

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item I.2

Committee: IAASB Consultative Advisory Group

Meeting Location: London

Meeting Date: September 14-15, 2010

Using the Work of Internal Auditors—ISA 610—Report Back

Objectives of Agenda Item

1. The objective of this Agenda Item is to provide a brief report back on proposals of the Representatives on this project as discussed at the March 2010 CAG Meeting.

Papers to Be Referred to during Discussion

2. The discussion on this topic will follow the structure of this CAG Paper.
3. The hyperlink presented at the end of this CAG Paper to the exposure draft of the proposed revised ISA 315¹ and ISA 610² is for reference only.

Project Status and Timeline

4. The IAASB approved an exposure draft of the proposed revised ISA 315 and ISA 610 at its June 2010 meeting.
5. The Appendix to this paper provides a project history, including links to the relevant CAG documentation.

March 1-2, 2010 CAG Discussion

6. Below is an extract from the draft minutes of the March 2010 CAG meeting,³ and an indication of how the IAASB or the Task Force responded to the Representatives' comments.

Representatives' Comments	Task Force/IAASB Response
<i>Inquiry of the Internal Audit Function</i>	
Ms. Bastolla noted the IIA supports the work	Point accepted.

¹ ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Identifying Environment*

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

³ The minutes will be approved at the September 2010 IAASB CAG meeting.

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that has been done to date and believes that the revised ISA more accurately reflects modern practices of internal auditors. She supported the new requirement for the auditor to make inquiries of the internal audit function and noted the Working Group was of the view that the emphasis in the guidance should be focused on reading <i>relevant</i> reports. Mr. Roussey supported this and noted that, in responding to inquiries from the external auditor, management of the internal audit function would likely suggest which reports may be relevant to the external auditor, especially those that deal with risks and uncertainties. Mr. Morris supported Mr. Roussey's point as it will assist the external auditor in limiting his review to reports on those activities of internal audit that are relevant to financial reporting.	<p>Proposed revised ISA 315 was clarified to state that if, based on responses to the auditor's inquiries, it appears that there are findings that may be <i>relevant</i> to the entity's financial reporting and the audit, the auditor may find it useful to read related internal audit reports.</p> <p>In addition, a requirement was added in proposed revised ISA 610 to require the external auditor to read the reports of the internal audit function relating to the work of the function that the external auditor plans to use.</p> <p><i>See paragraph 18 of proposed revised ISA 610 and paragraph A6b of proposed revised ISA 315 in the Exposure Draft.</i></p>
Mr. Morris suggested the wording of the requirement could be revised to not use the phrase "if present," when what is intended is that the requirement applies if the entity has an internal audit function. Mr. Diomeda noted that some SMEs may not believe the requirement is applicable if what constitutes an internal audit function is not well defined or may find the requirement onerous. Ms. Hillier noted that, after having considered the results of the inquiries, the external auditor may conclude that the work of the internal audit function is not relevant and would not be required to do anything further.	<p>Point accepted.</p> <p>In proposed revised ISA 315 and ISA 610, the words "if the [internal audit] function exists" are now used.</p> <p><i>See paragraph 6 of proposed revised ISA 315 and paragraph 2 of proposed revised ISA 610 in the Exposure Draft.</i></p>
Ms. Bastolla believed that the ISA should also steer the external auditor to consider what actions have been taken by management to respond to matters noted in internal auditors' reports.	<p>Point accepted.</p> <p>Proposed revised ISA 315 states the auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified weaknesses in internal</p>

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	control relevant to the audit. <i>See paragraph A71a of proposed revised ISA 315 in the Exposure Draft.</i>
Mr. Krantz asked Ms. Hillier to confirm that the internal auditor cannot replace the external auditor in any circumstance.	During the meeting, Ms. Hillier explained that the revised ISA notes circumstances where the external auditor can use the work of the internal auditor with appropriate support, validation and justification but the external auditor retains full responsibility for the audit.
Mr. Hallqvist noted his view that best practice is for an independent audit function to directly report to the audit committee. In such cases, it is helpful for the external audit partner to participate in each audit committee meeting in order to be fully aware of the work of the internal auditor and vice versa.	Point taken into account. Proposed revised ISA 315 recognizes that a well-established internal audit function is characterized by features including direct reporting to those charged with governance. <i>See paragraph A103 of proposed revised ISA 315 in the Exposure Draft.</i>
<i>Using the Work of Internal Auditors</i>	
Ms. de Beer and Mr. Morris supported the changes that had been made to the ISA in this respect.	Support noted.
Ms. de Beer was of the view that more could be done to bring in the linkage between the auditor's risk assessment and the auditor's consideration of whether to use the work of the internal audit function, suggesting that the external auditor may conclude it is inappropriate to use internal audit in areas of significant risk.	Point accepted. Proposed revised ISA 610 recognizes that for a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level (in particular for significant risks), the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor is less likely to be able to make substantial use of the work of the internal audit function. The ISA further states the external auditor will likely need to perform more of the work

