Objective of this Paper

1. To consider the Task Force’s proposals for revisions to clarified ISA 315\(^1\) and ISA 610\(^2\) in light of inputs received from the IAASB on significant issues at its September 2009 meeting.

Background

2. At its September 2009 meeting, the IAASB considered significant issues in the revision of clarified ISA 610 and provided input and direction to the Task Force on the way forward. The IAASB indicated general agreement with the issues the Task Force proposed to address in the revision of the ISA. There was also broad support for the underlying principles the Task Force proposed to use to shape its recommendations regarding the external auditor’s use of the work of the internal audit function.

3. The main issues considered in September 2009 and direction provided by the Board on those issues are as follows:

   (a) Role of internal auditing in the external auditor’s risk assessments, in particular:

   - The definition of internal audit, which influences the application of ISA 610. The IAASB directed the Task Force to focus on the relevant characteristics of an internal audit function that the external auditor needs to consider, rather than the precise wording of the definition.

   - The relationship between the internal audit function and the entity’s internal control (ISA 315), which is important in explaining why the approach to using the assurance work of the internal audit function is different than the auditor’s evaluation and testing of internal controls.

   - The effect of the internal audit function on the auditor’s risk assessments. The IAASB agreed that introducing a requirement for the external auditor to make inquiries of the internal audit function would enable the former to effectively leverage the function’s knowledge of the entity and its environment, and its assessment of risks. Additionally, the majority of board members agreed that while review of reports produced by the internal audit function should not be mandatory, guidance should be included to emphasize the value such reviews may bring to the external audit under the relevant circumstances of the engagement.

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

   - The external auditor’s assessment of the objectivity and competence of the internal audit function. The IAASB supported the Task Force’s proposal that

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\(^1\) ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.”

\(^2\) ISA 610 (Redrafted), “Using the Work of Internal Auditors.”

Prepared by: Jessie Wong (February 2010)
the external auditor’s assessment of both objectivity and competence is important in determining whether, and to what extent the external auditor may use the work of the internal audit function.

- The factors that influence the auditor’s judgments on the nature and extent of use of the work of the internal audit function. The IAASB agreed that the relevance of the work of the internal audit function to the external auditor’s overall audit strategy and audit plan is another dimension that is likely to be central to the external auditor’s consideration noting however that ISA 315 contains requirements and guidance in this regard.

- How the external auditor may use work of the internal audit function to achieve greater efficiency and effectiveness in the external audit.

- The nature, timing and extent of the work necessary to support the external auditor’s decision to use the work of the internal audit function. The IAASB agreed that re-performance is not necessary on each piece of internal audit work. However, the Task Force was asked to consider clarifying the external auditor’s procedures applied to either refute or verify the adequacy of the work of the internal audit function, for use in the external audit.

(c) Expansion of the scope of ISA 610 to address instances of the external auditor obtaining direct assistance from the internal auditors. The IAASB expressed broad support for this proposal but recognized that such practices may not be permitted in some jurisdictions.

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

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

**Significant Issues**

**Direct Assistance**

5. At its September 2009 meeting, the IAASB considered and broadly supported an expansion of the scope of ISA 610 to address circumstances where internal auditors are asked to provide direct assistance to the external auditor in carrying out audit procedures on the engagement, when not prohibited by local law or regulation. It was noted that a blanket prohibition on direct assistance would unnecessarily restrict a practice that is already accepted in many jurisdictions. It was also observed that the line between direct assistance and using the work of the internal audit function is not necessarily clear in practice. Arguments raised against permitting direct assistance can generally also be applied to any case involving the use of the work of the internal audit function.
6. In light of the fact that internal auditors are not independent of the entity, however, the IAASB instructed the Task Force to give further consideration to the measures that can be put in place when internal auditors provide direct assistance on the external audit under the direction and supervision of the external auditor, and to seek the input of the International Ethical Standards Board for Accountants (IESBA).

