Basis for Conclusions
Prepared by the Staff of the IAASB
March 2012

International Standards on Auditing

ISA 610 (Revised), Using the Work of Internal Auditors, and ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

IAASB
International Auditing and Assurance Standards Board

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BASIS FOR CONCLUSIONS:
ISA 610 (REVISED), USING THE WORK OF INTERNAL AUDITORS, AND ISA 315 (REVISED), IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 610 (Revised), *Using the Work of Internal Auditors*, and ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. In December 2011, the IAASB approved ISA 610 (Revised), ISA 315 (Revised), and conforming amendments to a number of other ISAs.[1]

I. Background

1. Extant ISA 610[2] was last revised in March 1994.[3] As part of the Clarity project,[4] ISA 610 was redrafted, but not revised, for conformity with the Clarity drafting conventions. Some respondents to the Clarity Exposure Draft (ED) of ISA 610 encouraged the IAASB to consider a more comprehensive revision of the ISA, a view shared by a number of the Representatives of the IAASB Consultative Advisory Group (CAG) and some national auditing standard setters (NSS). It was noted at that time that using the work of internal auditors can be important particularly in audits of financial institutions and other larger entities. There were concerns that the extant ISA failed to reflect developments in the internal auditing environment and national auditing practices. The IAASB was also encouraged to remove the current ambiguity in the scope of the extant ISA 610 regarding using internal auditors to provide direct assistance.[5]

2. At the time this revision project was commenced, the IAASB had not received indications that the overall structure and requirements of extant ISA 610 no longer remained sound. Accordingly, it did not anticipate the need for a major overhaul of the ISA. Rather, its aim was to enhance the performance of external auditors by:

   (a) Enabling better consideration and leveraging, as appropriate, of the knowledge and findings of the internal audit function in making risk assessments; and

   (b) Strengthening the framework for the evaluation and, where appropriate, use of the work of internal auditors in obtaining audit evidence, including resolving the ambiguity in extant ISA 610 regarding whether the ISAs permit the use of internal auditors to provide direct assistance.

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1 The IAASB approved ISA 610 (Revised) with the affirmative votes of 17 out of the 18 IAASB members, and one abstention. For a summary of the rationale given by the IAASB member who abstained, see the minutes of the December 5-9, 2011 IAASB meeting at www.ifac.org/sites/default/files/meetings/files/20120312-IAASB-Agenda%20Item%201-A-Dec_2011_Mtg_Public_Session_Minutes-Approved_0.pdf . ISA 315 (Revised) and the conforming amendments to other ISAs were approved by the IAASB with the affirmative votes of 18 out of the 18 IAASB members.

2 ISA 610, *Using the Work of Internal Auditors*

3 Conforming amendments were made when the IAASB issued the audit risk standards in October 2003.

4 Further information regarding the IAASB's Clarity Project is available on the IAASB website at www.iaasb.org/clarity-center.

5 See further discussion on direct assistance in Section IV of this Basis for Conclusions.

3. The IAASB published its proposals in an exposure draft (ED-ISA 610) in July 2010. The comment period for ED-ISA 610 closed on November 15, 2010. Fifty-seven comment letters were received from various respondents, including regulators and oversight bodies, NSS, IFAC member bodies, and firms (representing the views of a total of 72 organizations and individuals). As part of its consideration of comments on exposure, the IAASB held discussions with representatives of some of the regulatory respondents to fully understand the concerns they had expressed on the exposure draft as well as to explain more clearly the IAASB's proposals and further proposed changes. This Basis for Conclusions explains the more significant issues raised by respondents to the ED, and how the IAASB has addressed them.

4. The IAASB has also discussed this project with its CAG on six separate occasions during March 2009–September 2011. Further, the IAASB has engaged with the International Ethics Standards Board for Accountants (IESBA) closely throughout the course of the project, in particular regarding the matter of direct assistance. An IESBA member has been an active member on the project task force since inception. The IESBA has also received reports on related ethical issues arising from the revision of ISA 610 at a number of its public meetings. An IESBA task force was established following issuance of the ED to consider comments received that were relevant to IESBA, and provided input on IAASB's proposed responses to ED comments. The IESBA is slated to continue its consideration of the matter of direct assistance, in particular the need to amend the IESBA Code[6] to clarify the relationship of internal auditors providing direct assistance to the engagement team in 2012.[7]

II. Using the Work of the Internal Audit Function

5. While there was substantial support for the proposals in the ED, some stakeholders, especially regulators and oversight bodies, noted that, in their view, it would allow for *significantly* greater use of the work of the internal audit function by the external auditor. Concern was expressed that this could result in pressure on external auditors to use more of such work for efficiency reasons alone. Cases were cited where the nature and extent of use of the work of the internal audit function observed in inspections were viewed by the respondents as inappropriate.

