



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Washington

Meeting Date: September 9–11, 2009

Using the Work of Internal Auditors—Key Issues and Report Back

Objectives of Agenda Item

1. The objectives of this Agenda Item are:
 - (a) To obtain the Representatives' views on a number of key issues to be discussed by the IAASB at its September 2009 meeting, and
 - (b) To provide a brief report back on proposals of Representatives on this project discussed at the March 2009 CAG Meeting.

Background

2. At its March 2009 meeting, the IAASB unanimously approved a project proposal to commence work on the revision of ISA 610 (Redrafted).¹ The project is consistent with the IAASB's *Strategy and Work Program, 2009-2011*, which included a proposal to revise ISA 610 (Redrafted). This is in response to calls from respondents during the Clarity redrafting for a revision of the ISA to better reflect the current internal auditing environment.
3. The CAG discussed the project proposal at its March 2009 meeting and provided comments on directional matters relating to the project. It also agreed that a CAG Working Group will be formed for this project.

Matters for CAG Consideration

General Principles

4. The following underlying principles regarding the external auditor's use of internal audit work shaped the Task Force's² deliberations and, accordingly, its proposals on several of the key issues in connection with the revision of ISA 610:

¹ ISA 610 (Redrafted), "Using the Work of Internal Auditors."

² The Task Force comprises: Diana Hillier, Chair and IAASB Member; Cédric Gélard, IAASB Member; Daniel Montgomery, IAASB Member; Carman Lapointe, Institute of Internal Auditors Representative; Clyde MacLellan, International Organization of Supreme Audit Institutions Representative; and Robert Franchini, Correspondent Member and IESBA Member. Technical advisors on the project include Susan Lione (for Ms. Lapointe), Jon Rowden (for Ms. Hillier) and Isabelle Tracq-Sengeissen (for Mr. Gélard).

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- (a) The decision of whether or not to use the work (or assistance) of internal auditors in the external audit should rest with the external auditor; the ISA should not directly or indirectly encourage or discourage the use of internal audit work (or assistance).
- (b) While the external auditor must make an informed decision regarding whether to use internal audit work, the external auditor's evaluation of the internal audit function for purpose of the financial statement audit is not intended to provide a sufficient basis for forming an opinion about the overall effectiveness of the internal audit function.
- (c) Internal audit work that may be of relevance to the external audit generally falls into one of the following three categories:
 - Internal audit findings and insights may be a source of information on the entity and its environment that can assist the external auditor in the identification and assessment of the risk of material misstatement
 - Specific work which the external auditor may be able to use in place of performing that work directly themselves; typically this refers to assurance work performed by internal auditors often in relation to its evaluation of internal control
 - Direct assistance through the performance of audit procedures on the external audit under the direction, supervision and review of the external auditor
- (d) In deciding to use specific internal audit work, the external auditor is not “relying on internal control” in the same way that the auditor may obtain evidence from the effectiveness of a particular control activity. Rather, the external auditor is using that work in place of performing similar audit procedures directly. As a basis for determining whether it is appropriate to use that specific internal audit work as part of the external auditor's evidence, the external auditor obtains evidence regarding the internal audit function *as a whole*.

Matter for CAG Consideration

1. Does the CAG agree with the general principles outlined above in regard to the external auditor's use of the work of internal auditors?

Definition of Internal Audit Function

5. The definitions of “internal audit function” and “internal auditors” in ISA 610 are important in determining the relevance of the internal audit function to the external audit, and consequently when the external auditor needs to apply ISA 610 in the context of an audit of financial statements. On this basis, a review of the definitions in ISA 610 for their continued relevance was slated to be undertaken in the revision of the ISA.
6. In connection to this, the Task Force proposes that the following features be captured in the revised definition of internal audit function:

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- (a) The role of the internal audit function with regard to internal control is one of evaluating controls; this involves providing *assurance* on its operating effectiveness and is distinct from a control activity
 - (b) Internal audit to be identified as a *function* as distinct from ad hoc activities performed by individuals within entity. This is of importance because, amongst other matters, it is the organizational structure that establishes the basis for the internal audit function's objectivity. These functions may or may not have the title of internal audit and may be performed by one or more groups within or outside of (i.e., if outsourced) the entity
 - (c) The internal audit function employs a *systematic and disciplined* approach to the conduct of its work. This is an important characteristic which distinguishes it from other control activities performed on an ad hoc basis within the entity
 - (d) The internal audit function maintains *objectivity* (as opposed to *independence* as used in the Institute of Internal Auditors' (IIA) definition);³ this characteristic is of particular importance given its role to evaluate internal control
7. With consideration for the above, the Task Force proposes the following revised definition of internal audit function:

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

Matter for CAG Consideration

2. Does the CAG agree with the elements proposed to be captured in the definition of internal audit function and, if so, does it agree with the proposed revised definition?