**Expanding the Scope of ISA 610**

7. A benefit of expanding the scope of ISA 610 to explicitly address direct assistance is that it will remove ambiguity about whether direct assistance is allowed under the ISAs. Some have interpreted the paragraph in the scope of the extant ISA\(^3\) that it “does not deal with” instances of direct assistance to imply that an audit conducted in accordance with ISAs cannot, therefore, use direct assistance. Others interpret this paragraph as simply being an acknowledgment that the requirements and guidance in ISA 610 do not address that circumstance, but that it does not prohibit it in an ISA audit.

8. Importantly, addressing direct assistance in the revised ISA will also enable the IAASB to respond to some stakeholders’ concerns about such practices by emphasizing the considerations the external auditor would need to apply to direct, supervise and review the internal auditor’s work in light of the fact that the internal auditors are not independent of the entity.

9. It is proposed that ISA 610 would not require or encourage the external auditor to use, or even consider using, internal auditors to provide direct assistance on the engagement. This is to avoid inadvertently introducing undue pressures on the external auditor to obtain or consider obtaining the direct assistance, which should always be at the discretion of the external auditor taking into account the circumstances of the engagement. Equally, the Task Force believes that the scope of the ISA should acknowledge that direct assistance may not be allowed in some jurisdictions, and that it is not the intention of the ISA to override such prohibitions when they exist at the national level.

10. The Task Force proposes that the ISA include requirements and guidance setting out the external auditor’s responsibilities when considering whether to obtain the direct assistance of internal auditors. The objective of which is to guard against undue reliance and to ensure that the possible risks to audit quality arising from the lack of independence are guarded against by the external auditor’s planning, directing, supervising and reviewing the work performed by the internal auditors.

**Internal Auditors and the Engagement Team**

11. The views of the IESBA were sought on the matter of direct assistance at its October 2009 meeting; in particular, on the question of whether by performing audit procedures on the external audit these individuals may, under the prevailing definitions in the ISAs and the Code,\(^4\) be deemed to be members of the engagement team.\(^5\) The IESBA indicated that it

\(^3\) ISA 610, paragraph 2.

\(^4\) The IESBA’s *Code of Ethics for Professional Accountants*.

\(^5\) 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
was not intended that the definition of engagement team in the Code would encompass internal auditors providing assistance to the external auditor, but also noted that some of the wording in the Code could inadvertently be interpreted to suggest that an internal auditor may not work under the direction of the external auditor.

12. Section 290.163 of the Code states that an example of activities that would generally be considered a management responsibility includes directing and taking responsibility for the actions of the entity’s employees. In accordance with section 290.165 of the Code, the external auditor shall not assume a management responsibility for a client as the threats created would be so significant that no safeguards could reduce the threats to an acceptable level. In the event internal auditors are engaged to perform audit procedures under the direction, supervision and review of the external auditor, the external auditor could possibly be viewed as “directing and taking responsibility for the actions of the entity’s employees” which if interpreted in the context of the section 290.163 of the Code would constitute a management responsibility.

13. The IESBA’s discussion in October 2009 broadly indicated that the intent of the Code is not to prohibit the use of internal auditors by external auditors for direct assistance on the external audit. Further, the extent of the external auditor’s direction of and responsibility for the internal auditors would be restricted to the ambit of the external audit and, as such, there can be no management responsibility. Notwithstanding this, the IESBA noted that there is a lack of clarity and that a literal interpretation may inadvertently result in the wrong conclusion. The IESBA will resume its consideration of the matter at its February 2010 meeting.