6. These respondents felt that extensive use of such work is inappropriate as it could result in the external auditor not being, or at least not being seen to be, sufficiently involved in the audit, which could negatively affect the perception of the independence of the external auditor. In addition, some expressed the view that external auditors must themselves perform procedures directly to gather and corroborate audit evidence sufficient to support the external auditor's sole responsibility for the audit, although views on the nature and extent of that involvement that would be considered necessary varied among respondents. Respondents also challenged whether the requirements in the ED were sufficient to ensure that the use of such work is within acceptable levels. In particular, the proposed prohibitions and "standback" on the overall use of the work of the internal audit function introduced in the ED were not viewed as sufficient to prevent over or undue use of such work.

7. Respondents offered a number of suggestions to strengthen the framework for the external auditor's judgments for determining the nature and extent of work of the internal audit function that

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[6] The *IESBA's Code of Ethics for Professional Accountants* (IESBA Code)

[7] See further discussion on direct assistance in Section IV of this Basis for Conclusions.

can be used for purposes of the audit. Respondents, including regulators and oversight bodies, recommended that some of the requirements be strengthened by elevating some of the related application material. For example, while respondents acknowledged that the amount of judgment involved in planning, performing and evaluating the procedures was a relevant consideration, many thought the risk of material misstatement should also be a factor the external auditor should be required to consider. Some regulators also asked for greater prescription for the audit procedures that the external auditor should perform in order to have a sufficiently robust basis to evaluate the quality of the work of the internal audit function. The most common suggestion was to require a certain level of reperformance by the external auditor on the work of the internal audit function that the external auditor plans to use.

8. In addition, respondents also cited difficulties with some of the concepts in ED-ISA 610 relating to determining whether, in which areas, and to what extent the work of the internal audit function can be used. In particular, respondents noted that the concepts of "degree of objectivity" and "systematic and disciplined approach, including quality control" needed to be clarified. These respondents suggested additional guidance that could be usefully provided.

9. Further, a comment letter containing the input from a number of audit inspection bodies included the view that because the internal audit function is internal to the entity, by definition, it is an internal control. It was argued that the work of the function can only be considered, under the audit risk model, to reduce control risk, and only the external auditor can reduce detection risk. Therefore, in their view, ISA 610 should be more closely aligned with ISA 330[8] regarding evidence that the external auditor needs to obtain for controls.

IAASB Decisions

10. The IAASB reaffirmed its position in ED-ISA 610 that the external auditor has sole responsibility for the opinion expressed. The IAASB made amendments to emphasize this message in the introductory paragraphs to instill an appropriate mindset in external auditors when conducting engagements. However, it also became clear to the IAASB during its discussions that care needs to be taken to ensure that a balanced approach is adopted in the drafting of ISA 610 (Revised). Not only should the pitfalls of over and undue use of the work of the internal audit function for purposes of the audit be highlighted, but also the advantages to audit quality of a constructive and complementary relationship between external and internal auditors including, where appropriate, the possibility of coordination and cooperation.

11. Based on the above approach, the IAASB made the following amendments to the ED:

    (a) Amending the introductory paragraphs to establish an appropriate overarching tone for the ISA. In particular:

        - Adding cautionary language to emphasize more clearly in the introductory paragraphs that the external auditor's sole responsibility for the audit opinion expressed is not reduced by the external auditor's decision to use the work of the internal audit function, and that when using such work on the audit, external auditors should guard against over or undue use, and obtain sufficient appropriate audit evidence that the work of the

[8] ISA 330, *The Auditor's Responses to Assessed Risks*

function is adequate for purposes of the external audit. [ISA 610 (Revised), paragraph 9]