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	<p>directly where the assessed risk of material misstatement is greater and therefore more persuasive audit evidence is required in accordance with ISA 200⁴.</p> <p><i>See paragraphs A12-A13 of proposed revised ISA 610 in the Exposure Draft.</i></p>
<p>Mr. Morris suggested the concept of whether the work of internal audit is relevant to the external audit should make reference to financial reporting. He also believed that the ISA should address knowledge of accounting as one of the factors in assessing the competency in internal audit, given the fact that many internal audit functions deal with more operational issues.</p>	<p>Point accepted.</p> <p>Linkage to financial reporting is added as appropriate, where reference is made to the concept of whether the work of the internal audit function is relevant to the external audit.</p> <p><i>See paragraphs A6b, A102 and A103 of proposed revised ISA 315, and paragraphs 2 and 7 of proposed revised ISA 610 in the Exposure Draft.</i></p> <p>Proposed revised ISA 610 also recognizes that the level of competence of the internal audit function is, among other factors, determined by the internal auditor's possession of the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework.</p> <p><i>See paragraph A6 of proposed revised ISA 610 in the Exposure Draft.</i></p>
<p>Mr. Uchino noted that, in Japan, the internal audit function is considered to be part of the internal control over financial reporting. He suggested the ISAs could clarify the external auditor's evaluation of the degree of the internal auditor's objectivity, but acknowledged this is difficult for external auditors to do. Mr. Pickeur did not support requiring the auditor to judge the degree of</p>	<p>Point taken into account.</p> <p>Proposed revised ISA 610 provides guidance on factors that may affect the external auditor's determination of the degree of objectivity of the internal audit function.</p> <p>The ISA also prohibits the external auditor from using the work of the internal audit function where either its degree of objectivity</p>

⁴ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

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objectivity of the internal auditor, provided that the external auditor was able to conclude the internal auditor was sufficiently objective and competent.	or level of competence is low. <i>See paragraphs 14 and A6 of proposed revised ISA 610 in the Exposure Draft.</i>
Mr. Koster questioned the extent to which external auditors are used to provide the internal audit function for entities. Mr. Robberecht suggested this may impair the independence of the external auditor.	During the meeting, Ms. Hillier suggested this would need to be considered in the context of the <i>Code of Ethics for Professional Accountants</i> developed by the IESBA (the IESBA Code).
Mr. Koster also suggested that there would be implications for the audit when an external auditor cannot put confidence in an internal audit function in an entity of sufficient size.	Point accepted in part. Proposed revised ISA 315 recognizes that the understanding obtained by the external auditor of the role the internal audit function plays in the entity's monitoring of internal control over financial reporting, may provide information that is relevant to the auditor's identification and assessment of the risks of material misstatement. This is true regardless of the size of the entity. <i>See paragraph A102b of proposed revised ISA 315 in the Exposure Draft.</i>
Mr. Roussey was of the view that the ISA was requiring the external auditor to assess the effectiveness in determining whether or not to use its work.	Proposed ISA 610 provides a strengthened framework for the external auditor's <i>ex ante</i> evaluation of whether and, if so, to what extent to use of the work of internal auditors in obtaining audit evidence. The framework should guard against the use of the work of an internal audit function for efficiency reasons when it is not warranted in the circumstances (for example, when the objectivity or competence of the internal audit function is low). <i>See paragraphs 2 and 3 of proposed revised ISA 610 in the Exposure Draft.</i>
Mr. Baumann expressed a concern that the ISA does not explicitly require the external auditor	Point accepted This matter was raised for discussion with the

