

# ISA 610 ED – Using the Work of Internal Auditors

## Comment Letter from European Audit Regulators

### 1. Introduction

The objective of this letter is to summarize the comments of a number of independent European audit regulators and/or oversight bodies (“the audit regulators”) in relation to the exposure draft on ISA 610 (Revised), Using the Work of Internal Auditors. The content of this letter has been discussed and agreed between audit regulators who have met for this purpose, representing the following countries;

- Bulgaria – Commission for public oversight of statutory auditors (CPOSA)
- Estonia – Auditors Activities Oversight Council
- Finland – The Auditing Board of the Central Chamber of Commerce of Finland (AB3C)
- Greece – Hellenic Accounting and Auditing Standards Oversight Board
- Lithuania – The Authority of Audit and Accounting (3A)
- Luxembourg – Commission de Surveillance du Secteur Financier
- Malta – Accountancy Board
- Netherlands – Netherlands Authority for the Financial Markets (AFM)
- Norway – Finanstilsynet (The Financial Supervisory Authority)
- Portugal – Conselho Nacional de Supervisão de Auditoria
- Slovakia – Úrad pre dohľad nad výkonom auditu (UDVA)
- Slovenia – Agencija Republike Slovenije za javni nadzor nad revidiranjem (Agency for Public Oversight of Auditing)
- Spain – Instituto de Contabilidad y Auditoria de Cuentas (ICAC)
- Sweden – Swedish Supervisory Board of Public Accountants

We believe that we are in a good position to comment on the subject of internal audit as we have reviewed a number of audits where a high degree of reliance has been placed on the internal audit function and, in a number of cases, have raised issues regarding the approach taken in practice. We are concerned that the result of the proposed changes to ISA 610 could potentially lead to a significant reduction in the independent testing performed by the external auditors and could also impair their independence.

We consider ISA 610 to be an important standard as it typically applies to large Public Interest Entities, and we anticipate you taking our comments into account before ISA 610 is issued in final form. This is important in order to ensure a level playing field for auditors across jurisdictions, to ensure the credibility of the ISAs, and thus to ensure that the ISA 610 will be widely adopted.

### 2. Proposed revisions to the ISA 610 ED

We agree with the IAASB’s notion that “*recognition of the fact that the internal audit function applies a systematic and disciplined approach is important, and that this characteristic differentiates the work of the internal audit function from other internal controls.*” Whilst the exposure draft implies otherwise (para 10), we believe it should only relate to work performed by internal auditors, and that other types of testing, e.g. management testing of internal controls, although subject to a systematic and disciplined approach, cannot be considered equivalent. Finally, while we recognize that the internal audit function is an assurance function, it remains a part of the audit client’s internal control system.

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The main question is how the internal audit function affects the role of the independent auditor. We believe that the current exposure draft does not provide a clear distinction between the role of the internal audit function and the external audit team. While there needs to be a certain level of co-ordination between the external audit team and the internal audit function, an approach of co-operation where audit procedures are divided between the two is inappropriate, and blurs the distinctive roles of the external and internal auditors. Whilst the exposure draft (para 16) states that the external auditor has the sole responsibility for the audit opinion expressed, it does not clearly describe what is required to fulfill the sole responsibility under this ISA.

The current exposure draft permits the work of internal auditors to reduce detection risk, e.g. through the performance of substantive testing and by not requiring any reperformance testing of the work performed by internal auditors. However, it is clear from the Glossary of Terms that it is only the work of the external auditor that can reduce detection risk. On the other hand, we believe that an effective internal audit function contributes to a reduced control risk. In this case, the external auditor can accept a higher detection risk, and reduce the amount of substantive testing.

Finally, unlike other relevant standards, the revised ISA 610 includes no reference to the Code of Ethics. The Code of Ethics requires the audit team to be independent from the audit client. This is a requirement internal auditors cannot fulfill, which is why we consider it necessary to include such a reference to clearly distinguish between the role and independence requirements that apply to the external auditor versus the role and objectivity requirements that apply to internal auditors.