- Explaining more clearly in the introductory paragraphs that the external auditor may be able to use the work of the internal audit function in a constructive and complementary manner, but such decisions depend on: whether the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; the level of competency of the function; and whether it applies a systematic and disciplined approach. [ISA 610 (Revised), paragraph 7]
- Drawing on the guidance in ISA 200[9] regarding the external auditor's responsibility to plan and perform the audit with professional skepticism, introducing guidance in ISA 315 (Revised) and ISA 610 (Revised) to emphasize that communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters to the external auditor's attention that may affect the work of the external auditor.[10] The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. The guidance further points out that, if such information may be indicative of a heightened risk of material misstatement of the financial statements or relates to any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with ISA 240.[11] [ISA 610 (Revised), paragraph A26]

(b) Establishing more robust safeguards against undue use of internal audit work by clarifying the circumstances when the work of the internal audit function cannot be used and therefore is prohibited. These cases are as follows:

- The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- The function lacks sufficient competence; or
- The function does not apply a systematic and disciplined approach, including quality control. [ISA 610 (Revised), paragraph 14]

(c) Where use is permissible, ensuring there are adequate safeguards against over or undue use of the work of the internal audit function by strengthening the external auditor's decision-making framework for determining the planned nature and extent of work of the internal audit function that can be used. In particular, more clearly articulating in the requirements that the external auditor must make all significant judgments in the audit engagement, and plan to use less of the work of the internal audit function and perform more of the work directly in circumstances where the assessed risk of material misstatement is higher with special

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[9] ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraphs 15 and A18

[10] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*; ISA 315 (Revised), paragraph A116

[11] ISA 315 (Revised), paragraph A11

consideration given to risks identified as significant. Similarly, for the other factors,[12] elevating application material to incorporate in the requirement how the factors should influence the auditor's judgments. [ISA 610 (Revised), paragraphs 15-16]

(d) Strengthening the safeguard against overuse of the work of the internal audit function by clarifying the requirement that, having made preliminary judgments on the nature and extent of use, the external auditor should reflect on whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. [ISA 610 (Revised), paragraph 17]

(e) Requiring the external auditor, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with ISA 260,[13] to communicate how the external auditor has planned to use the work of the internal audit function. [ISA 610 (Revised), paragraph 18]

(f) Requiring safeguards against using work of the internal audit function that is not adequate for purposes of the audit by:

- More clearly defining the necessary work effort to obtain sufficient appropriate evidence regarding the work of the internal audit function that the external auditor plans to use.
- Clarifying that the external auditor's procedures need to be responsive to the external auditor's evaluations of the function and the work to be used.
- Introducing a requirement for reperformance of some of the work of the internal audit function that the external auditor plans to use (further discussed in Section III below). [ISA 610 (Revised), paragraphs 21-22]

12. Regarding the link to the audit risk model (see paragraph 9 above), the IAASB reaffirmed its view that ED-ISA 610 is consistent with the suite of ISAs. The ISA is grouped with the standards addressing the work of others – experts, component auditors and internal auditors – and how their work may be used in complying with the requirements of other ISAs. As explained in ISA 315, while the internal audit function is part of the entity's monitoring of controls, the function's work that the external auditor can use is distinct from other monitoring controls because it involves audit procedures similar to those performed by the external auditor. Further, ISA 610 only applies if the internal audit function applies a systematic and disciplined approach, including quality control. However, the internal audit function is not independent of the entity and, therefore, it is appropriate for the ISA to define the conditions that are necessary in order for the external auditor to be able to use such work, and the work effort needed to obtain sufficient appropriate evidence that the work is adequate for purposes of the audit.

13. As the perspective expressed by the respondent would be a fundamental shift from this underlying premise, and would result in significantly more work than both prescribed in the extant ISA and

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[12] These factors are: (a) the amount of judgment involved in planning and performing relevant audit procedures, and evaluating the audit evidence gathered; (b) the extent to which the internal audit function's organization status and relevant policies and procedures support the objectivity of the internal auditors; and (c) the level of competence of the internal audit function.