8. The following matters are also presented in the Issues Paper to be considered by the IAASB at its September 2009 meeting (provided as a CAG Reference Paper for this Agenda Item), with specific questions posed regarding their relevance to the revision of ISA 610 and appropriateness of the Task Force's proposals:
- Distinction between internal audit functions and control activities **(See paragraphs 11-13 of Agenda Item 8-A of the September 2009 IAASB meeting)**

³ For reference, the IIA's definition is: "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

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- How internal audit work may be relevant to and used by the external auditor (*See paragraphs 14-16 of Agenda Item 8-A of the September 2009 IAASB meeting*)

Matter for CAG Consideration

3. Does the CAG agree that the matters identified in paragraph 8 are relevant to the revision of ISA 610 and, if so, does it agree with the Task Force's conclusions / proposals?

Using the Work of the Internal Auditors

9. The internal audit function's knowledge of the organization and assessment of risk may be relevant to and capable of informing the external auditor's own risk assessment. In relation to this, ISA 240⁴ requires the auditor to make inquiries of the internal audit function regarding fraud. The Task Force believes it may also be appropriate for the external auditor to be required to make inquiries of the internal audit function about its findings and work performed that are likely to be relevant to the external audit and the external auditor's risk assessments. The information obtained would subsequently be supported by the external auditor's other risk assessment procedures and further audit procedures.
10. Paragraph 4 of ISA 610 states that the external auditor has sole responsibility for the audit opinion and this is not reduced by the external auditor's use of internal audit work. Guided by this, the Task Force is of the view that the decision of whether or not to use specific internal audit work should remain with the external auditor. Following from this, the Task Force considered approaches for determining the appropriate level of use of internal audit work and it was in favor of a judgment-based approach over a bright-line threshold. It believes that a bright-line threshold does not give sufficient acknowledgement to the fact that the appropriate nature and extent of the use of internal audit work will necessarily be contingent on the characteristics of the internal audit function and the external auditor's risk assessment and planned audit approach.
11. Under a judgment-based approach, the Task Force believes that the external auditor's decision regarding the extent of the use of internal audit work should be influenced by the competence and objectivity of the internal audit function. The higher the degree of competence and objectivity, the more appropriate it would be for the external auditor to use the work of internal auditors and in more areas. Another dimension is the amount of judgment required to be exercised in performing such work; the greater the judgment involved, the more the external auditor needs to be directly involved and the less likely that internal audit work may be used. (*See appended illustrative diagram in Agenda Item 8-A of the September 2009 IAASB meeting*)
12. In this regard, the Task Force believes that it is generally not appropriate for the external auditors to use internal audit work in areas of significant judgment. It is the degree of

⁴ ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs 19 and A18.

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judgment involved in the work (i.e., in designing the procedures or in evaluating the results) that is the key consideration, rather than the assessed level of risk or materiality of the related financial statement assertion.

13. Before using specific internal audit work, the Task Force believes that the external auditor should perform sufficient procedures to be satisfied as to the adequacy of the internal audit function *as a whole* to support:

- (a) The quality of internal audit work, given that it would be used in lieu of the external auditor directly performing that work; and
- (b) The nature and extent of that work that is appropriate to use in the circumstances.

Having obtained evidence to support the quality of internal audit work, and made an informed judgment on where such work may appropriately be used, the Task Force believes, therefore, that it is not necessary for the external auditor to “test” each individual piece of internal audit work. The external auditor does, however, need to evaluate the adequacy of specific work for the purposes of the external audit. In this regard, the Task Force believes that the procedures in extant ISA 610 are appropriate.

Matter for CAG Consideration

4. Does the CAG agree with the proposed judgment-based approach to determining the external auditor’s extent of use of internal audit work?

