

*Proposed International Standards on Auditing*

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ISA 315 (Revised), Identifying and  
Assessing the Risks of Material  
Misstatement through Understanding  
the Entity and Its Environment

ISA 610 (Revised), Using the Work of  
Internal Auditors



## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB) approved this exposure draft for publication in July 2010. This proposed exposure draft may be modified in light of comments received before being issued in final form.

Respondents are asked to submit their comments **electronically** through the IAASB website ([www.iaasb.org](http://www.iaasb.org)), using the “Submit a Comment” link on the Exposure Drafts and Consultation Papers page. Please note that first-time users must register to use this new feature. All comments will be considered a matter of public record and will ultimately be posted on the IAASB website.

Comments can also be faxed to the attention of the IAASB Technical Director at +1 (212) 856-9420, or mailed to:

Technical Director  
International Auditing and Assurance Standards Board  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017 USA

Comments should be submitted by **November 15, 2010**.

Copies of this exposure draft may be downloaded free of charge from the IAASB website at [www.iaasb.org](http://www.iaasb.org).

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance.

The objective of the IAASB is to serve the public interest by setting high-quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

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# EXPLANATORY MEMORANDUM

*(Including analysis of impacts of the IAASB's proposals)*

This memorandum provides background to, and explanations for, the proposed revisions to International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, and ISA 610, *Using the Work of Internal Auditors*. An analysis of the impacts anticipated by the IAASB to arise as a result of its proposed revisions is also presented.

## 1. Nature and Magnitude of the Issues and the Need for Action

Extant ISA 610 was last revised in March 1994.<sup>1</sup> As part of the IAASB's Clarity project, ISA 610 was redrafted for conformity with the Clarity drafting conventions. The IAASB issued redrafted ISA 610 in October 2008.

Since extant ISA 610 was first developed, there have been developments in the internal audit environment and audit practices at the national level that are not currently addressed in the extant ISA. For example, in many entities there have been changes in the organizational status of the internal audit function, the activities performed by internal auditors, and the manner of interaction between internal auditors and external auditors. During the clarity redrafting of extant ISA 610, a number of respondents referred to these developments and indicated to the IAASB the need to revise the ISA to better reflect the current internal auditing environment. This view was also shared by National Auditing Standard Setters (NSS)<sup>2</sup> and the IAASB Consultative Advisory Group (CAG).<sup>3</sup>

In its initial consideration of these developments, the IAASB became aware of perceptions that the ISAs do not currently reflect how the knowledge and findings of the internal audit function should be leveraged by the external auditor to further audit effectiveness. The IAASB is also cognizant that there are perceptions of undue reliance by external auditors on the work of internal auditors and, therefore, that the framework for the external auditor's judgments regarding when, where, and how to use work of the internal auditor should be strengthened.

## 2. Objective of the IAASB in Addressing the Issues

The IAASB's objective in revising ISA 315 and ISA 610 is to enhance the performance of external auditors by, (a) enabling them to better consider and leverage, as appropriate, the knowledge and findings of an entity's internal audit function in making risk assessments in the external audit, and (b) strengthening the framework for the evaluation and, where appropriate, use of the work of internal auditors in obtaining audit evidence. The IAASB believes that the proposed revision will enhance the quality of audits internationally.

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<sup>1</sup> Conforming amendments were made to the standard when the IAASB issued the audit risk standards (ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Identifying Environment*, and ISA 330, *The Auditor's Responses to Assessed Risks*, and ISA 500, *Audit Evidence*) in October 2003.

<sup>2</sup> Views were obtained at the March 2008 IAASB-NSS meeting.

<sup>3</sup> A listing of the member organizations of the IAASB CAG can be accessed at: <http://www.ifac.org/IAASB/CAG.php>.

### 3. Primary Options that Were Considered in Achieving the Objective

The IAASB is of the view that its objective is best achieved through a comprehensive revision of extant ISA 610 in order to ensure its continued relevance, usefulness, and rigor.

#### Key Issues Addressed in Achieving the Objective and Primary Options Considered

##### *Direct Assistance*

In some jurisdictions, internal auditors provide direct assistance to the external auditor through performance of audit procedures on the audit engagement under the direction, supervision, and review of the external auditor. Extant ISA 610 states explicitly that it does not deal with such instances.<sup>4</sup> There is ambiguity about whether the fact that ISA 610 does not deal with direct assistance meant that the IAASB does not support its use, or whether it was simply not addressed in the scope of the ISA. However, national auditing standards of a number of jurisdictions allow for direct assistance, and it is common practice in many; while in others, it is not allowed. The IAASB concluded that continued ambiguity about its intent is not in the public's interest.

The IAASB 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 under the direction, supervision and review of the external auditor. The IAASB is of the view that safeguards can be put in place, through adequate direction, supervision, and review, to ensure that direct assistance is employed only in appropriate areas, and that the external auditor can address possible risks to audit quality arising from the fact that internal audit staff are not independent of the entity as is required of the external auditor in an audit of financial statements.<sup>5</sup> Therefore, the IAASB proposes to establish requirements and guidance in revised ISA 610 to ensure direct assistance is obtained only in appropriate circumstances and clearly set out the external auditor's responsibilities in such cases including the required involvement of the external auditor.

The IAASB is cognizant that there are jurisdictions where obtaining direct assistance from internal auditors by external auditors are explicitly prohibited by local law or regulation. The proposed ISA acknowledges this fact.<sup>6</sup> It also explains that prohibitions or restrictions regarding the use of the work of internal auditors will not prevent the external auditor from complying with the ISA because the proposed requirements do not require or encourage the external auditor to obtain, or to consider obtaining, direct assistance of internal audit staff.<sup>7</sup>

The decisions of whether and if so, to what extent to obtain direct assistance are presented as remaining solely those of the external auditor.<sup>8</sup> The IAASB believes that this is important to avoid undue pressures being placed on the external auditor by the entity to use internal auditors for cost or other reasons, which could be detrimental to audit quality. Accordingly, the proposed revised ISA

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<sup>4</sup> ISA 610, paragraph 2

<sup>5</sup> Proposed ISA 610 (Revised), paragraphs 22-24 and A27-A28

<sup>6</sup> Proposed ISA 610 (Revised), paragraph 20

<sup>7</sup> Proposed ISA 610 (Revised), paragraph 8

<sup>8</sup> Proposed ISA 610 (Revised), paragraph A23

610 do not require the external auditor to defend to those charged with governance, or to seek their prior approval, regarding the decision on whether or not to use direct assistance. Nevertheless, in accordance with ISA 260,<sup>9</sup> the external auditor would communicate with those charged with governance the planned scope and timing of the audit, including the extent to which the auditor will use the work of the internal audit function, and any proposal for internal auditors to provide direct assistance to the external auditor on the audit engagement.