14. The Task Force proposes that the external auditor’s procedures when planning to use internal auditors to provide direct assistance on the engagement will first and foremost involve evaluation of the level of competence and degree of objectivity of the individual internal auditors who will be providing assistance (similar to the consideration regarding the internal audit function as a whole when using their work). As internal auditors are not independent of the entity as is required of the external auditor in a financial statement audit, the Task Force considered the additional measures that should be taken by the external auditor. ISA 500 observes that the reliability of audit evidence is greater when the evidence is obtained from independent sources outside the entity. Correspondingly, audit evidence obtained from sources internal to the entity are ordinarily deemed to be of lower reliability. There is always some risk to the reliability of evidence obtained by staff of the internal audit function which arises because the internal auditors are not independent of the entity. It is proposed, therefore, that there should be more extensive direction, supervision or review of the audit procedures performed by internal auditors than had members of the engagement team performed that work.

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

**Matters for IAASB Consideration**

The IAASB is asked:

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

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

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

17. The Task Force has considered the view expressed by the Board in September 2009 and proposes the following:

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

- Strengthening ISA 610’s focus on the external auditor’s evaluation of the internal audit function to determine whether the work of the internal audit function is likely to be adequate for the purposes of the audit. Specifically, emphasis is placed on the external auditor’s evaluation of the internal audit function’s objectivity, competence and application of a systematic and disciplined approach.

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

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

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

- Strengthening ISA 610’s focus on matters that need to be taken into account when determining the planned effect of the work of the internal audit function. It is proposed that the external auditor’s judgment shall be based on the consideration of the internal audit function’s objectivity and competence, and on the amount of judgment involved in planning and performing the audit procedures, and in evaluating the evidence gathered. Supporting guidance will explain that the greater the amount of judgment that is required, the greater the likelihood that the work of the internal audit function may not, on its own, be adequate for the purpose of the audit. This in case, there is greater likelihood that the external auditor would need to be directly involved to be satisfied that sufficient appropriate audit evidence is obtained.

- Providing guidance to explain that in specific areas (for example, specific line items or assertions), and overall in the engagement, other factors may also be relevant in the external auditor’s determination of the nature and extent of the use of the work of the internal audit function. For example, the assessed risk of material misstatement at the assertion level for particular classes of transactions, account balances and disclosures.

- Introducing a requirement for the external auditor to “stand-back” and consider whether there has been sufficient involvement by the external auditor to be able to conclude on the key audit judgments. The objective of this requirement is to prevent overreliance on the work the internal audit function performed on the external audit collectively. This draws on a similar premise to that in ISA 600 (in relation to other external auditors) that, regardless of the external auditor’s decision to use the work of the internal audit function, the full responsibility for the audit opinion remains with the external auditor. The external auditor therefore needs to have a sufficient basis for taking ownership of the key audit judgments.
• Establishing the external auditor’s obligation to discuss with the internal audit function the planned use of their work for the purpose of coordinating relevant activities with the function. This is in response to the emphasis various stakeholders have placed on the importance of effective and ongoing dialogue between the internal auditors and the external auditors.

Using the Work of the Internal Audit Function

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

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

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

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

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

Inquiry of the Internal Audit Function
19. At its September 2009 meeting, the IAASB discussed the importance of leveraging the internal audit function’s knowledge of the entity and its expertise in risk and control, to inform the external auditor’s understanding of the entity and its environment, as a basis for the external auditor’s risk assessment. There was support for the introduction of a requirement in the ISAs for the external auditor to make inquiries of the internal audit function about its findings and work performed that are likely to be relevant to the external
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The auditor’s overall audit strategy and audit plan. In this regard, the IAASB also considered whether the external auditor should be required to read reports issued by the internal audit function.

20. Whilst some felt this should be a required procedure, the majority of Board members were concerned that this could result in significantly more audit effort given the possible nature and extent of internal audit reports. It would not be appropriate to mandate the procedure of reading the reports as the costs of doing so might often outweigh the benefits obtained. If Whilst the requirement could be more specific about the reports that are likely to be of relevance to the external auditor, it was pointed out that such judgments could only be made upon reading all the reports. Notwithstanding this, the IAASB instructed the Task Force to give consideration to whether, in the application guidance, the external auditor could be encouraged to review reports of the internal audit function in appropriate circumstances.