14. The following matters are also presented in the Issues Paper to be considered by the IAASB at its September 2009 meeting, with specific questions posed regarding their relevance to the revision of ISA 610 and appropriateness of the Task Force’s proposals:

- Appropriateness of the present structure of ISA 315 (in regards to internal auditing) and ISA 610 *(See paragraphs 17-19 of Agenda Item 8-A of the September 2009 IAASB meeting)*
- Nature of internal audit work (test of controls vs. substantive procedures) and relevance to the external audit *(See paragraphs 31-34 of Agenda Item 8-A of the September 2009 IAASB meeting)*
- Determining the nature, timing and extent of audit procedures required to support the external auditor’s use of specific internal audit work *(See paragraphs 35-41 of Agenda Item 8-A of the September 2009)*

Matter for CAG Consideration

5. Does the CAG agree that the matters identified in paragraph 14 are relevant to the revision of ISA 610 and if so, does it agree with the Task Force’s conclusions / proposals?

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Direct Assistance

15. The provision of direct assistance by internal audit staff on the external audit was a matter slated for consideration in the revision of ISA 610. While there may be divergent views on this matter, the Task Force believes that the scope of ISA 610 should be appropriately expanded to address such scenarios given the widespread use of internal audit staff's direct assistance in many jurisdictions. It does not, however, believe that it would be appropriate to require or encourage the external auditor to use, or to consider using, internal auditors in this regard. In formulating its proposals, the Task Force gave consideration to the consultation paper issued by the UK Auditing Practices Board in March 2009 which included a proposal for expanding the scope of ISA 610 (UK and Ireland)⁵ to address the matter of direct assistance.
16. In this regard, key matters considered by the Task Force include the following:
- Whether overall the requirements in ISA 610 relating to the external auditor's use of internal audit work are generally applicable in cases involving direct assistance. The requirements in ISA 610 relating to the external auditor's assessment of the internal audit function should be applied before internal auditors may be assigned to specific tasks. Importantly, the external auditor will need to exercise skepticism with the work performed by internal audit staff and respond as appropriate, for example by imposing a heightened level of supervision or review. This is necessary given the internal audit staff's lack of independence and, in accordance with the hierarchy of evidence set out in ISA 500,⁶ the presumption that the work of internal auditors would provide less reliable evidence than work performed directly by the external auditor themselves.
 - Whether by performing audit procedures on the external audit, internal audit staff may, under the prevailing definitions in the ISAs and IFAC's *Code of Ethics for Professional Accountants* (IFAC Code), be deemed to be members of the engagement team.⁷ As members of the engagement team are expected to be independent, in the case of internal auditors, this creates an inconsistency with paragraph 4 in ISA 610, which states that the internal audit function is not independent of the entity. The view of the International Ethics Standards Board for Accountants (IESBA) will be sought on whether and what clarification is required to be made to the definition of engagement team in the IFAC Code in this regard.
 - Whether it is appropriate for a "threats-and-safeguard" approach, consistent with the IFAC Code, to be applied in circumstances involving direct assistance. Specifically, guidance

⁵ ISA 610 (UK and Ireland), "Using the Work of Internal Audit."

⁶ ISA 500, "Audit Evidence."

⁷ In the ISAs, the engagement team is defined as all partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes external experts engaged by the firm or a network firm. In the IFAC Code, the engagement team is defined as all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

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should be provided in ISA 610 on the appropriate safeguards to apply to deal with threats that may arise. In this regard, the Task Force does not believe that the external auditor seeking pre-approval from those charged with governance of the entity is a necessary safeguard in all cases. However, it is of the view that the external auditor needs to be satisfied that sufficient safeguards have been put in place to overcome the threats arising from the fact that internal audit staff are not fully independent.

Matter for CAG Consideration

6. Does the CAG agree with the proposal to expand the scope of the ISA to address direct assistance and if so, does it agree with the Task Force's conclusions / proposals in paragraph 16?

Other Matters

17. Other matters, as follows, are also presented in the Issues Paper to be considered by the IAASB at its September 2009 meeting, with specific questions posed regarding their relevance to the revision of ISA 610 and appropriateness of the Task Force's proposals:
 - Ethical principles of internal auditors (objectivity, competence and due care) (*See paragraphs 42-46 of Agenda Item 8-A of the September 2009 IAASB meeting*)
 - Communication with those charged with governance on the planned use of internal audit work (*See paragraphs 57-58 of Agenda Item 8-A of the September 2009 IAASB meeting*)
 - National laws and regulations exception clause (*See paragraph 59 of Agenda Item 8-A of the September 2009 IAASB meeting*)
 - Documentation by the external auditor to support its use of specific internal audit work (*See paragraphs 60-64 of Agenda Item 8-A of the September 2009 IAASB meeting*)

Matter for CAG Consideration

7. Does the CAG agree that the matters identified in paragraph 17 are relevant to the revision of ISA 610 and if so, does it agree with the Task Force's conclusions / proposals?