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

The IAASB proposes enhancements to the requirements in ISA 610 to establish a strengthened judgment-based framework for the external auditor in deciding whether and if so, to what extent to use the work of the internal audit function.

#### Determining Whether the Work of the Internal Audit Function Can Be Used

The IAASB proposes that the external auditor's initial assessment of whether the work of the internal audit function can be used for purposes of the audit should be based on an evaluation of the internal audit function's degree of objectivity (as supported by its organizational status, and relevant policies and procedures), level of competence and application of a systematic and disciplined approach, including quality control.<sup>10</sup> The related requirements and guidance on factors to consider in making this evaluation have been updated to reflect developments in internal audit practice.

The IAASB believes recognition of the fact that the internal audit function applies a systematic and disciplined approach is important. It is this characteristic that differentiates the work of the internal audit function from other internal controls and thereby provides support for the premise underlying the proposed revision to ISA 610. Specifically, the external auditor's objective is to obtain sufficient evidence about the internal audit function as a whole, rather than 'test' each individual piece of work performed by the function as is required by ISA 330<sup>11</sup> in relation to other controls.

In addition, the IAASB believes that it is appropriate to establish clearer boundaries for the circumstances when the use of any of the work of the internal audit function by the external auditor would not be appropriate. Specifically, where either the degree of objectivity or level of 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.<sup>12</sup>

Accordingly, the IAASB believes that, together, these proposed requirements 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; and

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<sup>9</sup> ISA 260, *Communication with Those Charged with Governance*, paragraph 15

<sup>10</sup> Proposed ISA 610 (Revised), paragraphs 13 and A4-A9

<sup>11</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>12</sup> Proposed ISA 610 (Revised), paragraphs 14 and A7

- (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.

#### Determining the Planned Use of the Work of the Internal Audit Function

The IAASB proposes that the external auditor should take into account the external auditor's evaluation of the internal audit function's degree of objectivity and level of competence, and the nature and scope of the work performed, for determining the relevance of such work to the audit engagement. The IAASB also proposes in determining the planned use of the work of the internal audit function, the external auditor should be required to take into account the amount of professional judgment that would be involved in planning and performing audit procedures, and in evaluating the audit evidence obtained by the internal audit function.

The IAASB acknowledges that some might expect the external auditor's decisions regarding the use of the work of the internal audit function to be related to the assessed risk of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures. The IAASB agrees that there is a relationship between the amount of judgment involved and the level of risk. The higher the risk of material misstatement, the greater the amount of judgment that would ordinarily be involved in planning and performing procedures, and evaluating the results of audit procedures.<sup>13</sup> However, the IAASB is of the view that, even in relation to significant risks, there may be some audit work involving less judgment that can contribute to the audit evidence obtained. For that reason, the IAASB believes the focus on judgment in the requirement is appropriate. Nevertheless, the IAASB acknowledges that the higher the assessed risk, particularly in relation to significant risks,<sup>14</sup> the less likely the external auditor will be able to make substantial use of the work of the internal audit function and the more likely the external auditor will need to perform more of the work directly.

As a further safeguard, the IAASB also proposes to clarify that because the external auditor has sole responsibility for the audit opinion, the external auditor needs to make all significant judgments in the audit engagement and perform sufficient procedures directly to be able to draw reasonable conclusions on which to base the external auditor's audit opinions.<sup>15</sup>

#### *Inquiry of the Internal Audit Function*

Inquiries made by the external auditor of the internal audit function (to comply with the requirements of ISA 315 and ISA 610) may help meet the external auditor's obligation under ISA 240 to inquire with the function regarding fraud in the entity.<sup>16</sup> Extant ISA 315 and ISA 610 do not contain a requirement for the auditor to make inquiries of the internal audit function. To address this, the IAASB proposes a requirement in ISA 315 for the external auditor to make

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<sup>13</sup> Proposed ISA 610 (Revised), paragraph A12

<sup>14</sup> Proposed ISA 610 (Revised), paragraphs A12-A13

<sup>15</sup> Proposed ISA 610 (Revised), paragraphs 16 and A13

<sup>16</sup> See ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 19 and A18. Paragraph 19 states that the objective of the inquiries is to determine whether the internal audit function has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

inquiries of the internal audit function about information of which they are aware that is relevant to identifying and assessing the risks of material misstatement due to fraud or error.<sup>17</sup> This should enable the external auditor to more fully leverage the internal auditor's understanding of the entity and its environment.

The IAASB believes this is appropriate because it provides a practicable basis for the external auditor to learn from and use the internal auditor's knowledge of the organization and expertise in risk and control. This should not only achieve greater efficiency and effectiveness on the audit engagement, but should also improve audit quality by seeking out relevant information that might not otherwise come to the auditor's attention.

The IAASB also considered, but did not support, a requirement for the external auditor to read all reports of the internal audit function. Such a requirement would impose an onerous amount of audit effort which, given the possible nature and extent of reports issued by the internal audit function, would likely outweigh the corresponding benefits.

The IAASB concluded, however, that it is appropriate for the external auditor to read the reports of the internal audit function relating to work that the external auditor is planning to use. This would assist the external auditor in obtaining a complete understanding of the nature and extent of audit procedures performed and the related findings.<sup>18</sup> Further, the IAASB has introduced guidance explaining the possible usefulness of reading related reports if based on responses to the external auditor's inquiries (conducted under the proposed revised ISA 315), it appears that there are findings that may be relevant to the entity's financial reporting and the audit.<sup>19</sup>

#### Linkage between ISA 315 and ISA 610

The IAASB proposes amendments to clarify the linkage between ISA 315 and ISA 610. The amendments (in proposed revised ISA 315) make clear that information obtained from the auditor's inquiries of the internal audit function, and the understanding obtained of the role the 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. Such information is relevant in all audits and, therefore, the IAASB concluded that the requirements to make those inquiries and obtain that understanding are appropriately placed in ISA 315. This is distinct from the external auditor's decision to use the work of internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed, which is addressed in the proposed revised ISA 610.

