free of any conflicting responsibilities.

- 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 whether there are any constraints or restrictions placed on the internal audit function by management, or to or those charged with governance, and is free of any other operating responsibility. In addition, 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.
Planning to Use the Work of the Internal Audit Function (Ref: Para. 8-9)

A6. Factors, in addition to those identified in paragraph A5, that may affect the external auditor’s evaluation of the internal audit function include:

Technical competence:
- Whether the internal auditors are members of relevant professional bodies.
- 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 activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and working papers.

Communication
Communication between the external auditor and the internal auditors may be most effective when:
- Meetings are held 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 auditors when such matters may affect the work of the external auditor.
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

Using the Work of the Internal Auditors (Ref: Para. 10)

A7. As the risk of material misstatement of the financial statement item increases, the need for the auditor to perform his or her own tests of the relevant assertions increases. 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.
A8. When planning to use the work of the internal audit function, the external auditor may 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.

A9. Liaison with the internal audit function is likely to be 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 that may affect the internal audit function.

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

A10. 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.

A11. 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.
Proposed Amendment to ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment”

Requirements

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates corrective actions to its controls. (Ref: Para. A94-96)

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. A95a-A95c)

(a) The nature of the internal audit function’s responsibilities and how it 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. A95d)

23. The auditor shall obtain an understanding of the sources of the information used in the entity’s monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for that purpose. (Ref: Para. A97)

Application Material

Components of Internal Control – Monitoring of Controls (Ref: Para. 22)

A94. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A95. ISA 610, “Considering the Work of Internal Audit” establishes requirements and provides guidance on the auditor’s consideration of the work of internal auditing. Management’s monitoring activities may also include using information from communications from external parties, such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

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3 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.”
Considerations Specific to Smaller Entities

A96. Management’s monitoring of control is often accomplished by management’s or the owner-manager’s close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

Internal Audit Functions (Ref: Para. 22x)

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 “Using the Work of Internal Auditors” applies.

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.

Sources of Information (Ref: Para. 23)

A97. Much of the information used in monitoring may be produced by the entity’s information system. If management assumes that data used for monitoring are accurate without having a
basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- the sources of the information related to the entity’s monitoring activities; and
- the basis upon which management considers the information to be sufficiently reliable for the purpose

is required as part of the auditor’s understanding of the entity’s monitoring activities as a component of internal control.