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<p>to re-perform work of the internal auditor in each instance of use, for example if the external auditor intended to rely on the work of internal auditor to support the existence of accounts receivable and the valuation of financial instruments. Ms. Hillier noted the external auditor's judgment of when to re-perform procedures would likely focus on the areas in which the internal auditor would have used more judgment and, in her view, the revised ISA would suggest that for an area like valuation of financial instruments it is likely that the auditor would not solely rely on the work of the internal audit function and would need to perform additional work. Mr. Baumann asked whether the decision to re-perform would change if the internal audit function had tested the existence of accounts receivable and the existence of inventory. Ms. Hillier explained that the external auditor's procedures are aimed at satisfying himself as to the adequacy of the work of the internal audit function as a whole, rather than re-performance on each piece of work the external auditor intends to use. Mr. Baumann suggested this is likely a difference between the ISAs and the PCAOB standards, as PCAOB standards require re-performance on each section of work for significant assertions. Ms. Hillier expressed the view that the ISA currently focuses on the judgment required to be exercised by the internal auditor rather than the risk. In her view, it is not appropriate to prohibit the external auditor from using work of internal auditor that may involve less judgment in an area that has been identified as a significant risk. Mr. Damant suggested that, if this is a difference in ISAs and PCAOB standards, this matter should be brought to the attention to the IAASB.</p>	<p>IAASB at its June 2010 meeting. The IAASB accepted that the previous draft did not have sufficient guidance to ensure appropriate judgments would be made in determining the procedures necessary to provide a sufficient basis to support the use of the work of the internal audit function. Proposed revised ISA 610 now establishes the principle that the external auditor needs to perform audit procedures that are appropriate in the circumstances on the work to determine its adequacy for purpose of the audit engagement. The application material describes the types of procedures that may be performed, one of which is reperformance.</p> <p>The IAASB concluded that it is not necessary for the external auditor to do some reperformance in each area of work of the internal audit function that is being used. However, as reperformance of some of such work provides a stronger form of evidence regarding the adequacy of the work of the internal audit function for purposes of the audit, the application material states that, in most circumstances, some reperformance of such work will be appropriate. The ISA also now indicates that the external auditor would more likely focus reperformance in those areas where more judgment is exercised by internal audit (which as noted above, would include areas of significant risk).</p> <p>Although presented differently than in the PCAOB standards, the IAASB concluded the application of them would be similar.</p> <p><i>See paragraph A20 of proposed revised ISA 610 in the Exposure Draft.</i></p>

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Mr. Robberecht suggested that the use of the phrase “the more appropriate it would be for the external auditor to use the work of the internal audit function and in more areas” in paragraph A4a of the revised ISA may be seen as a requirement to use the work of the internal audit function.	<p>Point accepted.</p> <p>These wordings have been replaced by “the more likely the external auditor may make use of the work of the internal audit function and in more areas.”</p> <p><i>See paragraph A7 of proposed revised ISA 610 in the Exposure Draft.</i></p>
Ms. Sucher suggested that audit quality may be affected by overreliance on internal audit. In her view, one driver often cited for external auditors to use the work of the internal audit function is to offer savings on audit fees, and that there is competition between the audit firms to do so.	<p>During the meeting, Ms. Hillier noted the ISA does not cite cost savings as a reason to rely on the work of internal auditor and believed that the sliding scale concept illustrates how much work the external auditor needs to do to support its use of the internal audit function. For that reason, Ms. Hillier explained that the ISA does not require the external auditor to communicate to those charged with governance why (or why not) they are using the work of the internal audit function.</p>
<i>Direct Assistance</i>	
Mr. Roussey suggested the indication that “work performed by internal auditors is presumed to provide less reliable evidence” in paragraph 4 of the revised ISA should be reconsidered in light of the fact that direct assistance is addressed in the ISAs, as he would question why the external auditor would use an internal auditor for direct assistance if this was the case. Ms. Hillier noted this phrase was used to indicate that the lack of independence would affect the reliability of the internal auditor’s work. Mr. Roussey suggested doing so at the beginning of the ISA was confusing but it was made clear later in the document. Mr. Pickeur supported this view.	<p>Point accepted.</p> <p>The indication in proposed revised ISA 610 that “work performed by internal auditors is presumed to provide less reliable evidence” has been replaced by “internal auditors are not independent of the entity.” This better communicates the intent of the ISA.</p> <p><i>See paragraphs 6 and 24 of proposed revised ISA 610 in the Exposure Draft.</i></p>
Ms. Bastolla supported the ISA addressing	Support noted.