## **4. Analysis of the Overall Impact of the Proposed ISA 315 (Revised) and Proposed ISA 610 (Revised), and of the Impacts of the Preferred Options (Impacts are Presented in Tabular Format in the Appendix)**

### **External Auditors**

#### *Audit Effectiveness*

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<sup>17</sup> Proposed ISA 315 (Revised), paragraphs 6(a) and A6-A6d

<sup>18</sup> Proposed ISA 610 (Revised), paragraphs 18 and A16

<sup>19</sup> Proposed ISA 315 (Revised), paragraph A6b



The IAASB is of the view, overall, that its proposals are likely to increase the effectiveness of audit engagements where an internal audit function exists.

A positive impact on audit effectiveness is anticipated to result from the strengthening of the framework for determining the external auditor's appropriate use of the work of the internal audit function. The external auditor will be required to focus on the internal audit function's level of objectivity, degree of competence, and application of a systematic and disciplined approach when determining whether to use work of the internal audit function. The external auditor will also be required to consider the amount of judgment involved in performing such work when determining the planned use of the work of the internal audit function.

The IAASB also proposes further strengthening of the framework in ISA 610 by establishing clear boundaries in the form of minimum requirements of the degree of objectivity and level of competence of the internal audit function, and the need for the external auditor to make all significant judgments and to perform sufficient work directly. These boundaries are intended to guard against inappropriate use of the work of the internal audit function under the circumstances of the engagement.

The IAASB also anticipates a positive impact on audit effectiveness will result from the proposed requirement for the external auditor to make inquiries of the internal audit function. Such inquiries will enable the external auditor to leverage 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. Further, by encouraging effective communication between internal auditors and external auditors, the revised ISA supports an environment in which internal auditors can bring significant matters that may affect the work of the external auditor to the external auditor's attention.

#### *Work Effort*

The IAASB is of the view that the overall effect of proposed revisions on the external auditor's work effort will in part be dependent on whether and to what extent external auditors are currently using the work of internal audit function or obtaining direct assistance from internal auditors.

When direct assistance of internal auditors is obtained, a reduction in the external auditor's work effort is expected for the audit procedures that would otherwise be performed by the external auditors. In addition, the larger the internal audit function and the more well-established it is, the greater the potential reduction in work effort of the external auditor. However, in formulating the requirements and guidance relating to direct assistance and the use of the work of the internal audit function, the IAASB has been careful to ensure that revised ISA 610 adequately guards against undue use of internal auditors on audit engagements and the consequent possible risks to audit quality.

The IAASB anticipates a small increase in the external auditor's work effort to ensure that the proposed strengthened framework is properly and adequately applied to determine whether and if so, to what extent to use of the work of the internal audit function on the audit engagement. A further marginal increase in the external auditor's work effort is anticipated as a result of making

inquiries with the internal audit function as part of the external auditor's risk assessment procedures. The aggregate work effort will be greater if the external auditor determines it is appropriate to use the work of the internal audit function and consequently is required by the revised ISA to examine the internal audit function's reports relating to such work.

The IAASB acknowledges that small- and medium-sized entities (SMEs) typically do not have a separate internal audit function.

#### *Other Impacts*

The IAASB believes that a positive impact on audit effectiveness may be had simply through the clarification of whether the practice of direct assistance is allowed under the ISAs. The IAASB is cognizant of the likelihood that threats to the independence of the external auditor (in fact or perceived) may be created due to the fact that internal auditors are not independent of the entity as is required of the external auditor. The IAASB believes, however, that the safeguards it proposes against undue use of the assistance of internal auditors on audit engagements should reduce actual threats to an acceptable level.

#### **Internal Audit Functions/Internal Auditors**

##### *Work Effort*

The IAASB recognizes that the overall effect of proposed revisions on the work effort of the internal audit functions/internal auditors may depend on whether and if so, to what extent direct assistance of internal auditors is obtained by the external auditor on an engagement.

The IAASB also anticipates a small increase in the work effort of internal audit functions resulting from the proposed requirement for the external auditor to make inquiries with appropriate individuals in the function. Where the external auditor determines it is appropriate to use the work of the internal audit function and consequently is required to read the corresponding reports of the internal audit function, the IAASB envisages that the assistance of the internal audit function will also be called upon to enable the external auditor to access and understand these reports.

#### **Audit Oversight Bodies**

When finalized, the new proposals would form part of the ISAs. The IAASB anticipates that audit oversight bodies may, depending on the circumstances, incorporate the final requirements in their inspection programs. The IAASB believes that the clarifications regarding the obligations of the external auditor when using the work of internal auditors, including that which relate to direct assistance, will be helpful when audit oversight bodies focus on this area in their inspection programs.

## **5. Consultation to Date**

Throughout the course of development of the proposals to revise ISA 315 and ISA 610, consultations were undertaken with the IAASB CAG Representatives to obtain views on the key aspects of the proposals. Among other matters, the IAASB CAG provides technical advice on

IAASB projects. More than thirty key stakeholder organizations participate in the bi-annual meetings of the IAASB CAG.

Through key IAASB consultative channels, preliminary inputs were also sought from the regulatory community and networks of audit firms.

Representatives from the internal auditing community, the International Ethics Standards Board for Accountants (IESBA), and the International Organization of Supreme Audit Institutions (INTOSAI) participated directly in the development of the proposed revisions to ISA 315 and ISA 610.

As part of due process, the IAASB will consider whether further consultation after this exposure would be appropriate to obtain necessary input before finalization of the revised ISAs.

## 6. Project Timetable

The following timetable identifies the major milestones for the project and the expected timeline for achieving those milestones:

Exposure Draft Comment Deadline	November 15, 2010
IAASB's Consideration of Comments on Exposure Draft <sup>20</sup>	March 2011 and June 2011
Approval of Final Revised Standard	June 2011
Release of Final Revised Standard <sup>21</sup>	September 2011
Provisional Effective Date	Effective for audits of financial statements for periods ending on or after December 15, 2013

## 7. Guide for Respondents

### General

The IAASB welcomes comments on all matters addressed in the Exposure Draft. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

<sup>20</sup> Dates shown indicate the relevant meetings at which the IAASB intends to consider respondents' comments on the Exposure Draft.