21. The Task Force has considered the view expressed by the Board and proposes the following revisions to extant ISA 610:

- Placement of the requirement (and its supporting application material). Extant ISA 315 deals with the external auditor’s responsibility to obtain an understanding of the entity and its environment, to be able to identify and assess the risks of material misstatement occurring in the financial statements. Paragraph 6 of the ISA requires the external auditor’s risk assessment procedures to include making inquiries of management and of others within the entity. It is proposed that the requirement for the external auditor to make inquiries of the internal audit function can be appropriately placed within that paragraph.

- The appropriate individuals with whom to inquire. It is proposed that guidance regarding the individuals in the internal audit function to whom inquiries may be directed should be included to support the proposed requirement. In this regard, the Task Force was of the view that the knowledge, experience and authority of the individuals within the internal audit function are relevant considerations, and that the chief internal audit executive be provided as an example of an appropriate individual.

- Guidance on reading reports issued by the internal audit function. The Task Force continues to believe that because of the volume and scope of the reports produced by the internal audit function given the range of activities performed by the function, it would not be efficient to require the external auditor to read all the reports produced. The Task Force proposes however that guidance should be provided in ISA 315 that resulting from the external auditor’s inquiries of internal audit function, the external auditor may view it as useful to follow up by reading about certain of the findings in relevant reports issued by the internal audit function.

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

The IAASB is asked:

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

Impact Analysis Consideration

23. IFAC is currently developing an impact analysis framework for its public interest activity committees (which include the IAASB). At its June 2009 meeting, the IAASB approved the proposed impact analysis for testing the practical application of the proposed analysis on one or more IAASB projects. This project was identified as a test case for that purpose.

24. In June 2009, the IAASB was briefed on the proposed process to be used to inform, develop and document the impact analysis. In brief, the proposed framework indicates the following:

- The impact analysis is informed throughout the development of the proposed new standard, and is documented in the Explanatory Memorandum that accompanies the Exposure Draft. The final impact analysis is documented in the Basis for Conclusions. Documenting the impact analysis in the Explanatory Memorandum is viewed as particularly important to obtain feedback from external stakeholders.
- The impact of both the proposed standard and the preferred option for each key issue addressed during the development of the standard would be analyzed. Narrative descriptions of these analyses would be included in the Explanatory Memorandum. These analyses are scalable; that is, their scope and depth depend on the nature and magnitude of the problem being addressed.
- The Explanatory Memorandum and Basis for Conclusions would include the impact analysis template.

25. The Task Force gave consideration to the issues addressed in the revision of ISA 610, and proposes that the following three key matters be highlighted in the impact analysis that will accompany the Exposure Draft:

(a) The proposed expansion of the scope of ISA 610 to address the matter of internal auditors providing direct assistance to external auditors on audit engagements.

(b) The proposed judgment-based approach to the external auditor’s determination of whether and to what extent to use the work of the internal audit function.

(c) The proposed requirement in ISA 315 for the external auditor to make inquiries of the internal audit function about its findings and work performed that are likely to be of relevance to the external audit as a basis for leveraging the knowledge and experience of the internal audit function to inform the external auditor’s risk assessments.
26. Subject to the IAASB’s views on the above, it is the Task Force’s intention that a draft impact analysis will be prepared for the next IAASB meeting at which this project would be considered for the purpose of seeking the Board’s preliminary feedback.

### Matters for IAASB Consideration

The IAASB is asked for its views on the key issues proposed for inclusion in the impact analysis for this project.
Factors Influencing the External Auditor’s Use of the Work of the Internal Audit Function

Other factors that may influence the external auditor’s decision regarding the areas in which work of the internal audit function may be used (e.g., specific line items or assertions) in order to be satisfied that the external auditor has been sufficiently involved to be able to conclude on the key audit judgments are as follows:

- Materiality; and
- Risk.