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direct assistance; while the IIA does not believe this is the best use of internal auditors, in her view the ISA adequately addresses the circumstance without overemphasizing it.	
Mr. Johnson expressed his personal view that he did not support the use of internal auditors to provide direct assistance and questioned why the IAASB had agreed to address the matter in the ISA.	During the meeting, Ms. Hillier explained that the use of internal auditors to provide direct assistance is common in many countries without negative effects on audit quality being noted. In her view, if the concept of direct assistance is not supported, she would question how the work of internal auditors could be used at all. Mr. Baumann supported Ms. Hillier's view.
<p>Ms. Munro noted the IESBA is currently considering the issue of direct assistance. In her view, using internal auditors to provide direct assistance is similar to the considerations when an auditor uses an external expert – this individual is subject to increased supervision and review but is not considered to be a part of the engagement team. Mr. Baumann supported this view. Mr. Johnson did not support this analogy, as he was of the view that direct assistance places the internal auditor as an integral part of the team as a day-to-day resource.</p> <p>Mr. Gutterman also noted that large insurance companies in the US include actuaries as experts in their in-house internal audit functions.</p>	<p>Points taken into account.</p> <p>In developing the proposals, the Task Force has considered the similarities and differences between ISA 610, and ISA 600, <i>Special Consideration—Audits of Group Financial Statements (Including the Work of Component Auditors)</i> and ISA 620, <i>Using the Work of an Auditor's Expert</i>.</p>
Ms. Sucher suggested that the impact analysis should explicitly address direct assistance, in particular as regards the perception of independence when direct assistance is used.	<p>Point accepted.</p> <p>The Explanatory Memorandum to the Exposure Draft acknowledges the concerns of some stakeholders about threats to the independence of the external audit team (in fact or perceived) when internal auditors provide direct assistance on the audit. It outlines the</p>

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	<p>IAASB's view in this regard and safeguards proposed to reduce actual threats to an acceptable level.</p> <p><i>See Explanatory Memorandum to the Exposure Draft.</i></p>

Material Presented – FOR IAASB CAG REFERENCE PURPOSES ONLY

Exposure draft of proposed revised ISA 315 and ISA 610

<http://www.ifac.org/Guidance/EXD-Download.php?EDFID=00339>

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Appendix

Project History

Project: Proposed Revised ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Identifying Environment* and ISA 610, *Using the Work of Internal Auditors*

Summary

	CAG Meeting	IAASB Meeting
Project Commencement	March 2009	March 2009
Development of Proposed International Pronouncement (up to Exposure)	September 2009 March 2010	September 2009 March 2010 June 2010
Exposure	July 2010	July 2010

CAG Discussions: Detailed References

Project Commencement	<p><u>March 2009</u></p> <p>See IAASB CAG meeting material:</p> <p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0170&ViewCat=1062</p> <p>See CAG meeting minutes (in Agenda Item D.1 of the following material):</p> <p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0171&ViewCat=1102</p> <p>See report back on September 2009 CAG meeting:</p> <p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0171&ViewCat=1147</p>
Development of Proposed International Pronouncement (Up to Exposure)	<p><u>September 2009</u></p> <p>See IAASB CAG meeting material:</p> <p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0171&ViewCat=1147</p> <p>See CAG meeting minutes (in Agenda Item M of the following material):</p> <p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0211&ViewCat=1239</p> <p>See report back on September 2009 CAG meeting (in paragraph 15 of the following material):</p>

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	<p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0211&ViewCat=1242</p> <p><u>March 2010</u></p> <p>See IAASB CAG meeting material:</p> <p>http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0211&ViewCat=1242</p> <p>See CAG meeting minutes (in Agenda Item C of the following material):</p> <p>See draft September 2010 CAG meeting minutes at Agenda Item B.</p> <p>See report back on March 2010 CAG meeting in paragraph 5 of this CAG paper.</p>
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