<sup>21</sup> Approval by the Public Interest Oversight Board of due process is required to be obtained before the final revised ISA may be released.

## Request for Specific Comments

The IAASB would welcome views on the following:

1. Do respondents believe it is appropriate to require the external auditor to make inquiries of appropriate individuals within the internal audit function? If so, do respondents agree such a requirement is appropriately placed in ISA 315?
2. Do respondents believe that appropriate factors have been proposed to be evaluated by the external auditor in determining:
  - (a) Whether the work of the internal audit function can be used for purposes of the audit engagement; and
  - (b) The planned use of the work of the internal audit function?
3. Do respondents believe it is appropriate to require the external auditor to read reports produced by the internal audit function relating to the work of the internal audit function that is planned to be used by the external auditor?
4. Do respondents believe that it is desirable for the scope of ISA 610 to be expanded to address the matter of direct assistance? If so, do respondents believe that when obtaining the direct assistance of internal auditors the external auditor should be required to:
  - (a) Consider the factors that have been proposed in determining the work that may be assigned to individual internal auditors; and
  - (b) Direct, supervise, and review the audit procedures performed by the internal auditors in a way that recognizes they are not independent of the entity?

The IAASB is also interested in comments on the following matters:

5. Public Interest Concerns—Respondents are asked to address whether there are any public interest concerns that have not been addressed.
6. Special Considerations in the Audit of Smaller Entities—Respondents are asked to comment whether, in their opinion, guidance addressing special considerations in the audit of smaller entities should be provided in the proposed revised ISAs. If so, respondents are asked to explain why and to suggest the nature of any such considerations.
7. Special Considerations in the Audit of Public Sector Entities—Respondents are asked to comment whether, in their opinion, special considerations in the audit of public sector entities have been dealt with appropriately in the proposed revised ISAs.
8. Developing Nations—Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised ISAs in a developing nation environment.
9. Translations—Recognizing that many respondents intend to translate the final revised ISAs for adoption in their own environments, the IAASB welcomes comment on potential translation issues noted in reviewing the proposed revised ISAs.

10. **Effective Date**—Respondents are asked to comment whether, in their opinion, the provisional effective date is appropriate for supporting effective adoption and implementation of the proposed revised ISAs at the national level.

### **Request for Comments on Analysis of Impacts**

The IAASB is piloting the use of impact analyses. The impact analysis contained in this Explanatory Memorandum shows the IAASB's consideration of the potential impacts of both the overall proposed revised ISA 315 and ISA 610 and the preferred option for each key issue addressed during the development of the proposed revised standards.

Narrative descriptions of this analysis are included in this Explanatory Memorandum and presented in tabular format in the Appendix. The impact analysis in the Appendix identifies who will be affected by the proposed revised standards and preferred options, how, and to what extent they will be affected. It is important to note that the impact analysis is intended to communicate the impact of the incremental difference between extant and proposed revised ISA 315 and ISA 610, not between current and future practice.

The IAASB would appreciate comments on the following matters:

11. Is the analysis of impact presented in Section 4 of this Explanatory Memorandum helpful to respondents in understanding the anticipated impacts of the IAASB's proposals?
12. Do respondents agree with the impact analysis as presented? Are there any other stakeholders, or other impacts on stakeholders, that should be considered and addressed by the IAASB?
13. Are there any changes to the narrative or tabular presentation of the impact analysis that would be helpful to respondents?
14. Would respondents find such an approach useful at the national level?

**Analysis of Impacts of the Revision of ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ISA 610, *Using the Work of Internal Auditors***

Audit Effectiveness	Direction and Magnitude of Impact (Note 1)	Variability by Size/Nature of Entity Subject to Audit (Note 2)	Duration of Impact (Note 3)
<p>Overall increase in audit effectiveness anticipated because of the following:</p> <ul style="list-style-type: none"> <li>The external auditor will be provided with a strengthened framework, focused on the attributes of a well-functioning internal audit function (objectivity, competence and application of a systematic and disciplined approach), for determining whether and if so, to what extent the work of the internal audit function can be used for purposes of the audit, and further, the amount of judgment involved in performing such work when determining its planned use. Clear boundaries are also established to guard against inappropriate use of work of the internal audit function in the circumstances of the audit;</li> <li>The external auditor will be required (under ISA 315) to make inquiries of the internal audit function to leverage the function’s knowledge of the entity and its expertise in risk and control. This will further inform the external auditor’s understanding of the entity and its environment which forms the basis for the external auditor’s risk assessments. Further, the revised ISA 315</li> </ul>	<p>Increase.</p> <p>The magnitude of impact is dependent on whether and if so, the extent to which the external auditor uses the work of the internal audit function.</p>	<p>All audits where an internal audit function exists. Small- and medium-sized entities (SMEs) typically do not have a separate internal audit function in which case there will be no impact.</p>	<p>Recurring</p>

<p><b>Audit Effectiveness</b></p>	<p><b>Direction and Magnitude of Impact</b> (Note 1)</p>	<p><b>Variability by Size/Nature of Entity Subject to Audit</b> (Note 2)</p>	<p><b>Duration of Impact</b> (Note 3)</p>
<p>encourages effective communication between internal auditors and external auditors, which supports an environment in which internal auditors can bring significant matters that may affect the work of the external auditor to the external auditor’s attention; and</p> <ul style="list-style-type: none"> <li>The external auditor will be required to read relevant reports of the internal audit function relating to the function’s work that the external auditor planned to use on the audit engagement. This would assist the external auditor in obtaining an understanding of the nature and extent of audit procedures performed and the related findings of the internal audit function.</li> </ul>			
<p><b>External Auditors</b> (Note 4)</p> <p>Overall decrease in work effort because of the following:</p> <ul style="list-style-type: none"> <li>The external auditor may obtain the direct assistance of internal auditors on the audit engagement to perform procedures that would otherwise be performed by the external auditors. To prevent inappropriate use of assistance from internal auditors on audit engagements, emphasis is placed on the nature and extent of direction, supervision and review that is required to be exercised by the external auditor over the internal audit staff.</li> </ul> <p>However, the decrease in work effort is off-set</p>	<p>Decrease.</p> <p>The magnitude of impact is dependent on whether and if so, the extent to which the external auditor uses the work of internal auditors.</p>	<p>All audits where an internal audit function exists but particularly those where the internal audit functions are bigger in size and are well-established. SMEs typically do not have a separate internal audit function in which case there will be no impact.</p>	<p>Recurring</p>