Consequently, we believe that the revised ISA 610 should:

- (1) include a description of how it conforms with the audit risk model as defined in the Glossary of Terms, and how it conforms with the independence requirements set forth in the Code of Ethics
- (2) set out clear requirements for how the external auditor's assessment of risks of material misstatement shall determine the extent to which the external auditor can use the work of internal auditors, i.e. that the higher the risks of material misstatement, the less reliance the external auditor can place on work performed by internal auditors
- (3) set out clear requirements in relation to the need for a minimum level of direct testing by the external auditors for each material area of the financial statements
- (4) set out clear requirements in relation to how the external auditor shall determine the adequacy of the work performed by internal audit, for each area where reliance is to be placed, including a specific requirement for the external auditor to re-perform a proportion of the work
- (5) define the limited extent to which direct assistance can be obtained by the external auditors considering that direct assistance is incompatible with the Code of Ethics and that independence regulation in many jurisdictions prohibits direct assistance.

The ISA should thus ensure that the external auditor has sufficient first hand understanding of the audit client, that he/she directly obtains sufficient appropriate audit evidence related to high-risk areas, and have sufficient appropriate audit evidence of the effectiveness of the internal audit work upon which the external auditor places reliance.

A further description of our considerations related to the exposure draft can be found in appendix A to this letter. Further, the results of a survey among 20 European audit regulators of local independence regulation and their views on the Code of Ethics are summarized in appendix B.

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## Appendix A

### Further considerations related to the exposure draft

#### 1. The Premise Underlying the Proposed Revision to ISA 610

In the Explanatory Memorandum (EM), the IAASB states that during the process of revising the ISA 610, the IAASB has been aware of perceptions both that there is a need to further “audit effectiveness” and that there is a need to avoid “*undue reliance*”. We agree with the notion that the revision of ISA 610 should enhance both audit effectiveness and audit quality.

We also agree with the IAASB’s notion that “*recognition of the fact that the internal audit function applies a systematic and disciplined approach is important, and that this characteristic differentiates the work of the internal audit function from other internal controls.*”

In the EM 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*”. Nevertheless, while “*the IAASB agrees that there is a relationship between the amount of judgment involved and the level of risk (...) 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.*”

We consider this to be an unnecessary and complicating departure from the fundamental Audit Risk model. The different parts of the ISA 610 ED (ED), which have prompted our comments below, are all related to the IAASB’s focus on judgment rather than risk. As stated in the EM in relation to the use of direct assistance, 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.*” We believe that the ED will result in undue pressures being placed on the external auditor both in relation to the use of internal auditors to perform direct assistance as well as in relation to the use of the work of internal auditors in general. Consequently, we believe that while the ED may enhance audit efficiency, it may not enhance audit quality.

#### 2. Using the Work of Internal Auditors

The ED does not require the assessed risk of material misstatement to be taken into account in determining whether and to what extent the work of the internal audit function may be used in a particular area. Instead, it provides that it is the amount of judgment involved in performing the audit procedures that is to be considered. The EM states that “*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.*” Nevertheless, we believe it is imperative to maintain a risk based approach throughout the audit, where the external auditor consistently designs and performs audit procedures based on his assessment of the risks of material misstatement for all areas. This is also necessary in order for the external auditor to effectively fulfill the sole responsibility for the audit opinion.

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## 3. Testing the Work of Internal Auditors

In the EM the IAASB states that *“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 in relation to other controls.”* This position is reflected in A 20 where it is stated that *“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.”* It seems unnecessary to point out that reperformance testing provides a stronger form of evidence, when, at the same time, the ED does not consider it necessary because evidence about the internal audit function as a whole is considered to be sufficient. We do not believe that it is appropriate for the auditor to place reliance on work performed by internal auditors, without performing tests directed at this work. As such, we are of the opinion that a requirement for testing the work of internal audit, including through reperformance, should be included in the ED.

## 4. Auditor, Risk of Material Misstatement and Detection Risk

The IAASB Glossary of Terms defines Audit Risk as: *“The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.”* The three terms “auditor”, “risks of material misstatement”, and “detection risk” are essential. As noted above, the IAASB does not consider 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. This raises the fundamental question whether the work of internal auditors may reduce detection risk.