[13] ISA 260, *Communication with Those Charged with Governance*, paragraph 15

carried out in practice, the IAASB consulted with its CAG during the course of formulating its response. Representatives of the CAG generally advised that it was important to keep in mind the importance of balancing technical considerations in light of the practical considerations when developing responses to comments received on exposure. CAG Representatives also provided advice on the safeguards and limitations regarding the use of the work of the internal audit function described above.

III. Reperformance

14. ED-ISA 610 included application material indicating that, in most circumstances, some reperformance would be appropriate. It explained that reperformance of the work of the internal audit function involves the external auditor's independent execution of procedures that were originally performed by the function and could involve examining items already examined by the internal audit function, or other similar items.

15. A number of respondents were of the view that reperformance should be a required procedure. Some respondents also questioned whether examining similar items not actually examined by the internal audit function would achieve the same objective as examining items already examined by the internal audit function.

IAASB Decision

16. The IAASB agreed to elevate to the requirements the need to reperform some of the work of the internal audit function that the external auditor plans to use. It also reaffirmed that reperformance may be achieved by the external auditor's independent execution of procedures to examine both items already examined by the internal audit function and other similar items not actually examined by the function. The IAASB noted that both approaches are necessary because, for example, there are some procedures which cannot be reperformed after the fact (for example, some procedures related to inventory counts). Performing similar procedures can, however, provide a basis for validating the conclusions that internal audit has reached. Guidance has been added in the ISA to further explain this concept. [ISA 610 (Revised), paragraphs 22 and A30]

IV. Direct Assistance

17. ED-ISA 610 also addressed the matter of direct assistance. The IAASB proposed to establish requirements and guidance in revised ISA 610 to ensure direct assistance is obtained only in appropriate circumstances, and to clearly set out the external auditor's responsibilities in such cases, including the required involvement of the external auditor.

18. Almost all the respondents agreed with the IAASB that it is undesirable for the ISAs to continue to be silent on the matter of direct assistance and that the ambiguity regarding whether or not external auditors are permitted to use internal auditors to provide direct assistance on the audit should be clarified. However, respondents' views on whether the ISAs should permit direct assistance were polarized. Regulators and oversight bodies expressed the least support for permitting direct assistance, with some expressing strong concerns. However, recognizing that it is established practice in some jurisdictions, many of them agreed that ISA 610 (Revised) should deal with it so that appropriate limitations and safeguards can be put in place. Those respondents who accepted the use of direct assistance generally felt that such practices should be restricted to more limited circumstances than use of the work of the internal audit function. Among the reasons cited,

respondents were most concerned that direct assistance appeared to be in conflict with the IESBA Code. This is because it was felt that the independence of the external auditor may be compromised in fact because the internal auditor is permitted to work at such close proximity with the external auditor in these circumstances.

IAASB Decision

19. The IAASB has given due consideration to comments received from respondents in relation to direct assistance and agreed on the amendments that, in its view, are required to appropriately and adequately respond to the comments received. As ethical considerations are central to direct assistance, the IAASB has engaged with the IESBA on how to address the perceived conflict with the IESBA Code.[14] The IESBA gave further consideration to the question of whether such practices should be prohibited and whether amendments need to be made to the IESBA Code to clarify the IESBA's intention. The IESBA provided input to the IAASB on proposed amendments to the requirements and guidance on direct assistance in ISA 610 (Revised) to ensure that they provide adequate safeguards, which the IAASB took on board in finalizing the wording of the requirements and application material in the revised ISA. The IESBA is now slated to continue deliberations on changes that may be needed to the IESBA Code in 2012.

20. In view of the fact that it is expected that changes will need to be made to the IESBA Code, the IAASB discussed possible options for the issuance of the final ISA 610 (Revised). The IAASB considered the option of deferring issuing the final ISA in its entirety until the IESBA has reached a resolution of how the matter of direct assistance should be addressed from an ethics perspective. The large majority of IAASB members did not support this option, however, because regulators' and other stakeholders have argued that there is a need for greater rigor in the external auditors' use of the work of the internal auditors in practice, particularly in the current economic environment. Therefore, the IAASB decided that it was important to release the amendments to ISA 315 on the inquiries of internal auditors and consideration of the internal audit function in obtaining an understanding of the entity and its environment, including internal control, and the sections of ISA 610 (revised) dealing with using the work of the internal audit function. The IAASB thought it was important to complete its consideration of ED comments on the requirements and application material on direct assistance and has therefore also finalized that section of ISA 610 (Revised). The Board concluded, however, that the issuance of the section will be withheld pending the IESBA's resolution of changes to the IESBA Code. For interested parties, the full approved wording of ISA 610 (Revised) (addressing both using the work of the internal audit function and direct assistance) is available on the IAASB's website.