<p><b>Audit Effectiveness</b></p>	<p><b>Direction and Magnitude of Impact</b> (Note 1)</p>	<p><b>Variability by Size/Nature of Entity Subject to Audit</b> (Note 2)</p>	<p><b>Duration of Impact</b> (Note 3)</p>
<p>marginally by the following:</p> <ul style="list-style-type: none"> <li>• The external auditor may spend greater effort to ensure the strengthened framework is properly and adequately applied in determining whether and if so, to what extent to use of the work of the internal audit function for purposes of the audit;</li> <li>• The external auditor will be required to make inquiries of the internal audit function as part of the external auditor’s risk assessment procedures; and</li> <li>• The external auditor will be required to read the relevant reports of the internal audit function relating to the function’s work that the external auditor plans to use on the audit.</li> </ul>			
<p><b>Internal Audit Functions/ Internal Auditors</b></p> <p>Overall increase in work effort because of the following:</p> <ul style="list-style-type: none"> <li>• The assistance of internal auditors may be obtained by the external auditor to perform procedures on the audit engagement which are otherwise performed by the external auditors themselves;</li> <li>• The internal audit function will be expected to interact with the external auditor and respond to inquiries posed by the external auditor; and</li> <li>• The internal audit function will be expected to assist the external auditor in accessing and understanding the relevant reports relating to the</li> </ul>	<p>Increase.</p> <p>The magnitude of impact is dependent on whether and if so, the extent to which the external auditor uses the work of internal auditors.</p>	<p>All audits where an internal audit function exists. SMEs typically do not have a separate internal audit function in which case there will be no impact.</p>	<p>Recurring</p>



<p><b>Audit Effectiveness</b></p>	<p><b>Direction and Magnitude of Impact</b> (Note 1)</p>	<p><b>Variability by Size/Nature of Entity Subject to Audit</b> (Note 2)</p>	<p><b>Duration of Impact</b> (Note 3)</p>
<p>work of the internal audit function that the external auditor plans to use.</p>			
<p><b>External Auditors: Clarifying Ambiguity Regarding Direct Assistance</b>  Clarification of whether the practice of direct assistance is allowed under the ISAs.</p>	<p>The magnitude of impact is dependent on whether and if so, the extent to which the external auditor uses the work of the internal auditors.</p>	<p>All audits where an internal audit function exists and the direct assistance of internal auditors are employed on the engagement. SMEs typically do not have a separate internal audit function in which case there will be no impact.</p>	<p>One-off</p>
<p><b>External Auditors: Independence (In Fact and Perceived)</b>  Threats to the independence of the external auditor may be created (in fact and perceived) when direct assistance of internal auditors are obtained for purposes of the audit because internal auditors are not independent of the entity as is required of the external auditor.</p>	<p>Safeguards to reduce actual threats to an acceptable level are required to be established to guard against undue use of the assistance of internal auditors by external auditors.</p>	<p>All audits where an internal audit function exists and the direct assistance of internal auditors are employed on the audit engagement. SMEs typically do not have a separate internal audit function in which case there will be no impact.</p>	<p>Recurring</p>
<p><b>Audit Oversight Bodies: Inspection Process</b>  When finalized, the new proposals would form part of the ISAs. Audit oversight bodies may, depending on the circumstances, incorporate the final requirements in their inspection programs. Clarifications regarding the obligations of the external auditor when using the work of internal auditors, including that which relate to direct assistance, could result in gains in efficiency.</p>	<p>The direction and magnitude of impact is dependent on whether and if so, the extent to which the new requirements are incorporated into audit inspection programs and the extent of divergence in national practices.</p>	<p>All audits where an internal audit function exists and which are subject to inspection oversight.</p>	<p>Recurring</p>

EXPLANATORY MEMORANDUM

- Note 1: The extent (magnitude) of the impact on audit effectiveness may be measured in qualitative terms, using a simple 7-point directional scale (The scale takes account of the direction (increase or decrease) and relative magnitude of the impact (small, moderate or large) [*Large increase, Moderate increase, Small increase, None, Small decrease, Moderate decrease, Large decrease*]). Impacts on different entities are to be described separately. For example, a large increase for large public companies and a small increase for small nonpublic companies should be described as such. They should not be combined and presented as an overall moderate impact for all companies. In the case of the proposed revisions to ISA 315 and ISA 610, the IAASB has determined that because the magnitude of each impact listed is dependent on a number of factors as described, determination of an overall magnitude for each impact would not be meaningful.
- Note 2: Indicate whether audit effectiveness, work effort, or other impact is affected for all entities or is limited to specific industries, particular types of entities, or entities in particular jurisdictions. In particular, the difference between the impact on small and large firms should be considered.
- Note 3: For auditors, the duration of the impact is measured at the engagement level. It is normally assumed that most impacts will be recurring, with the exception of the one-off impact of implementing the change. For example, a system may have a large on-off impact when it is modified to meet a new requirement.
- Note 4: The references to Auditors are assumed to include Supreme Audit Institutions.

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 315 (REVISED)**  
**IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT**  
**THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

(Effective for audits of financial statements for periods ending on or after December 15, 2013)

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International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* should be read in conjunction with ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

[No amendments are proposed to paragraphs 1-4.]

## **Requirements**

### **Risk Assessment Procedures and Related Activities**

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A5)
6. The risk assessment procedures shall include the following:
  - (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6-A6d)
  - (b) Analytical procedures. (Ref: Para. A7-A10)
  - (c) Observation and inspection. (Ref: Para. A11)

[Paragraph 5 is included for information only. No amendments are proposed to paragraphs 7-21.]

### **Monitoring of controls**

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)
23. If the entity has an internal audit function, the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, how the function fits in the entity's organizational structure, and the activities performed, or to be performed. (Ref: Para. A101-A103b)
24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A104)

[Paragraphs 22 and 24 are included for information only. No amendments are proposed to paragraphs 25-32.]

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## **Application and Other Explanatory Material**

[No amendments are proposed to paragraphs A1-A5.]