Further Consultation

18. Consideration was given to whether further consultation would be required to obtain necessary input before the development of an exposure draft on the proposed revised ISA 610. Cognizant of the likely interest of the regulatory and banking communities in the project's developments, the Task Force has made, and continues to make, a conscious effort to engage with these stakeholder groups early in the process where possible. In addition, timely inputs from specific constituencies will continue to be obtained through key IAASB consultative, liaison and promotional channels. On this basis, the Task Force believes that further consultation in addition to the above is not likely to elicit significant new information.

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Matter for CAG Consideration

8. Does the CAG agree with the Task Force's conclusion that further consultation in advance of development of an exposure draft on the revised ISA 610 is not required?

Report Back on the March 9-10, 2009 CAG Proposals

19. Below is an extract from the draft minutes of the March 2009 CAG meeting,⁸ and an indication of how the IAASB or the Task Force responded to the Representatives' comments:

Representatives' Comments	Task Force/IAASB Response
While the project proposal notes that the project task force will consider the appropriateness of "requiring external auditors to use internal auditors," Ms. Patti did not believe this would be appropriate as a requirement. She suggested the proposal use phrasing such as "strongly encourage."	<p>Point accepted.</p> <p>In approving the project proposal, some IAASB members emphasized that while it would be important to encourage greater use of the work of the internal auditors for efficiency reasons, it is equally important to avoid undue or overreliance on internal auditors.</p> <p>The Task Force is of the view that the decision of whether or not to use the work of internal audit should rest with the external auditor; the ISA should not directly or indirectly encourage or discourage the use of the work of internal audit.</p> <p><i>See paragraph 5(i) of Agenda Item 8-A of the September 2009 IAASB Meeting.</i></p>
Mr. Pickeur supported the involvement of the IIA on the project task force. He and Mr. Fleck also agreed that involvement of a representative of the International Ethics Standards Board for Accountants was beneficial.	<p>Point accepted.</p> <p>The membership of the Task Force consists of representatives from the IIA and the IESBA (see footnote 2).</p>
Mr. Johnson noted that while objectivity of internal audit is fundamental, the standard will need to be applicable to circumstances in which internal auditors report to	<p>Point taken into account.</p> <p>The Task Force recognized that the organizational structure of internal audit functions may vary between entities. This factor has been taken into account in the</p>

⁸ The minutes will be approved at the September 2009 IAASB CAG meeting.

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Representatives' Comments	Task Force/IAASB Response
management as well as to those charged with governance.	<p>Task Force's considerations on a number of matters including the definition of internal audit function and the external auditor's communication with those charged with governance.</p> <p><i>See paragraphs 7-9 and 54-55 of Agenda Item 8-A of the September 2009 IAASB Meeting.</i></p>
<p>Mr. Fleck noted that the UK Auditing Practice Board's (APB's) recent Consultation Paper dealing with revised draft ethical standards for auditors may be useful to the project Task Force. He encouraged the IAASB to gather views from regulators who have encountered issues in this area.</p>	<p>Point accepted.</p> <p>The Task Force has considered the proposals in the APB Consultation Paper which have relevance for the revision of ISA 610 and the responses received by the APB.</p> <p><i>See paragraph 50-41 of Agenda Item 8-A of the September 2009 IAASB Meeting.</i></p> <p>The Task Force is cognizant of the likely interest of certain stakeholder groups, including the regulatory community, in the project's developments. It has made, and will continue to make a conscious effort to engage with these stakeholder groups early in the process where possible. For example, representatives of the Task Force have met with staff of the UK's Audit Inspection Unit of the Financial Reporting Council.</p> <p><i>See paragraph 59-62 of Agenda Item 8-A of the September 2009 IAASB Meeting.</i></p>

Action Requested

20. The CAG is asked to review and comment on the key issues highlighted in this paper, as well as on other matters discussed in the Issues Paper to be considered by the IAASB at its September 2009 meeting, or any other matters which may be of relevance to the project.

Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

Agenda Item 8-A of the September 2009 IAASB Meeting – Using the Work of Internal Auditors – Issues and IAASB Task Force Proposals

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4938>