V. Inquiries by the External Auditor of Appropriate Individuals within the Internal Audit Function

21. Almost all of those who responded agreed that it is appropriate to require the external auditor to make inquiries of appropriate individuals within the internal audit function and that such a requirement is appropriately placed in ISA 315 (Revised). A few respondents noted that it is unclear whether the external auditor should make inquiries regardless of the external auditor's evaluation of the objectivity or the integrity of the internal audit function.

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[14] Also see paragraph 4 of this Basis for Conclusions.

IAASB Decision

22. The IAASB accepted respondents' suggestion to clarify the ambiguity in ED-ISA 610 on whether inquiries need to be made in all audits. The IAASB added guidance to clarify that, because such inquiries may provide useful information relevant to the external auditor's risk assessments, they should be made even if the auditor does not expect to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed. [ISA 315 (Revised), paragraph A9]

VI. Reading Reports of the Internal Audit Function

23. Almost all respondents expressed agreement with the proposal in the ED. A respondent however, disagreed, arguing that, due to differing internal audit reporting policies, such a requirement may be too onerous. Accordingly, the respondent suggested restating the proposed requirement as guidance to indicate best practice.

24. Views were also expressed that external auditors may benefit from obtaining and reading the formalized planning and risk assessment documents prepared by the function. This would be in addition to the proposals in ED-ISA 610 for the external auditor to make inquiries with the internal audit function and to read reports of the function related to specific work being used.

IAASB Decision

25. The IAASB did not agree that restating the requirement as guidance would be appropriate, because the reports produced by the internal audit function serve as evidence of the conclusions reached as a result of the work performed by the function. Such understanding would be important to the external auditor since the external auditor would be planning to use the work of the internal audit function to which the reports relate.

26. Further, the IAASB did not feel that it would be necessary to mandate that the external auditor obtain and read, in all circumstances, the formalized planning and risk assessment documents prepared by the function. The external auditor has sole responsibility for identifying and assessing the risks of material misstatement in conducting the audit and, depending on the focus of an entity's internal audit function's work, sufficient information may be obtained from the inquiries of internal audit personnel to adequately inform the external auditor's own risk assessments. However, the function's strategy and planning documents and reports prepared for management or those charged with governance were included as examples of reports that may be relevant to review if, based on responses to the external auditor's inquiries, it appears that the internal audit function's findings may be relevant to the entity's financial reporting and the audit. [ISA 315 (Revised), paragraph A10]

VII. Scope

27. A respondent suggested including a description of the different ways in which the external auditor could use the knowledge and work of the internal audit function and internal auditors. It was argued that clear recognition of the potential uses of the internal audit function as addressed in the ISAs would be important, as the various types of use may be aimed at achieving different purposes and therefore carry different considerations required of the external auditor.

IAASB Decision

28. The IAASB agreed with the view expressed and included an explanation of all of the various ways in which the external auditor may be able to use the knowledge and work of the internal audit function, and internal auditors, in the external audit. Particular emphasis was given to making clear the difference between external auditors' use of the knowledge and work of an internal audit function for assessing risks of material misstatement (addressed in ISA 315 (Revised)), and using such work which the external auditors would otherwise have to perform themselves, as audit evidence (addressed in ISA 610 (Revised)). [ISA 610 (Revised), paragraphs 5-8]

VIII. Definitions

29. Respondents were of the view that including definitions of the terms "internal audit function" and "internal auditor" in ISA 610 (Revised) would be especially helpful to the application of the ISAs, for example, in determining whether the entity has an internal audit function as envisaged by revised ISA 610.

IAASB Decision

30. The IAASB was in agreement and included the definition of the term "internal audit function" in ISA 610 (Revised). It decided that there was no need to include a definition of the term "internal auditor" as its usage in the revised ISA 610 is sufficiently clear. [ISA 610 (Revised), paragraph 12]

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