*Inquiries of Management, the Internal Audit Function and Others within the Entity* (Ref: Para. 6(a))

- A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity. As obtaining an understanding of the entity and its environment is a continuous, dynamic process, the auditor's inquiries may occur throughout the audit engagement.
- A6a. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. For example, in performing their work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on their work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's risk assessments or other aspects of the audit.
- A6b. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may find it useful to read related internal audit reports.
- A6c. Appropriate individuals within the function with whom inquiries are made are those who have the appropriate knowledge, experience and authority, such as the chief internal audit executive.
- A6d. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:
- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ISA 260<sup>22</sup> identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
  - Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
  - Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
  - Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

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<sup>22</sup> ISA 260, paragraph 4(b)

[When the revisions are included in the ISA, paragraphs A6a-A6d will become paragraphs A7-A10 and the ISA will be renumbered accordingly. No amendments are proposed to paragraphs A7-A70.]

#### Audit Evidence for Elements of the Control Environment

A71. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

A71a. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified weaknesses in internal control relevant to the audit.

[Paragraph A71 is included for information only. When the revisions are included in the ISA, paragraph A71a will become paragraph A76 and the ISA will be renumbered accordingly. No amendments are proposed to paragraphs A72-A100.]

#### Internal Audit Functions (Ref: Para. 23)

A101. Internal auditing refers to assurance and consulting activities designed to evaluate and improve the effectiveness of an entity's risk management, internal control, and governance processes.

A102. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organization, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, evaluating and performing procedures to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. However, the responsibilities of the internal audit function may be limited to the economy, efficiency and effectiveness of operations, for example, and may not relate to the entity's financial reporting.

A102a. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6 of this ISA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

A102b. The information obtained from the auditor's inquiries in paragraph 6, and the understanding obtained 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.

- A103. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting the auditor may also be able 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. Auditors are more likely to be able to use the work of an entity's internal audit function when it appears, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has a well-established internal audit function (for example, one that is adequately and appropriately resourced, and has a direct reporting relationship to those charged with governance). If the auditor expects 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 610 applies.
- A103a. As is further discussed in ISA 610, the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information. Other monitoring controls are often entity-level controls that are designed to contribute to how the entity prevents or detects misstatements.
- A103b. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of any significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

[When the revisions are included in the ISA, paragraphs A101-A103b will become paragraphs A107-A113 and the ISA will be renumbered accordingly. No amendments are proposed to paragraphs A104-A134.]

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 610 (REVISED)**  
**USING THE WORK OF INTERNAL AUDITORS**

(Effective for audits of financial statements for periods ending on or after December 15, 2013)

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<p>International Standard on Auditing (ISA) 610 (Revised), <i>Using the Work of Internal Auditors</i> should be read in conjunction with ISA 200, <i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</i>.</p>
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## **Introduction**

### **Scope of this ISA**

1. This International Standard on Auditing (ISA) deals with the external auditor's responsibilities relating to using the work of internal auditors.
2. ISA 315 addresses the understanding the external auditor obtains of an entity's internal audit function (if the function exists) and inquiries the external auditor makes of internal auditors to obtain information relevant to the external auditor's risk assessment. This ISA addresses the use of the work of the internal audit function when the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed. This ISA does not apply if an internal audit function does not exist or the function's responsibilities and activities are not related to the entity's financial reporting. In addition, the external auditor need not apply this ISA if the external 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.
3. This ISA also addresses the external auditor's responsibilities when using internal auditors to provide direct assistance under the direction and supervision of the external auditor. The requirements relating to direct assistance do not apply if the external auditor does not plan to obtain the direct assistance of internal auditors. (Ref: Para. A1)

### **Relationship between the Internal Auditors and the External Auditor**

4. This ISA deals with how the external auditor determines whether to use the work of the internal audit function, and if so, to what extent and the external auditor's evaluation of the adequacy of the work of the internal audit function for purposes of the audit. It also deals with relevant considerations, including the types of procedures needed, when contemplating whether to use internal auditors to provide direct assistance.
5. The objectives of the internal audit function are determined by management and, where applicable, those charged with governance and may include assurance and consulting activities within an entity designed to evaluate and improve the effectiveness of the entity's risk management, internal control, and governance processes. An entity's internal audit function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal controls relevant to the external audit. (Ref: Para. A2-A3)
6. External auditors may be able to use such work rather than perform that work themselves in obtaining sufficient appropriate audit evidence on which to base the auditor's opinion. Internal auditors may also provide direct assistance on the engagement by performing audit procedures under the direction and supervision of the external auditor. However, neither the internal audit function nor the internal auditors are independent of the entity as

is required of the external auditor in an audit of financial statements in accordance with ISA 200.<sup>23</sup>

7. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function. For this reason, even if some of the internal audit function's activities appear relevant to the external audit relate to the entity's financial reporting, the external auditor may decide not to use the work of the internal audit function.
8. In some jurisdictions, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function, from obtaining direct assistance from internal auditors, or from communicating with the internal audit function to the extent contemplated in this ISA. The ISAs do not override laws or regulations that govern an audit of financial statements.<sup>24</sup> However, such prohibitions or restrictions will not prevent the external auditor from complying with the ISAs as this ISA does not require the external auditor to use the work of the internal audit function or to obtain direct assistance from internal auditors.
9. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are determinants of whether or not the external auditor can use the work of the internal audit function. Rather, it is the nature of the activities, and the objectivity and competence of the function that are relevant.
10. There may be individuals within an entity that perform ad hoc procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered control activities and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with ISA 330.

### **Effective Date**

11. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2013.

### **Objectives**

12. The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects 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, are:

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<sup>23</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 14

<sup>24</sup> ISA 200, paragraph A55

- (a) To determine whether to use the work of the internal audit function, and if so, to what extent; and
- (b) If using the work of the internal audit function or obtaining direct assistance from internal auditors, to determine whether that work is adequate for purposes of the audit.