The ED does not require the auditor to test the work of internal auditors upon which the auditor places reliance. Thus, the ED encourages an audit approach where the work of internal auditors may reduce detection risk, as it permits the auditor to adopt audit evidence obtained by internal auditors without testing it. Internal auditors are effectively considered equivalent to the auditor. This is evident when considering the definition of detection risk: *“The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.”*

Considering internal auditors *“members of the engagement team”* represents a violation of the Code of Ethics, which requires members of the engagement team to be independent of the client. This situation is also probably not envisioned in the definition of auditor: *““Auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm.”* We believe that permitting the work of internal auditors to reduce detection risk both violates fundamental independence provisions and thus inevitably increases the risk of undue reliance.

As noted above, we agree that the systematic and disciplined approach of the internal audit function differentiates the work of the internal audit function from other internal controls. Nevertheless, the internal audit function remains a part of the audit client’s internal control system. Consequently, a well functioning internal audit function may reduce control risk, and thus the risk of material misstatement. However, as the internal audit function is an integral part of the audit client, it can only reduce the risk of material misstatement (control risk), but not reduce detection risk.

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## 5. Substantive Procedures

A17 gives substantive testing as an example of procedures that could be relied on. However, there is no specific reference for the need of the auditor to perform some work on all material balances (e.g. confirmations on cash balances). We believe that there is a risk that, for material but routine non judgmental balances (e.g. cash, stock, debtors, and creditors), the standard could be interpreted as allowing all or most of the work to be performed by internal audit alone. This is another area where the ED permits the work of internal auditors to reduce detection risk, and thus increases the risk of undue reliance.

## 6. Direct assistance

We do not agree that the ISA should address the use of direct assistance. In order to secure the independence of the auditors, a number of jurisdictions have independence laws or regulations in place with which direct assistance is incompatible. As noted above, the Code of Ethics also requires the audit team to be independent from the audit client.

Further, the ED provides that the external auditors may assign external audit work to individual internal auditors, applying similar considerations to those used in determining what reliance should be placed on the work of the internal audit function. It therefore seems that external audit procedures relating to areas of significant risk could be assigned to internal auditors if they are not deemed to involve making significant judgments. No reperformance of any such work undertaken by internal auditors under the direction and supervision of the external auditors is required. Instead, *“the level of direction, supervision and review shall recognize that internal auditors are not independent of the entity”* (para 24). (Para A27 indicates that the external auditor’s review could include *“walking through”* the procedures performed by the internal auditors if the records examined by the internal auditors are available during the review.) These provisions in the ED blur the distinct differences between the external audit team and the internal audit function. In this light we also refer to ISA 600 where auditors rely on the work of an independent (component) auditor. In such a case a minimum level of procedures are required. We do not see that the ED is consistent with this approach, as it does not include any requirements for (reperformance) testing of work performed by internal auditors who, unlike component auditors, are not independent.

In any case, when addressing direct assistance, the limited extent to which direct assistance can be obtained by the external auditors should be clearly defined, considering that direct assistance is incompatible with the Code of Ethics and that independence regulation in many jurisdictions prohibits direct assistance.

## 7. Changes to ISA 315

We believe that paragraph 23 of ISA 315 should be changed. As compared to the current version, there is no longer a requirement to determine whether or not to use internal audit. We believe, however, that it is an important requirement. Further, as ISA 610 does not apply when the auditor does not expect to use the work of internal auditors (see the end of paragraph 2 of proposed ISA 610), the determination by the auditor of whether internal audit is used, should not be part of ISA 610.

## 8. Conclusion

We believe that the ISA 610 like the other ISAs should incorporate the audit risk model and the independence requirements set forth in the Code of Ethics. Consequently, we do not believe that the work of internal auditors may reduce detection risk.

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## Appendix B

### Summary of a Survey among 20 European regulators

Countries where it has been confirmed that direct assistance is in conflict with statutory independence regulation (the list may not be complete):

- Germany
- Luxembourg
- The Netherlands
- Norway
- Portugal
- Slovenia
- Spain

Audit regulators considering direct assistance to be in conflict with IFAC's Code of Ethics:

- All 20 regulators considered direct assistance to be in conflict with the independence requirements set forth in the Code of Ethics

Audit regulators considering it problematic to use work of internal auditors for high risk areas:

- Substantially all 20 regulators considered it inappropriate to use the work of internal auditors for high risk areas

Audit regulators considering it inappropriate to use of work by internal auditors without testing it:

- All 20 regulators believed it to be inappropriate to use work of internal auditors without testing to some extent the work upon which the auditor places reliance