## Requirements

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

#### *Determining Whether the Work of the Internal Audit Function Can Be Used for Purposes of the Audit*

13. The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:
  - (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: Para. A4-A7)
  - (b) The level of competence of the internal audit function; and (Ref: Para. A4-A7)
  - (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A8-A9)
14. The external auditor shall not use the work of the internal audit function if it has:
  - (a) a low degree of objectivity, regardless of its level of competence; or
  - (b) a low level of competence, regardless of its degree of objectivity. (Ref: Para. A7)

#### *Determining the Planned Use of the Work of the Internal Audit Function*

15. In determining the planned use of the work of the internal audit function, the external auditor shall consider:
  - (a) The external auditor's evaluation of the degree of objectivity and level of competence of the internal audit function;
  - (b) The nature and scope of work performed, or to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan; and
  - (c) The amount of judgment involved in:
    - (i) Planning and performing relevant audit procedures for particular classes of transactions, account balances and disclosures; and
    - (ii) Evaluating the audit evidence gathered by the internal audit function in support of the relevant assertions. (Ref: Para. A10-A12)
16. Because the external auditor has sole responsibility for the audit opinion expressed, the external auditor shall:

- (a) Make the significant judgments in the audit engagement; and
  - (b) Plan to directly perform sufficient procedures to be able to draw reasonable conclusions on which to base the external auditor's opinion,
- regardless of the external auditor's decision to use the work of the internal audit function.  
(Ref: Para. A13)
17. If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of their work with the internal audit function as a basis for coordinating the respective activities. (Ref: Para. A14-A15)

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

18. Where the external auditor plans to use the work of the internal audit function, the external auditor shall read the reports of the function relating to such work. (Ref: Para. A16)
19. In order to have a sufficient basis to support the use of work of the internal audit function, the external auditor shall perform audit procedures that are appropriate in the circumstances on that work to determine its adequacy for purposes of the audit engagement. In determining the adequacy of such work, the external auditor shall evaluate whether:
- (a) The work was properly planned, performed, supervised, reviewed and documented;
  - (b) Adequate audit evidence has been obtained to enable the internal audit function to draw reasonable conclusions; and
  - (c) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal audit function are consistent with the results of the work performed.  
(Ref: Para. A17-A21)

### **Obtaining Direct Assistance from Internal Auditors** (Ref: Para. A22-A28)

20. The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. However, if the external auditor is permitted, and plans, to use internal auditors to provide direct assistance on the audit engagement, the external auditor shall evaluate the degree of objectivity and level of competence of the internal auditors who will be providing such assistance.
21. The external auditor shall not obtain the direct assistance of an internal auditor if the internal auditor has:
- (a) a low degree of objectivity, regardless of the internal auditor's level of competence;  
or
  - (b) a low level of competence, regardless of internal auditor's degree of objectivity.
22. In determining the work that may be assigned to individual internal auditors and the amount of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

- (a) The external auditor’s evaluation of the degree of objectivity and level of competence of the internal auditors who will be providing such assistance;
  - (b) The nature and scope of work to be performed by the internal auditors; and
  - (c) The amount of judgment involved in:
    - (i) Planning and performing relevant audit procedures for particular classes of transactions, account balances and disclosures; and
    - (ii) Evaluating the audit evidence in support of the relevant assertions. (Ref: Para. A11-A13)
23. The external auditor shall not obtain direct assistance from internal auditors:
- (a) Whereby the internal auditors make significant judgments in the audit engagement; or
  - (b) To perform procedures to determine whether the work of the internal audit function can be used for purposes of the audit or to provide a sufficient basis to support the external auditor’s use of the work of the internal audit function.
24. The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220.<sup>25</sup> The level of direction, supervision and review shall recognize that internal auditors are not independent of the entity.

### **Documentation**

25. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:
- (a) The evaluation of the degree of objectivity and level of competence of the internal audit function, and whether it applies a systematic and disciplined approach, including quality control;
  - (b) The nature and extent of the work used and the basis for that decision; and
  - (c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used.
26. The working papers prepared by the internal auditors who provided direct assistance on the audit engagement shall be included in the audit documentation.

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## **Application and Other Explanatory Material**

### **Scope of this ISA** (Ref: Para. 3)

- A1. Carrying out procedures in accordance with this ISA may cause the external auditor to re-evaluate the external auditor’s assessment of the risks of material misstatement.

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<sup>25</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

Consequently, this may affect the external auditor's determination of the relevance of the internal audit function to the audit and whether further application of this ISA is necessary. Similarly, the external auditor may decide not to otherwise use the work of the internal audit function to affect the nature, timing or extent of the external auditor's procedures, or to receive direct assistance from internal auditors. In those circumstances, the external auditor's further application of this ISA is not necessary.

**Relationship between the Internal Auditors and the External Auditor** (Ref: Para. 5)

- A2. As set out in ISA 315,<sup>26</sup> internal auditing refers to assurance and consulting activities within an entity designed to evaluate and improve the effectiveness of the entity's risk management, internal control, and governance processes.
- A3. The objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:

Activities relating to risk management

- The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control.

Activities relating to internal control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the operating effectiveness of the entity's internal control.
- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.
- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Activities relating to governance

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization

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<sup>26</sup> ISA 315, paragraph A101

and effectiveness of communication among those charged with governance, external and internal auditors, and management.

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

### *Determining Whether the Work of the Internal Audit Function Can Be Used for Purposes of the Audit*

#### Objectivity and Competence (Ref: Para. 13(a)-(b), 14)

- A4. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function may be used in the circumstances.
- A5. The degree of objectivity and level of competence of the internal audit function are particularly important in determining the nature and extent of the use of the work of the internal audit function that is appropriate in the circumstances. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Competence refers to the attainment and maintenance of knowledge and skills at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.
- A6. Factors that may affect the external auditor’s determination include the following:

#### Objectivity

- The organizational status of the internal audit function within the entity and the effect such status has on the ability of the internal audit function to be free from bias, conflict of interest or undue influence of others to override professional judgments.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal audit function has direct access to those charged with governance.
- Whether the internal audit function is free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance for example, in communicating internal audit findings to the external auditor.

#### Competence

- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors including possession of the required knowledge relating to the entity’s financial reporting and the applicable financial reporting framework.

Relevant criteria which may be considered by the external auditor in making the assessment may include for example, the internal auditors' possession of a relevant professional designation.

- Whether the internal auditors are members of relevant professional bodies and are obligated to comply with the relevant professional standards and continuing professional development requirements.
- A7. Objectivity and competence may be viewed as a continuum. The higher the degree of objectivity and level of competence, the more likely the external auditor may make use of the work of the internal audit function and in more areas. However, a high degree of objectivity cannot compensate for a low level of competence, and equally, a high level of competence cannot compensate for a lack of objectivity.

*Application of a Systematic and Disciplined Approach (Ref: Para. 13(c))*

- A8. The application of a systematic and disciplined approach is an important characteristic that distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.
- A9. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities include the following:
- The existence and adequacy of internal audit manuals or other similar documents, work programs, and documentation and reports prepared by the internal audit function.
  - Whether the internal audit function has appropriate quality control policies and procedures.

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

*Factors Affecting the Determination of the Planned Use of the Work of the Internal Audit Function (Ref: Para. 15-16)*

- A10. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, the determination of the nature and extent of the work of the internal audit function that the external auditor may decide to use in the circumstances will be influenced by the external auditor's evaluation of the degree of objectivity and level of competence of the internal audit function, as well as whether the work of the internal audit function is relevant to the overall audit strategy and audit plan and the amount of judgment needed in planning, performing and evaluating such work.
- A11. The greater the amount of judgment that is needed to be exercised in planning and performing the audit procedures and evaluating the results thereof, the more likely that the external auditor may need to perform some procedures directly because consideration of the work of the internal audit function alone is unlikely to provide the external auditor with sufficient appropriate audit evidence.



- A12. 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, it is less likely that the external auditor can make substantial use of the work of the internal audit function in obtaining sufficient appropriate audit evidence.
- A13. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 16. Significant judgments include assessments of the risks of material misstatements, sufficiency of tests performed, appropriateness of management's use of the going-concern assumption, evaluation of significant accounting estimates, adequacy of disclosures in the financial statements, and other matters affecting the auditor's report. Furthermore, as explained in ISA 200,<sup>27</sup> the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the more likely it will be that the external auditor will need to perform more of the work directly.

Discussion and Coordination with the Internal Audit Function (Ref: Para. 17)

- A14. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:
- The timing of such work;
  - The extent of audit coverage;
  - Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality;
  - Proposed methods of item selection;
  - Documentation of the work performed; and
  - Review and reporting procedures.
- A15. Coordination between the external auditor and the internal audit function is effective when:
- Discussions take place at appropriate intervals throughout the period;
  - The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal audit function when such matters may affect the work of the external auditor so that the external auditor may consider the implications of such matters for the audit engagement; and
  - The external auditor informs the internal audit function of any significant matters that may affect the internal audit function.

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<sup>27</sup> ISA 200, paragraph A29

## Using the Work of the Internal Audit Function

### *Reading Reports of the Internal Audit Function* (Ref: Para. 18)

A16. Reading reports of the internal audit function relating to the work of the function that the external auditor intends to use assists the external auditor in obtaining an understanding of the nature and extent of audit procedures performed and the related findings.

### *Procedures to Determine the Adequacy of Work of the Internal Audit Function* (Ref: Para. 19)

A17. Examples of work of the internal audit function that may be used by the external auditor include the following:

- Testing of the operating effectiveness of controls
- Substantive procedures (for example, checking reconciliations)
- Observations of inventory counts
- Tracing transactions through the information system relevant to financial reporting
- Audits or reviews of the financial information, of subsidiaries that are not significant components to the group

A18. The procedures the external auditor may perform to appraise the quality of the work performed and the conclusions reached by the internal audit function include the following:

- Reviewing the internal audit function's work program and working papers
- Reperforming some of the work of the internal audit function
- Observing the procedures performed by the internal audit function

A19. The nature, timing and extent of the audit procedures that the external auditor performs on the work of the internal audit function in order to have a sufficient basis for the use of that work will depend on the external auditor's evaluation of the degree of objectivity and level of competence of the internal audit function, and the amount of judgment exercised by the function in planning and performing relevant audit procedures for particular classes of transactions, account balances and disclosures. The lower the degree of objectivity or level of competence, or the more judgment involved, the more audit procedures are needed to be performed by the external auditor to support the decision to use the work of the internal audit function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

A20. Reperformance involves the external auditor's independent execution of procedures that were originally performed by the internal audit function. It involves examining items already examined by the internal audit function, or other similar items. While 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, 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. Accordingly, in most circumstances, some reperformance of such work will be appropriate. Moreover, the external auditor is more likely to focus reperformance in those

areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures.

- A21. In determining the adequacy of the work performed by the internal audit function, the external auditor may consider whether any exceptions or unusual matters disclosed by the function such as misstatements or control deficiencies are properly addressed by the entity and in the event they are not, whether the internal audit function followed-up on these matters.

**Obtaining Direct Assistance from Internal Auditors** (Ref: Para. 20-24)

- A22. It may be possible in some circumstances for the external auditor to obtain direct assistance from the internal auditors in carrying out audit procedures. In such circumstances, external auditors use internal auditors, under the direction, supervision and review of the external audit team, to perform audit procedures directly on the engagement which otherwise would be performed by the external auditors themselves.
- A23. As described in paragraph 16, the external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's decision to obtain the direct assistance of internal auditors on the audit engagement.
- A24. In accordance with ISA 260,<sup>28</sup> the external auditor communicates with those charged with governance an overview of the planned scope and timing of the audit. In doing so, the external auditor may discuss matters such as the extent to which the work of internal auditors will be used on the audit engagement, including the planned use of direct assistance.
- A25. In accordance with paragraph 21, the external auditor evaluates the degree of objectivity and level of competence of the internal auditors who are providing direct assistance before assigning them to specific tasks.
- A26. Paragraphs A11-A13 provide relevant guidance in determining the work that may be assigned to internal auditors.
- A27. As individuals in the internal audit function are not independent of the entity as is required of the external auditor when expressing an opinion on financial statements, the direction, supervision or review of the audit procedures performed by the internal auditors will ordinarily be more extensive than if members of the engagement team perform the work.
- A28. The extent of direction, supervision or review of the audit procedures performed by the internal auditors is also dependent on the external auditor's evaluation of the degree of objectivity and level of competence of, and the nature and extent of audit procedures to be performed by, the internal auditors. Reviewing the work performed by internal auditors includes consideration of whether the evidence obtained is sufficient and appropriate in the circumstances, and that it supports the conclusions reached.

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<sup>28</sup> ISA 260, *Communication with Those Charged with Governance*, paragraph 15